Transition report 2005

Business in transition

European Bank
for Reconstruction and Development

About this Report

The EBRD seeks to foster the transition to an open market-oriented economy and to promote private and entrepreneurial initiative in central eastern Europe and the Baltic states, south-eastern Europe and the Commonwealth of Independent States. To perform this task effectively, the Bank needs to analyse and understand the process of transition. The purpose of this Report is to advance this understanding and to share our analysis with our partners.

Central eastern Europe and the Baltic states (CEB) ▲

01 Czech Republic
02 Estonia
03 Hungary
04 Latvia
05 Lithuania
06 Poland
07 Slovak Republic
08 Slovenia

▲ European Union member states.

South-eastern Europe (SEE)

SEE-3 ◆
09 Bulgaria
10 Croatia
11 Romania
SEE-4
12 Albania
13 Bosnia and Herzegovina
14 FYR Macedonia
15 Serbia and Montenegro

◆ European Union candidate countries.

Commonwealth of Independent States (CIS)

16 Armenia
17 Azerbaijan
18 Belarus
19 Georgia
20 Kazakhstan
21 Kyrgyz Republic
22 Moldova
23 Russia
24 Tajikistan
25 Turkmenistan
26 Ukraine
27 Uzbekistan

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Contents

Abbreviations

The Bank, EBRD	European Bank for Reconstruction and Development
BEEPS	Business Environment and Enterprise Performance Survey
BIS	Bank for International Settlements
BSI	banking system indicator
BTC	Baku-Tbilisi-Ceyhan
CEB	central eastern Europe and the Baltic states (see map inside front cover)
CIS	Commonwealth of Independent States (see map inside front cover)
CPI	consumer price index
EC	European Commission
EGPRS	Economic Growth and Poverty Reduction Strategy
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ETCs	early transition countries
EU	European Union
FDI	foreign direct investment
FYR	Former Yugoslav Republic
GDP	gross domestic product
GNI	gross national income
IBC	International Business Council
IFRS	International Financial Reporting Standards
ILO	International Labour Organization
IMF	International Monetary Fund
IPO	initial public offering
LIS	Legal Indicator Survey
MPIs	macro-prudential indicators
na	not available
NATO	North Atlantic Treaty Organisation
NGOs	non-governmental organisations
OECD	Organisation for Economic Cooperation and Development
POEs	publicly owned enterprises
PPP	purchasing power parity
PRSP	Poverty Reduction Strategy Papers
PSA	production sharing agreements
SAA	Stabilisation and Association Agreement
SBA	Stand-By Arrangement
SEE	south-eastern Europe (see map inside front cover)
SEE-3	Bulgaria, Croatia, Romania
SEE-4	Albania, Bosnia and Herzegovina, FYR Macedonia, Serbia and Montenegro
SEZ	special economic zone
SMEs	small and medium-sized enterprises
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNECE	United Nations Economic Commission for Europe
USAID	United States Agency for International Development
VAT	value added tax
WTO	World Trade Organization

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Executive summary

- Substantial progress in transition over the past year was achieved by central Europe, where the markets have responded favourably to previous reforms, and by the Commonwealth of Independent States, which benefited from political change in some countries.
- Economic growth across the transition countries has slowed but is still forecast to reach 5.3 per cent in 2005. Sustained expansion of the financial sector is boosting demand but also increasing potential risks.
- The business environment has improved on average but business obstacles are still much more severe than in mature market economies. The most dynamic firms, such as new private companies, are the most severely affected.
- Foreign-owned and new private firms tend to be more efficient than privatised and state-owned enterprises. This difference in performance has remained constant over time.

1

Chapter 1: Progress in transition and economic governance

The transition countries made significant progress in 2004–05. In central eastern Europe and the Baltic states (CEB) this was driven by a favourable market response to recent structural and institutional reforms. In south-eastern Europe (SEE) a pause in reform among the candidate countries for EU accession resulted in slower progress than in previous years. However, Serbia and Montenegro introduced a number of reforms. In the Commonwealth of Independent States (CIS), reform was embraced in much of the Caucasus and the western CIS by new or re-elected leaders who have strengthened their commitment to democracy and markets. Russia advanced in some aspects of reform but undermined the privatisation process with the re-establishment of state ownership and control over sizeable assets in the oil and gas sector.

Much of the progress over the last year was in improving market-supporting institutions. Reforms in governance and enterprise restructuring were also stronger than in previous years. This reflected a positive market response to an improved institutional framework in CEB and a stronger commitment to market discipline and good governance elsewhere in the transition region.

A survey of over 9,500 companies for the 2005 Business Environment and Enterprise Performance Survey (BEEPS) showed steady improvement in economic governance overall but for many countries significant problems remain. CEB countries are well ahead of SEE and the CIS in many areas of economic governance and are slowly moving towards levels attained by other EU countries. The most significant business obstacles in CEB include labour regulations and corrupt practices in assigning government contracts. Most SEE and CIS countries have experienced improvements in economic governance but are still constrained by regulatory barriers and widespread corruption.

2

Chapter 2: The macroeconomic environment for transition

The transition countries have maintained a strong macroeconomic performance, with growth forecast at 5.3 per cent for 2005.

In CEB growth is expected to average 4.2 per cent in 2005. However, the Czech Republic, Hungary and Poland are still struggling to bring their government deficits into line with EU requirements, and several CEB countries continue to run large current account deficits. Growth of 4.8 per cent is expected in SEE in 2005. Most SEE countries have managed to reduce their public sector deficits, and inflation is maintaining a downward trend. Nevertheless, management of the large external imbalances still poses a serious macroeconomic challenge.

The CIS is expected to grow by 6.2 per cent in 2005, supported by continuing high oil prices. However, some countries are starting to suffer from capacity constraints and inadequate levels of domestic investment. At the same time, inflation and fiscal spending are increasing in some of the bigger CIS countries.

Strong domestic demand, which has underpinned growth across the transition region, has been fuelled by a rapid expansion in domestic credit to the private sector, including to households. Credit growth primarily reflects a deepening of financial systems, which is itself a sign of increasing income levels and institutional development. Financial reforms have strengthened confidence in banking systems, intensifying competition. However, the dangers posed by rapid credit growth coupled with weaknesses in individual banks or financial systems as a whole call for effective banking supervision.

3

Chapter 3: The business environment of firms in transition

The BEEPS shows clear differences in the way that business obstacles are perceived by firms across the transition region. This can be explained largely by variations in the business environment between countries. There are also differences, however, in the way that particular types of firms are affected by certain business constraints. The identification of these differences allows policy-makers to focus on the constraints that are particularly limiting the firms with the strongest potential for growth.

According to the survey data, there has been a general improvement in the business environment. Nevertheless, firms in the transition countries lag behind those in mature market economies, such as Germany, Greece and Portugal, according to a benchmark survey. The firms most affected by business constraints are those that are most likely to generate growth and new jobs – private firms, exporting companies, profitable firms that re-invest profits, and micro and small firms.

The costs of business regulation, poor-quality institutions, weak property rights and an unstable macroeconomic environment all emerge from the survey as major obstacles to businesses in transition countries. Access to finance is most difficult for smaller firms and enterprises located outside major cities – a finding that supports the need for financing programmes aimed at these firms. Foreign-owned firms tend to access finance more easily, suggesting that policies encouraging foreign direct investment may boost overall growth.

4

Chapter 4: The performance of firms in transition

The BEEPS results reveal the factors that support the growth and productivity of enterprises in transition countries. The survey shows that the impact of firm ownership on performance is not as clear-cut as widely assumed. As expected, foreign-owned firms have generally had higher levels of efficiency. However, their superior performance stems primarily from their acquisition of better-performing domestic firms and from establishing new private firms. Furthermore, while foreign-owned firms continue to be more efficient than domestic firms, this advantage is not increasing. The performance of domestically owned firms does not vary much between different types of firms as market forces and budget constraints have tended to even out any variations in performance. Firms that started in private ownership have tended to be more efficient than privatised firms.

Competition has had a positive impact on how quickly a firm improves its performance but less so on the overall level of efficiency. Although shortcomings in the business environment have hindered enterprise growth, they have not influenced as strongly as might have been expected a firm's overall level of efficiency or how quickly it changes.

Lobbying, "state capture" and corruption have declined in recent years but firms that bribe tend to have a better level of performance. This implies that firms gain some advantage from corruption (even though it is detrimental to the performance of the economy as a whole) or that government officials – the main beneficiaries of bribery – tend to target better-performing firms.

Foreword

A better business environment brings dividends to the region.

A resilient global economic expansion, sustained progress in reform and a better business environment underpinned another good year for the transition countries. Their pace of expansion in 2004-05 continued to exceed the levels of most other regions of the world. Market reforms advanced further in many countries but growth remains below rates witnessed during previous episodes of rapid expansion, such as the growth of western Europe in the post-war period. The challenge for eastern Europe today is to aim higher, to grow faster and to ensure that the benefits of growth are widely shared.

Eighteen months after joining the European Union, the eight countries of central Europe and the Baltics continue to experience the benefits from EU accession, which was in many respects smoother and more successful than had been forecast. An unexpectedly strong export expansion following accession provided a significant fillip to growth in these countries. Estonia and the Slovak Republic, for example, have gained reputations as dynamic and business-friendly economies, and investors and lenders are responding to improvements in the business environment by increasing their exposure to this region. These capital inflows have also been encouraged by high global liquidity and by low interest rates and risk premiums. However, the macroeconomic tests for accession to Economic and Monetary Union continue to pose challenges for the larger central European countries.

The strong growth performance of recent years in central Europe has gone hand-in-hand with rapidly expanding credit markets. While these credit booms contribute to much-needed financial development, they can also heighten risks in the financial sector and macroeconomic vulnerabilities. So far these risks seem manageable. They should remain so, provided that fiscal deficits are reduced further to make room for private borrowing and that the credit and market risks in this lending are assessed and managed appropriately, as shown in Chapter 2. In fact, similar financial deepening was observed in Greece, Ireland, Portugal and Spain when they were preparing for euro membership. However, full convergence with EU levels is still a long way off in terms of income per capita and financial depth. The same is true for the effectiveness of public administration and the legal framework. The region still has substantial challenges which, if met successfully, would further boost its growth performance.

While the new EU countries reap the rewards of EU membership, south-eastern Europe remains in the waiting room, with uncertain prospects regarding an accession date for some countries. Bulgaria and Romania are still on track to join the European Union in 2007 although this could be delayed by one year if obligations under the accession treaties are not fulfilled. The membership talks with Croatia have only just started, following a prolonged stalemate over cooperation with the International Criminal Tribunal for the former Yugoslavia in The Hague.

The timing of eventual accession for Albania, Bosnia and Herzegovina, FYR Macedonia and Serbia and Montenegro looks more uncertain. The prospects for further enlargement diminished after the Dutch and French rejection of the new EU constitution in their respective referendums but were boosted by the subsequent decision to open membership talks with Croatia and Turkey. Independent of the question of membership, the EU remains committed to the development of the region and its integration into the European economy. However, the countries of the Western Balkans need to move ahead with comprehensive reform agendas to promote investment, private entrepreneurship and trade.

The progress of reform in the Western Balkans in 2004–05 has generally been subdued. However, there has been a marked advance in Serbia and Montenegro, which had a late start to transition and is still lagging behind. The progress in Serbia in particular has surprised many observers, as the ruling coalition does not command a parliamentary majority and has an uncertain future.

Despite the uncertainties, south-eastern Europe saw robust growth and record capital inflows in 2004–05, reflecting an underlying confidence in its future prospects. The larger countries in this region — Bulgaria, Croatia and Romania — have attracted significant levels of foreign direct investment, and Serbia and Montenegro is increasingly doing so. However, the smaller countries remain heavily dependent on official financing inflows and remittances from workers living abroad.

The Commonwealth of Independent States experienced particularly robust growth in 2004–05, at rates approaching those seen in periods of rapid expansion within the global economy. However, this is due to good fortune as much as it is to sustained reforms and a better business environment. The good fortune for the energy-rich CIS countries — Azerbaijan, Kazakhstan and Russia — is the recent surge in oil prices. This has supported strong growth in output and domestic demand in these countries.

Unlike in central Europe, investors in Russia and the other energy-rich countries are not so much attracted by an improving business environment as by the profits to be made from natural resources. Consequently, they are less concerned about Russia's wavering commitment to market reforms and evidence of deterioration in the business environment. Over the past year the Russian government has resumed state control over important assets in the oil sector, and has re-established majority state ownership of Gazprom, the dominant gas producer.

As a result, Russia was the only country this year to attract a downgrade in the transition indicators that the EBRD uses to track progress towards open, market-oriented economies. Russia was downgraded in the area of large-scale privatisation. Nevertheless, Russia's macroeconomic fundamentals remain reasonably sound despite the falling fiscal surplus and rising inflation. Moreover, there have been positive developments in the financial sector, with the implementation of deposit insurance reform, strengthened prudential regulation and improved financial reporting and transparency.

Elsewhere in the CIS, dramatic political changes and changes in policy direction in some countries have added new momentum to reform in the region. New leaders have come to power in Georgia, the Kyrgyz Republic and Ukraine promising to deal with problems of systemic corruption and to reinvigorate reforms.

Some successes are already evident in Georgia and Ukraine in terms of greater openness and improved governance over the past year. Elections in Moldova in early 2005 also resulted in a more reform-minded government and openness towards European integration despite a largely unchanged leadership. In all these countries, especially the Kyrgyz Republic, the consolidation of recent political changes has some way to go. If the confidence of voters is to be maintained, there is a need for a greater focus on reform priorities — such as openness and achieving European standards for governance, competitiveness and living standards — and less attention to political vendettas against ousted elites and political rivals.

This *Transition Report* analyses these recent trends and developments in the transition region. In monitoring and assessing economic developments, the EBRD makes use of a wide range of sources. In particular, the Business Environment and Enterprise Performance Survey — known as the BEEPS — has become crucial to our ability to monitor the performance of firms and changes in the business environment.

In 2005 the EBRD and the World Bank jointly implemented a third round of the survey, covering over 9,500 firms in 26 transition countries and Turkey. Unfortunately, it was again not possible to implement the survey in Turkmenistan. The three BEEPS rounds since 1999 provide a rich source of information on enterprises in the transition region. This Report makes extensive use of these data. The generous funding for the surveys by the Japan-Europe Cooperation Fund and the Early Transition Countries Fund is gratefully acknowledged.

As Chapter 1 reports, between 2002 and 2005 there have been marked improvements in the business environment for the transition region as a whole in areas such as regulation, taxation, the judiciary, crime and corruption. The BEEPS shows that progress is being made in all of the sub-regions although some countries have been less successful in reducing corruption and bureaucracy. Moreover, even in the best-performing transition countries, survey results from non-transition countries suggest that further improvement is necessary to match the EU business environment standards.

Assessments of the average business environment in a country can conceal important differences in the business conditions experienced by individual firms. Access to finance, for instance, has generally improved since 2002. However, smaller firms still find it harder than larger enterprises to obtain finance. Similarly, as Chapter 3 shows, firms in remote areas face a more difficult business environment than those in capital cities — and not only with regard to finance. Such information is crucial in helping institutions like the EBRD to define their lending priorities.

The quality of the business environment has a significant influence on the performance of firms and their competitiveness in international markets. Chapter 4 of this Report confirms that differences in the business environment, particularly between countries, are important factors in determining the performance of enterprises. However, the business environment is not the only factor that influences the performance of firms. Ownership and management decisions on restructuring and other issues are also significant. Foreign-owned firms, for instance, which can draw on the technical and management know-how of their parent companies, tend to be more efficient than domestic firms.

Perhaps the most important factor that shapes the performance of enterprises is the extent of competition. The BEEPS confirms that firms operating in a competitive environment increase productivity at a faster rate than enterprises in more protected markets. The policy implications are clear for national policy-makers and for institutions like the EBRD. Governments should encourage fair competition among firms through the transparent and even-handed implementation of taxation, regulation and the rule of law and the reduction of barriers to market entry. The EBRD has a key role to play in supporting projects that increase competition in markets, promote innovation by firms and develop essential infrastructure and financial services.

This *Transition Report* provides an early opportunity to explore the extensive information contained in the 2005 BEEPS. It also aims, like previous *Transition Reports*, to throw light on the complex process of building a market economy and to share our insights with other investors, policy-makers, researchers and the public at large. Along with the many contributors to this Report, I hope that it helps to increase interest in the transition region and awareness of the challenges that lie ahead.

Steven Fries
Acting Chief Economist

10 October 2005

Part I: Progress in transition and macroeconomic performance

Part I of the *Transition Report* discusses the main economic developments in the transition region over the last year.

Chapter 1 reviews progress in transition from mid-2004 to mid-2005 and presents updated transition indicator scores for 2005. These indicators track each country's progress from a centrally planned to a market economy and cover four broad areas of reform – enterprises, markets and trade, financial institutions and infrastructure. The chapter also provides an overview of economic governance in transition countries, drawing on the results of the 2005 Business Environment and Enterprise Performance Survey (BEEPS), which are discussed in more detail in Part II of this Report. Annex 1.1 explains the scope and coverage of the BEEPS. Annex 1.2 presents the results of this year's legal indicator survey on corporate governance.

Chapter 2 looks at macroeconomic performance in 2004–05 in terms of output and inflation, monetary policy, fiscal policy and external balances. It also examines the link between rapid credit growth and financial sector transition – in particular, the extent to which the credit expansion of recent years affects financial stability. Annex 2.1 provides tables on a number of key macroeconomic indicators, including forecasts for growth and inflation for 2006.

Progress in transition and economic governance

1

The transition countries have made strong progress in structural and institutional reform over the past year although the reasons for this have varied across the region. Marked improvements in central eastern Europe and the Baltic states (CEB), following EU accession in May 2004, were driven largely by favourable market responses to recent progress in strengthening institutions. Advances in some parts of the Commonwealth of Independent States (CIS), meanwhile, followed significant political change. There was, however, a slow-down in the pace of reform in much of south-eastern Europe (SEE). This reflected not only continuing political uncertainty but also a pre-EU accession pause in reform by the candidate countries. The results of a large-scale survey of the business environment in 2005 showed an improvement overall since the previous survey in 2002. Nevertheless, significant problems remain for many countries.

Progress in reform in CEB, SEE and the CIS over the last 12 months has differed from the regional pattern of recent years. For the first time in several years there was considerable progress in the CEB countries, as markets have begun to respond to the structural and institutional reforms set in place during the EU accession process. However, the SEE countries, which had been catching up rapidly with CEB and outstripping the CIS, slowed down markedly (with the exception of Serbia and Montenegro). Progress in the CIS countries was confined mainly to the Caucasus (Armenia and Georgia) and western CIS (Moldova and Ukraine) while the pace of reforms in Russia, Belarus and Central Asia has remained slow. In Russia an advance in reform of the banking sector was balanced against the reassertion of state ownership and control over assets formerly in private hands.

The first section of this chapter describes the EBRD transition ratings and presents the scores for 2005. This is followed by an overview of the past year, looking at progress by country and by sector. The second half of the chapter takes a closer look at economic governance – that is, the key institutional, regulatory and legal foundations of a well-functioning market economy. This part of the chapter draws on the results of the third round of the Business Environment and Enterprise Performance Survey (BEEPS), conducted jointly by the EBRD and the World Bank. Annex 1.1

Chapter 1 at a glance

- Improvements in governance, enterprise restructuring and the financial sector have been the main features of progress in transition over the past year.
- The market played a key part in driving forward the transition process in the new EU member states of central Europe. New democratically elected leaders advanced reform in some CIS countries but reform momentum slowed in south-eastern Europe.
- Many transition countries have lessened the burden of business regulation, such as licensing and tax administration, and have made steady progress in reducing corruption and organised crime but significant problems remain for some countries.
- Many forms of bribery, including the need for kickbacks to secure government contracts, are still commonplace, especially in south-eastern Europe and the CIS.
- Stringent labour regulations are one of the biggest obstacles to doing business in the new EU member states, although less so than in the other EU member states.

describes the technical aspects of the BEEPS in greater detail and reports on how the business environment in each country has changed since 2002 according to local firms. Annex 1.2 covers the EBRD's annual survey on legal transition, focusing this year on corporate governance.

1.1 Transition progress in 2005

The EBRD assesses progress in transition through a set of nine transition indicators. These have been used to track reform developments in all 27 countries of the region since the beginning of transition. Progress is measured against the standards of industrialised market economies while recognising that there is neither a "pure" 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 a rigid centrally planned economy and 4+ represents the standards of an industrialised market economy. The reform scores reflect the assessments of EBRD country economists using the criteria described in the methodological notes at the back of this Report (see page 202).

Assessments are made in nine areas which together cover the four main elements of a market economy – markets and trade, enterprises, financial institutions and infrastructure.

- The reform of markets and trade is measured by the liberalisation of prices, the liberalisation of trade and access to foreign exchange, and the effectiveness of competition policy in facilitating market entry and combating the abuses of market dominance by large conglomerates and monopolies.
- The reform of enterprises includes separate indicators for large and small-scale privatisation and a measure of governance and enterprise restructuring, which assesses progress in cutting production subsidies, introducing effective bankruptcy procedures and applying sound corporate governance practices.
- The reform of financial institutions is measured by the development of the banking sector, including the quality of regulation and the development of securities markets and non-bank financial institutions.
- Infrastructure reform is measured by progress in five sectors – electricity, railways, roads, telecommunications, and water and waste water – covering such issues as commercialisation, tariff reform, quality of the regulatory framework and involvement of the private sector.

Table 1.1 presents the scores for reform progress in these areas for 2005. Table 1.2 provides an explanation for this year's rating changes. Table 1.3 presents the sector-by-sector scores for infrastructure reform. Table 1.4 explains ratings changes for the individual infrastructure sectors. Past ratings can be found in the country assessments at the back of the Report. These assessments also contain the country-by-country analyses that form the basis of the scores.

Reform progress by country

There was considerable progress in reform in the transition countries during the past year. Tables 1.1 and 1.2 show that the EBRD has awarded 30 upgrades across 18 countries (although Russia received one downgrade). SEE lagged behind with only seven, four of which were awarded to Serbia and Montenegro.[1] The number of upgrades for each country over the past year is illustrated in Chart 1.1.

Within CEB, four countries received two transition score upgrades each in 2005. Poland made progress in the financial sector, with a decrease in the role of state-owned banks and stronger supervision, and made improvements in governance and enterprise restructuring. Against a background of political uncertainty, this result is particularly striking. Despite being one of the pace-setting reformers in the early years, Poland had not received an upgrade since 2001. In addition to some marked improvements in the past 12 months, reforms implemented over several years – and the market response to them – warranted the upgrades this year.

The Czech Republic made progress in the financial sector, earning upgrades in the areas of banking sector reform and securities markets and non-bank financial institutions. Hungary received upgrades for improvements in governance and enterprise restructuring and for its maturing securities markets. Lithuania was upgraded for progress in large-scale privatisation and for banking reform.

CEB progress in transition following EU accession reflects steady achievement in structural reform over the past few years, pushing several countries into higher-rating categories. CEB "closed" the final chapters of the *acquis communautaire* (the main body of EU laws) in 2002, and since that time has seen a weakening of popular support for painful restructuring and slower-than-expected improvements in living conditions. Meanwhile, CEB governments concentrated on longer-term, institution-building projects in order to

Table 1.1

Transition indicator scores, 2005

Country	Population mid–2005 (million)	Private sector share of GDP mid–2005 (EBRD estimate in %)	Enterprises: Large-scale privatisation	Enterprises: Small-scale privatisation	Enterprises: Governance & enterprise restructuring	Markets and trade: Price liberalisation	Markets and trade: Trade & foreign exchange system	Markets and trade: Competition policy	Financial institutions: Banking reform & interest rate liberalisation	Financial institutions: Securities markets & non-bank financial institutions	Infrastructure: Infrastructure reform
Albania	3.2	75	3	4	2	4+	4+	2	3–	2–	2
Armenia	3.2	75	4– ↑	4	2+	4+	4+	2+ ↑	3– ↑	2	2+
Azerbaijan	8.3	60	2	4–	2+	4	4 ↑	2	2+	2–	2
Belarus	9.8	25	1	2+	1	3–	2+	2	2–	2	1+
Bosnia and Herz.	3.8	55 ↑	3– ↑	3	2	4	4–	1	3–	2–	2+
Bulgaria	7.8	75	4	4–	3–	4+	4+	3– ↑	4–	2+	3
Croatia	4.4	60	3+	4+	3	4	4+	2+	4	3–	3
Czech Republic	10.3	80	4	4+	3+	4+	4+	3	4 ↑	4– ↑	3+
Estonia	1.4	80	4	4+	4– ↑	4+	4+	3–	4	3+	3+
FYR Macedonia	2.0	65	3+	4	2+	4	4+	2	3–	2	2
Georgia	4.6	65	4– ↑	4	2+ ↑	4+	4+	2	3–	2–	2+
Hungary	10.0	80	4	4+	4– ↑	4+	4+	3	4	4 ↑	4–
Kazakhstan	15.1	65	3	4	2	4	3+	2	3	2+	2+
Kyrgyz Republic	5.1	75	4–	4	2	4+	4+	2	2+	2	2–
Latvia	2.3	70	4–	4+	3	4+	4+	3–	4–	3	3
Lithuania	3.4	75	4 ↑	4+	3	4+	4+	3	4– ↑	3	3–
Moldova	3.4	60 ↑	3	3+	2 ↑	4–	4+	2	3–	2	2+ ↑
Poland	38.2	75	3+	4+	4– ↑	4+	4+	3	4– ↑	4–	3+
Romania	21.7	70	4–	4–	2+ ↑	4+	4+	2+	3	2	3+
Russia	144.9	65 ↓	3 ↓	4	2+	4	3+	2+	2+ ↑	3–	3–
Serbia and Mont.	8.3	55 ↑	3– ↑	3+	2+ ↑	4	4– ↑	1	3– ↑	2	2
Slovak Republic	5.4	80	4	4+	4– ↑	4+	4+	3	4–	3–	3–
Slovenia	2.0	65	3	4+	3	4	4+	3–	3+	3–	3
Tajikistan	6.5	50	2+	4 ↑	2–	4–	3+	2–	2	1	1+
Turkmenistan	6.5	25	1	2	1	3–	1	1	1	1	1
Ukraine	47.3	65	3	4	2	4	3+ ↑	2+	3– ↑	2+	2
Uzbekistan	26.0	45	3–	3	2–	3–	2 ↑	2–	2–	2	2–

Source: EBRD.

Note: The transition indicators range from 1 to 4+, with 1 representing little or no change from a rigid centrally planned economy and 4+ representing the standards of an industrialised market economy. For a detailed breakdown of each of the areas of reform, see the methodological notes on page 202.

The private sector share of GDP is calculated using available statistics from both official (government) and unofficial sources. The share includes income generated from the formal activities of registered private companies, as well as informal activities where reliable information is available. The term "private company" refers to all enterprises in which private individuals or entities own the majority of shares.

The accuracy of EBRD estimates is constrained by data limitations, particularly in the area of informal activity. EBRD estimates may, in some cases, differ markedly from official data. This is usually due to differences in the definition of "private sector" or "non-state sector".

↑ and ↓ arrows indicate change from the previous year in that sectoral transition indicator. One arrow indicates a movement of one point (from 4 to 4+, for example). Up arrows indicate upgrades, down arrows downgrades.

The following scores have been revised and backdated this year to reflect historical conditions: large-scale privatisation for Albania, banking reform and interest rate liberalisation for Lithuania and the Kyrgyz Republic, small-scale privatisation for Moldova, governance and enterprise restructuring for the Slovak Republic and infrastructure for Slovenia.

Table 1.2

Changes in transition scores

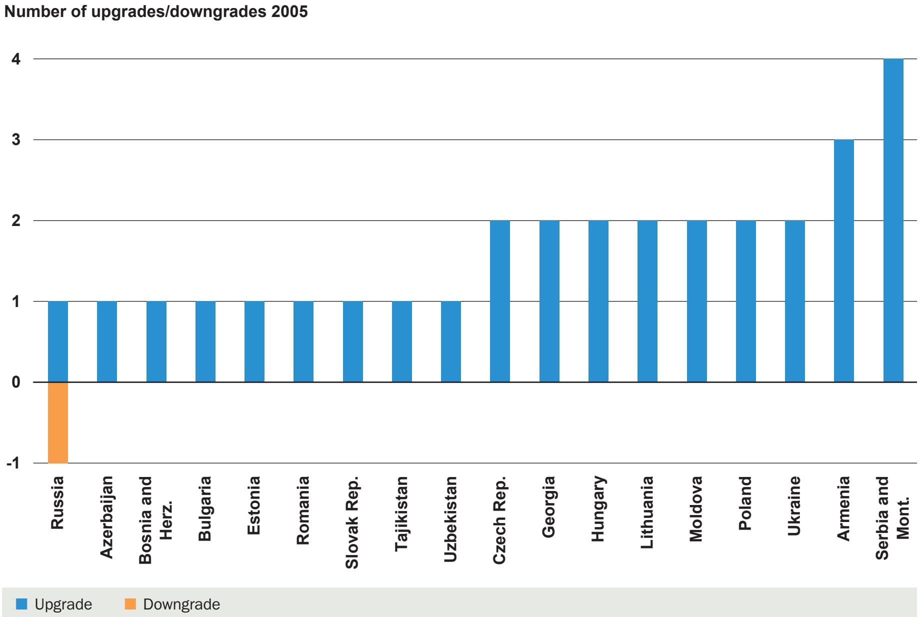
Country	Transition indicator	Change in score	Reason for change
Armenia	Large-scale privatisation	3+ to 4–	Privatisation of Zangezur copper-molybdenum plant. Only a few large-scale enterprises remain state-owned.
	Competition policy	2 to 2+	Enhanced effectiveness of the competition authority.
	Banking reform and interest rate liberalisation	2+ to 3–	Improved minimum capital requirements; the presence of four foreign banks in the sector (50 per cent of the sector's foreign ownership); the passing of an anti-money laundering law; the introduction of a deposit insurance scheme.
Azerbaijan	Trade and foreign exchange system	4– to 4	Acceptance of the IMF's Article VIII, preventing restrictions on payments and transfers for international transactions; progress with WTO accession.
Bosnia and Herzegovina	Large-scale privatisation	2+ to 3–	Progress with privatisations in the metals and minerals sectors.
Bulgaria	Competition policy	2+ to 3–	Improved legal framework consistent with EU regulations.
Czech Republic	Banking reform and interest rate liberalisation	4– to 4	Further financial deepening and significant growth in credit to the private sector.
	Securities markets and non-bank financial institutions	3+ to 4–	Substantial increase in liquidity and stock market capitalisation.
Estonia	Governance and enterprise restructuring	3+ to 4–	Dynamic business environment and increased confidence in governance post EU accession, as evidenced through increased investment and portfolio flows.
Georgia	Large-scale privatisation	3+ to 4–	Launch of new privatisation programme; sale of two of the ten largest state-owned firms. All strategic enterprises are currently up for sale.
	Governance and enterprise restructuring	2 to 2+	Progress by government to improve the business environment, harden budget constraints and reduce corruption.
Hungary	Governance and enterprise restructuring	3+ to 4–	Increased confidence in governance post EU accession, as evidenced through increased investment and portfolio flows.
	Securities markets and non-bank financial institutions	4– to 4	Substantial increase in liquidity and stock market capitalisation, and continued development of insurance sector and tradable debt instruments.
Lithuania	Large-scale privatisation	4– to 4	Substantial privatisations in the agribusiness, energy, transport and media sectors.
	Banking reform and interest rate liberalisation	3+ to 4–	Improvements in intermediation ratio and financial deepening.
Moldova	Governance and enterprise restructuring	2– to 2	Reduced state intervention in the economy and settlement of a series of disputes between enterprises and the authorities.
	Infrastructure	2 to 2+	Improvements in the telecommunications sector: progressive regulatory framework in place; small alternative fixed-line operators entering the market; competition in the VOIP (voice over internet protocol) and mobile sectors.
Poland	Governance and enterprise restructuring	3+ to 4–	Restructuring of the steel industry and renewed momentum in reforming large state-owned enterprises; increased confidence in governance post EU accession.
	Banking reform and interest rate liberalisation	3+ to 4–	Growth in household lending; cumulative improvements in consumer protection and banking supervision; privatisation of BGZ and partial privatisation and restructuring of PKO BP.
Romania	Governance and enterprise restructuring	2 to 2+	Series of improvements by new government with a strong anti-corruption focus.
Russia	Large-scale privatisation	3+ to 3	Effective renationalisation of large private companies in the oil and gas sector (e.g. Gazprom, selected Yukos assets).
	Banking reform and interest rate liberalisation	2 to 2+	Better regulation and growing intermediation; stricter minimum capital requirements; compulsory IFRS reporting.
Serbia and Montenegro	Large-scale privatisation	2+ to 3–	Renewed progress in enterprise and bank privatisations in Serbia; sale of KAP, the largest enterprise in Montenegro.
	Governance and enterprise restructuring	2 to 2+	Progress in tightening budget constraints, reducing subsidies to loss-makers and enforcement of new bankruptcy law.
	Trade and foreign exchange system	3+ to 4–	Progress in developing regional free trade agreements and the elimination of import/export quotas, together with full current account convertibility.
	Banking reform and interest rate liberalisation	2+ to 3–	Significant growth in credit to the private sector; introduction of a new deposit insurance law; improved regulation in the banking sector.
Slovak Republic	Governance and enterprise restructuring	3+ to 4–	Dynamic business environment and increased confidence in governance post EU accession, as evidenced through increased investment and portfolio flows.
Tajikistan	Small-scale privatisation	4– to 4	Almost all assets in the privatisation scheme are sold off, but weakness in land privatisation remains (land still not tradable).
Ukraine	Trade and foreign exchange system	3 to 3+	Abolished mandatory sale of 50 per cent of export proceeds; progress with WTO accession.
	Banking reform and interest rate liberalisation	2+ to 3–	Financial deepening; better regulation; growing share of foreign banks has increased competition.
Uzbekistan	Trade and foreign exchange system	2– to 2	Some progress in current account convertibility.

Source: EBRD.

Note: See Table 1.1 for transition indicator scores for all countries.

Chart 1.1

Change in average indicator scores, 2004–05



Source: EBRD.

Note: The chart reports the changes in nine areas of reform (see Table 1.1). No change was recorded in Albania, Belarus, Croatia, FYR Macedonia, Kyrgyz Republic, Kazakhstan, Latvia, Slovenia and Turkmenistan.

implement EU laws effectively. Consequently there has been a strong market response in many CEB countries, with higher levels of investment and access to international capital markets.

The CIS made significant progress in reform over the past year but certain countries fared better than others. Most of the 13 upgrades in the CIS were earned by countries in the Caucasus and in Moldova and Ukraine in the western CIS. Political change and policy reorientation were the main factors driving the renewed reform momentum in these countries. Meanwhile Russia, Belarus and Central Asia had only three upgrades between them.

Among the reforming countries in the CIS, Armenia led the way with three upgrades – for large-scale privatisation, competition policy and banking reform. Reforms in Armenia, one of the more advanced CIS countries according to the transition indicators, had slowed in 2003–04 due to election year uncertainties and post-election protests by the opposition. However, reforms resumed in Armenia in 2004–05 following the return of relative political stability and a policy orientation that favours markets and private enterprise. Georgia also made significant progress in transition, with improvements in large-scale privatisation and governance and enterprise restructuring. The change in political leadership at the end of 2003, with the installation of a democratic and market-oriented government, yielded a number of new reforms. In Azerbaijan, where political conditions have remained static by comparison and electoral uncertainties continue to loom, progress in transition was slower. The country received one upgrade for trade and foreign exchange liberalisation, based on its acceptance of the IMF's Article VIII obligations and some progress in meeting World Trade Organization (WTO) accession requirements.

Within the western CIS, Ukraine emerged from a turbulent political period at the end of 2004 with a new leadership committed to democratic and market reform and European integration. Under this leadership, the country built on the previous government's progress in two areas of reform: trade and foreign exchange policy, by eliminating export controls and reaching several legislative milestones on the way towards WTO accession; and the banking sector, with an improved regulatory framework, growth in lending to the private sector and increased foreign participation. However, despite these concrete achievements, progress in other areas has been slower than expected and questions remain about Ukraine's controversial programme of renationalisation of companies that may have been privatised illegally in the view of the authorities.

Moldova was upgraded for progress in governance and enterprise restructuring (having been downgraded in 2003) and for improvements in telecommunications. The country did not experience an abrupt transfer of political power like Ukraine but there was a marked shift in policy direction by the communist government in the run-up to national elections in 2005. As in Georgia and Ukraine, Moldova emerged from a political crossroads with a more Western-oriented policy on democratic and market reform and on global integration. The government's commitment to these policy goals is still largely untested but there has been evidence of positive change over the past year.

Elsewhere in the CIS, progress in reform was less pronounced. In Central Asia only Tajikistan and Uzbekistan received upgrades in 2005 – the former for small-scale privatisation and the latter for trade and foreign exchange liberalisation. Uzbekistan has not shown any sustained signs of climbing out of its transition trough. Moreover, the unsettling political events in the Andijan region of Uzbekistan and the questions raised by these events within the country and the international community have since set back the cause of reform.

Russia has largely stalled with reform, having once been the standard bearer for the CIS. The one exception is the financial sector, where the performance of Russian banks has improved, a comprehensive medium-term financial sector strategy was adopted, progress was made in setting up a deposit insurance system and there were significant improvements in the legal and regulatory framework for the sector. This resulted in an upgrade for financial institutions.

However, as a result of increased state interventions in a range of key economic areas, the privatisation process in Russia suffered a significant setback over the last year. Majority state ownership and control has been reinstated in large companies and re-established over substantial assets in the oil and gas sector. Due to this reduction in the scope of the private sector, large-scale privatisation was downgraded by one notch. The increased influence of the state combined with the stalled reform of public institutions could have detrimental consequences for corporate governance – as state-owned companies in Russia tend

Box 1.1

Recent developments in Kosovo

A lack of clarity over decision-making powers has been created by the sharing of power between the United Nations Interim Administration Mission in Kosovo (UNMIK) and the Provisional Institutions of Self-Government (PISG) that have emerged since 1999. UNMIK was put in charge of Kosovo under Security Council Resolution 1244 of June 1999 pending the resolution of the province's final status. There have been frequent disagreements between PISG and UNMIK, most recently over the awarding of licences to mobile telephone operators and the provision of budgetary allocations for UNMIK institutions. Foreign investors are deterred by this lack of predictability. Furthermore, there is a lack of clarity over the ownership of private and public assets. International institutions have so far been unable to lend for public investment projects in the absence of a sovereign guarantee. As a result, the government lacks access to international capital markets while private investors face high-risk premiums.

There has been some progress in developing the regulatory basis for future growth, with the exception of infrastructure networks. There is a well-capitalised and regulated financial sector (supervised by the Banking and Payments Authority of Kosovo). Labour laws are non-restrictive and there is a tax system with low harmonised rates and few exemptions. Also, there is improved legal redress in the new courts system and a relatively open trade regime. However, a number of profound economic challenges remain.

There has been little progress in restructuring publicly owned enterprises (POEs). In particular, the energy utility remains a hindrance to growth. It generates fiscal losses of approximately 7 per cent of GDP, with power shortages adding about 10 per cent to business costs according to the IMF. Efforts to reform the energy utility have so far met with only limited success. The authorities plan for all POEs to be incorporated by April 2006. Formal unemployment is about one-third of the workforce, making large-scale lay-offs difficult. The privatisation of socially owned enterprises (SOEs) has restarted following a two-year delay. By mid-2005 UNMIK had sold fewer than 50 of the 470 SOEs earmarked for privatisation before the end of 2006.

According to the IMF, GDP returned to positive growth in 2004 (3.7 per cent) following two years of recession. In 2005 the economy is expected to contract again by 0.5 per cent. This is largely because of the scaling back of expansionary fiscal policy and slower investment growth. The tax base is relatively narrow, with 80 per cent of revenues collected at the border through customs, excise and value added tax (VAT) on imports. Meanwhile, international donor grants are on a declining trend, falling from US$1.1 billion (70 per cent of GDP) in 2001 to approximately US$600 million (33 per cent of GDP) in 2004. This has led to a decline in demand for local goods and services from donors which, alongside over-capacity in some sectors, has led to a sharp fall in inflation. The consumer price index (CPI) turned negative in late 2004 and the IMF predicts deflation of 1.5 per cent in 2005.

The current account deficit remains high but is declining. According to the IMF, the current account balance of the domestic economy (excluding foreign assistance) has fallen from 45 per cent of GDP in 2001 to 29 per cent in 2004. Exports, consisting largely of agricultural produce, metals and minerals, have risen gradually from a very low base over the last five years.

Uncertainty over the province's future political status, the lack of clarity over decision-making authority and weak economic fundamentals remain the foremost barriers to transition progress and growth. Macroeconomic stability is threatened by a deteriorating fiscal position, a high current account deficit and weak growth. The budget deficit in 2004 was almost US$150 million, or approximately 5 to 7 per cent of GDP. Government cash reserves, which were US$183 million at the end of 2004, cannot sustain continued deficits into 2006. With limited access to external or domestic financing, the government will need to take difficult decisions requiring greater prioritisation of current and capital expenditures.

Source: EBRD.

to be less transparent and commercially oriented than private ones. Further reform and restructuring in energy and other key sectors could also be delayed.

Reform in SEE, which led the transition region during the previous two years, was far slower in 2004–05. The only exception was Serbia and Montenegro, with four transition score upgrades. Serbia and Montenegro made progress in large-scale privatisation, governance and enterprise restructuring, trade and foreign exchange liberalisation, and banking reform. This was despite continuing political uncertainty over the future of the State Union and the final status of Kosovo (see Box 1.1) and weakening public support for reform. Serbia and Montenegro has tended to make fitful progress in transition. In 2002 the country received five transition score upgrades and increases in two infrastructure sub-sectors (although from a very low base). That was followed by a sudden slow-down in 2003 and 2004. Even with the progress made in 2005, Serbia and Montenegro still has a long way to go to catch up with the more advanced countries in the SEE region.

Elsewhere in SEE, advances in market reform were more modest. In the Western Balkans (SEE-4) Bosnia and Herzegovina was the only country other than Serbia and Montenegro to receive an upgrade (for large-scale privatisation). Among the EU candidate countries (SEE-3), which last year received a total of nine upgrades, there were single upgrades for Bulgaria (for competition policy) and Romania (for governance and enterprise restructuring). Although they lag slightly behind the point that the CEB countries had reached at the same stage of the EU accession process, the candidate countries in SEE may have entered a pre-accession reform slow-down. Moreover, elections and post-election delays in forming stable coalition governments in Bulgaria and Romania may have resulted in a temporary relaxation in reform momentum for short-term political reasons.

Reform progress by sector

Over the past year, progress in building market-supporting institutions (second-phase reform) has continued to outpace market liberalisation (initial-phase reform) in the transition region.[2] Initial-phase reform includes price and trade liberalisation and small-scale privatisation, which are easier comparatively to initiate. For most countries, initial-phase reforms were largely completed within the first five to seven years of transition. Second-phase reform includes large-scale privatisation, governance and enterprise restructuring, competition policy, financial sector development and infrastructure reform (see Table 1.3). These reforms are more complex and tend to take longer to put into effect. Initial-phase reforms proceeded more rapidly in the early years of transition.

Year-on-year changes in both types of reforms were faster in the first five years of transition and then gradually tailed off (see Chart 1.2). Since the early impetus in initial-phase reform, institution-building reforms have outpaced market liberalisation nearly every year, although with some fluctuation. Over the past two years, year-on-year changes in second-phase reform have picked up again from a low point in 2003.

A total of five upgrades for initial-phase reforms were awarded in 2004–05.

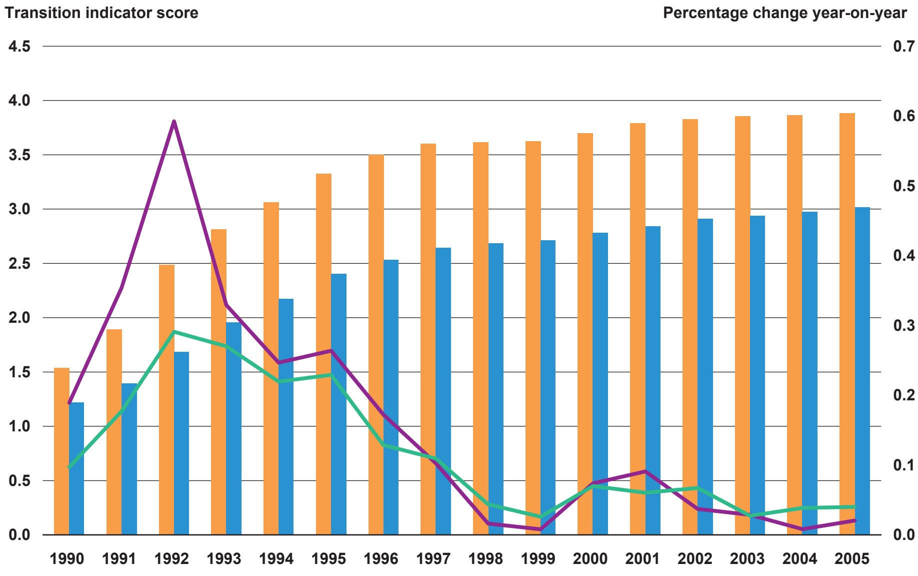
These were mainly in the area of trade and foreign exchange liberalisation among the less advanced transition countries, which are still coming into compliance with IMF Article VIII obligations and WTO requirements. Second-phase reform has dominated in the past year, and was particularly strong in the financial sector, in governance and enterprise restructuring, and in large-scale privatisation. Chart 1.3 shows the number of transition score upgrades by sector and region.

In 2005 eight countries (four of them in the CEB region) made significant progress in financial sector reform. This resulted in nine upgraded scores in this sector, including seven upgrades for banking reform and two for strengthening of securities markets. In 2003–04 there was a strong push in banking reform and private sector lending in SEE-3 countries. This year CEB, and to a lesser extent CIS countries, made the most progress. Upgrades over the past year have raised seven out of eight CEB countries to near the top of the ratings scale in banking sector and interest rate liberalisation. This reflected the positive response of markets to steady improvements in the supervisory and prudential regulation institutions. Three CIS countries — Armenia, Russia and Ukraine — made improvements in the regulatory and supervisory institutions in the banking sector. Nevertheless, they remain well below the standards attained in CEB, and the risks associated with rapid credit growth are still a source of concern (see Chapter 2).

In the area of securities markets and non-bank financial institutions, the Czech Republic and Hungary made headway, with each receiving an upgrade in 2005. This was due to the strong post-EU accession market response to institutional developments in these countries in recent years. With sound regulatory frameworks in place in these new EU member states, and with low global interest rates, capital has flowed into the larger stock markets, resulting in greater liquidity as well as much higher market capitalisation. Market capitalisation reached over 25 per cent of GDP for both countries by the end of 2004. Turnover ratios as a percentage of market capitalisation were 79 per cent for the Czech Republic and 60 per cent for Hungary. These figures are at the lower end of the range and still well below the average for EU member states as a whole.

Chart 1.2

Reform progress since 1990

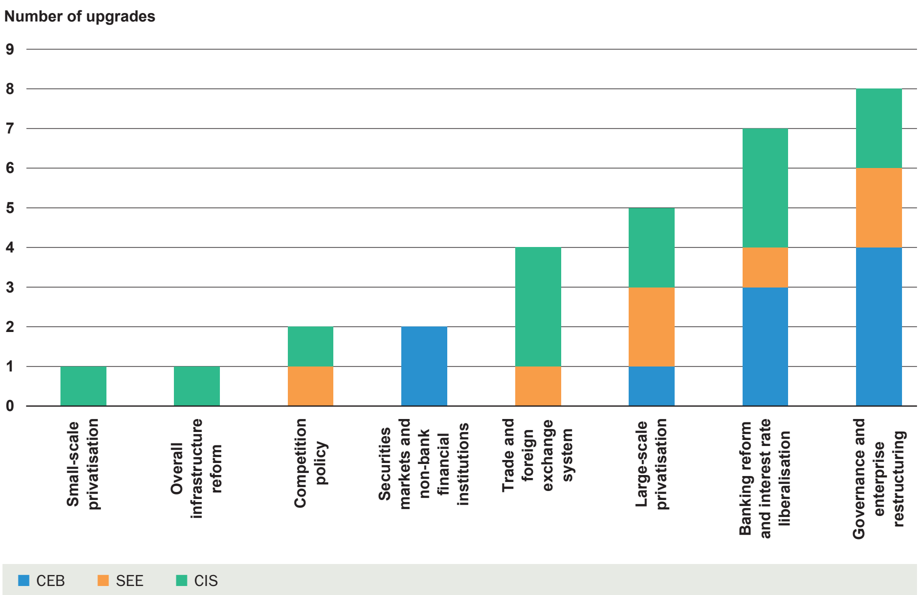


Source: EBRD.

Note: The chart reports the average score for all 27 transition countries in the two broad dimensions of reform. Initial-phase reforms include price liberalisation, trade and foreign exchange liberalisation, and small-scale privatisation. Second-phase reforms include large-scale privatisation, governance and enterprise restructuring, competition policy, infrastructure reforms, banking and interest rate liberalisation, and securities markets and non-bank financial institutions. Reforms are measured using the EBRD transition indicators (see Table 1.1). For a full explanation of the classification system, refer to the methodological notes on page 202.

Chart 1.3

Transition progress by sector, 2004-05



Source: EBRD.

Note: The chart reports the number of upgrades in each area of reform (see Table 1.1) in CEB, SEE and the CIS. Price liberalisation is not included as no change was recorded for the year.

Progress in the past year in governance and enterprise restructuring is a particularly important development as this has been an area of neglect for countries at every level of transition. This progress is partly related to general improvements in the business environment. Better standards of corporate governance and protection of minority shareholder rights (see Annex 1.2) as well as improved economic governance have in turn led to higher levels of investment. Improvements in the business environment are described in greater detail in Section 1.2 below.

Table 1.3

Infrastructure transition indicators, 2005

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

Source: EBRD.

Note: ↑ and ↓ arrows indicate a change from the previous year in the transition indicator. One arrow indicates a movement of one point (from 4 to 4+, for example). Up arrows indicate upgrades. The water and waste-water scores for the Slovak Republic and Slovenia have been revised and backdated this year. The overall infrastructure rating is the average of the five sector scores. The average is obtained by rounding down (see the methodological notes on page 202).

Table 1.4

Changes in infrastructure transition scores

Country	Transition indicator	Change in score	Reason for change
Bulgaria	Roads	2+ to 3–	Increased private sector participation, with two private road concession contracts awarded in late 2004.
Czech Republic	Telecommunications	4 to 4+	Presence of competitive mobile network, and completion of the fixed-line privatisation.
FYR Macedonia	Electric power	2+ to 3–	Unbundling of the sector through the creation of separate transmission, distribution and generation companies.
Kazakhstan	Railways	3– to 3	Presence of private freight operators and implementation of public service obligations. Renewed restructuring efforts since early 2004.
Moldova	Telecommunications	2+ to 3–	Improved interconnection arrangements and tariffs; a number of small alternative fixed-line operators have entered the market; competition in mobile and internet sectors.
Slovak Republic	Railways	3– to 3	Separation of passenger and freight operations.
Uzbekistan	Electric power	2 to 2+	Tighter payments discipline and presence of cost-covering tariffs.

Source: EBRD.

Eight upgrades in governance and enterprise restructuring were awarded: four to CEB and two each to SEE and the CIS. This suggests widespread recognition of the importance of good governance. Upgrades were awarded to three of the largest countries in the CEB region — Hungary, Poland and the Slovak Republic. This reflects improvements in building effective corporate governance institutions and progress in long-delayed restructuring and a positive market reaction to these developments.

In SEE, Romania has adopted a more disciplined and tougher approach to fighting corruption and strengthening governance institutions under a new, reform-oriented government. Serbia and Montenegro has reduced subsidies to large, state-owned companies (in transport industries, for example) and further tightened implementation of the law on insolvency. In the CIS, Georgia and Moldova took steps to align their policies more closely with European standards of good governance (although they still have a long way to go in terms of implementation). These included general improvements to the business environment, strengthening the legal framework for corporate governance, reducing state intervention in the economy, and cutting subsidies and other forms of state support.

Large-scale privatisation was another area where second-phase reforms showed marked improvement. Most CEB countries already have scores near the top of the ratings scale. This is because there is not much more to privatise outside of traditionally state-dominated sectors, such as segments of infrastructure, health care or defence. However, Poland and Slovenia still have some way to go to reach the overall CEB standard. In the past year, Lithuania has made progress in this area, earning an upgrade for sales of state-owned companies in a wide range of industrial sectors. Bosnia and Herzegovina and Serbia and Montenegro advanced the privatisation process in SEE, as did Armenia and Georgia in the CIS. However, Russia, as noted above, put the process into reverse with the renationalisation of companies in the energy and other sectors.

In infrastructure, there were seven sub-sector upgrades in 2005, with only one overall upgrade (in Moldova). Table 1.3 provides a breakdown of infrastructure scores by sub-sector as well as the overall score while Table 1.4 explains the reasoning behind this year's transition score upgrades. Progress in reform of infrastructure – in separation of industries, commercialisation and tariff restructuring, and improving regulation – has lagged behind other areas of transition.[3] Only Hungary has an overall infrastructure score in the "4" range.

This year upgrades were awarded for telecommunications in the Czech Republic and Moldova, railways in Kazakhstan and the Slovak Republic, electrical power in FYR Macedonia and Uzbekistan, and roads in Bulgaria and Estonia. Although the quality of infrastructure service in electricity and telecommunications is improving for most countries, further strengthening of the regulatory framework and tariff structures, especially for water, is still needed across nearly all countries and sectors.

1.2 Progress in economic governance

The transition indicators measure progress in enterprise reform, markets and trade, financial institutions and infrastructure but omit several important elements of economic governance. These include market-supporting institutions, such as a fair and uncorrupted judicial system and regulatory bodies that ensure a level playing field for business. To better understand firms' perceptions of these and other aspects of a good business environment (such as a stable macroeconomic environment, access to finance and the quality of infrastructure services), the EBRD and the World Bank have conducted periodic surveys of enterprises.

The EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS) was carried out in the transition countries for the first time in 1999, then again in 2002 and most recently in 2005. In 2002 and 2005 it has covered 26 out of the 27 transition countries (as it could not be implemented in Turkmenistan) and also Turkey. The BEEPS 2005 country averages reported in this chapter are based on the responses of around 8,000 firms in 26 transition countries. The BEEPS was also conducted in five other countries in Europe and Asia in 2004 – Germany, Greece, Portugal, South Korea and Vietnam. The survey results from these countries and Turkey provide a useful benchmark against which to measure progress in the transition countries.

The responses on the quality of economic governance can be grouped into two broad areas covering business regulation (for example, licensing, tax, customs and trade, and labour regulation) and institutions and property rights (relating to corruption, crime and the judiciary). The BEEPS asks firms to rank on a scale of 1 (minor) to 4 (major) how problematic the above factors are for the operation and growth of their business. As Table 1.5 shows, with the exception of labour regulations, perceptions of economic governance in each of these dimensions since 2002 have improved for the transition region as a whole and in each sub-region. Nevertheless, there is a significant amount of variation by country.

The ranking of business obstacles is a useful initial indication of how firms perceive the quality of economic governance. However, perceptions of what constitutes an obstacle are likely to differ from country to country (based on country-specific characteristics, such as cultural norms, levels of political freedom and economic well-being). Perceptions within countries are also likely to be affected over time due to economic cycles and other events that make firms feel more or less optimistic or pessimistic about business conditions and prospects. Moreover, average firm perceptions of the quality of economic governance do not provide specific, detailed information on the costs imposed by these obstacles in each area of the business environment. Therefore, the BEEPS asks firms to quantify the costs to their business from lapses in economic governance.

According to the survey, companies in CEB believe that economic governance has improved overall. Perceptions improved most sharply in the Slovak Republic. However, in some other CEB countries, companies believe that the state's governance of the economy has worsened since 2002. In the Czech Republic, for example, firms on average reported more problems across every aspect of economic governance in 2005 compared with 2002. Perceptions of state governance among firms in Hungary have also weakened on average, particularly in areas related to tax and the regulatory environment. Economic governance in Lithuania strengthened in most areas but the survey reveals that firms are having a more difficult time with corruption.

Economic governance has improved in SEE, according to the survey. In particular, firms in Bulgaria on average believe there has been a significant strengthening in all areas. Firms in SEE as a whole reported improvements in key aspects of governance although not all countries experienced this positive trend in equal measure. Moreover, in a few countries governance structures appear to have weakened since 2002. For example, in FYR Macedonia and Serbia and Montenegro, firms on average reported more problems with the judiciary and corruption than three years ago. Similarly, bribes are paid more frequently to "get things done" compared with 2002. In both countries contract enforcement was weaker in terms of the number of weeks it takes to resolve overdue payments.

In the CIS the view of the business environment and economic governance has improved most dramatically in Belarus, and, to a lesser extent, in Tajikistan since 2002. In the past, these largely unreformed countries, together with Uzbekistan, have tended to receive favourable ratings for economic governance from firms (although by some measures, corruption in Uzbekistan looks worse in 2005) despite clear indications of more heavy-handed state intervention

Table 1.5

Changes in perceptions of economic governance

Country	Judiciary	Crime	Corruption	Customs and trade regulations	Business licensing and permits	Labour regulations	Tax administration
Central eastern Europe and the Baltic states							
Czech Republic	0.58	0.24	0.50	0.48	0.24	0.65	0.77
Estonia	-0.39	-0.07	-0.01	-0.02	-0.25	0.66	-0.33
Hungary	0.11	-0.03	0.03	-0.07	0.03	0.23	0.24
Latvia	-0.06	-0.17	-0.19	-0.61	-0.12	-0.11	-0.11
Lithuania	0.05	-0.17	0.01	-0.09	0.09	0.25	-0.28
Poland	-0.15	-0.30	-0.32	-0.34	-0.04	-0.28	-0.13
Slovak Republic	-0.67	-0.45	-0.70	-0.75	-0.67	-0.32	-0.54
Slovenia	0.01	-0.12	-0.12	0.00	-0.01	0.21	0.68
Average	*-0.06*	*-0.13*	*-0.10*	*-0.18*	*-0.09*	*0.16*	*0.04*
South-eastern Europe							
SEE-3							
Bulgaria	-0.10	-0.44	-0.36	-0.10	-0.17	0.02	-0.04
Croatia	-0.03	-0.17	-0.16	-0.30	-0.18	-0.10	-0.43
Romania	-0.03	-0.12	-0.14	0.05	-0.05	0.40	0.20
SEE-4							
Albania	-0.24	-0.54	-0.27	-0.23	-0.07	0.06	0.15
Bosnia and Herzegovina	-0.16	-0.04	-0.25	-0.19	-0.15	-0.12	-0.42
FYR Macedonia	0.09	-0.17	0.17	-0.16	-0.03	0.15	0.00
Serbia and Montenegro	0.46	-0.07	0.44	-0.16	0.01	0.12	-0.24
Average	*0.00*	*-0.22*	*-0.08*	*-0.16*	*-0.09*	*0.07*	*-0.11*
Commonwealth of Independent States							
Armenia	0.12	0.22	0.21	-0.35	0.05	0.15	-0.07
Azerbaijan	0.11	0.27	0.37	0.35	0.33	0.12	0.57
Belarus	-0.55	-0.48	-0.56	-0.65	-0.34	-0.33	-0.94
Georgia	0.00	-0.23	-0.65	-0.24	-0.10	0.09	-1.46
Kazakhstan	0.16	-0.11	-0.06	-0.05	0.12	0.14	-0.04
Kyrgyz Republic	0.04	-0.11	0.32	0.00	0.08	0.12	0.26
Moldova	0.43	-0.34	-0.25	0.04	-0.12	0.57	-0.24
Russia	0.07	-0.01	0.19	-0.06	-0.01	0.20	-0.06
Tajikistan	-0.11	-0.20	-0.32	-0.49	-0.15	-0.09	-0.16
Ukraine	-0.08	-0.36	-0.26	-0.35	-0.27	-0.04	-0.44
Uzbekistan	-0.12	-0.11	-0.13	-0.14	0.14	0.07	-0.20
Average	*0.01*	*-0.13*	*-0.10*	*-0.18*	*-0.02*	*0.09*	*-0.25*
Overall average	***-0.02***	*-0.16*	*-0.10*	*-0.17*	*-0.06*	*0.11*	*-0.13*

Sources: BEEPS 2002 and 2005.

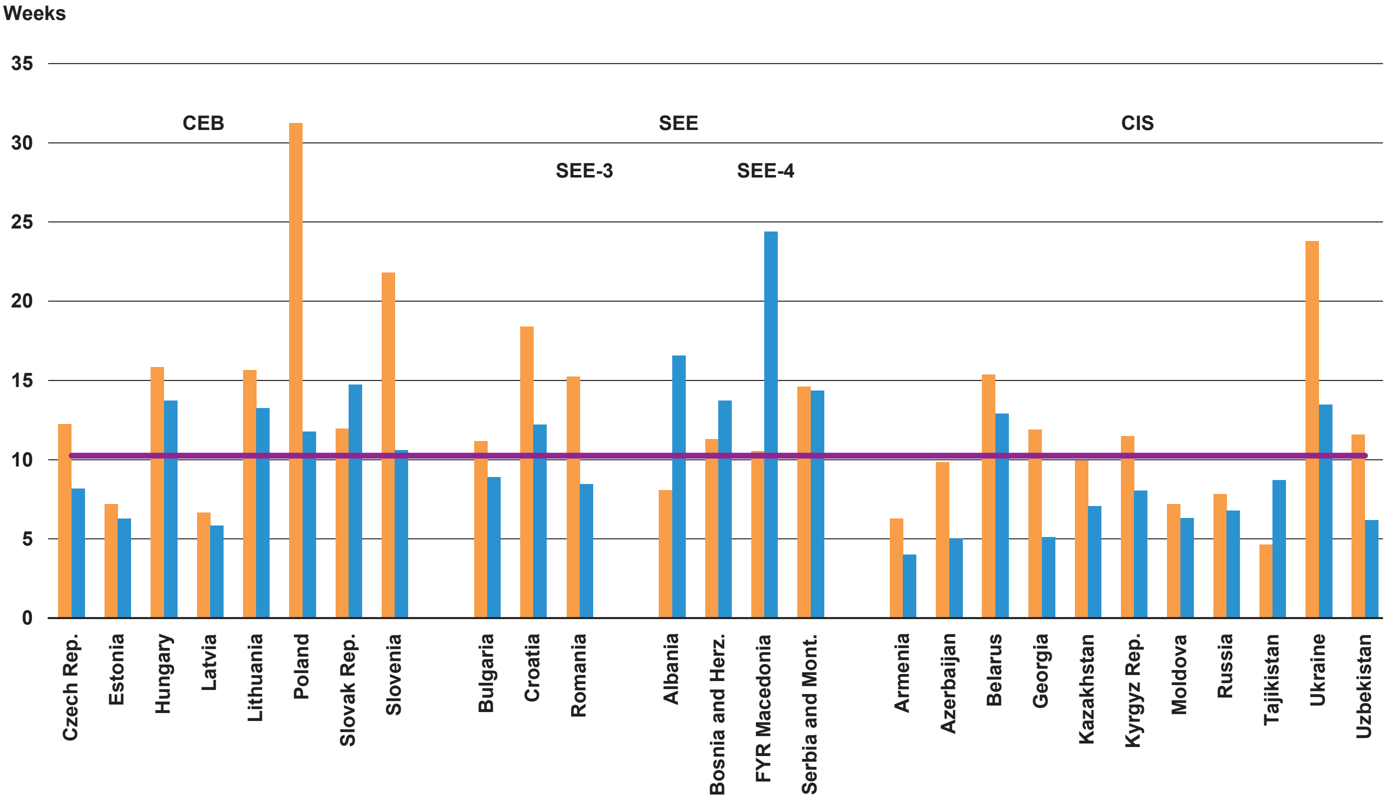
Notes: Firms were asked to report how problematic a series of governance dimensions are for their business on a scale of 1 (no obstacle) to 4 (major obstacle). The table shows the average change between responses received in 2002 and 2005. A negative sign indicates improved perceptions of that dimension in the business environment. Statistically significant improvements are shown in orange and statistically significant deteriorations are shown in blue (with 90 per cent confidence). Data for Turkmenistan were not available.

in the economy. This may be partly because firms operating in such generally oppressive political environments may be unwilling to speak openly with interviewers. (This problem has prevented implementation of the BEEPS in Turkmenistan since 1999.) Also, in countries that have yet to reform the state's role in the economy, firms are less likely to detect any reduction in services and so report increased obstacles to doing business. Furthermore, in countries with less dynamic private sectors and less competition — where there are fewer opportunities for entry and state subsidies prevent exit by poorly performing firms — respondents may perceive a business environment where the state intervenes on their behalf as having certain advantages (see Chapter 3). As for the ratings on corruption, in countries with more centralised, autocratic power structures, corruption may be more predictable and institutionalised, making firms less likely to perceive it as an obstacle.

In two other CIS countries — Armenia and Azerbaijan — economic governance is noticeably worse in 2005 in areas such as the judiciary, crime and corruption, according to the survey. In both countries, firms on average reported a higher share of annual revenues paid in bribes (the "bribe tax") and more senior managers' time spent with public officials to deal with regulatory issues (the "time tax").

Chart 1.4

Average time needed to resolve overdue payments, 2002 and 2005



Sources: BEEPS 2002 and 2005.

Note: Firms were asked to report the average time needed to resolve overdue payments. The time for each country is calculated as an unweighted average of responses from those firms that reported making such payments. Data for Turkmenistan were not available.

The remainder of this chapter looks in more detail at the main dimensions of economic governance, and how perceptions among firms have changed over the past three years. Corruption, the judiciary and crime have a major influence on the protection of property rights, which is a key requirement for the smooth functioning of markets. The extent, stability and application of business regulation (including taxation) are also important. They define to a large extent the administrative barriers to the growth and operation of firms.

The rest of this chapter focuses on how the business environment has evolved since 2002 at the aggregate country level. A more detailed analysis by company type (ownership, age, geographical location, sector, size and performance) is provided in Chapter 3.

The judiciary

The functioning of the judiciary as an obstacle to doing business has not changed much since 2002, according to the BEEPS. Some countries, such as Estonia and the Slovak Republic, have shown a significant improvement. In others, such as the Czech Republic, Moldova and FYR Macedonia, perceptions of the judiciary have worsened (see Table 1.5).

The BEEPS asked firms to assess their level of confidence in the legal system (including the courts as well as other agencies of law enforcement, such as the state prosecutor, bailiffs and police) in terms of protecting their contract and property rights in a business dispute. Overall there was little change since 2002 but in FYR Macedonia, Hungary, Serbia and Montenegro and Uzbekistan confidence in contract enforcement has declined. The average firm in these countries doubts the ability of the legal system to protect its contract and property rights.

At the same time, another indicator of the effectiveness of contract enforcement (which includes the courts) has improved, according to the firms surveyed. As Chart 1.4 shows, the time taken to resolve an overdue payment declined from an average of just over 12 weeks in 2002 to around 10 weeks in 2005. The most significant change was recorded in the CEB countries (particularly Poland and Slovenia), where the number of weeks fell from around 15 in 2002 to 11 in 2005. In contrast, contract enforcement deteriorated in SEE, with an increase in the number of weeks to resolve overdue payments from 13 in 2002 to 14 in 2005. Albania, Bosnia and Herzegovina and FYR Macedonia all fared worse in 2005.

Firms were asked to assess the courts in terms of their general fairness, honesty, speed, cost and ability to enforce decisions. They were also asked how often they use the courts to resolve business disputes. This was measured in terms of the number of cases in civil or commercial arbitration courts where firms were involved as a plaintiff over the past three years. The underlying assumption is that only firms that believe the courts function reasonably well would choose to make use of them.

Assessments of the courts in terms of their fairness, honesty, speed, cost and ability to enforce judgements have changed little since 2002. However, firms' use of courts has declined overall since 2002, with the largest changes in CEB and SEE. This could indicate that businesses have less confidence in the courts than before since they do not choose to use them to resolve disputes. On the other hand, payment delays have become less of a problem, making intervention by the courts to resolve them less necessary. Moreover, firms in Germany, Greece and Portugal use the courts less often than those in the most advanced transition countries (on average about 1.4 times over three years, compared with 2.3 times in CEB). This suggests that the more advanced transition countries may be moving towards the level in OECD countries, where disagreements among firms are often resolved through alternative dispute resolution mechanisms, and courts, which can be slow and costly, are avoided.

In fact, the results of the BEEPS suggest that the more experience firms have with courts, the less they like them. Firms may have a more positive assessment of the courts before they use them but turn negative once they have experienced first hand how poorly they function in practice. One factor that could explain this negative assessment of the courts after they have gained direct experience is corruption among judges and of the judicial process. The BEEPS asked firms how common it is for businesses to make unofficial payments/gifts in dealing with the courts. The replies indicate that corruption is high and rising in Albania, Serbia and Montenegro and the Kyrgyz Republic, and high but stable in Bosnia and Herzegovina.

Corruption

Corruption as an obstacle to doing business has diminished since 2002 (although less so in SEE than in CEB and the CIS) in the view of the firms surveyed (see Table 1.6). However, in some countries corruption may still be quite high even though firms do not report it as a significant impediment. In many cases, this is because paying bribes has become an accepted, and often predictable, cost of doing business. Survey data on corruption — both perceptions of how problematic it is, and on how much firms pay in bribes — is subject to measurement error. Since bribery and other forms of corruption are illegal, firms are often unwilling to talk openly about it with

Table 1.6

Types of corruption

Country	Bribe tax[1] 2002	Bribe tax[1] 2005	Kickback tax[2] 2002	Kickback tax[2] 2005	Frequency of bribery[3] 2002	Frequency of bribery[3] 2005
Central eastern Europe and the Baltic states						
Czech Republic	0.92	0.63	1.19	1.79	13.33	9.93
Estonia	0.34	0.29	1.01	0.46	12.14	6.47
Hungary	0.97	1.06	2.09	2.47	22.56	9.93
Latvia	0.93	0.71	1.32	1.69	17.90	7.49
Lithuania	0.74	0.87	1.03	1.98	20.62	24.08
Poland	1.22	0.70	2.21	1.04	18.57	14.77
Slovak Republic	1.45	0.93	3.31	1.88	36.02	10.64
Slovenia	0.80	0.17	0.66	0.50	7.15	4.65
Average	*0.92*	*0.67*	*1.60*	*1.48*	*18.54*	*11.00*
South-eastern Europe						
SEE-3						
Bulgaria	1.95	1.58	2.51	3.32	32.79	15.70
Croatia	0.64	0.76	0.89	0.69	12.86	11.27
Romania	2.57	0.81	2.11	0.67	36.74	22.56
SEE-4						
Albania	3.31	1.80	6.00	6.15	36.37	46.11
Bosnia and Herzegovina	0.95	0.39	1.19	0.51	22.42	19.63
FYR Macedonia	0.79	0.62	2.91	1.83	22.70	25.28
Serbia and Montenegro	1.52	0.67	1.84	1.36	15.88	33.20
Average	*1.67*	*0.95*	*2.49*	*2.07*	*25.68*	*24.82*
Commonwealth of Independent States						
Armenia	0.92	1.17	0.46	0.86	14.28	10.10
Azerbaijan	2.74	2.89	4.79	4.33	27.46	27.42
Belarus	1.49	1.11	1.07	0.97	23.97	21.65
Georgia	2.74	0.46	2.97	0.64	37.81	7.38
Kazakhstan	2.10	1.42	1.46	1.73	29.66	23.00
Kyrgyz Republic	3.70	2.46	2.41	2.16	43.70	52.85
Moldova	2.07	1.09	0.74	0.57	34.32	22.42
Russia	1.43	1.07	1.51	1.99	38.72	39.30
Tajikistan	2.60	1.07	1.82	1.10	35.08	21.33
Ukraine	2.19	1.52	2.12	1.80	34.93	27.53
Uzbekistan	1.45	0.99	1.06	1.40	20.24	21.37
Average	*2.13*	*1.39*	*1.86*	*1.60*	*30.92*	*24.94*
Overall average	***1.64***	***1.05***	***1.95***	***1.69***	***25.70***	***20.62***
Other countries						
Germany	-	0.40	-	1.71	-	8.17
Greece	-	0.49	-	1.02	-	22.48
Portugal	-	0.26	-	0.97	-	8.82
South Korea	-	0.06	-	0.47	-	8.20
Turkey	-	2.36	-	5.92	-	13.23
Vietnam	-	0.85	-	1.62	-	34.14

Sources: BEEPS 2002, 2004 and 2005.

[1] Bribe tax refers to typical unofficial payments/gifts to public officials as a percentage of annual sales. The figures reported are unweighted country averages.

[2] The kickback tax refers to the percentage of contract value that is typically paid in additional or unofficial payments/gifts to secure government contracts. The figures reported are unweighted country averages.

[3] The frequency of bribery is the percentage of respondents who agreed they have to pay some irregular payments/gifts for activities related to customs, taxes, licences, regulations or services frequently, usually or always.

Notes: The figures for other countries, except Turkey, are from the BEEPS survey carried out in 2004. Turkish figures refer to 2005. Statistically significant improvements are shown in orange, and statistically significant deteriorations are shown in blue (with 90 per cent confidence). Data for Turkmenistan were not available. The bribe tax and kickback tax for Turkey were calculated differently and are therefore not directly comparable with the data for other countries.

Table 1.7

Frequency of bribery by sector, 2002 and 2005

Types of corruption	CEB		SEE		CIS		Other countries 2004		
	2002	2005	2002	2005	2002	2005	Germany	Greece	Portugal
Public services	2.7	2.2	3.6	6.2	7.6	5.3	0.5	1.4	13.5
To get business licences	7.7	6.5	21.6	14.7	18.7	8.9	3.0	11.9	17.1
To get government contracts	16.8	16.8	21.0	20.2	13.0	13.4	13.5	7.7	10.8
Health and safety inspections	9.2	8.0	17.4	11.2	9.8	8.2	1.6	6.2	11.3
Fire and building inspections	7.8	6.2	12.8	6.8	15.6	13.9	0.8	5.4	8.4
Environmental inspections	6.1	4.5	9.3	5.2	9.1	8.0	2.1	2.7	6.4
Taxes and tax collection	6.0	5.6	18.3	12.1	23.0	21.3	1.1	17.4	14.5
Customs/imports	6.8	6.1	24.3	15.0	15.2	12.5	1.9	3.6	8.3
To deal with courts	3.8	4.7	14.9	14.0	7.3	16.2	0.3	2.6	9.9
To influence law making	3.9	4.5	7.3	5.8	4.4	4.1	3.4	1.8	1.4

Sources: BEEPS 2002, 2004 and 2005.
Note: Respondents were asked to report on how often they make unofficial payments in a given year for a range of public goods and services. The figures in the table represent the share of firms in each sub-region responding that such payments would be made frequently, usually or always in 2002 and 2005. The data for the CIS exclude Turkmenistan, where the survey could not be implemented.

researchers, even if confidentiality has been guaranteed.

Notwithstanding these potential shortcomings, the survey considered four aspects of bribery: unofficial payments or gifts as a share of annual sales (the bribe tax); the percentage of contract value that must be paid to secure a government contract (kickbacks); bribe frequency (how often rather than how much); and the distribution of bribes (what payments are made for).[4]

As Table 1.6 shows, the bribe tax has declined overall in the transition region from 1.6 per cent of annual revenues in 2002 to 1 per cent in 2005.[5] It has fallen most sharply in SEE (from 1.7 to around 1 per cent) and the CIS (from 2.1 to 1.4 per cent), although Armenia and Azerbaijan in the CIS and Hungary and Lithuania in the CEB region have recorded increases. Across the region, the bribe tax ranged from a high of 2.9 per cent in Azerbaijan to a low of under 0.2 per cent in Slovenia.

The overall decline in the bribe tax should be viewed in the context of rapidly growing economies in much of the transition region over the past three years. Because sales have grown for many of the firms in the BEEPS sample in that period, bribes as a share of annual sales (if they are fixed rather than adjustable) also would be expected to decline. Bribe payments in absolute terms, however, could still be significantly higher in 2005 than in 2002, even after adjusting for inflation.

The bribe tax in the transition countries does not compare favourably with the levels in several OECD countries. Bribes as a share of annual sales are 0.4 per cent on average in Germany (and lower in western regions than in eastern regions), 0.26 per cent on average in Portugal and 0.5 per cent on average in Greece.

Table 1.6 also shows that kickbacks have declined overall since 2002, despite considerable variation between countries. The percentage of contract value needed to secure a government contract rose in 10 of the 26 transition countries. It is high and rising in four (Albania, Bulgaria, Hungary and Russia) and high but stable in Azerbaijan and the Kyrgyz Republic.

The frequency of bribery also decreased overall between 2002 and 2005, particularly in the CEB countries. However, around 25 per cent of firms in SEE and the CIS countries still report paying bribes frequently, usually or always to get things done with regard to customs, taxes, licences, regulations and services (compared with only 8 per cent in Germany). Table 1.7 shows where bribe payments are most common across the transition sub-regions. Bribe frequency has declined for nearly all types of payments in all regions since 2002.

In CEB around 17 per cent of firms reported that kickbacks are a frequent practice. This is higher than in other OECD countries but about on a par with the frequency of kickbacks in eastern regions of Germany. The proportion of CEB firms citing frequent bribery related to business licensing, inspections, tax, customs and trade and dealing with the courts was below 10 per cent (but up to 20 per cent in SEE and the CIS). In the CIS bribe frequency in dealing with the courts shot up from around 7 per cent in 2002 to 16 per cent in 2005.

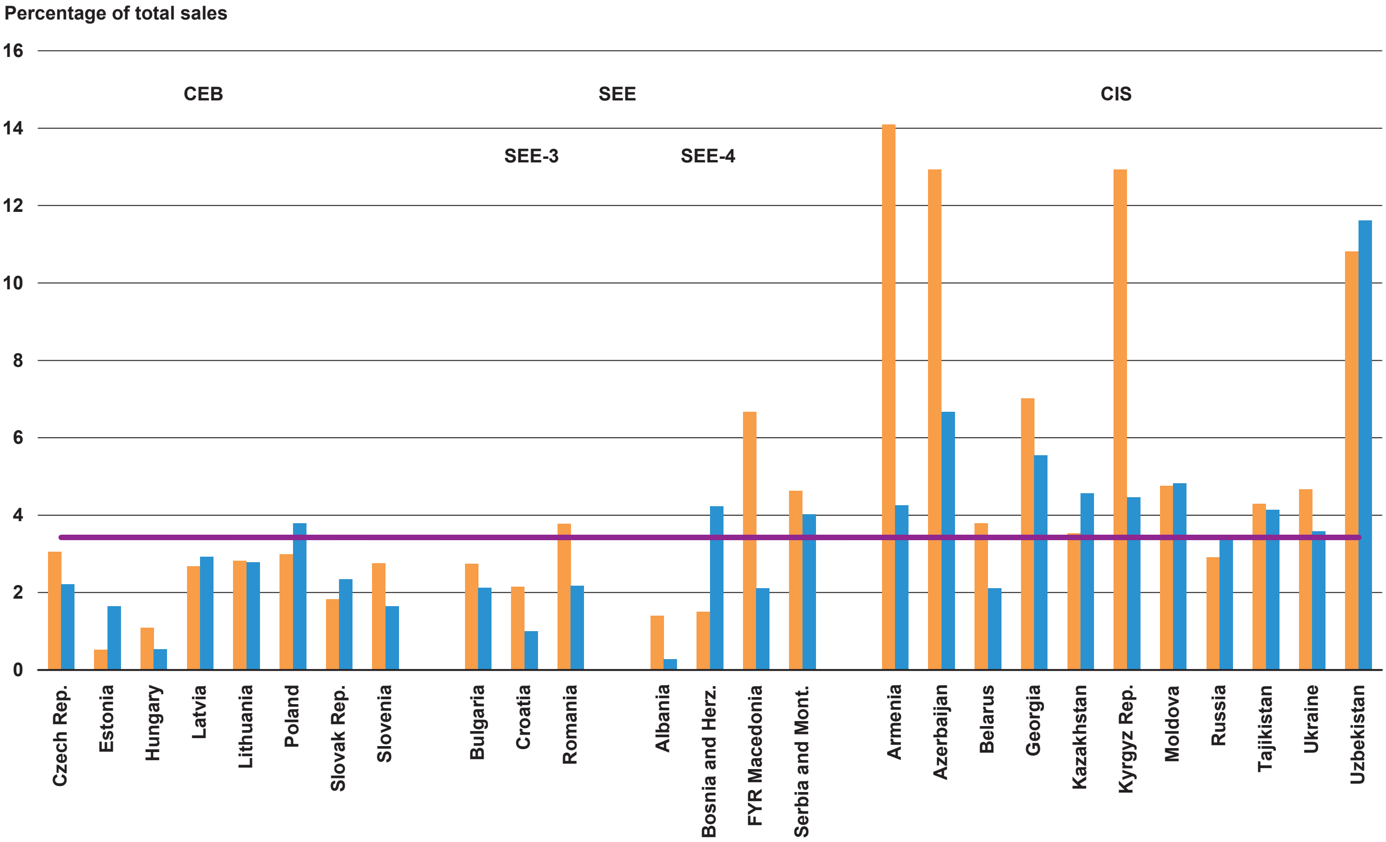
Crime

The clearest improvement in the business environment since 2002 concerns crime as an obstacle to doing business. Table 1.5 shows that, in all but three countries (Armenia, Azerbaijan and the Czech Republic), crime is viewed as a less significant obstacle to the growth and operation of business. This may reflect overall economic growth in the transition region, making more resources available for law and order reforms and providing more economic opportunities for groups that in the past may have turned to crime as a survival strategy.

The percentage of firms paying for security services declined from 61 per cent in 2002 to 55 per cent in 2005. The percentage paying organised criminal groups for protection (to prevent violence and property damage) also fell, from 17 per cent in 2002 to 8 per cent in 2005. Furthermore, average losses due to theft, robbery, vandalism or arson as a proportion of annual sales declined from 4.7 per cent in 2002 to 2.8 per cent in 2005 for the transition region as a whole — a level comparable with Germany, Greece and Portugal (see Chart 1.5).

Chart 1.5

Losses due to crime, as a share of sales, 2002 and 2005



Sources: BEEPS 2002 and 2005.

Note: Firms were asked to report the losses in total sales as a result of theft, robbery, vandalism or arson. The average loss for each country is calculated as an unweighted average of responses for those firms that reported experiencing such losses. Data for Turkmenistan were not available.

Regulations

The burden of state regulation on firms has declined in several areas, according to the BEEPS. As a broad indication of the overall burden imposed by state regulation, the BEEPS asks firms to report the percentage of time that senior managers spend dealing with public officials. This "time tax" fell from 7.8 per cent of senior managers' time in 2002 to 5.6 per cent in 2005, with an increasing proportion of firms – 46 per cent in 2005 as opposed to 31 per cent in 2002 – saying that senior managers spend no time at all on such bureaucratic matters. As Chart 1.6 shows, the decline in the time tax was evident in every region, and particularly in Georgia, Poland and Romania. It was notably worse (although from a low base in 2002) in Armenia and Azerbaijan.[6]

As a problem for doing business, tax administration has consistently ranked among the most onerous faced by firms, even surpassing tax rates for some. Between 2002 and 2005, assessments of tax administration as a problem for doing business improved only modestly. The percentage of firms indicating that tax administration is a significant obstacle to business declined from 54 per cent in 2002 to 49 per cent in 2005. Although perceptions of tax administration improved only slightly, the incidence of tax evasion declined markedly overall and quite sharply in some countries. In Georgia, for example, the reported percentage of income declared to tax authorities rose from 64 per cent in 2002 to 89 per cent in 2005. In the Czech Republic, where perceptions of tax administration deteriorated (see Table 1.5), reported declarations declined from 90 to 87 per cent.

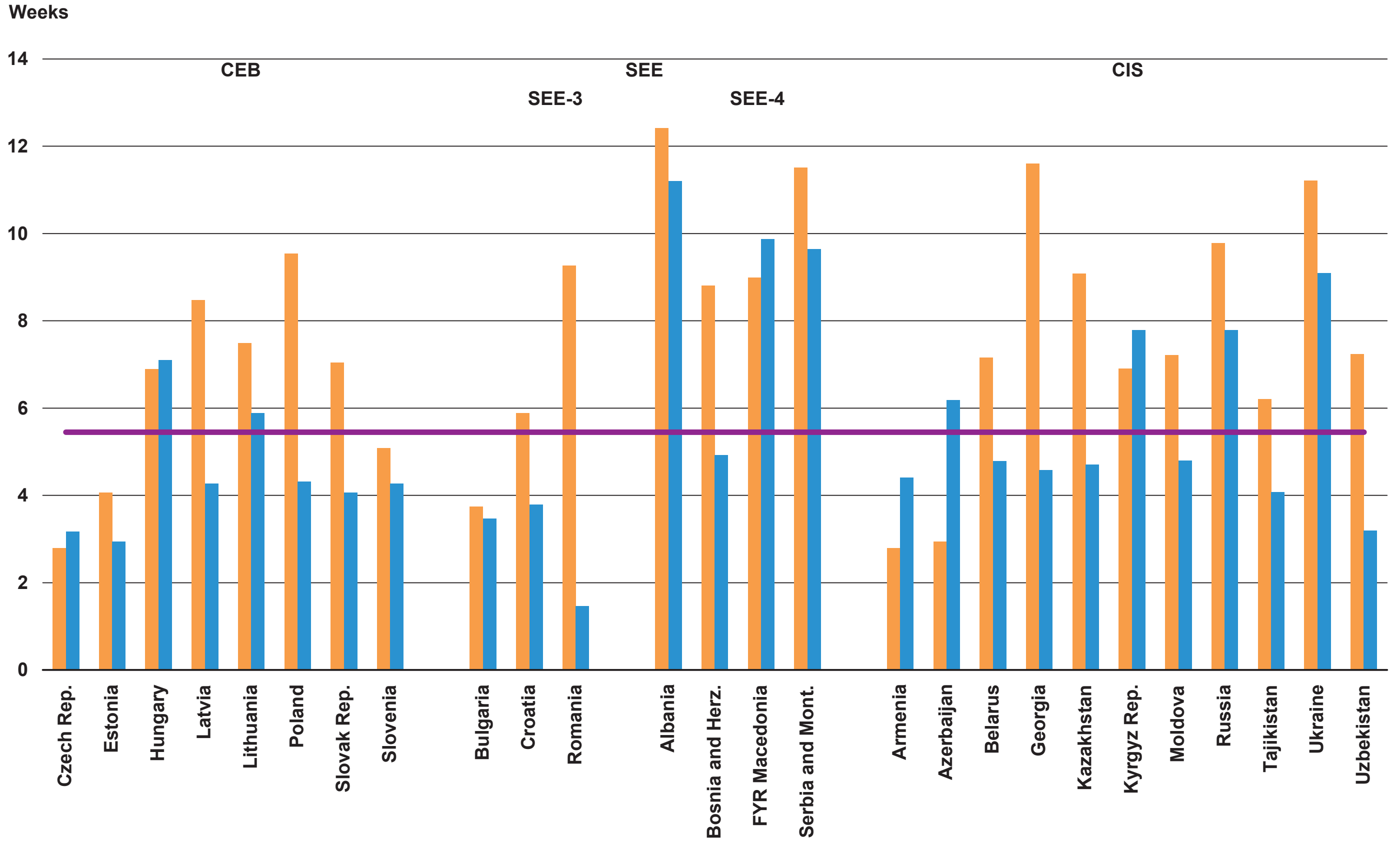
Firms in every region, especially those that import or export directly, perceived improvements in customs and foreign trade regulations in 2005. The biggest improvement was in the Slovak Republic, where only 13 per cent of trading firms thought regulations were problematic compared with 42 per cent in 2002. Improvements were also notable in the Baltic states and parts of the CIS. However, complaints about customs increased in Azerbaijan and the Czech Republic.

The general improvement in firms' perceptions of customs and trade regulations comes despite slightly longer delays in customs. The proportion of exporters whose goods took on average more than one day to clear customs increased from 42 to 56 per cent. However, the generally more positive assessments of customs regulations were matched by reports of less frequent unofficial payments at customs in every region (see Table 1.7). Paying fewer bribes would appear to have a greater impact on firms' perceptions of customs and trade obstacles than the length of customs delays.

Perceptions of business licensing as an obstacle to doing business have declined (see Table 1.5). Inspections are a natural

Chart 1.6

Average time spent by senior management in dealing with public officials, 2002 and 2005



Sources: BEEPS 2002 and 2005.

Note: Firms were asked to report the percentage of time senior management spent dealing with public officials on the application and interpretation of laws and regulations regarding access to public services over the past 12 months. The average ratio for each country is calculated as an unweighted average of firms' responses for 2002 and 2005. Data for Turkmenistan were not available.

part of business life which have a clear economic or social rationale (see Annex 3.1). However, they also entail costs for firms, most notably the time needed to comply. Every inspection also presents a potential opportunity for the firm to save these costs by making unofficial payments to inspectors. The frequency of such payments has declined markedly over the past three years, particularly in SEE (see Table 1.7). In the CIS there was an overall improvement but with significant variations between countries. For example, in Georgia the percentage of firms reporting frequent unofficial payments for occupational and safety inspections declined from 10 to 1 per cent; in Armenia, however, the frequency of payments in this area increased from 1 to 5 per cent.

One area of the regulatory environment that proved more problematic on average in 2005 is labour regulations. More firms in 2005 indicated that labour regulations posed a moderate or major constraint on the operation and growth of their business than in 2002. Labour regulations are perceived as a significant problem for a comparatively large proportion of CEB firms. This could reflect more stringent labour regulations associated with EU membership. In Estonia the percentage of firms indicating that labour regulations posed an important constraint rose from 20 per cent in 2002 to 53 per cent in 2005.

1.3 Conclusion

The EBRD transition indicators point to significant progress in reform, especially in building market-supporting institutions, over the past year. The BEEPS also indicates clear improvements in the business environment for most countries since the survey was last conducted in 2002. Across the transition region, reforms are advancing and governance is improving, with transaction costs of operating a business (including corruption, over-regulation and infrastructure bottlenecks) declining. In many cases, markets are responding with increased investment.

The clearest signs of improvement have been in the CEB countries. Some of these countries have put renewed energy into overdue reforms in large-scale privatisation, restructuring and financial sector development. They have also further strengthened their business environments and investment attractiveness by lowering costs associated with corruption and excessive regulation (except for labour regulation) and enhancing the enforceability of contracts. Markets have responded favourably, as reflected in higher investment, increased stock market capitalisation and more ready access to international capital markets.

The business environment and economic governance have also advanced in SEE over the last three years, coinciding with steady progress in reform over the same period. Regional averages for most of the indicators of institutional performance and regulation have improved since 2002. However, SEE countries must continue to implement institutional reform if they are to close the gap with CEB, which widened again this year. The relaxation in the pace of reform during 2004–05 could be a temporary effect of domestic political developments in the leading reformers, or it could be a reflection of a general weakening of the impetus for reform in the region.

Experience in CEB has demonstrated clearly the powerful impetus for reform that comes from the EU accession process. For the SEE countries that have not yet reached candidate status, it will be important to maintain a credible association process that continues to integrate these countries into European markets. This would reinforce external incentives for further market reforms and for beneficial regional integration among these countries.

In the CIS, progress in transition has been concentrated in those countries most committed to democratic and market-oriented policies and institutions. This suggests that political change – and the will to overcome the influence of entrenched interests – can be a powerful motivator for reform. In contrast, the limited commitment to democratic and market reform displayed recently in Russia, and more widely in Central Asia, puts those countries outside the transition mainstream. However, even the reform-minded CIS countries continue to face significant political resistance from privileged elites and divided populations.

The social consensus that kept CEB and EU candidate countries in SEE on track through the most trying years of transition may still elude even the committed reformers in the CIS. Although economic governance and the business environment are improving, high levels of corruption, weak institutions and regulatory barriers continue to erode trust among the population and limit the potential of firms to compete in the global market place. The task ahead for the CIS countries is, as before, to step up the pace of reform and to continue making improvements in the business environment that will encourage more investment and innovation.

Endnotes

1 Although there are some areas of overlap, the EBRD transition indicators and the World Bank's *Doing Business* indicators measure different aspects of economic development. In the past year, the top reformers from the transition region according to the World Bank's database include Serbia and Montenegro, Georgia and the Slovak Republic – which coincides with EBRD ratings for 2004–05 – but also lists Romania and Latvia, which were less prominent reformers according to the EBRD methodology. The World Bank's *Doing Business* indicators focus more intensively on business regulations and their enforcement than do the EBRD transition ratings. See the World Bank (2005).

2 The *Transition Report* has usually distinguished between liberalisation and privatisation on the one hand and reforms that build market-supporting institutions on the other. For a more in-depth discussion of initial-phase and second-phase reform, see the *Transition Report* 2001.

3 For a detailed examination of this problem, see the *Transition Report* 2004, Chapters 3 and 4.

4 To get around the problem of firms' reluctance to answer corruption questions honestly, the BEEPS asked respondents to comment on typical behaviour of "firms like theirs" or "firms in their industry" rather than their own conduct. In addition, respondents were reminded repeatedly of the confidentiality of their answers.

5 A large part of the decline is due to a significant increase in the number of firms reporting no unofficial payments at all. However, even after taking this into account, the bribe tax rate among those firms that do pay has declined since 2002.

6 The change for Armenia was not statistically significant.

References

World Bank (2005), *Doing Business in 2006: Creating Jobs*, Washington D.C.

Annex 1.1: Business Environment and Enterprise Performance Survey

In 2005 the EBRD conducted the third Business Environment and Enterprise Performance Survey (BEEPS) in collaboration with the World Bank. Covering more than 9,500 firms from 26 transition countries (plus Turkey), it exceeds by far the 1999 survey (covering 3,000 enterprises from 20 countries) and the 2002 survey (6,100 firms from 26 countries).

The types of firms taking part in the survey are described in detail in Table A.1.1.1. The distribution between manufacturing and service sectors was determined according to the sector's relative contribution to the GDP in each country. Firms operating in sectors subject to government price regulation and supervision, such as banking, electric power, rail transport, and water and waste water, were excluded from the survey.

Companies with 10,000 or more employees were also excluded, as were firms that started their operations in 2002 or later. Around 90 per cent of the firms surveyed were small and medium-sized enterprises. Most were privatised or had been in private ownership from the start of their operations. Foreign-owned companies (with foreign stakes of at least 50 per cent) and state-owned firms accounted for approximately 10 and 9 per cent respectively of the total sample.

The survey includes a group (or panel) of approximately 1,400 firms that have participated in both the 2002 and 2005 BEEPS (see Table A.1.1.2). The 2005 BEEPS also encompasses an additional 1,700 manufacturing enterprises from Armenia, Azerbaijan, Hungary, Kazakhstan, Moldova, Poland and Romania. A separate survey was conducted in 2004 (comprising some 3,300 enterprises) in five non-transition economies: Germany (approximately 1,200 enterprises), Greece (about 550), Portugal (about 500), South Korea (about 600) and Vietnam (about 500). This survey was conducted on the same basis as the BEEPS 2005.

One part of the BEEPS questionnaire asked firms to assess how the performance of the state, infrastructure services and financial institutions have affected their business operations (see Chapter 3). The BEEPS also asked enterprises about their own performance in terms of their investment activity, employment, growth and productivity (see Chapter 4). Seven broad areas of the business environment were identified: business regulation, labour, taxation, institutions and property rights, infrastructure, finance and the macroeconomic environment. Firms were asked to assess how problematic these factors are for the operation and growth of their business on a scale of 1 (minor obstacle) to 4 (major obstacle).

Table A.1.1.1

Firms participating in the BEEPS

Characteristics	Percentage
Sector	
Manufacturing	39
Services	61
Firm size (number of employees)	
Small (2 to 49)	70
Medium (50 to 249)	20
Large (250 to 9,999)	10
Ownership	
Privatised	75
New private	16
Foreign-owned	10
State-owned	9
Location	
Capital	32
Large cities (excluding the capital)	21
Small cities	23
Rural areas	24

Source: BEEPS 2005.
Note: Privatised firms were formerly state-controlled and are majority-owned by private domestic investors.
New private firms were never under state control and are majority-owned by domestic investors.
Foreign firms may be privatised or new private firms that are majority-owned by foreign individuals/ companies/ organisations.

Table A.1.1.2

BEEPS firms by country

Country	Total number of firms participating in BEEPS 2005	Panel firms participating in BEEPS 2002 and 2005	Additional manufacturing enterprises participating in BEEPS 2005
Albania	204	65	-
Armenia	351	49	150
Azerbaijan	350	68	150
Belarus	325	46	-
Bosnia and Herzegovina	200	16	-
Bulgaria	300	89	-
Croatia	236	61	-
Czech Republic	343	36	-
Estonia	219	69	-
FYR Macedonia	200	34	-
Georgia	200	58	-
Hungary	610	59	298
Kazakhstan	585	60	285
Kyrgyz Republic	202	40	-
Latvia	205	54	-
Lithuania	205	56	-
Moldova	350	32	150
Poland	975	78	395
Romania	600	64	285
Russia	601	41	-
Serbia and Montenegro	300	43	-
Slovak Republic	220	29	-
Slovenia	223	75	-
Tajikistan	200	18	-
Turkey	559	47	-
Ukraine	594	147	-
Uzbekistan	300	28	-
Total	**9,657**	**1,462**	**1,713**

Sources: BEEPS 2002 and 2005.
Note: The BEEPS could not be undertaken in Turkmenistan.

The changes between 2002 and 2005 are illustrated in Chart A.1.1.1 at the end of this annex. The results are calculated as follows:[1]

- Business regulation: weighted average of title and leasing of land, customs and trade regulations, business licensing and permits, and uncertainty about regulatory policies
- Labour: weighted average of labour regulations, and skills and education of available workers
- Taxation: weighted average of tax rates and tax administration
- Institutions and property rights: weighted average of functioning of the judiciary, corruption, street crime, theft and disorder, and organised crime
- Infrastructure: weighted average of telecommunications, electricity, transportation, and access to land
- Finance: weighted average of access to financing (for example, collateral requirements or unavailability of bank finance) and cost of financing (interest rates and charges)
- Macroeconomic environment: a separate component covering inflation and exchange rates.

The charts show changes to the business environment in transition countries overall, in CEB, SEE and the CIS and within 26 transition countries. The results of the 2002 BEEPS have been used as a benchmark to highlight the areas of the business environment which have improved or deteriorated between 2002 and 2005. The country averages are drawn from the main BEEPS sample of around 8,000 firms (excluding the additional manufacturing enterprises).

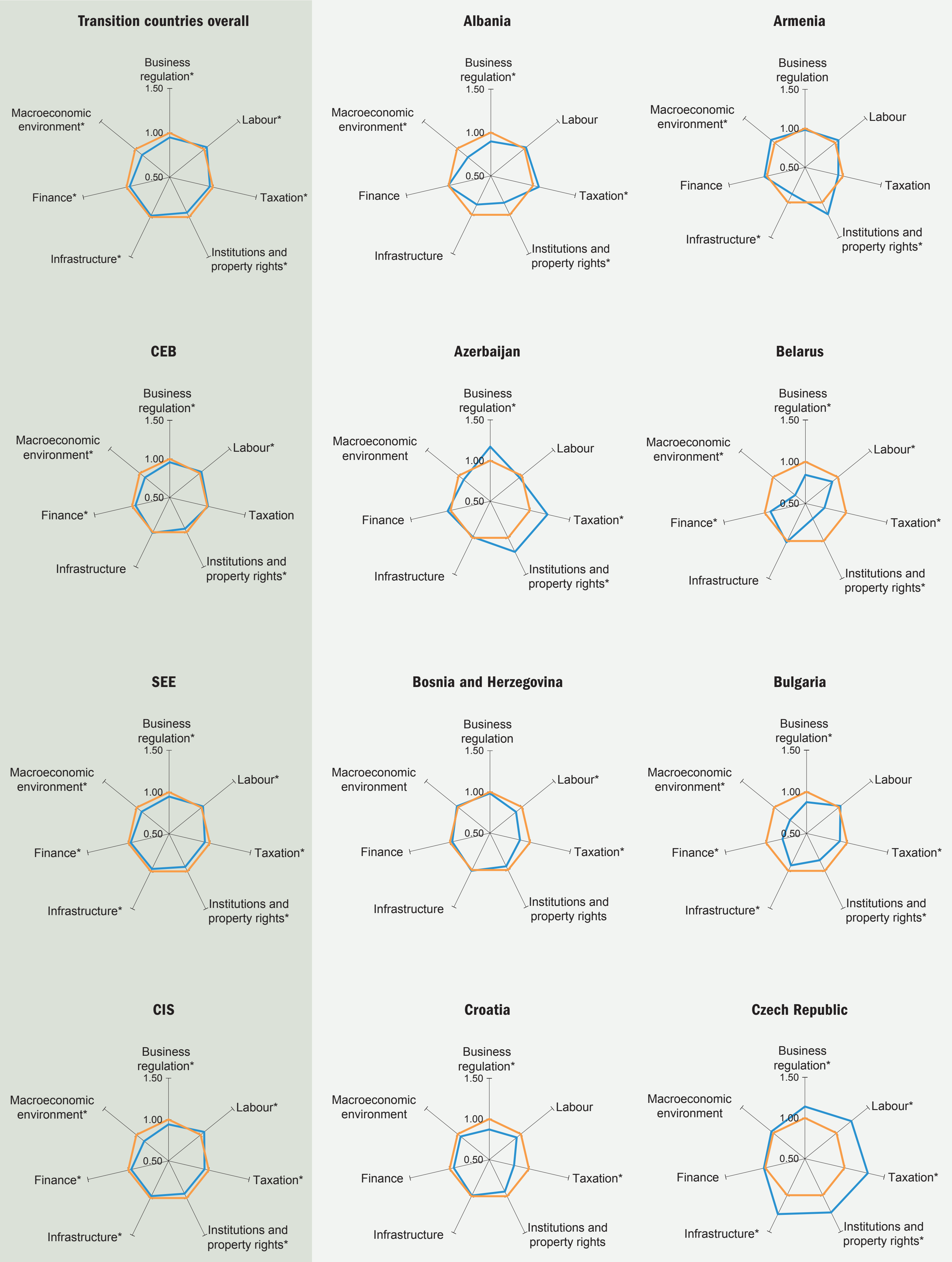
The BEEPS questionnaire and full dataset will be published shortly on the EBRD's web site.

Endnote

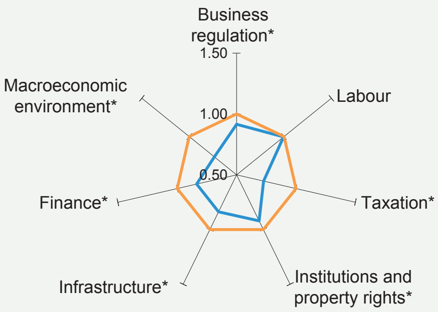
1 The weights assigned to the sub-components of the composite indices are determined according to a principal-component analysis (see Chapter 3 for details).

Chart A.1.1.1

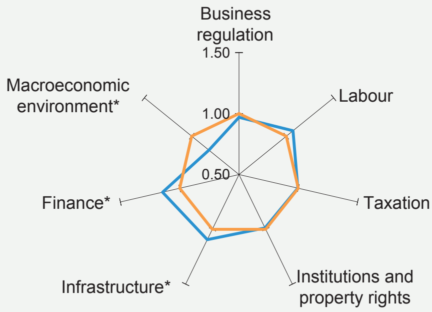
Changes in the business environment in transition countries, 2002–05



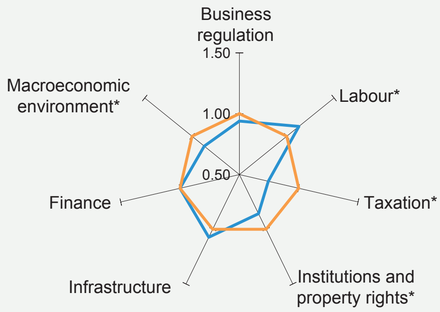
Estonia



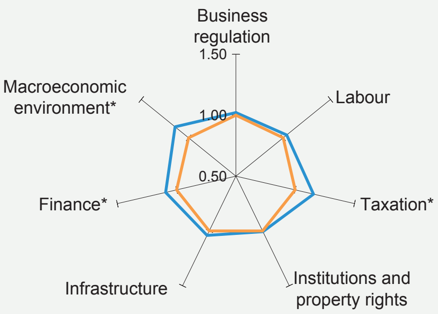
FYR Macedonia



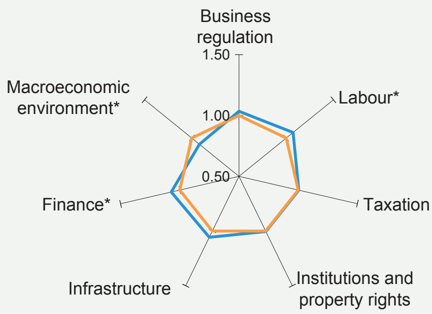
Georgia



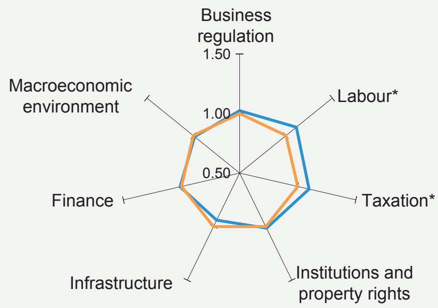
Hungary



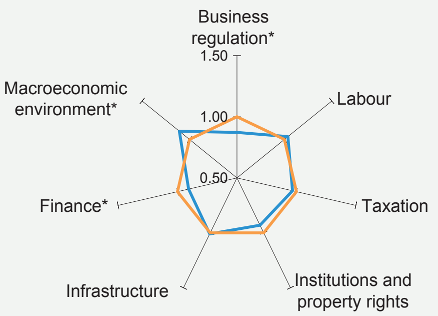
Kazakhstan



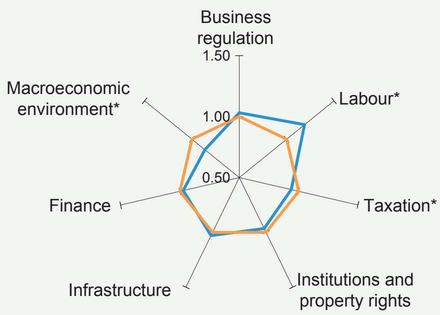
Kyrgyz Republic



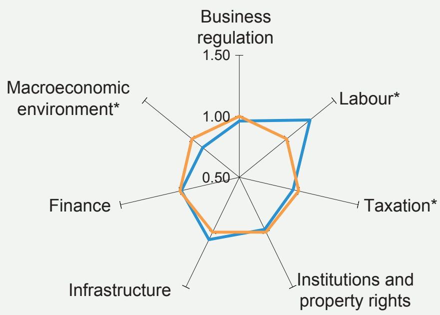
Latvia



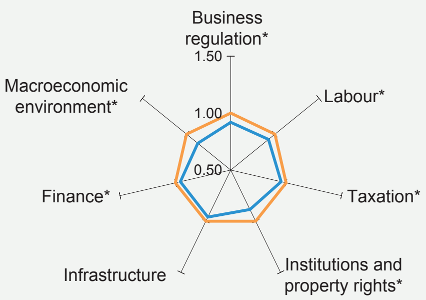
Lithuania



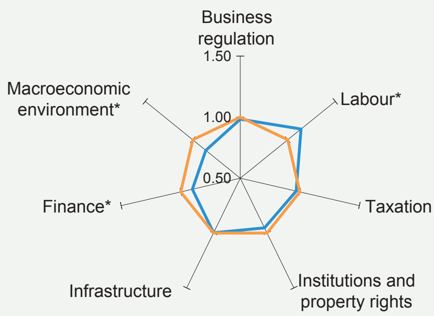
Moldova



Poland



Romania



■ Change between 2002 and 2005
■ 2002 benchmark

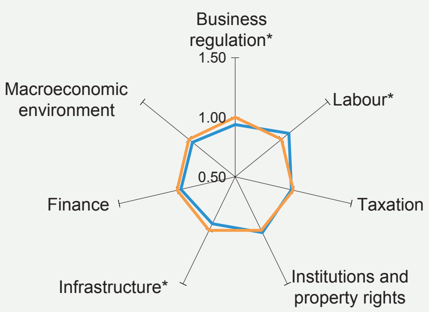
Sources: BEEPS 2002 and 2005.

Note: The spider charts show changes in seven aspects of the business environment between 2002 and 2005. The 2002 data represent a benchmark of no change. Where the line falls inside the benchmark, this represents an improvement in that aspect of the business environment. Where the line falls outside of the benchmark, this represents a deterioration in the business environment. Wherever the changes are statistically significant, the relevant categories are marked with an asterisk. The business environment was assessed on a scale from 1 (no obstacle) to 4 (major obstacle). The BEEPS could not be undertaken in Turkmenistan.

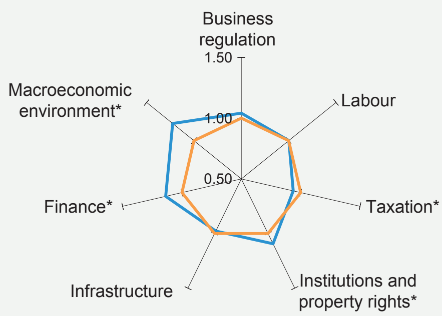
Chart A.1.1.1 (continued)

Changes in the business environment in transition countries, 2002–05

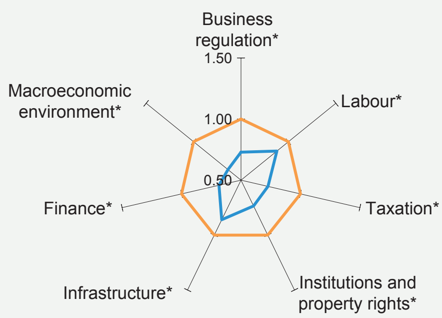
Russia



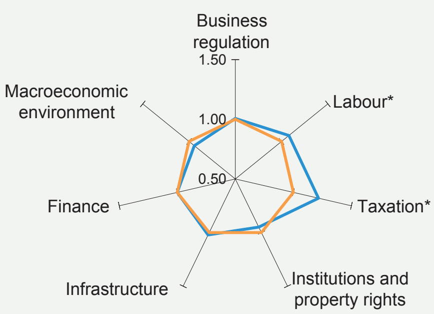
Serbia and Montenegro



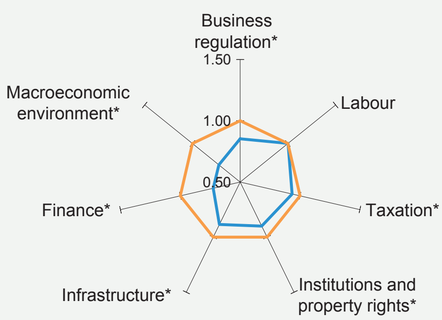
Slovak Republic



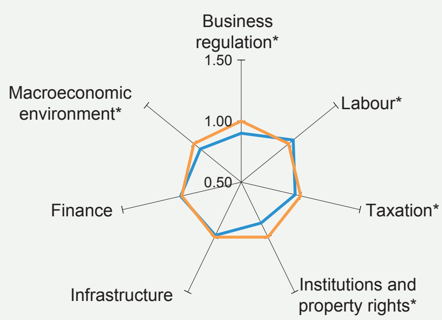
Slovenia



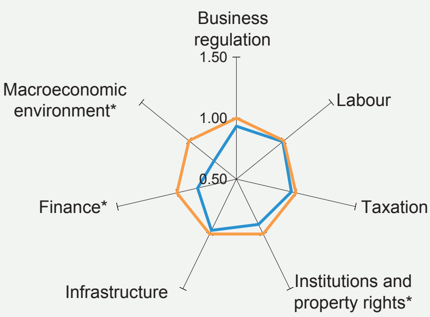
Tajikistan



Ukraine



Uzbekistan



■ Change between 2002 and 2005
■ 2002 benchmark

Sources: BEEPS 2002 and 2005.

Note: The spider charts show changes in seven aspects of the business environment between 2002 and 2005. The 2002 data represent a benchmark of no change. Where the line falls inside the benchmark, this represents an improvement in that aspect of the business environment. Where the line falls outside of the benchmark, this represents a deterioration in the business environment. Wherever the changes are statistically significant, the relevant categories are marked with an asterisk. The business environment was assessed on a scale from 1 (no obstacle) to 4 (major obstacle). The BEEPS could not be undertaken in Turkmenistan.

Annex 1.2: Corporate governance

This annex examines the extensiveness and effectiveness of corporate governance laws in the transition countries. Extensiveness – the quality of current laws – may be measured by comparing corporate governance legislation with a well-known international benchmark issued by the Organisation for Economic Cooperation and Development. Effectiveness – how these laws work in practice – can be gauged by the EBRD's Legal Indicator Survey, which this year focuses on the protection of minority shareholder rights in the context of related-party transactions.

Corporate governance, as defined by the Cadbury Report,[1] is "the system by which businesses are directed and controlled". According to the OECD, it involves "a set of relationships between a company's management, its board, its shareholders and other stakeholders" and it "provides the structure through which the objectives of the company are set and the means of obtaining those objectives and monitoring performances are determined".[2]

Sound corporate governance practices are essential for attracting investment. Evidence suggests that well-governed companies are able to raise funds at significantly lower costs than poorly managed firms.[3] This reflects the lower level of risk for non-controlling investors. Recent financial scandals confirm that poorly managed firms expose not only investors and shareholders to higher risks but also the company's employees, pensioners, creditors, consumers and suppliers.

Quality of legislation

This assessment considers the legal extensiveness of corporate governance laws and regulations (laws on the books) based on a checklist covering five aspects:[4]

1. rights of shareholders
2. equitable treatment of shareholders
3. role of stakeholders in corporate governance
4. disclosure and transparency
5. responsibilities of the board.

Legal experts from 27 transition countries were asked more than 140 questions relating to the checklist. Their responses were assessed and scores given for each answer. A weighted average was then calculated to reach an aggregate corporate governance score for each country.[5] Countries were then divided into five categories according to the overall grade assigned (see Table A.1.2.1), ranging from "very high" to "very low" compliance with international standards.[6]

High compliance countries

Nine countries have a "high" compliance rating, indicating a sound legal framework in line with the OECD Principles. FYR Macedonia has the best compliance rating, followed by Kazakhstan, Hungary and Lithuania. In FYR Macedonia the assessment reveals only minor flaws relating to the role of stakeholders in corporate governance. Hungary and Lithuania introduced a series of improvements in 2002 and 2003 to their company and securities market laws to bring their regulatory frameworks into line with the EU *acquis communautaire* – the main body of EU laws. As a result, only their legislation regarding the rights of shareholders shows some weaknesses. Kazakhstan's high rating is due mainly to a new Law on Joint Stock Companies enacted in May 2003 and to new accounting and financial reporting rules requiring compliance with International Financial Reporting Standards.

Medium compliance countries

Ten countries are deemed to have a legal framework generally in line with international standards despite a number of shortcomings. Slovenia has the lowest rating in central eastern Europe and the Baltic states (CEB), with particular weaknesses relating to disclosure and transparency. Estonia's rating is only slightly better, with deficiencies regarding board responsibility and disclosure and transparency. Croatia must improve disclosure and transparency and also the oversight of auditors' activities. In Albania and Serbia and Montenegro the assessment reveals some lack of compliance in disclosure and transparency although their overall legal frameworks are improving.[7] In the Kyrgyz Republic there were amendments to the Law on Joint Stock Companies in 2003 and 2004, which have improved the corporate governance framework on disclosure and transparency. However, problems relating to the protection of minority shareholders remain.

Low compliance countries

Four countries have a "low" compliance rating, implying serious shortcomings in their legislation when compared with international standards. In Bosnia and Herzegovina and in Romania the assessment reveals a need to improve legislation relating to disclosure and

Table A.1.2.1

Level of compliance with international standards for corporate governance

Very high compliance	High compliance	Medium compliance	Low compliance	Very low compliance
(none)	Armenia	Albania	Bosnia and Herz.	Azerbaijan
	FYR Macedonia	Bulgaria	Georgia	Belarus
	Hungary	Croatia	Romania	Tajikistan
	Kazakhstan	Czech Rep.	Turkmenistan	Ukraine
	Latvia	Estonia		
	Lithuania	Kyrgyz Rep.		
	Moldova	Serbia and Mont.		
	Poland	Slovak Rep.		
	Russia	Slovenia		
		Uzbekistan		

Source: EBRD Legal Indicator Survey 2005.

transparency.[8] In Turkmenistan, board responsibilities need to be extended and mechanisms for the protection of minority shareholders enhanced. The law does not regulate cross-shareholdings and there is currently no requirement for companies to prepare accounts on a consolidated basis. In Georgia, legislation does not give sufficient responsibility to boards for monitoring conflicts of interest among management, board members and shareholders, including the misuse of corporate assets.

Very low compliance countries

Four countries are judged to have corporate governance legal frameworks in urgent need of reform. Tajikistan is rated the lowest among all countries of the region. Its regulations on joint-stock companies do not provide minority shareholders with the necessary safeguards. In Belarus the overall disclosure rules need to be greatly improved.[9] In Ukraine, legislation defining the responsibilities of the board, the rights of shareholders and disclosure and transparency lag well behind international standards.[10] In Azerbaijan, transparency and disclosure requirements are insufficient, encouraging corruption and conflicts of interest.

Minority shareholder protection

To gauge how the law in each transition country protects minority shareholders – the focus of this year's Legal Indicator Survey – corporate governance experts in each country were asked to identify the remedies available to shareholders whose rights have been breached. These remedies exist in the civil procedural framework, which therefore needs to be consistent with the corporate framework.

The experts considered the specific instance of a shareholder with a 24 per cent stake in an unlisted joint-stock company who suspects that a related-party transaction has been entered into by the firm's management.[11] In the event that evidence of the transaction is established, the experts were asked to assess the extent to which the minority shareholder could use existing laws to obtain redress.[12] Related-party transactions have been identified as a major problem in transition countries and one of the main causes of recent financial scandals in Europe and the United States.[13]

Disclosure

Minority shareholders generally obtain information about their company at the annual general meeting, where they can verify its results through the annual financial documentation. In several transition countries the legislation and the accounting standards do not require related-party transactions to be registered in the annual report. Minority shareholders cannot, therefore, rely on the ordinary corporate documentation and must use other legal mechanisms to obtain the required information. The most common actions are to request access to company books or an independent audit, to question the company's auditor or to arrange an extraordinary shareholders' meeting to bring the management to account.

As Table A.1.2.2 shows, disclosure actions are limited in Estonia,[14] where minority shareholders only have the option

Table A.1.2.2

Legal mechanisms available to minority shareholders seeking disclosure

	Access to company books	Access to company's auditor	Independent audit	Court-appointed independent audit	Extraordinary shareholders' meeting	Other actions
Central eastern Europe and the Baltic states						
Czech Republic	No	No	No	No	Yes	Yes
Estonia	No	No	No	No	Yes	No
Hungary	Yes	Yes	Yes	Yes	Yes	No
Latvia	No	No	Yes	No	No	Yes
Lithuania	Yes	No	No	Yes	Yes	Yes
Poland	No	No	No	No	Yes	Yes
Slovak Republic	Yes	No	No	No	Yes	No
Slovenia	Yes	No	Yes	Yes	Yes	No
South-eastern Europe						
SEE-3						
Bulgaria	No	No	Yes	Yes	Yes	No
Croatia	No	No	Yes	Yes	Yes	No
Romania	No	No	No	Yes	Yes	No
SEE-4						
Albania	Yes	Yes	Yes	Yes	Yes	No
Bosnia and Herzegovina	Yes	Yes	Yes	Yes	Yes	No
FYR Macedonia	Yes	Yes	No	No	Yes	Yes
Serbia and Montenegro	Yes	No	Yes[1]	Yes[1]	Yes	Yes[1]
Commonwealth of Independent States						
Armenia	Yes	Yes	Yes	Yes	Yes	Yes
Azerbaijan	Yes	Yes	Yes	No	Yes	No
Belarus	Yes	Yes	Yes	Yes	Yes	No
Georgia	Yes	No	No	Yes	Yes	No
Kazakhstan	Yes	Yes	Yes	Yes	Yes	No
Kyrgyz Republic	No	Yes	Yes	Yes	Yes	No
Moldova	Yes	No	Yes	Yes	No	Yes
Russia	No	No	Yes	No	Yes	No
Tajikistan	Yes	No	No	No	Yes	No
Ukraine	No	No	Yes	Yes	Yes	No
Uzbekistan	Yes	No	Yes	No	Yes	No

Source: EBRD Legal Indicator Survey 2005.

Note: Data on Turkmenistan are not available. Data on Serbia and Montenegro do not include Kosovo.

[1] Legal mechanism not available in Montenegro.

to request a general shareholders' meeting to question the management. Any decision at such a meeting is adopted by a majority vote, leaving the minority shareholder with very little scope to pursue the action. Furthermore, the law does not provide for a request to the court for action in the case of management obstruction. As a result, minority shareholders can only rely on the annual financial documentation presented at the general meeting. Although such documentation is generally considered of good quality in Estonia, shareholders will have no other means of further investigation if they judge the information incomplete or incorrect.

Alternative mechanisms are available in other countries. In particular, minority shareholders in Armenia and Poland have the legal right to nominate a representative on the board. This should enhance supervision over a company's operations and discourage unethical behaviour by the controlling shareholders and the management.

Redress

The various remedies available to minority shareholders whose rights have been breached can be divided into actions before the civil or commercial court, arbitration proceedings and criminal prosecution.

Of the possible actions before the commercial court, filing a suit to challenge the validity of a transaction (render the transaction void) is one of the most common. As Table A.1.2.3 shows, it is available in most transition countries, with the exception of Bulgaria, Croatia, Estonia and Georgia, where only actions for damages are allowed. Another remedy is a liability suit against the company's management. This can be initiated by the shareholder (as a direct liability suit) or on behalf of the company (a derivative suit). In the former case, the plaintiff seeks redress for individual damages while the latter action targets damages suffered by the company. A direct liability suit may not be brought in Bosnia and Herzegovina,

Table A.1.2.3

Legal remedies available to minority shareholders seeking redress

	Challenge to validity of a transaction	Derivative liability suit	Direct liability suit	Derivative liability suit against the parent company	Direct liability suit against the parent company	Action against the parent company's subsidiary	National arbitration	International arbitration	Criminal prosecution	Other actions
Central eastern Europe and the Baltic states										
Czech Republic	Yes	Yes	No	No	No	No	Yes	Yes	Yes	Yes
Estonia	No	No	Yes	No	No	No	Yes	Yes	Yes	No
Hungary	Yes	Yes	No	No	No	Yes	Yes	Yes	Yes	No
Latvia	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Lithuania	Yes	Yes	Yes	Yes	Yes	Yes	No	No	Yes	No
Poland	Yes	Yes	Yes	No	No	No	Yes	Yes	Yes	No
Slovak Republic	Yes	Yes	No	No	No	No	Yes	Yes	Yes	No
Slovenia	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	No
South-eastern Europe										
SEE-3										
Bulgaria	No	Yes	No	No	No	No	No	No	Yes	No
Croatia	No	Yes	Yes	Yes	Yes	No	Yes	No	Yes	Yes
Romania	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
SEE-4										
Albania	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Bosnia and Herzegovina	Yes	No	No	No	No	No	No	No	Yes	No
FYR Macedonia	Yes	Yes	Yes	No	No	Yes	No	No	Yes	No
Serbia and Montenegro	Yes	Yes	Yes	Yes	Yes	Yes	Yes[1]	Yes[2]	Yes	Yes[1]
Commonwealth of Independent States										
Armenia	Yes	No	Yes	No	No	Yes	Yes	No	No	No
Azerbaijan	Yes	No	Yes	No	No	No	No	Yes	Yes	No
Belarus	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Georgia	No	No	Yes	Yes	No	No	Yes	Yes	Yes	No
Kazakhstan	Yes	No	No	No	Yes	No	Yes	Yes	Yes	No
Kyrgyz Republic	Yes	Yes	Yes	No	No	No	Yes	Yes	Yes	No
Moldova	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	No
Russia	Yes	Yes	No	Yes	Yes	No	Yes	Yes	Yes	Yes
Tajikistan	Yes	Yes	Yes	Yes	Yes	No	No	No	Yes	No
Ukraine	Yes	No	Yes	Yes	No	No	Yes	Yes	Yes	No
Uzbekistan	Yes	Yes	Yes	Yes	Yes	No	No	No	Yes	No

Source: EBRD Legal Indicator Survey 2005.

Note: Data on Turkmenistan are not available. Data on Serbia and Montenegro do not include Kosovo.

[1] Legal remedy not available in Montenegro.

[2] Legal remedy not available in Serbia.

Bulgaria, the Czech Republic, Hungary, Russia and the Slovak Republic. These countries also have no comprehensive definition of related-party transactions in their legislation.

Initiating a derivative suit requires specific legal provisions allowing a shareholder to represent a company in a legal action against the company's management. Such provisions are absent in Armenia, Azerbaijan, Bosnia and Herzegovina, Estonia, Georgia, Kazakhstan and Ukraine. Starting a liability action against the parent company is another option, provided that information on the controlling entity is available. This approach is an option in Albania, Belarus, Croatia, Latvia, Lithuania, Romania, Russia, Serbia and Montenegro, Slovenia, Tajikistan and Uzbekistan.

Parties to a dispute may also pursue their litigation through an arbitration court. Arbitration is available in most transition countries, provided that a specific clause is included in the company's charter or in a shareholder agreement. Criminal prosecution is possible in all transition countries although in some instances (such as Armenia) only a general action for fraud can be initiated. Overall, Bosnia and Herzegovina and Bulgaria appear to have the most limited legal frameworks for protecting minority shareholder rights.

Box A.1.2.1

A related-party transaction scenario

A joint-stock company, Alpha Ltd, is a leading firm in a transition country. Its registered headquarters is located in the main business centre within that country. Alpha is co-owned by two companies, Beta Ltd and Gamma Ltd.

Beta Ltd is the controlling shareholder with a 76 per cent stake. Its owner is an influential business leader, who also controls another company, Beta Holding Ltd, one of the main conglomerates in the country. Gamma Ltd is an investment company set up by a foreign investor. It owns a 24 per cent stake in Alpha Ltd. Alpha's board of directors is composed of three members, all appointed by Beta Ltd. Two of them also sit on Beta Holding's board.

Following an anonymous tip-off from an employee, Gamma has reason to believe that Alpha's directors have sold Alpha's property to a subsidiary of Beta Holding Ltd for 50 per cent less than its true worth.

According to the company's charter, such a transaction – that is, where a director has directly or indirectly a conflicting interest and which exceeds a given value – must be approved by the shareholders' meeting.

Gamma asks for legal advice on what can be done to:

- determine whether the transaction has indeed been entered into
- restore the status quo (by, for example, challenging the validity of the transaction)
- obtain damages for Alpha
- obtain damages for Gamma
- punish Alpha's directors and the majority shareholder (through, for example, criminal sanctions or disgorgement of profits).

The application of legislation

The remainder of this annex concentrates on the effectiveness of legislation in relation to disclosure and redress mechanisms available to minority shareholders. The 2005 Legal Indicator Survey examined a particular instance of related-party transaction and assessed the institutional environment in transition countries. A key problem with related-party transactions is that they can be used by controlling shareholders, managers and insiders as a means for extracting private benefits for themselves at the expense of minority shareholders.[15]

Legal practitioners in all 27 transition countries were asked how the corporate governance mechanisms would operate in their respective countries.[16] They were asked to advise a minority shareholder with a 24 per cent stake in a local, unlisted joint-stock company how to access corporate information to see if a related-party transaction had been entered into by the company and how to obtain compensation if damage had been suffered (see Box A.1.2.1). The effectiveness of legislation was then measured in terms of speed, enforceability, complexity, and the institutional environment (see Chart A.1.2.1).

Speed is the most straightforward factor. In disclosure cases, it refers to the time between the initial filing of proceedings with the court and the issuance of an executable court order, taking into consideration a possible appeal by the defendant. In cases of redress, it spans the period from the initial filing of the process to the court's executable judgement, again taking into consideration possible appeals by the defendant.

Enforceability relates to carrying out the executable judgement in cases where the other party fails to implement it. Enforcement of the rule of law is the central functional difference between developed market economies and transition countries. Enforcement – more than laws on the books – is key to effective corporate governance.[17] Complexity relates to the smoothness of proceedings and also takes into consideration the guidance offered by judicial precedents in interpreting the law.

The institutional environment includes a number of factors: judicial competence and experience, reliability of corporate books, auditor independence and the presence of international auditing firms in the country. It also reflects the extent to which outside influences, such as patronage and corruption, might influence the outcome of an action.[18]

The findings of the survey are necessarily limited and must be treated with some caution. First, they reflect the views of only a small number of practitioners. Secondly, they address a very specific set of circumstances and should be considered within the boundaries of the case study.

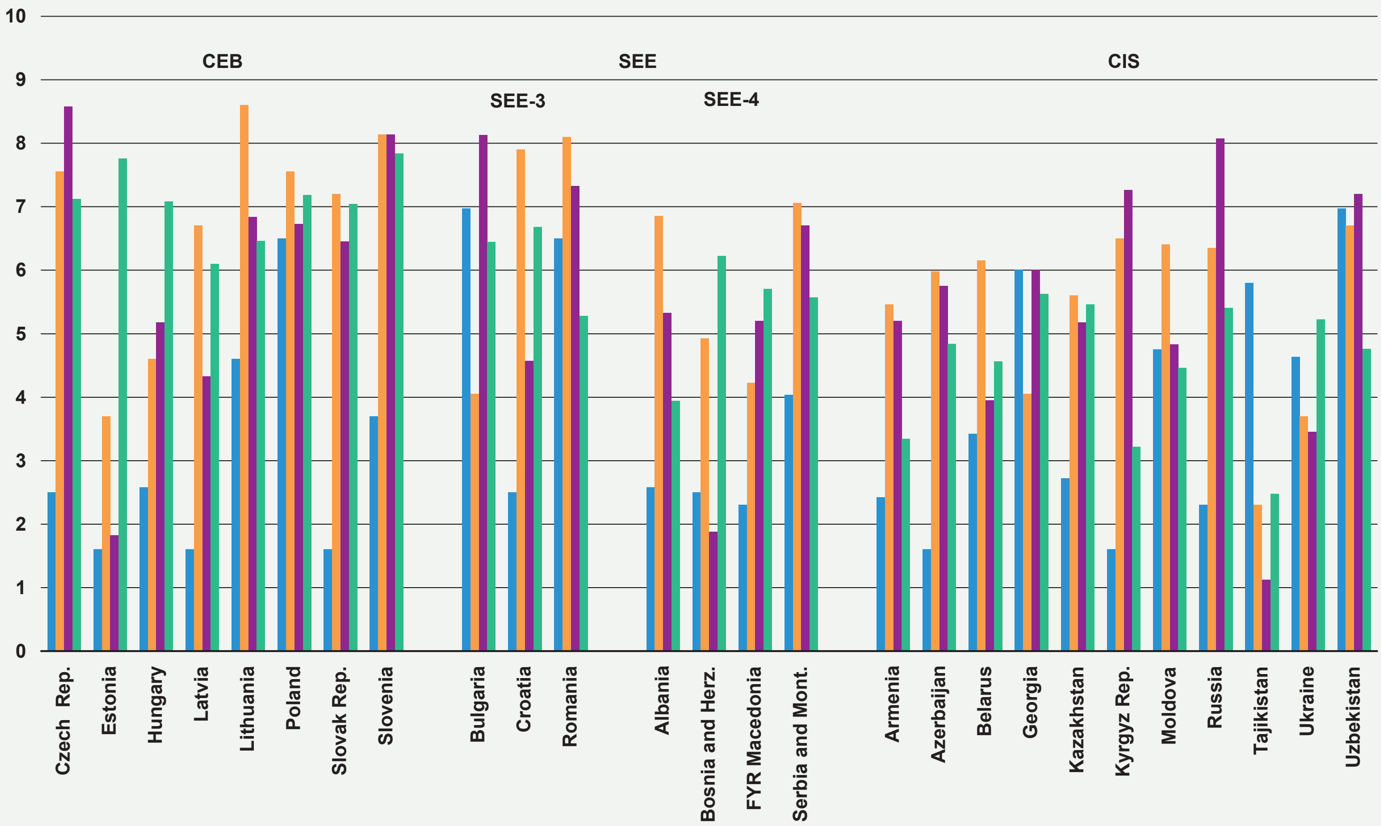
Effectiveness of disclosure

The first part of the analysis concentrates on how a minority shareholder might find out whether a related-party transaction has indeed been entered into by the company's management if the majority shareholder controls the board and does not spontaneously provide the requested information.

Disclosure is one of the key pillars of an effective corporate governance framework. As the Legal Indicator Survey reveals, only a few countries offer a legal system that provides minority shareholders with effective mechanisms to obtain disclosure. In many countries, minority shareholders face substantial problems and their actions can be easily blocked by majority shareholders.

Chart A.1.2.1

Effectiveness of disclosure to minority shareholders



Speed Enforceability Complexity Institutional environment

Source: EBRD Legal Indicator Survey 2005.

Note: The chart shows the scores for each country regarding the speed, enforceability, the complexity of procedures and the institutional environment. Scores are calculated on a scale of 0 to 10, with 10 being the highest possible score.

Data on Turkmenistan are not available. Data on Serbia and Montenegro do not include Kosovo.

Central eastern Europe and the Baltic states

Within the CEB region, the survey shows that legislation in the Czech Republic, Lithuania, Poland and Slovenia is perceived as having a reasonable level of effectiveness regarding disclosure. However, there are major problems in Estonia. The estimated time needed to obtain a court order varies from a few months in Poland to two or more years in the Czech Republic, Estonia and the Slovak Republic. Local practitioners reported that procedures are particularly complex in Estonia but generally clear and simple in the Czech Republic and Slovenia. While enforceability is a substantial obstacle in Estonia, it is considered particularly straightforward in Lithuania and Slovenia. Lastly, the institutional environment is deemed generally sound in all countries although Latvia has some weaknesses.

In Slovenia a number of actions are available to minority shareholders. Clear procedures and smooth enforceability are complemented by a sound institutional environment. Courts are considered generally competent and experienced and company books are regarded as reliable. Only the time needed to conclude an action – often exceeding one year – is deemed too long for obtaining disclosure.

In the Czech Republic (where the term "tunnelling" was first used to indicate company asset-stripping activities) related-party transactions must be registered in a specific report "on the relations between interconnected entities". This can provide minority shareholders with useful additional information. The institutional environment is deemed to be sound and procedures are considered clear and simple. Enforceability is generally efficient but can vary substantially depending on the type of action pursued. Only the time needed to conclude proceedings, which can exceed three years, is perceived as a problem. In Lithuania the length of proceedings can vary from six months to two years depending on the type of action.

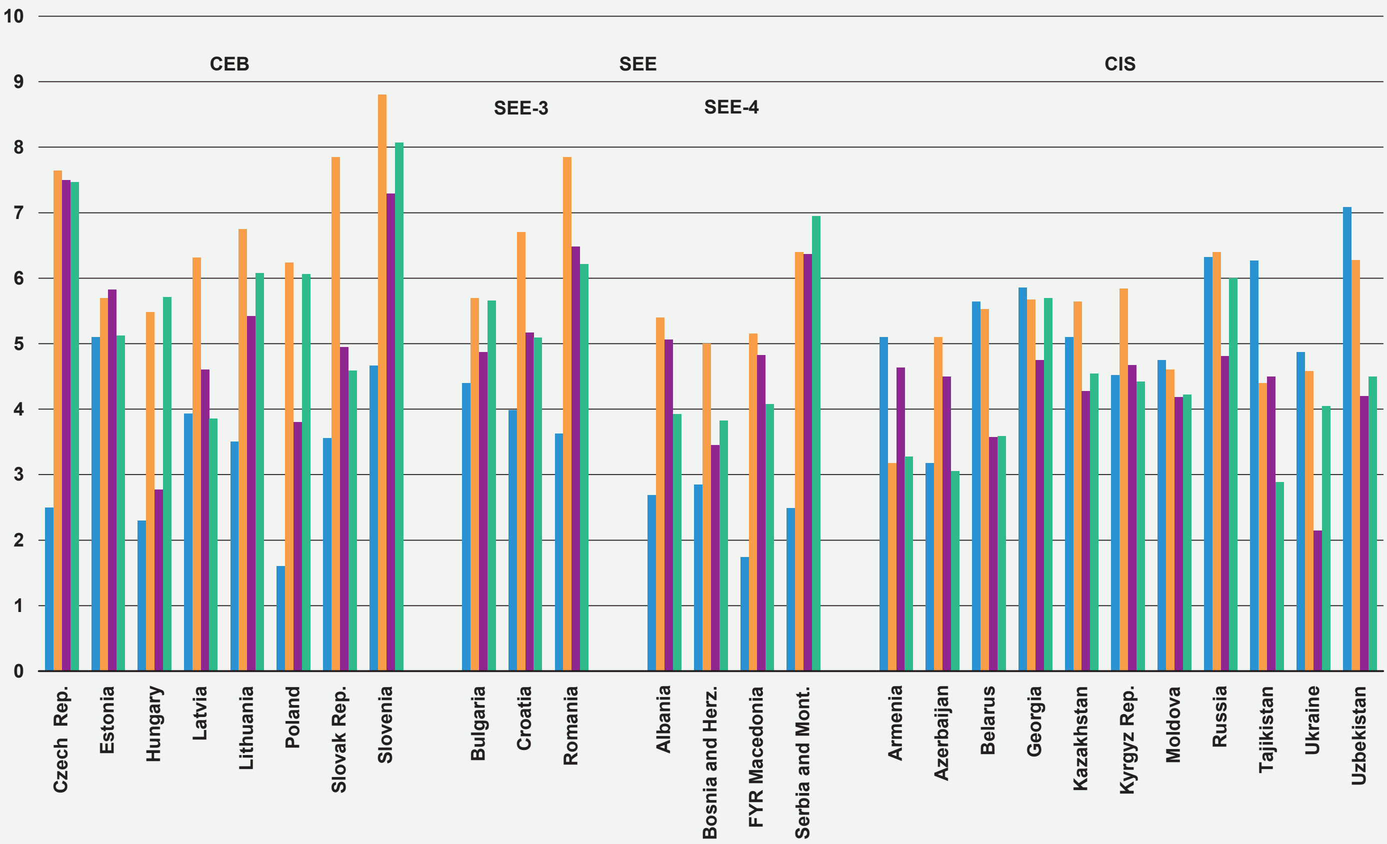
South-eastern Europe

In south-eastern Europe (SEE) a relatively effective framework for disclosure was reported in Bulgaria, Romania and Serbia and Montenegro. The average time needed to obtain a court order varies from a few months in Bulgaria and Romania to three or more years in Bosnia and Herzegovina. Procedures are also deemed complex and difficult to enforce in the latter country, especially if the defendant refuses to collaborate. The institutional environment is considered especially weak in Albania but relatively sound in Bulgaria and Croatia.

In Bosnia and Herzegovina, several courses of action are open to a minority shareholder but these do not have realistic prospects of enforcement if the controlling shareholder refuses to collaborate. In Albania the average time needed to get a court order is about six to eight months (although a defendant has several means of delaying the procedure) and procedures are not deemed particularly complex or difficult to enforce. However, the institutional environment is weak.

Chart A.1.2.2

Effectiveness of redress for minority shareholders



Speed | Enforceability | Complexity | Institutional environment

Source: EBRD Legal Indicator Survey 2005.

Note: The chart shows the scores for each country regarding the institutional environment, the complexity of procedures, enforceability and speed. Scores are calculated on a scale of 0 to 10, with 10 being the highest possible score.

Data on Turkmenistan are not available. Data on Serbia and Montenegro do not include Kosovo.

Company books are considered generally unreliable, statutory auditors are usually unable to act independently and courts are inexperienced in corporate cases.

Commonwealth of Independent States

In the Commonwealth of Independent States (CIS) there are substantial shortcomings in the legal framework for disclosure in all countries. Tajikistan has the least effective legislation. Procedures are deemed very long in Azerbaijan and the Kyrgyz Republic, and especially complex in Tajikistan. Enforceability is considered a problem in Georgia, Tajikistan and Ukraine, and the institutional environment particularly weak in Armenia, the Kyrgyz Republic and Tajikistan.

In Tajikistan there are no specific law enforcement proceedings and court executors do not have the necessary enforcement authority, particularly against a powerful defendant. This is further undermined by the generally weak institutional environment. Corporate information is considered reliable for only a minority of companies, statutory auditors are not generally thought to be independent and courts are inexperienced in such cases.

In Georgia, asking the court to appoint an independent auditor and/or calling a general shareholders' meeting to question the company's management are deemed the best mechanisms to obtain disclosure. However, such procedures are quite complex and difficult to enforce. In the Kyrgyz Republic several courses of action are available to minority shareholders but the procedures are likely to last more than a year. Furthermore, given the weak institutional environment, the outcome of any action is unpredictable. Company books are considered unreliable and may therefore be useless even if disclosure is obtained.

In Russia, requesting an internal audit of the company's financial documentation is considered the most effective action. The procedure is clear and the time usually limited to five months although the enforcement can be problematic due to several deficiencies in the Russian court system.

Effectiveness of redress

Once evidence of a related-party transaction has been secured, the legal framework must offer effective mechanisms to obtain redress. Local practitioners were asked to assess the complexity, enforceability and speed of the available actions before the commercial court, arbitration bodies (national and international) and criminal prosecution authorities. The results are shown in Chart A.1.2.2.

In all transition countries except Bosnia and Herzegovina and Bulgaria (see Table A.1.2.3), minority shareholders have several options for legal action. However, the effectiveness varies from country to country. In many instances, minority shareholders can face endless delays, long procedures and enforcement difficulties.

CEB

Among CEB countries, the Czech Republic and Slovenia appear to have the most effective mechanisms for redress while Hungary, Latvia and Poland show flaws. The estimated time needed to obtain an executable judgement varies across the region from about one year in Estonia and Latvia to two or more years in the Czech Republic, Hungary and Poland. It should be noted that in all transition countries the first-instance judgement can be appealed (with the effect of suspending its execution). Regarding complexity, local practitioners reported that redress procedures can be particularly awkward in Hungary and Poland but are generally straightforward in the Czech Republic and Slovenia. Enforcement can be problematic in Hungary but is considered simple in Slovenia.

Survey results for Slovenia confirm that the corporate governance framework is as effective for redress as for disclosure. The Czech Republic similarly has a sound institutional environment, with effective enforcement and clear procedures. The only relative weakness in both countries is the time needed for concluding an action (often exceeding two years).

SEE

Romania and Serbia and Montenegro have the most effective legislation in the SEE region regarding redress. Major weaknesses are evident in Bosnia and Herzegovina. The average time needed for obtaining an executable judgement varies from 18 months in Romania to more than five years in Serbia and Montenegro.

Challenging the validity of a related-party transaction is the only legal remedy available in Bosnia and Herzegovina. Courts have a backlog of cases and, despite strict time limits set by law, the complex legal proceedings can drag on for several years. Legal effectiveness is further undermined by a weak institutional environment. Bulgaria also offers only one course of legal redress – the derivative liability suit may sometimes have a positive outcome but the procedure is unclear and can lead to enforcement difficulties. The time required to reach an executable judgement can be anything up to two years and the defendant can easily delay the process further.

In Romania and Serbia and Montenegro, minority shareholders can choose between several different procedures which are generally deemed clear and enforceable. While in Montenegro the time needed to conclude proceedings is generally limited, courts in Serbia are not bound by any mandatory deadlines and the procedures can last up to 10 years.

CIS

As with disclosure, the legal framework for redress is deficient in all CIS countries. Enforceability is a problem across the region, and procedures are deemed particularly complex in Kazakhstan, Ukraine and Uzbekistan. Also, the institutional environment has significant flaws in all countries. Surprisingly, however, the time needed to obtain an executable judgement is generally short (with the exception of the Kyrgyz Republic).

In Russia, challenging the validity of the transaction is reported as the most effective action but the enforcement can be problematic. Courts are not very experienced in corporate cases and a powerful defendant can easily delay the procedure. Arbitration procedures are available but they can be complex and the award may be difficult to enforce. Armenia and Tajikistan are considered to have the least effective legislation, judicial competence and enforcement capacity for minority shareholder redress.

Conclusion

The 2005 Legal Indicator Survey confirms that related-party transactions remain an issue for concern in all transition countries. The degree to which minority shareholders can obtain effective disclosure or redress is limited and well below what could be expected in terms of prevailing legislation. Although the law in some countries reflects internationally recognised principles – for example, in Armenia and FYR Macedonia – its effectiveness is deficient in most of the region. Conversely, Slovenia, which is rated the lowest among CEB countries in terms of extensiveness of legislation, has the most effective laws. In particular, the country has built a sound institutional environment for corporate governance despite legislative priorities focusing in recent years on the adoption of the EU *acquis communautaire,* which does not specifically address the issues of minority shareholder protection.

In cases of related-party transactions, disclosure and redress are closely linked. This is because an action for redress can only be initiated when evidence is secured. The assessment reveals that requesting a general shareholders' meeting is the most common action provided by law to minority shareholders but it is unlikely to produce any disclosure when the company is controlled by a powerful shareholder. Requesting an external independent audit is a far more effective solution, especially when the "big four" auditors are present in the country and when the law adheres to international accounting and auditing standards. In cases of obvious misconduct, criminal proceedings are available by law in all countries in the region but the vast majority of contributing practitioners expressed serious doubts as to the experience and competence of prosecutors in corporate cases.

Two main conclusions may be drawn. First, countries that have developed a solid institutional environment can generally offer an effective legal framework. Nevertheless, as demonstrated by the issue of disclosure in Estonia, this alone is not enough to give minority shareholders adequate protection against illicit behaviour by controlling shareholders. The sound environment needs to be coupled with a corporate governance framework in line with international standards and with an effective civil procedural framework.

Secondly, even excellent laws can suffer from poor implementation. This undermines the usefulness of legal provisions and diminishes the confidence of foreign investors in the legal system as a whole – in particular, in its ability to uphold contractual rights. Most transition countries need to upgrade their commercial laws to standards that are generally acceptable internationally. Even more importantly, they must make those laws fully effective, particularly through strengthening their court systems, tackling corruption and adopting appropriate measures to strengthen the rule of law.

Endnotes

1 *The Financial Aspects of Corporate Governance*, known as the Cadbury Report, was the first code of corporate governance to advocate disclosure of compliance with a code of best practices by listed companies. The code, sponsored by the London Stock Exchange, the Financial Reporting Council and the accountancy profession, was developed by a committee chaired by Sir Adrian Cadbury in response to financial scandals in the late 1980s and early 1990s.

2 Preamble of the *Principles of Corporate Governance* (OECD).

3 See, for example, La Porta et al. (1999).

4 The assessment is based on legislation in force as of 30 September 2003. In some cases, footnotes provide indications of new legislation enacted after that date. The checklist is available at www.ebrd.com/country/sector/law/corpgov/assess/check.pdf. The checklist is based on the OECD *Principles of Corporate Governance* issued in 1999. The Principles were revised in 2004.

5 Questions in the checklist were given a weight according to their importance. A preliminary score was then finalised, taking into consideration the country's overall efforts in improving the corporate governance-related legal environment, promoting good corporate governance understanding and practice, and other ongoing related reform initiatives.

6 The 2004 corporate governance assessment is available at www.ebrd.com/country/sector/law/corpgov/assess

7 In Serbia and Montenegro a new company law was enacted in 2005, substantially improving the existing legal framework. However, corporate governance legislation differs in Serbia, Montenegro and Kosovo. In Albania a new law establishing auditing standards is due to enter into force in 2006 and will create a new National Accounting Committee.

8 The Romanian framework was improved in 2005 with the enactment of new provisions aimed at harmonising national law with EU legislation. However, it is too early to evaluate whether these provisions have addressed the failings identified in the assessment.

9 In 2005 an amendment to the Law on Joint-Stock Companies was enacted, partially improving the corporate governance framework.

10 On 1 January 2004 the Civil Code and the Commercial Code entered into force, substantially amending the existing legal framework. However, the new legislation is not always coherent and may create legal confusion.

11 A related-party transaction can be defined as a business deal or arrangement between two parties who are linked by a special relationship prior to the deal. For example, a business transaction between a major shareholder and the corporation, such as a sales contract, would be deemed a related-party transaction.

12 Remedies are based on the assumption that the controlling shareholder is not collaborating with the minority shareholder.

13 See, for example, OECD (2004a and b).

14 In Estonia the legislation provides that the court may only consider a request to appoint an independent auditor from shareholders holding at least 25 per cent of the company's shares.

15 See also OECD (2004b).

16 Among others, the following law firms contributed to and supported the 2005 Legal Indicator Survey: Studio Legale Tonucci (Albania and Romania); Chadbourne & Parke LLP (Azerbaijan, Belarus, Kazakhstan, Kyrgyz Republic, Russia, Ukraine, Uzbekistan); Advokat (Bosnia and Herzegovina); Spasov and Bratonov Lawyers Partnership (Bulgaria); Wolf Theiss (Croatia and Serbia and Montenegro); Linklaters (Czech Republic, Poland and Slovak Republic); Luiga, Mugu & Borenius (Estonia); Mgaloblishvili, Kipiani, Dzidziguri (MKD) Law Firm (Georgia); Ormai es Tarsai CMS Cameron McKenna (Hungary); Sorainen Law Offices (Latvia); Lideika, Petrauskas, Valiunas & Partners (Lithuania); Law Office Polenak (FYR Macedonia); Turcan & Turcan (Moldova); Colja, Rojs & partnerji o.p., d.n.o.i. (Slovenia); Akhmedov, Aziziv & Abdulhamidov, Attorneys (Tajikistan).

17 See Berglöf and Claessens (2004).

18 When considering disclosure, the institutional environment index consists of the perceived reliability of company books, the requirement to have the corporate financial information audited, the presence of the "big four" auditing firms in the country and the perceived independence of statutory auditors. When considering redress, the institutional environment index consists of the perceived degree of competence and experience of courts and prosecutors, the availability of up-to-date legislation, the ease with which the defendant can delay the proceedings and the perceived influence that might be exercised on courts and prosecutors by a powerful defendant.

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The macroeconomic environment for transition

2

The transition countries have maintained a strong macroeconomic performance. Although the external environment this year is not as favourable as in 2004, the forecast is for average growth of 5.3 per cent in 2005 (compared with the record 6.6 per cent achieved last year). Domestic demand and, to a lesser extent, net exports continue to drive growth across much of the region. Rapid expansion in domestic credit is sustaining consumption and investment but in many instances widening external imbalances. This expansion has supported financial intermediation across the region and helped the development of the less advanced economies. However, it has also raised concerns about the quality of loan portfolios and about possible risks to the banking sector and wider macroeconomic stability.

In central eastern Europe and the Baltic states (CEB) the boom in investment and exports that occurred last year is showing signs of subsiding. Nevertheless, GDP growth is still forecast to average 4.2 per cent for 2005 as a whole (down from 5.1 per cent in 2004). However, the Czech Republic, Hungary, Poland and the Slovak Republic are struggling to improve their fiscal positions in line with EU requirements.[1] In addition, current account deficits remain substantial in almost all CEB countries (except Poland and Slovenia), particularly in the Baltic states and Hungary.

In south-eastern Europe (SEE) the maintenance of political stability, some further progress with structural reforms and the prospect of EU accession for the SEE-3 countries (Bulgaria, Croatia and Romania) continue to underpin economic growth.[2] This is forecast at 4.8 per cent for 2005 compared with 6.5 per cent in 2004. While external imbalances remain substantial across the region, many countries (particularly Bulgaria and Romania last year) have shown further success in strengthening their fiscal positions. Inflation is expected to decrease in most countries although it remains at double-digit levels in Serbia and Montenegro.

In the Commonwealth of Independent States (CIS) growth is forecast to slow to 6.2 per cent in 2005 from 7.9 per cent in 2004. Although oil prices continue to rise, many of the oil-exporting CIS countries are beginning to suffer from capacity constraints and inadequate levels of domestic investment. Growth in the Russian economy, the region's largest, is forecast to slip to 6 per cent in 2005 from 7.1 per cent in 2004

Chapter 2 at a glance

- The transition countries continue to grow strongly, supported by rapid growth in domestic demand and net exports.
- In the new EU states of central Europe the main challenges include tackling fiscal deficits and reducing current account deficits. Addressing the current account is also a key issue in south-eastern Europe.
- The CIS needs to keep rising levels of inflation under control and resist pressures to spend fiscal surpluses generated by high oil prices.
- Private sector credit has expanded rapidly across the transition countries, reflecting much-needed deepening in financial markets.
- Growth in credit is helping to spur economic development but combined with weaknesses in the banking system or in individual banks it may make the financial sector vulnerable.

as a result of a marked deceleration in domestic investment (partly reflecting uncertainties in the business environment). At the same time, inflation and fiscal spending are on the increase in some of the bigger CIS economies.

Strong growth in domestic demand, which has underpinned growth across the transition region, has been fuelled by a rapid expansion in domestic credit to the private sector. Much of this expansion reflects the increase in financial services that accompanies economic development and convergence with the fully-fledged financial systems of advanced economies. Cyclical factors and possibly temporary gains in asset valuations have also played a role. Whatever its causes, the rapid growth of credit may strain the stability of banking systems. The ability of the banking sector to withstand domestic or external shocks will be in doubt if large individual banks perform poorly or the system as a whole is seen as vulnerable.

The remainder of this chapter looks at macroeconomic developments in 2004 and the first half of 2005 in more detail. It also examines the causes, characteristics and risks inherent in the rapid expansion of banking sector credit. It concludes with a review of policy options for addressing macroeconomic and financial vulnerabilities. An annex to this chapter provides tables on a number of key macroeconomic indicators and includes forecasts from a variety of institutions for growth and inflation in 2005 and 2006 (see Annex 2.1).

2.1 Macroeconomic performance

Global economic environment

The global economic environment has become less favourable for transition countries over the past year (see Chart 2.1). The IMF forecasts that GDP growth in 2005 will slow to 3.5 per cent in the United States (from 4.2 per cent in 2004), 1.2 per cent in the eurozone (from 2 per cent), 2 per cent in Japan (from 2.7 per cent) and 9 per cent in China (from 9.5 per cent).[3] Within the eurozone – the transition region's main export market – short-term prospects remain poor. France, Germany and Italy continue to experience weaknesses in domestic demand and growth. This could in turn dampen growth prospects for transition countries over the next couple of years.

Growth in the United States is also forecast to slow in 2005, particularly in the aftermath of Hurricane Katrina. The hurricane led to the temporary shut-down of almost all of the oil and gas production in the Gulf of Mexico in August, which could result in petrol shortages and further price rises. In addition, the cost of the disaster and relief measures will compound the already high general government deficit. In the medium term, the likelihood of continued high fiscal and current account deficits could affect confidence in US financial assets and trigger a slide in the foreign exchange value of the dollar. A drop in overall consumer demand could also result from petrol price rises and a potential fall in property prices. Few transition countries are heavily dependent on US growth. Nevertheless, lower US growth, particularly if combined with weaker demand from China, would have an adverse impact on the general health of the global economy.

China is an important market for some of the transition region's commodity exports and for Central Asia. The Chinese economy is forecast to decelerate in 2005–06 as the government's efforts to curb over-investment take effect. Figures for the first half of 2005 already show some easing in export and fixed-investment expansion, and further reductions are likely. In addition, the abolition in July 2005 of the Chinese currency's peg to the US dollar may result in its gradual appreciation against the dollar and dampen growth prospects further.

Despite weakening global growth prospects, oil prices have continued their upward trend, rising by 72 per cent in the first eight months of 2005 (see Chart 2.2). In mid-August the Brent crude oil spot price stood at US$67 a barrel (up from US$39 a barrel in early January). After Hurricane Katrina, prices rose temporarily to over US$70 a barrel before falling back upon the release of some of the US strategic oil reserves. Nevertheless, futures markets at the end of August were still predicting prices approaching US$70 per barrel for the remainder of the year.

The impact of continued high oil prices for medium-term growth in the region varies by sub-region. Oil-exporting transition countries, such as Azerbaijan, Kazakhstan and Russia, are benefiting from high prices, and high growth rates in these countries may continue to have important positive spillover effects for neighbouring countries. In contrast, oil-importing economies in CEB and SEE are likely to feel their negative impact on domestic demand, especially if the recent shocks to the oil price are regarded as permanent rather than temporary.[4] High oil prices are therefore likely to dampen growth prospects in most OECD and non-OECD countries, spur inflation and present further risks for current account deficits. In addition, prices for other commodities show signs of stabilising (in part due to weakening demand from China), leading to reduced export revenues for some transition countries.

Macroeconomic performance by region

CEB

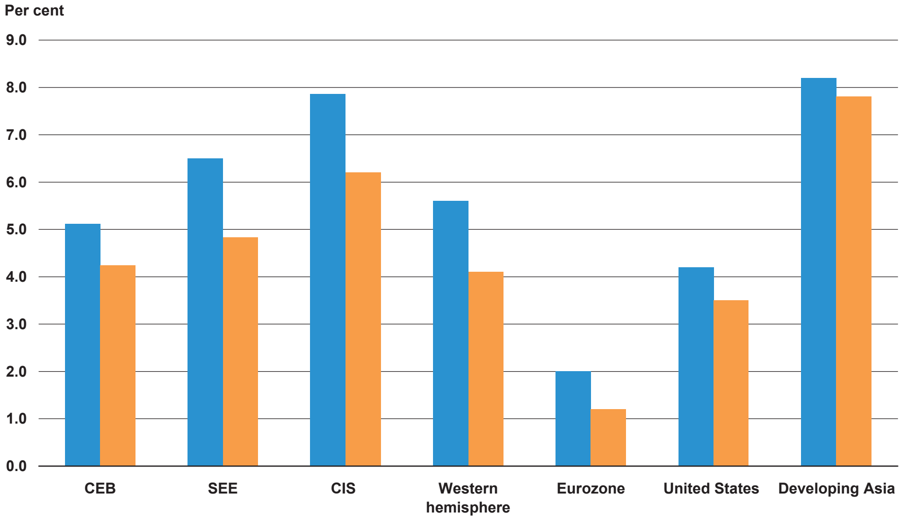
Two significant events shaped the macroeconomic environment for CEB countries over the past year. In May 2004 eight CEB countries joined the European Union, together with Malta and Cyprus. Since then, several countries have also joined the Exchange Rate Mechanism II (ERM II) as a first step towards adoption of the euro. Estonia, Lithuania and Slovenia joined ERM II in June 2004 and, following the re-pegging of the lat to the euro in January 2005, Latvia joined in May 2005. A favourable external environment, abundant international liquidity, EU accession and ERM participation for some of the smaller countries triggered a surge in CEB investment, exports and growth. In 2004 the weighted average growth in real GDP for CEB as a whole was 5.1 per cent, its highest rate since 1995.

However, growth decelerated across the region (with the exception of Estonia) in the first half of 2005, and particularly in Hungary, Poland and Slovenia. GDP growth for the year as a whole is forecast to average 4.2 per cent. Private consumption remains strong in the Baltic states and the Slovak Republic while growth in fixed capital formation has moderated across the region (except in the Slovak Republic) – see Chart 2.3.

Following the rise in inflation associated with EU accession (mainly due to alignments in excise taxes on fuel and alcohol and VAT), price increases have started to ease across the region apart from the Baltic states. Despite rising oil prices, average consumer price inflation in CEB is forecast to fall to 3.3 per cent in 2005 from 4.3 per cent in 2004. This largely reflects tighter monetary policies in Hungary, Poland and the Slovak Republic. As a result, all of these countries have been able to lower interest rates in recent months. Inflation remains a concern, however, in Estonia, Latvia and, increasingly, Lithuania. The higher rates in these countries are partly due to internal factors – rapid credit growth, rising wages and increases in food and administrative prices – but also to the oil price boom and the recent euro depreciation against the US dollar. Failure to control inflation may jeopardise plans for adoption of the euro, planned for early 2007 in Estonia and Lithuania and 2008 in Latvia.

Chart 2.1

International comparison of growth, 2004-05



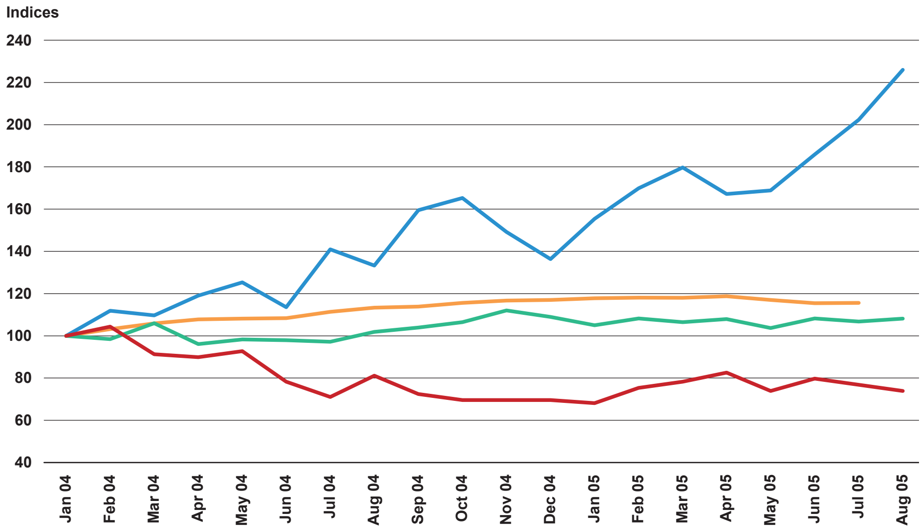
GDP growth 2004 GDP growth 2005 (forecast)

Sources: EBRD and IMF World Economic Outlook.

Note: Data for CEB, SEE and CIS are taken from the EBRD. Data for the eurozone, United States, developing Asia (Asia excluding Japan) and the Western hemisphere (which includes Central and Latin America) are taken from the World Economic Outlook. Regional aggregates are weighted averages.

Chart 2.2

Commodity price indices, 2004-05



Crude oil (Brent) Metal (Producer Price Index) Gold Cotton

Source: Bloomberg.

Fiscal deficits are set to deteriorate in 2005 in almost all CEB countries except Poland and the Slovak Republic. The average deficit across the region is likely to reach 3 per cent of GDP in 2005 compared with 2.4 per cent in 2004. Only Poland is forecast to reduce its general government deficit despite the recent weakening in its growth rate. The Polish fiscal deficit is projected to fall to 3.7 per cent of GDP from 3.9 per cent in 2004. The Czech Republic and Hungary, on the other hand, are expected to witness a significant deterioration in their fiscal deficits this year. Prospective elections in these two countries in 2006 may stall fiscal improvement. In both countries, talk of tax reductions has preceded the elections although expenditure reform should be a higher priority to bring fiscal deficits into line with EU requirements. Moreover, the Czech government's decision in August 2005 to postpone its adoption of the euro implies some reluctance to rein in fiscal spending. The new target date of 2010 brings the Czech

Republic into line with Hungary and Poland, which have also backtracked from original euro entry targets of 2007.

The average current account deficit across CEB in 2005 is forecast to decrease to 6.2 per cent of GDP (from 6.6 per cent in 2004). In most countries, exports continued to increase at double-digit rates at the beginning of 2005 although slightly below the pace in 2004. As a result, trade balances have narrowed, most notably in the Czech Republic and Hungary. However, the Hungarian current account deficit remains high in comparison with its neighbours and is projected to decline to 8 per cent of GDP in 2005 from 8.9 per cent last year. In Poland the trade deficit has narrowed due to a decline in imports. The current account deficit is widening rapidly in the Slovak Republic on the back of rising private consumption and investment. Current account deficits remain especially high in the Baltic states (and are widening in Lithuania) where ongoing increases in consumption and investment, fuelled by expanding credit, have led to higher import levels.

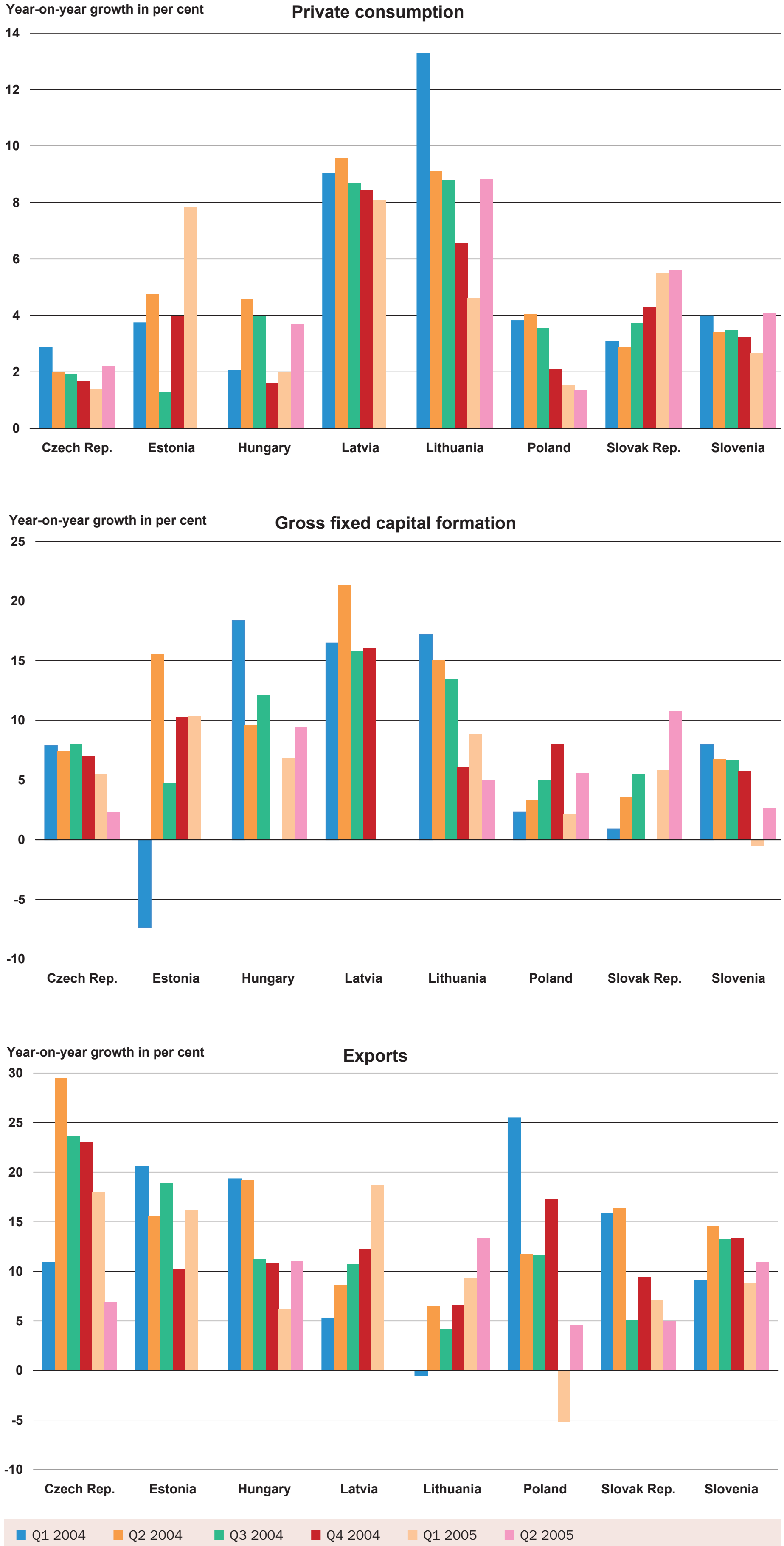
International liquidity and EU accession seem to have attracted further inflows of foreign direct investment (FDI) into the CEB economies. Net FDI inflows almost doubled to US$16.3 billion in 2004 and are projected to rise to US$24.4 billion in 2005, with an increase forecast for all countries except Hungary. Particularly large increases in FDI over the past two years have been achieved by the Czech Republic, Estonia, Hungary, Lithuania, Poland and the Slovak Republic. The sharp increase in net FDI inflows into the Czech Republic this year has been due largely to the privatisations of the petrochemicals company Unipetrol and Cesky Telecom. The much higher net inflow expected in Estonia this year is primarily due to the conversion of portfolio investments into direct investments following the buy-out of Hansabank's shares by its core investor, Swedbank.

SEE

In SEE the prospect of EU accession for the SEE-3 (Bulgaria, Croatia and Romania) as well as some limited progress with structural reforms in the SEE-4 (Albania, Bosnia and Herzegovina, FYR Macedonia and Serbia and Montenegro) helped to sustain economic performance. However, average GDP growth is expected to decelerate to 4.8 per cent in 2005 from

Chart 2.3

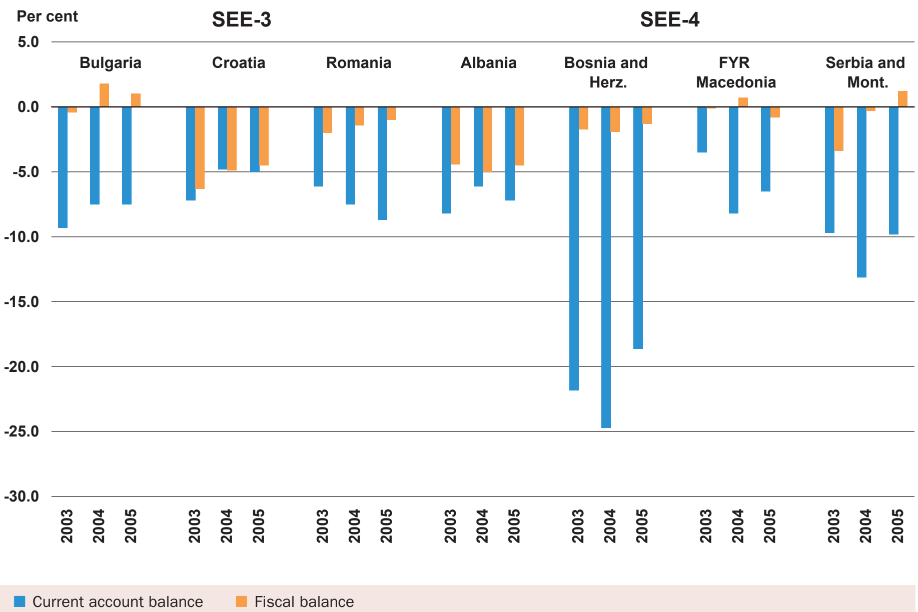
Quarterly real growth in private consumption, fixed investment and exports in CEB



Source: Eurostat.

Chart 2.4

Annual fiscal and current account balances in SEE, 2003-05



Source: EBRD.
Note: Data for 2005 are EBRD forecasts.

6.5 per cent in 2004. Growth in Bulgaria, Croatia and Romania has been driven primarily by increased private consumption, fuelled in turn by rapid credit growth as banking systems have developed further. Investment is driven by EU accession expectations, ongoing privatisations and progress with disinflation and, in the case of Romania, capital account liberalisation leading to sharp reductions in interest rates.

The most significant slow-down is expected in Serbia and Montenegro, where growth is forecast at 4 per cent for 2005 compared with 7.2 per cent in 2004. A deceleration was already apparent in industrial production in the first half of this year while the agriculture sector is unlikely to match in 2005 the very high growth rate achieved in 2004.

Average inflation in SEE is expected to rise again to 5.8 per cent in 2005. This regional increase stems from a marked acceleration in Serbia and Montenegro (mainly Serbia) from an average 9.5 per cent in 2004 (and double-digit levels by end-2004) to a likely 16 per cent in 2005, reflecting strong wage growth, increases in administered prices and high oil prices. Concern about inflation led the National Bank of Serbia to raise reserve requirements on enterprise foreign exchange deposits several times in 2005. The rate of inflation is falling in all other SEE countries except Croatia (where inflation is already low). In Romania average annual inflation is expected to come down to 9.2 per cent in 2005 from 12 per cent last year. This is despite the fact that the National Bank of Romania has started to liberalise the capital account and cut the policy interest rate by a cumulative 1,330 basis points between June 2004 and May 2005. The Romanian authorities have also moved from an implicit exchange rate-based framework to a flexible inflation-targeting monetary regime.

General government deficits came down to an average of 1.6 per cent of GDP in 2004 and are expected to remain largely unchanged in 2005 (see Chart 2.4). The highest deficits in the region are forecast for Albania and Croatia in 2005 — 4.5 per cent for both countries. In Bulgaria the consolidated general government balance recorded a surplus of 1.8 per cent of GDP in 2004. However, fiscal relaxation ahead of parliamentary elections in mid-2005 and the decision to raise the minimum wage by 25 per cent during 2004 caused protracted discussions on the first review of the IMF precautionary standby programme. Following corrective action, the programme is back on track and the general government recorded a large fiscal surplus in the first half of the year.

Romania is seeking a resumption of the IMF standby programme that was suspended in the spring of 2005. The authorities reached an initial agreement with the IMF on a new 2005 budget deficit target of 0.7 per cent of GDP. However, the government subsequently increased the target to 1 per cent of GDP to deal with the costs of widespread flooding in the summer of 2005 and decided to raise public sector wages. Although discussions are ongoing, no agreement has so far been reached with the IMF.

One of the consequences of rapid credit growth in the SEE region has been the continued high current account deficits. These averaged 10.3 per cent of GDP in 2004 and are expected to fall only slightly to 9 per cent in 2005. Deficits in some of the smaller SEE economies may be exaggerated by the under-recording of remittances from workers living abroad. However, deficits remain high in all SEE economies. While the current account deficit in Bulgaria is projected to remain unchanged at 7.5 per cent in 2005, an increase in deficits is expected for Albania, Croatia and Romania.

Net FDI inflows into the SEE region increased to a record US$9.2 billion in 2004 and are projected to rise further to US$11.6 billion in 2005. They remain concentrated in the SEE-3 (Bulgaria, Croatia and Romania), where they cover more than half of the current account deficits. Serbia and Montenegro is also becoming an important recipient of FDI but, in common with other countries of SEE-4, it relies to a significant degree on grants and loans from international financial institutions and other countries as well as remittances from workers living abroad. FYR Macedonia is planning to diversify its sources of international finance by placing its first eurobond in late-2005.

CIS

Growth in the CIS region has continued at a strong pace on the back of high commodity prices (particularly for oil and gas but also for metals and agricultural products) and strong domestic demand. Average GDP growth amounted to 7.9 per cent in 2004 and exceeded 10 per cent in Armenia, Azerbaijan, Belarus, Tajikistan and Ukraine. While average growth is expected to moderate in 2005 to 6.2 per cent, the outlook remains generally favourable due to the continued strength of oil prices. The most significant slow-down is expected in Ukraine, where growth is expected to fall from 12.1 per cent in 2004 to 4 per cent this year. This is due to a sharp drop in external demand for its steel output and a decrease in investment because of continuing uncertainty over the business and political environment.

In Russia GDP growth is expected to fall to 6 per cent this year from 7.1 per cent in 2004 as a result of a slow-down in oil production growth and domestic investment (see Chart 2.5). Moreover, recent political and social turmoil in the Kyrgyz Republic and Uzbekistan has dampened prospects for their economies. In contrast, Azerbaijan is likely to see a doubling of its already impressive growth rate from 10.2 per cent in 2004 to 20 per cent in 2005 following an increase in oil production and the inauguration of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline expected in the last quarter of 2005.

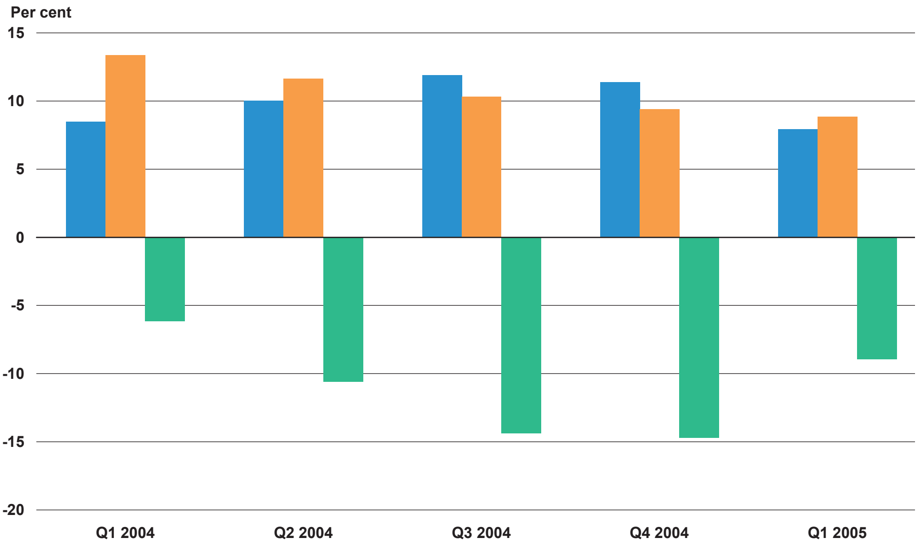
High inflows of foreign currency from booming commodity exports have led to substantial increases in foreign exchange reserves across the region. The resulting increase in base money has in most cases not been fully sterilised. The increased liquidity in the banking system has, as a result, led to a sharp credit expansion and a rise in inflation (although credit expansion in Russia slowed down in early 2005 perhaps on account of the 2004 banking turmoil). Average annual inflation in the CIS amounted to 8.9 per cent in 2004 and is expected to accelerate to 9.1 per cent in 2005.[5] The rate of inflation remains significant across the region, except in Armenia. Reducing it, particularly in countries such as Azerbaijan, Kazakhstan, Russia and Ukraine (see Chart 2.6), will require prudent managing of revenue gains from commodity exports in the face of strong domestic spending pressures (see below). In addition, monetary policy and banking supervision in many of the CIS countries need to deal with the challenges of rapid credit growth.

High commodity prices have generated fiscal surpluses that governments are coming under increasing pressure to spend. Oil funds and related fiscal rules in Azerbaijan, Kazakhstan and Russia play an important role in these countries in reining in public expenditure. The average fiscal deficit across the CIS region in 2004 amounted to just 0.3 per cent of GDP. The highest surpluses were recorded by Kazakhstan and Russia. In addition, the Russian authorities expect a full-year federal budget surplus of 7.6 per cent of GDP in 2005, against an initial target of 1.5 per cent. Stabilisation fund assets have also increased substantially, despite the use of US$3.2 billion for an advance repurchase from the IMF earlier in 2005 and US$15.1 billion to repay external debt to the Paris Club. There are consequent pressures on the authorities for fiscal relaxation (partially reflected in the 2006 budget draft).

Current account deficits in the CIS increased in 2004 to an average of around 2.3 per cent of GDP. A reduction to around 0.6 per cent is expected for this year. Azerbaijan should see the most significant reduction in its deficit – from 30 per cent in 2004 to 10 per cent this year – due to the completion of the BTC oil pipeline and its export growth potential. Kazakhstan, Russia, Ukraine and Uzbekistan should record significant current account surpluses on the back of high commodity exports. The Ukrainian surplus is expected to halve in 2005 because of reduced demand for its metal exports but the Russian surplus is forecast to increase to 12.3 per cent of GDP from 10.3 per cent in 2004. International reserves of the Russian Central Bank reached a record high of

Chart 2.5

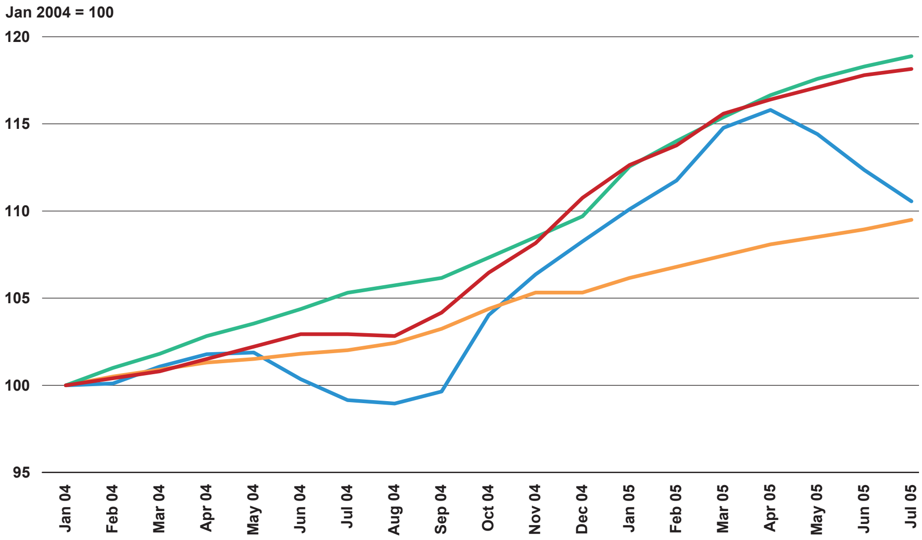
Quarterly real growth in consumption, investment and net exports in Russia



Private consumption Gross fixed capital formation Net exports
Source: OECD Main Economic Indicators.

Chart 2.6

Monthly CPI inflation for Azerbaijan, Kazakhstan, Russia and Ukraine, 2004-05



Azerbaijan Kazakhstan Russia Ukraine
Source: EBRD.

US$151.6 billion in mid-2005. In addition, gross FDI inflows reached a record US$9.3 billion in the first half of the year. These strong inflows have contributed to an almost halving of net private capital outflows.

Medium-term outlook and vulnerabilities

The medium-term outlook for transition countries is expected to moderate somewhat, partly due to an external environment that, on present trends, may be less favourable than it has been in recent years. The average GDP growth for the region as a whole in 2006 is forecast to stay almost unchanged at 5.2 per cent compared with 5.3 per cent in 2005. The CEB and CIS regions are expected to experience a slight deceleration (to 4.5 per cent and 5.9 per cent respectively) while the SEE region is forecast to witness a modest increase (to 4.8 per cent). Growth in Russia is forecast to decelerate slightly to 5.5 per cent next year. Average inflation is forecast to fall to 5.8 per cent in 2006. Tables A.2.9 to A.2.12 in the annex at the end of this chapter summarise the growth and inflation forecasts of several other financial or economic institutions.

Over the medium term, annual growth rates for each of the three sub-regions are expected to be similar to those forecast for next year. However, there are substantial downside risks to this outlook, stemming not only from the international environment but also from some potential domestic vulnerabilities. Table 2.1 shows some of the main indicators identified in the literature as good predictors of economic vulnerability.[6] The table also shows indicative risk thresholds above which a country is deemed to be more vulnerable.[7] These thresholds differ according to whether a country has regular access to international capital markets (and can sustain greater imbalances in its public and external finances).

The CEB region remains most vulnerable to a disruption to the financing of public sector deficits although there is currently still a large demand for government bonds issued in these countries. This is based on the expectation of further real convergence and gradual compliance with the Maastricht criteria. However, Estonia and Latvia continue to struggle with high inflation, which may put early euro entry in jeopardy.[8] Also, as noted earlier, the Czech Republic, Hungary and Poland still run large budget deficits and the prospects of meeting the EU's Stability and Growth Pact criteria remain uncertain. In addition, several CEB countries — Estonia, Hungary, Latvia and Lithuania — run higher current account deficits than other emerging markets. Higher investment ratios can be expected in transition countries because they need to replace their outdated capital stock and sustain high rates of growth. Moreover, in some of these countries current account deficits are associated with sizeable FDI inflows (including foreign investors' reinvested earnings). There is little evidence that these large deficits have been caused by losses in competitiveness. Eventually, therefore, these countries are likely to generate the exports that will reduce their current account deficits and overall debt burdens. However, the high imbalances mean that access to external finance — whether from international capital markets or from foreign direct investment — must be sustained.

Table 2.1

Vulnerabilities of transition countries

	CEB	SEE	CIS
Public sector			
Liquidity	Czech Rep. Hungary	Albania	Belarus, Kyrgyz Rep.; Tajikistan Turkmenistan
Solvency	Hungary	Bosnia and Herz. FYR Macedonia Serbia and Mont.	Armenia, Georgia; Kyrgyz Rep. Moldova, Tajikistan
External sector			
Liquidity	Estonia, Hungary Latvia, Lithuania	Albania Bosnia and Herz. Serbia and Mont.	Kyrgyz Rep.
Solvency	-	Croatia Serbia and Mont.	Armenia, Georgia Kyrgyz Rep. Moldova Tajikistan
Exchange rate regime and domestic monetary conditions	Latvia	-	Belarus, Moldova Tajikistan, Uzbekistan

Source: EBRD.

Note: The assessment of a country's vulnerability depends on quantitative benchmarks as well as qualitative assessments by EBRD staff. The quantitative benchmarks selected for each category are as follows:
Public sector liquidity: Measured by the general government fiscal deficit / GDP ratio; 4 per cent for countries with market access and 3 per cent for countries without.
Public sector solvency: Measured by (1) public debt / GDP ratio; 60 per cent for countries with market access and 40 per cent for countries without, and (2) public debt / revenue ratio; 200 per cent for countries with market access and 150 per cent for countries without.
External sector liquidity: Measured by the (current account balance + net FDI) / GDP ratio; -4 per cent for countries with market access and -3 per cent for countries without.
External sector solvency: Measured by (1) gross external debt / GDP; 60 per cent for countries with market access and 40 per cent for countries without, and (2) gross external debt / exports; 150 per cent for countries with market access and 100 per cent for countries without.
Exchange rate regime and domestic montary conditions: Measured by gross international reserves less than three months of imports.

In the SEE region, vulnerabilities in the public sector finances have been reduced significantly by reforms in fiscal management and public debt. Only Albania and Croatia stand out for the size of their fiscal deficits, and Bosnia and Herzegovina and Serbia and Montenegro for their public sector debt stocks. However, there are still large external imbalances in many SEE countries, particularly Albania, Bosnia and Herzegovina, Bulgaria and Serbia and Montenegro. In addition, external debt stocks and future debt servicing are also a concern, particularly in Croatia and in Serbia and Montenegro. Moreover, political uncertainties still hang over Bosnia and Herzegovina, FYR Macedonia and Serbia and Montenegro.

Vulnerabilities in the CIS stem from large public external debt in several of the least reformed countries. However, apart from Moldova, Turkmenistan and Uzbekistan, all other CIS countries have, or are negotiating, IMF support programmes to help bolster credibility and foreign reserve coverage and gain access to official financing on concessional terms. Some CIS countries also face vulnerabilities in their financial sectors which may arise from the rapid expansion of credit relative to banking capacity, or from poor banking supervision and transparency, or from problems related to the history of subsidised lending, which will be discussed in more detail in the remainder of the chapter.

2.2 Credit growth and financial stability

In 2004 transition countries continued an unusually rapid expansion in financial intermediation, in particular in credit to the private sector. Between 1999 and 2004 several countries experienced substantial increases in the ratio of private sector credit to GDP. In CEB the largest increase was in Latvia, where the ratio rose by 30 percentage points. In SEE, Bulgaria witnessed an increase of 24 percentage points and in the CIS, Kazakhstan saw an increase of 19 percentage points. This process will continue to have profound implications for economic growth, inflation and the external balance.

Causes and characteristics of the credit boom

There are positive as well as potentially negative aspects of credit growth.[9] Financial deepening (an increase in the credit-to-GDP ratio) is a positive process, where permanent increases in credit levels accompany, or even spur, economic development. It has long been recognised that financial intermediation grows together with economic development although it has been difficult to establish cause and effect. Given the rapid financial liberalisation and income gains in transition countries over recent years, financial development may have both contributed to, and been the effect of, economic growth.

However, credit growth may be excessive where economic agents mis-price risks. This may result where creditors have insufficient information about borrower characteristics. It can also reflect exuberance about future income prospects following financial liberalisation, or failure to recognise risks in asset markets. Gains in asset prices, in particular in equity and property markets, may raise the value of collateral and ease access to credit. This in turn fuels demand and valuations in asset markets. Once asset prices and collateral values collapse, perceived risks increase and interest rates go up, making debt servicing more difficult.[10]

Several studies have shown that credit to the private sector in transition countries (given their levels of income and institutional reform) remains well below what would be expected based on estimations for a wider range of developing and developed countries.[11] These studies support the view that the ongoing credit boom in emerging European markets is a structurally driven financial deepening as these economies move towards a new long-term equilibrium. This process is spurred by the low capital-labour ratios (relative to the EU countries prior to the 2004 enlargement), expectations of real exchange rate appreciation, still sizeable (in some cases) nominal interest rate differentials and the ensuing capital inflows. The credit boom of the new EU members in the CEB region may resemble that of Greece, Ireland, Portugal and Spain prior to the introduction of the euro. Despite a large increase in the ratio of credit to GDP from the mid 1990s, credit growth in these countries did not produce the banking sector stresses that were a concern at the time. Nevertheless, domestic credit in Portugal expanded in parallel with a substantial fiscal loosening and led to an appreciation in the real exchange rate, depressing economic growth below the potential growth rate.[12]

Cyclical developments have also affected credit growth in the transition region. High levels of liquidity have characterised international monetary conditions in the past two years. Transition countries with access to global capital markets have benefited from this, and interest rate spreads for most countries have contracted. The CIS region is undergoing a cyclical upturn, fuelled by large terms-of-trade gains by energy-producing countries (with knock-on benefits through trade and other channels for non-energy producers in the region). Moreover, CEB countries, several SEE countries, Kazakhstan, Russia and Ukraine have recently experienced a steep rise in asset valuations and in collateralised credit. Bank supervisors have responded by tightening collateral requirements but there are concerns about the impact of a sudden collapse in valuations on credit and on consumption through wealth effects. The downturn in the cycle may trigger a decline in asset valuations and credit would contract, as described earlier.

Chart 2.7 and Table 2.2 illustrate recent bank credit developments. At the end of 2004, Croatia had the deepest banking system in the region with a ratio of non-government credit to GDP of 57 per cent, followed by Hungary, Slovenia and Estonia. By comparison, this ratio was 117 per cent on average in the eurozone prior to the 2004 enlargement. From 1999 to 2004 the highest real credit growth was achieved in Kazakhstan (48 per cent annual average real growth rate) followed by Russia, Ukraine, Bulgaria and Latvia (each with annual growth rates above 30 per cent) although these countries started from very low levels of domestic credit. The Czech and Slovak credit-to-GDP ratios have declined over recent years in the course of their bank restructuring. The charts also underline the importance of household credit growth, which accounts for between 28 and 48 per cent of total lending to the non-government sector in the CEB countries. In most countries credit growth was funded primarily by a corresponding growth in deposits. Yet, in a number of countries, such as Croatia or Romania, external liabilities grew significantly faster and now account for a larger share of bank liabilities than five years ago.

The credit expansion started in the CEB countries, which initiated financial liberalisation and bank privatisation in the mid-1990s. Most transition countries are now experiencing this boom, and the pace of the current expansion appears to have quickened. This is due to a number of demand and supply factors in financial markets, including macroeconomic developments, structural reform and greater competition.

Macroeconomic developments

The favourable macroeconomic environment in most transition countries has given impetus to the credit boom. Renewed confidence among foreign creditors, greater access to international capital markets and inflows of other portfolio and direct investment capital have contributed to the accumulation of official reserves. A number of central banks, in particular in the CIS, have not offset the corresponding effects on money supply, which expanded rapidly.

The benign environment has also underpinned greater public confidence in banking systems. This is evident in higher ratios of bank deposits to cash in circulation, and has induced banks to draw down their net foreign assets, including by accessing international capital markets.[13] At the same time, governments in transition countries have scaled back their borrowing from the banking system, thereby freeing up credit for the private sector. This is partly a result of fiscal consolidation (although with important exceptions in several CEB countries) but also due to the public sector accessing other sources of financing, such as domestic and foreign capital markets.

Structural reform

Banking sector reform has encouraged sound banking practices, raised confidence in the sector and attracted deposits from households and private enterprise. The decline in state influence over the allocation of credit and an increase in bank privatisation were important first steps in this process. Improvements in regulation and supervision together with greater transparency in accounting, bank ownership and borrower characteristics have typically followed and are still ongoing in many countries. The entry of foreign-owned banks has been particularly important for the banking systems of the CEB and SEE countries, largely in connection with bank privatisations. The entry of foreign financial institutions is generally associated with greater efficiency through new technology, products and management and through improved access to credit for small and medium-sized enterprises.[14]

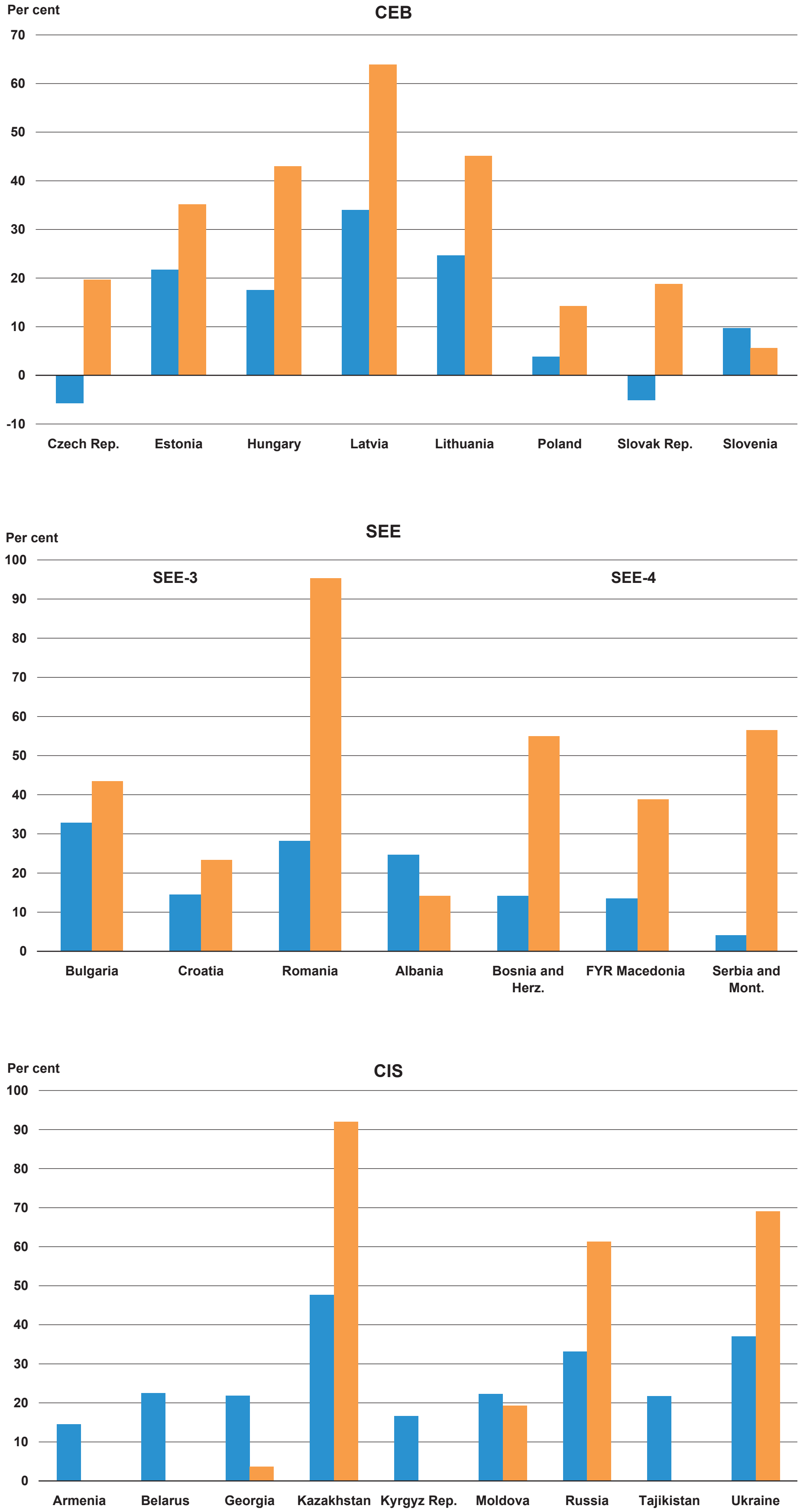
The EBRD transition indicator for banking sector reform and interest rate liberalisation shows progress in the CEB and SEE countries in the late 1990s but relatively few upgrades in the CIS. Since then, the pace of reforms has slowed in the CEB countries and picked up slightly in the CIS. Nevertheless, the latest transition indicators (see Chapter 1) suggest that banking reform is still much less advanced in the CIS than in either the CEB or SEE countries.

Competition in banking sectors

Greater competition in national banking systems has contributed to the credit expansion, particularly in the CEB and SEE countries. For foreign strategic investors in CEB banking systems, higher interest

Chart 2.7

Real growth in credit to the non-government sector and to households (annual averages, 1999-2004)



Non-government Households

Sources: National central banks and EBRD banking survey.

Table 2.2

Bank credit in selected countries

	Total credit as a percentage of GDP		Non-government credit as a percentage of GDP[1]		Household credit as a percentage of non-government credit		Foreign currency-denominated credit as a percentage of non-government credit		Long-term credit as a percentage of non-government credit	
	1999	2004	1999	2004	1999	2004	1999	2004	1999	2004
Central eastern Europe and the Baltic states										
Czech Republic	50.7	36.8	45.0	28.1	8.4	36.6	18.6	11.2	61.1	72.2
Estonia	31.1	65.2	23.2	43.3	28.3	47.9	73.7	72.7	86.3	90.1
Hungary	36.3	58.6	26.1	45.6	12.2	32.5	29.1	39.0	55.8	74.3
Latvia	20.2	60.0	15.5	46.1	14.5	39.6	58.6	59.8	71.8	85.4
Lithuania	13.1	30.1	11.4	25.1	13.4	28.5	60.5	58.4	57.5	86.4
Poland	28.1	28.5	25.5	25.6	22.7	36.6	19.3	24.2	59.9	68.1
Slovak Republic	68.2	59.3	48.7	32.9	10.9	41.7	14.7	38.29	63.5	58.9
Slovenia [2]	35.5	47.9	32.7	43.9	34.7	28.7	12.5	32.2	47.9	56.6
South-eastern Europe										
SEE-3										
Bulgaria	11.5	36.8	9.9	34.2	22.2	32.7	33.1	47.7	46.5	64.8
Croatia	38.0	62.2	35.7	57.3	38.1	55.0	13.6	9.1	na	na
Romania	18.8	15.3	10.4	16.3	5.2	30.6	58.5	59.3	33.2	56.5
SEE-4										
Albania	4.5	9.7	4.2	8.9	48.1	30.9	46.6	80.5	na	na
Bosnia and Herzegovina	30.9	45.7	30.5	44.8	9.8	45.1	80.3	15.4	na	na
FYR Macedonia	16.0	22.1	10.4	19.8	11.9	32.6	na	na	na	na
Serbia and Montenegro	32.0	21.9	27.0	18.8	3.2	24.5	55.0	23.0	na	na
Commonwealth of Independent States										
Armenia	8.7	7.8	5.8	6.9	na	37.8	na	na	na	na
Azerbaijan	9.4	10.8	na	5.3	na	57.0	na	na	na	na
Belarus	17.3	21.1	9.1	9.0	na	na	na	na	na	na
Georgia	5.5	9.7	4.7	9.5	11.1	4.9	na	na	na	na
Kazakhstan	9.3	30.2	7.4	26.8	5.5	20.5	53.9	51.9	49.3	65.7
Moldova	13.0	24.0	11.8	21.2	4.5	4.0	na	na	na	na
Russia [2]	20.2	28.7	9.1	22.4	6.3	16.5	44.1	25.6	38.5	48.3
Ukraine	9.2	26.7	9.0	26.5	5.8	16.6	51.5	41.4	22.4	52.2

Sources: National central banks and EBRD banking survey.

[1] Includes credit to the private sector (households, private enterprises) and state-owned enterprises. Data for all CIS countries except Russia, Kazakhstan and Ukraine refer to credit to the private sector only.

[2] Long-term credit refers to credit to the corporate sector only.

margins and expectations of above-average growth have compared very favourably with their home markets.[15] Foreign institutions and their domestic rivals have therefore sought to rapidly expand their market shares, and greater competition has gone hand in hand with a decline in lending spreads. In most transition countries the indicators of banks' operating efficiency (an important determinant of lending rates) appear to have improved (see Table 2.3).[16] Moreover, some studies suggest that cost efficiency gains are associated with improvements in the quality of credit evaluation and decisions.[17] However, there remains uncertainty about the quality of accounting data of banks in transition, in particular of those not yet compliant with international accounting standards.

Given the liquidity inflows and greater banking competition, financial supervisors are now monitoring the composition of bank assets for signs of increasing risk, in particular with regard to the nature of borrowers, the currency composition and the maturity structure of credit. All but three of the transition countries for which detailed data on the composition of bank credit were available from national central banks showed an increase in the ratio of household credit to total non-governmental credit.[18] In some countries household credit is growing more slowly following several years of rapid expansion — as in Croatia (where lending to households accounts for 55 per cent of total credit to the non-governmental sector), Estonia (48 per cent) and Poland (36 per cent). In other countries household credit is only starting to expand — as in Russia or Ukraine, where the ratio stands at only 16 per cent (equivalent to about 3.7 per cent of GDP). Mortgages account for a major share of lending to households in the Baltic states and Hungary but much less so in Russia. Mortgage lending is

Table 2.3

Efficiency and profitability measures in selected countries (in per cent)

	Return on assets[1]		Overhead costs[2]		Net interest margin[3]		Interest rate spreads[4]	
	1999	2004	1999	2004	1999	2004	1999	2004
Central eastern Europe and the Baltic states								
Czech Republic	-1.8	1.7	2.3	2.2	2.5	2.3	4.2	4.8
Estonia	1.5	2.1	6.1	2.9	4.2	2.4	6.9	3.5
Hungary	0.6	2.3	3.7	2.7	4.1	3.5	4.4	3.7
Latvia	1.0	1.7	5.1	2.9	4.0	2.7	9.2	4.2
Lithuania	0.1	1.2	7.2	2.9	4.5	2.5	7.6	3.5
Poland	0.9	1.4	13.0	13.8	4.0	3.2	5.7	3.7
Slovak Republic	-4.0	1.3	2.6	2.3	0.5	2.9	6.7	4.9
Slovenia	0.8	1.1	2.2	1.5	4.1	2.8	5.1	4.8
South-eastern Europe								
SEE-3								
Bulgaria	3.6	2.1	4.8	3.6	4.4	5.6	9.6	5.8
Croatia	0.8	1.7	4.4	3.5	4.2	3.1	10.6	9.9
Romania	-0.1	2.7	33.0	20.2	na	4.3	20.5	14.5
SEE-4								
Albania	0.6	1.6	1.3	1.8	1.7	2.7	8.7	5.2
Bosnia and Herzegovina	-1.0	0.6	4.8	5.8	1.7	3.5	15.2	6.6
FYR Macedonia	0.8	1.1	5.1	4.5	3.0	3.1	9.1	5.9
Serbia and Montenegro	na	na	na	37.1	na	4.7	32.3	11.0
Commonwealth of Independent States								
Armenia	2.7	5.9	7.3	5.5	8.6	5.8	11.5	13.7
Azerbaijan	na	2.4	na	4.2	na	6.2	6.5	8.6
Belarus	1.2	1.5	na	na	7.9	3.9	27.2	4.2
Georgia	5.0	3.1	9.2	6.7	8.9	6.7	23.6	21.7
Kazakhstan	2.8	1.5	8.3	7.1	5.3	4.4	7.3	4.4
Kyrgyz Republic	-0.1	0.0	14.3	6.2	4.6	0.1	25.3	22.6
Moldova	5.0	4.0	10.1	6.0	9.0	6.0	11.6	6.1
Russia	-0.3	2.9	na	na	-0.3	3.7	26.0	7.6
Ukraine	1.0	1.0	na	7.8	na	4.9	10.9	6.0

Source: EBRD banking survey and International Financial Statistics.

[1] The average rate of return on assets in all banks is calculated using profits before tax/total assets. It is expressed as a percentage of total assets.

[2] Overhead costs include non-interest expenses and depreciation, and are expressed as a percentage of total assets.

[3] Net interest margin is net interest revenue as a percentage of total assets.

[4] Interest rate spreads are the difference between the lending rate and deposit rate.

normally less risky as it is backed by collateral and the average size of loans is relatively small. However, risks can arise where collateral values are based on over-inflated property markets.

Given expectations of exchange rate stability in several countries, private borrowers have been increasingly inclined to take advantage of foreign currency-denominated credit, lower borrowing rates and longer maturities. This currency substitution appears to have been particularly pronounced in currency board countries where foreign exchange-denominated credit accounts for between 48 per cent of total credit to the non-government sector (as in Bulgaria) and 72 per cent (in Estonia) or 80 per cent (in Bosnia and Herzegovina). While some countries expect to maintain their parities to the euro and to enter ERM II and economic and monetary union (EMU) at these rates, currency risk will be more pronounced in countries in which exchange rates are flexible (Romania's corresponding ratio is 59 per cent) or fluctuate within a band, as in Hungary.

Banks have also been able to access more long-term funding, including through foreign credit lines. Consequently, the proportion of short-term credit in total private sector credit has fallen in almost all transition countries although short-term borrowing is still significant in the Russian and Ukrainian corporate sectors.

Assessing financial system risk

The process of rapid credit growth must be managed carefully as it may give rise to macroeconomic and financial instability. Strong demand fuelled by bank lending can lead to overheating and deterioration in the current account, putting fixed or pegged currency regimes under stress. External bank borrowing to fund domestic credit growth will increase vulnerability to disruptions in international capital markets, and some macroeconomic vulnerabilities (noted earlier) may at least in part be attributable to buoyant credit growth. Also, rapid credit growth may weaken the quality of bank assets, as loan evaluation standards are relaxed, risk perceptions become more optimistic and non-performing loans are rolled over. This interaction between deteriorating macroeconomic stability and weakening bank balance sheets may lead to bank stresses or even result in a systemic banking crisis.

Extensive literature on the causes of banking crises has examined macroeconomic variables (such as real interest rates or terms-of-trade shocks) and specific factors in the financial sector (such as the degree of liberalisation). However, past experience suggests that a country's susceptibility to financial crises reflects both a deterioration in macro-prudential indicators (gauging the strains on the financial system) and weaknesses in the banking system or in large individual banks.[19]

Macro-prudential analysis reveals the stresses on the banking system stemming from exposure to macroeconomic risk factors. The selection of variables is based on a study by the Bank for International Settlements (BIS), which has performed well in detecting banking crises in developing and industrialised countries.[20] The results show that a combination of above-average levels of private sector credit with excessive asset price inflation or real exchange rate appreciation gives useful early warning signals of banking system stress.[21]

Rapid real growth in credit to the private sector is a common precursor of banking crises. Asset price inflation and real exchange rate appreciation may be the symptoms of capital inflows that fuel a credit boom or excessive monetary growth. The usefulness of the BIS model for transition countries that undergo a structural shift to deeper financial systems is clearly limited. However, the following thresholds are used to detect macroeconomic risks:[22]

- real credit growth in excess of 15 per cent on average in 2003-04 — observed in 19 transition countries
- a real increase in the national stock market index of over 30 per cent in 2004 — eight of the 14 transition countries for which equity indices were available exceeded this threshold. Even though capitalisation in a number of stock markets is low, this is regarded as indicative of wider trends in asset prices.
- real effective exchange rate appreciation of 10 per cent over one year, 15 per cent over the last two years or 20 per cent over the last three years — only Moldova and Hungary exceeded this threshold.

These three factors are combined to produce macro-prudential indicators (MPIs), which range from 1 (lowest risk) to 4 (highest), listed in Table 2.4.[23] Only Hungary scores a "4" although six transition countries show real credit growth above the threshold and exhibit signs of either very high asset price or exchange rate appreciation.[24] The indicator's relevance is limited in countries with repressed financial systems where market signals are not allowed to operate fully, such as Belarus, Turkmenistan and Uzbekistan.

The analysis of banking sector strength combines two elements — the ratings of individual banks and an assessment of sector-wide vulnerabilities. The first element is the asset-weighted average of the individual credit ratings of systemically important banks. Where available, this is based on published bank ratings from Fitch Ratings, and for unrated countries this is complemented by the EBRD's own assessment of bank risks.[25] The rating scale ranges from A (very strong) to E (very weak), as shown in Table 2.4.

An analysis of system-wide vulnerabilities is important as a second step because bank credit ratings typically only draw on the financial conditions in individual institutions and do not capture systemic risks. For example, a high level of lending to a sub-investment grade government borrower may be a sound business decision by a bank in the light of poor investment alternatives. However, if many banks do the same, this can be a source of systemic risk if the borrower defaults (as was the case in Russia in 1998 and Argentina in 2001). This analysis identifies risks in banking systems, based on criteria that have proved relevant in previous banking crises.

Several criteria can be quantified (such as concentration risks, exposure to the borrower and inter-bank lending). Others are based on qualitative judgements (such as transparency, governance and quality of the supervisory system). These assessments draw on published reports of the IMF,[26] rating agencies,[27] and on the EBRD's own appraisal of the transition region's banking sectors. The number of high-risk factors for each country is presented in Table 2.4. From the distribution by region in Chart 2.8, the following key findings emerge:

- Despite improvements in recent years, the most common risk factor relates to transparency, governance and the quality of banking supervision (observed in 19 countries). This indicates that operational risks are high in many of the region's banks, necessitating greater capital adequacy ratios. It is important to stress that the quality of banking supervision differs widely among the CEB, SEE and CIS regions. The new EU member states and candidate countries in SEE have aligned their financial sector regulation and supervision with EU directives. Meanwhile, supervision is less advanced and effective in the rest of SEE and the CIS although there are important regulatory reforms in several countries, as highlighted in Chapter 1.
- Concentration risks are significant (in 17 countries), particularly in the undiversified economies in the SEE and CIS regions.
- A common risk is borrower exposure, particularly with regard to foreign currency lending to agents without foreign currency earnings (in 16 countries, many in CEB). A mitigating factor arises when a country is making credible progress towards adoption of the euro (at which point the transfer risk will be eliminated), as is the case for the Baltic states. Also, for some countries, remittances from workers living abroad provide large and stable foreign exchange income for households (for instance, Albania, Bosnia and Herzegovina, Moldova and Serbia and Montenegro).
- High exposure to a sub-investment grade government borrower (directly through holding government securities or, indirectly, through guarantees) is a source of risk in several CIS countries.
- Excessive lending to connected parties is a source of risk only in CIS countries, particularly the poorer and smaller economies. State-directed lending in some less advanced countries such as Belarus, Turkmenistan and Uzbekistan is one manifestation of this risk.

CEB countries exhibit the smallest number of risks. The most common risks lie in the areas of transparency and governance,

Table 2.4

Banking system risks and macro-prudential indicators

	Macro-prudential indicator[1]	Average individual bank rating[2]	Number of serious systemic risks[3]	Banking system indicator (BSI)[4]
Central eastern Europe and the Baltic states				
Czech Republic	1	C	0	B/C
Estonia	3	B	0	A/B
Hungary	4	D	1	C/D
Latvia	2	D	2	D
Lithuania	2	D	1	C/D
Poland	1	D	2	D
Slovak Republic	1	D	0	C/D
Slovenia	1	C	3	C/D
South-eastern Europe				
SEE-3				
Bulgaria	3	D	2	D
Croatia	1	D	1	C/D
Romania	3	D	2	D
SEE-4				
Albania	2	D	4	D/E
Bosnia and Herzegovina	2	D/E	2	D/E
FYR Macedonia	1	D	2	D
Serbia and Montenegro	2	D/E	4	E
Commonwealth of Independent States				
Armenia	2	D/E	4	E
Azerbaijan	2	E	5	E
Belarus	2	D/E	7	E
Georgia	2	D/E	5	E
Kazakhstan	3	D	4	D/E
Kyrgyz Republic	2	D/E	4	E
Moldova	3	D/E	4	E
Russia	2	D	6	E
Tajikistan	2	D/E	5	E
Turkmenistan	1	D/E	8	E
Ukraine	3	D	5	E
Uzbekistan	1	D/E	7	E

Source: Fitch Ratings and the EBRD.

[1] To assess macroeconomic risks to the banking system, thresholds for real credit growth, the national stock market index and the real exchange rate have been developed. These thresholds are combined to produce a macro-prudential indicator, which ranges from 1 (lowest risk to the banking system) to 4 (highest risk).

[2] The average individual bank ratings have been taken from Fitch. The ratings range from A (strong) to E (weak). Where ratings were not available, these have been estimated by the EBRD.

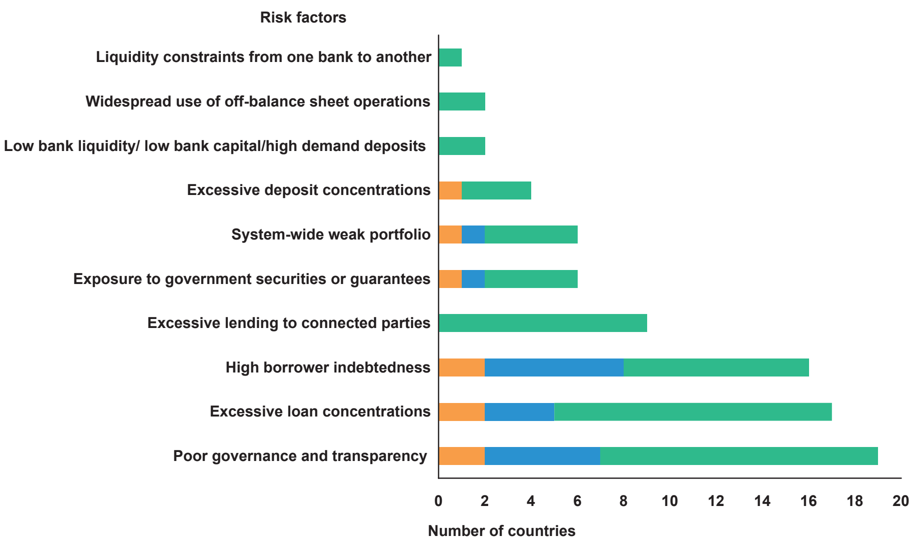
[3] The following list of 10 systemic risks have been used:

- *Liquidity constraints from one bank to another.*
- *Widespread use of off-balance sheet operations.*
- *Simultaneous existence of low bank liquidity, low bank capital ratios and high shares of demand deposits:* This raises the vulnerability of banking systems to sudden and large deposit withdrawals.
- *Excessive deposit concentrations:* If deposits are highly concentrated (as measured through the share of the 20 largest depositors), large deposit withdrawals are more likely to precipitate system-wide problems.
- *System-wide portfolio weaknesses:* Evident, for instance, in high non-performing loan ratios across a number of banks.
- *Exposure to the government, or extensive use of government bonds or guarantees as collateral:* In particular where the sovereign rating is below investment grade. This risk is assessed based on the share of sovereign assets or government guaranteed assets in total bank assets. Ratios above 15 per cent may indicate higher risk.
- *Excessive lending to connected parties:* This erodes the true capital adequacy of banks.
- *High borrower indebtedness or foreign currency mismatches.*
- *Excessive loan concentrations:* Assessed through the share of the 20 largest loans in bank portfolios. Where this ratio is high (above 20 per cent), defaults in a particular sector or industry are more likely to trigger a banking crisis.
- *Poor bank governance, lack of financial transparency, or weak bank regulation.*

[4] The BSI rates banking sector strength and ranges from A (strong) to E (weak). It combines the average individual bank ratings with the number of systemic risks. Where no or one systemic risk is identified, the average individual bank rating is upgraded by one category. Where more than two systemic risk factors are identified, the rating is downgraded by one category. Five or more risks incur a downgrade of two categories (applicable to Russia and Ukraine and some early transition countries).

Chart 2.8

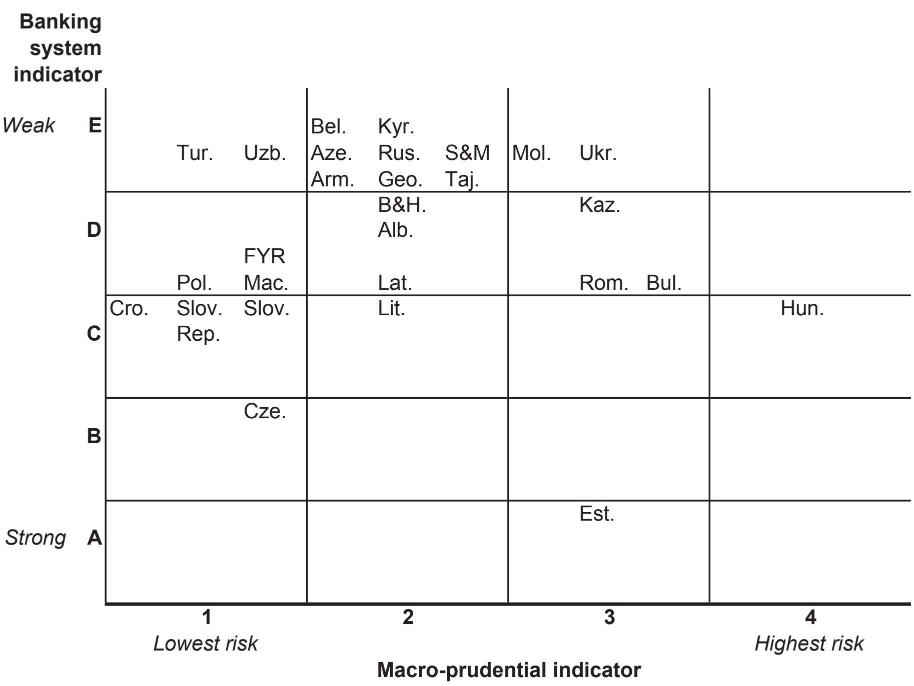
Incidence of systemic risk factors in the banking sector



CEB SEE CIS
Sources: Credit rating agencies, IMF and EBRD assessments.
Note: See Table 2.4 for a more detailed explanation of the risk factors.

Chart 2.9

Macro-prudential and systemic risks



Sources: Fitch Ratings and EBRD.
Note: For a more detailed explanation of the banking system indicator and the macro-prudential indicator, see Table 2.4.

and also borrower exposure – particularly through lending in foreign currency to borrowers with no matching foreign currency-denominated income. Slow reformers, such as Belarus, Turkmenistan and Uzbekistan, have the highest number of risks. The most common risks in CIS countries are lack of transparency, poor governance, loan concentration and connected lending.

Average bank ratings and systemic risk scores can be combined into an overall banking system indicator (BSI), as shown in Table 2.4. This indicator is presented together with the macro-prudential indicator in Chart 2.9, in which the horizontal axis measures the macroeconomic stresses (increasing towards the right) and the vertical axis records systemic strength (deteriorating towards the top).

The interplay of both factors is important as strong banking systems are more likely to withstand higher macroeconomic stresses than weak systems. For example, Estonia's macro-prudential risk is quite high (rated 3); however, it has the strongest banking system among the 27 transition countries, and is therefore more likely to weather a potential shock than a country with a weaker system. Weak banking systems (rated E) may have difficulty in absorbing even small macroeconomic shocks.

The two countries with the weakest combination of macroeconomic stresses and banking system risks are Moldova and Ukraine. Kazakhstan is subject to rapid credit growth (at an average of 39 per cent in 2003–04) but has a relatively strong banking system when compared with other CIS countries. Seven CIS countries and Serbia and Montenegro show moderate macroeconomic stresses (rated 2) but a high incidence of systemic risks (rated D/E). The results are less indicative for countries with repressed financial systems, such as Turkmenistan and Uzbekistan, where a history of state-directed credit, weak governance and a poor regulatory environment exposes these countries to bank insolvency and external liquidity constraints.

2.3 Conclusion

The overall macroeconomic outlook for the region remains positive, both in the short and medium term. Economic growth is likely to moderate to more sustainable levels across the transition region, and current account deficits and inflation should decline. Inflation is already decelerating in non-Baltic CEB countries and continued progress with fiscal consolidation will help to reduce it further. However, strong private sector demand in the Baltic states is being boosted by fiscal relaxation, which is leading to increases in inflation that could jeopardise the timetable for adoption of the euro. Throughout CEB, domestic demand should be moderated primarily by maintaining tight fiscal policies and by using regulatory measures to safeguard the banking sector from systemic stress.

Despite fiscal consolidation in much of SEE, the main threat to the medium-term outlook remains the persistently large external imbalances across the region. High external debt stocks represent an ongoing concern, especially in Croatia and in Serbia and Montenegro. Moreover, there is still the threat of political instability in Bosnia and Herzegovina, FYR Macedonia and Serbia and Montenegro. Addressing these vulnerabilities and pursuing increased integration with the EU will require continued progress with structural reform and higher inflows of FDI.

The CIS continues to record impressive economic growth but many economies are starting to show signs of capacity constraints and inadequate levels of domestic investment. Despite more sustainable growth rates and the strong fiscal position in Russia and other CIS countries, inflation is rising, partly due to insufficient sterilisation of the reserves build-up.

In most transition countries, demand has been fuelled by the rapid expansion in domestic credit to the private sector. This process is associated with a shift in credit levels towards a new equilibrium and will support further income convergence. Cyclical factors may have further fuelled this credit boom, raising concerns about potential overheating and systemic stress.

There are significant differences among the transition countries in terms of the strength of the banking sector, the nature of the cyclical elements in their ongoing credit boom and the quality of banking supervision. Countries are therefore likely to respond differently to external or domestic shocks, and consequently will require different policies. A wide range of policy options are being implemented but evidence of their effectiveness is limited.[28] The choice of such instruments will depend on the nature of any potential instability. In the more advanced CEB countries, a classical banking crisis – manifesting itself in widespread liquidity constraints and insolvency – is less likely given the relative strength of the sector, high foreign ownership and relatively good supervision. However, a deceleration in credit growth may ultimately hamper growth, particularly where the fiscal policy stance cannot be tightened to support private sector investment. This is currently the case in the three largest CEB countries – the Czech Republic, Hungary and Poland.

In several countries an important risk stems from the unhedged foreign exchange positions of borrowers, particularly households. This risk may be exacerbated if the date for the adoption of the euro is slipping, as is the case in Hungary. In these cases, fiscal and monetary policies could be the best instruments to address signs of cyclical overheating, accompanied by more extensive use of instruments for risk management and mitigation. In the Baltic states, tight fiscal policies may need to be combined with tighter prudential rules, such as strict loan-to-value limits, marginal reserve requirements or stricter provisioning requirements.

In contrast, the banking sectors in most CIS countries, and to some extent in the SEE countries, are still weak, making them potentially vulnerable to cyclical downturns. If a downturn occurs, these countries could be more susceptible to an overt banking crisis that would usually require extensive asset write-offs and, ultimately, government bail-outs. The size of the fiscal cost may be limited given their still low level of domestic credit. As international commodity prices are expected to remain favourable, these countries will continue to build up foreign exchange reserves that could serve to fund such costs. In these economies, strengthening of banking supervision through prudential regulation and market development measures, such as the establishment of credit bureaux, should be the priority.

Endnotes

1 All new EU members are subject to the EU Stability and Growth Pact, which sets a limit on the consolidated general government deficit of 3 per cent of GDP. However, the Czech Republic, Hungary, Poland and the Slovak Republic have been allowed a period of adjustment to adhere to this requirement.

2 Bulgaria and Romania signed the Accession Treaty on 25 April 2005, with the objective of EU membership from 1 January 2007. Croatia was granted candidate status in June 2004 but the start of negotiations was delayed until October 2005 due to the failure to arrest an army general indicted by the International Criminal Tribunal for the former Yugoslavia (ICTY).

3 See IMF (2005).

4 Recent research shows a statistically significant link in transition countries between a country's oil balance (exports minus imports of oil relative to GDP) and real GDP growth (see Falcetti *et al.*, 2005).

5 The 2005 average masks large differences. Inflation in the CIS is expected to range from 0.3 per cent in Armenia to 14.1 per cent in Ukraine.

6 See, for example, Goldstein *et al*. (2002).

7 These benchmarks were determined by EBRD staff on the basis of some of the currently available literature on the subject. See, for example, Dornbush (2000), Goldstein *et al.* (2000) and IMF (2004a).

8 Some of this inflation is due to the fact that productivity differentials between these countries and the EU are likely to be greater in the traded, rather than non-traded, sectors. Therefore, the relative price of non-traded goods will be rising faster in these countries. With traded goods prices at an equal level through international competition, the real exchange rate of the transition country will appreciate. With a pegged nominal exchange rate, this would imply that the effect would come through inflation. This is known as the "Balassa-Samuelson" effect.

9 See IMF (2004b).

10 This so-called financial accelerator model was set out in Bernanke *et al*. (1996).

11 See, for example, Cottarelli *et al*. (2003). Applying this methodology to a larger set of transition countries and using 2004 values for the independent variables again exposes substantial differences of up to 48 per cent of GDP between actual and predicted levels of financial depth. This underlines that credit growth throughout most transition countries is driven by convergence to deeper financial systems in line with the current levels of income and institutional development, a finding also supported by Schadler *et al*. (2005).

12 See Schadler *et al*. (2005).

13 See the *Update* 2005 for further details on capital flows and in particular syndicated bank lending.

14 See Cardenas *et al*. (2003).

15 See Breyer (2004).

16 Based on a sample of banks in 15 transition countries, Fries and Taci (2005) find that factors supporting such increases in efficiency are competition from foreign banks, the depth of financial intermediation and the quality of institutions.

17 See Berger and DeYoung (1997).

18 Non-governmental credit includes credit to the private sector (households, private enterprises) and state-owned enterprises.

19 This framework for banking sector risk assessments was first implemented for a large number of economies by Fitch Ratings (2005).

20 While a large number of macroeconomic variables have been studied as predictors of banking crises, monetary aggregates, such as domestic credit, regularly perform well (see Kaminsky and Reinhart, 1999, and Demirguc-Kunt and Detragiache, 1998). The three variables selected here are likely to serve the immediate purpose of ranking transition countries by the intensity of macroeconomic stresses on the banking system.

21 See Borio and Lowe (2002). The model performs slightly better for emerging markets. Unsurprisingly, asset prices perform relatively better for advanced countries, and the real exchange rate relatively better for emerging markets.

22 Based on Fitch Ratings (2004).

23 The score is constructed as follows: 1 — average real credit growth less than 15 per cent; 2 — real credit growth in excess of 15 per cent; 3 — real credit growth in excess of 15 per cent, and either excessive equity price inflation, or real exchange rate appreciation; 4 — all three criteria are triggered.

24 The ranking of countries would differ only marginally if these thresholds were set differently. If the threshold on real credit growth were raised to 25 per cent, five countries — Bosnia and Herzegovina, Georgia, Hungary, Moldova and Serbia and Montenegro — would no longer be deemed to experience excessive credit growth; if the threshold for the cumulative real effective exchange rate appreciation over the last three years were reduced to 15 per cent, three additional countries — Albania, Bulgaria and Serbia and Montenegro — would meet this criterion, which would put Bulgaria in category "4" (of highest macro-prudential risk) and the other two countries in category "3".

25 Fitch covers 15 of the EBRD's countries of operations.

26 Financial System Stability Assessments (FSSAs) have been compiled by the IMF for six countries in the region in 2004-05 (Albania, Belarus, Hungary, Moldova, Kazakhstan and Slovenia); other IMF reports include Article IV staff reports and, where appropriate, programme reviews.

27 In particular, the bank industry risk analyses by Standard and Poor's (S&P), including in S&P (2004) and various reports by Fitch Ratings.

28 For a summary of policy options, see Hilbers *et al*. (2005).

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Annex 2.1: Macroeconomic performance tables

Table A.2.1

Growth in GDP (real change, in per cent)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection	Estimated level of real GDP in 2004
Central eastern Europe and the Baltic states														*(1989=100)*
Czech Republic	0.1	2.2	5.9	4.2	-0.7	-1.1	1.2	3.9	2.6	1.5	3.2	4.4	5.0	**114**
Estonia	-8.8	-1.6	4.5	4.4	11.1	4.4	0.3	7.9	6.5	7.2	6.7	7.8	7.0	**112**
Hungary	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	3.8	3.5	2.9	4.2	3.5	**120**
Latvia	-14.9	2.2	-0.9	3.8	8.3	4.7	3.3	6.9	8.0	6.4	7.5	8.5	7.5	**90**
Lithuania	-16.2	-9.8	3.3	4.7	7.0	7.3	-1.7	3.9	6.4	6.8	9.0	6.7	6.8	**89**
Poland	3.8	5.2	7.0	6.0	6.8	4.8	4.1	4.0	1.0	1.4	3.8	5.4	3.5	**142**
Slovak Republic	-3.7	6.2	5.8	6.1	4.6	4.2	1.5	2.0	3.8	4.6	4.5	5.5	5.3	**121**
Slovenia	1.7	5.8	4.9	3.6	4.8	3.6	5.6	4.1	2.7	3.5	2.7	4.2	3.8	**126**
Average [1]	*0.9*	*3.9*	*5.5*	*4.7*	*4.9*	*3.7*	*3.3*	*4.2*	*2.4*	*2.4*	*3.8*	*5.1*	*4.2*	***126***
South-eastern Europe														
SEE-3														
Bulgaria	-1.5	1.8	2.9	-9.4	-5.6	4.0	2.3	5.4	4.0	4.8	4.5	5.6	5.5	**89**
Croatia	-8.0	5.9	6.8	6.0	6.5	2.5	-0.9	2.9	4.4	5.2	4.3	3.8	3.5	**94**
Romania	1.5	3.9	7.1	4.0	-6.1	-4.8	-1.2	1.8	5.3	4.9	5.2	8.3	5.5	**100**
SEE-4														
Albania	9.6	8.3	13.3	9.1	-10.2	12.7	10.1	7.3	7.2	3.4	6.0	5.9	6.0	**131**
Bosnia and Herzegovina	-10.0	0.0	20.8	86.0	37.0	15.6	9.6	5.5	4.3	5.3	4.0	5.7	5.0	**60**
FYR Macedonia	-9.1	-1.8	-1.2	1.2	1.4	3.4	4.3	4.5	-4.5	0.9	2.8	2.9	3.5	**80**
Serbia and Montenegro	-30.8	2.5	6.1	7.8	10.1	1.9	-18.0	5.0	5.5	3.8	2.7	7.2	4.0	**55**
Average [1]	*-2.0*	*3.8*	*6.4*	*4.2*	*1.1*	*0.6*	*-2.3*	*3.6*	*4.6*	*4.6*	*4.5*	*6.5*	*4.8*	***92***
Commonwealth of Independent States														
Armenia	-8.8	5.4	6.9	5.9	3.3	7.3	3.3	5.9	9.6	13.2	13.9	10.1	10.0	**98**
Azerbaijan	-23.1	-19.7	-11.8	0.8	6.0	10.0	11.0	6.2	6.5	8.1	11.5	10.2	20.0	**72**
Belarus	-7.6	-12.6	-10.4	2.8	11.4	8.4	3.4	5.8	4.7	5.0	7.0	11.0	8.0	**111**
Georgia	-25.4	-11.4	2.4	10.5	10.6	2.9	3.0	1.9	4.7	5.5	11.1	6.2	8.5	**45**
Kazakhstan	-9.3	-12.6	-8.2	0.5	1.7	-1.9	2.7	9.8	13.5	9.8	9.3	9.4	9.0	**103**
Kyrgyz Republic	-15.5	-20.1	-5.4	7.1	9.9	2.1	3.7	5.4	5.3	0.0	7.0	7.1	2.5	**80**
Moldova	-1.2	-30.9	-1.4	-5.9	1.6	-6.5	-3.4	2.1	6.1	7.8	6.6	7.3	6.5	**44**
Russia	-8.7	-12.7	-4.0	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.1	6.0	**82**
Tajikistan	-11.0	-18.9	-12.5	-4.4	1.7	5.3	3.7	8.3	10.2	9.1	10.2	10.6	8.0	**69**
Turkmenistan	-10.0	-17.3	-7.2	-6.7	-11.3	6.7	16.5	18.6	15.9	8.1	7.7	7.2	7.0	**112**
Ukraine	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.4	12.1	4.0	**57**
Uzbekistan	-2.3	-4.2	-0.9	1.6	2.5	4.3	4.3	3.8	4.1	3.1	1.5	7.4	4.0	**115**
Average [1]	*-9.3*	*-13.6*	*-5.0*	*-3.6*	*1.4*	*-3.9*	*5.3*	*9.0*	*6.0*	*5.1*	*7.6*	*7.9*	*6.2*	***81***
All transition countries														
Average [1]	***-4.7***	***-5.2***	***0.1***	***0.3***	***2.6***	***-0.9***	***3.5***	***6.0***	***4.3***	***3.9***	***5.7***	***6.6***	***5.3***	***91***

Note: Data for 1993-2003 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2004 are preliminary actuals, mostly official government estimates. Data for 2005 represent EBRD projections.

1 Weighted averages. The weights used for the growth rates are EBRD estimates of nominal dollar-GDP lagged by one year; those used for the index in the last column are EBRD estimates of GDP converted at PPP US$ exchange rates in 1989.

Table A.2.2

GDP growth by components in selected countries

(real change, in per cent)

	2001	2002	2003	2004 *Estimate*
Bulgaria				
Real GDP growth	4.0	4.8	4.5	5.6
Private consumption	4.5	3.9	7.1	4.8
Public consumption	4.7	6.2	3.0	5.8
Gross fixed capital formation	19.9	9.3	13.9	12.0
Exports of goods and services	8.5	6.2	8.0	13.1
Imports of goods and services	13.0	4.7	15.3	14.1
Croatia				
Real GDP growth	4.4	5.2	4.3	3.8
Private consumption	4.6	7.5	4.1	3.9
Public consumption	-4.3	-1.8	-1.8	-0.3
Gross fixed capital formation	9.7	10.1	na	na
Exports of goods and services	8.1	1.3	10.1	5.4
Imports of goods and services	9.3	8.8	10.9	3.5
Czech Republic				
Real GDP growth	2.6	1.5	3.2	4.4
Private consumption	2.8	2.7	4.6	2.0
Public consumption	5.3	4.5	3.8	-2.0
Gross fixed capital formation	5.4	3.4	4.7	7.6
Exports of goods and services	11.5	2.1	7.5	21.9
Imports of goods and services	13.0	4.9	7.9	18.4
Estonia				
Real GDP growth	6.5	7.2	6.7	7.8
Private consumption	6.2	10.3	5.7	4.4
Public consumption	1.8	5.9	5.8	9.1
Gross fixed capital formation	13.0	17.2	5.4	9.1
Exports of goods and services	-0.2	0.6	6.0	16.5
Imports of goods and services	2.1	5.4	9.0	14.7
Hungary				
Real GDP growth	3.8	3.5	2.9	4.2
Private consumption	6.0	9.4	7.2	2.5
Public consumption	5.3	5.7	6.5	-3.9
Gross fixed capital formation	5.9	9.3	2.5	7.9
Exports of goods and services	8.0	3.9	7.8	14.9
Imports of goods and services	5.3	6.5	11.0	11.6
Latvia				
Real GDP growth	8.0	6.4	7.5	8.5
Private consumption	7.3	7.4	8.6	8.9
Public consumption	0.3	2.4	2.5	1.4
Gross fixed capital formation	11.4	13.0	7.4	21.1
Exports of goods and services	6.9	6.3	4.3	8.9
Imports of goods and services	12.6	4.5	13.3	15.5

	2001	2002	2003	2004 *Estimate*
Lithuania				
Real GDP growth	6.4	6.8	9.0	6.7
Private consumption	3.7	5.8	11.1	9.3
Public consumption	0.3	1.9	5.7	6.7
Gross fixed capital formation	13.5	8.7	11.4	23.0
Exports of goods and services	21.2	19.5	6.0	4.3
Imports of goods and services	17.7	17.6	8.8	13.4
Poland				
Real GDP growth	1.0	1.4	3.8	5.4
Private consumption	2.0	3.3	3.1	3.4
Public consumption	0.6	0.6	0.2	1.4
Gross fixed capital formation	0.6	-5.8	-0.2	5.3
Exports of goods and services	8.0	5.0	6.0	7.0
Imports of goods and services	7.0	3.0	4.0	5.0
Romania				
Real GDP growth	5.3	4.9	5.2	8.3
Private consumption	6.4	3.0	7.1	10.1
Public consumption	-1.9	2.1	4.6	na
Gross fixed capital formation	6.6	8.3	9.2	10.8
Exports of goods and services	10.6	16.9	11.1	na
Imports of goods and services	17.5	12.1	16.3	na
Russia				
Real GDP growth	5.1	4.7	7.3	7.1
Private consumption	10.1	8.5	7.5	11.3
Public consumption	-0.8	2.6	2.2	2.3
Gross fixed capital formation	10.3	2.8	12.8	10.8
Exports of goods and services	4.2	10.3	12.5	12.3
Imports of goods and services	18.7	14.6	17.7	23.5
Slovak Republic				
Real GDP growth	3.8	4.6	4.5	5.5
Private consumption	4.7	5.5	-0.6	3.5
Public consumption	4.6	4.9	2.7	1.2
Gross fixed capital formation	13.9	-0.6	-1.5	2.5
Exports of goods and services	6.3	5.6	22.5	11.4
Imports of goods and services	11.0	5.5	13.6	12.7
Slovenia				
Real GDP growth	2.7	3.5	2.7	4.2
Private consumption	2.3	1.3	3.5	3.3
Public consumption	3.9	3.2	1.6	1.7
Gross fixed capital formation	0.4	0.9	7.1	5.9
Exports of goods and services	6.3	6.7	3.2	12.6
Imports of goods and services	3.0	4.9	6.8	12.4

Source: EBRD.

Note: Data for 2001-2003 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2004 are preliminary actuals, mostly official government estimates.

Table A.2.3

Inflation

(change in annual average consumer price level, in per cent)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
												Estimate	*Projection*
Central eastern Europe and the Baltic states													
Czech Republic	20.8	9.9	9.6	8.9	8.4	10.6	2.1	4.0	4.7	1.8	0.2	2.8	2.0
Estonia	89.8	47.7	29.0	23.1	11.2	8.1	3.3	4.0	5.8	3.6	1.3	3.0	3.9
Hungary	22.5	18.8	28.2	23.6	18.3	14.3	10.0	9.8	9.2	4.8	4.9	6.8	3.8
Latvia	109.2	35.9	25.0	17.6	8.4	4.7	2.4	2.6	2.5	1.9	3.0	6.3	6.4
Lithuania	410.4	72.1	39.6	24.6	8.9	5.1	0.8	1.0	1.5	0.3	-1.2	1.2	2.8
Poland	35.3	32.2	27.8	19.9	14.9	11.8	7.3	10.1	5.5	1.7	0.7	3.5	2.2
Slovak Republic	23.2	13.4	9.9	5.8	6.1	6.7	10.6	12.0	7.3	3.0	8.5	7.5	2.4
Slovenia	32.9	21.0	12.6	9.7	9.1	7.9	6.1	8.9	8.4	7.5	5.6	3.6	2.5
Median [1]	*34.1*	*26.6*	*26.4*	*18.8*	*9.0*	*8.0*	*4.7*	*6.5*	*5.7*	*2.5*	*2.2*	*3.6*	*2.7*
Mean [1]	*93.0*	*31.4*	*22.7*	*16.7*	*10.7*	*8.7*	*5.3*	*6.6*	*5.6*	*3.1*	*2.9*	*4.3*	*3.3*
South-eastern Europe													
SEE-3													
Bulgaria	73.0	96.3	62.0	123.0	1,082.0	22.2	0.7	9.9	7.4	5.9	2.3	6.1	4.2
Croatia	1,517.5	97.6	2.0	3.5	3.6	5.7	4.2	6.2	4.9	2.2	1.8	2.1	2.9
Romania	256.1	136.7	32.3	38.8	154.8	59.1	45.8	45.7	34.5	22.5	15.4	12.0	9.2
SEE-4													
Albania	85.0	22.6	7.8	12.7	33.2	20.6	0.4	0.1	3.1	5.2	2.4	2.9	2.1
FYR Macedonia	338.4	126.5	16.4	2.3	2.6	-0.1	-0.7	5.8	5.3	2.4	1.1	-0.3	0.0
Serbia and Montenegro	116.5×10^{12}	3.3	78.6	94.3	21.3	29.5	37.1	60.4	91.1	21.2	11.3	9.5	16.2
Median [1]	*256.1* [2]	*97.0*	*24.4*	*25.8*	*27.3*	*21.4*	*2.5*	*8.1*	*6.4*	*5.6*	*2.4*	*4.5*	*3.6*
Mean [1]	*454.0* [2]	*80.5*	*33.2*	*45.8*	*216.3*	*22.8*	*14.6*	*21.4*	*24.4*	*9.9*	*5.7*	*5.4*	*5.8*
Commonwealth of Independent States													
Armenia	1,822.0	4,962.0	175.8	18.7	14.0	8.7	0.7	-0.8	3.2	1.2	4.7	6.9	0.3
Azerbaijan	1,129.0	1,664.0	412.0	19.7	3.5	-0.8	-8.5	1.8	1.5	2.8	2.2	6.8	10.4
Belarus	1,190.3	2,220.9	709.3	52.7	63.8	73.0	293.7	168.6	61.1	42.6	28.4	18.1	10.6
Georgia	3,125.4	15,606.5	162.7	39.4	7.1	3.6	19.2	4.1	4.6	5.7	4.9	5.7	9.4
Kazakhstan	1,662.3	1,892.0	176.3	39.1	17.4	7.1	8.3	13.2	8.4	5.8	6.4	6.9	6.8
Kyrgyz Republic	772.4	180.7	43.5	31.9	23.4	10.5	35.9	18.7	6.9	2.0	3.1	4.1	4.9
Moldova	1,184.0	487.0	30.2	23.5	11.8	7.7	39.3	31.1	9.6	5.2	11.6	12.4	12.0
Russia	875.0	311.4	197.7	47.8	14.7	27.6	86.1	20.8	21.6	15.7	13.7	11.0	12.8
Tajikistan	2,195.0	350.0	609.0	418.0	88.0	43.2	27.6	32.9	38.6	12.2	16.3	7.1	7.9
Turkmenistan	3,102.0	1,748.0	1,005.3	992.4	83.7	16.8	24.2	8.3	11.6	8.7	6.5	10.0	10.5
Ukraine	4,734.0	891.0	377.0	80.0	15.9	10.6	22.7	28.2	12.0	0.8	5.2	9.0	14.1
Uzbekistan	534.2	1,568.3	304.6	43.1	70.9	29.0	57.3	49.2	47.5	44.3	14.8	8.8	10.0
Median [1]	*1,426.3*	*1,616.2*	*251.2*	*41.3*	*16.7*	*10.6*	*25.9*	*19.8*	*10.6*	*5.8*	*6.5*	*8.0*	*10.2*
Mean [1]	*1,860.5*	*2,656.8*	*350.3*	*150.5*	*34.5*	*19.8*	*50.5*	*31.3*	*18.9*	*12.3*	*9.8*	*8.9*	*9.1*
All transition countries													
Median [1]	*534.2*	*131.6*	*41.6*	*24.1*	*14.8*	*10.6*	*9.2*	*9.9*	*7.4*	*5.0*	*4.9*	*6.8*	*5.7*
Mean [1]	*1,013.6*	*1,254.5*	*176.3*	*85.2*	*69.1*	*17.0*	*28.3*	*21.4*	*16.1*	*8.9*	*6.7*	*6.7*	*6.6*

Note: Data for 1993-2003 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2004 are preliminary actuals, mostly official government estimates. Data for 2005 represent EBRD projections.

Estimates of inflation from parts of 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.

[2] The value for Serbia and Montenegro in 1993 is not included in the mean and median totals.

Table A.2.4

General government balances

(in per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
												Estimate	*Projection*
Central eastern Europe and the Baltic states													
Czech Republic	2.6	-1.2	-1.1	-1.6	-2.4	-4.2	-3.4	-4.5	-5.9	-6.8	-11.6	-3.3	-4.5
Estonia	na	1.2	-1.2	-1.5	2.0	-0.4	-4.0	-0.3	0.3	1.4	3.1	1.8	0.1
Hungary	-6.0	-7.5	-6.7	-5.0	-6.8	-8.0	-5.6	-3.0	-3.5	-8.5	-6.5	-5.4	-6.0
Latvia	na	-4.4	-3.6	-1.7	0.7	-0.7	-5.3	-2.7	-1.6	-2.7	-1.5	-0.8	-1.7
Lithuania	-5.3	-4.8	-4.2	-4.4	-1.1	-3.0	-5.6	-2.6	-2.1	-1.6	-1.9	-2.5	-2.6
Poland	-2.4	-2.2	-3.1	-3.3	-4.0	-2.1	-1.4	-1.9	-3.7	-3.3	-4.8	-3.9	-3.7
Slovak Republic	-5.7	-1.4	0.4	-1.3	-5.2	-5.0	-7.1	-12.3	-6.0	-5.7	-3.7	-3.3	-3.3
Slovenia	0.6	-0.2	-0.2	-0.2	-1.6	-2.2	-2.1	-3.4	-2.8	-2.4	-2.0	-1.9	-2.1
Average [1]	*-2.7*	*-2.6*	*-2.5*	*-2.4*	*-2.3*	*-3.2*	*-4.3*	*-3.8*	*-3.2*	*-3.7*	*-3.6*	*-2.4*	*-3.0*
South-eastern Europe													
SEE-3													
Bulgaria	-10.9	-5.7	-5.6	-10.3	-2.4	1.0	-0.9	-1.0	-0.9	-0.6	-0.4	1.8	1.0
Croatia	-0.8	1.2	-1.4	-1.0	-1.9	-1.0	-8.2	-6.5	-6.7	-5.0	-6.3	-4.9	-4.5
Romania	-0.4	-2.2	-2.5	-3.9	-4.5	-4.4	-2.1	-3.8	-3.5	-2.0	-2.0	-1.4	-1.0
SEE-4													
Albania	-15.5	-12.6	-10.1	-10.8	-13.6	-12.0	-12.2	-9.2	-8.5	-7.2	-4.4	-5.0	-4.5
Bosnia and Herzegovina	na	na	-0.3	-4.4	-0.5	-5.2	-4.8	-3.1	-2.5	-4.1	-1.7	-1.9	-1.3
FYR Macedonia	-13.4	-2.7	-1.0	-1.4	-0.4	-1.7	0.0	2.5	-6.3	-5.6	-0.1	0.7	-0.8
Serbia and Montenegro	na	na	na	na	na	na	na	-0.9	-1.3	-4.6	-3.4	-0.3	1.2
Average [1]	*-8.2*	*-4.4*	*-3.5*	*-5.3*	*-3.9*	*-3.9*	*-4.7*	*-3.1*	*-4.2*	*-4.2*	*-2.6*	*-1.6*	*-1.4*
Commonwealth of Independent States													
Armenia	-54.7	-16.5	-9.0	-8.5	-5.8	-4.9	-7.2	-6.4	-3.8	-0.4	-1.2	-1.7	-2.7
Azerbaijan	-15.3	-11.2	-3.1	-2.4	-4.0	-3.9	-4.7	-0.6	-0.4	-0.5	-1.2	0.8	1.8
Belarus	-5.5	-3.5	-2.7	-1.5	-0.7	-1.0	-2.0	-0.1	-1.9	-1.8	-1.4	0.0	-0.3
Georgia	-26.2	-7.4	-5.3	-7.3	-6.7	-5.4	-6.7	-4.0	-2.0	-2.0	-2.5	2.3	-3.5
Kazakhstan	-4.1	-7.4	-3.4	-5.3	-7.0	-8.0	-5.2	-1.0	2.7	1.4	2.9	2.7	1.7
Kyrgyz Republic	-14.4	-11.6	-17.3	-9.5	-9.2	-9.5	-12.7	-11.4	-5.6	-5.3	-5.2	-4.5	-4.6
Moldova	-7.5	-10.6	-6.7	-8.0	-10.5	-7.4	-6.2	-1.8	-0.3	-2.2	1.1	0.4	-1.6
Russia	-7.3	-10.4	-6.6	-9.4	-8.5	-8.1	-3.1	3.2	2.9	0.6	1.1	5.0	7.6
Tajikistan	-22.3	-10.1	-6.1	-5.8	-3.8	-3.8	-3.1	-5.6	-3.2	-2.5	-1.8	-2.7	-4.4
Turkmenistan	-3.5	1.7	0.4	0.3	-0.2	-2.6	0.0	-0.4	0.7	0.2	-1.8	-2.1	-3.2
Ukraine	-16.2	-8.7	-4.7	-3.2	-5.4	-2.5	-2.3	-1.1	-0.9	0.1	-0.7	-4.6	-2.9
Uzbekistan	-18.3	-4.4	-4.1	-7.3	-2.2	-3.3	-2.6	-2.2	-2.1	-1.5	-0.8	0.4	-3.7
Average [1]	*-16.3*	*-8.3*	*-5.7*	*-5.7*	*-5.3*	*-5.0*	*-4.7*	*-2.6*	*-1.2*	*-1.2*	*-1.0*	*-0.3*	*-1.3*
All transition countries													
Average [1]	***-11.0***	***-5.7***	***-4.2***	***-4.6***	***-4.1***	***-4.2***	***-4.6***	***-3.1***	***-2.6***	***-2.7***	***-2.2***	***-1.3***	***-1.8***

Note: Data for 1993-2003 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2004 are preliminary actuals, mostly official government estimates. Data for 2005 represent EBRD projections.

[1] Unweighted average for the region.

Table A.2.5

General government revenue

(in per cent of GDP)

	1998	1999	2000	2001	2002	2003	2004 *Estimate*
Central eastern Europe and the Baltic states							
Czech Republic	36.1	36.4	36.3	36.8	37.6	38.6	38.6
Estonia	37.9	36.3	35.6	35.3	36.6	38.0	38.8
Hungary	44.2	44.4	44.6	44.3	44.1	43.9	44.6
Latvia	39.5	37.4	34.6	32.8	32.9	33.5	35.4
Lithuania	31.6	31.6	30.1	29.6	29.3	31.8	27.4
Poland	37.1	37.2	37.6	37.5	36.8	37.4	39.1
Slovak Republic	57.1	49.8	47.6	45.5	45.2	35.5	44.7
Slovenia	40.3	41.0	44.7	45.1	45.7	46.2	45.4
Average [1]	*40.5*	*39.3*	*38.9*	*38.4*	*38.5*	*38.1*	*39.3*
South-eastern Europe							
SEE-3							
Bulgaria	38.0	38.7	38.7	37.7	36.5	37.9	39.2
Croatia	45.6	48.4	46.2	44.0	44.5	46.3	47.1
Romania	27.9	30.7	31.2	30.1	29.7	30.0	28.9
SEE-4							
Albania	22.5	22.7	22.7	23.0	23.9	24.0	23.7
Bosnia and Herzegovina	56.7	60.3	53.6	49.6	49.7	49.6	48.9
FYR Macedonia	33.3	35.4	36.2	34.0	34.9	38.4	37.5
Serbia and Montenegro	na	na	36.7	38.9	43.3	43.1	45.2
Average [1]	*37.3*	*39.4*	*37.9*	*36.8*	*37.5*	*38.5*	*38.6*
Commonwealth of Independent States							
Armenia	20.7	22.7	19.6	17.1	18.8	17.8	16.0
Azerbaijan	19.6	17.9	21.2	21.5	27.3	26.6	27.3
Belarus	44.4	45.3	45.8	44.9	44.6	45.8	46.2
Georgia	13.7	15.4	15.2	16.3	15.8	16.2	21.8
Kazakhstan	18.0	18.0	22.2	25.7	22.5	25.4	26.0
Kyrgyz Republic	24.4	21.3	18.5	20.4	22.8	22.2	22.6
Moldova	37.6	30.4	30.7	29.1	29.3	34.4	34.7
Russia	34.4	33.6	36.9	37.3	37.6	36.7	38.6
Tajikistan	11.2	13.5	13.6	15.2	16.7	17.3	17.9
Turkmenistan	22.0	22.7	26.3	23.3	21.3	24.5	25.9
Ukraine	35.6	31.9	33.4	33.5	35.6	37.0	35.6
Uzbekistan	31.1	29.3	28.0	33.9	35.7	33.1	32.3
Average [1]	*26.1*	*25.2*	*26.0*	*26.5*	*27.3*	*28.1*	*28.7*
All transition countries							
Average [1]	***33.1***	***32.8***	***32.9***	***32.7***	***33.3***	***33.7***	***34.4***

Note: Data for 1998-2003 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2004 are preliminary actuals, mostly official government estimates.

[1] Unweighted average for the region.

Table A.2.6

General government expenditure

(in per cent of GDP)

	1998	1999	2000	2001	2002	2003	2004 *Estimate*
Central eastern Europe and the Baltic states							
Czech Republic	38.4	39.0	40.4	41.6	43.9	43.7	41.9
Estonia	38.2	40.3	36.2	34.9	35.5	35.6	37.1
Hungary	50.4	49.9	47.7	48.7	52.6	50.2	48.9
Latvia	40.2	41.0	37.2	34.9	35.7	35.0	36.2
Lithuania	36.9	39.6	33.0	31.1	30.8	31.7	32.2
Poland	40.1	40.3	41.0	43.0	43.4	44.2	44.6
Slovak Republic	60.8	56.9	59.9	51.5	50.9	39.2	48.0
Slovenia	41.7	41.9	48.2	47.9	48.1	48.2	47.7
Average [1]	*43.3*	*43.6*	*43.0*	*41.7*	*42.6*	*41.0*	*42.1*
South-eastern Europe							
SEE-3							
Bulgaria	37.0	39.6	39.7	38.6	37.2	38.4	37.5
Croatia	46.7	56.6	52.7	50.7	51.4	52.7	52.0
Romania	34.7	35.2	34.8	33.4	32.3	32.3	30.5
SEE-4							
Albania	34.5	34.9	31.9	31.6	31.1	28.4	28.7
Bosnia and Herzegovina	61.8	65.0	56.6	52.1	53.9	51.3	50.8
FYR Macedonia	35.0	35.4	33.7	40.3	40.5	38.5	36.8
Serbia and Montenegro	na	na	37.6	40.2	47.8	46.5	45.5
Average [1]	*41.6*	*44.5*	*41.0*	*41.0*	*42.0*	*41.2*	*40.3*
Commonwealth of Independent States							
Armenia	25.6	30.1	25.9	20.9	19.3	18.9	16.0
Azerbaijan	23.7	23.6	20.8	18.7	27.7	28.3	26.5
Belarus	45.4	47.3	45.9	46.8	46.4	47.2	46.2
Georgia	19.1	22.1	19.2	18.3	17.8	18.7	19.5
Kazakhstan	26.1	23.2	23.2	23.0	21.0	22.5	23.3
Kyrgyz Republic	33.9	34.0	29.9	26.0	28.1	27.4	27.1
Moldova	44.9	36.6	34.5	29.4	31.5	33.3	35.7
Russia	42.5	36.7	33.7	34.6	37.0	35.6	33.6
Tajikistan	15.0	14.9	19.2	18.4	19.2	19.1	20.7
Turkmenistan	24.6	22.7	26.7	22.6	21.1	26.3	28.0
Ukraine	38.0	34.1	34.5	34.4	35.6	37.7	40.2
Uzbekistan	34.3	32.0	30.2	36.0	37.2	33.9	32.0
Average [1]	*31.1*	*29.8*	*28.6*	*27.4*	*28.5*	*29.1*	*29.1*
All transition countries							
Average [1]	***37.3***	***37.4***	***36.1***	***35.2***	***36.2***	***35.7***	***35.8***

Note: Data for 1998-2003 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2004 are preliminary actuals, mostly official government estimates.

[1] Unweighted average for the region.

Table A.2.7

Current account balances

(in per cent of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Central eastern Europe and the Baltic states													
Czech Republic	1.3	-1.9	-2.5	-6.7	-6.3	-2.1	-2.5	-4.9	-5.4	-5.6	-6.3	-5.2	-3.5
Estonia	1.3	-6.9	-4.2	-8.6	-11.4	-8.6	-4.4	-5.4	-5.7	-10.2	-12.1	-12.7	-11.4
Hungary	-9.0	-9.4	-5.6	-3.9	-4.5	-7.2	-7.9	-8.7	-6.2	-7.2	-8.9	-8.9	-8.0
Latvia	19.1	5.5	-0.3	-5.0	-5.6	-9.8	-9.1	-6.4	-8.9	-6.5	-8.6	-12.4	-10.5
Lithuania	-3.2	-2.2	-9.6	-9.0	-10.0	-11.7	-11.0	-5.9	-4.7	-5.2	-6.7	-7.1	-8.6
Poland	-0.7	1.0	0.6	-2.1	-3.7	-4.1	-7.6	-6.0	-2.9	-2.6	-2.2	-1.5	-1.3
Slovak Republic	-4.5	4.3	2.0	-10.1	-9.2	-9.3	-5.3	-3.3	-9.0	-8.0	-0.8	-3.5	-5.4
Slovenia	1.5	4.0	-0.4	0.3	0.3	-0.6	-3.3	-2.9	0.1	1.8	0.0	-1.3	-0.7
Average [1]	*0.7*	*-0.7*	*-2.5*	*-5.6*	*-6.3*	*-6.7*	*-6.4*	*-5.4*	*-5.3*	*-5.4*	*-5.7*	*-6.6*	*-6.2*
South-eastern Europe													
SEE-3													
Bulgaria	-10.1	-0.3	-1.5	1.7	10.0	-0.5	-5.0	-5.6	-7.3	-5.3	-9.3	-7.5	-7.5
Croatia	5.7	5.9	-7.7	-5.5	-11.6	-6.7	-7.0	-2.5	-3.7	-8.4	-7.2	-4.8	-5.0
Romania	-4.5	-1.4	-5.0	-7.3	-6.1	-6.9	-3.6	-3.6	-5.8	-3.4	-6.1	-7.5	-8.7
SEE-4													
Albania	-29.1	-14.3	-7.1	-8.1	-12.6	-6.8	-7.7	-7.4	-6.4	-9.7	-8.2	-6.1	-7.2
Bosnia and Herzegovina	na	na	-10.3	-27.3	-30.0	-27.0	-17.9	-13.1	-16.1	-21.7	-21.8	-24.7	-18.6
FYR Macedonia	0.6	-5.3	-5.0	-7.7	-7.7	-7.5	-0.9	-2.0	-5.7	-8.4	-3.5	-8.2	-6.5
Serbia and Montenegro	na	na	na	-9.8	-6.5	-4.2	-4.4	-4.7	-4.6	-8.9	-9.7	-13.1	-9.8
Average [1]	*-7.5*	*-3.1*	*-6.1*	*-9.1*	*-9.2*	*-8.5*	*-6.6*	*-5.6*	*-7.1*	*-9.4*	*-9.4*	*-10.3*	*-9.0*
Commonwealth of Independent States													
Armenia	-14.3	-16.0	-17.0	-18.2	-18.0	-21.3	-16.6	-14.5	-10.0	-6.3	-6.8	-4.6	-4.6
Azerbaijan	-10.2	-10.3	-13.2	-25.8	-23.1	-30.7	-13.1	-3.5	-0.9	-12.3	-27.8	-30.3	-10.0
Belarus	-11.9	-9.1	-4.4	-3.6	-6.1	-6.7	-1.6	-3.1	-3.5	-2.1	-2.4	-4.6	2.6
Georgia	-40.2	-22.3	-7.5	-9.1	-10.6	-8.9	-7.7	-4.5	-6.6	-5.8	-7.2	-7.6	-11.8
Kazakhstan	-7.8	-7.6	-1.3	-3.6	-3.6	-5.5	-1.4	2.0	-6.3	-4.2	-0.9	1.3	2.5
Kyrgyz Republic	-10.0	-7.6	-15.7	-23.3	-7.8	-22.1	-14.7	-5.7	-1.6	-3.1	-4.2	-3.4	-4.5
Moldova	-14.5	-8.4	-8.0	-11.1	-14.2	-19.7	-5.8	-7.6	-1.7	-4.0	-6.6	-4.4	-4.5
Russia	na	2.8	2.2	2.8	0.0	0.1	12.6	18.0	11.1	8.4	8.3	10.3	12.3
Tajikistan	-28.8	-20.1	-14.8	-7.1	-5.4	-9.1	-3.4	-6.4	-7.0	-2.7	-1.2	-3.9	-4.3
Turkmenistan	na	4.0	0.9	0.1	-25.3	-36.7	-28.4	15.2	3.4	15.2	8.8	-1.1	1.0
Ukraine	na	-3.2	-3.1	-2.7	-2.7	-3.1	5.2	4.7	3.7	7.5	5.8	10.5	5.4
Uzbekistan	-8.4	2.1	-0.2	-7.8	-5.4	-0.9	-2.0	2.4	-1.5	3.0	8.9	9.8	8.3
Average [1]	*-16.2*	*-8.0*	*-6.8*	*-9.1*	*-10.2*	*-13.7*	*-6.4*	*-0.3*	*-1.7*	*-0.5*	*-2.1*	*-2.3*	*-0.6*
All transition countries													
Average [1]	***-8.1***	***-4.7***	***-5.3***	***-8.1***	***-8.8***	***-10.3***	***-6.5***	***-3.2***	***-4.2***	***-4.3***	***-5.1***	***-5.6***	***-4.5***

Note: Data for 1993-2003 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and Eurostat. Data for 2004 are preliminary actuals, mostly official government estimates. Data for 2005 represent EBRD projections.

[1] Unweighted average for the region.

Table A.2.8

Foreign direct investment

(net inflows recorded in the balance of payments)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection	Cumulative FDI inflows 1989-2004	FDI inflows per capita 1989-2004	FDI inflows per capita 2003	FDI inflows per capita 2004	FDI inflows 2003	FDI inflows 2004
Central eastern Europe and the Baltic states							*(in US$ million)*							*(in US$ mln)*	*(US$)*	*(US$)*		*(in per cent of GDP)*	
Czech Republic	563	749	2,526	1,276	1,275	3,591	6,234	4,943	5,476	8,276	1,895	3,917	8,500	41,704	4,080	186	383	2.1	3.7
Estonia	156	212	199	111	130	574	222	324	343	153	763	781	2,500	4,046	2,995	563	578	8.3	7.0
Hungary	2,328	1,097	4,410	3,295	3,719	3,065	3,065	2,191	3,580	2,590	874	3,653	3,500	37,294	3,693	86	362	1.1	3.6
Latvia	50	279	245	379	515	303	331	401	170	374	328	538	622	3,910	1,686	141	232	3.0	4.0
Lithuania	30	31	72	152	328	921	478	375	439	715	142	510	655	4,193	1,217	41	148	1.0	2.3
Poland	580	1,846	3,617	4,445	4,863	6,049	7,239	9,327	5,804	3,901	3,927	5,353	6,431	57,352	1,502	103	140	2.0	2.0
Slovak Republic	107	236	194	199	84	374	701	2,058	1,460	4,007	549	1,259	1,800	11,444	2,128	102	234	1.7	3.1
Slovenia	111	129	161	167	303	221	59	71	226	1,489	-139	277	346	3,130	1,573	-70	139	0.0	1.0
Total	*3,925*	*4,580*	*11,422*	*10,023*	*11,217*	*15,098*	*18,329*	*19,689*	*17,497*	*21,504*	*8,339*	*16,288*	*24,354*	*163,074*	*2,235*	*114*	*223*	*2.4*	*3.3*
South-eastern Europe																			
SEE-3																			
Bulgaria	40	105	98	138	507	537	802	998	803	876	2,070	1,232	2,697	8,309	1,071	265	159	10.4	5.1
Croatia	102	110	109	486	347	835	1,420	1,085	1,407	591	1,700	898	1,000	9,102	2,049	383	202	6.0	2.6
Romania	87	341	417	415	1,267	2,079	1,025	1,051	1,154	1,080	2,156	5,020	5,300	16,185	747	99	232	3.8	6.9
SEE-4																			
Albania	45	65	89	97	42	45	51	143	204	135	178	343	288	1,457	455	56	107	3.0	5.0
Bosnia and Herzegovina	na	0	0	0	0	67	177	150	130	266	382	490	540	1,661	437	101	129	5.0	6.0
FYR Macedonia	0	24	12	12	18	118	32	176	439	77	97	150	150	1,155	577	48	75	2.0	3.0
Serbia and Montenegro	na	na	na	0	740	113	112	25	165	562	1,405	1,028	1,600	4,150	498	169	123	7.0	4.0
Total	*274*	*646*	*725*	*1,148*	*2,920*	*3,794*	*3,618*	*3,628*	*4,302*	*3,587*	*7,989*	*9,162*	*11,575*	*42,018*	*821*	*156*	*179*	*5.3*	*4.7*
Commonwealth of Independent States																			
Armenia	1	8	25	18	52	221	122	104	70	111	121	217	198	1,069	333	38	67	4.0	6.0
Azerbaijan	0	22	330	627	1,115	1,023	510	149	299	1,048	2,353	2,351	1,173	9,828	1,190	285	285	32.0	28.0
Belarus	18	11	15	105	350	201	443	119	96	453	170	168	160	2,147	218	17	17	1.0	0.7
Georgia	0	8	6	54	236	221	62	153	80	122	335	503	731	1,781	386	73	109	8.0	10.0
Kazakhstan	473	635	964	1,137	1,320	1,143	1,468	1,278	2,861	2,164	2,210	5,548	2,700	21,301	1,413	148	368	7.2	13.6
Kyrgyz Republic	10	38	96	47	83	87	38	-7	-1	5	46	131	83	573	112	9	26	2.4	5.9
Moldova	14	12	25	23	78	75	38	127	102	132	71	148	120	862	255	20	44	4.0	5.7
Russia	na	408	1,460	1,656	1,681	1,492	1,102	-463	216	-72	-1,769	2,132	5,000	7,843	54	-12	15	0.0	0.0
Tajikistan	9	12	10	18	18	25	21	24	9	36	32	272	40	495	76	5	42	2.0	13.0
Turkmenistan	79	103	233	108	108	62	125	131	170	276	226	330	330	1,951	300	36	51	5.0	7.0
Ukraine	na	151	257	516	581	747	489	594	769	698	1,411	1,711	900	7,924	168	30	36	3.0	3.0
Uzbekistan	48	73	-24	90	167	140	121	75	83	65	70	187	250	1,104	42	3	7	1.0	2.0
Total	*652*	*1,480*	*3,398*	*4,399*	*5,789*	*5,437*	*4,540*	*2,284*	*4,753*	*5,038*	*5,276*	*13,699*	*11,685*	*56,876*	*203*	*19*	*49*	*5.8*	*7.9*
All transition countries																			
Total	***4,850***	***6,706***	***15,545***	***15,569***	***19,926***	***24,328***	***26,487***	***25,601***	***26,552***	***30,129***	***21,603***	***39,148***	***47,614***	***261,969***	***647***	***53***	***97***	***4.7***	***5.7***

Sources: IMF, central banks and EBRD estimates.

Note: Regional FDI inflows per capita are weighted averages (by population). Regional FDI in per cent of GDP is an unweighted average.

Table A.2.9

GDP growth forecasts for 2005

(in per cent)

	Average[1]	Range[2]	EBRD (Sep 2005)	European Union (Apr 2005)	IMF (Sep 2005)	OECD (May 2005)	United Nations DESA[4] (Sep 2005)	CSFB[5] (Sep 2005)	Dun & Bradstreet (Aug 2005)	Economist Intelligence Unit (Aug 2005)	Global Insight, Inc.[6] (Aug 2005)	IWH[7] (Sep 2005)	JP Morgan (Sep 2005)	Kopint-Datorg[8] (Sep 2005)	Vienna Institute[9] (Jun 2005)
Central eastern Europe and the Baltic states															
Czech Republic	4.2	1.5	5.0	4.0	4.1	4.1	4.3	na	3.5	4.2	4.0	4.1	4.2	4.9	4.3
Estonia	6.8	2.0	7.0	6.0	7.0	na	6.5	na	6.0	6.8	7.3	7.5	na	8.0	6.0
Hungary	3.6	0.5	3.5	3.9	3.4	3.6	3.5	3.4	3.7	3.6	3.4	3.5	3.5	3.8	3.4
Latvia	7.5	2.2	7.5	7.2	7.8	na	6.5	na	7.2	6.8	7.6	8.0	na	8.7	7.2
Lithuania	6.5	0.8	6.8	6.4	6.8	na	6.5	na	6.4	6.5	6.5	7.0	na	6.2	6.4
Poland	3.5	1.4	3.5	4.4	3.0	4.2	3.6	3.5	3.5	3.4	3.1	3.4	3.3	3.3	3
Slovak Republic	5.2	0.7	5.3	4.9	5.0	4.8	5.4	na	5.5	5.3	5.1	5.0	4.8	5.2	5.5
Slovenia	3.7	0.7	3.8	3.7	3.9	na	3.6	na	4.0	3.5	3.3	3.5	na	4.0	3.4
Average	*5.1*	*1.2*	*5.3*	*5.1*	*5.1*	*4.2*	*5.0*	*3.5*	*5.0*	*5.0*	*5.0*	*5.3*	*4.0*	*5.5*	*4.9*
Weighted average[3]	*4.0*	*1.2*	*4.2*	*4.4*	*3.8*	*na*	*4.1*	*na*	*4.0*	*4.0*	*3.8*	*4.0*	*na*	*4.2*	*3.8*
South-eastern Europe															
SEE-3															
Bulgaria	5.4	1.0	5.5	6.0	5.5	na	5.0	5.5	5.5	5.2	5.2	5.3	5.5	na	5.5
Croatia	3.4	1.0	3.5	4.0	3.4	na	3.0	3.8	3.7	3.1	3.3	na	na	na	3.0
Romania	5.5	1.0	5.5	5.5	5.0	na	5.0	6.0	6.0	5.0	5.9	5.5	6.0	na	5.5
SEE-4															
Albania	6.1	0.5	6.0	na	6.0	na	6.0	na	6.0	6.0	6.0	na	na	na	6.5
Bosnia and Herzegovina	4.9	0.9	5.0	na	na	na	4.6	na	4.4	5.0	5.3	na	na	na	5.0
FYR Macedonia	3.8	0.5	3.5	na	3.8	na	3.8	na	3.7	4.0	3.7	na	na	na	4.0
Serbia and Montenegro	4.4	1.2	4.0	na	na	na	4.0	4.5	5.2	4.0	5.2	na	na	na	4.0
Average	*4.8*	*0.9*	*4.7*	*5.2*	*4.7*	*na*	*4.5*	*5.0*	*4.9*	*4.6*	*4.9*	*5.4*	*5.8*	*na*	*4.8*
Weighted average[3]	*4.9*	*1.0*	*4.8*	*na*	*na*	*na*	*4.5*	*na*	*5.2*	*4.5*	*5.1*	*na*	*na*	*na*	*4.8*
Commonwealth of Independent States															
Armenia	9.5	3.0	10.0	na	8.0	na	10.0	na	na	8.5	11.0	na	na	na	na
Azerbaijan	18.2	4.2	20.0	na	18.7	na	16.0	na	15.8	20.0	18.4	na	na	na	na
Belarus	8.2	2.4	8.0	na	7.1	na	9.5	na	8.0	8.0	8.3	na	na	na	na
Georgia	8.0	2.5	8.5	na	7.5	na	7.0	na	9.5	8.0	7.4	na	na	na	na
Kazakhstan	9.0	0.8	9.0	na	8.8	na	9.0	na	8.5	9.3	9.1	na	na	na	na
Kyrgyz Republic	3.1	4.7	2.5	na	4.0	na	4.0	na	4.4	4.0	-0.3	na	na	na	na
Moldova	6.2	0.5	6.5	na	6.0	na	6.5	na	na	6.0	6.0	na	na	na	na
Russia	5.8	0.9	6.0	6.0	5.5	6.0	6.0	5.5	5.5	6.2	5.9	5.5	5.6	na	5.3
Tajikistan	8.3	0.6	8.0	na	8.0	na	8.5	na	8.5	8.0	8.6	na	na	na	na
Turkmenistan	7.8	6.7	7.0	na	9.6	na	6.0	na	7.0	12.0	5.3	na	na	na	na
Ukraine	4.9	3.8	4.0	na	5.5	na	5.0	3.7	7.5	4.3	4.5	na	4.5	na	5.5
Uzbekistan	4.9	5.7	4.0	na	3.5	na	5.5	na	2.5	5.5	8.2	na	na	na	na
Average	*7.8*	*3.0*	*7.8*	*6.0*	*7.7*	*6.0*	*7.8*	*4.6*	*7.7*	*8.3*	*7.7*	*5.5*	*5.1*	*na*	*5.4*
Weighted average[3]	*6.1*	*1.4*	*6.2*	*na*	*5.9*	*na*	*6.3*	*na*	*na*	*6.5*	*6.2*	*na*	*na*	*na*	*na*
All transition countries															
Average	*6.2*	*1.9*	*6.3*	*5.2*	*6.3*	*4.5*	*6.1*	*4.5*	*6.1*	*6.4*	*6.2*	*5.3*	*4.7*	*5.5*	*4.9*
Weighted average[3]	*5.2*	*1.3*	*5.3*	*na*	*na*	*na*	*5.2*	*na*	*na*	*5.3*	*5.2*	*na*	*na*	*na*	*na*

Note: All forecasts quoted were published or reported to the EBRD between April and September 2005. 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 average for all transition countries is calculated using the mean of all the average forecasts shown in this column.
2 Data show the difference between the highest and the lowest of the forecasts.
3 Weighted average based on EBRD estimates of nominal US dollar GDP in each country in 2004.
4 United Nations, Department of Economic and Social Affairs (DESA).
5 Credit Suisse First Boston.
6 Global Insight Inc, formerly DRI-WEFA.
7 Institute for Economic Research, Halle, Germany.
8 Kopint-Datorg is the Institute for Economic and Market Research Information, Hungary.
9 Vienna Institute for International Economic Studies (WIIW).

Table A.2.10

GDP growth forecasts for 2006

(in per cent)

	Average[1]	Range[2]	EBRD (Sep 2005)	European Union (Apr 2005)	IMF (Sep 2005)	OECD (May 2005)	United Nations DESA[4] (Sep 2005)	CSFB[5] (Sep 2005)	Dun & Bradstreet (Aug 2005)	Economist Intelligence Unit (Aug 2005)	Global Insight, Inc.[6] (Aug 2005)	IWH[7] (Sep 2005)	JP Morgan (Sep 2005)	Kopint-Datorg[8] (Sep 2005)	Vienna Institute[9] (Jun 2005)
Central eastern Europe and the Baltic states															
Czech Republic	4.3	0.7	4.2	4.2	3.9	4.3	4.5	na	3.8	4.4	4.3	4.5	4.2	4.5	4.3
Estonia	6.4	1.0	6.4	6.2	6.0	na	6.5	na	6.2	6.4	6.5	7.0	na	6.2	6.2
Hungary	3.8	0.7	4.0	3.8	3.6	3.9	4.0	3.6	3.3	3.9	3.7	3.8	3.6	4.0	3.7
Latvia	6.7	1.5	6.5	6.9	6.8	na	6.5	na	6.9	6.5	6.0	7.5	na	6.5	6.9
Lithuania	6.0	1.6	6.5	5.9	6.5	na	5.5	na	6.2	5.4	5.5	7.0	na	5.5	5.9
Poland	4.3	0.6	4.5	4.5	4.0	4.5	4.2	4.0	4.6	4.1	4.5	4.5	4.2	4.0	4.0
Slovak Republic	5.4	1.0	5.0	5.2	5.4	5.7	5.5	na	5.2	5.5	5.4	5.5	5.2	5.0	6.0
Slovenia	3.8	0.6	3.5	4.0	4.0	na	3.9	na	4.0	3.9	4.0	4.0	na	3.8	3.4
Average	*5.1*	*1.0*	*5.1*	*5.1*	*5.0*	*4.6*	*5.1*	*3.8*	*5.0*	*5.0*	*5.0*	*5.5*	*4.3*	*4.9*	*5.1*
Weighted average[3]	*4.4*	*0.7*	*4.5*	*4.5*	*4.2*	*na*	*4.4*	*na*	*4.4*	*4.4*	*4.5*	*4.6*	*na*	*4.3*	*4.3*
South-eastern Europe															
SEE-3															
Bulgaria	5.1	5.1	5.5	4.5	5.5	na	4.3	5.2	5.4	4.2	4.6	6.0	5.8	na	5.3
Croatia	3.7	3.7	3.8	4.3	3.9	na	3.5	4.4	3.7	3.6	3.5	na	na	na	3.0
Romania	5.5	5.5	5.3	5.1	5.0	na	5.0	6.0	5.5	4.8	6.2	6.5	5.5	na	5.5
SEE-4															
Albania	6.1	0.5	6.0	na	6.0	na	6.0	na	6.0	6.0	6.0	na	na	na	6.5
Bosnia and Herzegovina	5.3	1.1	5.0	na	na	na	5.0	na	4.9	5.5	5.5	na	na	na	6.0
FYR Macedonia	3.8	0.5	4.0	na	3.7	na	4.0	na	3.5	4.0	3.5	na	na	na	4.0
Serbia and Montenegro	4.9	1.8	4.0	na	na	na	4.5	5.0	5.0	5.0	5.8	na	na	na	5.0
Average	*4.9*	*2.6*	*4.8*	*4.6*	*4.8*	*na*	*4.6*	*5.2*	*4.9*	*4.7*	*5.0*	*6.3*	*5.7*	*na*	*5.0*
Weighted average[3]	*5.0*	*4.0*	*4.8*	*na*	*na*	*na*	*4.6*	*na*	*5.0*	*4.6*	*5.3*	*na*	*na*	*na*	*4.9*
Commonwealth of Independent States															
Armenia	7.0	2.0	8.0	na	6.0	na	7.0	na	na	6.0	7.8	na	na	na	na
Azerbaijan	20.3	15.6	25.0	na	26.6	na	15.0	na	11.0	25.0	18.9	na	na	na	na
Belarus	5.9	4.5	5.0	na	4.0	na	8.5	na	6.0	6.0	6.1	na	na	na	na
Georgia	7.2	5.5	6.0	na	4.5	na	5.5	na	10.0	10.0	7.1	na	na	na	na
Kazakhstan	8.3	2.0	8.5	na	7.7	na	8.0	na	7.3	8.9	9.3	na	na	na	na
Kyrgyz Republic	5.1	1.8	5.1	na	5.5	na	5.8	na	4.0	5.5	4.6	na	na	na	na
Moldova	5.1	0.5	5.0	na	5.0	na	5.5	na	na	5.0	5.1	na	na	na	na
Russia	5.4	1.1	5.5	5.3	5.3	6.0	5.5	5.0	4.9	5.5	5.3	6.0	5.3	na	5.0
Tajikistan	7.5	1.0	8.0	na	7.0	na	8.0	na	7.5	7.0	7.4	na	na	na	na
Turkmenistan	6.3	2.0	6.8	na	6.5	na	5.0	na	6.5	7.0	5.7	na	na	na	na
Ukraine	5.6	3.5	5.5	na	5.4	na	5.0	5.5	6.5	5.0	7.5	na	4.0	na	6.0
Uzbekistan	4.1	4.5	4.0	na	2.5	na	6.0	na	1.5	5.0	5.8	na	na	na	na
Average	*7.3*	*3.7*	*7.7*	*5.3*	*7.2*	*6.0*	*7.1*	*5.3*	*6.5*	*8.0*	*7.6*	*6.0*	*4.7*	*na*	*5.5*
Weighted average[3]	*5.8*	*1.7*	*5.9*	*na*	*5.6*	*na*	*5.8*	*na*	*na*	*5.9*	*5.9*	*na*	*na*	*na*	*na*
All transition countries															
Average	*6.0*	*2.6*	*6.2*	*5.0*	*6.0*	*4.9*	*5.8*	*4.8*	*5.6*	*6.3*	*6.1*	*5.7*	*4.7*	*4.9*	*5.1*
Weighted average[3]	*5.1*	*1.6*	*5.2*	*na*	*na*	*na*	*5.1*	*na*	*na*	*5.2*	*5.3*	*na*	*na*	*na*	*na*

Note: All forecasts quoted were published or reported to the EBRD between April and September 2005. 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.

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2 Data show the difference between the highest and the lowest of the forecasts.
3 Weighted average based on EBRD estimates of nominal US dollar GDP in each country in 2004.
4 United Nations, Department of Economic and Social Affairs (DESA).
5 Credit Suisse First Boston.
6 Global Insight Inc, formerly DRI-WEFA.
7 Institute for Economic Research, Halle, Germany.
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9 Vienna Institute for International Economic Studies (WIIW).

Table A.2.11

Average annual inflation forecasts for 2005

(change in the average consumer price level, in per cent)

	Average[1]	Range[2]	EBRD (Sep 2005)	European Union (Apr 2005)	IMF (Sep 2005)	OECD (May 2005)	United Nations DESA[3] (Sep 2005)	CSFB[4] (Sep 2005)	Dun & Bradstreet (Aug 2005)	Economist Intelligence Unit (Aug 2005)	Global Insight, Inc.[5] (Aug 2005)	IWH[6] (Sep 2005)	JP Morgan (Sep 2005)	Kopint-Datorg[7] (Sep 2005)	Vienna Institute[8] (Jun 2005)
Central eastern Europe and the Baltic states															
Czech Republic	1.9	0.4	2.0	1.9	2.0	2.0	2.0	na	1.8	2.0	1.8	2.0	1.8	1.6	1.8
Estonia	3.7	1.2	3.9	3.3	3.9	na	4.0	na	3.8	3.9	3.9	3.5	na	3.7	2.8
Hungary	3.8	0.9	3.8	3.8	4.0	3.8	4.0	3.7	4.5	3.8	3.7	3.8	3.7	3.7	3.6
Latvia	5.9	1.4	6.4	5.0	6.3	na	6.0	na	6.0	5.9	6.3	6.0	na	6.1	5.5
Lithuania	2.4	1.4	2.8	2.9	2.7	na	2.5	na	1.7	2.5	2.5	2.5	na	2.6	1.5
Poland	2.3	1.0	2.2	2.1	2.2	2.5	2.3	2.0	2.5	2.1	2.3	2.5	2.1	2.2	3.0
Slovak Republic	2.8	1.4	2.4	3.7	2.7	2.8	2.9	na	3.5	2.7	2.7	2.8	2.7	2.3	3.0
Slovenia	2.6	0.7	2.5	2.6	2.6	na	2.5	na	3.0	2.4	2.5	3.0	na	2.3	2.7
Average	*3.2*	*1.1*	*3.3*	*3.2*	*3.3*	*2.8*	*3.3*	*2.9*	*3.4*	*3.2*	*3.2*	*3.3*	*2.6*	*3.1*	*3.0*
South-eastern Europe															
SEE-3															
Bulgaria	4.2	0.5	4.2	4.0	4.4	na	4.5	4.4	4.0	4.5	4.1	4.5	4.0	na	4.0
Croatia	2.9	1.2	2.9	2.7	3.0	na	3.0	3.1	2.0	3.2	3.2	na	na	na	3.0
Romania	8.7	2.0	9.2	8.2	8.8	na	9.0	9.0	7.2	8.9	9.0	9.0	8.4	na	9.0
SEE-4															
Albania	2.4	0.5	2.1	na	2.4	na	2.6	na	2.3	2.5	2.4	na	na	na	2.5
Bosnia and Herzegovina	1.6	2.4	na	na	na	na	1.2	na	0.9	2.3	2.9	na	na	na	0.5
FYR Macedonia	1.2	2.7	0.0	na	1.2	na	1.0	na	2.7	1.0	0.7	na	na	na	2.0
Serbia and Montenegro	15.0	7.0	16.2	na	na	na	15.0	17.5	10.5	15.5	15.0	na	na	na	15.0
Average	*5.1*	*2.3*	*5.8*	*5.0*	*4.0*	*na*	*5.2*	*8.5*	*4.2*	*5.4*	*5.3*	*6.8*	*6.2*	*na*	*5.1*
Commonwealth of Independent States															
Armenia	2.3	4.2	0.3	na	2.2	na	4.5	na	na	2.4	2.0	na	na	na	na
Azerbaijan	11.6	2.5	10.4	na	12.7	na	10.5	na	10.9	12.0	12.9	na	na	na	na
Belarus	11.5	2.5	10.6	na	12.1	na	12.5	na	11.5	12.0	10.0	na	na	na	na
Georgia	8.3	2.4	9.4	na	9.0	na	8.5	na	7.0	8.0	7.8	na	na	na	na
Kazakhstan	7.3	0.7	6.8	na	7.4	na	7.5	na	7.0	7.5	7.4	na	na	na	na
Kyrgyz Republic	4.9	2.3	4.9	na	5.0	na	4.5	na	3.9	6.2	5.0	na	na	na	na
Moldova	12.5	1.9	12.0	na	13.3	na	13.5	na	na	12.3	11.6	na	na	na	na
Russia	12.5	2.5	12.8	na	12.8	13.0	12.5	12.5	10.5	13.0	12.9	13.0	12.7	na	12.0
Tajikistan	7.4	2.4	7.9	na	7.2	na	8.0	na	5.6	8.0	7.8	na	na	na	na
Turkmenistan	10.2	6.5	10.5	na	13.5	na	12.0	na	7.0	10.0	8.2	na	na	na	na
Ukraine	13.6	2.5	14.1	na	14.2	na	14.5	14.0	12.0	13.8	13.5	na	14.2	na	12.0
Uzbekistan	11.0	12.4	10.0	na	14.1	na	18.5	na	10.8	6.1	6.5	na	na	na	na
Average	*9.4*	*3.6*	*9.1*	*na*	*10.3*	*13.0*	*10.6*	*13.3*	*8.6*	*9.3*	*8.8*	*13.0*	*13.5*	*na*	12.0
All transition countries															
Average	*6.5*	*2.5*	*6.6*	*3.7*	*6.8*	*4.8*	*7.0*	*8.3*	*5.7*	*6.5*	*6.2*	*4.8*	*6.2*	*3.1*	*4.9*

Note: All forecasts quoted were published or reported to the EBRD between April and September 2005. 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.

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2 Data show the difference between the highest and the lowest of the forecasts.

3 United Nations, Department of Economic and Social Affairs (DESA).

4 Credit Suisse First Boston.

5 Global Insight Inc, formerly DRI-WEFA.

6 Institute for Economic Research, Halle, Germany.

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8 Vienna Institute for International Economic Studies (WIIW).

Table A.2.12

Average annual inflation forecasts for 2006

(change in the average consumer price level, in per cent)

	Average[1]	Range[2]	EBRD (Sep 2005)	European Union (Apr 2005)	IMF (Sep 2005)	OECD (May 2005)	United Nations DESA[3] (Sep 2005)	CSFB[4] (Sep 2005)	Dun & Bradstreet (Aug 2005)	Economist Intelligence Unit (Aug 2005)	Global Insight, Inc.[5] (Aug 2005)	IWH[6] (Sep 2005)	JP Morgan (Sep 2005)	Kopint-Datorg[7] (Sep 2005)	Vienna Institute[8] (Jun 2005)
Central eastern Europe and the Baltic states															
Czech Republic	2.4	0.7	2.5	2.6	2.5	2.5	2.0	na	2.0	2.0	2.7	2.5	2.6	2.3	2.2
Estonia	2.9	1.0	3.0	2.7	2.8	na	3.0	na	3.3	3.2	3.5	2.5	na	2.5	2.5
Hungary	3.0	2.5	3.0	3.6	3.6	3.8	3.0	2.3	4.0	2.7	1.5	3.5	2.0	2.3	3.3
Latvia	4.2	1.9	4.0	3.6	5.1	na	4.0	na	5.0	4.2	4.1	4.0	na	3.2	4.5
Lithuania	2.1	1.6	2.5	2.6	2.5	na	2.0	na	1.5	1.9	2.5	2.0	na	2.4	1.0
Poland	2.3	1.3	2.0	2.3	2.5	2.6	2.0	1.7	2.4	1.9	2.5	2.5	1.7	2.4	3.0
Slovak Republic	2.8	0.8	2.9	2.9	2.7	2.7	2.5	na	3.0	2.4	3.2	3.0	2.7	2.6	2.5
Slovenia	2.6	0.8	3.0	2.6	2.5	na	2.5	na	2.7	2.6	2.5	2.8	na	2.2	2.5
Average	*2.8*	*1.3*	*2.9*	*2.9*	*3.0*	*2.9*	*2.6*	*2.0*	*3.0*	*2.6*	*2.8*	*2.9*	*2.3*	*2.5*	*2.7*
South-eastern Europe															
SEE-3															
Bulgaria	3.8	1.3	3.5	4.0	3.5	na	4.3	3.9	3.6	4.0	3.6	4.0	3.0	na	4.0
Croatia	2.8	1.5	2.6	2.8	2.5	na	3.0	3.3	1.9	2.9	3.4	na	na	na	2.5
Romania	6.8	1.5	7.5	6.5	6.9	na	7.0	7.2	6.0	6.9	6.4	7.0	6.8	na	7.0
SEE-4														na	
Albania	2.9	1.6	3.5	na	3.0	na	3.0	na	2.1	2.8	3.7	na	na	na	2.5
Bosnia and Herzegovina	2.0	3.4	na	na	na	na	1.5	na	1.4	2.8	3.9	na	na	na	0.5
FYR Macedonia	2.0	1.4	2.0	na	1.8	na	2.3	na	2.5	2.0	1.1	na	na	na	2.0
Serbia and Montenegro	11.5	7.4	12.0	na	na	na	12.0	16.4	9.0	11.4	9.9	na	na	na	10.0
Average	*4.5*	*2.6*	*5.2*	*4.4*	*3.5*	*na*	*4.7*	*7.7*	*3.8*	*4.7*	*4.6*	*5.5*	*4.9*	*na*	*4.1*
Commonwealth of Independent States															
Armenia	2.8	4.7	0.3	na	3.9	na	5.0	na	na	2.5	2.2	na	na	na	na
Azerbaijan	10.1	5.7	13.0	na	8.3	na	9.5	na	7.8	8.3	13.5	na	na	na	na
Belarus	11.8	10.0	10.1	na	12.5	na	10.5	na	10.0	19.0	9.0	na	na	na	na
Georgia	7.0	2.0	6.0	na	7.0	na	8.0	na	6.8	7.8	6.6	na	na	na	na
Kazakhstan	6.6	2.5	6.8	na	7.1	na	7.0	na	6.1	7.5	5.0	na	na	na	na
Kyrgyz Republic	4.5	1.8	4.0	na	4.0	na	4.0	na	3.8	5.5	5.6	na	na	na	na
Moldova	10.4	3.8	10.0	na	11.9	na	12.0	na	na	10.0	8.2	na	na	na	na
Russia	10.6	2.5	9.8	na	10.7	12.0	10.5	10.8	9.5	9.8	10.8	12.0	10.8	na	10.0
Tajikistan	6.9	4.3	9.1	na	5.0	na	7.0	na	4.8	7.0	8.6	na	na	na	na
Turkmenistan	8.5	6.0	11.0	na	5.0	na	10.5	na	6.5	10.5	7.4	na	na	na	na
Ukraine	10.5	4.5	11.3	na	12.1	na	10.8	11.8	9.5	10.0	7.6	na	11.5	na	10.0
Uzbekistan	10.4	11.1	6.5	na	13.0	na	16.8	na	12.5	5.7	7.8	na	na	na	na
Average	*8.3*	*4.9*	*8.2*	*na*	*8.4*	*12.0*	*9.3*	*11.3*	*7.7*	*8.6*	*7.7*	*12.0*	*11.2*	*na*	*10.0*
All transition countries															
Average	*5.7*	*3.2*	*5.8*	*3.3*	*5.7*	*4.7*	*6.1*	*7.2*	*5.1*	*5.8*	*5.4*	*4.2*	*5.1*	*2.5*	*4.1*

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8 Vienna Institute for International Economic Studies (WIIW).

Part II: Business in transition

Part II of the *Transition Report* looks at transition from the perspective of enterprises. The two chapters in this part of the Report draw heavily on the third round of the Business Environment and Enterprise Performance Survey (BEEPS) undertaken in spring 2005. The survey covered over 9,500 firms in 26 transition countries plus Turkey.

The 2005 survey followed earlier rounds of the BEEPS carried out in 1999 and 2002. The three rounds provide an overview of the evolving business environment and the performance of firms in the transition region. Some 1,400 enterprises participated in both the 2002 and 2005 rounds, allowing a direct examination of trends and developments in these particular firms. Similar surveys conducted in Germany, Greece, Portugal, South Korea and Vietnam in 2004 provide comparative data.

Using the survey results, Chapter 3 outlines how firms are constrained by the business environment. It compares results for different types of firms and explores how constraints have changed over time. Chapter 4 looks at the performance of firms and seeks to explain changes in labour productivity, profitability and sales. Annex 3.1 examines the BEEPS results from an environmental point of view.

The business environment of firms in transition

3

Transition countries have made substantial progress in structural and institutional reform over recent years. This assessment is supported by the firms interviewed for the latest Business Environment and Enterprise Performance Survey (BEEPS). Firms have reported a number of improvements in their business environment since the BEEPS started in 1999. However, the quality of the business environment varies considerably across the transition region; even within individual countries, assessments differ considerably from firm to firm. This chapter analyses the variation in assessments, examining the differences in business environments across the region and assessing how different types of firms are affected by constraints to doing business.

How firms evaluate constraints on their development depends in part on the overall business environment in their country. For example, a survey of firms in a country with an inadequate and inefficient telecommunications system is likely to report frequent service interruptions, poor-quality connections and delays in getting new lines. Firms' perceptions of specific obstacles will also vary according to their characteristics. For instance, expanding firms may identify delays in obtaining a new line as an especially costly constraint on their ability to reach new markets and extend sales.

This chapter analyses business constraints in the transition countries in a number of ways. In particular, it identifies which types of firms report constraints and what these constraints are. The results of the BEEPS conducted in 2004 in Germany, Greece and Portugal are used as benchmarks.[1] Comparisons of responses by firms in these mature market economies with their equivalents in the transition region provide a rough indication of progress in transition at the macroeconomic level. They also aid in the understanding of how constraints affect firms in transition and market economies.

Two inferences may be drawn from the analysis of business constraints. First, aspects of the business environment that are reported as constraints may help policy-makers target potential areas for reform. For example, new private firms have been the engine of growth in many transition countries and loosening the constraints affecting these firms in particular could have broader benefits.[2] Secondly, it may be possible to identify constraints that affect certain types of firms in transition countries but not in mature market economies. Such differences can indicate areas where countries need to make further progress to complete the transition.

Chapter 3 at a glance

- Constraints to doing business vary significantly across the transition countries, with different types of firms affected in different ways.
- Many improvements have been made in the business environment, including more reliable infrastructure services and greater economic stability, but the transition countries are still a long way behind mature market economies.
- Business obstacles have the biggest impact on the most dynamic enterprises – private sector firms, exporters, firms that reinvest their profits and smaller businesses. State-owned firms are the least affected.
- The biggest obstacles to doing business are the costs of business regulation, poor-quality institutions, weak property rights and macroeconomic instability.
- Gaining access to finance is hardest for smaller enterprises and firms located outside major cities. Foreign-owned firms have the fewest problems in this regard.

The next section of this chapter describes how the analysis of business constraints was undertaken. This is followed by a summary of the business constraints and how these relate to particular types of firms. The remainder of the chapter investigates the various aspects of the business environment. For each element, the analysis identifies those aspects of the business environment that different types of firms cite as obstacles.

3.1 Understanding the business environment

Consider the following scenario. Two poorly performing, state-owned, small manufacturing firms are located in similar neighbourhoods in the same city. At the outset the two firms are essentially identical. One firm is then privatised. Over the course of the next year the owner introduces a range of basic restructuring measures that require relatively little investment. The measures are very successful and the owner thinks about expanding. The state-owned firm, meanwhile, continues to operate as before. Both firms are then visited by BEEPS interviewers. The firms are questioned about constraints in their business environments and are asked to evaluate the importance of these constraints. Although the two firms operate in the same market and in the same city, their managers report different constraints.

The manager of the privatised, expanding company reports greater constraints on growth than the manager of the state-owned, poorly-performing firm, for most aspects of the business environment. The private sector manager identifies, in particular, more regulatory and property rights obstacles. This is because he/she needs a business permit to start a new activity, entailing bribery and the risk of potential profits being taken by the state.[3] The state-owned firm, on the other hand, may be better able to obtain regulatory exemptions, using personal connections instead of bribes, and lacks private property that can be seized.

A similar scenario in a mature market economy surveyed in the BEEPS would probably differ from the above in two ways. First, the two firms in these countries would report smaller obstacles on average than those in the transition country. Secondly, the private firm would be unlikely to report greater property rights obstacles than its state-owned counterpart because property rights are better protected and reinvested profits are not at risk from the state.

The examples above illustrate that responses to questions about the business environment are influenced by the characteristics of the firm being questioned. The rest of the section sets out the methodology used to identify these patterns.[4]

The analysis focuses on how firms responded to a set of questions about how problematic various features of the business environment are for the operation and growth of their firm and how their responses relate to the characteristics of the firm. The firms' answers are scored on a scale of 1 (not an obstacle) to 4 (a major obstacle). Annex 1.1 provides a fuller description of how the 2005 BEEPS was undertaken. The answers to the survey questions are in effect estimates by the firms of the cost of these constraints and indicate therefore the benefits that would result from these constraints being loosened. The responses from firms in the mature market economies act as benchmarks.

The business environment is measured using the following categories:[5]

- business regulation
- labour
- taxation
- institutions and property rights
- infrastructure
- finance
- macroeconomic environment

The characteristics of a firm that are used to explain the level of business constraints include ownership, export activity, size, location, competitive environment and industrial sector.[6] Ownership is well established as a key factor in determining a firm's performance.[7] In particular, new private firms have been identified as an engine of growth in many transition countries.[8] Privatisation is also thought to lead to an improvement in performance although the evidence on this is mixed (see also Chapter 4). Ownership may influence the constraints faced by firms in other ways; in particular, state-owned firms may have privileged access to resources or markets, and closer links to government. The analysis therefore distinguishes between new private firms and privatised firms, with state ownership as the benchmark for both.

Foreign ownership is often associated with stronger performance of firms. This is partly because foreign owners from developed market economies bring in new technology, working practices and access to markets, and partly because they tend to focus on acquiring firms that are strong or that have growth potential. Foreign ownership is also likely to lead to lower reported business constraints because firms are able to draw on the substantial resources that foreign owners can make available.[9]

Export activity plays an important role in the growth process, and exporting firms can face strong competition. This has also been identified as a factor determining the growth of firms in transition countries.[10] Export activity and competition may involve a number of constraints – for example, exporters naturally complain more than non-exporters about the burden of customs regulations. The analysis therefore looks at various aspects of export activity and whether a firm faces strong competition (defined in this chapter as four or more competitors).

The size of firms is particularly significant for the business environment. This is because small firms play a key role in promoting economic growth and creating employment, and policy-makers and international financial institutions attach great importance to lending to and supporting micro, small and medium-sized firms. The analysis creates a separate category for micro and small firms (employing fewer than 50 people).[11]

The location of a firm can also represent a constraint. The growth process in transition countries is typically uneven, in so far as economic activity and growth pick up quickly in the capital cities and then gradually spread to the regions. Lastly, whether a firm is reinvesting its profits is a direct indicator of growth and investment activity and of the existence of private capital that is potentially at risk of expropriation by the state.[12]

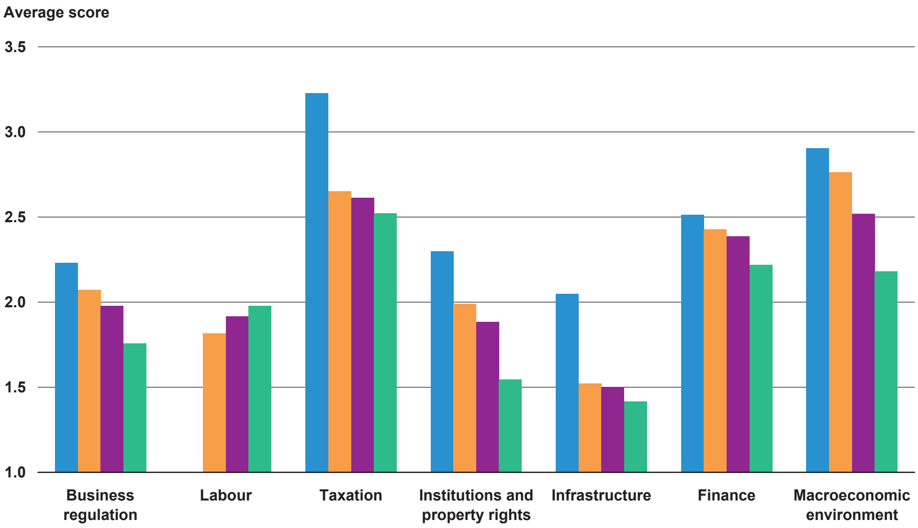
3.2 Business environment constraints

This section presents the basic patterns and findings of the business environment analysis using general indicators of business constraints. This is followed by a detailed analysis of each type of constraint.

Chart 3.1 shows that reported business constraints have generally been diminishing in the transition region since the first BEEPS in 1999. They are approaching – but are still greater than – the constraints reported in mature market economies. The most progress between 1999 and 2005 has been in infrastructure and taxation. Nevertheless, taxation is still regarded as a major obstacle in transition – as in mature market economies, where it is the largest perceived constraint by a considerable margin. This underlines a limitation in this analysis, in that firms

Chart 3.1

Overall business constraints



Sources: BEEPS 1999, 2002, 2004 and 2005.

Note: Firms were asked to report how problematic different factors were to their operation and growth. Scores range from 1 (no obstacle) to 4 (major obstacle). Data correspond to BEEPS undertaken in transition countries in 1999, 2002 and 2005 and in mature market economies (Germany, Greece and Portugal) in 2004. BEEPS data for labour in 1999 were not available.

do not necessarily take into account the full consequences that would result if the constraint was loosened – for example, the effect on public services if tax revenues were to disappear.

The biggest differences between the transition countries and mature market economies relate to macroeconomic stability (not surprisingly, as all three comparison countries are in the eurozone) and to institutions (broadly defined as regulation, corruption and protection of property rights). One area where reported constraints in the transition countries have been increasing is labour regulation but these have yet to reach the higher levels recorded in mature market economies. This indicates that as countries grow richer, employment protection becomes more developed and the demand for skilled labour increases (see below).

A reduction in business constraints over the past three years has been reported by firms across the transition region, particularly with regard to the macroeconomic environment, institutions and business regulation. The biggest improvement has been in the Commonwealth of Independent States (CIS) and south-eastern Europe (SEE) – both in the EU candidate countries and the Western Balkans. Central eastern Europe and the Baltic states (CEB) – the region closest to the mature market economies – has shown the smallest (although still substantial) improvement.

There is considerable variation between countries (see Annex 1.1). Approximately 60 to 90 per cent of the variation in reported constraints can be attributed to specific country characteristics, and the remainder to differences between firms.[13] The highest shares attributed to country characteristics are for infrastructure, macroeconomic instability and institutions, and the smallest is for business regulation (where country characteristics account for just over half of the total variation).[14]

Table 3.1 indicates the relationship between the characteristics of a firm and the importance of different business obstacles. The table shows that firms with characteristics associated with strong performance – private ownership, export activity and reinvesting profits – tend to be particularly constrained by their business environment.[15] This is consistent also with state-owned firms having privileged access to resources – lower taxes, cheap credit and lighter regulation – and less fear of state interference. The typical difference between new private firms and state-owned firms is 0.10 to 0.30 on the BEEPS scale, which ranges from 1 to 4. To put this into context, the difference is about the same as that between the average response of a firm in a transition country and its equivalent in a mature market economy.

Not surprisingly, firms facing high levels of competition report tougher constraints

Table 3.1

Business constraints and firm characteristics in transition countries

	New private firms	Privatised firms	Majority foreign-owned firms	Exporting firms	Firms facing high competition	Micro and small firms	Firms located in capitals	Firms reinvesting profits
Business regulation	0.22	0.14	0.07	0.14	0.10	-0.08	0.05	0.08
Title or leasing of land	0.20	0.09	–	–	0.05	–	0.11	0.07
Customs and trade regulations	0.29	0.19	0.15	0.36	0.11	-0.13	0.07	0.09
Business licensing and permits	0.28	0.20	–	0.07	0.13	–	–	0.14
Regulatory policy uncertainty	0.13	0.12	–	0.09	0.13	-0.05	-0.05	–
Labour	0.10	–	–	0.08	0.10	-0.10	–	0.06
Labour regulations	0.15	0.08	–	0.09	0.11	-0.11	–	0.06
Skills of available workforce	–	–	–	0.08	0.09	-0.09	–	0.06
Taxation	0.32	0.25	-0.12	0.05	0.17	–	–	0.05
Tax rates	0.32	0.30	-0.17	–	0.18	–	–	–
Tax administration	0.32	0.21	-0.07	0.08	0.16	–	–	0.07
Institutions and property rights	0.14	0.08	–	0.06	0.11	–	–	0.05
Judiciary	0.12	0.09	–	0.14	0.14	-0.09	–	0.06
Corruption	0.27	0.20	–	0.11	0.18	–	–	0.10
Street crime	0.09	–	-0.09	–	0.08	–	–	–
Organised crime	0.13	–	-0.08	–	0.07	–	–	–
Infrastructure	–	–	–	–	0.03	–	-0.03	0.03
Telecommunications	–	–	–	-0.04	–	–	–	–
Electricity	–	–	–	-0.05	–	–	-0.12	–
Transport	–	–	0.06	–	–	–	–	–
Access to land	0.14	–	–	–	0.05	–	0.09	0.10
Finance	0.10	0.09	-0.29	–	0.12	0.13	-0.11	-0.05
Access to finance	–	–	-0.31	–	0.10	0.15	-0.05	-0.09
Cost of finance	0.17	0.20	-0.28	–	0.15	0.11	-0.16	–
Macroeconomic environment	0.19	0.16	–	0.16	0.10	–	–	–

Source: BEEPS 2005.
Note: BEEPS respondents were asked to rate the importance of different business obstacles on a scale from 1 (no obstacle) to 4 (major obstacle).
The table shows the difference in scores for various types of firms, relative to a benchmark category. New private and privatised firms are compared with state-owned firms; foreign firms are compared with domestic firms; micro and small firms are compared with medium and large firms, and so on. A positive number indicates that the constraints are greater than those experienced by the benchmark category. A negative indicates the reverse. "–" denotes cases where the difference is not statistically significant; figures in blue are statistically significant with 90 per cent confidence, and figures in orange are statistically significant with 99 per cent confidence.

in terms of their business environment. Majority foreign-owned firms, by contrast, consider themselves to be substantially less financially constrained, either in terms of access to, or cost of, credit (a difference of about 0.30 on the BEEPS scale) or in terms of their tax burden (a difference of 0.12). The likely explanation is their ability to draw on the financial resources of the parent firm and their lack of dependence on local financial institutions for financing (see below).

Location in a capital city loosens some constraints. Infrastructure is better and finance is more accessible, either because lending institutions are more sophisticated or because buoyant local demand means firms can generate profits instead of having to borrow. However, other constraints can be more evident, especially business regulation and access to land. Smaller firms are more constrained than others in terms of obtaining finance (reporting higher obstacles of about 0.13 on the BEEPS scale).

Table 3.2 gives comparable aggregate results for the market economies surveyed in BEEPS. Because there were virtually no privatised firms in the survey, no results for privatised firms are reported. The table shows that private firms, exporters and firms that reinvest profit generally report higher constraints than state-owned enterprises, reflecting the pattern in the transition countries. However, in the "institutions" category, private firms and firms with profits to reinvest do not report higher constraints for property rights. Even more so than in transition countries, foreign ownership is associated with lower constraints.

Smaller firms in mature market economies do not face financial constraints to the same extent as those in transition countries. This implies that financial systems in transition countries are still facing problems in identifying and lending to creditworthy smaller firms. Lastly, the geographical pattern of constraints is more even in the mature market economies, as indicated by the near absence of any relationship between location in a capital city and reported constraints. This probably reflects a smaller geographical variation in the level of economic activity and development in these countries compared with transition

Table 3.2

Business constraints and firm characteristics in mature market economies

	Private firms	Majority foreign-owned firms	Exporting firms	Firms facing high competition	Micro and small firms	Firms located in capitals	Firms reinvesting profits
Business regulation	0.21	-0.18	0.22	–	-0.15	–	0.12
Labour	–	-0.15	0.12	–	-0.25	–	–
Taxation	0.48	-0.32	–	0.16	–	0.15	0.14
Institutions and property rights	–	-0.18	0.09	0.06	–	–	–
Infrastructure	0.20	-0.22	–	–	–	–	0.12
Finance	0.39	-0.36	–	0.22	–	–	–
Macroeconomic environment	0.30	-0.33	0.23	0.12	-0.23	–	–

Source: BEEPS 2004.

Note: BEEPS respondents were asked to rate the importance of different business obstacles on a scale from 1 (no obstacle) to 4 (major obstacle). The table shows the difference in scores for various types of firms, relative to a benchmark category. New private and privatised firms are compared with state-owned firms; foreign firms are compared with domestic firms; micro and small firms are compared with medium and large firms, and so on. A positive number indicates that the constraints are greater than those experienced by the benchmark category. A negative indicates the reverse. "–" denotes cases where the difference is not statistically significant; figures in blue are statistically significant with 90 per cent confidence, and figures in orange are statistically significant with 99 per cent confidence.

countries, where capital cities often lead in economic activity, and in the introduction of new technologies.

3.3 Aspects of the business environment

Business regulation

Regulations are typically designed to limit any negative impact resulting from the behaviour of firms and are enforced by state authorities through law. However, excessive business regulations can increase transaction costs in an economy and often become a major source of corruption and inefficiency. Arbitrary regulatory changes can be discriminatory, weakening the incentives for long-term planning that firms have in stable markets.

In the BEEPS, firms were asked to assess the obstacles stemming from various forms of regulation – licensing and permits (for example, fire, sanitary and environmental standards),[16] customs and foreign trade regulations, title or leasing of land, and uncertainty about regulatory policies. While licensing and other forms of regulation affect the short-term operation of a company, changes in the regulatory policy can drastically affect business planning and medium to long-term performance.

Chart 3.2 shows that firms in transition countries report substantial regulatory constraints. Customs and trade regulations are noticeably more burdensome for firms in transition countries than for Western firms. However, the key difference between transition and mature market economies lies in uncertainty about regulatory policy. Firms in transition countries cite this as a major constraint for their businesses, unlike in mature market economies where it is seen as a relatively minor problem. This partly reflects the nature of transition itself – progress in transition implies that the regulatory framework must develop. It also suggests that there are benefits to be gained if policy-makers reduce the regulatory uncertainty facing firms and clearly map out prospective changes and their implications for businesses.

Significantly fewer firms reported regulatory constraints in 2005 compared with 1999 although the level of constraint remains high. Regulatory uncertainty is on the decline, mainly in the SEE countries but also in CEB and the CIS.[17] The only constraint that is becoming greater for enterprises is the issue of land regulations in CEB and the CIS, where access to land in general has become more expensive.

Table 3.1 suggests that new private firms and privatised companies are more likely to be affected adversely by regulations than state-owned firms.[18] The regulatory burden on private firms is more pronounced for customs, trade, licensing and permit regulation but it is also present in terms of regulatory uncertainty. Dynamic firms that reinvest profits find regulation more costly than stagnant firms while start-up and privatised firms find it difficult to build solid business plans in the absence of regulatory predictability. State-owned firms in transition countries, by contrast, often lack long-term strategies and operate on short-term objectives that are less affected by regulatory instability.

It is not clear if the fear of arbitrary redistribution or seizure of profits by the state through regulatory action represents a greater constraint in transition countries than in mature market economies. The results from the BEEPS comparison countries show that private firms and reinvesting firms are more likely to find regulation a major constraint to doing business. Compared with the average private firm in transition countries, foreign firms and especially exporting firms are more concerned about customs and trade regulations. Micro and small firms are less concerned about customs regulations and regulatory policy uncertainty in both transition and mature market economies.

Labour

Job creation, supported directly by labour market reforms and indirectly by other transition reforms, is an important issue for the authorities in almost all transition countries. Firms are mostly concerned about the flexibility and quality of the labour force. The BEEPS therefore asked firms about labour regulation and the skill levels of the available workforce as potential obstacles to their activities.

In contrast to all other areas of the business environment, labour regulation is a greater obstacle in mature market economies than it is in the transition region (see Charts 3.1 and 3.3). Although labour market constraints in the transition countries were reported to be greater in 2005 than in 2002, the levels are still below those in mature market economies. The increase in the perceived cost of labour regulation is greatest in the countries that joined the European Union in 2004. This is probably due to the impact of accession on the flexibility of labour markets in these countries. More generally, as countries grow richer and the transition progresses, regulation relating to employment protection becomes an established feature of the business environment.

Many characteristics of a firm influence the perceptions of labour market flexibility and the skills of the workforce (see Table 3.1). It is mainly new private firms, and to a lesser extent privatised firms, that see labour regulations as significant business obstacles. Many state-owned firms have largely completed an initial round of cutting jobs and are less concerned about regulations. State-owned firms that still regard labour restructuring as an issue include large enterprises in strategically important sectors that fall outside the BEEPS sample. Foreign-owned firms do not assess local labour markets any differently from local firms, as labour regulations and workforce limitations apply equally to both categories.

Since employment growth is on average higher in new private firms compared with state-owned and privatised firms, labour market obstacles are felt more keenly by firms creating new jobs, notably new private firms. It is therefore not surprising that more dynamic companies are more concerned about labour regulations and the skills of the available workforce.

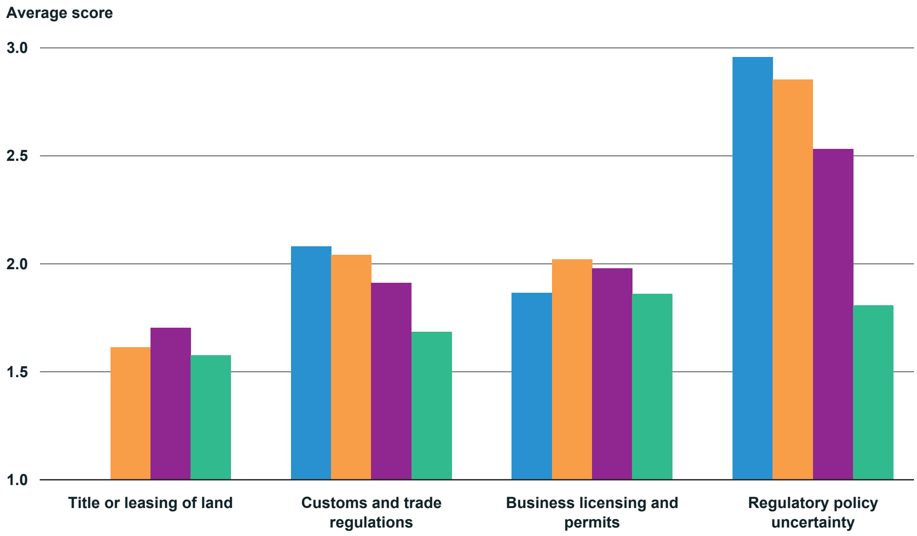
The BEEPS asked enterprises how they would change their employment strategy in the absence of binding labour regulations (for example, severance payments). Privatised companies and new private firms in particular replied that they would expand their employment to a greater degree than state-owned firms. Companies that expanded employment the most between 2002 and 2005 reported that, without binding regulations, they would have increased their employment levels even further. This, however, might reflect the level of optimism of strongly performing companies.

Significantly, although mainly large enterprises complain about regulations, it is SMEs that create most new jobs and these companies would also increase their employment levels in the absence of labour constraints (see Chart 3.4). Smaller enterprises may complain less because they often face less strict labour regulations regarding hiring and firing and collective bargaining than those faced by larger enterprises. Large firms report that without the constraint on firing, they would reduce their employment levels.

Concern about the skills of available workers is a more important issue for firms that have the highest share of unskilled labour. Firms with a higher proportion of professional and skilled staff, as well as firms with a lower ratio of workers who completed only primary education, view skills of available workers as a lesser concern. The relatively high quality of the educational systems in transition countries is an important factor. A much larger proportion of their population completes secondary and formal vocational training compared with other middle-income countries. As a result, unskilled workers with only a

Chart 3.2

Regulatory constraints



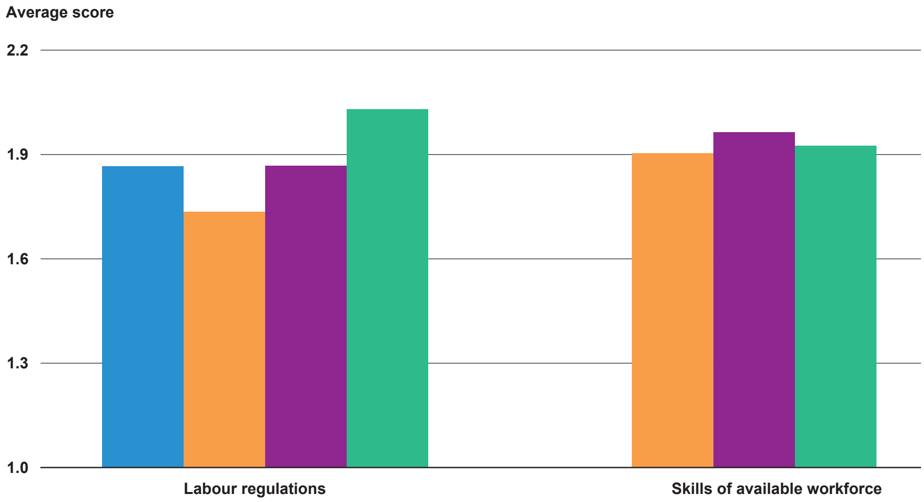
1999 2002 2005 Mature market economies 2004

Sources: BEEPS 1999, 2002, 2004 and 2005.

Note: Firms were asked to report how problematic different factors were to their operation and growth. Scores range from 1 (no obstacle) to 4 (major obstacle). Data correspond to BEEPS undertaken in transition countries in 1999, 2002 and 2005 and in mature market economies (Germany, Greece and Portugal) in 2004. BEEPS data for title or leasing of land in 1999 were not available.

Chart 3.3

Labour constraints



1999 2002 2005 Mature market economies 2004

Sources: BEEPS 1999, 2002, 2004 and 2005.

Note: Firms were asked to report how problematic different factors were to their operation and growth. Scores range from 1 (no obstacle) to 4 (major obstacle). Data correspond to BEEPS undertaken in transition countries in 1999, 2002 and 2005 and in mature market economies (Germany, Greece and Portugal) in 2004. BEEPS data for skills of available workforce in 1999 were not available.

primary level of education make up a much smaller part of the working age population. The difference between their skills level and the average skills level is therefore much more pronounced. Nevertheless, it is the firms that have greater difficulties in hiring skilled labour that complain more about the availability of a sufficiently skilled workforce.

Taxation

Tax systems in transition countries have undergone major changes, and the institutional set-up has often led to distortions. In some developing and transition countries, tax administrations are a major source of corruption and inefficiency. The BEEPS provides some insights into how firms perceive tax systems, in terms of the effect of tax rates and the efficiency of tax administration. The 2005 survey suggests that the percentage of firms that have had dealings with the tax authorities varies widely across countries, from just above 20 per cent in Estonia to almost all in the Kyrgyz Republic.

Chart 3.5 shows that the perception of taxation as a major business constraint in transition countries is in line with the pattern in more mature Western economies. When assessing the impact of taxation on businesses, it is important to remember that firms regard taxation as a "pure" burden because they ignore the benefits of taxation in terms of public services (for example, education, health care and infrastructure financed by government expenditure). However, taxation is seen as less of a burden than it was in 1999 and the similarity with mature economies demonstrates substantial progress in reforming tax systems in transition countries.

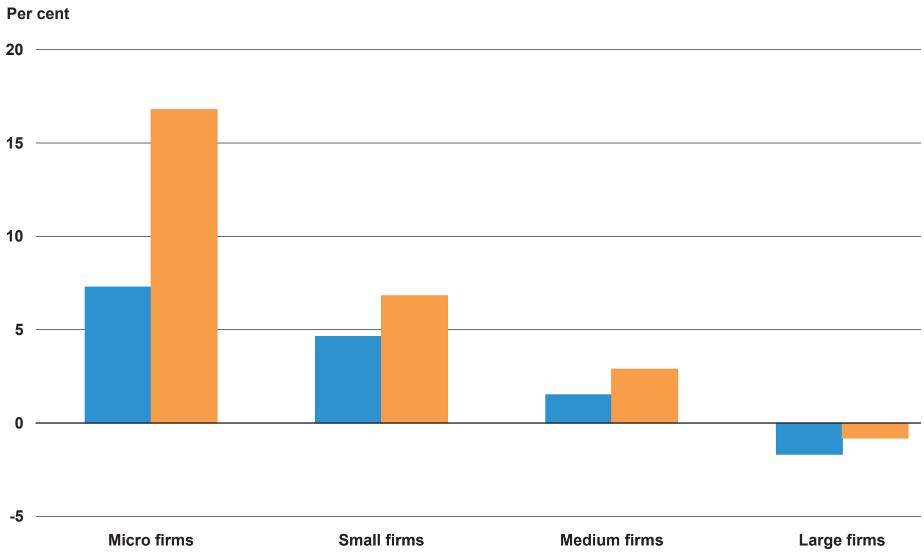
The transition countries experienced substantial improvements between 1999 and 2002 in terms of the perception of tax rates and tax administration constraints. Between 2002 and 2005 the most significant gains were in SEE, followed by the CIS.[19] Firms in CEB countries, however, complain slightly more about taxation in 2005 than they did in 2002.[20] Furthermore, in CEB and mature market economies the frequency of dealings with the tax authorities is much lower than in SEE and the CIS (see Chart 3.6).

The taxation burden is perceived to be more costly by private firms than by state-owned firms, both in transition countries and in mature market economies (see Table 3.1). This has at least two explanations. First, private firms are the growing segment of the economy and therefore want to retain more funds for investment or paying dividends. Secondly, state-owned firms often benefit, implicitly or explicitly, from state support in the form of tax breaks, toleration of non-payment of taxes, or operating subsidies. Nevertheless, in transition and mature market economies, foreign ownership mitigates the effects of taxation, in particular with respect to tax rates. This is because foreign multinationals are either able to reduce their tax obligations through transfer pricing or often get significant tax breaks from the authorities for large investment projects.

Not surprisingly, firms that reinvest their profits assess taxation as a major burden

Chart 3.4

Job creation and labour constraints



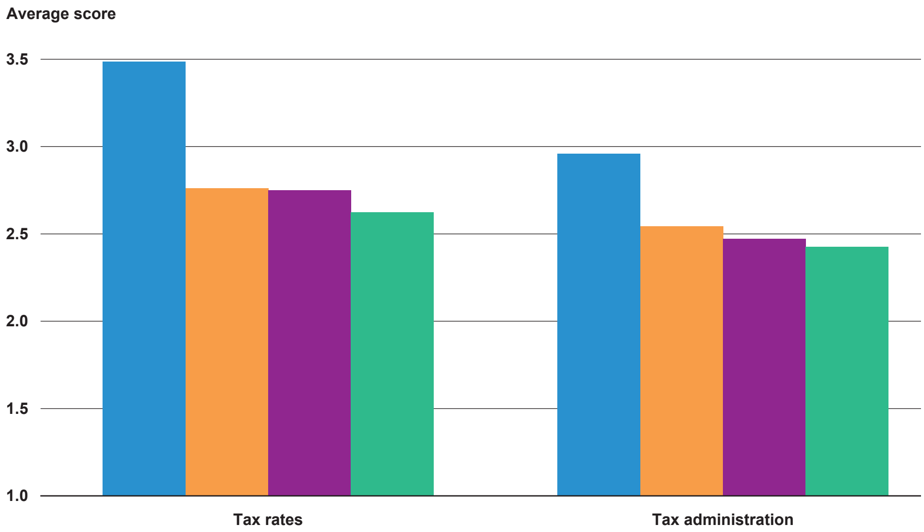
Annual growth in employment in the last three years · Potential change in employment with no labour regulations

Source: BEEPS 2005.

Note: The size of a firm is defined as follows: micro firms have 1-9 employees, small firms have 10-49 employees, medium firms have 50-199 employees and large firms have 200 or more employees.

Chart 3.5

Taxation constraints



1999 · 2002 · 2005 · Mature market economies 2004

Sources: BEEPS 1999, 2002, 2004 and 2005.

Note: Firms were asked to report how problematic different factors were to their operation and growth. Scores range from 1 (no obstacle) to 4 (major obstacle). Data correspond to BEEPS undertaken in transition countries in 1999, 2002 and 2005 and in mature market economies (Germany, Greece and Portugal) in 2004.

because bigger, more profitable firms pay more in corporation tax. Moreover, companies that reinvest profits complain more about the tax administration as they are subject to tax controls more often than other firms. The incidence of tax controls on exporters is also greater, and these companies report more administrative constraints. Unlike their counterparts in mature market economies, micro and small firms in transition countries complain more than large firms about tax rates. This suggests that the tax regime for smaller firms may still be burdensome in some transition countries, in particular in the absence of adequate access to finance.

Institutions and property rights

At the start of transition in 1989–91 there was a general consensus among economists and policy-makers that reform of property rights, and in particular privatisation of state-owned enterprises, would be central to further progress in transition. The subsequent experience of transition countries together with new research on developing countries and historical data on world economic evolution suggest that properly functioning economic institutions are essential for the protection of private property rights and for economic growth more generally. The most up-to-date assessment of progress in transition countries in building the institutions that protect property rights and the rule of law can be found in Chapter 1.

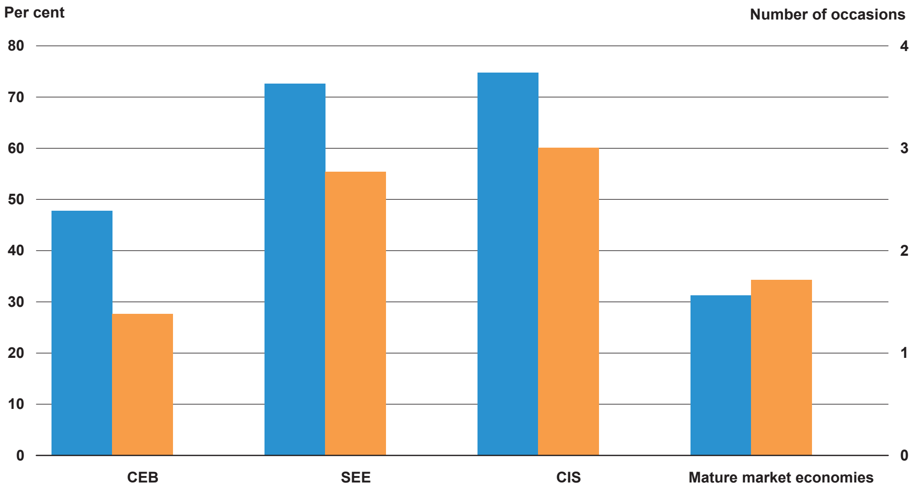
The BEEPS collects information on various aspects of property rights and on the economic institutions that are supposed to protect them. This section focuses on how firms perceive the functioning of the judiciary, corruption, organised crime and street crime in terms of constraining the growth of their firms. These aspects of the business environment can be interpreted in terms of the institutions that protect property rights; the firms' answers indicate the effectiveness of these institutions.

As Chapter 1 states, the transition countries have made substantial progress in improving institutions in recent years, and this progress is visible across the region. As far as firms are concerned, however, this progress has not been uniform in terms of property rights and the rule of law. Chart 3.7 shows that the costs of crime and corruption in transition countries have diminished considerably, in the view of the firms surveyed, especially between 1999 and 2002. However, in terms of the effectiveness of the legal system and judiciary, there has been little progress. In all respects, the transition countries lag well behind mature market economies, indicating that there is a considerable way still to go in improving institutions and the protection of property rights.

Table 3.1 shows that new private firms consider the institutions responsible for protecting their property rights to be failing to do so. This is evident from the extent to which the judiciary and corruption are seen as important business obstacles, and from the degree that street crime and especially organised crime are seen as problems.

Chart 3.6

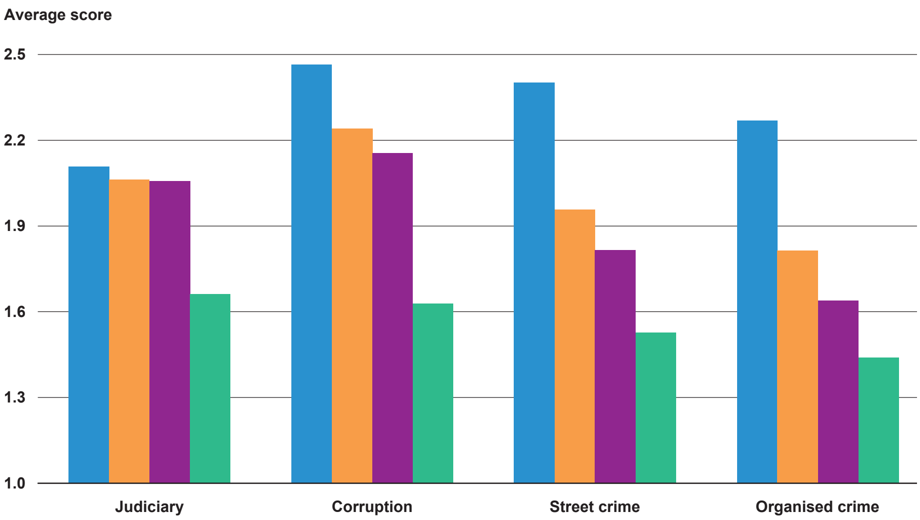
Incidence and frequency of dealings with tax authorities



Percentage of firms dealing with tax authorities in the past year (left axis)
Frequency of dealings with tax authorities in the past year (right axis)
Sources: BEEPS 2004 and 2005.
Note: The chart reports the percentage of firms that had dealings with tax authorities in the past year, as well as the average number of tax inspections per firm for companies in transition countries (2005) and in mature market economies (Germany, Greece and Portugal) in 2004.

Chart 3.7

Institutional constraints



1999 2002 2005 Mature market economies 2004
Sources: BEEPS 1999, 2002, 2004 and 2005.
Note: Firms were asked to report how problematic different factors were to their operation and growth. Scores range from 1 (no obstacle) to 4 (major obstacle). Data correspond to BEEPS undertaken in transition countries in 1999, 2002 and 2005 and in mature market economies (Germany, Greece and Portugal) in 2004.

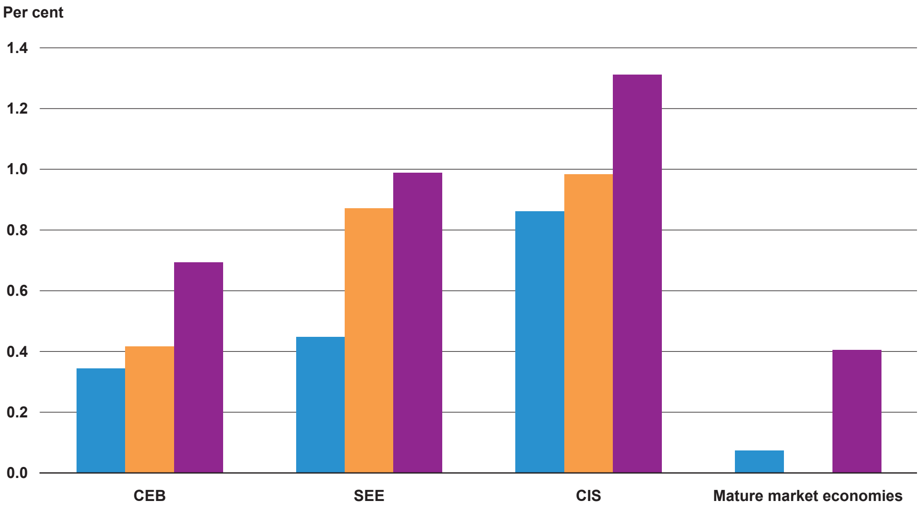
Privatised firms, by contrast, either have more experience in dealing with these obstacles, or are preyed on to a lesser extent by criminals. Like new private firms, however, privatised firms are very concerned about interference from the state, as evidenced by the high score registered by corruption as a business obstacle. Foreign-owned firms cope better with organised and street crime (or perhaps, as foreign investors, they avoid sectors and firms that are prone to these problems). Nevertheless, they are just as impeded as domestically owned firms by the failure of state institutions to protect their property rights and to enforce the rule of law. The size of the firm appears to make little difference. Small and large firms alike complain about constraints arising from weak institutions. The exception is the functioning of the judiciary, which generates far fewer complaints from micro and small firms. This is probably because more of their activity takes place in the informal sector.

Exporters are particularly constrained by poor property rights protection. They are less prone to encounter problems with organised or street crime but the state presents obstacles in the form of corruption and a poorly functioning legal system. Possibly because of the nature of their business activity, exporters are more likely to be exposed to these institutional failures, particularly in the form of corrupt customs officials and a corrupt legal system. Firms reinvesting their profits are also more likely to regard the legal system and especially corruption as costly constraints for their business operations. In other words, firms reinvesting their profits are more concerned about protecting their property rights in the future. The clear implication is that poor protection of property rights is a disincentive to investment and a hindrance to growth.

In mature market economies, protection of private property rights is extensive. Therefore growing, profitable or privately owned firms should not differ from poor performers or state-owned firms in terms of how they perceive institutions as obstacles. This is confirmed by the analysis. Private firms and those reinvesting their profits in mature market economies generally do not complain significantly more than other firms about institutions and property rights. There are, however, exceptions to this pattern. Just as in transition countries, exporters in mature economies are more likely to report corruption and the workings of the legal system as costly constraints on their operations. Also, private firms and firms reinvesting their profits report bigger problems with corruption. Mature market economies suffer less from these constraints but are not immune to them.

Chart 3.8

Bribe tax by region and firm ownership



State-owned firms | Privatised firms | New private firms

Sources: BEEPS 2004 and 2005.

Note: The chart reports how much is paid in bribes (expressed as a percentage of sales) by different types of firms in transition countries in 2005 and in mature market economies (Germany, Greece and Portugal) in 2004. Data for privatised firms in mature market economies were not available.

Chart 3.8 shows the variation in corruption using the BEEPS "bribe tax" indicator (how much firms report in unofficial payments as a percentage of annual sales). The average bribe tax is highest in the CIS, followed by SEE and CEB. The lowest average is reported by mature market economies. Within each group of countries, private firms are hit hardest by this form of corruption and state-owned firms are the least affected – even in mature market economies. Similarly, firms reinvesting profits pay more in bribe tax in each region than firms that do not reinvest. However, the average firm in the CIS that is not reinvesting profits still pays more in bribe tax than the average reinvesting firm in SEE, which in turn pays more than the average reinvesting CEB firm.

Infrastructure

A number of factors have led to the improvement of infrastructure services (power, telecommunications, transport services and land access) in the transition region. The emergence of mobile telephony has greatly extended the availability of telecommunications for businesses, and partial restructuring of the power sector has led to increased network reliability. On average, electrical power cuts across the region were reduced from 12.4 days in 2002 to 7.7 days in 2005, and outages in fixed-line telecommunications from 6.6 days in 2002 to 1.6 days in 2005.

Despite these improvements, infrastructure services in many transition countries still lag behind the levels achieved in market economies. In telecommunications, for example, access to fixed-line services is below 10 per cent in Central Asia. Firms in transition countries report an average of 17 days to obtain a telephone line and 14 days for an electrical connection. Outages are rather costly, amounting in 2004 to just over 3 per cent of annual sales in the case of electric power and to just over 2 per cent for telecommunications.

Most firms in transition countries do not rank infrastructure services as a major constraint on growth and development. A closer analysis, however, reveals that land access is increasingly problematic. Property prices and rents have been rising, and so acquiring or renting business premises has become increasingly costly, particularly for new firms. As Chart 3.9 shows, firms in transition countries still report more infrastructure constraints than their counterparts in mature market economies, especially in the power and telecommunications sectors.

Chart 3.1 shows that infrastructure was viewed as much less of a constraint across the transition region in 2002 than it was in 1999. Since 2002 there have been further changes in specific areas. Access to land has become more costly in the CIS while power supply concerns have eased in the CIS and SEE, and telecommunications constraints have decreased in the CIS as well (see Annex 1.1).

Table 3.1 suggests that private and state-owned firms are equally likely to be constrained by poor infrastructure. Detailed analysis reveals that power, telecommunications and road infrastructure affect all firms regardless of ownership whereas new private firms are most constrained by access to land. Unlike their mature market counterparts, foreign-owned firms in transition economies complain about transport infrastructure, largely because as exporters they expect international standards of transportation. A highly competitive environment increases the cost incurred by firms constrained by poor infrastructure and increases concerns about access to land in the transition region. This result is consistent with findings in mature market economies. In transition countries, locating in the capital city (typically the most dynamic economic area in the country) mitigates the constraints relating to power infrastructure but significantly increases the perceived cost of land access. By contrast, in mature market economies, location in the capital city does not appear to generate any particular infrastructure benefits.

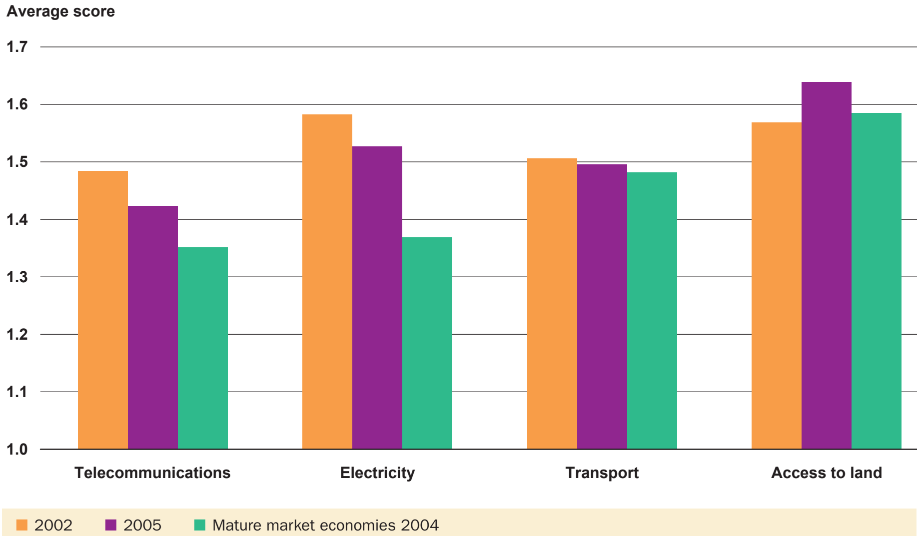
Finance

Finance is reported by many firms as one of the major constraints on their entrepreneurial activities. However, as the financial systems in transition countries have expanded, the perceived difficulties in obtaining finance have declined. This trend is apparent in all of the BEEPS since 1999 (see Chart 3.10). Finance remains a greater obstacle in the transition countries than in mature market economies but the gap has narrowed considerably. The cost of finance is seen as a more important constraint than other obstacles related to access, such as the need for collateral. Nevertheless, even the cost of finance is less of a problem than it was in 1999 or 2002. The improvement in access to finance across the transition countries in recent years is in line with the progress in banking reform (see Chapter 1) and with the credit booms experienced by a number of countries (see Chapter 2). The 2005 BEEPS asked firms about access to finance in general (for example, the need to provide collateral) and also about the cost of finance (interest rates and charges). In some cases, enterprises may be offered the option of external financing but decline to take it up because the financial terms make the loan uneconomic.[21] Firms that use external finance for working capital feel more constrained in their access to finance; firms using it for investment purposes, on the other hand, feel more constrained by the cost of finance. This may be explained by the relative ease of collateralising fixed assets as opposed to inventory.

Table 3.1 shows that the ownership of enterprises has a significant impact on the assessment of access to finance

Chart 3.9

Infrastructure constraints

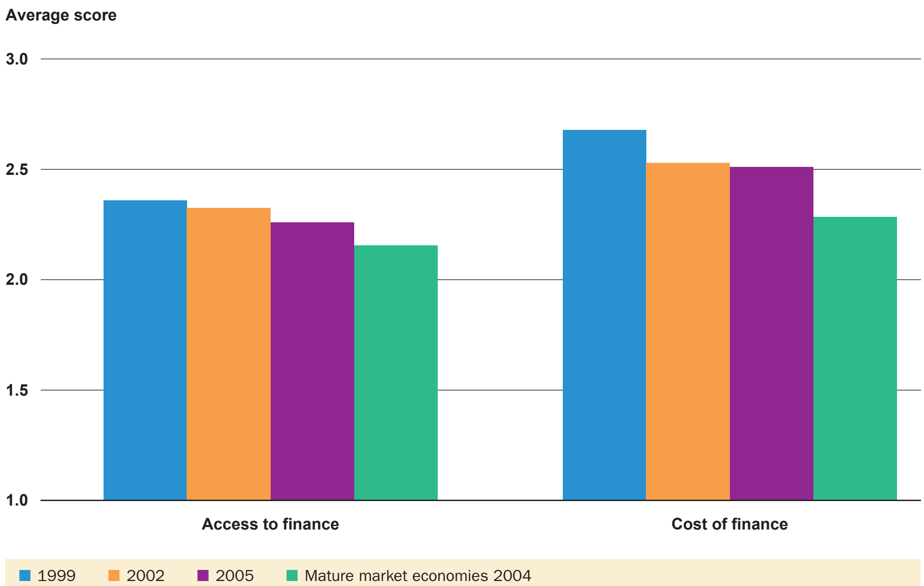


Sources: BEEPS 2002, 2004 and 2005.

Note: Firms were asked to report how problematic different factors were to their operation and growth. Scores range from 1 (no obstacle) to 4 (major obstacle). Data correspond to BEEPS undertaken in transition countries in 2002 and 2005 and in mature market economies (Germany, Greece and Portugal) in 2004.

Chart 3.10

Financial constraints



Sources: BEEPS 1999, 2002, 2004 and 2005.

Note: Firms were asked to report how problematic different factors were to their operation and growth. Scores range from 1 (no obstacle) to 4 (major obstacle). Data correspond to BEEPS undertaken in transition countries in 1999, 2002 and 2005 and in mature market economies (Germany, Greece and Portugal) in 2004.

within a country. Local firms see access to finance as a more important obstacle than foreign-owned firms. Foreign-owned firms may have implicit or explicit parent company guarantees;[22] they may use the parent company's financial providers or shareholder funds if external finance is not available to them directly or they may have greater internal sources of finance due to strong business performance. In more advanced countries, such as the Czech Republic or Hungary, a large part of foreign direct investment inflows are not new inflows but reinvested earnings generated by local subsidiaries.

Implicit or explicit state guarantees for state-owned companies may partly explain why private companies report greater difficulties in accessing finance compared with state-owned firms. The cost of finance is a bigger problem for privatised companies, many of which need extensive restructuring, including write-offs of substantial financial obligations.

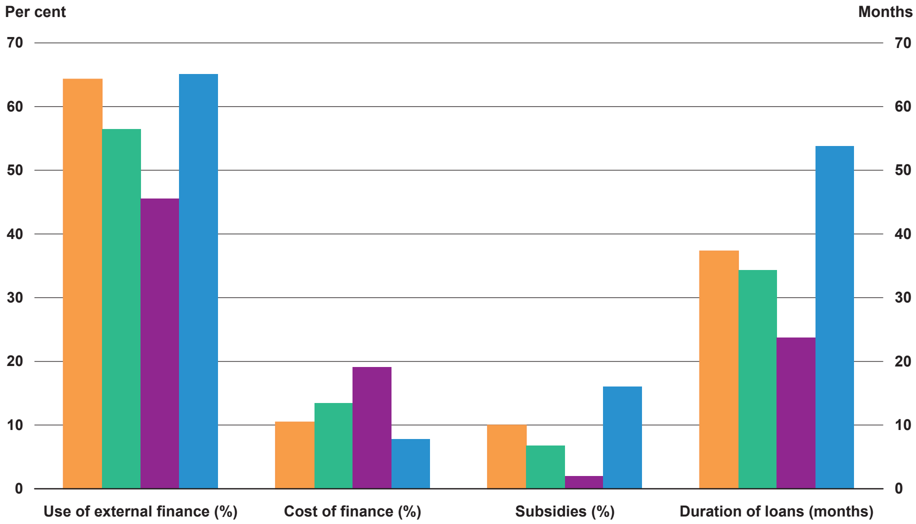
New private and privatised firms report lower subsidies relative to sales than state-owned firms although these are small in absolute terms in most cases. There is a wealth of anecdotal evidence about large state-owned conglomerates being bailed out by the state, particularly in CEB – an option largely unavailable to private companies (see Chart 3.11). CEB firms not only have greater access to subsidies but also, as a result of more developed financial sectors, report greater use of external finance, longer maturities and lower costs.

The BEEPS data show no link between having accounts audited according to international standards and reporting lower financial constraints, once other characteristics are taken into account. The most likely explanation is the reliance of local financial institutions on local accounting standards and their lack of familiarity with international standards.

Table 3.1 and Chart 3.12 show that the size of firms has a direct impact on their access to finance. In line with other studies on SME finance, the BEEPS data indicate that smaller firms face greater obstacles than large enterprises in accessing finance. The larger the company, the more likely it is to use external financing. There are many different reasons for this finding. These include the cost of processing loans (which makes larger loans more cost effective for financial institutions), the

Chart 3.11

Regional differences in access to finance



Sources: BEEPS 2004 and 2005.

Note: The chart reports the use of external finance (percentage of firms), the average interest rate on existing loans (in per cent), the average maturity of the last loan (months) and the average percentage of firms that received subsidies in transition countries in 2005 and in mature market economies (Germany, Greece and Portugal) in 2004.

lack of fixed assets available for smaller companies to offer as collateral for loans, and the higher proportion of newly established SMEs without a business track record.

An analysis of the BEEPS data for mature market economies shows that SMEs in these countries are less likely to report financial constraints, especially the cost of finance, as major obstacles for their businesses. Evidence of the difficulties that SMEs face in access to finance in transition countries indicates the need for supportive measures, including SME credit lines, the establishment of specialised micro-credit institutions and technical assistance for the financial sector with the explicit aim of increasing lending to SMEs.

Enterprises based in capital cities feel less constrained by access to finance than firms in other regions. Most financial institutions have their headquarters and a denser branch network in the capitals, and the number of banks is also highest in these cities. The more developed financial environment consequently promotes easier access to finance. In the mature market economies, by contrast, access to finance is more uniformly available throughout the country. This explains why in the BEEPS results for these countries, firms located in a capital city do not report easier access to finance than firms operating elsewhere.

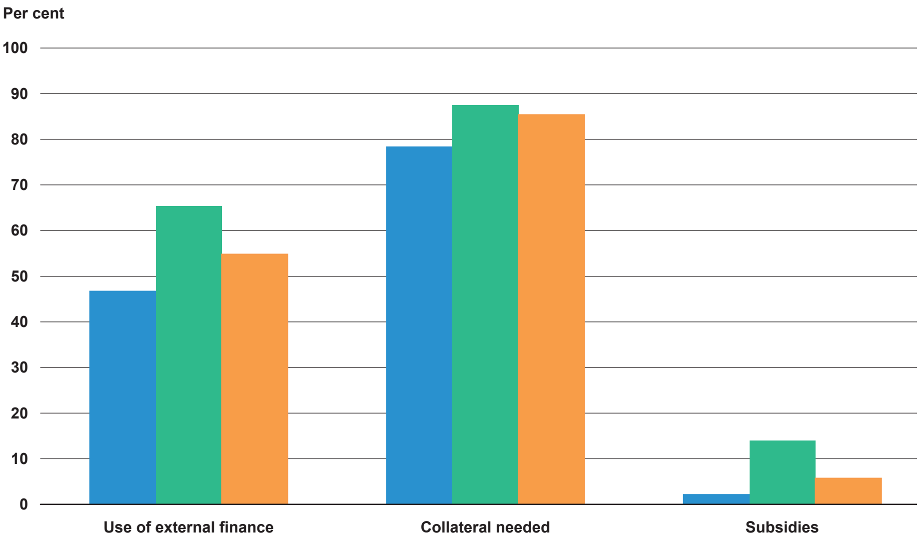
There is a strong link between the performance of companies and access to finance, although which factor leads to the other is unclear. More dynamic companies that reinvest profits report smaller constraints in terms of access to finance. Firms performing strongly also use external finance more often than less dynamic enterprises, the maturity of their loans is longer and their actual cost of finance is lower. One possible explanation is the rational allocation of credit in the financial sector, which leads to poorly performing companies having greater difficulties in obtaining external finance. Another explanation is that firms which have more difficulties in accessing finance perform less well as a consequence. Easing their financial constraints would therefore lead to improved performance (see Chapter 4).

Macroeconomic environment

Macroeconomic conditions are an important aspect of the business environment for firms. The BEEPS asked the participating firms whether they consider macroeconomic instability (for example, high inflation or exchange rate instability) to be a serious obstacle to their activities. A comparison of responses in the 1999, 2002 and 2005 surveys shows that macroeconomic stability in transition countries is improving although it is still worse than

Chart 3.12

Differences in access to finance for micro and large firms



■ Micro firms ■ Large firms ■ All firms

Source: BEEPS 2005.

Note: The chart reports the percentage of firms obtaining external finance, requiring collateral and receiving subsidies in transition countries in 2005. Micro firms are defined as firms with 1-9 employees while large firms have 200 or more employees.

that reported for mature market economies (see Chart 3.1).

The assessment of macroeconomic environment differs by regions. The CIS countries experienced a post-Russian crisis recovery between 1999 and 2002 and subsequently a boom in prices for natural resources. Not surprisingly, firms in these countries report the biggest improvements in their assessments of macroeconomic environment. CEB and SEE countries, on the other hand, report a significant improvement only in the last three years. In CEB the macroeconomic environment was mostly influenced by economic factors such as the impact of depressed export markets in the EU whereas in the SEE region it was also influenced adversely by political instability.

This evaluation of the perceived cost of macroeconomic instability is closely associated with objective macroeconomic indicators, such as GDP growth and inflation.[23] During economic downturns, the performance of enterprises is likely to deteriorate and they may be prone to relate their own performance to the macroeconomic situation. Nevertheless, enterprise characteristics also influence the perception of macroeconomic instability (see Table 3.1). State-owned firms (the benchmark category) are less concerned about macroeconomic instability than new private and privatised firms (although there is no impact for foreign ownership). The concern about macroeconomic instability does not change in relation to the location of the firms or the size of firms. Enterprises based in capital cities feel that they are affected by macroeconomic instability in the same way as firms based elsewhere, and there is similarly no difference between smaller and larger firms.

The vast majority of constraints, except those regarding licensing, labour regulation and street crime, are perceived as more significant by firms located in countries with lower GDP growth. These results emphasise the importance of achieving and maintaining macroeconomic stability, particularly for non-state enterprises operating in competitive sectors and facing international competition.

3.4 Conclusion

The BEEPS shows that there has been an overall reduction in business constraints in the transition region. However, there are still significant differences between the transition countries and mature market economies, which are less affected by business constraints. The one exception is in the area of labour regulation, which currently represents a smaller constraint in the transition countries. Complaints by firms in transition countries about labour regulations are increasing, however, towards the levels reported by companies in mature market economies.

As the transition countries introduce further reforms, improve their institutions and experience further growth in GDP and incomes, the policy issues facing mature market economies, such as labour market inflexibility, will increasingly become challenges for the transition countries as well. The current challenges, however, reflect the substantial distances that these countries need to travel before their business environments are comparable with those of mature market economies.

The biggest constraints in the business environment are those affecting the firms that are most likely to generate growth — private firms, especially new private companies, exporters, profitable firms that are reinvesting and micro and small firms. The BEEPS data confirm that it is these firms that are most constrained by their business environment.

The costs of regulation emerge as major constraints on the operations of businesses in transition countries. Furthermore, the most dynamic firms, including private firms and firms reinvesting profits, are the most affected. Streamlining regulations and rationalising the number of permits required to start and operate businesses would benefit these firms considerably. Regulatory uncertainty is reported by firms to be their single most important business constraint. Firms would be better able to take long-term business decisions if the direction of the government's economic policy and regulation were defined and communicated to firms in a medium-term context. Macroeconomic stability is also an important factor for the development of these companies, particularly for private firms operating in competitive sectors and facing international competition.

The BEEPS shows that the transition countries lag well behind mature market economies in terms of protecting private property. The costs to business arising from weak institutions fall heaviest on the firms with the most growth potential. New private firms and exporters, both engines of growth in transition, are more likely to be constrained by poor protection of their property rights. Reinvesting companies are particularly affected by these constraints. State-owned firms in transition countries are affected much less by these problems, indicating that they retain privileged treatment by the state. This pattern is largely absent from mature market economies, where the institutional treatment of state-owned and private firms is generally even-handed. These findings imply that improvements in the protection of property rights – better legal protection, less corruption, less crime and less discrimination in favour of state-owned firms – are most likely to benefit firms that drive the growth process in transition countries and to encourage profitable firms to reinvest their profits and expand.

Lastly, the BEEPS shows that the firms reporting the greatest financial constraints are private companies, firms lacking a strong foreign partner, those based outside capital cities and micro and small firms. In mature market economies foreign and state-owned firms also report lower financial constraints but firms in capital cities and large firms do not. This implies that further development of the financial sector in the transition countries should reduce the constraints facing smaller firms and those in towns and rural areas. This will take time. These findings also emphasise the importance of promoting finance programmes aimed at smaller enterprises and those located outside major cities, and for policies encouraging foreign direct investment.

Endnotes

1 The 2004 BEEPS also covered South Korea and Vietnam; these results are not used here.

2 Although the importance of new private firms in generating growth in output and jobs is well established, the evidence on their levels of efficiency is more mixed. See Chapter 4 for an analysis of the relationship between business environment constraints and firm efficiency using the BEEPS data.

3 See Shleifer and Vishny (1999).

4 For a more detailed discussion of the methodology adopted here, with an extension to non-transition as well as transition countries, see Carlin *et al.* (2005) and Goldberg *et al.* (2005).

5 To simplify the analysis, a set of additional composite constraint measures has been constructed for six of the seven categories listed. Each composite measure is a weighted average of a firm's responses about a specific category of constraints. The weights are estimated using a principal components analysis, and so the composite measure can be interpreted as an estimate of an unobserved or "latent" variable – namely, the importance of an overall constraint placed on a firm by a general aspect of its business environment. The exceptions are the macroeconomic indicator, for which there is only one raw measure, and the infrastructure measure, for which there is only one measure in 1999 but for which composite measures can be constructed for 2002 and 2005.

6 The statistical analysis includes controls (country dummy variables or fixed effects) for each country. These capture all country-specific aspects of the business environment that do not vary systematically within the country. In effect, they capture the country-average constraints as rated by firms. The variation in the data that remains after these country-level effects are removed is the variation across firms within countries. The analysis links this variation to the characteristics of the surveyed firms. All constraint regressions also include industry dummy variables.

7 See, for example, Chapter 4, Carlin *et al.* (2001) and Djankov and Murrell (2002).

8 See, for example, World Bank (2002).

9 Foreign ownership may also include some firms owned by local investors based offshore. The share of such firms in the BEEPS is, however, very small and should not affect the results.

10 See Carlin *et al.* (2004).

11 The results of the analysis are unchanged if medium-sized firms are included with small and micro firms.

12 The results for re-investing profit come from a separate regression that omits the private ownership variables; including them generates qualitatively similar results. These results should be interpreted with some caution because of possible endogeneity: the re-investment of profits is an outcome rather than a characteristic of the firm (as with the other variables used).

13 More precisely, the R^2 of the regression falls by 10 to 40 per cent when the country dummy variables (fixed effects) are omitted and the business environment constraint equation is estimated by pooled OLS.

14 Therefore, being an exporter is strongly correlated with constraints attributable to one aspect of business regulations, namely customs regulations, and hence firm characteristics explain a large part of the variation in assessments of customs regulations as a business constraint.

15 While constraints fall most heavily on the firms with the most potential, constraints do not necessarily have to be associated with lower levels of, or growth in, efficiency (see Chapter 4). While new private firms generate growth in output and jobs, productivity per worker need not increase and can easily decline during the growth phase. New private firms also tend to be small and small firms typically have a low total factor productivity compared with large firms.

16 See Annex 3.1 on Environmental Regulation.

17 One possible explanation is the EU enlargement, which imposes a set of institutions and regulatory policies on the accession countries. This pattern is observed in CEB and SEE.

18 Here, as with the other results, the impact of privatised and new private ownership is measured against the benchmark category of state ownership.

19 The improved perception of the tax administration in SEE and the CIS is partly related to the tax reforms promoted in recent years, for example the introduction of flat corporate and income taxes in countries such as Russia, Ukraine and Romania.

20 A notable exception is the Slovak Republic, where the income, corporate and value added tax rates were set in 2004 at a flat 19 per cent, substantially simplifying tax procedures.

21 The answers to the two questions are, however, highly correlated, with a correlation coefficient of 0.93.

22 Indeed, foreign-owned firms are less likely to need collateral for loans than local firms.

23 Enterprises based in countries with higher growth rates or lower inflation rates are less concerned about macroeconomic instability than firms in slow-growing, high-inflation countries.

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Annex 3.1: Environmental regulation

Environmental regulation has to strike a balance between monitoring and enforcing compliance effectively and keeping the administrative burden on regulated firms as light as possible. The ability of environmental authorities to achieve this goal is usually assessed by analysing the capacity and performance of regulatory agencies. This annex looks at regulation from the business perspective. Drawing on data from the 2005 Business Environment and Enterprise Performance Survey (BEEPS), it considers what level of regulatory burden is faced by different types of firms and how enterprises in transition countries deal with the environmental authorities.

An effective environmental regulatory framework typically requires:

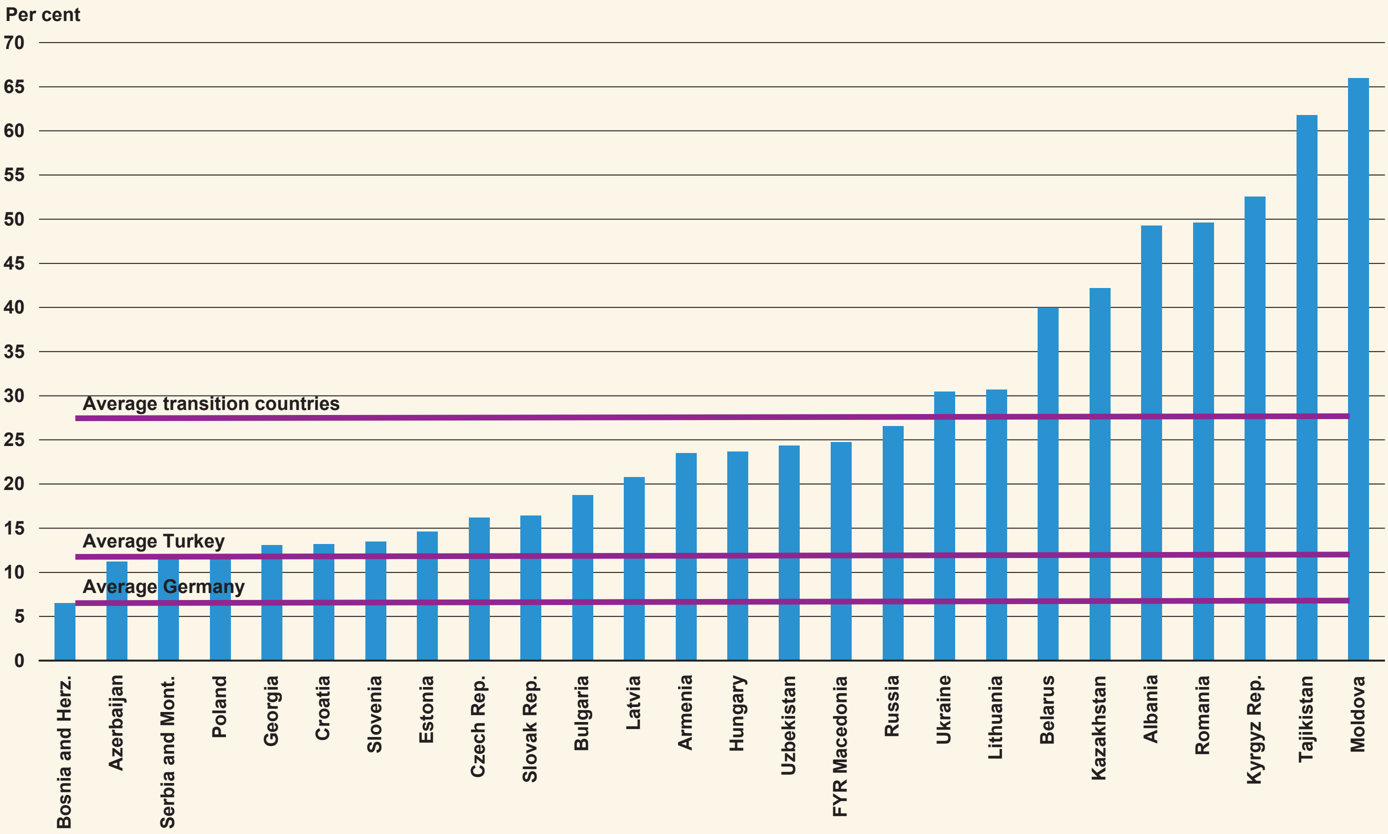
- an emphasis on proactive regulation with clear and realistic standards, complemented by user charges and other market instruments. It should encompass the "polluter pays" principle and encourage efficient use of resources.
- effective enforcement mechanisms to promote compliance with environmental regulation. There should be regular inspections and monitoring to detect non-compliance as well as adequate and timely responses to violations, including the rigorous use of penalties.
- a general "compliance culture" among businesses and the general public, reflecting the fact that regulations and enforcement are perceived as fair and effective. Higher levels of environmental compliance can be anticipated in countries where overall corruption levels are low.

Transition countries have traditionally faced difficulties in establishing an effective framework for environmental regulation. During the Soviet era, regulation was characterised by reactive authoritarian policies, lack of preventive action, centralised decision-making and discretionary allocation of resources. Enforcement was hampered by a lack of data and monitoring capacity. Moreover, the responsibility for environmental protection was dispersed among several agencies without a comprehensive regulatory structure.

Consolidated environmental agencies and ministries did not exist before the late 1980s. Even then, powers and resources were generally low. Transition countries frequently committed to over-ambitious goals. At the same time, regulations were often too complex and therefore difficult to implement and enforce. There was little incentive to comply with environmental regulation, given that user charges and the fines for non-compliance were usually negligible. Collections rates for user charges and penalties were also low.[1]

Chart A.3.1.1

Percentage of firms receiving at least one environmental inspection in the previous 12 months



Source: BEEPS 2005.

During the transition process, most countries have revised their environmental policies and developed new programmes, often in the context of National Environmental Action Plans. However, implementation has generally been slow.[2] Only in the more advanced transition countries have governments and the business sector been able to commit funds for environmental protection. Elsewhere, the environmental situation has not improved and in some cases has deteriorated.

For the countries of central eastern Europe and the Baltic states (CEB) and the EU candidate countries of south-eastern Europe (SEE-3), the prospect of EU membership and the need to adopt and implement EU standards and legislation have been the impetus for reform. Countries have taken steps to build capacity by developing new legislation, strengthening institutions, introducing innovative policies and encouraging public participation.

Nevertheless, the weakness of enforcement agencies and the low level of penalties continue to be a problem.

In the other countries in south-eastern Europe (SEE-4), too little attention is still being paid to environmental enforcement and institutional capacity. Some of the common difficulties include a lack of human, technical and financial resources and weaknesses in the regulatory framework. Also, a high degree of discretion enjoyed by inspectors leads to arbitrary enforcement and encourages corruption.[3]

Institutional weaknesses and implementation problems are also prevalent in the Commonwealth of Independent States (CIS). New policy and legal frameworks have often inherited old practices from the central planning era, adopting ambitious and unrealistic standards with insufficient monitoring or enforcement. As a consequence, the communist culture of non-compliance has tended to prevail.

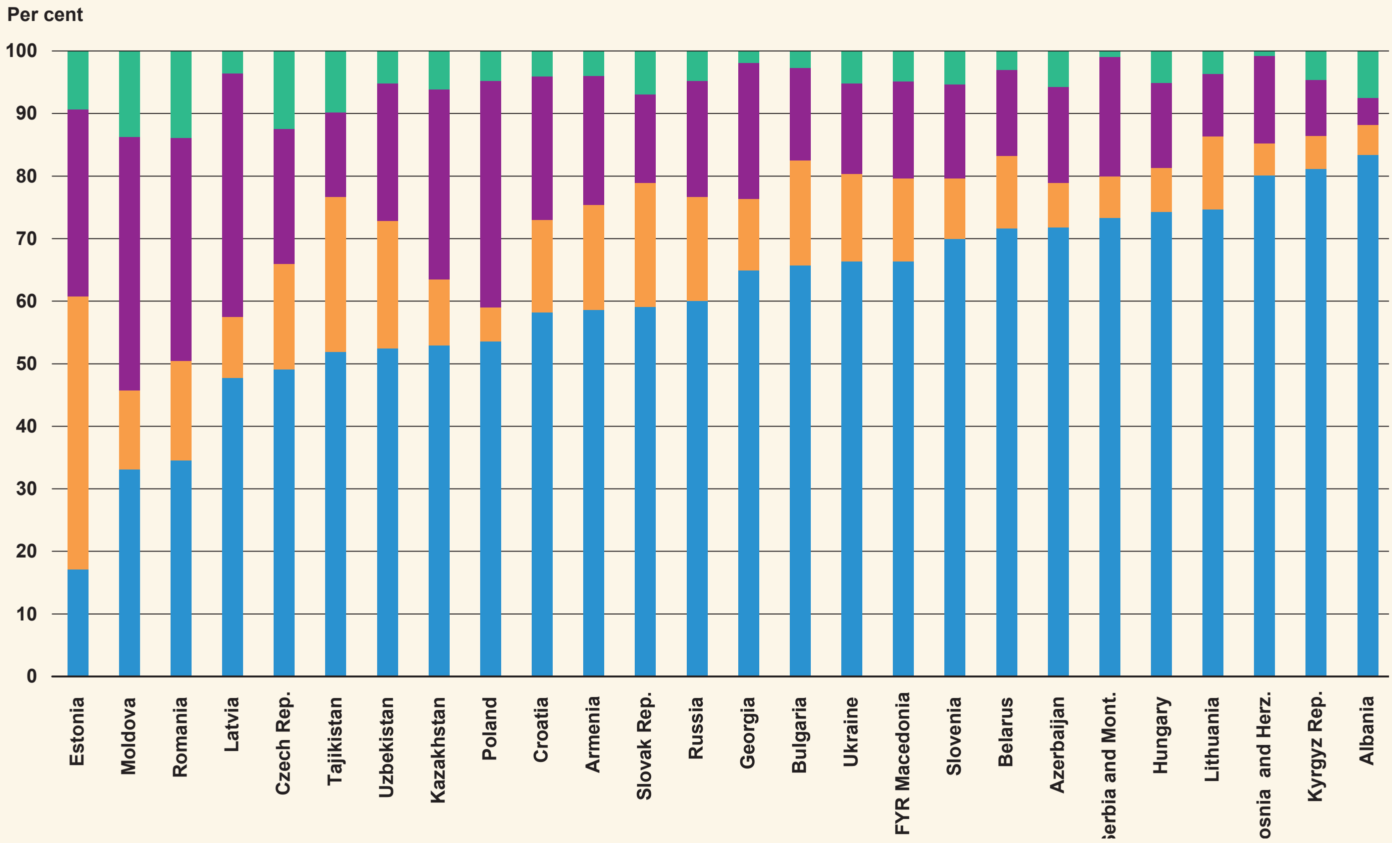
The BEEPS, which looks at how firms view environmental regulation, broadly confirms this assessment. The survey provides information about the frequency and duration of environmental, health and safety inspections in transition countries. It can therefore indicate the effectiveness of environmental regulation and enforcement and give an insight into the extent of corruption in this area.

Environmental inspections

Environmental inspections in transition countries are not very frequent; 74 per cent of the enterprises participating in BEEPS were not inspected on environmental grounds in the 12 months prior to the survey, 16 per cent of firms were inspected once and 10 per cent more than once. However, there was considerable variation between countries. In Moldova and Tajikistan, for example, over 60 per cent of firms reported at least one inspection in the previous 12 months (see Chart A.3.1.1).

Chart A.3.1.2

Inspection levels in transition countries



■ Tax inspections ■ Fire and building inspections ■ Sanitation and epidemiology inspections ■ Environmental inspections

Source: BEEPS 2005.

Note: Inspection levels are calculated by multiplying the average number of inspections by the average duration of the inspections. This level is expressed as a percentage of total inspections.

More frequent inspections do not necessarily imply more effective enforcement. In Germany, for instance, only about 6 per cent of firms are inspected at least once each year. Nevertheless, regulatory oversight may well be more effective in Germany than in Moldova or Tajikistan due to the thoroughness of inspections, a consistent stance against non-compliance, a well-developed compliance culture and a lower incidence of corruption.

In terms of the administrative burden on enterprises, a more relevant indicator than the frequency of inspections may be inspection levels or total inspection time – the number of visits multiplied by their duration (see Chart A.3.1.2). In most countries, environmental inspections take up less time than other site visits. Tax inspections, for example, typically account for at least 50 per cent of overall inspection time. Not surprisingly, enterprises view them as a greater burden.

This does not necessarily imply that environmental regulation is a lower priority in transition countries. It may simply reflect differences in the complexity of inspections – tax issues may require more frequent checks that also take longer to conduct. The comparison with three EU countries – Germany, Greece and Portugal – suggests that this may be the case. Their inspection levels display a similar pattern to the situation in transition countries. On average, much more time is spent on tax inspections than on environmental issues, suggesting that tax inspections are inherently more onerous. However, in the three EU countries, non-tax related inspections tend to feature more prominently than in the transition region.

The three EU countries also display more uniformity in the duration of inspection times. The maximum duration is similar for the various types of inspections whereas in transition countries it varies widely by type of inspection and across countries. Overall, however, the duration of environmental inspections is low throughout the transition region.

Targeting enterprises

Effective monitoring systems tend to concentrate on enterprises where the environmental consequences of violation are potentially severe or where the probability of non-compliance is high – or both. This section explores to what extent this has been the case in transition countries.

Environmental risk

The EBRD's guidance on business activity risk for financial institutions was used to measure environmental and health and safety risks, grouping firms into three categories depending on the nature of their operations. High-risk industries include mining and quarrying, road construction and certain types of manufacturing involving metals, chemicals and petroleum products. Medium-risk industries include most other types of manufacturing, such as textiles, wood and food products. Low environmental risk covers wholesale, retail and other services.[4]

The BEEPS data indicate that the environmental inspection level is much higher on average for firms in high environmental risk sectors (see Table A.3.1.1). This is particularly the case for firms in CEB and SEE-3. In SEE-4 and the CIS the picture is less clear and there are a number of countries (Azerbaijan, FYR Macedonia, Georgia and Russia) where medium-risk firms are scrutinised more carefully than high-risk firms. This suggests that the targeting of inspections is less effective in the CIS region. In contrast, inspections of enterprises in high-risk sectors in the Slovak Republic and Lithuania are particularly high – almost 30 times higher than in Azerbaijan and Georgia.

Likelihood of non-compliance

Environmental inspectors should pay particular attention to firms with a track record of violation. Although compliance data collected by regulators are not available publicly, the BEEPS contains a number of enterprise characteristics that are generally associated with good environmental performance.

One characteristic that is likely to indicate good environmental performance is a quality accreditation certificate, such as ISO 9000 or ISO 14001.[5] The BEEPS data show that both the frequency and the duration of inspections is lower for accredited firms. This may be because the environmental performance of quality-accredited firms is better, or because these firms are monitored less carefully.

Quality accreditations have been obtained by a greater percentage of enterprises in high environmental risk industries than in low or medium-risk industries. This may be because the environmental performance of enterprises in high-risk sectors tends to attract greater public scrutiny, creating a greater incentive for firms to obtain accreditation certificates. Only 7 per cent of firms in low-risk sectors have obtained an accreditation certificate, compared with 27 per cent of firms in high-risk sectors.

The BEEPS data also indicate that firms with higher export shares are more likely to obtain a quality accreditation certificate. This suggests that the maintenance of business links and sales performance in OECD export markets (where demand for accredited suppliers is highest) is a major incentive for firms to obtain certification.

Firms that have invested heavily in new (and usually more efficient) technology are also less likely to violate environmental standards. BEEPS data indicate that the duration of environmental inspections is significantly lower among firms that have made this type of investment over the previous 12 months. Nevertheless, the frequency of inspections is not significantly different for these firms because inspectors may be unaware of technological upgrades until a site visit has taken place.

Types of firms

The BEEPS data indicate that larger firms are inspected more frequently than smaller firms. This is probably due to the fact that firms in the high-risk sectors are more likely to be large. Only 1.4 per cent of small firms (with fewer than 50 employees) operate in high-risk sectors while the equivalent figure for large firms (with over 1,000 employees) is 18 per cent.

Similarly, there is no significant link between inspection frequency or inspection time and company ownership. Private and state-owned firms seem equally likely to be the subject of environmental inspections.

Table A.3.1.1

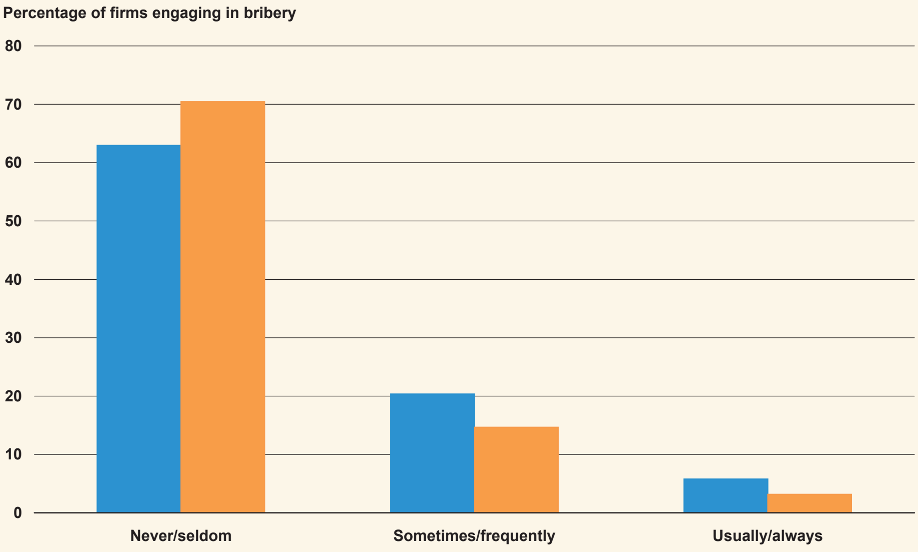
Inspection levels and environmental risk

	High-risk firms	Medium-risk firms	Low-risk firms
Czech Republic	8.3	2.3	0.9
Estonia	6	0.9	0.1
Hungary	4.3	1.9	0.2
Latvia	na	0.3	1.3
Lithuania	22.5	2.6	0.8
Poland	2.7	1	0.3
Slovak Republic	30	2	0.6
Slovenia	2	1.1	0.2
CEB average	***10.8***	***1.5***	***0.5***
Bulgaria	13	1.9	0.7
Croatia	5	0.4	0.5
Romania	10.1	3.1	1.5
SEE-3 average	***9.3***	***1.8***	***0.9***
Albania	8.7	5.2	1.8
Bosnia and Herzegovina	1.7	0.1	0.2
FYR Macedonia	2.5	3.2	1.2
Serbia and Montenegro	4.9	0.2	0.2
SEE-4 average	***4.5***	***2.2***	***0.9***
Armenia	3	0.7	0.3
Azerbaijan	0.7	0.8	0
Belarus	1.9	1.9	1.1
Georgia	0.5	1.1	0.7
Kazakhstan	13.2	2.5	1.5
Kyrgyz Republic	14.3	11.5	2.5
Moldova	4.8	2.7	1.6
Russia	2.6	3.2	0.4
Tajikistan	7.1	3.7	4.3
Ukraine	8.7	2.5	2.6
Uzbekistan	7.2	1.6	1.2
CIS average	***5.8***	***2.9***	***1.5***

Sources: BEEPS 2005 and the EBRD.
Note: Industries are assigned ratings of high, medium or low environmental risk according to the EBRD's Environmental Risk Manual for Financial Institutions. Inspection levels are calculated by multiplying the average number of inspections by the average duration of the inspections. This level is expressed as a percentage of total inspections.

Chart A.3.1.3

Frequency of bribery

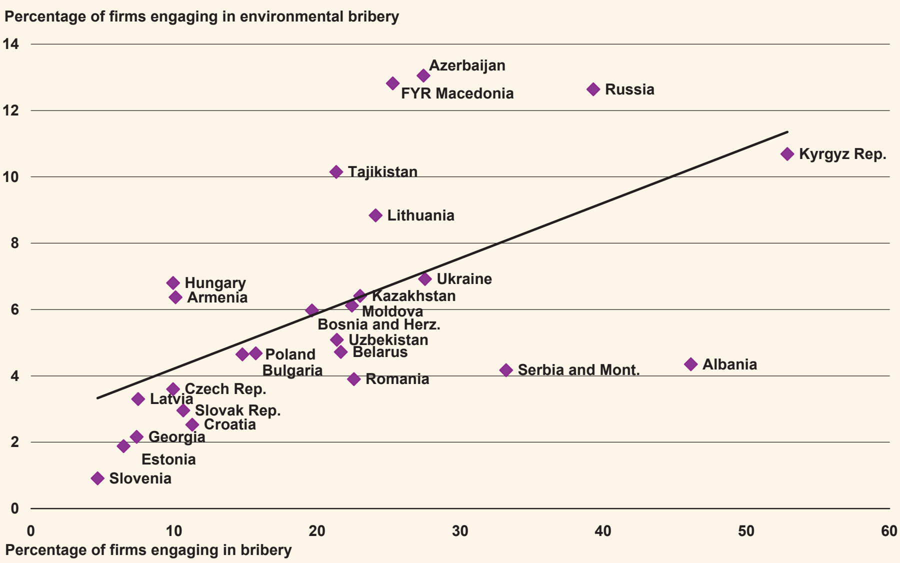


Source: BEEPS 2005.

Note: Enterprises were asked how frequently firms like theirs resort to bribery to obtain business licences and permits and to avoid operational health and safety inspections, fire and building inspections and environmental inspections. The chart groups responses into three categories: never/seldom, sometimes/frequently and usually/always.

Chart A.3.1.4

Environmental bribery and general levels of corruption



Source: BEEPS 2005.

Note: Bribery is measured as the percentage of firms which reported paying bribes for environmental inspections (y-axis) and for wider tax, customs and regulation issues (x-axis). The same relationship holds for other indices of overall corruption.

Environmental inspections and bribes

As in other areas of regulatory oversight in transition countries, environmental inspections are subject to bribery and corruption. However, as Chart A.3.1.3 shows, corruption is generally less prevalent in this area. Enterprises are more likely to bribe in order to obtain business licences and permits.

Environmental bribery tends to be more common if there is a general culture of corruption (see Chart A.3.1.4). In countries such as Azerbaijan, FYR Macedonia, the Kyrgyz Republic and Russia, where environmental bribery is among the highest in the transition region, overall corruption levels are also relatively high.

At the other end of the scale are countries such as Albania and Serbia and Montenegro, where environmental corruption is relatively low compared with overall corruption levels. This could indicate a more lax enforcement of environmental regulation.

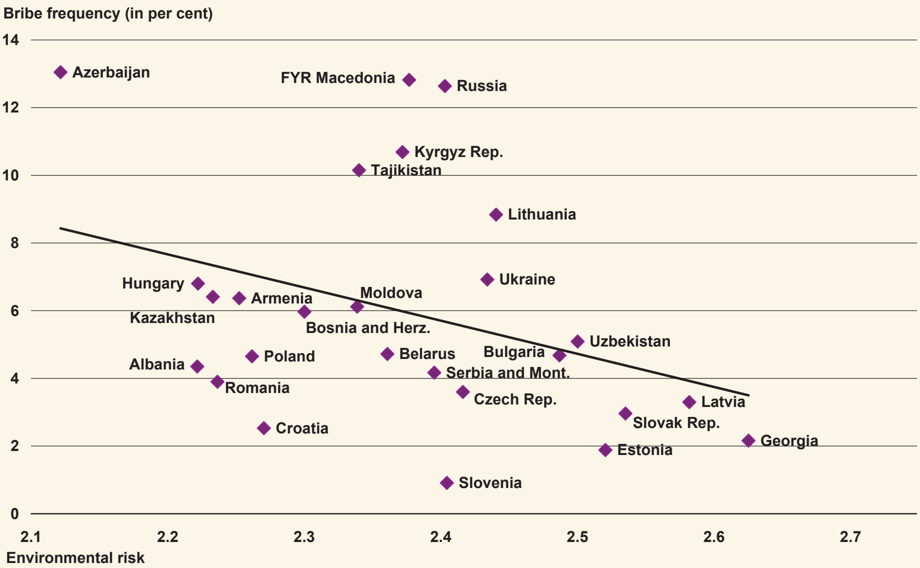
The likelihood of bribing officials increases according to the length of time spent on environmental inspections although overall corruption levels also play a role. This suggests that bribery is not used by firms to avoid inspections or lighten the regulatory burden. Rather, bribes are used to avoid or reduce costly fines for non-compliance.

Environmental bribes are more likely in industries with higher environmental risk (see Chart A.3.1.5). Similarly, large firms are more likely than small firms to bribe environmental officials. Since enterprises with higher environmental risk tend to be large, the two findings are consistent. This again suggests that bribes are primarily paid to prevent fines rather than to avoid inspections.

Firms with quality accreditation certificates were less likely than unaccredited firms to bribe on environmental grounds. Ownership of companies does not appear to have a strong influence on the level of environmental bribery. However, fewer private than state-owned enterprises reported “never” bribing environmental inspectors, suggesting that environmental bribes are more widespread among firms in the private sector.

Chart A.3.1.5

Environmental bribes and risk



Source: BEEPS 2005.

Note: Environmental risk is determined by assessing an enterprise's potential impact on the environment. An average has been calculated for each transition country. The ratings range from 1 (highest risk) to 3 (lowest risk). Bribery is measured as the percentage of firms which reported paying bribes regarding environmental inspections.

Conclusion

The BEEPS provides an insight into environmental regulation from the company perspective. The survey complements and broadly confirms the findings of other studies looking at the performance of regulatory agencies.

Environmental regulation does not provide a significant incentive for businesses to take their impact on the environment into consideration. Despite numerous reform efforts in the last decade, enforcement mechanisms throughout the region remain comparatively weak. There is evidence of an uneven level of inspection, considerable corruption and, in some SEE-4 and CIS countries, poor targeting of inspections. The incidence of bribery is highest in environmentally risky sectors and in countries where inspections are frequent but it is also closely linked to the overall level of corruption in the country.

CEB countries have made the most progress in improving the effectiveness of environmental regulation and enforcement. They have a higher number of better-targeted inspections and a lower level of environmental bribery. These positive developments are partly driven by the need to comply with EU regulations but also perhaps by a better compliance culture and broader acceptance of the need for environmental regulation.[6]

In SEE, and particularly the former Yugoslav states, environmental legislation is only just beginning to be recognised as a priority among governments and the business community. Bosnia and Herzegovina, for instance, adopted a modern environmental legislative framework, modelled on EU principles, only in 2003-04. Even where ambitious legislation exists on paper, its effective enforcement is hampered by a lack of financial and technical resources. The BEEPS results suggest that, with one or two exceptions, the targeting of inspections in SEE is generally adequate. However, overall inspection levels are lower than in CEB. In countries with relatively high levels of environmental inspections, corruption also tends to be greater. Also, enterprises have yet to recognise and evaluate the environmental costs of their operations.

Environmental regulation faces particularly severe obstacles in the CIS, where reform incentives such as the prospect of EU membership do not exist. The communist legacy, when the environment was perceived as a resource to be exploited, still prevails. Environmental regulation is characterised by an overly complex structure and a lack of transparency and consistency, making enforcement and the development of a "compliance culture" more difficult.[7] The BEEPS suggests that, while the frequency of inspections is relatively high in many CIS countries, the duration of inspections is short and bribery is prevalent (although no more so than in other areas). The targeting of inspections is much less efficient than in other regions.

The majority of countries have made progress in improving their environmental regulatory frameworks. However, progress in implementation and enforcement has been limited to those countries which have led reform in other areas and where there were strong incentives to comply with EU/international legislation.

Endnotes

1 See, for example, the discussion in UNECE (2003).

2 For an overview and assessment, see Michalak and Bularga (2002).

3 See REC (2002) and UNECE (2003).

4 The complete environmental risk categorisation list is available in the EBRD Environmental Risk Manual for Financial Institutions, available at www.ebrd.com/enviro/init

5 The International Standards Organisation (ISO) 9000 Series relates to Quality Management Systems and the ISO 14000 Series to Environmental Management Systems. They do not certify regulatory compliance.

6 See, for instance, Michalak and Bularga (2002), REC (2002), UNECE (2003) and OECD (2003).

7 See, for instance, Michalak and Bularga (2002) and Morziladze and Bularga (2004).

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The performance of firms in transition

4

The performance of firms in the transition countries is central to explaining the performance of the economy as a whole. At the start of transition, most firms were state-owned, inefficient and limited in their objectives by the dictates of central planning. To escape these limitations, a combination of privatisation, the entry of new private firms and fundamental changes to the competitive and regulatory environment has been at the core of the transition process. However, the extent to which barriers to doing business have been eliminated has varied widely across the region. This chapter uses the Business Environment and Enterprise Performance Survey (BEEPS) to analyse the factors explaining how firms have performed. The BEEPS provides data over a nine-year period that allows us to analyse how important firm characteristics and country factors are in determining performance.

Transition has had two principal characteristics – the reallocation of resources from the state to the private sector and the restructuring of firms to raise their efficiency as they shed the constraints of the planned economy.[1] These constraints included widespread over-staffing, inefficient working practices, an inadequate emphasis on product quality and marketing, and limited access to modern technology. In addition, firms received subsidies that allowed them to perpetuate inefficiencies and under-performance. Above all, firms were not generally motivated by the maximisation of profit – the overriding characteristic of market economies.

With the exception of a small number of countries in the Commonwealth of Independent States (CIS), there has been significant progress in the reallocation of resources and restructuring across the transition region. In most transition countries the private sector has become the main engine of growth and its share of GDP has expanded enormously. The private sector has also diversified, with new private firms entering alongside privatised enterprises. Foreign investment has also complemented domestic ownership in many countries.

Early studies that looked into the reasons for how firms perform in the context of transition found that privately owned firms – especially new private firms – generally perform better. Foreign participation and exposure to export markets were also found to be positive factors for good performance, whether measured in terms of sales, labour productivity or total factor productivity (output taking account of

Chapter 4 at a glance

- A country's business environment has a significant impact on a firm's performance. However, differences in business obstacles experienced by firms within a country do not affect their efficiency.
- Firms in central Europe have substantially higher levels of efficiency than those in south-eastern Europe and the CIS.
- Foreign-owned firms tend to be the most efficient. This is mainly because foreign owners usually acquire better-performing firms and establish new firms that benefit from modern working practices.
- Competition prompts firms to improve their levels of efficiency more quickly but it does not have an impact on the overall level of efficiency.
- Firms that bribe tend to have higher growth in efficiency, particularly in the CIS. However, corruption is detrimental to the economy as a whole.

labour and capital inputs).[2] However, more recent evidence suggests that privatised domestic firms do not necessarily perform markedly better than the remaining state-owned firms. It also finds that all types of domestic firms in transition countries continue to lag behind their equivalents in advanced market economies.[3] Domestic firms tend to have lower efficiency in generating output from inputs while their scope for raising prices may be limited by product quality, poor marketing and highly competitive markets. In addition, they tend to have fewer intangible assets, greater vertical integration and higher financing costs.

Existing evidence also highlights the role that ownership change has played. It has not, for example, had any positive impact on performance without complementary changes to the management structure, financing, competitive environment or other factors specific to the firm. It has been argued that privatisation by sale rather than by voucher has avoided the pitfalls of either dispersed or insider ownership and has consequently tended to improve post-privatisation performance. Nevertheless, some studies have argued to the contrary.[4] In many cases where privatisation initially favoured insiders – mostly existing management and workers – particularly in central eastern Europe and the Baltic states (CEB), ownership has passed in due course into the hands of outside investors, including through resale. Allowing outside investors to acquire assets, coupled with greater competition in the product market, has led to strong improvements in performance, particularly in CEB. Increasing foreign investment (whether in new or existing plant) has also proved to have a positive impact on firm performance, not least by improving efficiency.

Factors external to the firm can also exert an influence on performance. Studies using earlier rounds of the BEEPS have suggested that a better business environment can have a positive effect although the size of that effect and the validity of the findings are open to question.[5]

Chapter 3 concentrates on understanding the constraints facing firms and the changes in those constraints over time. This chapter examines how firms perform, given those constraints. The main emphasis is on the efficiency of firms but this has obvious and important implications for economic growth and the aggregate performance of an economy. The findings are drawn from detailed analysis of the three rounds of the BEEPS.

4.1 How firms have performed

This section focuses on the evolution of sales revenue to assess the performance of firms. In particular, it looks at how efficiently various types of firms have generated revenue from 1996 to 2005. The three BEEPS rounds cover the period 1999-2005 but also include a series of questions that look back over the previous three years. Over this period, the performance of firms will have varied, depending on a number of factors. Firms may have tried to imitate or develop other methods of production, import advanced technologies, launch new products or introduce new managerial and marketing techniques.[6] However, their success or failure will have been affected by developments in the macroeconomic, legal and institutional environment (see Chapters 1 and 3).

Three indicators of performance are used in the following analysis. The first is how efficiently firms generate sales revenue, taking into account inputs of capital and labour. This is equivalent to total factor productivity but broader in that it also captures improvements in pricing, marketing and other aspects of revenue generation. The second measure is the change in sales revenue per worker – or labour productivity. The third is the change in sales revenue, ignoring capital and labour inputs, which reflects the change in a firm's scale of operations.

Average performance

The average performance of firms in the three transition regions – CEB, south-eastern Europe (SEE) and the CIS – has varied in a number of ways. Charts 4.1, 4.2 and 4.3 present the average rates of change in sales revenue per worker, sales revenue and export revenue in the three regions.[7] Chart 4.1 shows that the average rate of growth in real revenue per worker has been positive. However, the magnitude and pattern of growth has differed. In CEB the average three-year rate of growth rose from almost 4 per cent per year in 1996-99 to over 5 per cent per year in 2002-05. In SEE, growth has been higher; since 1999 annual growth has ranged from 6 to 8 per cent per year. In the CIS there has been a clear decline in growth, with labour productivity expanding at only around 4 per cent per year in 2002-05 (a similar rate as in CEB) from nearly 10 per cent in 1999.

Regarding the average growth of real sales revenue (see Chart 4.2), a declining pattern can be observed in CEB from over 10 per cent per year in 1996-99 to around 5 per cent in 2002-05. In contrast, average growth in SEE and the CIS peaked in the 1999-2002 period before falling back in 2002-05. However, the rates of growth in the CIS since 2002 have been higher than in CEB. This suggests that restructuring in the SEE and CIS regions has followed with a lag the example of CEB. Meanwhile, the average rates of change in export revenue (see Chart 4.3) show that from 1996 to 2005 exports continued to grow strongly in CEB, and at rates mostly in excess of those in either SEE or the CIS. In the CIS, the duration and aftermath of the Russian crisis of 1998 can be observed in falling exports from 1996 to 1999, with growth of over 2 per cent per year thereafter. In all three regions domestic sales have evidently been the principal engine of sales growth.

4.2 Factors affecting overall performance

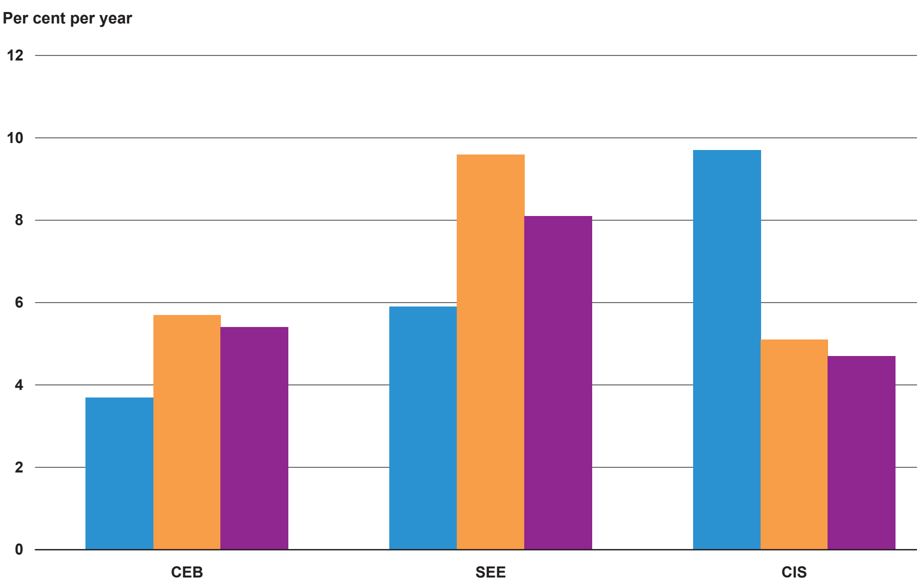
In trying to understand the factors that influence the performance of firms, it is useful to distinguish between the level at which a firm operates and the changes in levels over time. Each of the three performance measures identified above – total factor productivity, sales per worker, and sales revenue – are analysed from these two perspectives. These measures are then related to government policy and other factors that form the business environment in which the firms operate.[8] The analysis aims to determine whether such factors influence a firm's performance and to identify the causality – or cause and effect.[9] However, this can be problematic since BEEPS data on performance and the explanatory factors are gathered simultaneously. Yet, there is a need to isolate the effect of policy-related factors on a firm's performance (such as changing ownership through privatisation or reducing the constraints facing a firm) from the effects of performance on ownership and constraints.[10]

For a sub-group or panel of 1,462 firms that have participated in both the 2002 and 2005 BEEPS, it is possible to examine directly the effects of policy and other factors in 2002 on the performance of firms from 2002 to 2005.[11] In addition, the full 2002 and 2005 samples provide information for several key variables on the rate of change between 2002 and 2005 and this information has also been used in the analysis.

The principal variables that may affect a firm's performance include the constraints faced by the firm, ownership, the firm's export market and the extent of competition. In addition, factors such as the age, size, sector, geographic location, labour force structure and legal status of the firm are identified to take account of other structural features that may affect performance. The analysis also looks at the effect of the business environment in a particular country on a firm's performance. The average business environment in a country can be estimated by using data on the average level of performance and the change in performance of all firms in a given country while taking into account the specific characteristics of the firm or sector.

Chart 4.1

Growth in sales revenue per worker



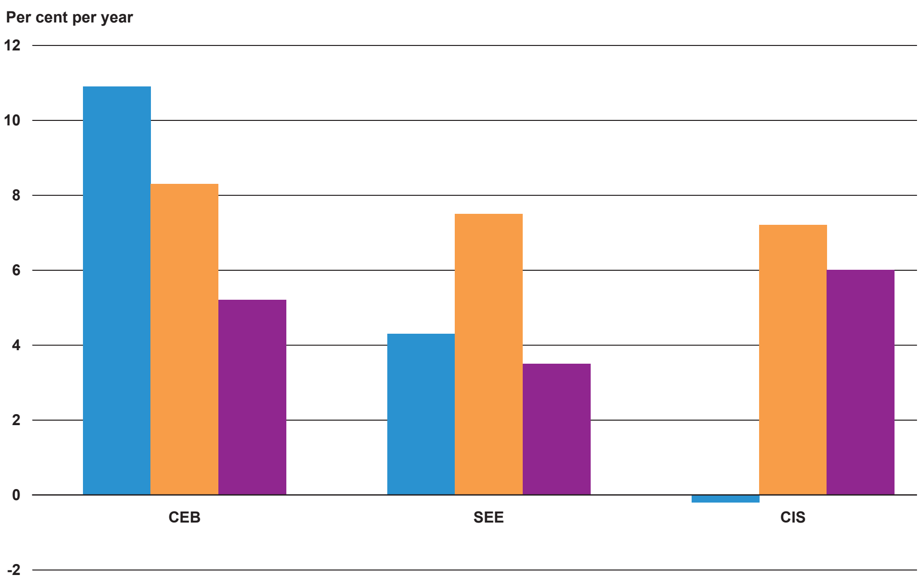
1999 2002 2005

Sources: BEEPS 1999, 2002 and 2005 and the EBRD.

Note: Firms were asked to report their growth in sales revenue per worker over the previous three years. Data show responses from the BEEPS in 1999, 2002 and 2005 and are weighted averages.

Chart 4.2

Growth in sales revenue



1999 2002 2005

Sources: BEEPS 1999, 2002 and 2005 and the EBRD.

Note: Firms were asked to report their growth in sales revenue over the previous three years. Data show responses from the BEEPS in 1999, 2002 and 2005 and are weighted averages.

4.3 The effect of ownership, policy and market structure

The analysis in this section considers whether particular ownership, policy or market structures have had an impact on a firm's performance, and the significance of this impact. The results broadly confirm some of the findings from earlier research, although with some important qualifications.

A significant feature of the transition process has been the change in the ownership of firms, as state-owned firms have been privatised or closed down. Many studies have found that private firms have performed significantly better than state-owned firms. However, some research has found differences in performance among different types of private firms. It has been argued that new private firms have tended to perform better than privatised firms, emerging as the principal engine of growth in some transition countries. It has also been suggested that competition and exposure to export markets has had a positive impact on performance.

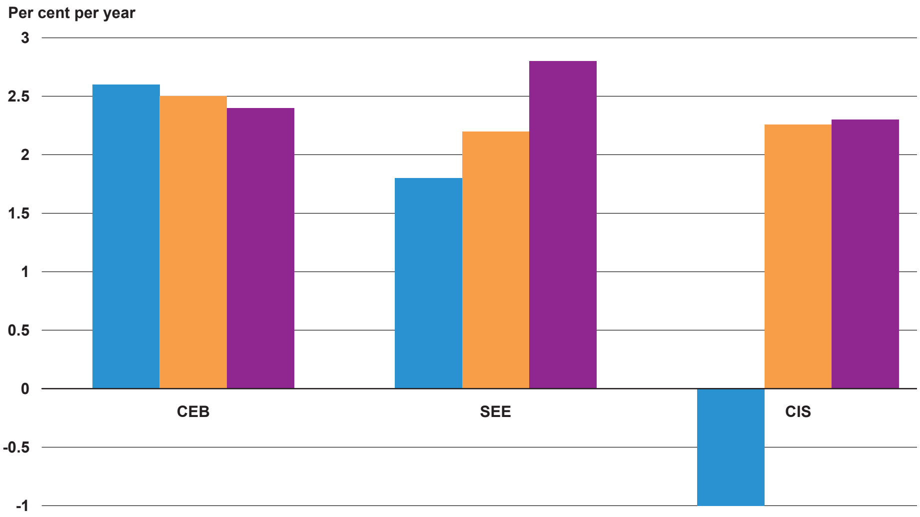
Chart 4.4 shows how ownership, competition and the export market have affected the performance of firms in the BEEPS. Two indicators of firm efficiency — sales per worker and total factor productivity — are considered for different types of ownership.[12] It is apparent that foreign-owned firms have consistently higher levels of efficiency than state-owned firms. For both sales per worker and total factor productivity, foreign firms have around 40 per cent higher levels. Privatised state firms have around 10 per cent higher levels while new private firms are between 18 and 23 per cent higher. Exporting firms have substantially higher levels of efficiency than non-exporters. Competition is also associated with a slightly higher efficiency level.

In terms of growth rates, the results are more ambiguous. Regarding labour productivity, foreign and privatised firms have higher growth rates than state-owned firms. However, only in the case of foreign-owned firms is this difference significant. New private firms actually show significantly less growth in labour productivity than state firms. Foreign firms also have a significantly higher growth rate in terms of the change in sales revenue while new private firms again perform less well. For exporters and firms facing more competition, both the level and rates of change are higher than for non-exporters and firms in less competitive markets.

The effect of ownership on performance broadly confirms findings from earlier research but it is important to take account of other policy and structural factors. The rest of this section analyses these factors, taking into account the issue of causality.[13] When this is done, a number of different findings emerge.

Chart 4.3

Growth in export revenue



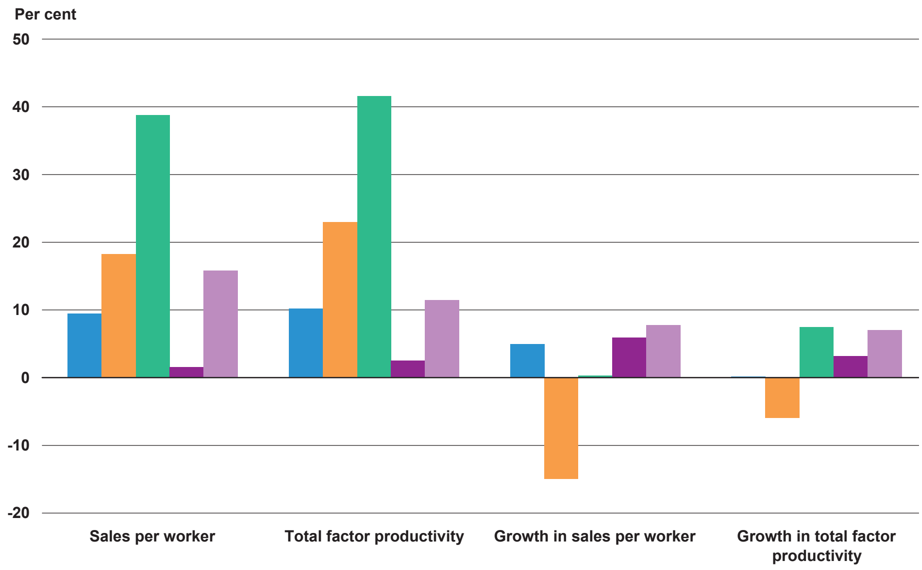
1999 2002 2005

Sources: BEEPS 1999, 2002 and 2005 and the EBRD.

Note: Firms were asked to report their growth in export revenue over the previous three years. Data show responses from the BEEPS in 1999, 2002 and 2005 and are weighted averages.

Chart 4.4

Efficiency by type of ownership



Privatised New private Foreign Competition Export

Sources: BEEPS 2002 and 2005 and the EBRD.

Note: The chart compares the efficiency of different types of firms, relative to a base category.

The firm types are as follows:
- Privatised: firms majority-owned by private domestic investors, which were formerly state-controlled.
- New private: firms majority-owned by domestic investors, which were never under state control.
- Foreign: firms majority-owned by foreign individual(s)/ company(s)/ organisation(s).
- Competition: firms exposed to more than three competitors.
- Export: firms that export.

The following base categories are used:
- For privatised, new private and foreign firms: state-owned enterprises.
- For competing firms: firms with fewer than three competitors.
- For exporting firms: non-exporting firms.

Firm ownership

Foreign-owned firms have on average been more successful than all types of domestic firms in terms of generating sales and sales per worker. The average foreign firm produces 20 to 50 per cent more sales revenue and has a 20 to 40 per cent higher revenue per worker than the average domestic firm. This difference tends to be greater in SEE than in CEB or the CIS. Furthermore, the difference persists even when other policy-related issues and structural factors are taken into account. However, this difference may mostly be due to foreign owners acquiring better-performing firms.[14] On average, the scale of operations does not differ much between foreign firms, state firms and domestically owned private firms that are not controlled by individuals or families.

When using the smaller panel of firms to examine changes in performance, it is clear that changes in scale and efficiency between 2002 and 2005 have been similar for both foreign firms and domestic firms. In CEB and SEE, however, foreign firms have tended to increase their scale of operation at a faster rate than domestic firms but their efficiency (in terms of sales per worker or total factor productivity) has increased no faster. This finding differs from the results of studies in the 1990s, where foreign firms were found to be increasing their efficiency at a faster rate than domestic firms. This implies that since 2000 the advantage of foreign ownership has mainly been in maintaining higher levels of efficiency and less in increasing efficiency.

The various categories of domestically owned firms have broadly similar levels of efficiency. Moreover, they have generally experienced similar rates of change of scale, total factor productivity and labour productivity.[15] However, firms with individual and family ownership tend to operate on a smaller scale. In short, one type of domestic ownership does not confer any major advantages over another in terms of improving a firm's performance. This suggests that by the second decade of transition, market forces and budget constraints have tended to even out the performance across different types of domestic ownership. However, the results also indicate that the sale of state-owned firms to domestic owners has not necessarily brought about the expected efficiency gains.[16]

The evidence also shows that private start-up firms operate on a smaller scale and are between 10 and 20 per cent more efficient than privatised firms (although that partly reflects the higher efficiency of foreign start-ups). In SEE and the CIS, firms that began as private firms have tended to grow more slowly. Overall, this suggests that start-ups, especially foreign ones, tend to be more efficient than existing domestic firms. However, it also indicates that in SEE and the CIS – unlike in CEB – these firms do not necessarily perform as well over time as firms that emerged from privatisation.[17] These results imply that the transition countries can improve their efficiency by stimulating entrepreneurship and the entry of new firms. Even so, the business environment plays an important role in determining their subsequent performance.

Competition

It has been argued that competition has played an important role in explaining performance.[18] The following analysis assumes that competition involves the presence of more than three competitors in a firm's market. The results indicate that in all three transition regions, firms operating in more competitive settings are smaller than other firms but have similar levels of efficiency (total factor productivity and revenue per worker). Competition is mostly found to have exerted a positive effect on the level of efficiency (as in CEB and the CIS) – although not to a significant extent.

Greater competition has, however, had a largely positive impact on how quickly firms have improved their performance between 2002 and 2005. More competition has been significantly linked with a faster increase in efficiency. This positive effect has been consistently strong in SEE and, to a slightly lesser extent, in the CIS. There is no evidence that competition has spurred performance in the more advanced CEB countries.[19] Since CEB producers have on average been more exposed to external competition, the presence of domestic competitors is in their case less likely to have been an important issue. These results support the belief that competition generally exerts a positive impact on a firm's performance.

Export market

Export sales have formed a large share of total revenue in the transition countries but the share across the three regions has developed at different rates. In CEB and SEE the export share has remained at the relatively high level of 10 to 15 per cent of total sales. By contrast, in the CIS the export share has risen slightly from a low level of under 5 per cent in 1999. This raises the question of whether the extent of exporting undertaken by firms has improved their performance. Exporting firms are more exposed to world competition and modern business practices. This might be expected to increase their efficiency.[20] On the other hand, as a result of government policies, the transition countries have opened up increasingly to all types of trade and foreign investment. This increased exposure may make the effect of exporting less significant.

The results show that exporting firms operate on a larger scale than other firms. While exporting has mostly a positive impact on the firm's level of efficiency – particularly in the CIS – this effect almost entirely disappears when ownership and other factors are taken into account. Factors such as foreign ownership account for many of the efficiency gains. However, when looking at the simple effect of exporting on a firm's efficiency, a clear positive relationship emerges. This is particularly true for the CIS, and to a lesser extent, SEE. This shows that even when taking account of ownership and other factors, exporting has a positive impact on the change in a firm's performance, if not on the overall level of performance.

Constraints on doing business

Chapter 3 discusses how different types of firms are affected by business constraints. The chapter shows that these constraints particularly affect fast-growing firms. In this chapter, the constraints experienced by firms are analysed to see whether they also have a material impact on efficiency. The analysis reveals that while there is a link between constraints and overall levels of efficiency, these constraints have very little impact on how quickly a firm improves efficiency.

Access to financing is regarded as a particularly tight constraint by smaller firms. However, firms that report greater difficulty in obtaining financing are generally not less efficient in terms of total factor productivity or revenue per worker. Higher costs of obtaining financing are associated with a smaller scale of operation in CEB and a lower level of efficiency in CEB and the CIS. However, tighter constraints have no significant effect on efficiency, except in the CIS, where the cost of financing has a positive effect on the level of efficiency and rate of change. This suggests that a higher cost of financing has tended to induce greater efficiency in the CIS.

Infrastructure constraints have tended to be experienced by smaller firms in SEE and less efficient firms in the CIS. Larger, more efficient firms tend to report greater constraints from foreign trade regulation. However, this can mostly be explained by the fact that larger and more efficient firms tend to engage in foreign trade and hence are more likely to report more binding constraints in this area than other firms. It is also possible that regulations in this area benefit firms by limiting competition from imports.

A higher perceived level of macroeconomic instability leads to smaller-scale operations in the CIS but to a larger scale and lower revenue per worker in CEB. A perception of greater anti-competitive practices has no detectable impact. Business licensing is found to have no impact on a firm's level of efficiency but there is a negative effect on improvements in efficiency. Corruption has had a negative impact on how firms expand but only in CEB.

Overall, the analysis reveals that in most instances where firms perceive greater constraints, these obstacles are mostly associated with the ability of firms to expand and are not significantly associated with their level of efficiency or improvements in efficiency. Firms that have perceived higher levels of constraints (in access to financing, tax administration, business licensing and permits, corruption and macroeconomic instability) have not been found to have lower efficiency when other policy and structural factors are taken into account.[21] Similarly, such constraints have not been found to have a significant impact on improvements in efficiency for the smaller panel of firms.

Impact of the business environment

One way of identifying the overall effect of the business environment on a firm's performance is to use information about how firms have changed on average in a given country and over a particular time period (taking into account a variety of features specific to the sector or firm).

The level of sales per worker and total factor productivity differ considerably across countries (see Table 4.1). For

Table 4.1

Sales per worker and productivity in transition countries (in per cent relative to Ukraine)

Level of efficiency

Countries	Sales per worker (in per cent)	Countries	Total factor productivity (in per cent)
Estonia	204	Slovenia	211
Hungary	200	Estonia	166
Poland	183	Poland	147
Czech Republic	162	Hungary	146
Slovak Republic	156	Croatia	136
Slovenia	151	Slovak Republic	122
Croatia	147	Bulgaria	111
Lithuania	99	Romania	101
Bulgaria	92	Latvia	92
Latvia	87	Bosnia and Herzegovina	87
FYR Macedonia	47	Serbia and Montenegro	56
Bosnia and Herzegovina	45	Czech Republic	56
Serbia and Montenegro	45	Albania	50
Albania	37	Lithuania	38
Belarus	26	FYR Macedonia	36
Georgia	15	Belarus	25
Ukraine	0	Georgia	18
Romania	-5	Russia	3
Uzbekistan	-16	Ukraine	0
Moldova	-18	Moldova	-6
Russia	-33	Kazakhstan	-21
Armenia	-42	Uzbekistan	-29
Kazakhstan	-55	Armenia	-54
Azerbaijan	-106	Azerbaijan	-55
Kyrgyz Republic	-133	Kyrgyz Republic	-64
Tajikistan	-204	Tajikistan	-81

Change in efficiency

Countries	Sales per worker (in per cent)	Countries	Total factor productivity (in per cent)
Romania	15	Tajikistan	7
Bulgaria	5	Estonia	5
Serbia and Montenegro	3	Romania	2
Estonia	3	Kazakhstan	2
Slovak Republic	3	Russia	1
Ukraine	0	Ukraine	0
Czech Republic	-3	Belarus	-1
Slovenia	-4	Moldova	-1
Kazakhstan	-5	Slovak Republic	-1
Croatia	-5	Latvia	-2
Latvia	-6	Slovenia	-3
Georgia	-7	Serbia and Montenegro	-3
Albania	-7	Bulgaria	-3
Lithuania	-8	Croatia	-4
Hungary	-8	Czech Republic	-5
Russia	-10	Azerbaijan	-5
Poland	-10	Lithuania	-6
FYR Macedonia	-13	Georgia	-6
Armenia	-14	Kyrgyz Republic	-7
Uzbekistan	-14	Albania	-8
Kyrgyz Republic	-15	Bosnia and Herzegovina	-9
Tajikistan	-15	Armenia	-9
Moldova	-16	Hungary	-10
Bosnia and Herzegovina	-16	FYR Macedonia	-12
Belarus	-18	Poland	-14
Azerbaijan	-18	Uzbekistan	-18

Note: The countries are ranked using country co-efficients from the sales per worker and productivity instrumental variable regressions. Ukraine has been used as the base country of reference for both the level of efficiency and change in efficiency.

example, firms in the CEB countries have substantially higher levels of efficiency than either SEE or the CIS. Slovenia's level of efficiency is between 20 and 30 times higher than the Kyrgyz Republic's when measured in US dollar terms. Table 4.1 provides a ranking for sales per worker and total factor productivity for each transition country. Ukraine is used as the benchmark.

The CEB countries tend to have higher levels of efficiency for labour productivity and total factor productivity. The CIS states are mostly towards the lower end of the scale. With respect to growth rates, most CEB countries score highly for labour productivity, along with some SEE countries. For efficiency in generating revenue, a number of CIS states rank more positively. This suggests (as in Chapter 1) that there has been some improvement (although from a low base) in the overall business environment in the CIS.

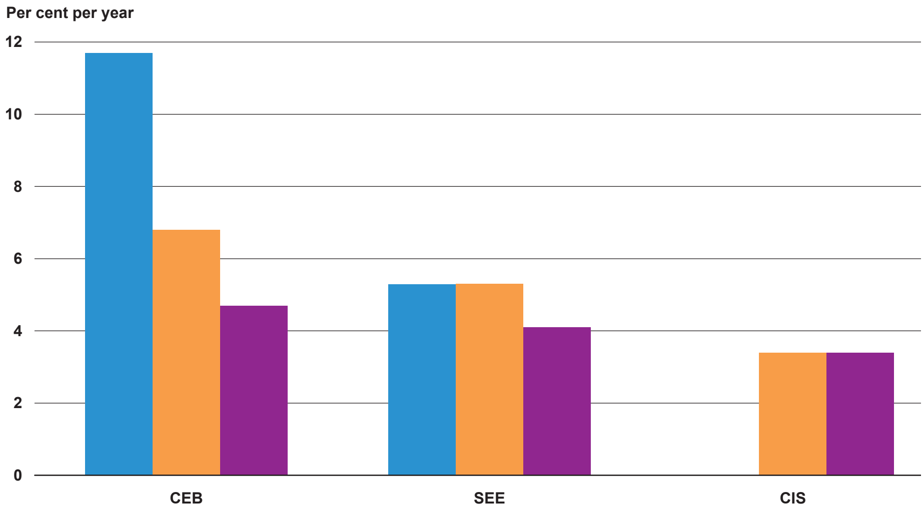
4.4 How firms have improved performance

The preceding analysis has identified the factors explaining the relative performance of firms. This section now analyses what firms have done to improve their performance, focusing on a number of intermediate steps. These include changes to employment levels, the mix of labour skills and investment. Charts 4.5 and 4.6 show the weighted average rates of growth in fixed assets (capital) and employment (labour) for firms in the sample. Chart 4.7 provides a summary of restructuring initiatives by region. These indicators reflect the labour and investment policies of firms and their restructuring and performance in terms of changes to key inputs. They also provide another perspective on how quickly a firm's scale of operations changes.

Charts 4.5 and 4.6 show how capital and labour have changed across the region from 1996 to 2005. There has been a pronounced rise in employment in SEE since 1999. In the CIS employment has grown but at relatively low rates of around 1 to 2 per cent per year. In CEB employment fell substantially between 1996 and 1999 (the height of the restructuring phase)[22] and since then growth in employment has not recovered significantly. In SEE and the CIS there has been positive growth since 1999 in fixed assets although rates have remained in the range of 3 to 4 per cent per year. From the employment and fixed assets data, it is evident that between 1996 and 2005 firms in CEB have on average increased the capital intensity of production (the capital-labour ratio) relative to their counterparts in SEE and, most particularly, in the CIS. If this trend is maintained, it will signal greater differences in techniques of production across regions and ultimately in differences in wages. Chart 4.7 shows that, in terms of restructuring initiatives, there has been relatively limited variation by region although firms in SEE and the CIS have undertaken more restructuring than their CEB counterparts.

Chart 4.5

Growth in fixed assets



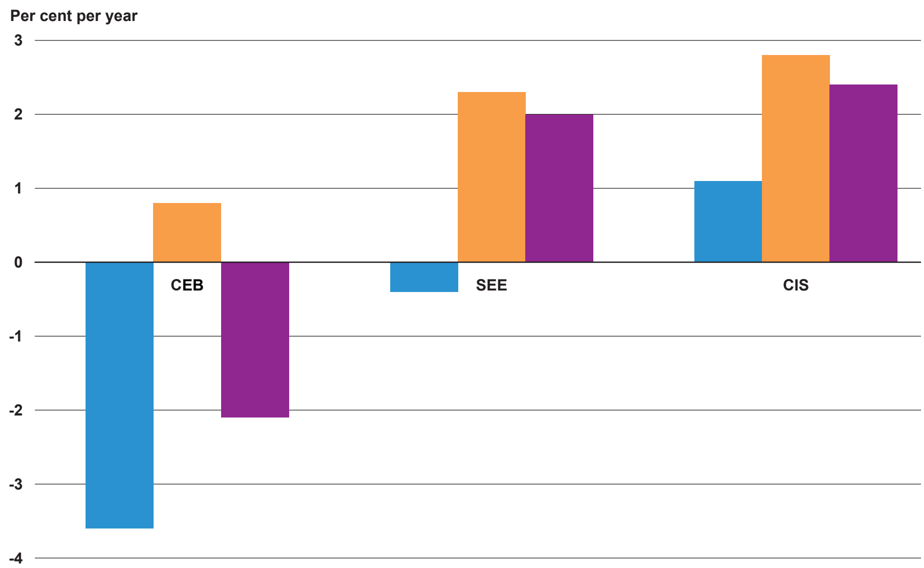
1999 2002 2005

Sources: BEEPS 1999, 2002 and 2005 and the EBRD.

Note: Firms were asked to report their growth in fixed assets over the previous three years. Data show responses from the BEEPS in 1999, 2002 and 2005 and are weighted averages. For 1999 the change in investment rather than fixed assets is reported. Growth for the CIS in 1999 was 0 per cent.

Chart 4.6

Growth in employment



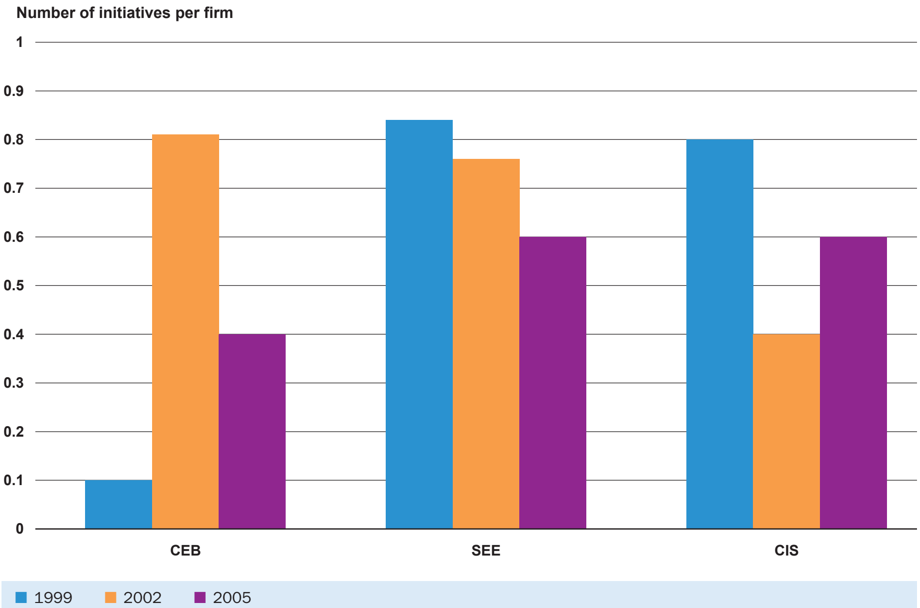
1999 2002 2005

Sources: BEEPS 1999, 2002 and 2005 and the EBRD.

Note: Firms were asked to report their growth in employment over the previous three years. Data show responses from the BEEPS in 1999, 2002 and 2005 and are weighted averages.

Chart 4.7

Restructuring initiatives



Sources: BEEPS 1999, 2002 and 2005 and the EBRD.

Note: Firms were asked how many restructuring initiatives they had undertaken in the previous three years. The chart shows the average number of restructuring initiatives per firm.

Employment

Employment has largely grown across the region between 2002 and 2005 but there has been significant variation in the scale of employment growth. This suggests that the early phase of downsizing has mostly passed for some firms but not yet begun for others. In terms of ownership, it is striking that new private firms have seen strong growth in employment, especially in SEE and the CIS. This is also true for foreign-owned firms in CEB.

State-owned firms in the CIS have performed relatively poorly in terms of employment growth, as might be expected from a shrinking sector. The extent of competition facing firms has had no material impact on employment growth. However, greater levels of exporting have resulted in faster employment growth in the CIS. Business obstacles as a whole, as perceived by firms, have had very little impact on changes in employment although, as Chapter 3 shows, specific labour constraints may have affected employment growth.

The increase in employment has been strongest in a number of CIS countries, including Belarus, Russia and Tajikistan. In contrast, much of CEB has experienced a declining rate of growth in employment. This pattern reflects the different growth rates of GDP and stages of reform in each region. Most firms in all three regions have passed through the early phase of cutting employment. However, more recently firms in the CIS have accommodated growth in demand by expanding their labour force more quickly. CEB firms have recorded slower growth rates in employment while the situation in SEE reflects the variation between countries in terms of overall reform.

Capital

Fixed assets have increased at a positive rate in almost all transition countries between 2002 and 2005. The rate of growth has been particularly strong in some CIS countries, notably Russia and Ukraine. Significant advance has also been recorded in many SEE and CEB countries, where (when taking employment growth into account) capital intensity has mostly increased. In terms of ownership, foreign-owned firms have seen faster rates of growth for fixed assets, especially in SEE. In the CIS large and medium-sized domestic private firms have experienced slower rates of growth for capital than other firms.

In CEB foreign trade regulations and more constrained access to financing have had a negative effect on the rate of capital accumulation. Conversely, in the CIS greater constraints in accessing finance, as perceived by firms, are associated with growth in fixed assets. Firms that have invested more have experienced greater changes in their mix of labour skills. The evidence indicates that such firms have raised the share of skilled and professional workers.

Restructuring initiatives

Restructuring may range from cutting employment to changing product lines and the organisation of a firm or ownership. The BEEPS measures restructuring in a number of ways. These include developing a new product, upgrading an existing product and forming a joint venture with a foreign partner. These measures are analysed in the following section.

Contrary to expectations, there are no significant differences between the regions in terms of restructuring. CEB, for example, does not have higher overall restructuring scores although its firms seem more inclined to create joint ventures with foreign partners. This indicates that differences between firms are primarily driving change. However, particular restructuring initiatives are not strongly associated with firm ownership, competition or most business constraints. In the CIS, firms that export more are less likely to form a joint venture or to undertake extensive restructuring. It is also evident that in CEB foreign firms are more likely to introduce new products. Overall, this suggests that the early phase of restructuring in many transition countries has already taken place, except possibly in some strategic industries that are under-represented in the sample.

Firms have certainly invested in changing their product lines and have taken other steps to improve their performance. This in turn has resulted in a broad range of outcomes. However, particular attributes of firms, such as the type of ownership, no longer give a good indication of the expected level of restructuring. The evidence from the BEEPS implies that firms may periodically make adjustments, such as introducing a new product, but that major restructuring is no longer a widespread feature of the transition countries.

4.5 Market distortions

An important aspect of market structure is the way in which firms and governments interact – in particular, through lobbying and corruption. Earlier rounds of the BEEPS and information from other surveys[23] have identified widespread corruption in transition countries and a high degree of "state capture", where vested interests exert undue influence over the state.[24] While corruption is largely of an administrative nature and mostly involves firms bribing public sector officials, state capture can involve attempts by particular firms to influence the content of laws and regulations affecting their business. This sometimes involves the payment of bribes to acquire specific advantages that may materially affect the competitive environment.

The lobbying of legislators by specific interest groups is certainly an established aspect of the democratic process. However, there is a difference between such lobbying and non-transparent and illegal attempts to gain influence. The BEEPS distinguishes between these two types of behaviour. The survey asks to what extent firms seek to influence legislation, whether they make unofficial payments to do this and to what extent state capture by other firms has had an impact on their business. The data also shed light on whether engaging in state capture or corruption results in the loosening of any constraints facing firms.

Table 4.2 shows the incidence of corruption and state capture in the transition region over time. In CEB roughly 5 per cent of firms made unofficial payments to influence legislation on a frequent basis. However, only 2 to 4 per cent of firms in CEB reported that this had had a major impact on their business. In SEE nearly 25 per cent of respondents took part in lobbying in 2005 (and over 35 per cent of firms from the smaller panel) but only 5 per cent reported making unofficial payments. A further 6 to 9 per cent reported being significantly affected by state capture. Lobbying and state capture either declined or remained broadly stable in the CIS between 2002 and 2005 and a relatively small share of firms – 3 to 5 per cent – reported having been significantly affected by state capture. Corruption (as measured by the BEEPS) has broadly declined since 1999 (see also Chapter 1). The average ratio of bribes to sales has fallen across all regions.[25]

Table 4.2

Lobbying and state capture

	All firms[1]		Panel firms[2]	
	2002	2005	2002	2005
CEB				
Lobbying [3]	21.0	17.5	24.7	25.7
State capture with bribes [4]	3.8	4.6	4.7	5.6
Impact [5]				
Payment to parliamentarians	2.8	2.6	3.7	2.2
Payment to government officials	3.6	3.6	4.0	3.6
SEE				
Lobbying	32.0	24.4	38.4	35.9
State capture with bribes	7.4	5.1	8.0	5.3
Impact				
Payment to parliamentarians	6.4	5.7	13.4	8.0
Payment to government officials	8.3	6.3	7.1	9.4
CIS				
Lobbying	21.2	15.1	24.6	21.0
State capture with bribes	4.5	4.6	4.7	6.7
Impact				
Payment to parliamentarians	3.1	3.0	4.5	5.0
Payment to government officials	3.4	3.5	3.5	4.6

Source: BEEPS.
[1] All firms refers to all firms that participated in BEEPS.
[2] Panel firms refers to firms that participated in both the 2002 and 2005 survey.
[3] Lobbying is the percentage of firms using lobbying to influence the content of laws or regulation affecting their firm.
[4] State capture with bribes is the percentage of firms making unofficial payments to the state to influence the content of new legislation, rules or decrees.
[5] Impact is the percentage of firms reporting a significant impact on their firm resulting from unofficial payments to parliamentarians or government officials.

State capture, corruption and firm performance

This section considers what links exist between engaging in lobbying, state capture and corruption and the relative performance of the firm engaging in such activity. Lobbying or state capture could be expected to help a firm improve its performance but the reasons behind such behaviour may be very different. For example, some firms may act this way as a means of survival. As subsidies – or soft budget constraints – that were commonplace in the early years of transition have waned, some firms may have looked to other means, such as state capture, to stay afloat. As a consequence, the types of firms likely to be engaged in state capture may be quite diverse, ranging from the relatively successful to the poor performers.

Although the reasons for corruption can be quite broad, it is more likely to reflect the firm's desire to weaken or eliminate constraints on its performance. An example might be the payment of bribes to loosen trade restrictions. To the extent that firms giving bribes face weaker constraints, this may lead to a stronger performance for these firms than for those not offering bribes. However, if bribes simply act as a "tax" on most producers, they will bring little advantage to a particular firm.

This analysis looks at the characteristics of firms engaging in lobbying, state capture and corruption, drawing on information from the full 2002 and 2005 BEEPS as well as the panel firms. The results indicate that larger firms have tended to engage in state capture. Firms in transport, trade and property have engaged in state capture more than firms in manufacturing. Foreign-owned and exporting firms also appear to have been involved in capture[26] while firms operating in competitive markets have been more active in this respect than monopolists.

Furthermore, firms with higher investment rates have tended to be more likely to engage in state capture. In the case of state-owned firms, many of which have performed relatively poorly, there is no strong evidence of them engaging in capture.[27] These findings suggest that state capture tends to be practised by better-performing firms rather than firms simply aiming to survive. This finding may reflect the fact, however, that many of the firms with poor prospects had already failed or been restructured by 2005, particularly in the more advanced transition countries.

No robust patterns emerge for firms that indicated making unofficial or corrupt payments on a regular basis. However, foreign-owned firms are less likely to make such payments. There is also no evidence that firms operating at low levels of capacity are more inclined to make such payments. However, it appears that smaller firms have tended to pay more, relative to sales, than larger firms.

To identify the impact of state capture and corruption with more precision, the approach applied throughout this chapter was extended to include lobbying or state capture, unofficial payments and time spent by senior management in the estimation of constraints. These estimates have then been incorporated into a further stage of analysis explaining growth in sales and sales per worker.

The results show that lobbying, state capture and time spent by senior management do not exert a significant impact indirectly or directly on the performance of firms in the sample. However, indulging in state capture has a small impact on one of the constraints facing firms – tax administration. Firms that make unofficial payments perceive this as less of a constraint. In contrast, the ratio of unofficial or corrupt payments to sales has had a significant impact on a firm's performance. Firms that bribe tend to experience higher growth in sales and sales per worker. This impact is particularly pronounced for firms operating in the CIS. In terms of the change in sales, a 1 per cent increase in bribes has resulted in an increase of around 0.4 per cent in annual sales.

Other studies have clearly demonstrated that corruption tends to have a negative impact on the performance of an economy.[28] However, this need not rule out individual firms gaining from corruption. The fact that corruption can help to boost sales for individual firms should be a matter of concern for policy-makers. It suggests that attempts at limiting bribery have achieved only partial success. The incidence of bribery (particularly in the CIS) mostly concerns the interaction of firms with various levels of government for tax, regulation or trade reasons. It is evident that the ability of corrupt government agents to act with relative impunity remains a key problem. In effect, governments have continued to extract resources from firms. The fact that better-performing firms have been involved suggests that public officials are preying on the more successful firms in the economy rather than levying a more generalised tax.[29]

4.6 Conclusion

The results of this analysis of the BEEPS confirm a number of findings from earlier studies on the factors that influence a firm's performance but also qualify some of these findings.

The impact of ownership on the performance of firms is not as clear-cut as widely assumed. Foreign-owned firms have on average higher levels of efficiency in terms of generating sales revenue and sales revenue per worker (labour productivity) than all types of domestic firms. However, this superior performance may stem primarily from their acquisition of better-performing domestic firms and from launching new private firms. Unlike in the 1990s, during the present decade foreign-owned firms are not improving their efficiency more quickly than domestic firms. In other words, foreign firms are still more efficient than domestic firms but the difference is not increasing.

There is little variation in the performance of domestically owned firms. This suggests that market forces and tighter budgetary constraints have tended to make performance more uniform. However, new private firms are usually more efficient than privatised firms. This implies that the transition countries can increase efficiency by stimulating entrepreneurship – both domestic and foreign. The presence of competing producers has helped to improve performance but has had less impact on the level of efficiency. In terms of the use of labour and capital, firms in CEB have been more successful than their counterparts in SEE and the CIS in increasing the capital intensity of production. This will gradually lead to greater differences in production techniques between regions and to greater differences in wage levels.

Another important finding is that the constraints faced by individual firms and the change in perceived constraints do not have a significant impact on a firm's level of efficiency or improvements in efficiency. However, the business environment in a particular country has an impact on the performance of firms. Indeed, it is the country's business climate that has a more dominant influence on the performance of a firm.

The BEEPS shows that corruption, lobbying and state capture have tended to decline over the past decade. Corruption is known to have a detrimental impact on economic growth but it has had a positive impact on the performance of individual firms. This implies that firms gain an advantage from bribery or that government officials – the principal recipients of bribes – tend to target better-performing firms. Whichever is the case, there is a clear need for a sustained effort to limit the scope for corruption across the transition region.

Endnotes

1 See, for example, Blanchard (1998).

2 See, for example, Carlin (2000), Claessens and Djankov (1999 a and b), Frydman *et al.* (1999), Djankov (1999) and the *Transition Report* 1995 and 1999.

3 See, for example, Sabirianova *et al.* (2005 a and b) and Hanousek *et al.* (2004 and 2005).

4 See, for example, Bennett *et al.* (2004).

5 See Carlin *et al.* (2001).

6 Note that adjustments on the input side, such as shedding of labour, are taken into account by controlling for the use of inputs.

7 The data are weighted by the size of the firm in the total population and by the ratio of the total population of firms to the population in the sample.

8 For more detail, see Commander and Svejnar (2005).

9 This two-way causality between performance and explanatory variables, such as the firm's ownership or constraints, means that the estimated effects of these variables on performance can be severely biased.

10 Gupta *et al.* (2000), for instance, show that better performing firms tend to be privatised first while Sabirianova *et al.* (2005 a and b) find that foreign firms acquire better-performing domestic firms.

11 See Commander and Svejnar (2005) for a detailed discussion of how this analysis has been implemented.

12 In this initial estimation, the explanatory variables include the ownership categories, with state firms as the omitted category, as well as country dummy variables.

13 To deal with causality, the analysis uses instrumental variables in a two-stage process. A first stage estimates constraints, which are used in a second stage where the performance measures are estimated.

14 This finding is corroborated by other studies of individual or smaller sets of countries (see, for example, Sabirianova *et al.* 2005 a and b).

15 The exceptions are family-owned firms in SEE that have grown more slowly and registered a lower rate of growth of efficiency and revenue per worker.

16 This result was found in several studies related to the 1990s (for example, Sabirianova *et al.* 2005 a and b and Hanousek *et al.* 2004 and 2005). The fact that it is found also in 2002–05 data suggests that it is a long-term phenomenon rather than just a short-term effect associated with post-privatisation adjustment.

17 For further corroborative evidence, see Sabirianova *et al.* (2005 a and b).

18 See, for example, Fries *et al.* (2003) and Carlin *et al.* (2001).

19 This finding holds irrespective of whether control variables are included in the regression or whether a different measure of competition – the perceived price elasticity of demand – is used.

20 The results of the existing literature on the subject are mixed. Using a random sample of Yugoslav firms, Klinedinst *et al.* (1992) found no relationship between export orientation and productive efficiency.

21 This result holds even when most control variables are excluded from the regressions.

22 See, for example, Commander (1999) and the *Transition Report* 1995.

23 See, for example, Frye and Shleifer (1998).

24 See Hellman and Schankerman (2000), Fries *et al.* (2003), *Transition Report* 1999 and *Transition Report* 2002.

25 Looking at whether bribing has been persistent between 2002 and 2005, the raw correlation is quite high at 0.4 but in over 50 per cent of cases the bribe share had declined, with most of that decline being from a positive to a zero share.

26 This result – taken from Probit estimations – is significant only for the two cross-sections but not for the panel.

27 See Commander and Svejnar (2005).

28 See Mauro (1995 and 1997), Tanzi and Davoodi (2001) and Pellegrini and Gerlagh (2004).

29 Frye and Shleifer (1998) have referred to this as the "grabbing hand".

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Part III: Country assessments

Part III of the *Transition Report* charts reform progress and identifies macroeconomic issues in each of the 27 transition countries. Key developments in liberalisation and privatisation, the business environment and competition, infrastructure, the financial sector and social reform are highlighted.

To provide a quantitative foundation for analysing progress in transition, each country assessment includes a set of tables containing structural, institutional and macroeconomic indicators.

These data help to describe transition in a particular country, but are not intended to be comprehensive. Given the inherent difficulties of measuring structural and institutional change, the data cannot give a complete account or precise measurement of progress in transition.

The data should also be interpreted with caution due to variations in quality across countries and categories. The data are based on a wide variety of sources, including national authorities, other international organisations and EBRD staff estimates. To strengthen the degree of cross-country comparability, some of the data were collected through standardised EBRD surveys of national authorities. The source of data and the exact definition of variables are provided in the methodological notes at the end of the Report.

The “cut-off” date for data was mid-September 2005. Data for 2005 are projections.

Albania

Key challenges

- Resolution of land ownership issues and improvements in the efficiency and impartiality of the judiciary and public administration, particularly in the tax system, are key to enhancing the business environment.
- Further improvements to the transport network are needed, including upgrades of the road system and modernisation and expansion of seaports and regional airports, to reduce transport costs and promote trade.
- Expansion of export capacity and an increase in export-oriented foreign direct investment are required to reduce the trade deficit and maintain current rates of economic growth.

Country data

Population (in millions)	**3.2**
Area ('000 sq. km)	**28.7**
GDP (in billion US$, 2004)	**7.6**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 4,929**
National currency	**Lek**

Progress in structural reform

Liberalisation and privatisation

The privatisation of the oil and natural gas extraction firm Albpetrol is progressing, along with the sale of minority state holdings in two banks and a mobile telephone company. The privatisation of Albanian Refining and Marketing Oil (ARMO), however, requires relaunching due to a lack of investor interest.

In June 2005 the government approved the sale of the state-owned fixed-line telecommunications operator Albtelecom. However, by September 2005 the privatisation had yet to be approved by the new parliament. Calik Energy Telecommunication has won the right to acquire a 76 per cent stake in the company for € 120 million, with the state retaining 24 per cent.

As part of the privatisation, Albtelecom was awarded Albania's third mobile telephone licence, allowing it to compete directly with the two incumbent providers. Managing the increased competition in this sector, particularly interconnection between operators, will be challenging for the regulatory framework which is weaker than many other transition countries. Fixed-line penetration is about 8 per cent, but the expanding mobile penetration is around 45 per cent.

Business environment and competition

Unclear land ownership in major urban and coastal areas continues to hinder economic development, with only about 18 per cent of immovable property properly registered. In contrast, registered land in rural areas accounts for 80 per cent of the total. A new law on the restoration and compensation of property was adopted in July 2004. Nevertheless, the implementation methodology was not approved until April 2005. In addition, law enforcement administration remains weak and under-funded, and the compensation mechanism for owners who cannot reclaim their land is uncertain.

The law on the legalisation of recently constructed unauthorised real estate, adopted in October 2004, is also being implemented. About 50,000 requests for legalisation were made by the March 2005 deadline. However, there have been an estimated 300,000 unauthorised buildings constructed in recent years.

In the first half of 2005 tax revenues increased by over 10 per cent year-on-year, partly due to improved collection. Nevertheless, the extent of the informal economy continues to represent between 24 and 28 per cent of GDP according to the OECD. The tax base remains very narrow, with the agricultural sector, which accounts for about a quarter of GDP, not being taxed. In addition, the tax administration is considered inefficient and susceptible to corruption. According to the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey, the tax system, corruption and the shortcomings of the judicial process represent the three main constraints on local enterprise.

Infrastructure

In 2004 the government spent about € 110 million on new roads and road improvements, about a third of which was financed through foreign official assistance. Many main and local roads, however, remain in poor condition. In December 2004 the government abolished the special road tax, which had been introduced to fund a new road between Durres and Kukes, linking the Adriatic port with Kosovo. It was replaced by a general road circulation tax.

In May 2005 the government approved a € 77 million loan to the state railways for the construction of a light railway between Tirana and Durres, with a spur line to the country's only international airport. By September 2005 the loan had yet to be approved by parliament. The contract for the railway construction was awarded to General Electric in September 2003 without an open tender.

Major upgrades of the port at Durres, supported by the European Investment Bank, were completed in summer 2005. In October 2004 a local company won the tender for a 30-year concession on the oil terminal in Porto Romano with a proposed investment of about € 18 million.

In July 2005 the government signed an agreement with the World Bank for a US$ 27 million loan to upgrade the electricity network, as part of a regional initiative to integrate the energy market in south-eastern Europe. Electricity prices have increased substantially over the past five years to reach about 6 US cents/kWh by the end of 2004. Tariff increases should continue for the following three years according to the 2000 law. Management improvements and investment in the power system have cut large-scale blackouts in the past year. However, the reliability of the supply network remains well below international standards and localised blackouts occur frequently.

Macroeconomic performance

Real economy

Real GDP growth was around 6 per cent in 2004 (as in 2003) and a similar performance is expected in 2005. Growth has been driven mainly by construction, business services and transport, and has benefited from the rapid credit expansion (from a very low base) in recent years. Official unemployment remains at around 15 per cent of the labour force, but under-employment is widespread and usually unreported.

Economic policies

Annual consumer price inflation has been within the Bank of Albania's 2 to 4 per cent target range over the last two years and should remain subdued in 2005. The Bank lowered its main repo rate to 5 per cent in March 2005. The exchange rate appreciated by about 5 per cent in nominal terms against the euro during 2004 and further appreciation pressure was noticeable in the first half of 2005.

The general government deficit was around 5 per cent of GDP in 2004 and a similar outcome is expected in 2005. Along with growing tax revenues in the first half of 2005, government expenditure increased rapidly in the run-up to parliamentary elections in July. Total domestic debt declined from over 60 per cent of GDP in 2003 to about 55 per cent in 2004. A large proportion of government debt contracted in recent years is from international institutions on favourable terms.

External sector

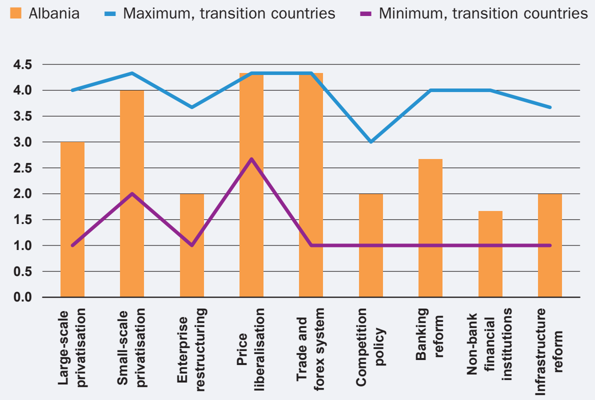
The trade deficit remains above 20 per cent of GDP. It is mostly financed by large remittance inflows, estimated at about 13 to 14 per cent of GDP. Exports and imports are growing at double-digit rates, with export growth exceeding that of imports. Foreign direct investment (FDI) inflows reached US$343 million in 2004. However, Albania has limited potential for further privatisation-related FDI and fresh investment remains constrained by the difficult business environment and poor infrastructure quality.

Total external debt (mostly official and long-term) is modest and has declined from 25 per cent of GDP in 2003 to 22 per cent by end-2004. International reserves increased by more than 30 per cent in 2004 to reach US$1.4 billion, covering more than five months of imports of goods and services. The IMF's three-year Poverty Reduction and Growth Facility was extended by five months to November 2005.

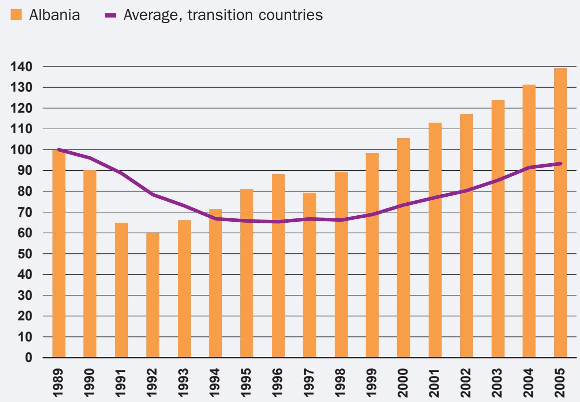
Outlook and risks

The economy has strong growth potential. Political stability, continued support from abroad and the successful conclusion of the Stabilisation and Association Agreement with the EU are key factors. One of the main problems is the high trade deficit. Its sustainable reduction depends on increasing Albania's export capacity. The country may be able to generate substantial service income from tourism over the longer term, but the necessary infrastructure is still lacking.

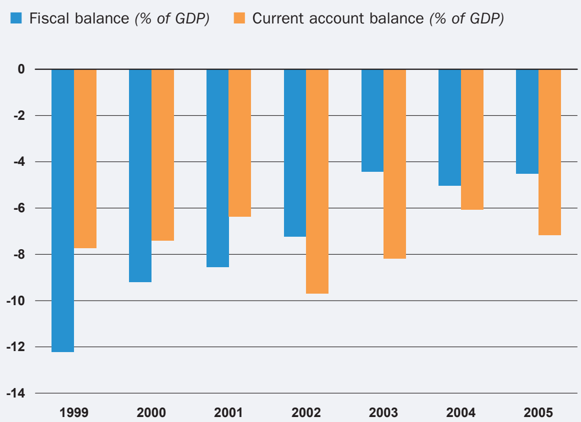
Transition indicators, 2005



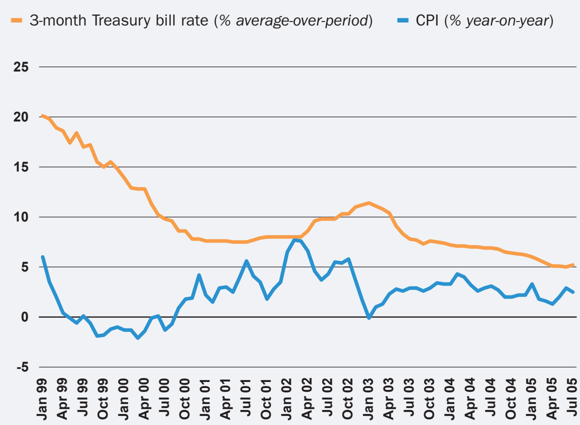
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradability of land – **limited de facto**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **advanced**

Quality of corporate governance law – **medium**

Infrastructure

Independent telecoms regulator – **partially**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operations – **no**

Quality of concession laws – **low**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **low**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **11.8 per cent** (2002)

Government expenditure on health – **2.7 per cent of GDP**

Government expenditure on education – **3.7 per cent of GDP**

Share of power, water in total household expenditure – **7.6 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	3.9	7.1	9.3	9.3	9.5	11.3	na
Private sector share in GDP (in per cent)	75.0	75.0	75.0	75.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	80.0	80.0	80.0	80.0	80.0	80.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.4	1.0	1.3	1.0	0.7	0.5	0.3
Share of industry in total employment (in per cent)	5.8	5.5	6.0	5.3	5.2	5.2	na
Change in labour productivity in industry (in per cent)	84.3	5.0	13.6	3.9	4.8	3.1	na
Investment/GDP (in per cent)	20.0	24.7	29.2	26.2	25.0	23.7	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation [1]	2.7	2.7	3.0	3.0	3.0	3.0	3.0
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	3.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	96.3	95.2	91.2	90.6	88.2	87.6	na
Share of trade in GDP (in per cent)	35.3	36.1	39.9	40.4	38.8	36.7	na
Tariff revenues (in per cent of imports)	8.8	8.7	6.7	6.4	6.4	6.0	na
EBRD index of price liberalisation	3.7	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	1.7	1.7	1.7	1.7	1.7	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	13 (11)	13 (12)	13 (12)	13 (12)	15 (13)	16 (14)	na
Asset share of state-owned banks (in per cent)	81.1	64.8	59.2	54.1	51.9	na	na
Asset share of foreign-owned banks (in per cent)	18.9	35.2	40.8	45.9	47.1	na	na
Non-performing loans (in per cent of total loans)	32.7	42.6	6.9	5.6	4.6	4.2	na
Domestic credit to private sector (in per cent of GDP)	2.2	3.0	4.0	5.0	5.5	6.2	na
Domestic credit to households (in per cent of GDP)	na	na	na	na	na	2.8	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	2.0	2.3	2.3	2.3	2.3	2.7	2.7
EBRD index of reform of non-bank financial institutions	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	3.7 (0.3)	3.9 (0.8)	6.4 (12.7)	7.1 (27.6)	8.3 (35.8)	na (na)	na
Internet penetration rate (per 10,000 inhabitants)	0.6	0.6	0.6	0.6	0.8	1.7	na
Railway labour productivity (1989=100)	32.1	34.9	38.3	39.8	39.4	38.5	na
Residential electricity tariffs (in USc kWh)	na	3.3	3.4	4.2	5.1	6.2	na
Average collection rate, electricity (in per cent)	58	60	76	93	92	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	6.4	6.8	7.3	6.9	na	na	na
EBRD index of infrastructure reform	1.3	2.0	2.0	2.0	2.0	2.0	2.0
Electric power	2.0	2.3	2.3	2.3	2.3	2.7	2.7
Railways	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Roads	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	1.0	3.3	3.3	3.3	3.3	3.3	3.3
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0

[1] Series has been revised.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	10.1	7.3	7.2	3.4	6.0	5.9	6.0
Private consumption	2.7	5.3	na	na	na	na	na
Public consumption	15.9	7.4	na	na	na	na	na
Gross fixed capital formation [1]	14.9	17.9	na	na	na	na	na
Exports of goods and services	47.0	5.8	na	na	na	na	na
Imports of goods and services	11.3	6.5	na	na	na	na	na
Industrial gross output	34.2	0.5	7.1	-7.9	2.7	3.1	na
Agricultural gross output	0.4	4.5	2.2	2.1	3.0	3.8	na
Employment [2]			*(Percentage change)*				
Labour force (end-year)	-1.1	-1.8	-3.0	-12.2	-0.3	-0.8	na
Employment (end-year)	-1.8	0.2	-13.8	0.0	0.7	-0.4	na
			(In per cent of labour force)				
Unemployment (end-year)	18.4	16.8	14.5	15.8	15.0	14.5	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	0.4	0.1	3.1	5.2	2.4	2.9	2.1
Consumer prices (end-year)	-1.0	4.2	3.5	1.7	3.3	2.2	2.5
Producer prices (annual average)	na	5.0	-5.8	6.5	6.7	12.4	na
Producer prices (end-year)	na	na	-4.0	11.2	5.0	12.3	na
Gross average monthly earnings in economy (annual average)	14.1	19.7	24.7	11.7	10.0	6.0	na
Government sector			*(In per cent of GDP)*				
General government balance	-12.2	-9.2	-8.5	-7.2	-4.4	-5.0	-4.5
General government expenditure	34.9	31.9	31.6	31.1	28.4	28.7	na
General government debt	72.7	71.3	66.8	64.8	60.6	55.6	na
Monetary sector [3]			*(Percentage change)*				
Broad money (M2, end-year)	20.3	10.4	15.4	5.3	9.2	10.8	na
Domestic credit (end-year)	9.8	8.6	4.1	6.7	11.0	7.7	na
			(In per cent of GDP)				
Broad money (M2, end-year)	50.5	49.8	51.9	51.0	50.4	49.9	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate [4]	17.8	10.8	7.0	8.5	6.5	5.3	na
Treasury bill rate (3-month maturity)	17.5	10.8	8.0	11.2	7.4	6.2	na
Deposit rate (1 year)	9.5	6.9	6.9	8.0	5.5	4.5	na
Lending rate (1 year) [5]	21.7	21.2	15.3	14.6	11.8	11.0	na
			(Leks per US dollar)				
Exchange rate (end-year)	135.2	142.8	135.9	134.0	106.4	92.6	na
Exchange rate (annual average)	138.1	143.9	143.6	140.2	121.3	102.8	na
External sector			*(In millions of US dollars)*				
Current account	-265	-273	-261	-435	-470	-460	-621
Trade balance	-663	-821	-1,027	-1,155	-1,336	-1,579	-1,933
Merchandise exports	275	255	305	330	447	603	766
Merchandise imports	938	1,076	1,332	1,485	1,783	2,182	2,699
Foreign direct investment, net	51	143	204	135	178	343	288
Gross reserves, excluding gold (end-year)	485	608	737	860	1,026	1,374	na
External debt stock	1,109	1,173	1,200	1,180	1,420	1,673	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	5.3	4.8	4.9	5.0	4.8	5.1	na
			(In per cent of exports of goods and services)				
Debt service	4.1	4.0	4.1	6.8	5.0	4.6	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	3.1	3.1	3.1	3.2	3.2	3.2	na
GDP (in billions of leks)	474	531	589	630	696	780	857
GDP per capita (in US dollars)	1,108	1,185	1,309	1,406	1,812	2,372	na
Share of industry in GDP (in per cent)	8.4	8.1	7.8	7.7	7.5	7.3	na
Share of agriculture in GDP (in per cent)	34.1	32.0	31.9	28.4	27.6	26.8	na
Current account/GDP (in per cent)	-7.7	-7.4	-6.4	-9.7	-8.2	-6.1	-7.2
External debt - reserves (in US$ million)	624	565	463	320	394	299	na
External debt/GDP (in per cent)	32.3	31.8	29.3	26.3	24.7	22.0	na
External debt/exports of goods (in per cent)	204.7	166.2	142.9	128.9	121.7	104.2	na

[1] Includes changes in inventories.

[2] Figures do not include emigrant workers abroad who accounted for an estimated 27.4 per cent of the total labour force in 2000.

[3] Data up to and including 2001 are based on the previous reporting standard. The new reporting standard, in accordance with the 2000 Monetary and Financial Statistics Manual, excludes blocked deposits from broad money.

[4] From 2001 the figures show the repo rate of the Central Bank.

[5] The figures show the weighted average monthly rate for new credit in leks for maturities between 6 months and 1 year in December each year.

Armenia

Key challenges

- To maintain growth in investment, renewed efforts are needed to improve access to finance and increase the effectiveness of public institutions.
- Consolidation in the power sector has led to the emergence of a single dominant player, rendering effective regulation crucial to ensure that consumers do not suffer from monopoly abuses.
- Although encouraging progress has been made in tax collection, further improvements in tax and customs administration are needed, particularly strengthening the institutional capacity of authorities to raise the low ratio of tax revenue to GDP.

Country data

Population (in millions)	**3.2**
Area ('000 sq. km)	**29.8**
GDP (in billion US$, 2004)	**3.5**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 4,006**
National currency	**Dram**

Progress in structural reform

Liberalisation and privatisation

After a relatively fast start, the pace of privatisation has slowed in the past year. To date, only 34 of 81 strategic enterprises completed their privatisations. The most notable sale in 2004 was that of the Zangezur copper-molybdenum plant to a German-led consortium for US$ 70 million. The government also privatised or liquidated a number of medium and large-scale enterprises and made some progress in land privatisation. To complete the privatisation process, the government is preparing a new law on the sale of state property for 2005–07.

Business environment and competition

Over the past year there have been some improvements in the business environment. For example, the tax system was simplified and the administration of VAT returns to exporters was improved. Partly due to these developments, foreign investments have increased significantly. In recognition of these and other improvements in governance, Armenia has qualifed for grant financing through the US Millennium Challenge Account. However, as shown in the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey, enterprises continue to perceive the business environment as weak, with particular concerns over cumbersome administrative procedures, corruption and limited access to finance.

The effectiveness of the competition authority has shown signs of improvement, four years after the establishment of the state commission on protection of economic competition. For example, in July 2005 the commission acted quickly to address cases of anti-competitive behaviour by the incumbent telecommunications operator Armentel against a new mobile operator by imposing fines.

Infrastructure

After eight years in which a single operator held a monopoly, the mobile telecommunications market was liberalised in November 2004. A second mobile licence was awarded to K-Telecom, an affiliate of Karabakh Telecom. The exclusivity rights of the incumbent operator Armentel were re-negotiated in November 2004 following a prolonged dispute between the government and Armentel's owner OTE.

Under the revised agreement, mobile services were liberalised but OTE retained its monopoly on fixed lines and data transmission services. Although the fairness and transparency of the tendering process for selecting a second mobile operator were questioned, the introduction of competition resulted in an immediate tariff reduction by Armentel.

British Midland Resources, the owner of Armenian electricity distribution networks since 2003, has transferred the ownership of the networks to Interenergo, an affiliate of Russia's RAO UES. RAO UES already owns the Hrazdan thermal power plant and also manages financial flows over the Medzamor nuclear power plant. Another development in the electricity sector was the decision to liquidate Armenergo, the state-owned electricity dispatching company, which was removed from all cash transactions from October 2004. The company was criticised for its non-transparent cash control and was considered a substantial obstacle to sector restructuring.

Financial sector

The banking sector has been strengthened through further consolidation and greater foreign ownership. The increase of minimum capital requirements from US$ 2 million to US$ 5 million, starting from July 2005, has promoted consolidation. Twenty-one banks, all privately owned, remain in operation. Until recently foreign participation was limited to two banks, including the largest one that accounts for 16 per cent of total banking assets.

However, in early 2005 the Central Bank of Armenia (CBA) awarded a licence to a third foreign bank, ARM SwissBank. The bank is funded with 100 per cent Swiss capital (US$ 5 million) and will specialise in private banking, as well as carrying out international transactions. Also in 2005, there have been two bank acquisitions by foreign investors. Cascade Capital Holding (USA) has bought Emporiki Bank, while Turan Alem Bank (Kazakhstan), together with other Kazakh investors, has acquired BTA Investbank.

The CBA has taken steps to improve public confidence in the banking sector. An anti-money laundering law was adopted in January 2005. A deposit insurance scheme became operational from July 2005, providing 100 per cent guarantees on deposits up to AMD 1.5 million (approximately US$ 3,000). Recent indicators for the banking sector are encouraging, with growing assets and capital, and improving asset quality, liquidity and profitability. Nevertheless, the level of financial intermediation remains among the lowest in the transition economies. Enterprise surveys indicate that access to finance remains a difficult obstacle.

Macroeconomic performance

Real economy

The economy continued to record strong real GDP growth of 11.7 per cent year-on-year during the first eight months of 2005, after four consecutive years of exceptionally high growth rates (averaging 11.7 per cent per year) during 2001-04. Recent growth was driven mainly by improved performance in the agriculture, construction and services sectors, while increased consumer spending has been supported by higher incomes and growing remittances. However, the diamond processing sector is still suffering from the disruption of cheap raw supplies from Russia since 2004 and has yet to recover fully.

Economic policies

The government has managed fiscal expenditures tightly over the past year, with limited increases in social sector spending and wages. Encouragingly, tax revenues have risen significantly during 2005. This is due in part to changes in tax legislation, including the introduction in January 2005 of a minimum corporate tax rate of 1 per cent of company turnover, and improved tax and customs administration. However, the ratio of tax revenue to GDP remains low at about 15 per cent, partly due to growing industries, such as foreign-financed construction and some other foreign investments, being untaxed.

The CBA continues to maintain a prudent monetary policy, with a strong focus on price stability. During 2004-05 this was challenged by high food and oil prices and continued private transfer flows. The year-on-year inflation rate was kept under 2 per cent, partly thanks to a bountiful harvest. The CBA is also making efforts to broaden its policy tools, for example through the issuance of its own domestic bonds in August 2005.

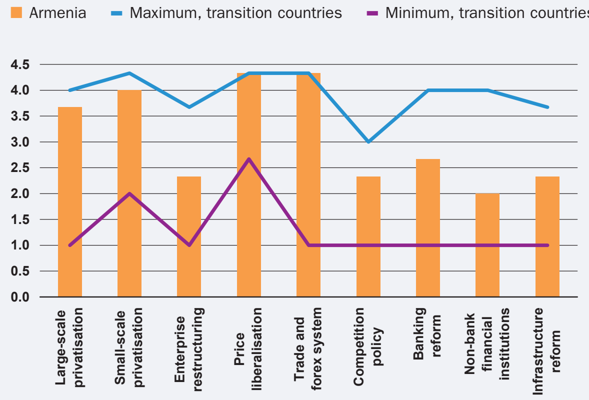
External sector

Although diamond exports were reduced, other exports continued to grow rapidly during 2004 (by 24 per cent compared with 2003). Imports grew by 11.8 per cent (excluding diamonds) due mainly to increased spending on foreign products and on materials and machines for construction projects. The trade deficit remains large, but continues to be offset by substantial remittance flows. According to the CBA, total private transfers, including those not captured by the balance of payments, rose by over 50 per cent in 2004 to US$740 million (mainly from Russia). External debt increased slightly to US$1.2 billion by the end of 2004, but strong economic growth ensured that the ratio of external debt to GDP fell to around 33 per cent.

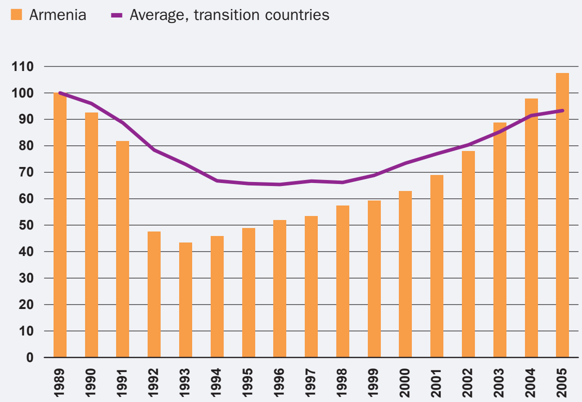
Outlook and risks

Continuing growth is expected in the medium term, provided tight macroeconomic policies and progress in structural reforms are maintained. New investments in infrastructure and other industries, and increased grant flows from the United States, should also stimulate the economy. However, the key risks remain the continued appreciation of the currency, the ongoing economic blockage by some neighbouring countries (resulting not only in the loss of key markets but also higher transport costs) and high dependence on soft financing from donors and international financial institutions.

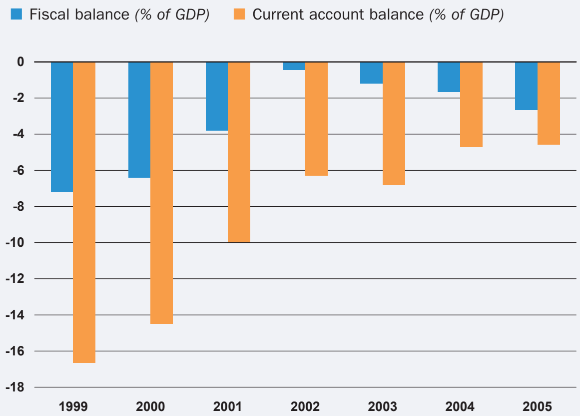
Transition indicators, 2005



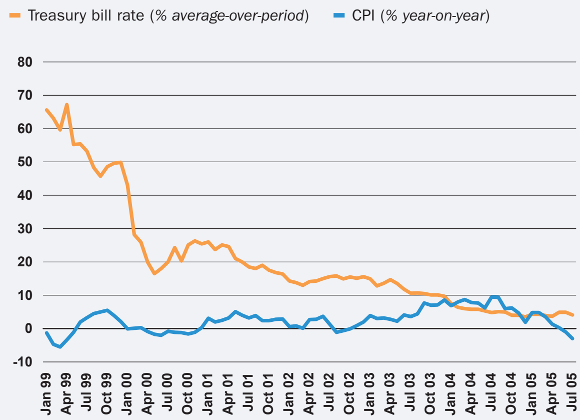
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **floating**

Wage regulation – **no**

Tradability of land – **full except foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **malfunctioning**

Quality of corporate governance law – **high**

Infrastructure

Independent telecoms regulator – **yes**

Independent electricity regulator – **yes**

Separation of railway infrastructure from operations – **no**

Quality of concession laws – **na** [1]

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **medium**

Private pension funds – **no**

Social reform

Share of population living in poverty – **49 per cent** (1998)

Government expenditure on health – **1.3 per cent of GDP** (2003)

Government expenditure on education – **2.2 per cent of GDP** (2003)

Share of power, water in total household expenditure – **6.2 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP) [2]	6.7	8.8	9.4	9.5	10.2	10.2	na
Private sector share in GDP (in per cent)	60.0	60.0	60.0	70.0	70.0	75.0	75.0
Private sector share in employment (in per cent)	73.0	74.0	75.0	74.0	76.0	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	1.4	0.8	0.6	0.6	0.9	0.8	na
Share of industry in total employment (in per cent)	15.0	14.4	13.4	12.9	na	na	na
Change in labour productivity in industry (in per cent)	12.9	13.3	12.0	36.0	na	na	na
Investment/GDP (in per cent)	18.4	18.6	19.8	21.7	24.2	22.0	na
EBRD index of small-scale privatisation	3.3	3.3	3.7	3.7	3.7	4.0	4.0
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.3	3.3	3.3	3.7
EBRD index of enterprise reform	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Markets and trade							
Share of administered prices in CPI (in per cent)	10.6	6.3	6.3	8.1	8.7	8.0	na
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	1.0	1.0	1.0	na
Share of trade with non-transition countries (in per cent)	62.0	78.4	79.8	76.4	77.0	73.6	na
Share of trade in GDP (in per cent)	52.5	56.7	52.6	58.8	65.1	54.5	na
Tariff revenues (in per cent of imports)	2.1	2.1	2.3	1.9	1.6	2.0	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.0	4.3	4.3	4.3
EBRD index of competition policy	1.0	1.0	2.0	2.0	2.0	2.0	2.3
Financial sector							
Number of banks (foreign-owned)	31 (12)	31 (11)	30 (14)	20 (8)	19 (8)	20 (9)	na
Asset share of state-owned banks (in per cent)	3.5	3.8	0.0	0.0	0.0	0.0	na
Asset share of foreign-owned banks (in per cent)	44.3	45.5	57.6	54.2	51.8	56.7	na
Non-performing loans (in per cent of total loans)	4.7	7.2	6.8	4.9	4.9	2.1	na
Domestic credit to private sector (in per cent of GDP)	5.8	7.1	6.0	4.8	5.8	6.9	na
Domestic credit to households (in per cent of GDP)	na	na	na	1.5	1.8	2.6	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	1.3	1.3	1.2	1.0	1.0	0.5	na
Stock trading volume (in per cent of market capitalisation)	3.8	0.0	4.6	5.6	2.7	9.8	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.3	2.3	2.3	2.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	15.5 (0.2)	15.2 (0.5)	14.0 (0.7)	14.3 (1.9)	14.8 (3.0)	19.1 (6.7)	na
Internet penetration rate (per 10,000 inhabitants)	6.1	7.0	6.2	7.5	5.5	6.2	na
Railway labour productivity (1989=100)	16.2	15.2	17.2	20.6	23.5	29.1	na
Residential electricity tariffs (in USc kWh)	4.7	4.6	4.4	4.3	4.4	4.5	na
Average collection rate, electricity (in per cent)	88	80	87	98	95	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.8	3.6	4.1	5.0	na	na	na
EBRD index of infrastructure reform	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Electric power	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Railways	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water	2.0	2.0	2.0	2.0	2.0	2.0	2.0

[1] Armenia has no specific concession law but generally conforms with internationally accepted principles on concession laws.

[2] Privatisation proceeds in principle finance fiscal deficits only. The part saved in the Special Privatisation Accounts is not included.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	3.3	5.9	9.6	13.2	13.9	10.1	10.0
Private consumption	1.4	8.2	7.5	8.8	8.5	10.2	na
Public consumption	1.3	2.8	4.3	2.5	13.9	16.1	na
Gross fixed capital formation	0.6	16.2	5.3	33.1	33.7	12.4	na
Exports of goods and services	6.5	16.6	20.8	26.3	23.2	3.7	na
Imports of goods and services	-8.1	5.1	1.2	9.0	31.0	3.0	na
Industrial gross output	5.2	6.5	3.8	14.4	15.3	2.1	na
Agricultural gross output	1.3	-2.4	11.6	4.5	4.0	14.5	na
Employment			*(Percentage change)*				
Labour force (end-year)	-0.9	-1.0	-2.5	0.3	-0.6	-0.5	na
Employment (end-year)	-2.9	-1.6	-1.0	-12.5	0.5	-0.1	na
			(In per cent of labour force)				
Unemployment (annual average) [1]	11.2	11.7	10.4	10.8	10.1	9.4	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	0.7	-0.8	3.2	1.2	4.7	6.9	0.3
Consumer prices (end-year)	2.1	0.4	3.0	2.0	8.6	1.9	-0.8
Producer prices (annual average)	2.3	0.8	-0.4	2.5	8.9	21.7	na
Producer prices (end-year)	3.8	0.4	-3.6	0.9	21.1	25.3	na
Gross average monthly earnings in economy (annual average)	21.8	15.0	10.7	12.2	21.7	22.8	na
Government sector [2]			*(In per cent of GDP)*				
General government balance	-7.2	-6.4	-3.8	-0.4	-1.2	-1.7	-2.7
General government expenditure	30.1	25.9	20.9	19.3	18.9	16.0	na
General government debt	44.4	44.0	41.5	45.4	40.5	30.6	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	13.6	39.7	4.3	34.0	10.4	22.3	na
Domestic credit (end-year)	3.7	12.3	-9.8	-8.1	-9.6	18.6	na
			(In per cent of GDP)				
Broad money (M2, end-year)	11.0	14.7	13.4	15.6	14.4	15.1	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	43.0	25.0	15.0	13.5	7.0	3.8	na
Money market rate [3]	23.7	18.6	19.4	12.3	7.5	3.1	na
Deposit rate [4]	27.4	18.1	14.9	9.5	6.9	4.4	na
Lending rate [4]	34.5	28.6	27.7	23.4	20.8	18.2	na
			(Drams per US dollar)				
Exchange rate (end-year)	523.8	552.2	561.8	584.9	566.0	486.3	na
Exchange rate (annual average)	535.1	539.5	555.1	573.4	578.8	533.5	na
External sector			*(In millions of US dollars)*				
Current account	-307	-277	-211	-149	-191	-162	-213
Trade balance	-474	-463	-431	-369	-434	-458	-524
Merchandise exports	247	310	342	514	696	738	785
Merchandise imports	721	773	773	883	1,130	1,196	1,309
Foreign direct investment, net	122	104	70	111	121	217	198
Gross reserves, excluding gold (end-year)	305	314	329	430	502	541	na
External debt stock	870	860	906	1,026	1,098	1,183	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.0	3.9	4.0	4.7	4.3	4.3	na
			(In per cent of exports of goods and services)				
Debt service	14.3	10.7	9.7	10.1	11.4	7.2	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	3.1	3.3	3.2	3.2	3.2	3.2	na
GDP (in billions of drams)	987	1,031	1,176	1,362	1,623	1,893	2,107
GDP per capita (in US dollars)	590	582	659	740	873	1,104	na
Share of industry in GDP (in per cent)	21.2	21.9	20.5	18.9	19.9	19.7	na
Share of agriculture in GDP (in per cent)	30.8	27.0	24.9	23.4	21.3	22.5	na
Current account/GDP (in per cent)	-16.6	-14.5	-10.0	-6.3	-6.8	-4.6	-4.6
External debt - reserves (in US$ million)	565	546	577	596	596	642	na
External debt/GDP (in per cent)	47.1	45.0	42.8	43.2	39.1	33.3	na
External debt/exports of goods and services (in per cent)	227.1	192.4	171.3	147.0	121.6	120.1	na

[1] Registered unemployed. Unofficial estimates indicate substantially higher unemployment.

[2] Central government account only.

[3] Average of one to three-month Treasury bills.

[4] Weighted average rate for maturities of 15 days to less than one year.

Azerbaijan

Key challenges

- Effective and consistent implementation of anti-corruption legislation and improvement of the legal and regulatory framework are essential for developing the business climate and stimulating competition.
- Privatisation of the remaining state-owned banks, together with efforts to reduce the International Bank of Azerbaijan's monopoly position, would advance progress in the banking sector.
- Tighter fiscal policy and improved fiscal discipline of state-owned enterprises are important to curb real exchange rate appreciation pressures and support the development of the non-oil sector.

Country data

Population (in millions)	**8.3**
Area ('000 sq. km)	**86.6**
GDP (in billion US$, 2004)	**8.6**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 4,185**
National currency	**Manat**

Progress in structural reform

Liberalisation and privatisation

Azerbaijan is making progress towards accession to the World Trade Organization (WTO), possibly in 2006. After long delays in the negotiating process, working party meetings took place in October 2004 and June 2005. Major outstanding issues include low domestic energy prices (regarded as subsidies to domestic production) and regulation of natural monopolies. In November 2004 Azerbaijan accepted the obligation under Article VIII of the IMF statutes to remove restrictions on the system of payments and transfers for current international transactions, therefore complying with the WTO requirement on liberalisation of foreign exchange and payment systems.

Business environment and competition

The business environment has not improved since 2002, according to the EBRD/World Bank Business Environment and Enterprise Performance Survey. In particular, corruption remains a significant obstacle to doing business. An anti-corruption law has been in effect since the beginning of 2005, but implementation is still uncertain. Governance has been especially weak in the state-owned enterprise sector, which remains highly inefficient and non-transparent. In June 2005 the government approved a resolution on improving monitoring and financial discipline of major state-owned companies, including the State Oil Company (SOCAR).

Measures to strengthen the business environment are under consideration. In January 2005 a presidential decree established a commission responsible for civil service reform and a timetable for public sector employment reform. A rationalisation of the pay structure of budgetary organisations is also under discussion.

New anti-monopoly legislation was submitted to parliament in July 2005. An investment law and competition law are being prepared with the assistance of the World Bank.

Infrastructure

Some progress has been made in reforming the energy sector. The government is raising energy prices closer to international levels. In November 2004 the prices for oil products were increased by 12 per cent. The prices for natural gas have been increased twice, most recently by 200 per cent in March 2005 (to US$ 48 per thousand cubic metres), bringing them closer to the actual marginal cost of US$ 62.

Construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline was completed in April 2005 and is expected to become operational by the end of the year. Construction of the South Caucasus (SC) gas pipeline is under way, with completion expected in 2006. Positive steps have been taken to increase the transparency of resource revenues. Azerbaijan was the first country under the Extractive Industry Transparency Initiative (EITI) to submit an internationally audited progress report.

Restructuring plans for the gas and water sectors have stalled since February 2004. However, the delayed separation of commercial and regulatory functions of state-owned enterprises in the telecommunications sector prior to their privatisation is under way. Pre-privatisation assessments for the telecommunications and transport sectors have yet to be concluded.

Financial sector

Reform in the financial sector has gathered pace. The new national bank law, approved at the end of 2004, strengthens the independence of the Azerbaijan National Bank and enhances its role in corporate governance and supervision. The National Bank is continuing to promote consolidation of the banking sector through a gradual increase in capital requirements. It has announced that it will double the minimum capital requirements from the current level of about US$ 5.3 million for new banks from January 2006 and for existing banks in the next two years. Nevertheless, the sector remains weak, with many of the 43 banks still undercapitalised. Also, the largest bank – International Bank of Azerbaijan (IBA) – at times operates in breach of regulatory requirements, although it has been adhering to a transitional compliance schedule issued by the National Bank.

Growth in credit to the private sector has been strong, reaching about 48 per cent year-on-year real growth as of June 2005 (although from a low level). Low real interest rates, due to high inflation, an increase in demand for investments and the establishment of a credit registry in 2005 have contributed to this.

In March 2005 the president issued a decree to revive the privatisation of the remaining state-owned banks (IBA and Kapital Bank) through competitive tender. To strengthen competition, the government has introduced tenders for the procurement of all banking services to the government. More generally, the new anti-monopoly law is expected to be extended to the financial sector. One indication of increased competition for state-owned banks is the rise in credit from private banks to 51.3 per cent in mid-2005 from 45.4 per cent in mid-2004.

Macroeconomic performance

Real economy

The economy is booming on the back of high oil prices. Real GDP growth reached a record 16.5 per cent year-on-year in the first half of 2005, supported by increases in oil production and exports. Also, large capital investments, mainly in the oil and gas sectors, remain a key source of economic expansion. Over the same period, industry grew by about 20 per cent whereas agricultural growth was only 4.8 per cent. The economy is expected to grow by 20 per cent in 2005, compared with 10.2 per cent in 2004.

Economic policies

Government revenues increased 3.5 per cent above target in the first half of 2005 as tax revenues were boosted by high oil prices and production. However, higher expenditures, mainly in long-term infrastructure investment projects, limited the general government budget surplus to 1.2 per cent of GDP, similar to its level during the same period in 2004. A sharp rise in money supply and credit has put strong pressure on inflation, as have increases in administered prices of energy and other utilities implemented in November 2004 and in January and March 2005. In response, the Azerbaijan National Bank abandoned the de facto fixed exchange rate to the US dollar in February 2005 and allowed the manat to appreciate. It also increased its refinancing rate twice by 0.5 per cent in May and July 2005. As a result, annual inflation fell slightly to 11.5 per cent in July 2005 from 13.9 per cent in April 2005.

External sector

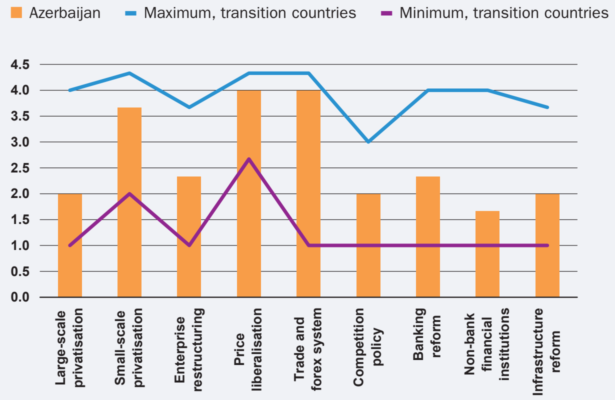
Exports have been rising, due mainly to the increase in oil production. Imports have also grown, mostly due to capital imports related to ongoing oil and gas projects. As the BTC oil pipeline becomes fully operational in the last quarter of 2005, service income will increase sharply and capital goods imports will decrease. The current account deficit is expected to decline to about 10 per cent of GDP in 2005 from 30 per cent in 2004. Foreign direct investment will continue to largely cover the deficit. The public and publicly guaranteed external debt-to-GDP ratio declined to 14.7 per cent of GDP by end-June 2005, compared with about 18.6 per cent at the end of 2004.

Outlook and risks

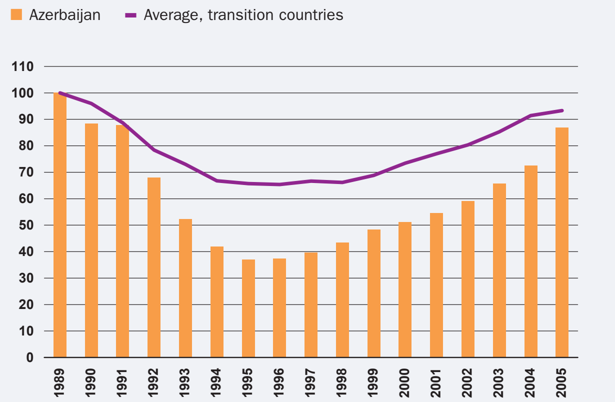
The growth rate is expected to exceed 20 per cent in the short term, reflecting new capital investment, the opening of the BTC oil pipeline and the South Caucasus gas pipeline operations, and a further increase in oil and gas production. With increased oil export capacity, the current account should turn from a large deficit to a surplus by 2006.

However, the economy is vulnerable to a decline in oil prices, and the current high level of oil-related revenues may delay essential structural reforms. While economic diversification is necessary for growth sustainability, the real exchange rate appreciation associated with large capital inflows and oil revenue spending is a major risk for non-oil sector development.

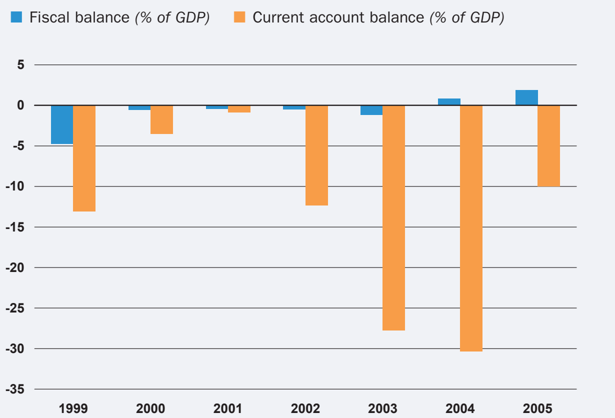
Transition indicators, 2005



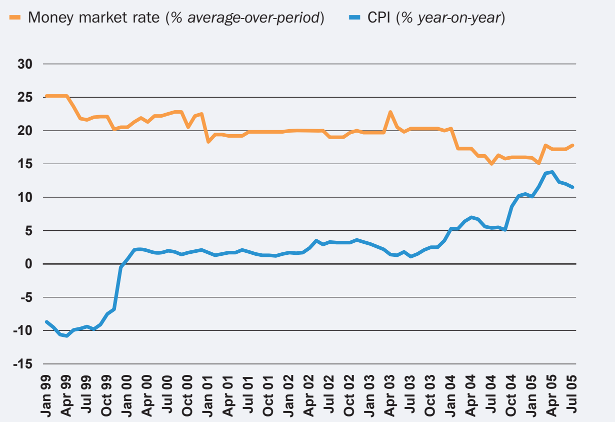
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **yes**

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradability of land – **limited de jure**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **malfunctioning**

Quality of corporate governance law – **very low**

Infrastructure

Independent telecoms regulator – **no**

Independent electricity regulator – **no**

Separation of railway infrastructure from operations – **no**

Quality of concession laws – **na** [1]

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **no**

Quality of securities market laws – **very low**

Private pension funds – **no**

Social reform

Share of population living in poverty – **33.4 per cent** (2001) [2]

Government expenditure on health – **1.6 per cent of GDP**

Government expenditure on education – **4.9 per cent of GDP**

Share of power, water in total household expenditure – **3.5 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	1.5	1.7	2.0	2.4	2.6	3.0	na
Private sector share in GDP (in per cent)	45.0	45.0	60.0	60.0	60.0	60.0	60.0
Private sector share in employment (in per cent)	63.7	65.5	66.6	68.0	68.5	68.4	na
Budgetary subsidies and current transfers (in per cent of GDP)	7.1	6.9	6.6	11.9	11.9	10.9	na
Share of industry in total employment (in per cent)	7.0	6.7	6.6	6.8	6.7	6.7	na
Change in labour productivity in industry (in per cent)	0.4	10.7	6.4	1.5	6.6	6.7	na
Investment/GDP (in per cent)	26.5	20.6	20.7	34.6	50.7	48.5	na
EBRD index of small-scale privatisation	3.3	3.3	3.3	3.7	3.7	3.7	3.7
EBRD index of large-scale privatisation	1.7	1.7	2.0	2.0	2.0	2.0	2.0
EBRD index of enterprise reform	1.7	2.0	2.0	2.0	2.3	2.3	2.3
Share of administered prices in CPI (in per cent)	6.0	6.0	6.0	6.0	6.0	7.0	na
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	3.0	3.0	3.0	3.0	na
Share of trade with non-transition countries (in per cent)	59.2	78.2	79.3	75.0	70.0	67.4	na
Share of trade in GDP (in per cent)	53.7	63.3	61.5	66.2	73.5	85.9	na
Tariff revenues (in per cent of imports)	7.3	8.8	12.5	9.1	6.0	4.9	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	3.3	3.3	3.3	3.7	3.7	3.7	4.0
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	70 (5)	59 (5)	53 (5)	46 (4)	46 (4)	44 (5)	na
Asset share of state-owned banks (in per cent)	82.5	60.4	58.3	62.0	55.3	56.1	na
Asset share of foreign-owned banks (in per cent)	na	4.4	4.6	4.1	5.2	5.8	na
Non-performing loans (in per cent of total loans)	35.1	14.4	20.5	19.7	14.6	14.5	na
Domestic credit to private sector (in per cent of GDP)	na	na	na	3.6	4.1	5.3	na
Domestic credit to households (in per cent of GDP)	na	na	1.0	1.4	2.0	3.0	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	0.0	0.1	0.1	na	na	na	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	2.0	2.0	2.3	2.3	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	9.5 (4.8)	10.4 (5.6)	10.8 (9.1)	11.4 (10.7)	11.8 (13.9)	11.6 (21.1)	na
Internet penetration rate (per 10,000 inhabitants)	0.8	1.9	1.6	1.4	0.7	0.4	na
Railway labour productivity (1989=100)	17.5	23.7	25.4	29.4	31.9	37.4	na
Residential electricity tariffs (in USc kWh)	2.3	2.1	2.1	2.0	2.0	2.0	na
Average collection rate, electricity (in per cent)	na	15	30	45	21	27	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.4	1.8	2.0	2.2	na	na	na
EBRD index of infrastructure reform	1.3	1.7	1.7	2.0	2.0	2.0	2.0
Electric power	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Railways	2.0	2.3	2.3	2.3	2.3	2.3	2.3
Roads	1.0	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	1.0	1.0	1.0	1.0	1.0	1.7	1.7
Water and waste water	2.0	2.0	2.0	2.0	2.0	2.0	2.0

[1] Azerbaijan has no specific concession law but generally conforms with internationally accepted principles on concession laws.

[2] The State Statistics Committee reported 49 per cent of the population was living in poverty in 2001. Poverty is defined by the national authorities as households with a budget of less than AZM 120,000 (US$ 25) per month.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	11.0	6.2	6.5	8.1	11.5	10.2	20.0
Private consumption	12.1	12.1	9.9	6.2	19.2	13.2	na
Public consumption	-1.3	2.2	4.9	5.2	18.2	11.2	na
Gross fixed capital formation	-2.0	2.6	20.6	31.9	32.9	23.4	na
Exports of goods and services	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na
Industrial gross output [1]	3.6	6.9	5.1	3.6	6.6	6.7	na
Agricultural gross output	7.1	12.1	11.1	6.4	5.6	7.6	na
Employment			*(Percentage change)*				
Labour force (end-year)	0.1	0.0	0.4	0.4	0.6	0.5	na
Employment (end-year)	0.1	-0.1	0.3	0.3	0.5	0.5	na
			(In per cent of labour force)				
Unemployment (end-year)	1.1	1.1	1.3	1.3	1.4	1.5	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	-8.5	1.8	1.5	2.8	2.2	6.8	10.4
Consumer prices (end-year)	-0.5	2.2	1.5	3.3	3.6	10.5	4.2
Producer prices (annual average)	-6.1	27.4	1.8	-2.3	16.1	12.9	na
Producer prices (end-year)	17.9	14.5	-4.4	-5.2	11.2	na	na
Gross average monthly earnings in economy (annual average)	9.5	20.2	17.3	21.3	21.4	26.2	na
Government sector			*(In per cent of GDP)*				
General government balance [2]	-4.7	-0.6	-0.4	-0.5	-1.2	0.8	1.8
General government expenditure	23.6	20.8	18.7	27.7	28.3	26.5	na
General government debt	24.2	20.3	20.9	20.5	20.0	18.6	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	15.2	15.9	7.7	15.6	27.9	31.9	na
Domestic credit (end-year)	-10.4	13.5	-38.1	84.2	27.1	42.5	na
			(In per cent of GDP)				
Broad money (M2, end-year)	7.4	6.9	6.6	6.7	7.3	8.2	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinance rate (6 months)	10.0	10.0	10.0	7.0	7.0	7.0	na
Interbank interest rate (3 months) [3]	20.5	22.5	19.8	19.7	20.3	16.6	na
Deposit rate	11.4	12.9	8.5	8.7	9.5	9.2	na
Lending rate	17.9	19.7	19.7	17.4	15.5	15.7	na
			(Manats per US dollar)				
Exchange rate (end-year)	4,378	4,565	4,775	4,893	4,923	4,903	na
Exchange rate (annual average)	4,120	4,474	4,657	4,861	4,911	4,913	na
External sector			*(In millions of US dollars)*				
Current account	-600	-187	-49	-770	-2,020	-2,586	-1,229
Trade balance	-408	260	581	482	-98	162	1,177
Merchandise exports	1,025	1,799	2,046	2,305	2,625	3,743	5,552
Merchandise imports	1,433	1,539	1,465	1,823	2,723	3,581	4,375
Foreign direct investment, net	510	149	299	1,048	2,353	2,351	1,173
Gross reserves, excluding gold (end-year) [4]	673	680	725	721	803	923	na
External debt stock	964	1,044	1,154	1,252	1,432	1,585	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.2	4.0	4.1	2.8	2.0	1.8	na
			(In per cent of exports of goods and services)				
Debt service	0.1	4.6	4.9	4.4	5.2	3.6	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	8.0	8.0	8.1	8.2	8.3	8.3	na
GDP (in billions of manats)	18,875	23,591	26,578	30,312	35,733	41,873	58,881
GDP per capita (in US dollars) [5]	571	659	705	760	881	1,032	na
Share of industry in GDP (in per cent)	22.2	36.0	37.6	37.4	37.3	37.8	na
Share of agriculture in GDP (in per cent)	18.2	15.9	14.8	13.8	12.2	11.3	na
Current account/GDP (in per cent)	-13.1	-3.5	-0.9	-12.3	-27.8	-30.3	-10.0
External debt - reserves (in US$ million)	291	364	429	531	629	662	na
External debt/GDP (in per cent)	21.0	19.8	20.2	20.1	19.7	18.6	na
External debt/exports of goods and services (in per cent)	75.2	50.7	49.4	46.9	46.8	37.4	na

1 Industrial output excludes crude oil production.

2 General government consolidates all levels of government, except for municipalities and state-owned enterprises, and includes the State Oil Fund and other extra-budgetary funds.

3 90-day interbank offer rate in manats, nominal.

4 By end-December 2004 there were additional foreign exchange assets of approximately US$ 970 million in the State Oil Fund.

5 An improved method of calculating value-added in the oil sector has led to a sharp upward revision in nominal GDP and related variables for 2000 relative to previous estimates.

Belarus

Key challenges

- The dominant and growing role of the government in the economy, which has resulted in excessive regulation, directed lending and the imposition of wage targets, continues to undermine the business climate for domestic and foreign investors.
- Fundamental market-oriented reforms, including the imposition of hard budget constraints on enterprises, are essential for sustainable, private sector-led growth over the longer term.
- A reduction in quasi-fiscal activities, greater efficiency in public spending and the continuation of a responsible monetary policy are needed to maintain macroeconomic stability.

Country data

Population (in millions)	**9.8**
Area ('000 sq. km)	**207.6**
GDP (in billion US$, 2004)	**22.9**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 6,894**
National currency	**Belarussian rouble**

Progress in structural reform

Liberalisation and privatisation

In September 2004 Belarus and Russia signed an agreement on indirect taxation in export and import operations. The agreement set out the "country of destination" principle which will apply to value added tax (VAT) and excise tax. The new regime came into force in January 2005. Individual entrepreneurs engaged in trade with Russia protested against the new regime as they were previously exempt from paying VAT and paid single tax only.

In addition to the higher tax burden, the new measure also increased the operational costs for proper accounting of imported goods. In response to this protest, the president issued a decree in March 2005. This allowed entrepreneurs to delay repayment of arrears to the Social Security Fund. It also imposed a ceiling on the rents charged to individual entrepreneurs. However, this administrative measure, aimed at reducing costs for individual entrepreneurs, negatively affects the owners of trade centres and markets. It may also support the development of a growing grey market for rental properties.

Little progress was made in privatisation in 2004. Shares in six companies were sold to domestic buyers out of a list of 189 joint-stock companies up for sale. About 145 enterprises were incorporated into joint-stock companies, but they remain state-owned. In 2005, 136 of these incorporated enterprises were prepared for privatisation. By September, however, only nine had been sold off. In 2005 the government plans to incorporate a further 67 enterprises. In the meantime, the state has increased its stake in a number of enterprises and banks.

Negotiations on accession to the World Trade Organization (WTO) have continued. While there has been some progress in bilateral negotiations, the multilateral process has not moved forward substantially. Several problematic issues remain to be addressed, including the investment regime, state ownership and privatisation, administrative appeal procedures, pricing policies, import and export restrictions, and state trading. The WTO also requires more government efforts to improve market access and legislative implementation.

Business environment and competition

The state continues to dominate the economic environment, with the majority of enterprises still under state control. The privately owned enterprises experience excessive state regulation and interference, and a high tax burden. The legislative and regulatory frameworks are complex and subject to frequent revision. A vast number of economic activities are regulated by presidential decrees, which often contradict existing laws.

Amendments to the Investment Code, which came into force on 1 January 2005, abolished the tax and import tariff preferences previously granted to foreign investors. In particular, companies with foreign capital are no longer entitled to profit tax exemptions during the first three years of operation. Nor are they any longer exempt from VAT and import tariffs on imported capital goods.

The "golden share", or special right of the state to participate in the management of privatised enterprises, remains a serious concern for investors. In the first half of 2005 the government exercised this right and interfered in management decisions in a number of enterprises, including one firm that was never formally state-owned. The shareholders of the firm challenged the decision in the Supreme Economic Court but were unsuccessful. Despite these obstacles, there have been signs of growing private sector investment in real estate, the retail sector and process-based industries.

Financial sector

Most of the major banks remain under state control. They are involved in directed lending activities and benefit from some privileges granted by the government. For instance, six major banks (only one of which is privately owned) currently enjoy government guarantees on household deposits, giving them a competitive advantage over their rivals. (However, under a proposed new deposit insurance law, government guarantees on such deposits may be extended to all banks.)

Similarly, some state enterprises were recently instructed to move their accounts to state-owned banks. Banks are also often requested, formally or informally, to apply preferential interest rates, close to the refinancing rate, to loans for priority enterprises and sectors (such as agriculture) and socially important projects.

Macroeconomic performance

Real economy

Real GDP rose by 11 per cent in 2004, the highest level of growth since 1997, supported by high prices for commodity exports and strong demand from Russia. Growth has slowed in 2005 with evidence of some accumulation of inventories. Nevertheless, it is still robust at 8.5 per cent year-on-year in the first eight months of 2005. On the demand side, the main drivers of growth have been private consumption and investment, supported by rapidly rising real wages and a significant increase in lending activities. On the supply side, growth has been broadly based, with industrial output, agriculture and construction all expanding in 2004 at a rate above 10 per cent.

Economic policies

The government continues to play a dominant role in the economy through budget and off-budget financing of specific projects, support to enterprises through state-owned banks and wage growth targets. Fiscal revenues in the first half of 2005 were above projections due to higher than expected receipts from profit tax and VAT. However, the effect of the change in the VAT regime in January 2005 (whereby VAT on trade with Russia is now based on the country of destination) was not accounted for in the 2005 Budget Law. The extra VAT revenue contributed to a consolidated fiscal surplus of 3.3 per cent of GDP in the first half of 2005. Progress has been made in fiscal consolidation, with incorporation in the fiscal accounts of the Social Protection Fund in 2004 and Innovation Funds in 2005. The tightening of monetary policy has been a key determinant of the slowdown in inflation since 2004, although administrative price controls on basic goods and utility services have also played a role. In the first half of 2005, average prices grew by just 4.0 per cent year-on-year compared with 8.1 per cent for the same period in 2004. The prospective currency union between Belarus and Russia remains on hold.

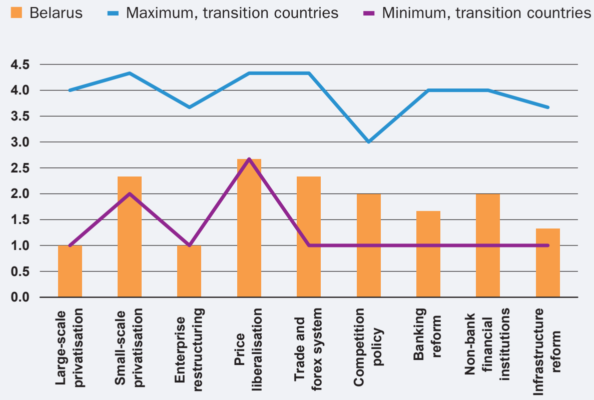
External sector

The current account deficit widened to 4.6 per cent of GDP in 2004 from 2.4 per cent in 2003. Although higher gas prices had some impact, much of the increase appears to have been due to a temporary shock in the last quarter of 2004, as companies increased their import orders in anticipation of changes in the VAT regime. This was offset by a large current account surplus of about US$970 million (around 7.5 per cent of GDP) in the first half of 2005. Reserves rose to US$1.1 billion by end-July 2005, a 60 per cent increase since the end of 2004, but still below one month of import cover.

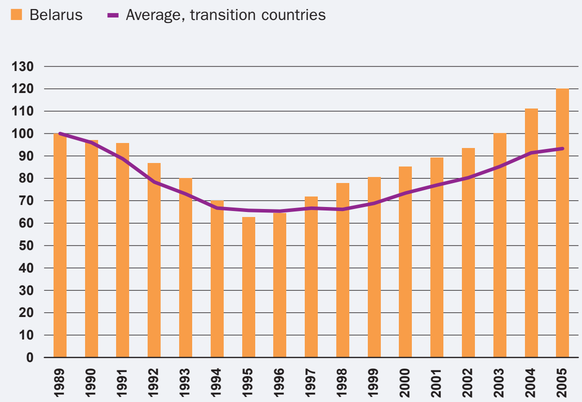
Outlook and risks

The government's policy of enterprise support and directed wage increases, combined with strong external demand, should ensure positive growth in the short term. However, long-term growth prospects remain bleak unless fundamental market-oriented reforms are implemented, including the imposition of hard budget constraints on enterprises. Also, excessive dependence on Russia as the main export market and cheap energy supplier is a major source of vulnerability.

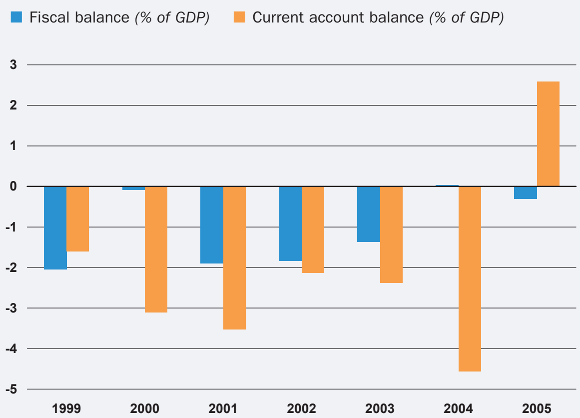
Transition indicators, 2005



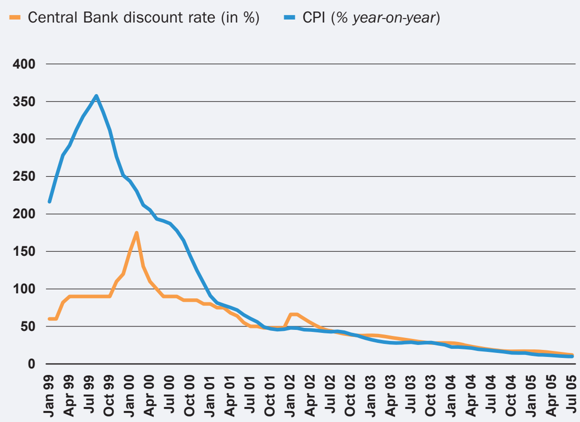
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **limited**	Competition office – **no**	Independent telecoms regulator – **no**	Capital adequacy ratio – **8 per cent** [1]	Share of population living in poverty – **<2 per cent** (2000)
Controls on inward direct investment – **yes**	Quality of insolvency law – **medium**	Independent electricity regulator – **no**	Deposit insurance system – **yes**	Government expenditure on health – **4.9 per cent of GDP**
Interest rate liberalisation – **limited de facto**	Secured transactions law – **malfunctioning**	Separation of railway infrastructure from operations – **no**	Quality of securities market laws – **low**	Government expenditure on education – **6.1 per cent of GDP**
Exchange rate regime – **crawling peg**	Quality of corporate governance law – **very low**	Quality of concession laws – **very low**	Private pension funds – **no**	Share of power, water in total household expenditure – **5.1 per cent**
Wage regulation – **yes**				
Tradability of land – **limited de jure**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	1.0	1.1	1.2	2.8	2.9	3.0	na
Private sector share in GDP (in per cent)	20.0	20.0	20.0	25.0	25.0	25.0	25.0
Private sector share in employment (in per cent)	18.6	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	18.9	18.9	19.9	18.9	18.8	18.3	na
Share of industry in total employment (in per cent)	24.4	24.2	23.8	23.8	22.7	22.5	na
Change in labour productivity in industry (in per cent)	9.2	8.8	8.4	5.6	12.6	16.9	na
Investment/GDP (in per cent)	23.7	25.4	23.8	22.2	26.6	28.3	na
EBRD index of small-scale privatisation	2.0	2.0	2.0	2.0	2.3	2.3	2.3
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	1.0	1.0	1.0
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Markets and trade							
Share of administered prices in CPI (in per cent)	27.0	27.0	25.0	24.0	21.0	24.0	27.0
Number of goods with administered prices in EBRD-15 basket	6.0	6.0	6.0	6.0	4.0	5.0	6.0
Share of trade with non-transition countries (in per cent)	26.4	22.1	22.9	26.9	27.4	27.0	na
Share of trade in GDP (in per cent)	97.5	136.0	125.3	115.4	120.1	130.6	na
Tariff revenues (in per cent of imports) [2]	3.9	1.7	2.7	3.3	4.1	3.2	na
EBRD index of price liberalisation	2.3	2.3	2.7	2.7	2.7	2.7	2.7
EBRD index of forex and trade liberalisation	1.0	1.7	2.0	2.3	2.3	2.3	2.3
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	36 (4)	31 (6)	29 (9)	28 (12)	30 (17)	32 (19)	na
Asset share of state-owned banks (in per cent)	66.6	66.0	53.2	61.9	61.6	70.2	na
Asset share of foreign-owned banks (in per cent)	2.9	4.3	7.5	8.1	20.4	20.0	na
Non-performing loans (in per cent of total loans)	13.1	15.2	11.9	8.3	3.7	2.8	na
Domestic credit to private sector (in per cent of GDP)	9.1	8.6	6.0	6.3	7.6	9.0	na
Domestic credit to households (in per cent of GDP)	na	na	na	na	na	na	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	3.4	4.1	2.9	na	na	na	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.7	1.7	1.7	1.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	25.7 (0.2)	26.9 (0.5)	28.8 (1.4)	29.9 (4.7)	31.1 (11.3)	31.1 (11.3)	na
Internet penetration rate (per 10,000 inhabitants)	0.9	2.0	3.3	4.1	5.0	7.0	na
Railway labour productivity (1989=100)	35.9	37.5	35.1	38.3	40.1	41.5	na
Residential electricity tariffs (in USc kWh)	0.4	1.4	1.3	3.2	3.2	3.3	na
Average collection rate, electricity (in per cent)	na	50	na	98	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.9	2.0	2.1	2.2	na	na	na
EBRD index of infrastructure reform	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Electric power	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Railways	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Roads	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0

1 Ratio is 12 per cent for the first two years of operation of a bank.
2 Refers to taxes on international trade.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	3.4	5.8	4.7	5.0	7.0	11.0	8.0
Private consumption	9.5	8.0	17.9	11.4	7.2	12.9	na
Public consumption	5.5	5.8	3.1	0.3	0.2	0.0	na
Gross fixed capital formation	-16.0	14.7	1.9	2.6	27.2	18.8	na
Exports	-2.3	na	na	na	na	na	na
Imports	-8.6	na	na	na	na	na	na
Industrial gross output	10.3	7.8	5.9	4.5	7.1	15.6	na
Agricultural gross output	-8.3	9.3	1.8	0.7	6.6	12.9	na
Employment			(Percentage change)				
Labour force (end-year)	0.3	-0.1	-0.4	-0.4	-0.5	-1.2	na
Employment (end-year)	0.6	-0.1	-0.6	-1.1	-0.6	0.0	na
			(In per cent of labour force)				
Unemployment (end-year)	2.1	2.1	2.3	3.0	3.1	1.9	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	293.7	168.6	61.1	42.6	28.4	18.1	10.6
Consumer prices (end-year)	251.2	107.5	46.1	34.8	25.4	14.4	9.5
Producer prices (annual average)	355.8	185.6	71.8	40.4	37.5	24.1	na
Producer prices (end-year)	245.1	168.0	39.1	42.6	28.1	18.8	na
Gross average monthly earnings in economy (annual average)	322.4	200.9	108.8	53.8	32.5	39.6	na
Government sector			(In per cent of GDP)				
General government balance	-2.0	-0.1	-1.9	-1.8	-1.4	0.0	-0.3
General government expenditure	47.3	45.9	46.8	46.4	47.2	46.2	na
General government debt	13.0	16.5	13.2	11.0	10.4	9.0	na
Monetary sector			(Percentage change)				
Broad money (M3, end-year)	133.2	219.3	61.8	50.3	56.3	44.1	na
Domestic credit (end-year)	143.2	190.8	65.0	54.6	70.7	31.0	na
			(In per cent of GDP)				
Broad money (M3, end-year)	16.7	17.7	15.2	15.0	16.8	17.9	na
Interest and exchange rates			(In per cent per annum, end-year)				
Refinancing rate	120.0	80.0	48.0	38.0	28.0	17.0	na
Deposit rate (1 year) [1]	23.8	37.6	34.2	26.9	17.4	12.7	na
Lending rate (1 year) [2]	51.0	67.7	47.0	36.9	24.0	16.9	na
			(Belarussian roubles per US dollar)				
Official exchange rate (end-year)	320	1,180	1,580	1,920	2,156	2,170	na
Official exchange rate (annual average)	249	877	1,390	1,791	2,051	2,160	na
External sector			(In millions of US dollars)				
Current account	-194	-323	-435	-311	-424	-1,043	723
Trade balance	-570	-884	-807	-914	-1,256	-2,066	-200
Merchandise exports	5,646	6,641	7,334	7,965	10,073	13,917	16,000
Merchandise imports	6,216	7,525	8,141	8,879	11,329	15,983	16,200
Foreign direct investment, net	443	119	96	453	170	168	160
Gross reserves, excluding gold (end-year)	294	351	391	619	595	690	na
External debt stock [3]	1,261	1,265	1,381	1,655	1,615	1,351	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	0.5	0.5	0.5	0.8	0.6	0.5	na
			(In per cent of exports of goods and services)				
Debt service	3.9	4.2	3.4	4.1	4.6	4.0	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	10.1	10.0	10.0	10.0	9.9	9.8	na
GDP (in billions of Belarussian roubles)	3,026	9,134	17,173	26,138	36,565	49,445	60,343
GDP per capita (in US dollars)	1,207	1,040	1,237	1,467	1,801	2,324	na
Share of industry in GDP (in per cent)	31.9	31.0	29.9	29.6	30.1	30.0	na
Share of agriculture in GDP (in per cent)	14.6	14.2	11.9	11.8	9.8	10.3	na
Current account/GDP (in per cent)	-1.6	-3.1	-3.5	-2.1	-2.4	-4.6	2.6
External debt - reserves (in US$ million)	967	914	991	1,037	1,021	660	na
External debt/GDP (in per cent)	10.4	12.1	11.2	11.3	9.1	5.9	na
External debt/exports of goods and services (in per cent)	19.7	16.5	16.4	17.8	14.0	8.6	na

[1] Data refer to weighted average interest rates on new one-year deposits in commercial banks.

[2] Data refer to weighted average interest rates for one-year loans by commercial banks.

[3] Includes medium and long-term public and publicly guaranteed debt and an estimate of private debt.

Bosnia and Herzegovina[1]

Key challenges

- Further measures are needed to strengthen the single economic space, including the introduction of state-level VAT, the development, operation and regulation of infrastructure at state level, and the merger of bank supervisory agencies.
- A firm commitment to reforms in the energy, transport, telecommunications and municipal infrastructure sectors, as well as compliance with the relevant EU directives, will be essential for attracting much-needed foreign investment.
- A gradual reduction in public spending, resolution of the domestic debt problem and the fundamental restructuring of the corporate sector will be necessary to ensure long-term economic sustainability.

Country data

Population (in millions)	**3.8**
Area ('000 sq. km)	**51.0**
GDP (in billion US$, 2004)	**8.2**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 7,168**
National currency	**Convertible mark**

Progress in structural reform

Liberalisation and privatisation

Plans to introduce a state-wide value added tax (VAT) in 2006, replacing existing Entity-based sales taxes, are proceeding. On 1 July 2005 the VAT registration process began for all businesses and other legal entities whose tax turnover in 2005 is expected to exceed KM 50,000 (€ 25,500). The deadline for registration was end-September.

Limited progress was recorded over the past year in the areas of large-scale privatisation and foreign investment. A notable deal occurred in August 2004 with the purchase by UK-based Mittal Steel of 51 per cent of shares in BiH Steel Zenica. This investment has already helped to expand steel production and may boost the country's exports dramatically over the medium term.

In addition, Natron, a paper mill based in Maglaj, was sold to Hayat Group, a Turkish investor. Some advance has also occurred in the Republika Srpska (RS), with important sales in the aluminium, iron ore and coal mining sectors as well as the re-tendering (for the third time) of Banja Luka Brewery. Nevertheless, the process has been slow and several other high-profile tenders have failed.

Bosnia and Herzegovina's integration into regional and international structures remains hesitant. Whilst the country has achieved sufficient progress in most areas identified in the European Commission's feasibility study (adopted in 2003), negotiations on a Stabilisation and Association Agreement (SAA) have not yet begun. This is pending agreement on a package of policy reforms.

Negotiations with the World Trade Organization (WTO) have begun, following the submission in October 2004 of initial offers on goods and services. The country has bilateral free trade agreements with all of its neighbours but several of these have been marred by disputes.

Business environment and competition

New business registration laws were adopted in both Entities and in Brčko District during the second quarter of 2005. Implementation should begin later in the year. The new laws are expected to reduce the time needed to start up a business, which at 54 days (according to the World Bank's *Doing Business* in 2006) is the longest in south-eastern Europe. They are also expected to lead to a reduction in the size of the informal economy, estimated at about 30 to 50 per cent of GDP in a recent IMF study. A new law on competition, modelled on EU legislation, entered into force in July 2005.

Infrastructure

The new law on railways was enacted in July 2005. Its passage paves the way for further reform and strengthening of the sector, including the separation of infrastructure and operations and the establishment of transparent financing mechanisms for public service obligations. It also enables new foreign investment, including planned finance from the EBRD and European Investment Bank.

In the RS the privatisation of the fixed-line and mobile telecommunications operator, Telekom Srpske, is proceeding slowly. The original deadline of end-2004 has been extended. The expectation is that a tender will be launched by the end of 2005 and that privatisation can take place in the first half of 2006. The selection of a consultant for the privatisation is under way. In the Federation little progress has been made towards beginning the privatisation of BH Telekom or completing the privatisation process of HT Mostar.

Financial sector

Consolidation of the banking sector continued in 2004 with 33 banks in operation at the end of the year (compared with 37 at end-2003). Total assets of the sector increased to 71.8 per cent of GDP from 57.2 per cent at end-2003. Average lending rates have declined steadily to an annual rate of below 10 per cent for long-term investments, although this is still high in real terms relative to the eurozone.

Domestic credit to the private sector has meanwhile nearly doubled over the past two years. Although the ratio of non-performing loans to total assets has fallen to below 4 per cent, concerns have been raised about the rapid growth in bank lending, especially to the household sector. A proposal to bring the two Entity bank supervision agencies under the umbrella of the Central Bank has yet to be implemented.

[1] *The territorial constitutional entities distinguished in this assessment include the State of Bosnia and Herzegovina (BH), the Federation of Bosnia and Herzegovina (FBH), the Republika Srpska (RS) and the cantons of the Federation. The FBH and the RS are referred to as the "Entities". The District of Brčko enjoys a special status based on an Arbitration Award in accordance with the Dayton Peace Agreement.*

Macroeconomic performance

Real economy

Economic growth in 2004 is provisionally estimated at 5.7 per cent, the highest level since 1999. This reflects double-digit growth in the industrial sector (following major investments in selected key industries), a recovery in the agricultural sector and strong export growth. The private sector has been boosted by enhanced access to credit and an overall improvement in the investment climate. However, corporate profitability remains weak, due to slow progress over recent years in privatisation and restructuring.

Economic policies

Monetary policy throughout the transition has been prudent, guided by the currency board of the Central Bank. A new governor and governing board of the Bank took over in January 2005. The annual inflation rate, at less than 1 per cent in 2004, remains one of the lowest among all transition countries and below the average level in the eurozone. On the fiscal side, the budgets in both Entities are broadly on target but concerns exist about the overall size of public spending, which is around 50 per cent of recorded GDP. There is a danger that the expansion of state competencies, including the establishment of an effective fiscal council, will not be matched by a corresponding reduction in spending at the Entity level. In addition, the agreement reached in 2004 among all parties (state and Entities) to restructure and substantially write down the level of domestic debt is on hold. This follows recent court rulings casting doubt on the legality of the original plan. It raises once again the potential for large liabilities facing governments at all levels in the country.

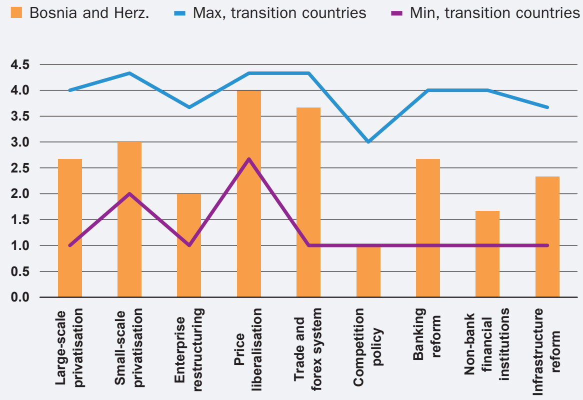
External sector

Export performance improved significantly in 2004. However, import growth was also substantial and, according to the most recent estimates, the current account deficit may have been above 20 per cent of GDP, even higher than the previous year. The deficit continues to be covered fully by a combination of capital transfers, foreign direct investment (FDI) and other capital inflows. Foreign reserves have risen steadily, reaching €1.8 billion in mid-2005. In addition, the level of public external debt is moderate at about 30 per cent of GDP. Private external debt, however, is estimated by the IMF to be another 20 per cent of GDP. Net FDI is on an upward trend, helping to offset the decline in war-related transfers.

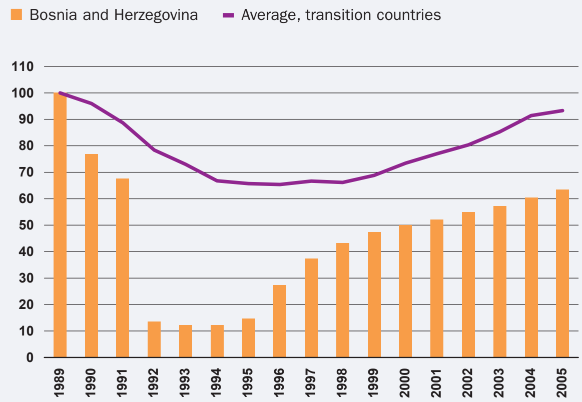
Outlook and risks

The outlook remains positive but is clouded by considerable uncertainty, much of it of a political nature. It is still unclear when the country might be able to pass all the necessary conditions to begin negotiations on an SAA with the EU. No IMF programme has been in place since the completion of the last Stand-By Arrangement (SBA) in February 2004, although provisional agreement has been reached on a new SBA, which is expected to begin in 2006. Progress on both of these fronts would send a positive signal to investors about the country's commitment to prudent macroeconomic policies and integration with Europe.

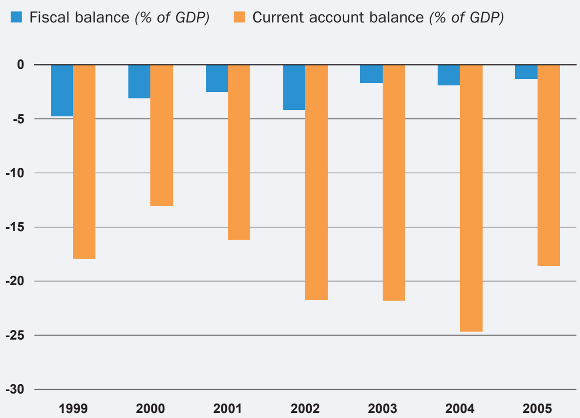
Transition indicators, 2005



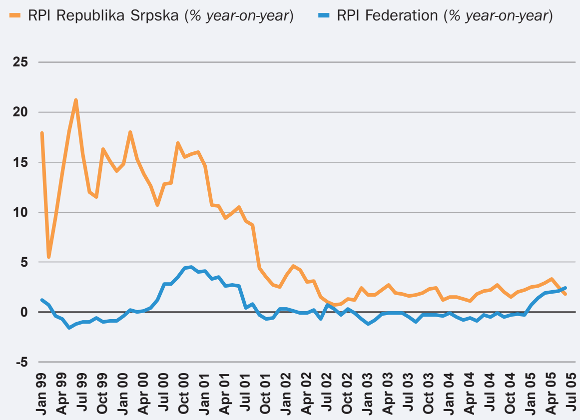
Real GDP (1989=100)



Fiscal balance and current account balance



Inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **no**	Independent telecoms regulator – **partially**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **na**
Controls on inward direct investment – **yes** [1]	Quality of insolvency law – **high**	Independent electricity regulator – **partially**	Deposit insurance system – **yes**	Government expenditure on health – **na**
Interest rate liberalisation – **full**	Secured transactions law – **inefficient**	Separation of railway infrastructure from operations – **partially**	Quality of securities market laws – **medium**	Government expenditure on education – **na**
Exchange rate regime – **currency board**	Quality of corporate governance law – **low**	Quality of concession laws – **medium**	Private pension funds – **no**	Share of power, water in total household expenditure – **9.1 per cent**
Wage regulation – **no**				
Tradability of land – **limited de jure**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	0.7	2.0	2.7	2.8	2.9	2.9	na
Private sector share in GDP (in per cent)	35.0	35.0	40.0	45.0	50.0	50.0	55.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.5	0.8	0.4	na	na	na	na
Share of industry in total employment (in per cent)	na	na	na	na	na	na	na
Change in labour productivity in industry (in per cent)	na	na	na	na	na	na	na
Investment/GDP (in per cent)	21.0	20.6	18.9	20.4	19.9	20.3	na
EBRD index of small-scale privatisation	2.0	2.3	2.7	3.0	3.0	3.0	3.0
EBRD index of large-scale privatisation	2.0	2.0	2.3	2.3	2.3	2.3	2.7
EBRD index of enterprise reform	1.7	1.7	1.7	1.7	2.0	2.0	2.0
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket[2]	4.0	5.0	5.0	5.0	5.0	5.0	5.0
Share of trade with non-transition countries (in per cent)[3]	67.4	75.5	52.8	50.8	49.6	na	na
Share of trade in GDP (in per cent)	106.0	71.1	71.0	74.3	76.2	82.0	na
Tariff revenues (in per cent of imports)	6.5	11.1	14.2	9.9	8.8	6.6	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	3.0	3.0	3.0	3.0	3.7	3.7	3.7
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Financial sector							
Number of banks (foreign-owned)	61 (9)	56 (14)	49 (20)	40 (21)	37 (19)	33 (17)	na
Asset share of state-owned banks (in per cent)	75.9	55.4	17.3	6.2	5.3	4.0	na
Asset share of foreign-owned banks (in per cent)	3.8	21.6	65.3	76.7	79.7	80.9	na
Non-performing loans (in per cent of total loans)	58.7	13.9	20.7	11.5	8.4	6.1	na
Domestic credit to private sector (in per cent of GDP)	8.9	5.6	9.0	11.2	14.5	18.8	na
Domestic credit to households (in per cent of GDP)	3.1	3.6	5.7	11.0	14.2	17.2	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.3	2.3	2.7	2.7
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.7	1.7	1.7	1.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	9.6 (1.4)	10.3 (3.0)	22.3 (11.7)	23.7 (19.6)	22.5 (27.4)	24.5 (27.4)	na
Internet penetration rate (per 10,000 inhabitants)	5.2	5.3	8.6	15.0	18.9	20.1	na
Railway labour productivity (1996=100)	184.2	265.2	351.0	358.6	378.4	635.3	na
Residential electricity tariffs (in USc kWh)	5.7	4.9	5.7	6.0	7.1	6.7	na
Average collection rate, electricity (in per cent)	94	75	95	86	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	5.4	4.8	4.9	5.5	na	na	na
EBRD index of infrastructure reform	1.3	2.0	2.0	2.3	2.3	2.3	2.3
Electric power	2.0	2.3	2.3	3.0	3.0	3.0	3.0
Railways	2.0	2.0	2.3	3.0	3.0	3.0	3.0
Roads	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	1.0	3.3	3.3	3.3	3.3	3.3	3.3
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0

[1] There are restrictions on the production and sale of arms, ammunition, military equipment and public information.

[2] Administered prices in either the Federation or Republika Srpska or both entities. Data for 1999 for Federation only.

[3] For some years data were unavailable for important trading partners such as Croatia, FYR Macedonia and Serbia and Montenegro. As a result, the share of trade with non-transition countries for these years has been over-estimated.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	9.6	5.5	4.3	5.3	4.0	5.7	5.0
Total consumption	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na
Industrial gross output	12.1	9.4	-2.0	11.5	3.8	na	na
Agricultural gross output	na	na	na	na	na	na	na
Employment			*(Percentage change)*				
Labour force (end-year)	-0.9	2.1	-1.3	3.1	1.3	0.5	na
Employment (end-year)	-3.1	1.6	-2.3	1.9	-0.6	0.2	na
			(In per cent of labour force)				
Unemployment (end-year)	39.3	39.6	40.3	40.9	42.0	0.0	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)							
Federation (KM-based)	-0.9	1.9	1.9	-0.2	0.2	-0.3	na
Republika Srpska (KM-based)	14.1	14.0	7.0	1.7	1.8	2.2	na
Consumer prices (end-year)							
Federation (KM-based)	-1.0	4.0	0.3	-0.7	0.3	-0.3	na
Republika Srpska (KM-based)	14.0	16.1	2.2	2.4	1.3	2.2	na
Gross average monthly earnings in economy (annual average)							
Federation	5.2	10.0	7.6	9.2	8.3	1.7	na
Republika Srpska	22.7	23.2	14.7	18.7	9.3	11.5	na
Government sector			*(In per cent of GDP)*				
General government balance	-4.8	-3.1	-2.5	-4.1	-1.7	-1.9	-1.3
General government expenditure	65.0	56.6	52.1	53.9	51.3	50.8	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	39.9	13.9	89.3	8.6	8.4	24.3	na
Domestic credit (end-year)	-1.3	10.0	5.2	28.2	19.8	18.0	na
			(In per cent of GDP)				
Broad money (M2, end-year)	25.2	24.5	42.5	43.6	44.8	52.6	na
Exchange rates			*(KM per US dollar)*				
Exchange rate (annual average)	1.84	2.12	2.19	2.08	1.73	1.57	na
External sector			*(In millions of US dollars)*				
Current account	-837	-621	-811	-1,218	-1,543	-2,035	-1,669
Trade balance	-1,852	-1,715	-1,831	-2,259	-2,804	-3,436	-3,200
Merchandise exports	831	832	870	952	1,296	1,664	2,100
Merchandise imports	4,126	2,547	2,701	3,211	4,100	5,100	5,300
Foreign direct investment, net [1]	177	150	130	266	382	490	540
Gross reserves, excluding gold (end-year)	455	497	1,221	1,295	1,765	2,389	na
External debt stock	3,095	2,814	2,382	2,113	2,356	2,570	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	1.3	2.2	5.1	4.5	4.9	5.4	na
			(In per cent of exports of goods and services)				
Debt service	13.8	12.1	6.2	9.2	8.2	6.5	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million) [2]	3.8	3.8	3.8	3.8	3.8	3.8	na
GDP (in millions of markas)	8,603	10,086	10,986	11,636	12,261	12,997	13,829
GDP per capita (in US dollars)	1,231	1,251	1,323	1,475	1,862	2,172	na
Share of industry in GDP (in per cent)	na	na	na	na	na	na	na
Share of agriculture in GDP (in per cent)	na	na	na	na	na	na	na
Current account/GDP (in per cent)	-17.9	-13.1	-16.1	-21.7	-21.8	-24.7	-18.6
External debt - reserves (in US$ million)	2,640	2,317	1,161	818	591	181	na
External debt/GDP (in per cent)	66.2	59.2	47.4	37.7	33.3	31.1	na
External debt/exports of goods and services (in per cent)	268.9	218.5	183.7	156.1	130.3	115.2	na

[1] Excludes capital transfers for reconstruction.

[2] Excludes refugees abroad.

Bulgaria

Key challenges

- Although the business environment has improved, further measures are still needed to enhance the functioning of the judiciary and public administration ahead of EU accession.
- The supervision and regulation of non-bank financial institutions need to be tightened in order to strengthen the sector and to complement efforts to curb credit expansion.
- The containment of demand pressures and improved fiscal transparency are crucial in view of the large external imbalances.

Country data

Population (in millions)	**7.8**
Area ('000 sq. km)	**111.0**
GDP (in billion US$, 2004)	**24.1**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 8,026**
National currency	**Lev**

Progress in structural reform

Business environment and competition

Conditions for doing business in Bulgaria have significantly improved. Nevertheless, shortcomings remain in specific areas such as the functioning of the judiciary and public administration. A law on mediation was introduced in December 2004 as an alternative mechanism for the resolution of commercial conflicts. Another law passed in May 2005 allows for the enforcement of judgements by private bailiffs. However, the reform of the Administrative and Civil Procedure Codes has been delayed. Many locally owned medium-sized companies are ill-prepared for EU accession and will face considerable investment needs.

The Bulstat law to set up a central register of legal entities was passed in April 2005. It will unify registration tax and social security. However, further legislation to transfer responsibility for company registration from the judiciary to a purely administrative body has not yet been submitted to parliament.

According to an OECD survey, corruption is still perceived as a serious obstacle to the implementation of the new law. Tax procedures remain complex and are applied inconsistently. Collateral and bankruptcy legislation is in place, but its implementation by the judiciary is also uneven.

Infrastructure

Privatisation of infrastructure is advancing, with the sale of 67 per cent stakes in Bulgaria's seven electricity distribution companies, which were privatised in three regional packages in January 2005. The privatisation of five district heating companies has reached its final stage, while the sale of two thermo-electric power plants in Varna and Rousse to Russia's RAO UES is to be finalised in 2005.

The expected sale of the Bobov Dol thermo-electric plant to Greece's Public Power Corporation, however, has been cancelled because the price offered was deemed too low. Three hydro power plants were sold in May 2005. Three more coal pits were also privatised and the sale of one of the two state coal mines is being prepared. State aid to the coal sector will be phased out by the end of 2005.

Electricity tariffs have been increased and a feed-in tariff has been introduced to stimulate the generation of renewable energy. Bulgaria has become a regional leader in the emerging carbon market, with several emission reduction (Joint Implementation) projects already under way. Nevertheless, energy intensity remains high.

Tariff increases for rail passenger services have narrowed the gap with full cost-recovery levels. The licensing of a second national freight operator in April 2005 has opened the way for more competition. Concessions were also granted for private operators in two airports, one seaport and one river port.

Financial sector

The privatisation of the banking sector is nearly complete, with over 80 per cent of banking assets in the hands of foreign-owned institutions. Competition in the sector is intense and an increasingly broader range of financial products is being offered. Reform efforts are focusing on improving the bank insolvency regime.

Domestic credit to the private sector remained strong, despite the introduction of measures to reduce bank liquidity. The credit expansion was funded by robust deposit expansion and by the increased borrowing of banks from abroad. Despite the credit expansion, asset quality has so far only marginally deteriorated. The impaired loan ratio was just under 8 per cent and the capital adequacy ratio under 16 per cent in July 2005, compared with 7 and 17 per cent respectively at the end of 2004.

In April 2005 the Central Bank introduced further measures to curb credit growth. However, they were designed in such a way that 14 out of 35 banks, including the largest bank, were exempt from the new requirements. The IMF estimates that the Central Bank should be able to reduce credit expansion to the private sector to 30 per cent in 2005 after dealing with these loopholes.

Leasing activity is also booming, although from a small base. This activity, however, remains unregulated and unsupervised, similar to insurance companies and pension funds. These factors could render the credit-curbing measures of the Central Bank less effective. The authorities are committed to introduce new legal provisions requiring leasing companies to report on their ownership and financial operations to the Financial Supervision Commission by the end of 2005.

Macroeconomic performance

Real economy

The Bulgarian economy grew strongly in 2004, continuing a sustained, five-year period of robust expansion. Real GDP grew by 5.6 per cent for the year as a whole, up from 4.5 per cent in 2003 and by 6.2 per cent year-on-year in the first half of 2005. Investment grew by 12 per cent in 2004 and by 13.4 per cent year-on-year in the first half of 2005. Private consumption growth slowed in 2004 compared with the previous year, following the introduction of tighter regulations on bank lending, but public consumption picked up. A significant rise in agricultural production and the accelerating development of the service sector were the main sources of growth on the supply side.

Economic policies

Fiscal policy was tightened in 2004, with the consolidated general government balance recording a surplus of 1.8 per cent of GDP. However, BGN 340 million (€173 million) of budget revenues in excess of projections were used to set up the Public Investment Company without the need of parliamentary approval. This lack of fiscal transparency, and the decision to raise the minimum wage by 25 per cent during 2004, caused an interruption of the IMF precautionary stand-by programme. The programme has since been put back on track. In July 2005 the 12-month rolling budget surplus stood at 2 per cent of GDP, but expenses linked to flood damage are expected to put downward pressure on the budget.

On the monetary side, annual inflation had fallen by end-2004 to 4 per cent as temporary pressures from increased excise taxes and food and energy prices subsided. After rising again in the first quarter of 2005 to a peak of 5.1 per cent in April, inflation subsided again to 3.9 per cent in July. The currency board arrangement remains firmly in place and the Central Bank has announced Bulgaria's intention of adopting the euro in 2010, three years after the target EU entry date of 2007.

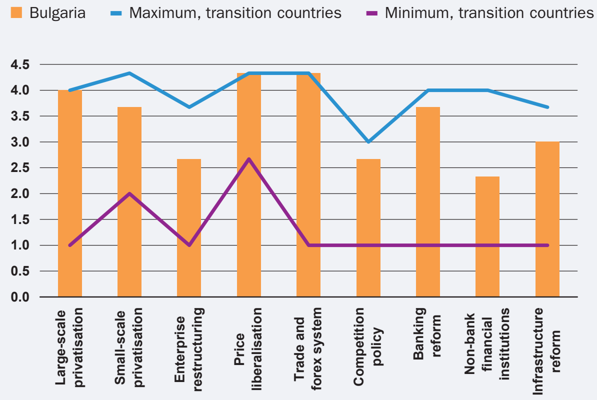
External sector

The current account deficit fell to 7.5 per cent of GDP in 2004 from 9.3 per cent in 2003. This reflects an increased surplus in the balance of services, mainly due to higher revenues from tourism and a reduced net income deficit. The 12-month rolling current account deficit widened again to 10.8 per cent of GDP in July 2005, an expanding trade deficit being largely responsible for this increase. The financing of the current account deficit has been eased in the short term by strong net foreign direct investment and other inflows, including bank lending.

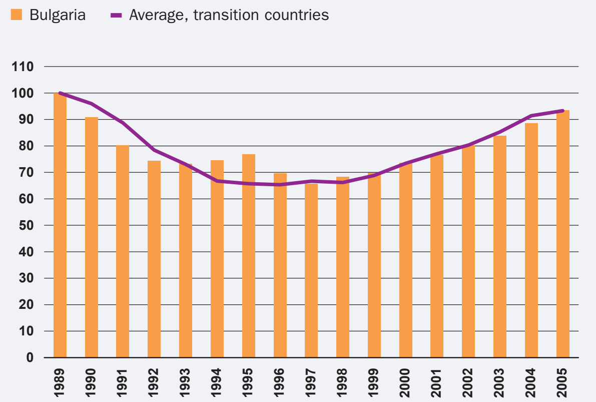
Outlook and risks

The economy remains strong and growth prospects for the medium term are good. However, the external position is vulnerable to a further acceleration in import growth and to continuing high oil prices. The currency board regime will continue to constrain monetary policy, and further fiscal tightening may eventually be necessary to accommodate possible external shocks.

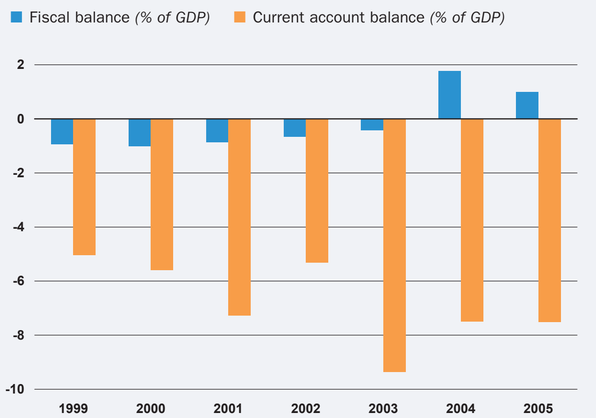
Transition indicators, 2005



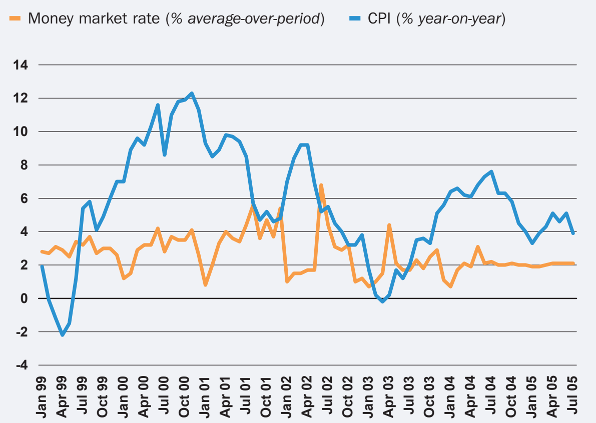
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **currency board**

Wage regulation – **yes**

Tradability of land – **full except foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **advanced**

Quality of corporate governance law – **medium**

Infrastructure

Independent telecoms regulator – **fully**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operations – **fully**

Quality of concession laws – **high**

Financial sector

Capital adequacy ratio – **12 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **medium**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **16.2 per cent** (2001) [1]

Government expenditure on health – **4.3 per cent of GDP** (2002)

Government expenditure on education – **4.1 per cent of GDP** (2002)

Share of power, water in total household expenditure – **11.2 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	8.4	9.7	12.6	13.4	14.6	17.7	na
Private sector share in GDP (in per cent)	70.0	70.0	70.0	70.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	45.9	54.9	58.9	60.8	62.1	65.9	na
Budgetary subsidies and current transfers (in per cent of GDP)	1.6	0.9	2.4	2.4	3.0	2.5	na
Share of industry in total employment (in per cent)	27.0	26.2	26.1	24.0	23.5	23.4	na
Change in labour productivity in industry (in per cent)	-1.8	18.7	5.1	8.2	9.6	11.5	na
Investment/GDP (in per cent)	17.9	18.3	20.4	19.7	21.7	23.5	na
EBRD index of small-scale privatisation	3.3	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of large-scale privatisation	3.0	3.7	3.7	3.7	3.7	4.0	4.0
EBRD index of enterprise reform	2.3	2.3	2.3	2.3	2.7	2.7	2.7
Markets and trade							
Share of administered prices in CPI (in per cent)	17.2	20.0	20.6	21.3	22.0	24.7	21.3
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	80.4	76.0	72.1	76.4	77.1	78.0	na
Share of trade in GDP (in per cent)	70.2	85.9	87.1	83.4	88.6	95.6	na
Tariff revenues (in per cent of imports)	10.2	9.9	8.9	9.9	10.2	9.4	na
EBRD index of price liberalisation	4.0	4.0	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	2.3	2.7
Number of banks (foreign-owned)	34 (22)	35 (25)	35 (26)	34 (26)	35 (25)	35 (24)	na
Asset share of state-owned banks (in per cent)	50.5	19.8	19.9	14.1	2.5	2.3	na
Asset share of foreign-owned banks (in per cent)	42.8	75.3	72.7	75.2	82.7	81.6	na
Non-performing loans (in per cent of total loans)	17.5	10.9	7.9	10.4	4.4	3.7	na
Domestic credit to private sector (in per cent of GDP)	14.0	11.6	14.6	18.0	25.8	23.2	na
Domestic credit to households (in per cent of GDP)	2.1	2.1	2.8	3.7	7.2	10.0	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	1.2	2.7	na
Stock market capitalisation (in per cent of GDP)	5.8	4.8	3.7	4.3	7.9	10.6	na
Stock trading volume (in per cent of market capitalisation)	9.7	9.0	13.0	14.0	16.0	23.0	na
Eurobond issuance (in per cent of GDP)	0.4	0.0	1.6	12.8	0.0	1.1	na
EBRD index of banking sector reform	2.7	3.0	3.0	3.3	3.3	3.7	3.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	34.2 (4.2)	35.0 (9.0)	35.9 (19.1)	36.8 (33.3)	37.2 (50.0)	35.4 (60.4)	na
Internet penetration rate (per 10,000 inhabitants)	19.4	22.7	33.2	42.3	66.6	84.0	na
Railway labour productivity (1989=100)	65.3	71.2	70.3	65.9	75.2	78.4	na
Residential electricity tariffs (in USc kWh)	na	3.5	3.8	5.2	5.2	3.8	na
Average collection rate, electricity (in per cent) [2]	112	na	85	95	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.5	2.7	2.7	3.0	na	na	na
EBRD index of infrastructure reform	2.7	2.7	2.7	2.7	2.7	3.0	3.0
Electric power	3.0	3.3	3.3	3.3	3.3	3.7	3.7
Railways	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.7
Telecommunications	3.0	3.0	3.0	3.0	3.0	3.3	3.3
Water and waste water	2.0	3.0	3.0	3.0	3.0	3.0	3.0

1 The official 12.8 per cent poverty rate, reported in the Bulgaria 2001 Poverty Assessment published by the World Bank, is based on a different poverty line. The latter was fixed at two-thirds of the 1997 average per capita consumption, deflated by 2001 prices.

2 Numbers greater than 100 per cent reflect the collection of arrears.

	1999	2000	2001	2002	2003	2004 *Estimate*	2005 *Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	2.3	5.4	4.0	4.8	4.5	5.6	5.5
Private consumption	9.3	4.9	4.5	3.9	7.1	4.8	na
Public consumption	4.1	13.3	4.7	6.2	3.0	5.8	na
Gross fixed capital formation	20.8	15.4	19.9	9.3	13.9	12.0	na
Exports of goods and services	-5.0	16.6	8.5	6.2	8.0	13.1	na
Imports of goods and services	9.3	18.6	13.0	4.7	15.3	14.1	na
Industrial gross output	-4.3	12.0	0.7	2.6	12.0	15.0	na
Agricultural gross output	2.7	-9.1	-0.1	4.2	-1.4	na	na
Employment			*(Percentage change)*				
Labour force (end-year)	-2.7	-3.4	-0.2	-0.5	1.1	1.2	na
Employment (end-year)	-3.9	-2.7	-3.9	2.9	4.5	3.4	na
			(In per cent of labour force)				
Unemployment (end-year)	17.0	16.4	19.5	16.8	13.7	12.0	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	0.7	9.9	7.4	5.9	2.3	6.1	4.2
Consumer prices (end-year)	6.2	11.4	4.8	3.9	5.6	4.0	4.3
Producer prices (annual average)	4.4	17.3	3.6	1.3	4.9	6.0	na
Producer prices (end-year)	14.0	14.7	-1.8	6.3	4.3	5.2	na
Gross average monthly earnings in economy (annual average)	5.1	15.7	11.9	4.2	6.9	3.2	na
Government sector			*(In per cent of GDP)*				
General government balance [1]	-0.9	-1.0	-0.9	-0.6	-0.4	1.8	1.0
General government expenditure [1]	39.6	39.7	38.6	37.2	38.4	37.5	na
General government debt [2]	99.1	89.3	70.9	55.1	46.8	40.9	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	13.4	7.5	53.0	11.7	18.8	23.3	na
Domestic credit (end-year)	3.9	31.0	26.0	27.4	33.9	34.3	na
			(In per cent of GDP)				
Broad money (M2, end-year)	31.7	30.3	41.9	42.9	47.8	53.4	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Base interest rate [3]	4.5	4.6	4.7	3.3	2.8	2.4	na
Interbank interest rate (up to 1 month)	2.9	3.0	3.7	2.5	1.1	2.0	na
Deposit rate (1 month)	3.3	3.1	2.9	2.8	2.8	3.3	na
Lending rate (less than 1 year)	14.1	11.5	11.1	9.4	9.1	8.4	na
			(Leva per US dollar)				
Exchange rate (end-year) [4]	1.9	2.1	2.2	1.9	1.5	1.4	na
Exchange rate (annual average) [4]	1.8	2.1	2.2	2.1	1.7	1.6	na
External sector			*(In millions of US dollars)*				
Current account	-652	-704	-984	-827	-1,856	-1,806	-2,003
Trade balance	-1,081	-1,176	-1,581	-1,595	-2,519	-3,353	-3,975
Merchandise exports	4,006	4,825	5,113	5,692	7,541	9,859	11,702
Merchandise imports	5,087	6,000	6,693	7,287	10,059	13,212	15,678
Foreign direct investment, net	802	998	803	876	2,070	1,232	2,697
Gross reserves, excluding gold (end-year)	2,900	3,460	3,591	4,407	6,291	8,776	na
External debt stock	10,907	11,165	10,626	11,312	13,437	16,713	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	5.3	5.4	5.1	5.8	6.0	6.4	na
			(In per cent of exports of goods and services)				
Debt service	18.0	16.7	20.9	16.3	14.0	24.6	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	8.2	8.1	7.9	7.8	7.8	7.8	na
GDP (in millions of leva) [4]	23,790	26,753	29,618	32,324	34,410	38,008	41,302
GDP per capita (in US dollars)	1,582	1,546	1,718	1,984	2,546	3,109	na
Share of industry in GDP (in per cent)	25.1	25.8	25.2	24.5	20.6	26.0	na
Share of agriculture in GDP (in per cent)	14.5	12.3	12.1	11.0	10.1	9.4	na
Current account/GDP (in per cent)	-5.0	-5.6	-7.3	-5.3	-9.3	-7.5	-7.5
External debt - reserves (in US$ million)	8,007	7,705	7,035	6,905	7,146	7,937	na
External debt/GDP (in per cent)	84.2	88.6	78.4	72.7	67.7	69.3	na
External debt/exports of goods and services (in per cent)	188.2	159.5	146.8	140.4	125.5	119.5	na

[1] In 2003 and 2004 general government expenditure includes capital transfers for about 0.4 per cent of GDP, which were classified below the line in the Budget Law.

[2] From April 2001 direct debt to the Bulgarian National Bank (BNB) is excluded from domestic debt to avoid double reporting of IMF credit extended through the BNB.

[3] Effective interest rate at end-month, based on the average annual yield attained at three-month government securities primary actions.

[4] The lev was redenominated in July 1999. All data have been converted to the post-July 1999 rate.

Croatia

Key challenges

- The privatisation and restructuring of remaining state-owned assets remains a priority.
- While administrative barriers to doing business have been reduced, further measures are still needed to enhance the functioning of the judiciary and public administration.
- A continuation of tight monetary policies and further fiscal consolidation are crucial to lower the persistently large external imbalances.

Country data

Population (in millions)	**4.4**
Area ('000 sq. km)	**87.6**
GDP (in billion US$, 2004)	**34.3**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 12,336**
National currency	**Kuna**

Progress in structural reform

Liberalisation and privatisation

The privatisation process regained some momentum in early 2005 with the sale of several agricultural and food processing companies, as well as the successful privatisation of a major tourist resort, Suncari Hvar, under a public-private partnership. As a result, the value of state-owned assets still under the responsibility of the Croatian Privatisation Fund (CPF) fell by 13 per cent in the first half of 2005. However, the initial objective to complete all small-scale privatisations by June 2005 has not been achieved, partly due to several lawsuits against the CPF. The prospects for privatising a number of strategic entities not included in the CPF portfolio, such as the insurance company CO, also remain uncertain.

In August 2005 the government overruled a CPF decision to transfer an 85 per cent stake in the tourist company Liburnia Riviera Hoteli to two former privatisation investment funds. The head of the CPF was dismissed for his role in the proposed transaction. The transfer had been intended as settlement of outstanding state debt accumulated during the coupon privatisation in the late 1990s.

Business environment and competition

The first "one-stop shop" for company registration was established in Zagreb in May 2005, followed by similar offices in Split, Osijek and Rijeka. Others are planned to further reduce the administrative burden. The average registration time is expected to come down to 16 days in 2005 from over 50 days in 2004. Registration time has already been reduced to three days for crafts and trades. However, there is still widespread dissatisfaction in the business community about inefficiencies in the judicial system.

Progress has also been made on the reform of the land registry. Procedures have been simplified and judges have been replaced by authorised land registry clerks. The backlog of land registry cases was reduced from around 360,000 in mid-2004 to around 270,000 by the end of April 2005. However, the remaining backlog and persisting administrative weaknesses still hamper the development of a real estate market.

Infrastructure

An international adviser has been selected for the second-phase privatisation of the oil company INA, which involves the sale of a further 15 per cent stake. The restructuring of the state-owned, vertically integrated electricity company HEP has been delayed. However, a restructuring plan was eventually adopted in April 2005 and a foreign consultant was contracted to undertake the reforms. The government intervened directly in the sector when it halved the 12 per cent tariff increase sought by HEP and endorsed by the energy regulatory agency.

The new telecommunications regulatory agency, established in September 2004, has broken the monopoly of Croatia Telecom (T-HT) in the fixed-line market by awarding 12 licences. However, only T-HT and two local companies have so far launched services.

Competition in the mobile market has also increased following the award of a third GSM licence to the Swedish operator Tele2. The new entrant has launched its network and is preparing to start operations. In June 2005 the regulatory agency launched the tender for a fourth GSM licence, but subsequently rejected the sole bid submitted by a Syrian-led consortium.

Financial sector

The banking system has been strengthened and its creditworthiness improved. This reflects the radical capitalisation and restructuring carried out primarily in the foreign-owned banks, which account for more than 90 per cent of banking assets. Sector concentration remains significant, with the top two banks holding some 43 per cent of total assets. Given the growing foreign indebtedness of banks, the sector has also become more vulnerable to unfavourable exchange rate developments.

The banking sector continued to expand on the back of strong domestic demand for credit. However, by the end of 2004 the share of bank assets in total financial assets had fallen to less than 82 per cent. The biggest winners were leasing companies, whose asset share grew to about 6 per cent of the total. Smaller financial players such as pension funds, open-end investment funds and housing savings societies also grew above average, although their combined asset share remains below 3 per cent.

Macroeconomic performance

Real economy

Real GDP growth slowed to 1.8 per cent year-on-year in the first quarter of 2005, compared with the 3.8 per cent achieved in 2004. Private consumption weakened for the second consecutive quarter and annual export growth dropped from 5.8 per cent in the fourth quarter of 2004 to 1 per cent in the first quarter of 2005. However, preliminary second-quarter figures for industrial production indicate an upturn and may support real GDP growth of 3.5 per cent for the year as a whole.

Economic policies

Annual inflation has remained relatively low. Nevertheless, there was some upward pressure on prices in the second half of 2004 and in early 2005, mainly due to higher energy and food costs and excise taxes. This led to a slight increase in annual average inflation from 2.1 per cent in 2004 to 2.6 per cent in June 2005. The Croatian National Bank (CNB) remains committed to exchange rate stability.

On the fiscal side, the general government deficit in 2004 was 4.9 per cent of GDP. This was down from 6.3 per cent in 2003 but above the government's target of 4.5 per cent. In line with the precautionary Stand-By Arrangement with the IMF, the budget was amended in July 2005 to give a general government deficit target of 4.2 per cent of GDP. This is higher than the initial target of 3.7 per cent, but it was agreed with the IMF. Achievement of this target is conditional on reforms in the pension and health care systems, state subsidies and privatisation.

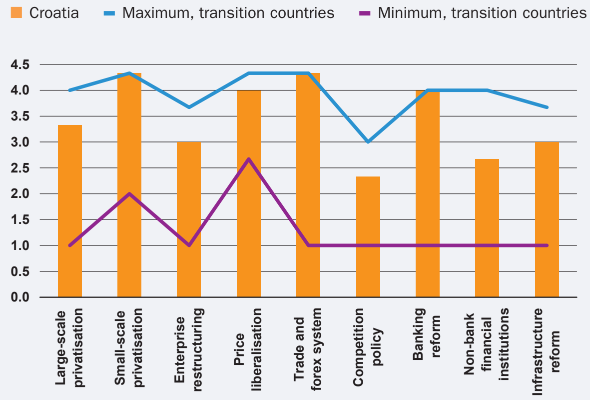
External sector

The current account deficit fell to around 5 per cent of GDP in 2004, down from 7.2 per cent in 2003, reflecting significantly higher exports. Gross external debt exceeded 82 per cent of GDP, at the end of 2004. However, it had dipped below that figure by May 2005. The biggest decline has been in government external debt, as the government has borrowed on domestic markets during 2005. The commercial banks' foreign indebtedness is also falling, due partly to measures taken by the Croatian National Bank. In particular, there were two increases so far in 2005 in the marginal reserve requirement on foreign liabilities of commercial banks (most recently in May from 30 to 40 per cent).

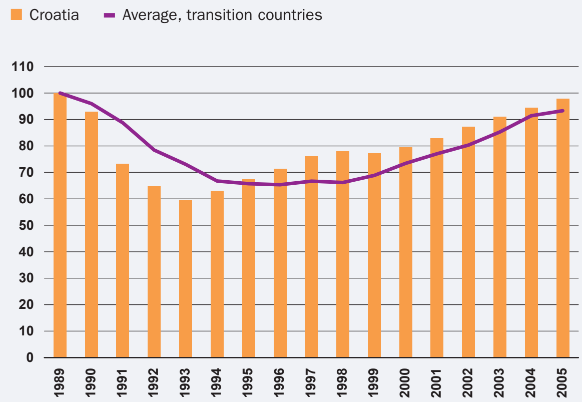
Outlook and risks

Sustained growth of real output in the region of 3 to 5 per cent each year is forecast for the medium term, assuming some improvement in the external environment. The competitiveness of Croatia's export industries has improved, but still lags behind that of several neighbouring countries. The fiscal consolidation programme agreed with the IMF is expected to help the government strengthen fiscal discipline and reduce the external deficit and the high level of external indebtedness, which pose a major risk to future growth.

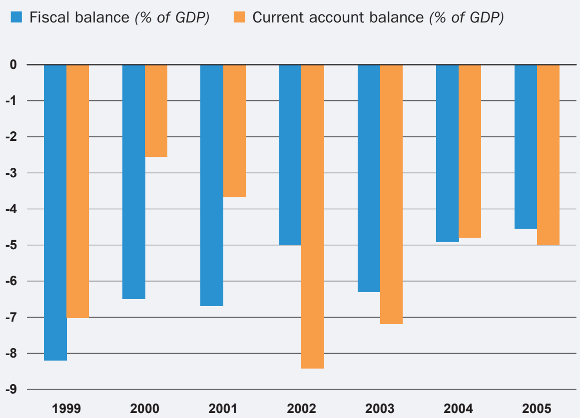
Transition indicators, 2005



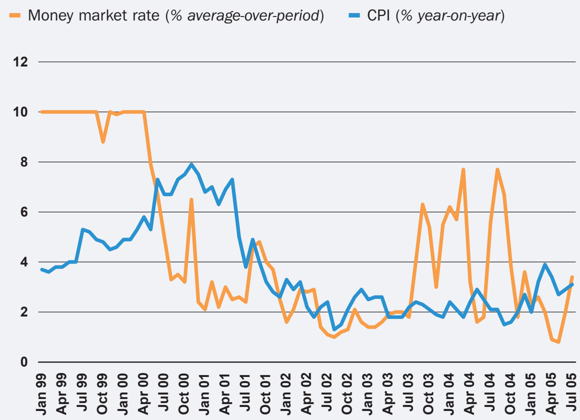
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no** [1]

Interest rate liberalisation – **full**

Exchange rate regime – **managed float**

Wage regulation – **no**

Tradability of land – **full** [2]

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **high**

Secured transactions law – **inefficient**

Quality of corporate governance law – **medium**

Infrastructure

Independent telecoms regulator – **partially**

Independent electricity regulator – **partially**

Separation of railway infrastructure from operations – **partially**

Quality of concession laws – **medium**

Financial sector

Capital adequacy ratio – **10 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **high**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **<2 per cent** (2001)

Government expenditure on health – **7.0 per cent of GDP**

Government expenditure on education – **4.7 per cent of GDP**

Share of power, water in total household expenditure – **13.2 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP) [3]	8.2	10.2	13.5	15.3	17.5	18.7	na
Private sector share in GDP (in per cent)	60.0	60.0	60.0	60.0	60.0	60.0	60.0
Private sector share in employment (in per cent)	58.0	56.0	58.0	58.0	60.0	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	10.1	11.4	16.7	19.0	19.7	na	na
Share of industry in total employment (in per cent) [4]	28.3	27.7	27.7	27.1	27.3	na	na
Change in labour productivity in industry (in per cent)	1.8	4.3	7.7	7.7	4.5	na	na
Investment/GDP (in per cent)	23.0	20.2	21.5	26.6	30.4	na	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.3	3.3	3.3
EBRD index of enterprise reform	2.7	2.7	2.7	2.7	2.7	3.0	3.0
Markets and trade							
Share of administered prices in CPI (in per cent)	3.0	5.6	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	1.0	1.0	1.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	69.8	68.9	73.0	72.6	74.2	78.0	na
Share of trade in GDP (in per cent)	60.7	67.0	68.6	68.7	71.3	72.2	na
Tariff revenues (in per cent of imports) [5]	7.8	6.1	4.4	2.4	1.9	na	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial sector							
Number of banks (foreign-owned)	53 (13)	43 (21)	43 (24)	46 (23)	41 (19)	37 (15)	na
Asset share of state-owned banks (in per cent)	39.8	5.7	5.0	4.0	3.4	3.3	na
Asset share of foreign-owned banks (in per cent)	40.3	84.1	89.3	90.2	91.0	91.2	na
Non-performing loans (in per cent of total loans)	20.6	19.8	15.0	11.0	9.1	8.5	na
Domestic credit to private sector (in per cent of GDP)	22.1	27.8	33.7	44.0	48.5	52.1	na
Domestic credit to households (in per cent of GDP)	13.6	15.3	18.2	24.0	28.5	31.5	na
Of which mortgage lending (in per cent of GDP)	5.3	5.4	5.7	6.9	8.8	10.3	na
Stock market capitalisation (in per cent of GDP)	14.0	14.5	16.8	16.1	19.2	29.8	na
Stock trading volume (in per cent of market capitalisation)	5.0	7.0	4.0	4.0	5.0	6.0	na
Eurobond issuance (in per cent of GDP)	3.2	5.2	6.3	3.7	3.3	4.5	na
EBRD index of banking sector reform	3.0	3.3	3.3	3.7	3.7	4.0	4.0
EBRD index of reform of non-bank financial institutions	2.3	2.3	2.3	2.7	2.7	2.7	2.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	36.5 (6.6)	36.5 (23.1)	40.7 (40.1)	41.7 (53.5)	43.3 (58.4)	38.9 (58.4)	na
Internet penetration rate (per 10,000 inhabitants)	31.9	37.9	50.3	67.8	67.8	78.6	na
Railway labour productivity (1989=100)	49.8	55.4	67.3	78.1	90.4	92.7	na
Residential electricity tariffs (in USc kWh)	5.5	5.1	6.1	6.5	8.2	11.1	na
Average collection rate, electricity (in per cent)	na	93	95	94	95	96	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.7	5.1	5.4	5.5	na	na	na
EBRD index of infrastructure reform	2.3	2.3	2.7	2.7	2.7	3.0	3.0
Electric power	2.3	2.3	3.0	3.0	3.0	3.0	3.0
Railways	2.3	2.3	2.3	2.3	2.3	2.7	2.7
Roads	2.3	2.3	2.3	2.3	2.7	2.7	2.7
Telecommunications	3.0	3.0	3.3	3.3	3.3	3.3	3.3
Water and waste water	3.0	3.0	3.3	3.3	3.3	3.3	3.3

1 Registration is required with commercial courts and the Croatian Central Bank.

2 Land is tradable but the right to trade land applies to foreigners only on a reciprocity basis. Foreigners cannot acquire certain types of land (including agricultural) from the state.

3 Excludes swaps with frozen currency deposits.

4 Based on Employment Service and enterprise data according to the National Classification of Economic Activities.

5 Refers to all taxes on international trade.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	-0.9	2.9	4.4	5.2	4.3	3.8	3.5
Private consumption	-2.9	4.2	4.6	7.5	4.1	3.9	na
Public consumption	-1.0	-8.9	-4.3	-1.8	-1.8	-0.3	na
Gross fixed capital formation	-3.9	-3.8	9.7	10.1	na	na	na
Exports of goods and services	0.7	12.0	8.1	1.3	10.1	5.4	na
Imports of goods and services	-3.5	3.7	9.3	8.8	10.9	3.5	na
Industrial gross output	-1.4	1.7	6.0	5.4	5.0	4.8	na
Agricultural gross output	-3.5	2.8	8.7	4.5	1.7	3.2	na
Employment [1]			*(Percentage change)*				
Labour force (end-year)	-1.0	7.2	-5.6	2.7	-0.1	1.1	na
Employment (end-year)	-3.4	4.1	-5.4	4.0	0.6	3.0	na
			(In per cent of labour force)				
Unemployment (end-year)	13.6	16.1	15.8	14.8	14.3	13.8	na
Prices and wages			*(Percentage change)*				
Retail prices (annual average)	4.2	6.2	4.9	2.2	1.8	2.1	2.9
Retail prices (end-year)	4.4	7.4	2.6	2.9	2.2	2.7	2.9
Producer prices (annual average)	2.6	9.7	3.7	-0.5	1.9	3.5	na
Producer prices (end-year)	5.9	11.2	-3.1	2.3	1.0	4.8	na
Gross average monthly earnings in economy (annual average)	10.2	7.0	3.9	6.0	4.8	3.1	na
Government sector [2]			*(In per cent of GDP)*				
General government balance	-8.2	-6.5	-6.7	-5.0	-6.3	-4.9	-4.5
General government expenditure	56.6	52.7	50.7	51.4	52.7	52.0	na
General government debt	46.4	51.1	50.8	50.7	53.2	54.3	na
Monetary sector			*(Percentage change)*				
Broad money (M4, end-year)	-1.2	28.9	45.2	9.5	11.0	9.4	na
Domestic credit (end-year)	-1.5	9.3	21.6	28.4	12.3	10.0	na
			(In per cent of GDP)				
Broad money (M4, end-year)	40.0	47.9	64.0	64.7	66.8	68.1	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate (3 months)	11.6	7.0	4.3	2.7	2.5	3.9	na
Interbank interest rate (daily)	12.7	4.5	2.2	1.9	6.8	7.0	na
Deposit rate [3]	4.3	3.4	2.8	1.6	1.7	1.7	na
Lending rate [3]	13.5	10.5	9.5	10.9	12.0	11.8	na
			(Kuna per US dollar)				
Exchange rate (end-year)	7.6	8.2	8.4	7.1	6.1	5.6	na
Exchange rate (annual average)	7.1	8.3	8.3	7.9	6.7	6.0	na
External sector			*(In millions of US dollars)*				
Current account	-1,397	-469	-726	-1,920	-2,072	-1,641	-1,869
Trade balance	-3,299	-3,204	-4,101	-5,649	-7,908	-8,346	-8,542
Merchandise exports	4,395	4,567	4,759	5,004	6,308	8,208	8,840
Merchandise imports	7,693	7,771	8,860	10,652	14,216	16,555	17,382
Foreign direct investment, net	1,420	1,085	1,407	591	1,700	898	1,000
Gross reserves, excluding gold (end-year)	3,025	3,525	4,704	5,886	8,191	8,700	na
External debt stock	10,143	11,282	11,870	15,680	24,759	30,200	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.7	4.4	5.2	5.4	5.7	5.2	na
			(In per cent of exports of goods and services)				
Debt service	22.4	22.9	19.6	23.2	19.5	22.3	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	4.6	4.4	4.4	4.4	4.4	4.4	na
GDP (in billions of kuna)	142	153	166	179	193	207	223
GDP per capita (in US dollars)	4,371	4,206	4,476	5,131	6,484	7,721	na
Share of industry in GDP (in per cent)	20.7	20.7	20.4	19.6	19.2	19.1	na
Share of agriculture in GDP (in per cent) [4]	8.1	7.4	7.5	7.3	6.9	6.8	na
Current account/GDP (in per cent)	-7.0	-2.5	-3.7	-8.4	-7.2	-4.8	-5.0
External debt - reserves (in US$ million)	7,118	7,757	7,166	9,794	16,568	21,500	na
External debt/GDP (in per cent) [5]	54.8	60.6	60.7	62.2	77.6	82.1	na
External debt/exports of goods and services (in per cent)	124.9	130.2	123.2	148.3	165.7	169.4	na

[1] Based on labour force surveys.
[2] Consolidated central government. Government expenditures include net lending. From 2002 data based on government finance statistics 2001.
[3] Weighted average over all maturities.
[4] Includes hunting, forestry and fishing.
[5] Ratio calculated in euros.

Czech Republic

Key challenges

- Further reforms are needed to improve the business environment and reduce corruption, including parliamentary adoption of the new bankruptcy code, simplification of tax codes, enhanced transparency in public administration and improvements to the legal system.
- The continued restructuring of state-owned companies remains a priority, together with improvements in labour mobility to promote employment.
- Comprehensive reform of the education, health care, social security and pension systems are needed to make public finances and debt levels sustainable over the medium term.

Country data

Population (in millions)	**10.2**
Area ('000 sq. km)	**78.9**
GDP (in billion US$, 2004)	**107.0**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 19,311**
National currency	**Koruna (Crown)**

Progress in structural reform

Liberalisation and privatisation

The government has continued with the privatisation of a number of high-profile companies and the process is nearing completion. The privatisation of the petrochemicals company Unipetrol was completed in May 2005, with the sale of a 62.99 per cent stake to Poland's PKN Orlen. In June 2005 the government finalised the sale of its 51.1 per cent stake in Cesky Telecom to Telefonica of Spain. At CZK 83 billion (€2.8 billion), this was the second largest Czech privatisation to date.

The government announced the sale of Vitkovice Steel, the country's third largest steel producer, to Russia's Evraz Holding in July 2005. In the same month the government opened exclusive talks with the state-owned power company Ceske Energeticke Zavody (CEZ) on the sale of the state's 55 per cent stake in the leading brown coal mining company Severoceske doly. CEZ currently holds close to a 37 per cent stake in Severoceske and buys 80 per cent of the mine's production. An earlier controversial attempt to sell the coal mine had been abandoned in March 2004 after the government concluded that the received offers were too low.

The National Privatisation Fund is scheduled to close down at the end of 2005. The remaining state holdings are likely to be transferred to the Ministry of Finance. The authorities also announced plans to divest assets from, and wind down the activities of, the Czech Consolidation Agency (CKA) by the end of 2007. This should help to limit both direct state involvement in enterprise restructuring and potential future drains on the general government budget.

Business environment and competition

The Czech Republic still ranks as the country with the highest inflow of foreign direct investment (FDI) per capita in the transition region, estimated at US$380 by the end of 2004. This is partly attributable to the country's advantageous geographical location and its well-educated workforce. It also reflects the work of the CzechInvest promotion agency and the provision of a number of investment incentives in select cases. However, recent surveys – such as the EBRD/World Bank Business Environment and Enterprise Performance Survey – point to continued problems in the business environment. These relate particularly to the protection of property rights, business regulation and the functioning of the judiciary. Some steps have been taken to address these problems. In February 2005 the government simplified company registration through the introduction of standardised forms and an automatic five-day registration deadline.

Progress has also been made in establishing a "one-stop shop" for trade licensing. In August 2005 the government finally approved a long-awaited new law on bankruptcy, which strengthens creditor rights and facilitates procedures. The law, however, still needs to be approved by parliament. Measures to increase transparency in the awarding of public contracts, the introduction of a conflict of interest law and legislation to reduce political immunity are still pending. Moreover, steps to simplify the tax code and tax administration have not yet been taken.

Infrastructure

The restructuring of state-owned companies in the mining, steel, railway and energy sectors remains a priority. In January 2005 the European Commission approved the Czech Republic's compensation plan for workers affected by the restructuring of the national rail operator Ceske drahy (CD). Compensation valued at CZK 1.86 billion (€62 million) will be available for an estimated 11,100 of the 16,000 employees to be made redundant in 2004-08. Some 6,800 of CD's 70,000 employees were dismissed in 2004 and a further 6,000 redundancies are scheduled for 2005. The restructuring of CD also envisages the transfer of the entire freight and passenger transport divisions into separate holding subsidiaries.

In July 2005 CEZ announced a restructuring plan which envisages a staff cut of about 1,500 and a reduction in operating costs by over CZK 5 billion (€167 million). Under the plan, the assets and staff of five power distributors in the CEZ group will be transformed into 10 new firms. The restructuring plan will comply with a law requiring the separation of distribution and sales activities.

Social sector

The unemployment rate, although below the regional average, remained high at 8.3 per cent in 2004. The authorities have initiated measures to address rising youth and long-term unemployment, regional disparities, skills mismatches and low labour force mobility. In July 2005 the government announced a cut to subsistence-level benefits to encourage more active job seeking. It has also limited the rate of increase in social benefits.

Macroeconomic performance

Real economy

The economy grew by 4.4 per cent in 2004, the highest rate since 1996. In the first and second quarters of 2005 year-on-year growth remained robust at 4.7 and 5.1 per cent respectively. Growth continues to be driven by exports and gross capital formation, while private and government consumption has remained subdued. However, the unemployment rate (which was 8.3 per cent in 2004) and non-wage labour costs are still high. Therefore, increasing labour market flexibility further remains a priority.

Economic policies

The general government deficit declined sharply from 11.7 per cent in 2003 to 3.3 per cent in 2004. This was mostly due to one-off factors in 2003 (such as banking sector restructuring costs) and the introduction of revised budgetary rules in 2004 allowing unspent allocations to be carried over. Current plans envisage an increase in the general government deficit of 1.5 to 2 percentage points to reach 4.5 to 5 per cent of GDP in 2005. This represents a significant pro-cyclical stimulus, although developments so far this year suggest the increase could be smaller. Recent discussions about fiscal reforms have focused on social welfare expenditure cuts, pension and health care reform, and reductions in direct taxation. However, both the political consensus and popular support for fiscal reform are lacking. Public debt has more than doubled since 2000, reaching 37.4 per cent of GDP at the end of 2004. Meanwhile, annual inflation remains low at less than 2 per cent in August 2005.

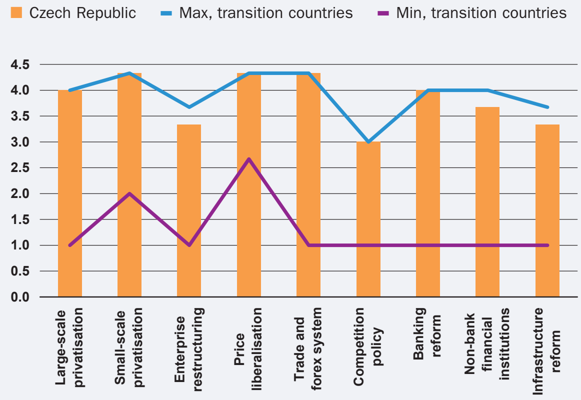
External sector

The current account deficit declined to 5.2 per cent of GDP in 2004. This was largely due to a fall in the trade deficit to less than 1 per cent of GDP as a result of strong export growth. The deficit on the income account, consisting mostly of reinvested earnings and dividends of foreign-owned enterprises, widened further to 5.1 per cent of GDP. Net FDI inflows more than doubled in 2004 compared with the previous year to US$3.9 billion. Net FDI levels are expected to increase further in 2005 to around US$8.5 billion as a result of the recent privatisations. External debt had risen as a share of GDP to about 37 per cent by the end of 2004. International reserves (excluding gold) still exceeded four months of imports in 2004.

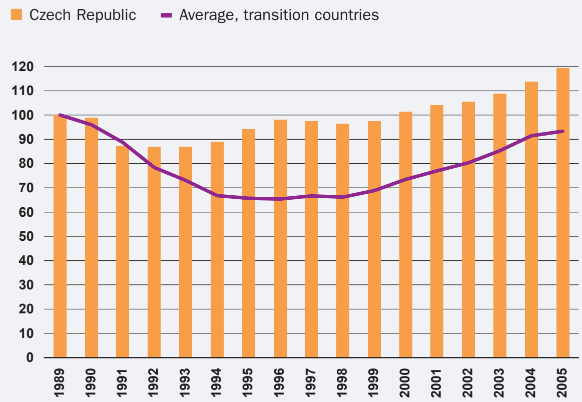
Outlook and risks

Medium-term prospects for the economy are favourable. Record FDI inflows should result in robust GDP growth over the next few years, while consumer prices and the exchange rate are expected to remain stable. However, recent economic performance has not been underpinned by fundamental reform. In particular, the slow speed of fiscal consolidation remains the main macroeconomic risk. More determined action is needed to enhance labour mobility, improve the business environment and reform the pensions, health and social security systems. This would lessen the vulnerability to external shocks and the escalation of adjustment costs.

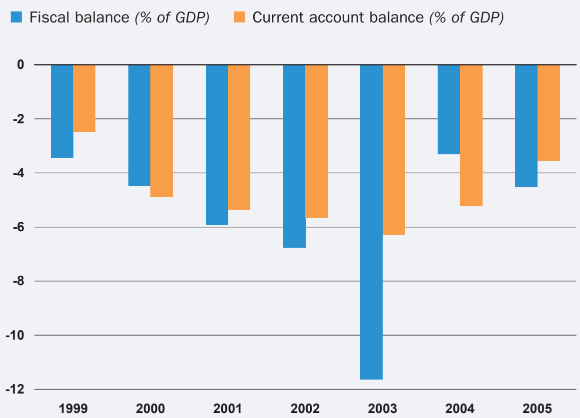
Transition indicators, 2005



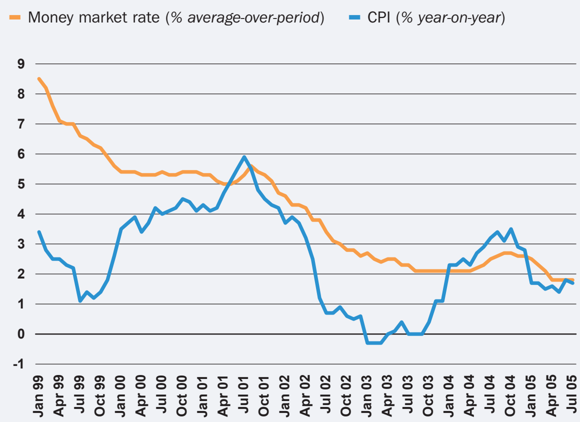
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **8 per cent**	Share of population living in poverty – **<2 per cent** (1996)
Controls on inward direct investment – **yes** [1]	Quality of insolvency law – **medium**	Independent electricity regulator – **fully**	Deposit insurance system – **yes**	Government expenditure on health – **5.5 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **inefficient**	Separation of railway infrastructure from operations – **fully**	Quality of securities market laws – **medium**	Government expenditure on education – **4.7 per cent of GDP**
Exchange rate regime – **managed float**	Quality of corporate governance law – **medium**	Quality of concession laws – **na** [2]	Private pension funds – **yes**	Share of power, water in total household expenditure – **7.0 per cent**
Wage regulation – **no**				
Tradability of land – **full except foreigners**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	11.5	12.4	15.0	20.3	21.3	21.9	na
Private sector share in GDP (in per cent)	80.0	80.0	80.0	80.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	65.0	65.0	70.0	70.0	70.0	70.0	na
Budgetary subsidies and current transfers (in per cent of GDP)[3]	6.6	6.5	7.0	7.4	9.0	9.3	na
Share of industry in total employment (in per cent)	30.8	30.2	31.0	30.7	30.1	29.9	na
Change in labour productivity in industry (in per cent)	3.1	8.0	4.2	4.9	8.6	11.1	na
Investment/GDP (in per cent)	32.6	33.2	34.2	34.9	35.7	35.0	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of enterprise reform	3.0	3.3	3.3	3.3	3.3	3.3	3.3
Markets and trade							
Share of administered prices in CPI (in per cent)	13.3	13.3	12.4	12.4	10.9	10.9	10.9
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	73.9	76.8	79.9	80.7	80.6	79.1	na
Share of trade in GDP (in per cent)	92.3	110.0	114.7	106.9	109.9	125.4	na
Tariff revenues (in per cent of imports)	1.2	1.1	0.7	0.7	0.7	0.3	0.2
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Financial sector							
Number of banks (foreign-owned)	42 (27)	40 (26)	38 (26)	37 (26)	35 (26)	35 (26)	na
Asset share of state-owned banks (in per cent)	41.2	27.8	3.8	4.6	3.0	2.9	na
Asset share of foreign-owned banks (in per cent)	38.4	65.4	89.1	85.8	86.3	84.9	na
Non-performing loans (in per cent of total loans)	43.4	39.7	14.8	9.5	5.0	4.1	na
Domestic credit to private sector (in per cent of GDP)	40.0	35.7	27.3	24.0	25.0	27.1	na
Domestic credit to households (in per cent of GDP)	5.5	5.7	6.0	7.4	9.2	11.3	na
Of which mortgage lending (in per cent of GDP)	1.5	2.0	2.4	3.1	4.3	6.0	na
Stock market capitalisation (in per cent of GDP)	22.3	20.9	15.3	21.0	17.8	25.7	na
Stock trading volume (in per cent of market capitalisation)	37.0	60.0	34.0	37.0	52.0	79.0	na
Eurobond issuance (in per cent of GDP)	0.8	0.0	0.1	0.6	0.4	2.8	na
EBRD index of banking sector reform	3.3	3.3	3.7	3.7	3.7	3.7	4.0
EBRD index of reform of non-bank financial institutions	3.0	3.0	3.0	3.0	3.0	3.3	3.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	37.1 (19.0)	37.8 (42.4)	37.8 (68.0)	36.2 (84.9)	36.0 (96.5)	33.7 (105.3)	na
Internet penetration rate (per 10,000 inhabitants)	118.6	154.5	210.8	223.2	274.4	376.1	na
Railway labour productivity (1989=100)	66.6	72.2	71.8	68.0	71.0	72.4	na
Residential electricity tariffs (in USc kWh)	5.1	5.7	7.3	9.0	8.4	10.3	na
Average collection rate, electricity (in per cent)	100	100	100	100	100	100	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.5	3.6	3.7	3.8	na	na	na
EBRD index of infrastructure reform	2.7	2.7	3.0	3.0	3.3	3.3	3.3
Electric power	2.0	2.0	3.0	3.0	3.3	3.3	3.3
Railways	2.3	2.3	2.3	2.3	3.0	3.0	3.0
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	4.0	4.0	4.0	4.0	4.0	4.0	4.3
Water and waste water	4.0	4.0	4.0	4.0	4.0	4.0	4.0

[1] There are controls in the air-transport sector for non-resident investors.

[2] The Czech Republic has no specific concession law but largely conforms with internationally accepted principles on concession laws.

[3] Subsidies to enterprises and financial institutions, including the Czech Consolidation Agency.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	1.2	3.9	2.6	1.5	3.2	4.4	5.0
Private consumption	2.2	2.9	2.8	2.7	4.6	2.0	na
Public consumption	2.3	-1.0	5.3	4.5	3.8	-2.0	na
Gross fixed capital formation	-3.5	4.9	5.4	3.4	4.7	7.6	na
Exports of goods and services	5.5	16.5	11.5	2.1	7.5	21.9	na
Imports of goods and services	5.0	16.3	13.0	4.9	7.9	18.4	na
Industrial gross output	-0.4	5.1	6.8	4.8	5.8	9.9	na
Agricultural gross output	2.3	-4.5	2.5	-4.4	0.0	2.3	na
Employment			*(Percentage change)*				
Labour force (end-year)	0.4	0.2	0.0	1.0	0.4	0.0	na
Employment (end-year)	-2.1	-0.7	-0.1	0.8	-0.7	-0.6	na
			(In per cent of labour force)				
Unemployment (end-year)	8.7	8.8	8.1	7.3	7.8	8.3	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	2.1	4.0	4.7	1.8	0.2	2.8	2.0
Consumer prices (end-year)	2.6	4.1	4.2	0.6	1.1	2.8	2.8
Producer prices (annual average)	1.0	4.9	2.9	-0.5	-0.3	5.7	na
Producer prices (end-year)	3.4	5.0	0.8	-0.7	0.9	7.7	na
Gross average monthly earnings in economy (annual average)	8.2	7.0	8.6	7.5	7.0	6.6	na
Government sector[1]			*(In per cent of GDP)*				
General government balance	-3.4	-4.5	-5.9	-6.8	-11.6	-3.3	-4.5
General government expenditure	39.0	40.4	41.6	43.9	43.7	41.9	na
General government debt	13.5	18.5	27.2	30.7	38.3	37.4	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	8.1	6.8	7.9	3.2	7.2	4.4	na
Domestic credit (end-year)	-2.0	1.0	-5.3	-7.1	21.9	0.1	na
			(In per cent of GDP)				
Broad money (M2, end-year)	67.8	68.8	68.9	68.2	69.1	67.1	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
2-week repo rate	5.3	5.3	4.8	2.8	2.0	2.5	na
3-month PRIBOR	5.6	5.4	4.7	2.6	2.1	2.6	na
Deposit rate	4.5	3.4	2.6	1.7	1.3	1.4	na
Lending rate	8.7	7.2	8.7	8.8	8.2	8.0	na
			(Korunas per US dollar)				
Exchange rate (end-year)	35.7	38.8	36.5	30.7	26.3	22.9	na
Exchange rate (annual average)	34.6	38.6	38.0	32.7	28.2	25.7	na
External sector			*(In millions of US dollars)*				
Current account	-1,462	-2,718	-3,273	-4,166	-5,690	-5,574	-4,400
Trade balance	-1,903	-3,131	-3,068	-2,179	-2,473	-869	500
Merchandise exports	26,265	29,052	33,378	38,319	48,568	66,678	81,000
Merchandise imports	28,167	32,183	36,446	40,497	51,041	67,547	80,500
Foreign direct investment, net	6,234	4,943	5,476	8,276	1,895	3,917	8,500
Gross reserves, excluding gold (end-year)	12,825	13,139	14,464	23,709	26,955	28,448	na
External debt stock	22,861	21,608	22,374	26,983	34,861	45,303	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.5	4.2	4.1	6.1	5.5	4.4	na
			(In per cent of exports of goods and services)				
Debt service	12.7	12.3	8.6	9.1	6.4	4.7	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	10.3	10.3	10.2	10.2	10.2	10.2	na
GDP (in bllions of korunas)	2,041	2,150	2,315	2,415	2,556	2,750	2,945
GDP per capita (in US dollars)	5,722	5,422	5,964	7,229	8,873	10,471	na
Share of industry in GDP (in per cent)	35.5	36.0	37.5	38.7	39.7	41.8	na
Share of agriculture in GDP (in per cent)	3.9	3.9	3.9	3.7	3.6	3.5	na
Current account/GDP (in per cent)	-2.5	-4.9	-5.4	-5.6	-6.3	-5.2	-3.5
External debt - reserves (in US$ million)	10,036	8,469	7,910	3,274	7,906	16,855	na
External debt/GDP (in per cent)	38.7	38.8	36.8	36.6	38.5	42.3	na
External debt/current account revenues, excluding transfers (in per cent)	68.6	60.2	55.3	59.5	61.9	59.3	na

[1] Calculated according to Eurostat methodology (ESA95).

Estonia

Key challenges

- Further measures to stimulate enterprise development are required, particularly in the poorer regions of the country.
- In spite of recent improvements, the energy sector still needs reform, including the restructuring of Eesti Energia and the opening of the market.
- The sharp rise in domestic credit growth and the dependence on financing from external sources should be managed carefully in the face of possible negative shocks.

Country data

Population (in millions)	**1.4**
Area ('000 sq. km)	**45.0**
GDP (in billion US$, 2004)	**11.2**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 13,740**
National currency	**Kroon**

Progress in structural reform

Business environment and competition

Estonia remains one of the world's most open and competitive economies according to various surveys of the business environment. The Heritage Foundation ranked the country fourth in its 2005 Index of Economic Freedom. Transparency International records it as the least corrupt country in the region.

The results from the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey also confirm Estonia's progress. Nevertheless, challenges remain, particularly streamlining the bureaucracy and further stimulating enterprise development in the poorer regions of the country. Small businesses are still hindered by administrative inefficiencies and opaque licensing requirements. They have also been affected by changing tax requirements due to EU harmonisation.

Starting a business is not too burdensome. According to the World Bank's *Doing Business* report, it takes six different procedures and an average of 35 days to register a company. Company registration costs are equal to 6.2 per cent of gross national income (GNI) per capita, lower than the average cost for OECD countries (6.5 per cent). A credit registry is in place to provide information on most of the population. The legal and regulatory frameworks have overcome most of their past inefficiencies. Intellectual property rights and legislation are in place, although their enforcement is uneven. The government has initiated steps to improve this situation.

Infrastructure

Following the adoption of the Electricity Market Act in 2003, the unbundling process of the state-owned, vertically integrated power company Eesti Energia started in April 2004. As a result, the company set up separate subsidiaries for the transmission network (OU Pohivork) and the distribution network (OU Jaotusvork), based on its existing business units. The company has also started to separate its power generation and transmission tariffs and accounts.

The further separation of Eesti Energia into fully independent companies has also been considered, but appears unlikely. The Eesti Energia subsidiaries Eesti Polevkivi (Estonian Oil Shale) and Narva Elektrijaamad (Narva Power Plants) will remain in government ownership until 2008, when the market for companies that consume over 20 GWh is scheduled to open. The market for smaller consumers will subsequently be liberalised, with retail clients free to choose a supplier by 2016. Meanwhile, Eesti Energia has announced a 15-year investment and rehabilitation plan to ensure that it will be able to satisfy 85 per cent of Estonia's electricity demand by 2018. The plan includes significant investments in Estonia's Narva Power Plants in the north east of the country.

The Estonian telecommunications market was fully liberalised in January 2001 with the opening of local, long-distance and international markets and the removal of the fixed-line monopoly. Since January 2005 the law has allowed users to change mobile operators while retaining the same phone number. A similar system is in place in the fixed-line segment. In the second half of 2004 the government rejected an offer by the Finnish-Swedish conglomerate TeliaSonera to buy its remaining 27 per cent shareholding in Eesti Telecom because of pricing. A second offer by TeliaSonera was rejected by the government in the first half of 2005. However, talks on privatising the remaining government stake have since been revived and include plans for a listing on the local stock exchange. TeliaSonera has confirmed its interest and has built up its shareholding to 50.26 per cent.

Financial sector

The financial sector, one of the mainstays of the Estonian economy, is highly concentrated and profitable. Over 97 per cent is foreign-owned, mostly by Nordic banks which have significantly improved managerial and operational skills and raised the level of technological sophistication. Domestic credit has risen on average by 27 per cent per year since 2000, reaching 63 per cent of GDP in 2004. Credit to the private sector has also increased significantly over the past few years, but remains modest as a percentage of GDP (43.3 per cent in 2004) compared with other countries at a similar stage of development. This particularly affects smaller companies, although commercial banks and leasing companies have started to extend some loans and leases to micro, small and medium-sized enterprises.

Macroeconomic performance

Real economy

Real GDP growth during 2004 and the first half of 2005 exceeded expectations, largely due to strong internal demand and a better than expected external environment. Following the Statistical Office's recent revisions of GDP data, the economy grew at an estimated 7.8 per cent in real terms in 2004. This was driven largely by technology sector exports and strong domestic demand. Growth accelerated further in the first half of 2005. Higher employment, real wage increases and rapid credit growth have all fuelled investment and private consumption (especially relating to services).

Economic policies

On the back of robust government revenues, the general government balance was in surplus by 1.8 per cent of GDP in 2004, making Estonia the only country among the new EU member states to record a surplus for the year. The maintenance of a disciplined fiscal policy has led to record low public debt ratios (4.9 per cent of GDP at end-2004).

Confidence in the currency board remains strong. Short-term interest rate differentials with the euro have decreased and local and foreign currency sovereign ratings have converged. Following Estonia's entry into the Exchange Rate Mechanism II (ERM II) in 2004, the government has committed to joining the Economic and Monetary Union (EMU) by January 2007. Continued export growth suggests that the current kroon/euro parity is close to the equilibrium rate and that no major competitiveness concerns will emerge. However, annual average inflation rose slightly to 3.0 per cent in 2004, reflecting tax increases (in line with EU tax policy) on various goods, notably fuel, sugar and food products.

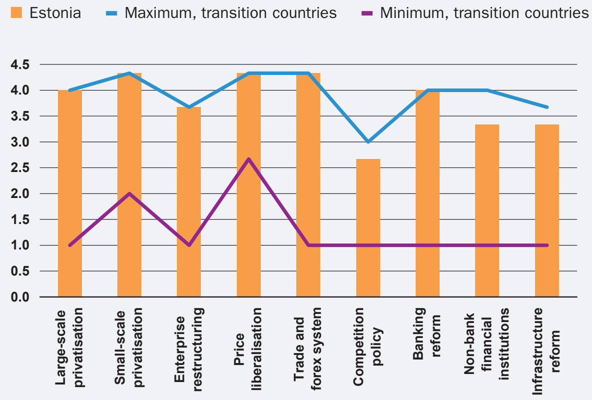
External sector

The balance of payments recorded a current account deficit in excess of 12 per cent of GDP in 2004. Although the first half of 2005 has seen accelerating export growth, the current account deficit is expected to remain high for the year as a whole. After a lull in 2004, net foreign direct investment flows have resumed in 2005 at an unprecedented pace. This is mainly the result of portfolio investments being converted into direct investments following the buyout of Hansabanka's shares by its core investor SwedBank. Gross external debt remains high at over 80 per cent of GDP, a large part of which is owed to the foreign parents of Estonian subsidiaries.

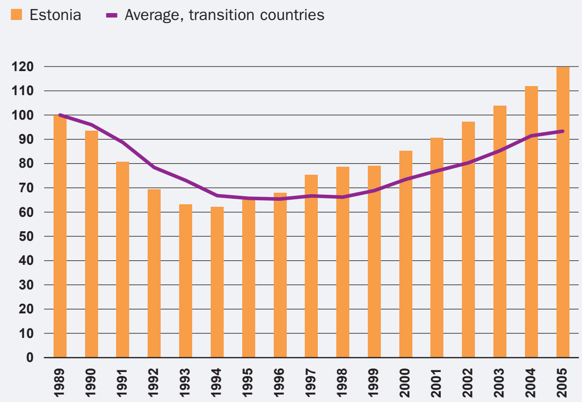
Outlook and risks

Despite a deteriorating external environment, real GDP growth in 2005 is expected to average 7 per cent. It will continue to be driven by internal demand as interest rates remain low and credit continues to expand. Domestic credit reached 63 per cent of GDP in 2004 and is expected to grow further in 2005. While rapid credit growth is in line with Estonia's current phase of development, the country may be vulnerable to the risk of a sudden downturn in asset markets or a disruption to finance available from parent banks. On the fiscal side, moderate deficits may result from new expenditure commitments (notably higher pensions and maternity benefits).

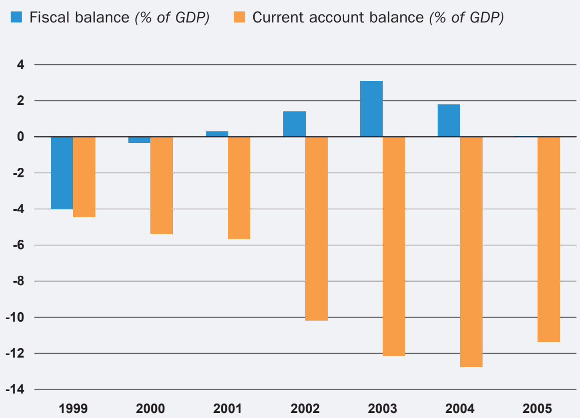
Transition indicators, 2005



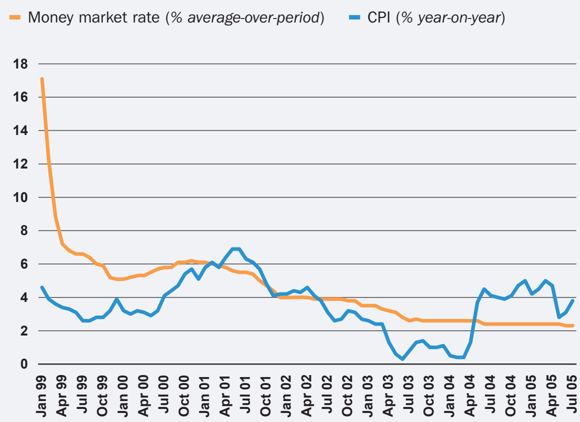
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **currency board in ERM II**

Wage regulation – **no**

Tradability of land – **full**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **medium**

Secured transactions law – **inefficient**

Quality of corporate governance law – **medium**

Infrastructure

Independent telecoms regulator – **fully**

Independent electricity regulator – **fully**

Separation of railway infrastructure from operations – **fully**

Quality of concession laws – **na** [1]

Financial sector

Capital adequacy ratio – **10 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **high**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **4.7 per cent** (1998)

Government expenditure on health – **5.6 per cent of GDP**

Government expenditure on education – **6.1 per cent of GDP**

Share of power, water in total household expenditure – **10.6 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	4.0	4.8	6.7	7.1	7.3	7.5	na
Private sector share in GDP (in per cent)	75.0	75.0	75.0	80.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	69.0	71.3	71.3	73.4	73.9	74.7	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.8	0.7	0.8	1.0	1.1	1.7	na
Share of industry in total employment (in per cent)	25.3	26.3	26.1	24.7	25.2	27.0	na
Change in labour productivity in industry (in per cent)	1.4	10.8	7.7	19.5	3.9	1.1	na
Investment/GDP (in per cent)	24.9	27.8	29.2	31.8	30.8	28.8	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of enterprise reform	3.0	3.0	3.3	3.3	3.3	3.3	3.7
Share of administered prices in CPI (in per cent) [2]	25.6	25.6	28.9	28.5	24.9	26.9	26.7
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Share of trade with non-transition countries (in per cent)	76.3	84.7	74.3	71.8	72.0	72.9	na
Share of trade in GDP (in per cent)	105.0	134.9	125.6	115.8	117.2	123.8	na
Tariff revenues (in per cent of imports)	0.0	0.1	0.1	0.0	0.1	0.2	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Financial sector							
Number of banks (foreign-owned)	7 (3)	7 (4)	7 (4)	7 (4)	7 (4)	9 (6)	na
Asset share of state-owned banks (in per cent)	7.9	0.0	0.0	0.0	0.0	0.0	na
Asset share of foreign-owned banks (in per cent)	89.8	97.4	97.6	97.5	97.5	98.0	na
Non-performing loans (in per cent of total loans)	2.9	1.3	1.2	0.8	0.5	0.3	na
Domestic credit to private sector (in per cent of GDP)	24.3	24.0	25.7	27.5	33.3	43.3	na
Domestic credit to households (in per cent of GDP)	6.5	7.3	8.7	11.0	15.0	20.4	na
Of which mortgage lending (in per cent of GDP)	4.1	4.8	5.8	7.9	11.6	16.4	na
Stock market capitalisation (in per cent of GDP)	36.6	34.4	26.6	33.6	41.5	51.1	na
Stock trading volume (in per cent of market capitalisation)	18.0	19.0	14.0	15.0	18.0	17.0	na
Eurobond issuance (in per cent of GDP)	2.3	5.7	2.0	4.2	3.6	8.4	na
EBRD index of banking sector reform	3.7	3.7	3.7	3.7	3.7	4.0	4.0
EBRD index of reform of non-bank financial institutions	3.0	3.0	3.0	3.3	3.3	3.3	3.3
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	35.7 (26.8)	36.3 (38.7)	35.4 (45.5)	35.1 (65.0)	33.9 (72.3)	34.0 (96.0)	na
Internet penetration rate (per 10,000 inhabitants)	219.7	298.6	356.9	467.6	498.9	486.3	na
Railway labour productivity (1989=100)	124.6	148.7	172.2	223.7	256.5	294.4	na
Residential electricity tariffs (in USc kWh)	na	4.3	4.4	5.7	6.5	8.1	na
Average collection rate, electricity (in per cent)	na	na	97	90	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.7	3.1	3.3	3.7	na	na	na
EBRD index of infrastructure reform	3.0	3.3	3.3	3.3	3.3	3.3	3.3
Electric power	3.0	3.7	3.7	3.0	3.0	3.0	3.0
Railways	4.0	4.0	4.0	4.3	4.3	4.3	4.3
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Water and waste water	3.0	4.0	4.0	4.0	4.0	4.0	4.0

[1] Estonia has no specific concession law but generally conforms with internationally accepted principles on concession laws.

[2] The high share is explained by the inclusion of gasoline (on which there are excise taxes) in the calculations of the Statistical Office.

	1999	2000	2001	2002	2003	2004 *Estimate*	2005 *Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	0.3	7.9	6.5	7.2	6.7	7.8	7.0
Private consumption	-2.5	8.6	6.2	10.3	5.7	4.4	na
Public consumption	2.9	1.1	1.8	5.9	5.8	9.1	na
Gross fixed capital formation	-15.6	14.3	13.0	17.2	5.4	9.1	na
Exports of goods and services	0.7	28.3	-0.2	0.6	6.0	16.5	na
Imports of goods and services	-5.2	28.3	2.1	5.4	9.0	14.7	na
Industrial gross output	-4.6	13.9	7.6	14.5	7.9	8.5	na
Agricultural gross output	-2.4	-0.8	-5.4	0.1	-1.5	-8.0	na
Employment			*(Percentage change)*				
Labour force (annual average)	-1.9	0.4	-0.2	-1.2	1.2	-0.2	na
Employment (annual average)	-4.5	-1.2	0.9	1.4	1.5	0.2	na
			(In per cent of labour force)				
Unemployment (annual average)	12.2	13.6	12.6	10.3	10.0	9.7	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	3.3	4.0	5.8	3.6	1.3	3.0	3.9
Consumer prices (end-year)	3.8	5.0	4.2	2.6	1.2	5.0	3.6
Producer prices (annual average)	-1.2	4.9	4.4	0.4	0.2	2.9	na
Producer prices (end-year)	2.2	6.0	1.7	1.4	0.3	3.9	na
Gross average monthly earnings in economy (annual average)	7.7	10.6	12.1	11.6	9.4	8.4	na
Government sector			*(In per cent of GDP)*				
General government balance	-4.0	-0.3	0.3	1.4	3.1	1.8	0.1
General government expenditure	40.3	36.2	34.9	35.5	35.6	37.1	na
General government debt	6.0	4.7	4.4	5.3	5.3	4.9	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	23.5	25.1	23.8	11.1	10.9	15.8	na
Domestic credit (end-year)	9.6	27.2	24.4	27.6	28.7	29.2	na
			(In per cent of GDP)				
Broad money (M2, end-year)	32.2	35.5	39.0	38.8	39.5	41.1	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Deposit rate (over 12 months)	8.9	6.8	4.5	3.7	2.4	2.1	na
Lending rate (over 12 months)	8.6	8.9	10.1	6.6	5.1	6.2	na
			(Kroons per US dollar)				
Exchange rate (end-year)	15.6	16.7	17.6	14.9	12.4	11.5	na
Exchange rate (annual average)	14.7	17.0	17.5	16.6	13.9	12.6	na
External sector			*(In millions of US dollars)*				
Current account	-247	-294	-339	-716	-1,116	-1,432	-1,450
Trade balance	-822	-767	-788	-1,089	-1,553	-1,966	-1,942
Merchandise exports	2,515	3,309	3,359	3,530	4,607	5,971	6,813
Merchandise imports	3,337	4,076	4,148	4,619	6,161	7,937	8,754
Foreign direct investment, net	222	324	343	153	763	781	2,500
Gross reserves, excluding gold (end-year)	944	921	820	1,000	1,373	1,640	na
External debt stock [1]	2,879	3,007	3,279	4,704	7,054	10,012	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.7	2.2	1.9	2.1	2.2	2.0	na
			(In per cent of exports of goods and services)				
Debt service	12.5	8.9	10.7	12.5	11.7	11.1	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	1.4	1.4	1.4	1.4	1.4	1.4	na
GDP (in billions of kroons)	82	93	104	117	127	141	157
GDP per capita (in US dollars)	4,061	4,004	4,390	5,190	6,800	8,314	na
Share of industry in gross value added (in per cent)	22.9	24.0	24.1	24.8	24.9	24.3	na
Share of agriculture in gross value added (in per cent)	5.6	5.1	4.7	4.4	3.9	3.5	na
Current account/GDP (in per cent)	-4.4	-5.4	-5.7	-10.2	-12.1	-12.7	-11.4
External debt - reserves (in US$ million)	1,935	2,086	2,458	3,703	5,680	8,371	na
External debt/GDP (in per cent)	51.7	54.9	54.9	66.8	76.8	89.1	na
External debt/exports of goods and services (in per cent)	71.9	62.6	65.5	89.7	103.1	113.8	na

[1] Data from the Bank of Estonia and include non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

FYR Macedonia

Key challenges

- Greater flexibility in the labour market is required to support job creation in the private sector, while clearer property rights and a stronger judiciary are needed to boost productivity and investment.
- The transparent privatisation of generation and distribution assets would support the restructuring of the power sector and facilitate participation in the regional energy market.
- Weak growth potential could be improved through increased foreign direct investment in export-oriented industries which are currently operating in an unfavourable business environment.

Country data	
Population (in millions)	**2.0**
Area ('000 sq. km)	**26.0**
GDP (in billion US$, 2004)	**5.3**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 6,767**
National currency	**Denar**

Progress in structural reform

Liberalisation and privatisation

In February and May 2005 the government responded to an EU questionnaire on the country's readiness to begin the accession process. It also concluded talks with the IMF on a new three-year, € 59 million Stand-By Arrangement focusing on reforms in health care, the judiciary and the labour market. The facility was approved by the IMF in August 2005. Meanwhile, as the Privatisation Agency closes down, the remaining state holdings in enterprises are being transferred to other public institutions.

In December 2004 the government amended its trade regime for wheat imports, with a view to gradually introducing World Trade Organization (WTO) standards and becoming fully compliant by 2007. However, the lack of up-to-date information makes it difficult to implement the system in practice and hinders the commercial operations of major agribusiness companies. The shortage of quality grain in the local market, coupled with import restrictions, has already put financial strain on some large local wheat processing companies.

Business environment and competition

New labour legislation was adopted in July 2005, easing conditions for hiring and firing employees, particularly in smaller companies. The new rules facilitate the use of fixed-term and part-time contracts, strengthen the position of employers during labour disputes, reduce paid sick leave and regulate overtime work in larger enterprises. The legislation also regulates annual leave allowance and contains provisions on collective agreements as the basis for labour relations in all firms. The unemployed can still obtain health insurance only after registering with the employment agency, even if they are not actually looking for a job.

In July 2005 the government approved an action plan to increase economic growth, promote job creation and lower the trade deficit. It proposes setting up a "one-stop shop" for registering companies, customs exemption for re-exported goods and increased labour market flexibility. In January 2005 a new agency for foreign investment promotion was established.

The business environment remains challenging for domestic and foreign investors. According to the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey, enterprises see corruption and judicial shortcomings as major constraints on their activities. The high cost of financing is also a key obstacle.

Access to finance is further complicated by ambiguities over property rights. This makes it difficult to provide adequate collateral and hinders the inflow of foreign direct investment. At present, less than 50 per cent of real estate assets are properly registered. Long administrative procedures with unpredictable outcomes and unequal treatment of licence applications are other impediments adversely affecting business development.

Infrastructure

In January 2005 a new power transmission company, MEPSO, was created through the partial unbundling of the previously integrated power company ESM. In August 2005 further restructuring steps were approved by the government and two separate power generation companies were spun off from ESM.

The first company will run the Negotino power station. The second, to be called Power Plants of Macedonia, will take over ESM's remaining thermal and hydropower plants. ESM will keep the power distribution assets. The authorities plan to sell a 100 per cent stake in Negotino and a 90 per cent stake in the ESM distribution concern. The international tender is to be launched in October 2005. MEPSO and Power Plants of Macedonia are to remain state-owned.

In May 2005 the government completed talks with the World Bank on a US$15 million loan to support railways restructuring. The railways will be split into separate infrastructure and transport companies, and the authorities may grant concessions of up to 20 years to private operating companies. About 800 employees out of a total 3,600 have already been laid-off as part of the restructuring.

Social sector

The government is stepping up pension reform. Second-pillar pension insurance funds have been made mandatory for all workers who entered employment after 1 January 2003. For other workers, participation is optional. Total pension and invalidity insurance contributions remain at 21 per cent, 13.7 per cent of which will be paid by the employer into the first pillar, while the employee's second-pillar account will receive 7.4 per cent. Licences for the establishment of the first private pension funds were awarded in April 2005. In September 2005 a new pension law came into force. It sets the retirement age at 64 for men and 62 for women with 15 years minimum service required.

Macroeconomic performance

Real economy

Real GDP growth remained subdued in 2004 at less than 3 per cent, but the economy has since shown signs of recovery. In the first half of 2005, industrial growth reached 9.3 per cent year-on-year, due mainly to the strong performance of the steel, textile and chemical sectors. The entry in 2004 of a strong strategic investor – Mittal Steel – to the metal processing sector has also led to a sharp rise in base metal production. However, continuing high unemployment (more than a third of the labour force) and labour restructuring in a number of companies and in the public sector are dampening private consumption.

Economic policies

In 2004 the economy experienced deflation. Consumer prices overall fell by almost 2 per cent year-on-year to December 2004 and continued to decline until April 2005. The exchange rate remains stable in line with the long-established Central Bank policy of a de facto near-peg of the denar to the euro.

The consolidated government account was balanced in 2004. Public debt remains below 50 per cent of GDP. Fiscal decentralisation was introduced in July 2005 as part of the overall plan included in the Ohrid Agreement, and municipalities will have greater freedom to manage their finances. In July 2005 the government amended the budget law and is currently targeting a central government deficit of 0.7 to 0.8 per cent of GDP in 2005.

External sector

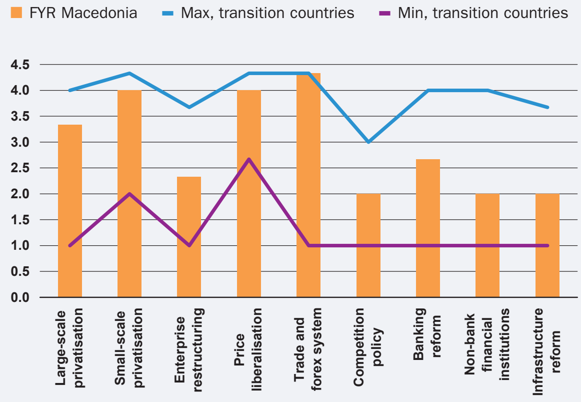
The trade deficit increased from 18 per cent in 2003 to over 21 per cent of GDP in 2004 due to surging car imports, while the current account deficit increased from 3.5 per cent to 8.2 per cent of GDP. In the first half of 2005, exports grew by about 35 per cent (reflecting the resurgence of industry) and imports by 18 per cent year-on-year. The trade deficit is mostly covered by remittance inflows, but net current transfers declined from 15.7 per cent of GDP in 2003 to less than 14.9 per cent in 2004. Inflows of foreign direct investment remain low and are mostly concentrated in utilities, mining and metal processing.

The authorities plan to issue a eurobond in the second half of 2005. In August 2005 Standard and Poor's upgraded the long-term foreign and local currency sovereign credit ratings to 'BB+' from 'BB', and to 'BBB–' from 'BB+' respectively, reflecting sustained political stabilisation in the country. The level of external debt was moderate at about 45 per cent of GDP at end-2004, 80 per cent of which was public long-term debt.

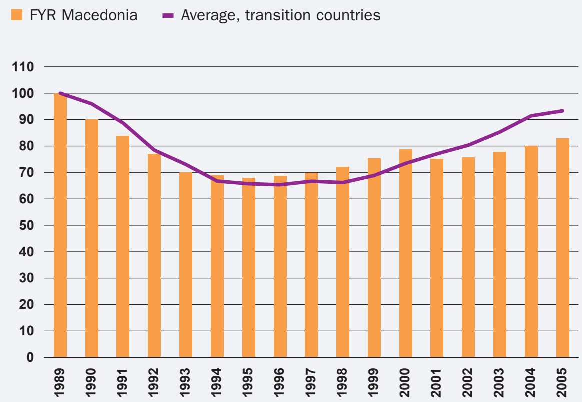
Outlook and risks

Macroeconomic stability is expected to be maintained over the medium term. However, the impact of fiscal decentralisation on the general government balance is uncertain. Unemployment is likely to decline as a result of new labour legislation, but restructuring in a number of large firms will put pressure on the labour market. The greatest risks to the economy are related to political stability, both internally and in neighbouring Kosovo. A substantial increase in the growth rate will depend on improvements in the business environment and on greater foreign direct investment in export-oriented industries. Progress in the EU accession process would provide an important support for policy making and political stability.

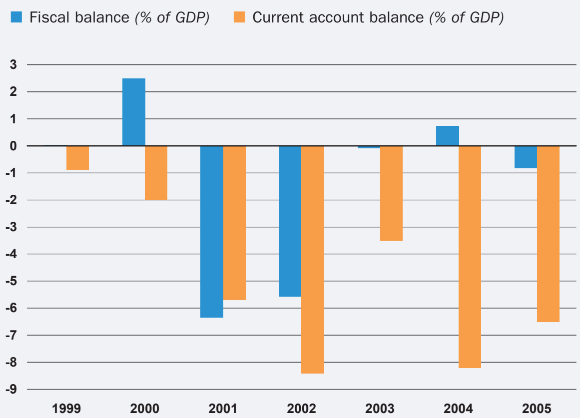
Transition indicators, 2005



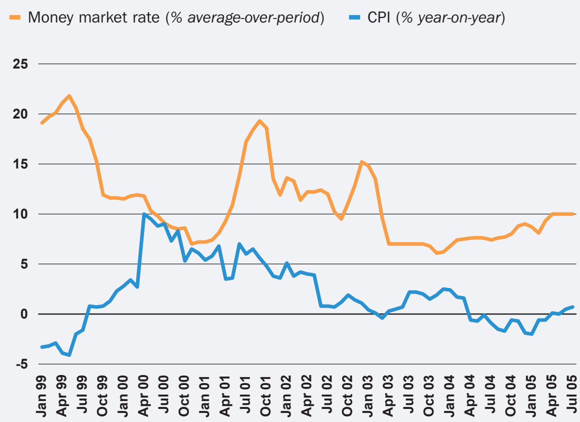
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **no**	Independent telecoms regulator – **partially**	Capital adequacy ratio – **8 per cent**	Share of population living in poverty – **4 per cent** (1998)
Controls on inward direct investment – **yes** [1]	Quality of insolvency law – **medium**	Independent electricity regulator – **partially**	Deposit insurance system – **yes**	Government expenditure on health – **na**
Interest rate liberalisation – **full**	Secured transactions law – **some defects**	Separation of railway infrastructure from operation – **no**	Quality of securities market laws – **high**	Government expenditure on education – **na**
Exchange rate regime – **de facto fixed to euro**	Quality of corporate governance law – **high**	Quality of concession laws – **medium**	Private pension funds – **yes**	Share of power, water in total household expenditure – **16.0 per cent**
Wage regulation – **no**				
Tradability of land – **limited de jure**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	0.9	2.1	12.6	13.3	13.6	13.8	na
Private sector share in GDP (in per cent)	55.0	55.0	60.0	60.0	60.0	65.0	65.0
Private sector share in employment (in per cent)	45.0	45.0	50.0	50.0	50.0	55.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	1.2	8.1	7.5	10.5	8.5	8.7	na
Share of industry in total employment (in per cent)	27.7	27.1	26.5	24.8	23.8	23.2	na
Change in labour productivity in industry (in per cent)	2.4	10.9	-10.6	13.5	12.4	4.7	na
Investment/GDP (in per cent)	19.7	21.4	14.8	16.6	16.7	17.0	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.3	3.3
EBRD index of enterprise reform	2.0	2.3	2.3	2.3	2.3	2.3	2.3
Markets and trade							
Share of administered prices in CPI (in per cent)	19.5	11.9	8.3	10.9	13.4	1.5	1.2
Number of goods with administered prices in EBRD-15 basket	2.0	1.0	1.0	1.0	1.0	0.0	0.0
Share of trade with non-transition countries (in per cent) [2]	84.7	63.4	57.6	56.6	68.7	54.1	na
Share of trade in GDP (in per cent)	78.3	92.9	82.8	79.3	77.1	86.5	na
Tariff revenues (in per cent of imports)	8.7	5.8	5.3	5.2	5.1	4.2	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	4.0	4.0	4.0	4.0	4.3	4.3	4.3
EBRD index of competition policy	1.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	23 (5)	22 (7)	21 (8)	20 (7)	21 (8)	21 (8)	na
Asset share of state-owned banks (in per cent)	2.5	1.1	1.3	2.0	1.8	1.9	na
Asset share of foreign-owned banks (in per cent)	11.5	53.4	51.1	44.0	47.0	47.3	na
Non-performing loans (in per cent of total loans)	62.6	46.5	44.4	35.7	34.9	27.5	na
Domestic credit to private sector (in per cent of GDP)	10.4	10.5	12.8	14.2	14.9	17.7	na
Domestic credit to households (in per cent of GDP)	1.2	1.6	1.7	2.4	3.7	5.8	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	0.2	0.2	0.4	4.4	7.6	7.3	na
Stock trading volume (in per cent of market capitalisation)	na	na	7.0	4.0	8.0	8.6	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	2.7	2.7	2.7	2.7	2.7	2.7	2.7
EBRD index of reform of non-bank financial institutions	1.7	1.7	1.7	1.7	1.7	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	23.4 (2.4)	25.5 (5.7)	26.4 (10.9)	27.1 (17.7)	27.5 (20.5)	25.2 (37.2)	na
Internet penetration rate (per 10,000 inhabitants)	11.2	7.9	12.7	15.3	17.3	17.4	na
Railway labour productivity (1989=100)	66.7	89.7	78.9	59.2	67.2	76.2	na
Residential electricity tariffs (in USc kWh)	na	na	na	4.1	5.1	5.5	na
Average collection rate, electricity (in per cent)	87	60	80	75	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	na	na	na	na	na	na	na
EBRD index of infrastructure reform	1.7	2.0	2.0	2.0	2.0	2.0	2.0
Electric power	2.0	2.3	2.3	2.3	2.3	2.3	2.7
Railways	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Water and waste water	1.0	2.0	2.0	2.0	2.0	2.0	2.0

[1] There are controls on arms production, trade in narcotics, historical and cultural heritage.

[2] For some years data were unavailable for important trading partner countries, such as Bosnia and Herzegovina, Croatia and Serbia and Montenegro. As a result, the share of trade with non-transition countries for these years has been over-estimated.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	4.3	4.5	-4.5	0.9	2.8	2.9	3.5
Industrial gross output	1.7	9.4	-4.6	-0.8	5.1	-2.1	na
Agricultural gross output	0.9	1.0	-10.8	-2.0	4.8	4.4	na
Employment			*(Percentage change)*				
Labour force (end-year)	-2.1	0.6	6.3	-4.4	4.4	-3.3	na
Employment (end-year)	1.0	0.8	9.0	-6.3	-2.9	3.0	na
			(In per cent of labour force)				
Unemployment (end-year)	32.4	32.1	30.5	31.9	36.7	37.2	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	-0.7	5.8	5.3	2.4	1.1	-0.3	0.0
Consumer prices (end-year)	2.4	6.1	3.7	1.0	2.5	-1.9	1.0
Producer prices (annual average)	-0.1	8.9	2.0	-0.9	-0.3	0.9	na
Producer prices (end-year)	4.2	7.9	-2.5	1.1	-0.2	1.3	na
Gross average monthly earnings in economy (annual average)	2.9	5.5	3.6	6.9	4.8	3.5	na
Government sector			*(In per cent of GDP)*				
General government balance	0.0	2.5	-6.3	-5.6	-0.1	0.7	-0.8
General government expenditure	35.4	33.7	40.3	40.5	38.5	36.8	na
General government debt	57.4	53.2	51.6	49.6	47.7	46.5	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	29.7	24.4	66.3	-8.0	18.4	5.2	na
Domestic credit (end-year)	12.8	-10.7	-11.5	28.8	2.7	11.1	na
			(In per cent of GDP)				
Broad money (M2, end-year)	16.1	17.7	29.8	26.3	30.2	31.0	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Basic rate of the National Bank	8.9	8.9	10.7	10.7	7.0	6.5	na
Interbank interest rate	11.6	7.2	11.9	14.4	5.8	7.9	na
Deposit rate	11.3	10.7	10.0	9.2	6.7	6.5	na
Lending rate	20.0	19.0	19.2	17.7	14.5	12.0	na
			(Denars per US dollar)				
Exchange rate (end-year)	60.3	65.3	69.2	58.6	49.9	49.4	na
Exchange rate (annual average)	56.9	65.9	68.1	64.7	54.3	50.0	na
External sector			*(In millions of US dollars)*				
Current account	-33	-72	-244	-362	-152	-415	-220
Trade balance	-496	-690	-533	-765	-852	-1,122	-800
Merchandise exports	1,190	1,321	1,155	1,113	1,359	1,672	1,600
Merchandise imports	1,686	2,011	1,688	1,878	2,211	2,794	2,400
Foreign direct investment, net	32	176	439	77	97	150	150
Gross reserves, excluding gold (end-year)	469	714	775	735	903	839	na
External debt stock	1,490	1,488	1,506	1,635	1,813	2,029	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.2	5.2	4.5	3.8	3.3	2.9	na
			(In per cent of exports of goods and services)				
Debt service	12.4	14.9	18.5	22.0	19.3	13.9	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in billions of denars)	209	236	234	244	251	258	271
GDP per capita (in US dollars)	1,837	1,793	1,717	1,885	2,316	2,581	na
Share of industry in GDP (in per cent)	18.4	18.1	17.5	17.2	17.6	16.7	na
Share of agriculture in GDP (in per cent)	11.0	10.0	9.8	9.5	9.7	9.8	na
Current account/GDP (in per cent)	-0.9	-2.0	-5.7	-8.4	-3.5	-8.2	-6.5
External debt - reserves (in US$ million)	1,021	774	731	900	910	1,190	na
External debt/GDP (in per cent)	40.6	41.5	43.9	43.4	42.4	44.8	na
External debt/exports of goods and services (in per cent)	101.9	91.0	107.8	119.5	133.4	121.0	na

Georgia

Key challenges

- Completion of the privatisation programme in a fair and transparent manner and further improvements in the business environment, including the sustained implementation of anti-corruption measures, are key priorities in the enterprise sector.
- Energy sector reforms, including restructuring and rehabilitation, are needed to strengthen investment incentives and improve financial and technical performance.
- Maintaining macroeconomic stability, including low inflation and fiscal sustainability, while implementing structural reforms is crucial to sustaining economic growth and managing external indebtedness.

Country data	
Population (in millions)	**4.6**
Area ('000 sq. km)	**70.0**
GDP (in billion US$, 2004)	**5.1**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 2,914**
National currency	**Lari**

Progress in structural reform

Liberalisation and privatisation

Reform of trade and customs regulations is under way. In line with the World Trade Organization (WTO), the authorities have simplified the tariff structure, reducing the number of import tariff bands from 21 to 16 since January 2005. A further reduction in the number of bands and the maximum import tariff rate from January 2006 is expected to be discussed in the autumn. The ongoing administrative modernisation aims to simplify customs procedures, which have been a source of abuse and corruption.

The large-scale privatisation programme launched in September 2004 has progressed. The programme envisages the quick sale or liquidation of more than 1,800 remaining state-owned enterprises, including farm land, over 18 months. More than 120 enterprises, including two out of 10 large companies, were sold at the beginning of 2005: Armstrong Holdings ASP (UK-Australia) bought the shipping company Georgia Ocean for US$ 93 million; the American company International Tinsel Inc. bought Georgia Telecom for US$ 5 million; and Russia's Vneshtorgbank bought a 51 per cent stake in United Georgian Bank. The government has since invited bids for some additional large enterprises, including Rustavi and Madnueli metallurgical plants and the Batumi crude oil storage complex.

Business environment and competition

Progress has also been made in improving the business climate. In a move to increase efficiency and reduce corruption in the public administration, a civil service council responsible for coordinating civil service reform was established in August 2004. During that year 30,000 jobs were cut, with the savings in the wage bill financing a gradual increase in the remuneration of the remaining civil servants. Changes to the tax code introduced at the beginning of 2005 reduced the number of taxes from 21 to seven and broadened the tax base.

These changes make the tax system more equitable and create a more favourable business climate. The government has also introduced legal reforms for simplifying the business licensing system to reduce corruption. A new licensing law, passed in July 2005, provides a "one-stop shop" and "silence is consent" system for issuing licences. This reduces the types of businesses that need to apply for a licence to begin operations by six-fold.

As an indication of the country's progress in improving governance, Georgia qualified for inclusion in the US Millennium Challenge Account. An agreement for US$ 295 million over the next five years was signed in September 2005.

Infrastructure

The energy sector remains a fundamental bottleneck for businesses due to unreliable power supply. A related problem is the high level of indebtedness of energy companies. Action has been taken to improve technical and financial viability of the sector by strengthening payment discipline and increasing cash collection from key customers.

Aided by an ongoing extension of metering to rural areas, the measures have contributed to an increase in cash collection for distribution companies and to a reduction of the quasi-fiscal deficit in the energy sector from 4.9 to 4.7 per cent of GDP in 2004. However, the non-payment rate for electricity outside Tbilisi remains high and payment discipline in the gas sector has not yet improved.

Essential rehabilitation projects of power plants are under way, while repairs to the Enguri hydropower plant should be carried out in spring 2006. The government has opened the privatisation process for two major regional distribution companies – the United Distribution Company, the distributor of electricity outside Tbilisi, and JSC Adjara Energy Company – as well as a number of power stations. The authorities are working with the World Bank on a new tariff structure that would ensure cost recovery by mid-2006.

Social sector

In line with its poverty reduction strategy, the government is reforming the social assistance system. It will introduce a means-tested poverty benefit in 2006. Social assistance will no longer be available for certain categories of the population. Instead, relief to all households living below the extreme poverty line will be enhanced. A special working group has been set up to design a system for identifying extremely poor households based on the level of income and the size of the family.

As the first step to implementing pension reform, the accumulation of pension arrears stopped and the repayment of outstanding arrears started from mid-2004. From January 2005 the pension rate was raised to GEL 28 (US$ 16) from GEL 18 (US$ 10).

Macroeconomic performance

Real economy

The economy grew by an estimated 6.8 per cent in the first half of 2005, compared with 6.2 per cent in 2004. Growth in the industrial sector was particularly strong at 12.8 per cent. This was due in part to privatisations of some important enterprises and to structural reforms (including measures to bring businesses out of the informal sector). While the service sector continued to benefit from oil and gas-related developments in the region, their effect on boosting the construction sector decreased with the completion of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline in May. Growth in agricultural production during the same period reached 5.3 per cent despite spring flooding.

Economic policies

Fiscal performance was robust in 2004 and the first half of 2005. The general government budget recorded an overall surplus (on a commitments basis) of 2.3 per cent of GDP in 2004 and remained approximately in balance in the first half of 2005. Improved tax administration and anti-corruption measures contributed to an increase in tax receipts by 38 per cent year-on-year during this period. This was despite the decrease in tax rates introduced in January 2005. As a result, the government introduced two supplementary budgets in April and May 2005 approving a large increase in expenditure, especially for infrastructure rehabilitation.

The money supply has grown sharply in the past year. This factor, combined with increases in excise taxes on fuel and tobacco, has led to an increase in annual inflation. Inflation was above 9 per cent for most of the first half of 2005, compared with 7.5 per cent at the end of 2004. A slowdown in money growth and a seasonal reduction in food prices helped to reduce the rate to 6.2 per cent in July 2005.

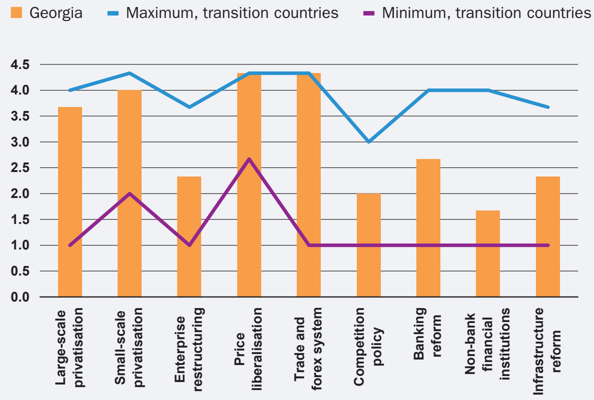
External sector

The current account deficit remained stable in the first half of 2005 at an estimated 7 per cent of GDP. Imports and exports have been increasing markedly, the former influenced heavily by investment needs associated with oil and gas pipeline construction. The external deficit has been mainly financed by privatisation-related and other private capital inflows. Following the Paris Club debt rescheduling in July 2004 (equivalent to a US$161 million debt service reduction), bilateral agreements for debt relief have been reached with a number of creditors including Russia (the largest at over US$94 million). The ratio of public external debt to GDP decreased to 31 per cent of annualised GDP in the first half of 2005 compared with about 36 per cent of GDP at end-2004.

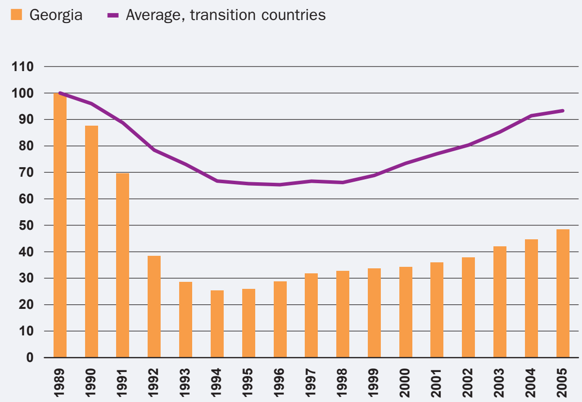
Outlook and risks

Real GDP growth in the medium term is expected to slow beyond 2005 as construction of the BTC oil pipeline and the South Caucasus gas pipeline is completed. The current account deficit is likely to narrow with an expected increase in service balance due to transit fees and a decrease of pipeline-related imports when the pipelines become operational. In addition to issues of political and regional stability, the main economic risks to sustained long-term growth are the country's persistent significant external indebtedness, decaying physical infrastructure and the poor financial and technical conditions of the energy sector.

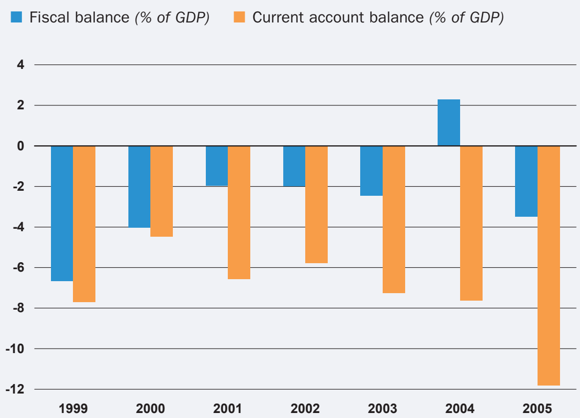
Transition indicators, 2005



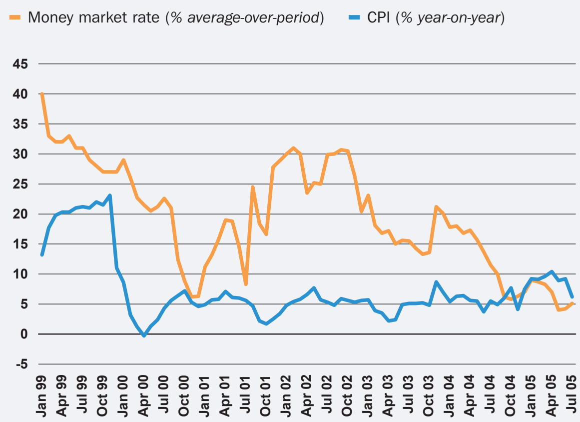
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **15.7 per cent** (2001)
Controls on inward direct investment – **no**	Quality of insolvency law – **low**	Independent electricity regulator – **partially**	Deposit insurance system – **no**	Government expenditure on health – **0.55 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **malfunctioning**[1]	Separation of railway infrastructure from operations – **no**	Quality of securities market laws – **medium**	Government expenditure on education – **0.66 per cent of GDP**
Exchange rate regime – **floating**	Quality of corporate governance law – **low**	Quality of concession laws – **very low**	Private pension funds – **yes**	Share of power, water in total household expenditure – **14.7 per cent**
Wage regulation – **no**				
Tradability of land – **limited for foreigners**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	22.7	23.0	23.1	23.3	23.6	24.5	na
Private sector share in GDP (in per cent)	60.0	60.0	60.0	65.0	65.0	65.0	65.0
Private sector share in employment (in per cent)	40.0	35.0	35.0	35.0	33.3	34.3	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.5	2.8	2.1	1.8	1.6	2.4	na
Share of industry in total employment (in per cent)	6.9	7.3	6.4	6.3	5.9	6.5	na
Change in labour productivity in industry (in per cent)	-2.3	-13.5	11.3	17.5	11.1	9.0	na
Investment/GDP (in per cent)	22.0	21.6	21.9	22.0	24.4	26.6	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	3.3	3.3	3.3	3.3	3.3	3.3	3.7
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.3
Markets and trade							
Share of administered prices in CPI (in per cent)	5.3	5.4	5.3	5.4	5.5	5.4	5.4
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	70.0	72.4	68.4	64.5	64.0	55.4	na
Share of trade in GDP (in per cent)	52.9	51.5	44.7	45.5	51.6	63.2	na
Tariff revenues (in per cent of imports)	7.5	7.4	7.3	7.1	6.8	7.9	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	39 (7)	32 (9)	29 (7)	27 (5)	24 (6)	21 (8)	na
Asset share of state-owned banks (in per cent)	0.0	0.0	0.0	0.0	0.0	0.0	na
Asset share of foreign-owned banks (in per cent)	16.1	17.4	15.3	12.2	34.9	58.1	na
Non-performing loans (in per cent of total loans)	6.8	7.2	11.3	7.9	7.5	6.2	na
Domestic credit to private sector (in per cent of GDP)	4.7	6.4	6.7	7.9	8.5	9.5	na
Domestic credit to households (in per cent of GDP)	0.5	0.6	0.9	1.0	1.0	1.4	na
Of which mortgage lending (in per cent of GDP)	na	0.1	0.3	0.5	0.5	1.0	na
Stock market capitalisation (in per cent of GDP)	na	0.8	2.9	2.9	5.3	3.5	na
Stock trading volume (in per cent of market capitalisation)	na	na	7.0	3.8	0.4	14.1	na
Eurobond issuance (in per cent of GDP)	0.3	11.0	3.7	0.0	0.0	0.0	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.3	2.3	2.7	2.7
EBRD index of reform of non-bank financial institutions	1.0	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	12.3 (1.9)	13.9 (3.4)	11.4 (6.1)	13.1 (10.2)	13.3 (10.7)	13.5 (16.6)	na
Internet penetration rate (per 10,000 inhabitants)	1.7	3.2	4.2	6.2	10.1	12.4	na
Railway labour productivity (1989=100)	48.0	59.5	65.1	71.9	72.6	68.6	na
Residential electricity tariffs (in USc kWh)	4.7	4.6	5.0	5.2	4.5	4.7	na
Average collection rate, electricity (in per cent)	32	35	32	90	72	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.3	3.4	4.2	4.6	na	na	na
EBRD index of infrastructure reform	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Electric power	3.3	3.3	3.3	3.3	3.0	3.0	3.0
Railways	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Roads	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	2.0	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water	2.0	2.0	2.0	2.0	2.0	2.0	2.0

[1] Assessment as of end-2004. A new law has since been approved by the parliament.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	3.0	1.9	4.7	5.5	11.1	6.2	8.5
Industrial gross output	3.7	5.3	-4.5	7.8	14.0	12.2	na
Agricultural gross output	6.9	-12.0	8.2	-1.4	7.0	-6.7	na
Employment [1]			*(Percentage change)*				
Labour force (end-year)	-3.7	9.3	-2.2	-5.0	8.1	-4.4	na
Employment (end-year)	-6.2	15.0	-2.1	-6.8	9.6	-6.3	na
			(In per cent of labour force)				
Unemployment (end-year)	14.8	10.4	10.3	11.9	10.7	12.5	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	19.2	4.1	4.6	5.7	4.9	5.7	9.4
Consumer prices (end-year)	11.0	4.6	3.4	5.6	7.0	7.5	7.0
Producer prices (annual average)	15.7	5.8	3.6	6.0	2.3	3.8	na
Producer prices (end-year)	15.7	2.4	8.9	1.5	5.4	0.7	na
Gross average monthly earnings in economy (annual average)	21.8	7.1	30.8	20.5	10.4	19.9	na
Government sector [2]			*(In per cent of GDP)*				
General government balance	-6.7	-4.0	-2.0	-2.0	-2.5	2.3	-3.5
General government expenditure	22.1	19.2	18.3	17.8	18.7	19.5	na
General government debt	77.0	69.8	68.4	67.4	61.5	46.4	na
Monetary sector			*(Percentage change)*				
Broad money (M3, end-year)	21.0	39.4	18.5	17.1	22.7	42.6	na
Domestic credit (end-year)	40.1	17.5	2.3	9.5	14.5	20.6	na
			(In per cent of GDP)				
Broad money (M3, end-year)	7.9	10.4	11.1	11.6	12.4	15.2	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Money market rate	34.6	18.2	17.5	27.7	16.9	11.9	na
Treasury bill rate (3-month maturity) [3]	na	26.0	29.9	43.4	44.3	19.2	na
Deposit rate (3-month) [4]	14.6	12.0	7.8	9.8	9.3	7.2	na
Lending rate (3-month)	33.4	32.8	27.0	31.8	32.3	31.2	na
			(Laris per US dollar)				
Exchange rate (end-year)	1.9	2.0	2.1	2.1	2.1	1.8	na
Exchange rate (annual average)	2.0	2.0	2.1	2.2	2.1	1.9	na
External sector			*(In millions of US dollars)*				
Current account	-217	-136	-210	-196	-289	-395	-742
Trade balance	-536	-398	-486	-439	-598	-752	-1,234
Merchandise exports	477	584	473	553	730	1,264	1,386
Merchandise imports	1,013	982	959	992	1,328	2,016	2,620
Foreign direct investment, net	62	153	80	122	335	503	731
Gross reserves, excluding gold (end-year)	132	109	161	198	191	383	na
External debt stock	1,722	1,582	1,712	1,858	1,954	2,039	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	1.3	0.9	1.4	1.6	1.3	1.8	na
			(In per cent of current account revenues, excluding transfers)				
Debt service	20.4	16.7	19.3	7.4	10.0	10.2	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	5.4	4.6	4.6	4.6	4.6	4.6	na
GDP (in millions of laris)	5,665	6,013	6,638	7,448	8,565	9,951	11,660
GDP per capita (in US dollars)	524	659	693	734	864	1,124	na
Share of industry in GDP (in per cent)	13.0	13.7	12.2	12.4	13.3	13.2	na
Share of agriculture in GDP (in per cent)	24.7	20.2	20.7	19.3	20.3	16.2	na
Current account/GDP (in per cent)	-7.7	-4.5	-6.6	-5.8	-7.2	-7.6	-11.8
External debt - reserves (in US$ million)	1,590	1,473	1,551	1,660	1,763	1,656	na
External debt/GDP (in per cent)	61.1	52.0	53.5	54.8	49.0	39.3	na
External debt/exports of goods and services (in per cent)	232.5	143.8	175.6	167.2	151.7	111.9	na

1 Figures consistent with ILO methodology.

2 General government includes the state, municipalities and extra-budgetary funds.

3 Data from 2000 relate to the average auction rates during that year.

4 Data refer to average rates for local currency from International Financial Statistics.

Hungary

Key challenges

- Improvements in public administration and the tax regime, as well as further infrastructure reform focusing on the railway and municipal sectors, are essential.
- Labour market rigidities need to be addressed to increase participation in the labour market, alleviate regional disparities and improve competitiveness and productivity.
- Fiscal discipline and coherent economic policies are essential to sustain economic growth, avoid currency volatility and prepare for eventual membership in the Exchange Rate Mechanism II.

Country data

Population (in millions)	**10.1**
Area ('000 sq. km)	**93.0**
GDP (in billion US$, 2004)	**100.3**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 16,596**
National currency	**Forint**

Progress in structural reform

Liberalisation and privatisation

The privatisation process is coming to a close. In 2004 sales included a 10.9 per cent stake in the oil and gas company MOL and the remaining 25 per cent state holding in Richter, a pharmaceutical producer. In July 2005 the State Privatisation and Holding Company sold a 73.7 per cent stake in terrestrial broadcaster Antenna Hungaria to a Swiss investor for €189 million. Enterprise restructuring and corporate governance improvements have continued. Hungary's accession to the EU and growth in investor confidence has contributed to an increase in portfolio investments and renewed foreign direct investment (FDI) flows.

Business environment and competition

Hungary has made considerable progress in improving the business environment, but has not yet reached the standard of advanced economies. The World Bank's *Doing Business* report praised the relatively efficient contract enforcement. However, it was critical of the long business registration process, the high registration and legal costs, underdeveloped credit information systems and the weak insolvency regime, which continue to inhibit enterprise growth. The 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey revealed that enterprises now perceive access to finance, tax administration, the functioning of the judiciary and business regulation as larger obstacles to business activity than in 2002.

Despite a recent increase, unemployment in Hungary remains relatively low at about 7.1 per cent. The employment rate, however, is significantly below the EU average of around 63 per cent, measuring 50.3 per cent in the first five months of 2005. This reflects low internal labour mobility, skills mismatches and a benefit system which offers little incentive to enter the labour market.

Infrastructure

Partial liberalisation of the electricity market started in 2003 with the launch of regular auctions for electricity trading companies and commercial users. In the first half of 2005 about 30 per cent of all electricity consumed in Hungary was purchased on the deregulated market compared with around 20 per cent a year earlier. Retail energy prices remain regulated by the government, which sets separate prices for different consumer groups to ensure protection of the poorest users. In summer 2005, the government decided to merge the electricity system operator with MVM, the state-owned electricity generation and transmission company.

Most investments under the ongoing motorway construction programme are being implemented by the state-owned National Road Management Company (ÁAK). Public-private partnerships (PPP) have been limited to the M1/M15, M5 and M6 motorway projects. Under the adopted PPP schemes the demand risk remains with the state and private operators are remunerated according to the cost of capital and availability of the motorways to traffic.

The railway sector continues to lag behind in the reform process, with over-employment and slow commercialisation. Privatisation of Budapest Airport, the largest airport operating company in Hungary, has been delayed by court action and trade union protests. The municipal sector remains fragmented, often suffering from poor administrative capacity and low-level corruption. It faces substantial challenges in the implementation of infrastructure and environmental projects co-financed from EU funds.

Financial sector

Privatisation of the banking sector is almost complete. Although the Land Credit and Mortgage Bank remains state-owned, with no immediate privatisation plans, its asset share in the financial sector is small. Despite some slowdown, the growth in bank loans (particularly to households) exceeded 15 per cent in 2004. There has also been an increasing shift towards small and medium-sized enterprise lending. Foreign currency-denominated lending is growing sharply. The share of non-banking financial institutions in total assets of the financial sector is growing steadily, reaching 31 per cent in December 2004.

The private pension system accounted for about 7 per cent of financial sector assets at the end of 2004. There are 18 mandatory pension funds and more than 150 voluntary, privately managed funds. The return performance of the system has been disappointing. Competition between funds suffers from a lack of comparability between fee structures and rates of return. At the same time, portfolio diversification is negatively affected by the large exposure to government bonds and a lack of alternative investment instruments.

The market capitalisation of the Budapest Stock Exchange recovered to around 28 per cent of GDP in May 2005 after a drop to 18 per cent in 2002. Mortgage bonds have been introduced and their stock reached around 3 per cent of GDP in May 2005. There is also some derivative trading, mainly in futures.

Macroeconomic performance

Real economy

In the first quarter of 2005 real GDP growth slowed to 2.9 per cent year-on-year, compared with 4.2 per cent in 2004. Performance in 2004 was driven primarily by exports, which grew by 14.9 per cent. With retail spending and industrial activity showing signs of recovery in the second quarter of 2005, overall GDP growth for the year is likely to be about 3.5 per cent. However, the unemployment rate edged up to 7.1 per cent in the second quarter of 2005, compared with 5.8 per cent a year earlier.

Economic policies

Insufficient revenues and weak expenditure discipline persist despite some improvements in macroeconomic policies in the first half of 2005. As a result, the full-year budget deficit target of 3.8 per cent of GDP (calculated according to a methodology that treats part of the contributions to the pension system as budgetary revenues) will not be achieved. This target requires large infrastructure projects to be transferred to off-budget financing. As the Eurostat has rejected such practices, the 2005 budget deficit will more likely fall to around 6 per cent of GDP, as compared with 6.5 per cent of GDP in 2003 and 5.4 per cent in 2004. The fiscal position of the government remains challenging, particularly given the track record of missed targets in recent years.

Annual inflation fell to about 3.6 per cent by August 2005. The decline over the past year has allowed the Central Bank to lower the reference rate in a series of cuts from 9.5 per cent in January 2005 to 6 per cent by September. The forint continued to appreciate in 2004 and the first half of 2005. In May 2004, the government postponed the target date for accession to the eurozone, allowing more time to meet the Maastricht criteria.

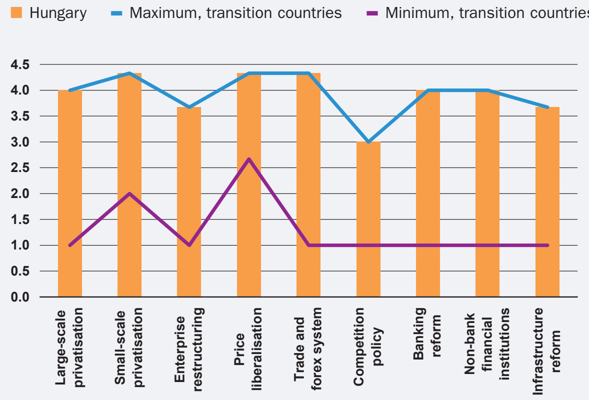
External sector

The current account deficit was 8.9 per cent of GDP in 2004, the same as in 2003. In the first quarter of 2005 the deficit increased to €1.5 billion from €1.3 billion in the corresponding period of 2004. This was primarily due to a widening of the deficit on the services and income accounts. The external balance was financed by government and corporate borrowing, significant (but volatile) portfolio investments and FDI. Net FDI recovered to an estimated 3.7 per cent of GDP in 2004, driven largely by substantial reinvested profits of foreign companies.

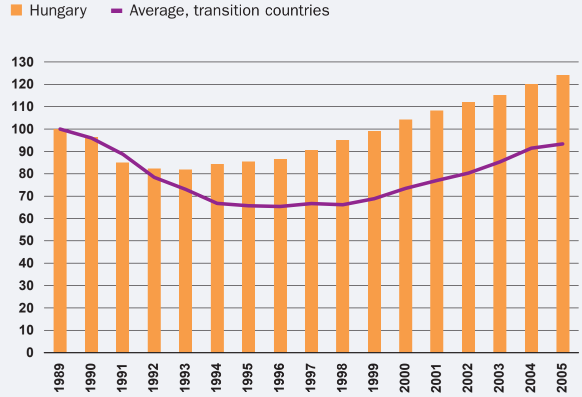
Outlook and risks

The Hungarian economy has benefited from a sound banking sector, sustained market-oriented reforms and large-scale foreign investment since the beginning of transition. However, there remain substantial fiscal challenges over the medium term. Increasing off-budget financing of infrastructure projects will weigh heavily on the budget in the future. With pending elections in 2006, necessary fiscal adjustments may be delayed, and possible tax reforms have uncertain overall consequences for the central budget. Also, given that 30 per cent of forint denominated government bonds are held by non-residents, any further fiscal slippage may lead to volatility of the exchange rate, with possible negative consequences for inflation and overall economic performance.

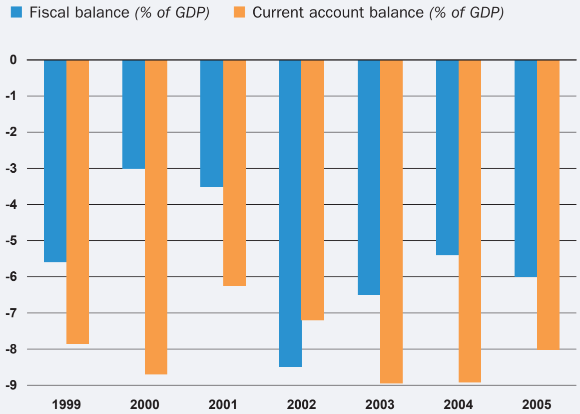
Transition indicators, 2005



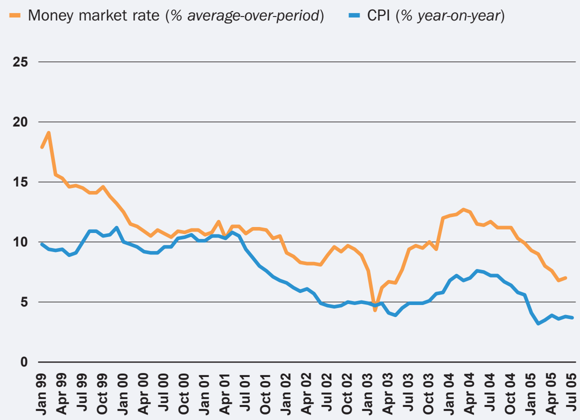
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **no**

Interest rate liberalisation – **full**

Exchange rate regime – **fixed with band**

Wage regulation – **no**

Tradability of land – **full except foreigners**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **advanced**

Quality of corporate governance law – **high**

Infrastructure

Independent telecoms regulator – **fully**

Independent electricity regulator – **fully**

Separation of railway infrastructure from operations – **partially**

Quality of concession laws – **low**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **medium**

Private pension funds – **yes**

Social reform

Share of population living in poverty – **2.0 per cent** (2002)

Government expenditure on health – **3.8 per cent of GDP**

Government expenditure on education – **4.3 per cent of GDP**

Share of power, water in total household expenditure – **10.3 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	29.8	30.2	30.6	30.7	31.1	31.7	na
Private sector share in GDP (in per cent)	80.0	80.0	80.0	80.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	82.1	84.0	84.5	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.2	2.4	2.4	2.5	2.4	3.8	na
Share of industry in total employment (in per cent)	34.0	33.7	34.1	34.1	33.3	32.9	na
Change in labour productivity in industry (in per cent)	7.7	18.5	1.8	2.9	7.6	5.0	na
Investment/GDP (in per cent)	23.9	23.5	23.5	23.4	22.3	22.5	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of enterprise reform	3.3	3.3	3.3	3.3	3.3	3.3	3.7
Markets and trade							
Share of administered prices in CPI (in per cent)	18.2	18.3	18.5	18.9	19.4	17.9	17.0
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	2.0	na
Share of trade with non-transition countries (in per cent)	87.9	87.2	84.4	84.5	84.0	82.1	na
Share of trade in GDP (in per cent)	111.1	129.3	124.2	110.4	109.5	113.2	na
Tariff revenues (in per cent of imports)	2.1	1.5	1.3	1.4	1.3	0.4	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Financial sector							
Number of banks (foreign-owned)	43 (29)	42 (33)	41 (31)	38 (27)	38 (29)	38 (27)	na
Asset share of state-owned banks (in per cent)	7.8	7.7	9.1	10.7	7.4	6.6	na
Asset share of foreign-owned banks (in per cent)	61.5	67.4	66.5	85.0	83.5	63.0	na
Non-performing loans (in per cent of total loans)	4.4	3.1	3.0	4.9	3.8	3.7	na
Domestic credit to private sector (in per cent of GDP)	25.8	30.1	31.4	34.5	42.6	46.0	na
Domestic credit to households (in per cent of GDP)	2.6	3.3	4.7	7.5	11.2	13.1	na
Of which mortgage lending (in per cent of GDP)	1.0	1.1	1.8	4.2	8.1	9.5	na
Stock market capitalisation (in per cent of GDP)	36.4	25.8	19.2	17.6	18.8	25.5	na
Stock trading volume (in per cent of market capitalisation)	96.0	91.0	44.0	46.0	58.0	60.0	na
Eurobond issuance (in per cent of GDP)	5.0	1.2	2.4	0.0	2.7	4.2	na
EBRD index of banking sector reform	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of reform of non-bank financial institutions	3.3	3.7	3.7	3.7	3.7	3.7	4.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	37.1 (16.2)	37.3 (30.2)	37.5 (49.8)	36.1 (67.6)	33.4 (78.3)	36.4 (88.8)	na
Internet penetration rate (per 10,000 inhabitants)	118.9	103.6	168.0	191.6	357.8	492.1	na
Railway labour productivity (1989=100)	117.0	122.8	123.3	130.3	133.9	145.1	na
Residential electricity tariffs (in USc kWh)	5.9	6.2	7.0	8.7	11.4	13.5	na
Average collection rate, electricity (in per cent)	na	na	na	90	99	99	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.7	5.1	5.3	5.6	na	na	na
EBRD index of infrastructure reform	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Electric power	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Railways	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Roads	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Telecommunications	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Water and waste water	4.0	4.0	4.0	4.0	4.0	4.0	4.0

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	4.2	5.2	3.8	3.5	2.9	4.2	3.5
Private consumption	4.8	4.9	6.0	9.4	7.2	2.5	na
Public consumption	1.8	1.2	5.3	5.7	6.5	-3.9	na
Gross fixed capital formation	5.9	7.7	5.9	9.3	2.5	7.9	na
Exports of goods and services	12.2	22.0	8.0	3.9	7.8	14.9	na
Imports of goods and services	13.3	20.2	5.3	6.5	11.0	11.6	na
Industrial gross output	10.4	18.7	3.6	2.8	6.4	3.5	na
Agricultural gross output	0.4	-6.4	15.8	na	na	na	na
Employment			*(Percentage change)*				
Labour force (annual average)	2.1	0.6	-0.4	0.2	1.4	0.3	na
Employment (annual average) [1]	3.1	1.2	0.3	0.1	1.3	-0.3	na
			(In per cent of labour force)				
Unemployment (end-year)	7.0	6.4	5.7	5.8	5.9	6.3	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	10.0	9.8	9.2	4.8	4.9	6.8	3.8
Consumer prices (end-year)	11.2	10.1	6.8	5.3	5.8	5.6	3.5
Producer prices (annual average)	5.1	11.6	5.2	-1.8	2.4	3.5	na
Producer prices (end-year)	8.2	12.4	-0.4	-1.3	6.2	1.6	na
Gross average monthly earnings in economy (annual average)	13.9	13.5	18.2	18.3	12.0	6.2	na
Government sector			*(In per cent of GDP)*				
General government balance [2]	-5.6	-3.0	-3.5	-8.5	-6.5	-5.4	-6.0
General government expenditure	49.9	47.7	48.7	52.6	50.2	48.9	na
General government debt	61.2	55.3	52.2	55.5	57.4	57.4	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	15.8	12.1	16.8	13.8	13.6	9.9	na
Domestic credit (end-year)	0.4	11.8	4.7	15.3	19.8	11.9	na
			(In per cent of GDP)				
Broad money (M2, end-year)	44.5	43.1	44.7	45.1	46.6	46.4	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinance rate	14.5	11.0	9.8	8.5	12.5	9.5	na
Interbank interest rate (up to 30-day maturity)	14.5	11.9	10.0	8.9	10.2	9.5	na
Deposit rate weighted average (fixed for less than 1 year)	11.9	9.9	9.4	7.4	8.7	9.1	na
Lending rate weighted average (maturing within 1 year)	19.4	12.8	12.0	9.7	11.2	11.0	na
			(Forints per US dollar)				
Exchange rate (end-year)	252.5	284.7	279.0	225.2	207.9	180.3	na
Exchange rate (annual average)	237.3	282.2	286.5	257.9	224.3	202.7	na
External sector			*(In millions of US dollars)*				
Current account [3]	-3,773	-4,060	-3,236	-4,675	-7,343	-8,946	-9,056
Trade balance [3]	-2,170	-2,911	-2,235	-2,120	-3,366	-2,970	-2,800
Merchandise exports [3]	25,579	28,734	31,068	34,780	43,238	55,291	66,000
Merchandise imports [3]	27,749	31,645	33,303	36,900	46,604	58,261	68,800
Foreign direct investment, net [3]	3,065	2,190	3,579	2,590	874	3,653	3,500
Gross reserves, excluding gold (end-year)	10,978	11,229	10,766	10,394	12,791	15,963	na
External debt stock	31,316	30,287	33,951	36,883	53,761	70,574	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.1	3.7	3.4	2.9	2.8	2.8	na
			(In per cent of exports of goods and services)				
Debt service [4]	17.9	15.5	14.6	13.9	14.4	15.4	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	10.1	10.0	10.2	10.1	10.1	10.1	na
GDP (in billions of forints)	11,393	13,172	14,850	16,740	18,409	20,338	22,139
GDP per capita (in US dollars)	4,757	4,648	5,092	6,491	8,207	10,031	na
Share of industry in GDP (in per cent)	26.7	27.9	27.2	26.8	27.5	28.3	na
Share of agriculture in GDP (in per cent)	5.3	4.6	5.5	4.7	4.4	4.6	na
Current account/GDP (in per cent)	-7.9	-8.7	-6.2	-7.2	-8.9	-8.9	-8.0
External debt - reserves (in US$ million)	20,338	19,058	23,185	26,490	40,970	54,611	na
External debt/GDP (in per cent)	65.2	64.9	65.5	56.8	65.5	70.4	na
External debt/exports of goods and services (in per cent)	101.7	88.2	90.0	88.5	105.0	107.9	na

[1] Data from labour force survey.

[2] Calculated according to Eurostat methodology (ESA95), excluding part of the cost of pension reform. Figures from 2003 onwards are subject to methodological revisions as accounting is brought into compliance with the Eurostat standards.

[3] Data from balance of payments.

[4] Excluding inter-company loans.

Kazakhstan

Key challenges

- To enhance competitiveness, improve the business environment and sustain economic diversification, the authorities should refrain from direct interference in the economy.
- A modern competition policy which eliminates regulatory inconsistencies and encourages investment in liberalised infrastructure services should be developed in conjunction with the regulatory framework for natural monopolies.
- While some steps have been taken to contain rapid monetary expansion, fiscal policy should be tightened and exchange rate policy made more flexible to combat inflation.

Country data

Population (in millions)	**15.1**
Area ('000 sq. km)	**2,728**
GDP (in billion US$, 2004)	**40.7**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 7,436**
National currency	**Tenge**

Progress in structural reform

Business environment and competition

Legislative changes have been introduced regulating investment activity in oil and gas projects. These changes have strengthened the state's control over the sector. The most controversial change, introduced in December 2004, awards a pre-emptive right to the state enabling the acquisition of any subsoil usage rights.

A new law on production sharing agreements (PSAs) relating to operations at sea, effective from July 2005, has strengthened the position of state-owned KazMunaiGas (KMG), the dominant oil and gas company. KMG will receive an automatic stake of at least 50 per cent as a contractor in all PSAs related to the Caspian or Aral Sea. The local content rules for investments in the sector have also been tightened, granting a competitive advantage to local firms.

According to the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey, corruption is seen by local firms as quite common and increasingly costly. At the same time the government has stepped up its anti-corruption drive. A tougher approach towards abuse of office by officials and corporate misconduct has been evident. During the first half of 2005 the Committee for Financial Control and State Purchases uncovered misappropriation of budget funds worth KZT 14 billion (over US$ 100 million) and filed 600 cases with law enforcement agencies. Disciplinary measures have been taken against nearly 700 officials.

In 2004 the Agency for Fighting Corruption and Economic Crime (Financial Police) filed 857 criminal cases ranging from violation of the tax code to breaches of competition and consumer protection law. There is some concern that the activities of the Agency could become politicised and be used to punish firms on a selective basis, which would impair the investment climate.

Infrastructure

The regulatory framework for natural monopolies has changed. In July 2004 the Committee for the Protection of Competition (CPC), under the Ministry of Industry and Trade, was established. In December regulatory responsibility for small natural monopolies was transferred to local authorities (Akimates).

Following these changes, the responsibilities of the Agency for the Regulation of Natural Monopolies (AREM) were revised to no longer include competition enforcement and regulatory authority over small monopolies operating at the municipal level. These changes will enable AREM to further develop sector-specific tariff methodologies.

There is a risk, however, that inconsistencies could arise between AREM and CPC responsibilities, as both regulate a number of dominant natural monopolies. The CPC regulates these companies through *ex ante* price controls as set out in the law on competition.

Small natural monopolies that are regulated by Akimates could also be subject to rules that may not reflect best practice. Following an address by the president in February 2005, raising concerns about inflationary pressures in the economy, several Akimates have asked natural monopoly companies in their region to freeze prices.

Liberalisation in the power sector has progressed since the enactment of the law on the electric power industry in July 2004. Regional electricity companies owning and operating regional distribution networks have begun separating supply activities, although this process was not completed by the 1 October 2004 deadline. New supply companies have also entered the market following the liberalisation.

Financial sector

Banking regulation has been tightened following a rapid expansion of credit, partially financed by international borrowing. As of 1 July 2005 banks were required to assign a 150 per cent risk weight to exposures of non-residents with credit ratings below BB– when calculating the capital adequacy ratio. This measure was introduced to stem cross-border lending, mainly in the CIS, which increased by more than 200 per cent in 2004.

Reserve requirements which currently apply to short-term domestic liabilities will be extended as of 1 October 2005 to cover net foreign liabilities, excluding interbank liabilities. By increasing costs, international borrowing — which reached 40 per cent of total banking sector liabilities in net terms by the end of 2004 — should be dampened. The authorities have also tightened asset classification rules for property and consumer loans, and reduced the limit of open foreign exchange positions.

Macroeconomic performance

Real economy

The economy grew strongly by 9.4 per cent in 2004 and 9.1 per cent year-on-year during the first half of 2005. A looser fiscal policy and high domestic liquidity resulting from favourable commodity prices stimulated domestic consumption and investment. Increased production in the oil and gas sector also contributed to rapid growth in exports.

Economic policies

The general government surplus narrowed to 2.7 per cent of GDP in 2004 from 2.9 per cent in 2003. This reflected higher spending and various tax cuts, although revenues from the hydrocarbon sector increased by 1.4 per cent of GDP as oil prices soared. The fiscal surplus is likely to drop again in 2005 (relative to GDP), as further expenditure increases on social spending and civil service salaries have been accommodated in the supplementary budget passed in May. During 2004 the National Bank of Kazakhstan (NBK) maintained its policy of intervention in the foreign exchange market to stem upward pressure on the domestic currency. This pressure was the result of high oil prices and strong capital inflows. Base and broad money (M3) increased sharply by 82 per cent and 70 per cent respectively in 2004. Also, inflation edged upwards from 6.4 per cent in 2003 to 6.9 per cent in 2004 on an annual average basis. Civil service pay increases in 2005 may add to inflationary pressures. However, in the first half of 2005, base money growth eased as the NBK scaled back its interventions in the foreign exchange market.

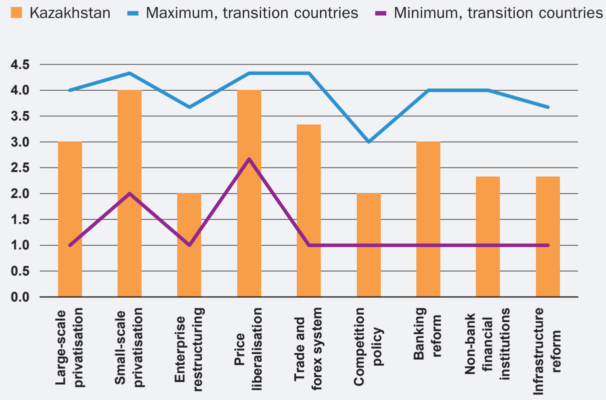
External sector

The current account recorded a surplus of 1.3 per cent of GDP in 2004. Exports of mineral products, including hydrocarbons and metal products, increased sharply (by 65 per cent and 47 per cent respectively in US dollar terms), more than offsetting the surge in oil-related imports, interest and income payments. The current account surplus rose further in the first quarter of 2005 as hydrocarbon prices remained buoyant. The high level of private external debt (72 per cent of GDP at end-2004) is increasing further as ongoing investments in the oil and gas sector are financed mainly by inter-company debt. The external debt of banks also increased sharply from 12 per cent of GDP in 2003 to 17 per cent at end-2004 as banks tapped into the international market, taking advantage of tighter market spreads and improved investor perception.

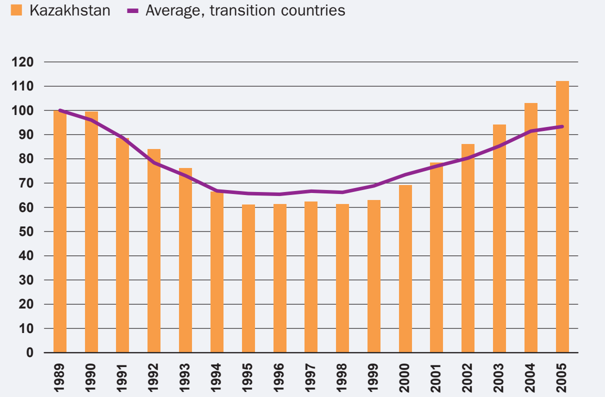
Outlook and risks

Short-term economic prospects are good. A slight slowdown in growth to 9 per cent is expected in 2005 because of a probable reduction in hydrocarbon production and further monetary tightening. The key medium-term risk to the economy arises from rapid credit expansion in recent years. Further regulatory improvement of the banking sector may be required if there is a tightening of credit. The proposed extension of reserve requirements (to be implemented in October 2005) will also help reduce risks by dampening the appetite of banks for short-term external funding.

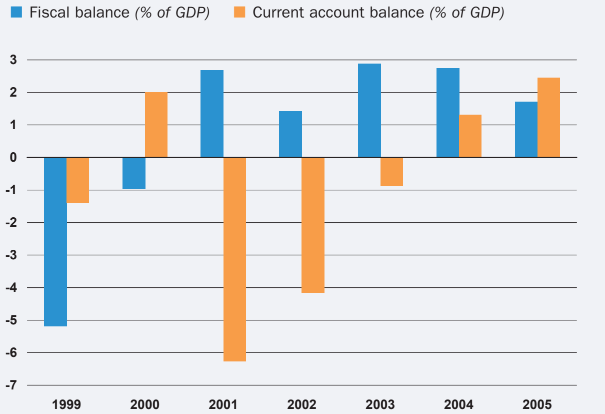
Transition indicators, 2005



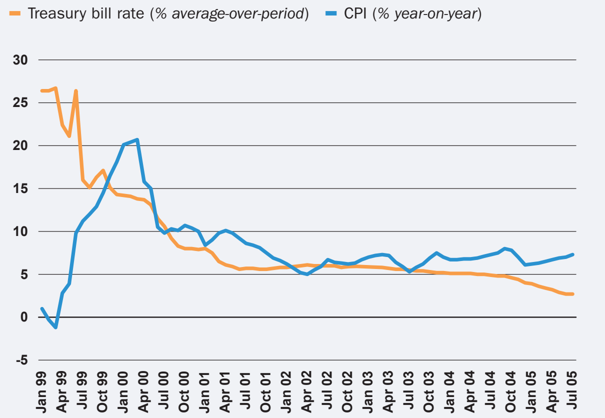
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full** Controls on inward direct investment – **yes** Interest rate liberalisation – **full** Exchange rate regime – **managed float** Wage regulation – **no** Tradability of land – **full except foreigners** [1]	Competition office – **yes** Quality of insolvency law – **medium** Secured transactions law – **inefficient** Quality of corporate governance law – **high**	Independent telecoms regulator – **partially** Independent electricity regulator – **partially** Separation of railway infrastructure from operations – **partially** Quality of concession laws – **na** [2]	Capital adequacy ratio – **12 per cent** Deposit insurance system – **yes** Quality of securities market laws – **medium** Private pension funds – **yes**	Share of population living in poverty – **24.9 per cent** (2003) Government expenditure on health – **2.4 per cent of GDP** Government expenditure on education – **3.5 per cent of GDP** Share of power, water in total household expenditure – **3.7 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	14.8	15.6	16.1	16.6	17.9	18.1	na
Private sector share in GDP (in per cent)	60.0	60.0	60.0	65.0	65.0	65.0	65.0
Private sector share in employment (in per cent)	77.1	78.8	74.9	75.0	75.4	75.3	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.3	0.1	0.1	0.1	0.1	na	na
Share of industry in total employment (in per cent)	14.8	13.8	12.4	12.3	12.1	na	na
Change in labour productivity in industry (in per cent)	2.6	22.2	17.2	11.4	6.1	na	na
Investment/GDP (in per cent)	17.8	18.1	26.9	27.3	25.9	24.0	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Markets and trade							
Share of administered prices in CPI (in per cent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	58.7	64.2	57.3	61.8	65.5	65.3	na
Share of trade in GDP (in per cent)	69.0	89.7	76.2	73.3	73.9	84.5	na
Tariff revenues (in per cent of imports) [3]	1.7	1.8	2.1	3.1	3.0	2.7	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	3.0	3.3	3.3	3.3	3.3	3.3	3.3
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	55 (18)	48 (16)	44 (15)	38 (15)	36 (14)	35 (9)	na
Asset share of state-owned banks (in per cent) [4]	19.9	1.9	3.5	5.2	5.1	3.7	na
Asset share of foreign-owned banks (in per cent)	na	na	na	na	na	5.5	na
Non-performing loans (in per cent of total loans)	5.5	2.1	2.1	2.0	2.1	2.9	na
Domestic credit to private sector (in per cent of GDP)	7.4	10.6	14.9	16.9	19.1	22.5	na
Domestic credit to households (in per cent of GDP)	0.4	0.6	1.0	1.6	2.7	5.6	na
Of which mortgage lending (in per cent of GDP)	na	na	0.1	0.2	0.6	1.8	na
Stock market capitalisation (in per cent of GDP)	15.5	7.5	5.6	5.5	8.0	9.2	na
Stock trading volume (in per cent of market capitalisation)	0.8	8.5	25.0	27.0	22.0	25.7	na
Eurobond issuance (in per cent of GDP)	3.0	1.9	1.1	1.0	2.3	8.5	na
EBRD index of banking sector reform	2.3	2.3	2.7	2.7	3.0	3.0	3.0
EBRD index of reform of non-bank financial institutions	2.0	2.3	2.3	2.3	2.3	2.3	2.3
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	10.8 (0.3)	11.3 (1.2)	12.1 (3.6)	13.0 (6.4)	14.7 (9.4)	16.2 (17.9)	na
Internet penetration rate (per 10,000 inhabitants)	2.5	5.0	6.8	10.4	13.5	14.7	na
Railway labour productivity (1989=100)	27.6	42.5	46.3	51.0	58.5	62.6	na
Residential electricity tariffs (in USc kWh)	0.5	2.8	2.7	3.0	3.1	3.0	na
Average collection rate, electricity (in per cent)	na	na	na	92	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.7	1.8	1.8	1.9	na	na	na
EBRD index of infrastructure reform	2.0	2.0	2.3	2.3	2.3	2.3	2.3
Electric power	3.3	3.0	3.0	3.0	3.0	3.3	3.3
Railways	2.0	2.3	2.7	2.7	2.7	2.7	3.0
Roads	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water	1.7	1.7	1.7	1.7	1.7	2.0	2.0

[1] Ownership of agricultural land is limited to Kazakhstani residents and only applies to one-third of the total land area.

[2] Kazakhstan has no specific concession law but generally conforms with internationally accepted principles on concession laws.

[3] Refers to taxes on international trade.

[4] In December 2000 the state reduced its stake in the Savings Bank to less than 50 per cent.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	2.7	9.8	13.5	9.8	9.3	9.4	9.0
Private consumption	0.1	1.2	7.8	12.2	3.5	9.5	na
Public consumption	7.6	15.0	19.2	-4.3	7.5	18.4	na
Gross fixed capital formation	0.5	16.1	25.3	10.2	8.9	12.4	na
Exports of goods and services	3.0	28.7	-1.8	22.6	5.5	10.5	na
Imports of goods and services	0.6	26.1	0.3	4.3	-4.1	14.5	na
Industrial gross output	2.7	15.5	13.8	10.5	9.1	10.1	na
Agricultural gross output	28.0	-4.2	17.3	3.4	1.6	1.0	na
Employment [1]			*(Percentage change)*				
Labour force (end-year)	0.0	0.7	5.2	-1.1	3.5	2.4	na
Employment (end-year)	-0.4	1.6	8.0	0.2	4.1	2.8	na
			(In per cent of labour force)				
Unemployment (end-year)	13.5	12.8	10.4	9.3	8.8	8.4	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	8.3	13.2	8.4	5.9	6.4	6.9	6.8
Consumer prices (end-year)	17.8	9.8	6.4	6.6	6.8	6.7	7.1
Producer prices (annual average)	18.8	38.0	0.3	0.3	9.3	16.7	na
Producer prices (end-year)	57.2	19.4	-14.1	11.9	5.9	23.8	na
Gross average monthly earnings in economy (annual average)	22.5	21.2	20.4	17.5	13.8	22.2	na
Government sector [2]			*(In per cent of GDP)*				
General government balance [3]	-5.2	-1.0	2.7	1.4	2.9	2.7	1.7
General government expenditure [4]	23.2	23.2	23.0	21.0	22.5	23.3	na
General government debt	31.5	25.5	20.4	17.7	15.0	12.1	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	84.4	45.0	40.2	30.1	29.5	68.1	na
Domestic credit (end-year) [5]	35.4	57.3	17.1	30.2	24.1	70.0	na
			(In per cent of GDP)				
Broad money (M2, end-year)	13.6	15.3	17.1	19.2	20.3	28.4	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	18.0	14.0	9.0	7.5	7.0	7.0	na
Treasury bill rate (3-month maturity) [6]	15.6	6.6	5.3	5.2	5.9	3.3	na
Deposit rate [7]	13.5	15.6	12.8	11.0	10.9	9.3	na
Lending rate [8]	20.8	18.8	15.3	14.1	14.9	13.7	na
			(Tenges per US dollar)				
Exchange rate (end-year)	138.2	144.5	150.2	155.6	144.2	130.0	na
Exchange rate (annual average)	119.5	142.1	146.7	153.3	149.6	136.0	na
External sector			*(In millions of US dollars)*				
Current account	-236	366	-1,390	-1,024	-270	533	1,217
Trade balance [9]	340	2,168	983	1,987	3,679	6,786	9,512
Merchandise exports	5,989	9,288	8,928	10,027	13,233	20,603	26,784
Merchandise imports	5,648	7,120	7,944	8,040	9,554	13,818	17,272
Foreign direct investment, net	1,468	1,278	2,861	2,164	2,210	5,548	2,700
Gross reserves, excluding gold (end-year)	1,479	1,594	1,997	2,551	4,236	8,473	na
External debt stock [10]	12,081	12,685	15,158	18,197	22,884	32,017	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year) [11]	2.6	2.1	2.3	2.6	3.8	5.4	na
			(In per cent of exports of goods and services)				
Debt service	27.3	51.2	37.6	35.4	35.2	38.2	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	14.9	14.9	14.9	14.9	15.0	15.1	na
GDP (in billions of tenges)	2,016	2,600	3,251	3,776	4,612	5,542	6,449
GDP per capita (in US dollars)	1,132	1,231	1,492	1,657	2,062	2,703	na
Share of industry in GDP (in per cent)	23.9	25.2	25.2	25.3	25.3	25.4	na
Share of agriculture in GDP (in per cent)	11.1	9.8	10.1	9.5	8.9	8.1	na
Current account/GDP (in per cent)	-1.4	2.0	-6.3	-4.2	-0.9	1.3	2.5
External debt - reserves (in US$ million)	10,602	11,091	13,160	15,647	18,648	23,540	na
External debt/GDP (in per cent)	71.6	69.3	68.4	73.9	74.2	78.6	na
External debt/exports of goods and services (in per cent)	174.7	122.7	148.8	157.3	153.1	141.6	na

[1] Employment data based on labour force surveys.
[2] General government includes the state, municipalities and extra-budgetary funds and is on a cash basis.
[3] Government balance includes quasi-fiscal operations and transfers to the National Fund. Balance excludes privatisation revenues.
[4] Expenditures include extra-budgetary funds.
[5] Domestic credit from International Financial Statistics. Break in series in 2001. Data include National Fund from 2001.
[6] Average effective yield of short-term NBK notes.
[7] Deposit rate refers to the weighted average of interest rates on time deposits of individuals, in tenge by maturity.
[8] Lending rate refers to weighted average of interest rates on credits extended to legal entities excluding banks in tenge by maturity.
[9] Exports at declared customs prices and have not been corrected for under-invoicing of oil and gas exports.
[10] Includes inter-company debt by branches of non-resident foreign enterprises and short-term debt.
[11] Excludes National Fund.

Kyrgyz Republic

Key challenges

- The new government needs to step up the fight against corruption, particularly in the public administration and the judiciary.
- Following the approval of the amended pledge law, the government should work with banks and courts to ensure its effective implementation.
- Despite further Paris Club debt restructuring, fiscal and monetary prudence should be maintained as insufficient diversification makes the economy vulnerable to shocks.

Country data	
Population (in millions)	**5.1**
Area ('000 sq. km)	**200.0**
GDP (in billion US$, 2004)	**2.2**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 1,931**
National currency	**Som**

Progress in structural reform

Business environment and competition

Following elections in July 2005, the new government made the fight against corruption a priority. A national strategy to combat corruption was adopted and the parliament ratified the UN Convention against Corruption. Also, an action plan decreed by the president identified initiatives to be followed up during the remainder of 2005. These included the formation of an anti-corruption body and amendments to the existing anti-corruption law; administrative and civil service reform; strengthening of anti-money laundering capacity; a law on financial disclosure by public officials; increased transparency in public sector finance; and some steps in reform of the judiciary.

Surveys conducted by the International Business Council and the EBRD/World Bank suggest there has been a deterioration in investor confidence. Perceptions may have been affected by recent political upheaval in the country. Nevertheless, shortcomings in the functioning of the main regulatory institutions and the incidence of bribery underlie a weak, and in some cases worsening, business environment. The business community is also increasingly concerned about the involvement of criminal elements in the economy.

Infrastructure

In the telecommunications sector, the long-delayed privatisation of Kyrgyz Telecom has been put on hold. In the mobile market, BiTel, the largest operator, was sold to a Kazakh investor, Seimar Investment Group, in April 2005.

In the electricity sector, average collection rates improved from 78 per cent in 2003 to 89 per cent in 2004. However, the level of non-technical losses remains high. A USAID-funded project estimated that distribution companies lose approximately US$50 million annually because of theft and corruption.

The new government has agreed with IMF officials to further reduce the electricity quasi-fiscal deficit (defined as the cost of production minus cash revenues) from 8.3 per cent of GDP in 2004 to 6.3 per cent in 2006. This would be achieved through efficiency improvements, a further increase in collection rates and by reducing theft. However, a planned 15 per cent tariff increase in April 2005 did not take place and tariffs remain far below the level needed to cover the short-run costs of supply.

Financial sector

The banking sector continued to grow rapidly in 2004, with total customer loans growing by more than 90 per cent in real terms. Loan quality also improved, with non-performing loans as a percentage of total loans declining from 11 per cent in 2003 to 6 per cent in 2004. The system survived the political upheavals in March 2005 without serious incident.

Total deposits declined by 13 per cent in March from their February level, but recovered by May. Customer loans were less affected, although the rate of credit growth slowed during the first half of 2005 compared with the corresponding period in 2004. Confidence in Energo bank, which experienced significant deposit withdrawals after the unrest in March 2005, was restored when ATF Bank of Kazakhstan increased its stake and became a majority shareholder in May.

The regulatory and institutional framework in the financial sector is developing. A new pledge law was approved by the parliament in February 2005, but further amendments are needed to simplify the registration of collateral. In December 2004 a new anti-money laundering law passed its first reading in the parliament. Under the draft law, a Financial Investigation Unit will be established with the authority to investigate suspicious transactions. However, the draft law does not define sanctions in cases of non-compliance, which could undermine its effectiveness.

A law regulating the activities of credit information bureaux is also being prepared. The first credit bureau was established in March 2003 (the first in the CIS), but has developed slowly due to unclear rules about compulsory information sharing by lenders. Following advice from the IMF, the establishment of a universal deposit insurance scheme has been postponed. The IMF believes the quality of supervision, reporting, ownership transparency and financial and operational soundness is not yet sufficient to support such a scheme.

There are a number of non-bank financial institutions that provide rural and agricultural finance. The state-owned Kyrgyz Agricultural Finance Corporation (KAFC) is the largest institution. Its customer credit portfolio at the end of 2004 was equivalent to 26 per cent of total customer credit provided by commercial banks. Since its establishment in 1996, KAFC's activities have been supported by sovereign-guaranteed donor funding. The authorities are seeking ways to transform it into a more sustainable entity without further need for government support. The commercialisation and privatisation of KAFC should enhance competition in the financial sector and promote financial development in the rural sector.

Macroeconomic performance

Real economy

The economy grew strongly in 2004 by 7.1 per cent, the highest rate since the 1998–99 banking sector crisis. Growth was led by the service sector which expanded by 11.7 per cent. Agriculture, accounting for 33 per cent of GDP, also grew solidly by 4.1 per cent. During 2005 the economy has been adversely affected by the March political events, with preliminary estimates showing real GDP growth of just 0.9 per cent year-on-year for the first seven months of the year.

Economic policies

Fiscal policy has been tightened gradually in recent years under the IMF's Poverty Reduction and Growth Facility. The general government deficit in 2004 was 4.5 per cent of GDP. Further fiscal consolidation is planned under a new IMF programme, starting in February 2005, primarily through continued restraint on capital expenditures. (An increase in social spending will be accommodated.) The unrest in March delayed the adoption of a new tax code, as well as the planned broadening of the tax base and simplification of the tax system. Monetary policy remains focused on price stability while accommodating remonetisation. Broad money grew strongly in the last three years, but the pace has declined as money demand has increased at an even faster rate. The events in March temporarily reduced money demand and pushed consumer prices up as distribution channels for commodities were disrupted. However, prices declined month-on-month in June 2005, giving an inflation rate of 6.3 per cent year-on-year.

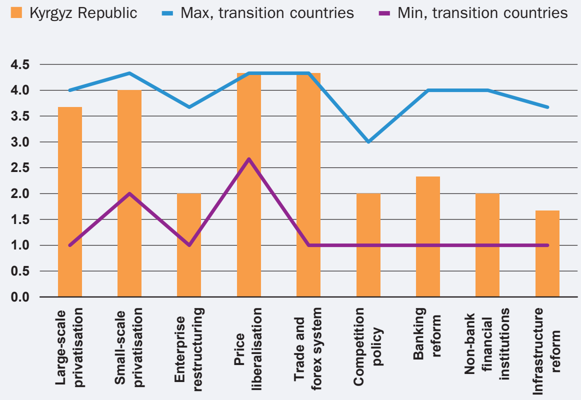
External sector

The current account deficit narrowed in 2004 to 3.4 per cent of GDP from 4.2 per cent in 2003. This was due to increased prices and volume of gold exports, higher exports of food, electricity and light industry products to Russia and Kazakhstan, and to increased inflows of remittances. Net foreign direct investments reached a record US$131 million in 2004. Gross official reserves (excluding gold) increased to 5.8 months of import cover at the end of 2004, compared with five months in 2003. Total external debt declined from 103 per cent of GDP in 2003 to 95 per cent in 2004. The ratio is likely to decline further as the Paris Club granted further debt relief in March 2005. Under this agreement, the net present value of bilateral debt is expected to be reduced by 36 per cent and the remainder will be rescheduled on favourable terms. Negotiations with each bilateral donor are scheduled to be completed by the end of September 2005.

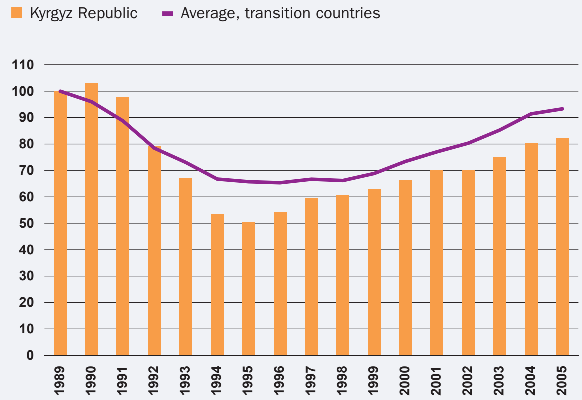
Outlook and risks

Growth is projected to decelerate sharply to 2.5 per cent in 2005, due to falling production at the Kumtor gold mine and a slowdown in the rest of the economy. However, economic activity may pick up again if political stability is restored. The new Paris Club debt relief will help to further reduce the debt service burden and relieve pressure on international reserves. However, the economy remains vulnerable to shocks due to the lack of diversification. The new government must therefore improve the business environment to foster private sector investment and productivity growth.

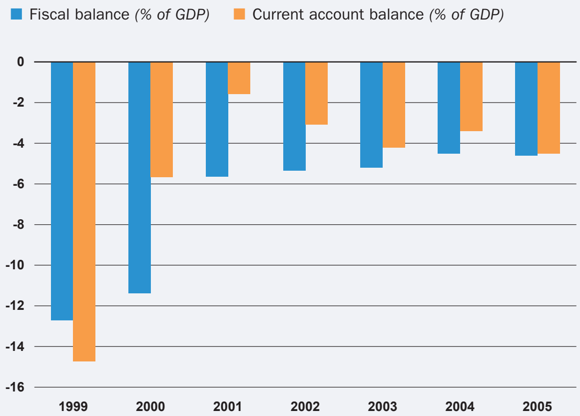
Transition indicators, 2005



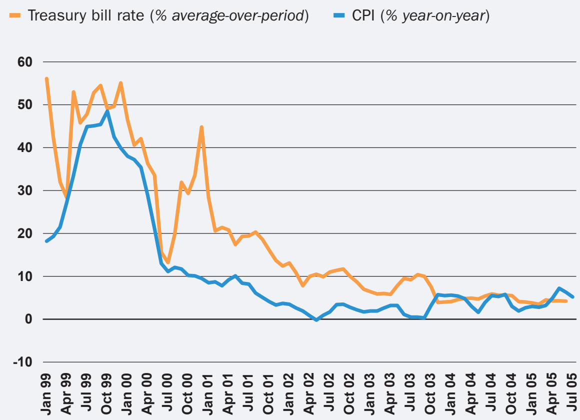
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **partially**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **24.6 per cent** (2002)[2]
Controls on inward direct investment – **no**[1]	Quality of insolvency law – **medium**	Independent electricity regulator – **partially**	Deposit insurance system – **no**	Government expenditure on health – **2.1 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **some defects**	Separation of railway infrastructure from operations – **no**	Quality of securities market laws – **low**	Government expenditure on education – **4.2 per cent of GDP**
Exchange rate regime – **managed float**	Quality of corporate governance law – **medium**	Quality of concession laws – **low**	Private pension funds – **yes**	Share of power, water in total household expenditure – **4.0 per cent**
Wage regulation – **no**				
Tradability of land – **limited de facto**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.0	2.3	2.7	2.9	3.2	7.4	na
Private sector share in GDP (in per cent)	60.0	60.0	60.0	65.0	65.0	75.0	75.0
Private sector share in employment (in per cent)	77.7	78.2	79.1	79.7	80.3	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.3	na	3.0	3.4	3.2	3.1	na
Share of industry in total employment (in per cent)	9.0	8.0	7.9	7.8	7.7	na	na
Change in labour productivity in industry (in per cent)	3.6	18.5	5.8	-10.2	15.9	na	na
Investment/GDP (in per cent)	18.0	20.0	18.0	17.6	11.8	10.0	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.7	3.7
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	12.0	na
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	55.7	56.9	52.5	53.8	50.3	53.9	na
Share of trade in GDP (in per cent)	81.1	74.3	60.8	66.6	68.4	74.2	na
Tariff revenues (in per cent of imports)	1.4	1.1	1.4	1.6	1.3	1.2	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	23 (5)	22 (6)	20 (5)	20 (6)	21 (7)	19 (10)	na
Asset share of state-owned banks (in per cent)	25.8	15.8	16.6	9.7	7.2	4.1	na
Asset share of foreign-owned banks (in per cent)	16.5	24.6	32.7	50.5	61.3	70.1	na
Non-performing loans (in per cent of total loans)	6.4	16.3	13.8	13.3	11.2	6.4	na
Domestic credit to private sector (in per cent of GDP)	3.0	2.2	2.0	2.6	na	na	na
Domestic credit to households (in per cent of GDP)	na	na	na	na	na	na	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	0.4	0.3	0.3	0.5	1.6	1.5	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform[3]	2.0	2.0	2.0	2.0	2.3	2.3	2.3
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	7.6 (0.1)	7.7 (0.2)	7.8 (0.5)	7.8 (1.0)	7.9 (1.2)	7.9 (5.8)	na
Internet penetration rate (per 10,000 inhabitants)	3.2	3.6	9.1	11.6	11.0	10.8	na
Railway labour productivity (1990=100)	15.4	15.3	15.0	16.2	22.0	27.4	na
Residential electricity tariffs (in USc kWh)	na	0.6	0.7	1.0	1.0	1.0	na
Average collection rate, electricity (in per cent)	na	45	na	na	78	89	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.9	3.1	3.6	3.2	na	na	na
EBRD index of infrastructure reform	1.3	1.3	1.3	1.3	1.3	1.7	1.7
Electric power	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Railways	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Roads	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Telecommunications	2.0	2.3	2.3	2.3	2.7	3.0	3.0
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0

1 All investments must be registered with the Ministry of Justice and statistical agencies.

2 Based on the nationally defined poverty line, the percentage of population living in poverty was 41 per cent in 2003.

3 Series has been revised.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	3.7	5.4	5.3	0.0	7.0	7.1	2.5
Private consumption	0.7	-4.2	1.6	4.2	22.1	9.9	na
Public consumption	3.5	7.5	0.0	-0.2	-2.0	6.7	na
Gross fixed capital formation	27.7	26.4	-1.9	-7.3	-6.3	-2.9	na
Exports of goods and services	-10.4	10.5	-3.2	8.1	5.3	14.8	na
Imports of goods and services	-4.9	0.4	-13.8	13.1	16.0	18.5	na
Industrial gross output	-4.3	6.0	5.4	-10.9	17.0	3.7	na
Agricultural gross output	8.2	2.6	7.3	3.1	3.2	4.1	na
Employment			*(Percentage change)*				
Labour force (end-year) [1]	2.1	1.7	1.8	2.0	4.7	na	na
Employment (end-year) [2]	3.5	0.2	1.1	1.1	1.7	na	na
			(In per cent of labour force)				
Unemployment (end-year)	7.4	7.5	7.8	8.6	9.0	na	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	35.9	18.7	6.9	2.0	3.1	4.1	4.9
Consumer prices (end-year)	39.8	9.5	3.7	2.3	5.6	2.8	4.6
Producer prices (annual average)	53.7	30.7	12.0	4.8	4.6	5.9	na
Producer prices (end-year)	43.6	22.9	5.2	6.0	7.8	4.5	na
Gross average monthly earnings in economy (annual average)	24.9	16.9	18.6	15.8	13.7	14.9	na
Government sector [3]			*(In per cent of GDP)*				
General government balance	-12.7	-11.4	-5.6	-5.3	-5.2	-4.5	-4.6
General government expenditure	34.0	29.9	26.0	28.1	27.4	27.1	na
General government debt	134.3	113.3	107.3	107.3	104.9	93.7	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	33.7	11.7	11.3	33.9	33.4	32.1	na
Domestic credit (end-year)	5.0	10.0	-8.1	21.6	11.3	-18.8	na
			(In per cent of GDP)				
Broad money (M2, end-year)	13.6	11.3	11.1	14.6	17.5	20.6	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Lombard rate	51.6	32.8	10.7	4.4	4.0	4.0	na
Money market rate [4]	47.2	32.3	19.1	7.0	4.0	4.0	na
Deposit rate [5]	35.6	18.4	12.5	5.9	5.0	6.7	na
Lending rate [5]	60.9	51.9	37.3	24.8	21.7	29.3	na
			(Soms per US dollar)				
Exchange rate (end-year)	45.8	48.3	47.7	46.1	44.2	41.6	na
Exchange rate (annual average)	39.0	47.7	48.3	46.9	43.7	42.6	na
External sector			*(In millions of US dollars)*				
Current account	-184	-78	-24	-49	-81	-75	-112
Trade balance	-89	4	31	-74	-133	-171	-256
Merchandise exports	463	511	480	498	590	733	683
Merchandise imports	551	507	450	572	724	904	939
Foreign direct investment, net	38	-7	-1	5	46	131	83
Gross reserves, excluding gold (end-year)	230	205	230	289	365	549	na
External debt stock	1,647	1,704	1,678	1,785	1,978	2,104	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.9	3.8	4.8	4.8	5.0	5.8	na
			(In per cent of exports of goods and services)				
Debt service [6]	26.0	28.1	30.8	21.0	22.3	19.1	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	4.9	4.9	4.9	5.0	5.0	5.1	na
GDP (in millions of soms)	48,744	65,358	73,883	75,367	83,872	94,078	101,148
GDP per capita (in US dollars)	257	279	309	322	381	433	na
Share of industry in GDP (in per cent)	24.7	27.2	26.8	21.3	20.2	19.0	na
Share of agriculture in GDP (in per cent)	34.9	34.2	34.5	34.4	33.6	32.9	na
Current account/GDP (in per cent)	-14.7	-5.7	-1.6	-3.1	-4.2	-3.4	-4.5
External debt - reserves (in US$ million)	1,418	1,499	1,448	1,496	1,614	1,555	na
External debt/GDP (in per cent)	131.8	124.4	109.6	111.1	103.0	95.3	na
External debt/exports of goods and services (in per cent)	312.3	297.5	299.3	278.8	265.5	223.3	na

[1] Based on labour force data from World Bank *World Development Indicators*.

[2] The number of people employed in legal entities, which excludes employment in agriculture and forestry. Based on data from the National Statistical Committee (NSC).

[3] General government includes the state, municipalities and extra-budgetary funds. It also includes expenditure under the foreign-financed public investment programme and net lending.

[4] Weighted average rate on interbank loans in soms with 1-90 days maturity, from International Financial Statistics.

[5] Weighted average over all maturities from International Financial Statistics.

[6] Debt service scheduled and excludes US$ 111 million debt rescheduling granted by the Paris Club of official creditors for 2002-04.

Latvia

Key challenges

- The implementation of measures to reduce tax evasion and enforce anti-fraud and anti-money laundering laws needs to be strengthened to further improve the business environment.
- Progress in the telecommunications sector has been hampered by an uncertain regulatory environment, particularly regarding the implementation of tariff rebalancing, universal service obligations and interconnection charges.
- Fast credit growth continues to contribute to a high current account deficit. While credit quality does not appear to have suffered, the effects of this expansion on inflation and on the debt burden of household borrowers must be managed carefully.

Country data

Population (in millions)	**2.3**
Area ('000 sq. km)	**64.5**
GDP (in billion US$, 2004)	**13.5**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 11,962**
National currency	**Lat**

Progress in structural reform

Business environment and competition

Results from the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey highlight Latvia's progress in developing its business environment. Since the previous survey in 2002, business perceptions of the regulatory burden and the level of corruption have improved. Meanwhile, perceptions of the judiciary and the state of infrastructure have remained largely the same.

The authorities have initiated several measures to fight corruption and reduce the risk of fraud and money laundering. A National Programme for Preventing and Combating Corruption has been launched by the Corruption Prevention Bureau. New anti-money laundering legislation has also brought Latvian laws in line with EU requirements. However, the implementation of the new legislation remains slow, with two Latvian banks still included in the US Treasury's list of financial institutions that are "primary money laundering concerns".

The IMF has also called on the government to amend the law on insolvency to guarantee creditors' rights and to streamline public procurement procedures.

Infrastructure

The liberalisation of the power sector is continuing. State-owned Latvenergo is being unbundled, although its privatisation is not envisaged. In May 2005 the Latvian parliament adopted a new law aimed at finalising market liberalisation according to EU requirements. As a result, industrial consumers and rival power suppliers gained access to Latvenergo's transmission grid. As of July 2007 Latvian consumers will in principle be able to choose another electricity supplier within the EU. The law also obliges Latvenergo to install high-voltage power lines for industrial consumers at its own expense from January 2006. In addition, Latvia must increase the share of its energy consumption produced from renewable resources from 45 to 49 per cent by 2010. Tariffs are broadly cost-reflective and there is an independent regulator.

The fixed-line telecommunications operator was partly privatised in 1994 and granted a long-term exclusivity arrangement. The early termination of this agreement led to a dispute over compensation between the state and the strategic investor TeliaSonera. After a three-year arbitration case, a settlement was agreed in 2004.

Although this dispute has not delayed the opening up of the fixed-line sector, it has delayed the sale of the state's remaining 51 per cent stake in the fixed-line operator. Effective competition is still lagging behind. This is due to the uncertain regulatory environment, particularly regarding the implementation of tariff rebalancing, universal service obligations and interconnection charges. Although the Public Utilities Commission has already issued a number of licences, the market remains controlled by the dominant operator.

Financial sector

Improved macroeconomic fundamentals and compliance with EU accession requirements have significantly strengthened Latvia's banking system. At the end of 2004 the financial sector included 23 banks. Nine were foreign-owned, accounting for 45 per cent of total banking assets and 54 per cent of total banking capital.

Foreign owners include Swedish, German, Russian and Ukrainian banks. The sector is less concentrated than elsewhere in the region, with only around 50 per cent of the market share belonging to the three largest banks. However, the other banks are mainly smaller niche banks.

Regulation and financial supervision have been tightened since the establishment of a unified regulatory agency, the Financial and Capital Market Commission (FCMC), in 2001. The Central Bank and the FCMC, in cooperation with the IMF, have concluded that the banking system is resilient to possible shocks such as credit quality deterioration and large changes in interest rates and the exchange rate.

The volume of non-performing loans has declined from 4 per cent of total loans in 1999 to 1.4 per cent in mid-2005. In addition, the provision of banks for non-performing loans is comfortable at around 90 per cent. Non-resident deposits have traditionally been important in the sector. However, only smaller institutions remain heavily reliant on them.

Macroeconomic performance

Real economy

The economy expanded by 8.5 per cent in real terms in 2004, the fastest pace among the new EU member countries. This reflected high growth in the construction, manufacturing, transport and communications sectors. Real GDP growth accelerated to 9.5 per cent year-on-year in the first half of 2005. Low interest rates and longer available maturities for local bank loans have stimulated rapid credit growth (for businesses and households) and buoyant domestic demand.

Economic policies

The general government deficit decreased to 0.8 per cent of GDP in 2004 compared with 1.5 per cent in 2003. It is expected to remain below 2 per cent for the period through to 2007. The decrease in 2004 reflected higher tax revenues, despite a reduction in corporate tax from 19 to 15 per cent. On the expenditure side, EU and NATO-related costs turned out to be lower than budgeted. A pro-cyclical fiscal stance is expected in 2005 as EU funds finance a 25 per cent increase in government spending. As a result of a prudent fiscal policy in recent years, public debt is relatively modest (less than 15 per cent of GDP by the end of 2004).

Following the re-pegging of the currency to the euro in January 2005, Latvia was admitted to the Exchange Rate Mechanism II (ERM II) in May. However, annual inflation had exceeded 7 per cent by the end of 2004 and has remained at a relatively high level in 2005. Credit growth strengthened domestic demand, while on the supply side factors fuelling inflation have included administrative changes related to EU accession, increases in food prices as a result of a poor harvest, depreciation against the euro, and global increases in commodity prices (notably oil and gas). In response, the Central Bank twice raised its refinancing rate by 50 basis points in March and November 2004 to reach 4 per cent.

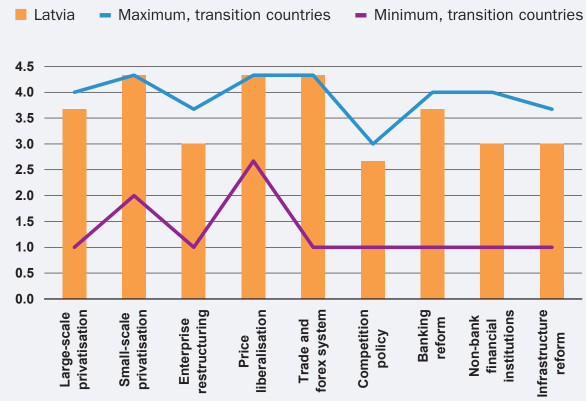
External sector

The current account deficit exceeded 12 per cent of GDP in 2004, but is expected to fall to 10 per cent in 2005 on the back of a declining trade deficit. Imports of capital and intermediate goods continue to flow in at a strong rate, reflecting the restructuring of enterprises and infrastructure. Exports (mostly wood and wood products) also grew at a fast pace in 2004. Foreign direct investment (FDI) coverage of the deficit declined to some 30 per cent in 2004. However, it is expected to bounce back to around 50 per cent in 2005 through higher investments in equity capital in commercial services and trade. Gross external debt is high at over 80 per cent of GDP, but assets owned by foreigners in the country account for some 60 per cent of GDP.

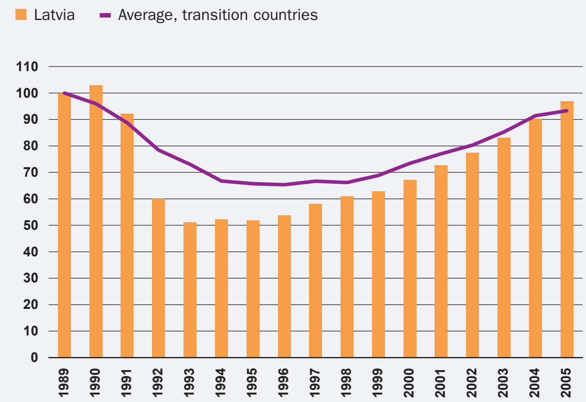
Outlook and risks

Annual real GDP growth is expected to stabilise at a robust 7.5 per cent in 2005. However, the rapid credit growth of recent years raises some macroeconomic risks. While this has not yet affected credit quality, it is reflected in a high current account deficit that is only partly covered by FDI inflows. In the absence of a tight fiscal policy, a continuing credit expansion could also worsen the already high level of inflation and delay EMU membership.

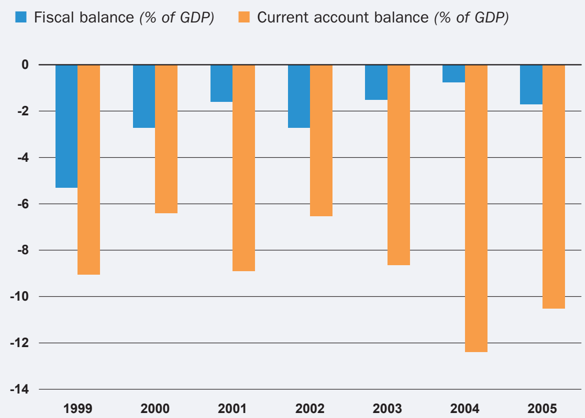
Transition indicators, 2005



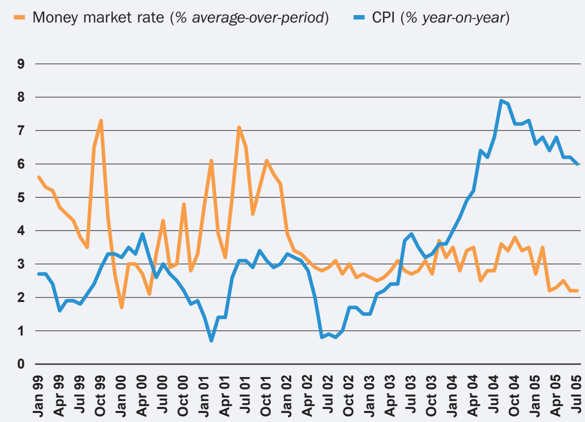
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **10 per cent**	Share of population living in poverty – **11.5 per cent** (1998)
Controls on inward direct investment – **no** [1]	Quality of insolvency law – **low**	Independent electricity regulator – **fully**	Deposit insurance system – **yes**	Government expenditure on health – **3.3 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **advanced**	Separation of railway infrastructure from operations – **partially**	Quality of securities market laws – **medium**	Government expenditure on education – **6.5 per cent of GDP**
Exchange rate regime – **fixed peg in ERM II**	Quality of corporate governance law – **high**	Quality of concession laws – **low**	Private pension funds – **yes**	Share of power, water in total household expenditure – **3.1 per cent**
Wage regulation – **no**				
Tradability of land – **full except foreigners**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	3.2	3.8	4.4	5.0	5.2	5.3	na
Private sector share in GDP (in per cent)	65.0	65.0	65.0	70.0	70.0	70.0	70.0
Private sector share in employment (in per cent)	70.0	72.0	73.0	75.0	76.0	76.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	4.8	4.6	4.8	5.5	5.4	5.1	na
Share of industry in total employment (in per cent)	19.9	20.5	18.3	19.5	19.7	19.7	na
Change in labour productivity in industry (in per cent)	5.2	5.4	19.2	-0.8	6.7	8.2	na
Investment/GDP (in per cent)	23.2	23.5	26.9	26.8	28.8	32.6	na
EBRD index of small-scale privatisation	4.0	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.3	3.7	3.7	3.7
EBRD index of enterprise reform	2.7	2.7	2.7	2.7	3.0	3.0	3.0
Markets and trade							
Share of administered prices in CPI (in per cent)	22.0	22.3	22.0	20.7	16.3	16.0	14.3
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Share of trade with non-transition countries (in per cent)	72.9	79.8	68.6	67.7	65.5	59.6	na
Share of trade in GDP (in per cent)	66.5	67.0	70.2	71.6	75.4	82.3	na
Tariff revenues (in per cent of imports)	0.9	0.8	0.7	0.6	0.6	0.3	0.4
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.7	2.7	2.7
Financial sector							
Number of banks (foreign-owned)	23 (12)	21 (12)	23 (10)	23 (9)	23 (10)	23 (9)	na
Asset share of state-owned banks (in per cent)	2.6	2.9	3.2	4.0	4.1	4.0	na
Asset share of foreign-owned banks (in per cent)	74.0	74.4	65.2	42.8	53.0	48.6	na
Non-performing loans (in per cent of total loans)	6.8	5.0	3.1	2.1	1.4	1.1	na
Domestic credit to private sector (in per cent of GDP)	14.8	18.1	24.6	30.5	38.8	49.9	na
Domestic credit to households (in per cent of GDP)	2.2	3.4	4.6	7.4	11.8	18.0	na
Of which mortgage lending (in per cent of GDP)	1.0	1.6	2.4	4.2	7.7	12.2	na
Stock market capitalisation (in per cent of GDP)	5.9	8.0	9.1	8.1	9.6	11.7	na
Stock trading volume (in per cent of market capitalisation)	11.0	49.0	26.0	24.0	16.0	8.0	na
Eurobond issuance (in per cent of GDP)	3.6	0.0	4.6	0.0	0.0	0.0	na
EBRD index of banking sector reform	3.0	3.0	3.3	3.7	3.7	3.7	3.7
EBRD index of reform of non-bank financial institutions	2.3	2.3	2.3	3.0	3.0	3.0	3.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	30.0 (11.3)	30.3 (16.6)	30.7 (27.9)	30.1 (39.4)	28.3 (52.9)	27.6 (67.2)	na
Internet penetration rate (per 10,000 inhabitants)	79.3	110.1	106.4	152.4	178.8	258.7	na
Railway labour productivity (1989=100)	73.6	84.5	90.5	108.6	129.9	125.9	na
Residential electricity tariffs (in USc kWh)	na	6.3	6.3	6.5	7.1	8.2	na
Average collection rate, electricity (in per cent)	na	na	99	100	100	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.4	5.0	4.6	5.1	na	na	na
EBRD index of infrastructure reform	2.7	2.7	3.0	3.0	3.0	3.0	3.0
Electric power	3.0	3.0	3.0	3.0	3.0	3.3	3.3
Railways	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Water and waste water	3.0	3.0	3.3	3.3	3.3	3.3	3.3

[1] There are controls on raffles and gambling for certain nationals.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	3.3	6.9	8.0	6.4	7.5	8.5	7.5
Private consumption	4.3	6.3	7.3	7.4	8.6	8.9	na
Public consumption	0.0	-1.9	0.3	2.4	2.5	1.4	na
Gross fixed capital formation	-6.8	10.2	11.4	13.0	7.4	21.1	na
Exports of goods and services	-6.4	12.0	6.9	6.3	4.3	8.9	na
Imports of goods and services	-5.2	4.9	12.6	4.5	13.3	15.5	na
Industrial gross output	-2.4	5.4	8.7	8.8	9.4	9.3	na
Agricultural gross output	-3.3	11.5	6.4	4.4	1.0	4.0	na
Employment			*(Percentage change)*				
Labour force (end-year)	-1.6	-2.9	0.9	1.5	0.3	-1.6	na
Employment (end-year)	-1.8	-2.8	2.2	2.8	1.8	1.1	na
			(In per cent of labour force)				
Unemployment (end-year)	14.3	14.4	13.1	12.4	10.6	8.5	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	2.4	2.6	2.5	1.9	3.0	6.3	6.4
Consumer prices (end-year)	3.3	1.9	3.0	1.5	3.6	7.3	6.0
Producer prices (annual average)	-4.0	0.6	1.7	1.0	3.2	8.6	na
Producer prices (end-year)	-1.1	1.0	1.8	0.8	4.1	11.3	na
Gross average monthly earnings in economy (annual average)	5.7	6.2	6.5	8.7	11.2	9.6	na
Government sector			*(In per cent of GDP)*				
General government balance	-5.3	-2.7	-1.6	-2.7	-1.5	-0.8	-1.7
General government expenditure [1]	41.0	37.2	34.9	35.7	35.0	36.2	na
General government debt	12.1	12.2	13.7	13.4	13.4	13.2	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	8.0	27.9	20.8	21.0	21.1	27.0	na
Domestic credit (end-year)	15.2	44.3	36.2	39.8	39.2	40.2	na
			(In per cent of GDP)				
Broad money (M2, end-year)	23.6	27.2	29.8	32.8	35.7	39.3	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	4.0	3.5	3.5	3.0	3.0	4.0	na
Interbank market rate [2]	2.7	3.3	5.4	2.7	3.2	3.5	na
Deposit rate (short-term, under 1 year)	4.2	4.2	5.7	3.2	3.0	3.3	na
Lending rate (short-term, under 1 year)	12.5	11.8	9.9	7.4	5.4	7.5	na
			(Lats per US dollar)				
Exchange rate (end-year)	0.58	0.61	0.64	0.59	0.54	0.52	na
Exchange rate (annual average)	0.59	0.61	0.63	0.62	0.57	0.54	na
External sector			*(In millions of US dollars)*				
Current account	-654	-494	-732	-601	-956	-1,673	-1,502
Trade balance	-1,027	-1,058	-1,351	-1,444	-1,998	-2,749	-2,772
Merchandise exports	1,889	2,058	2,216	2,576	3,171	4,185	4,978
Merchandise imports	2,916	3,116	3,567	4,020	5,169	6,935	7,750
Foreign direct investment, net	331	400	170	374	328	538	622
Gross reserves, excluding gold (end-year)	840	851	1,149	1,241	1,432	1,912	na
External debt stock [3]	3,821	4,702	5,570	6,970	9,140	10,810	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.8	2.6	3.2	3.2	2.8	2.8	na
			(In per cent of exports of goods and services)				
Debt service	14.3	16.5	21.5	15.4	13.8	11.7	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	2.4	2.4	2.4	2.3	2.3	2.3	na
GDP (in millions of lats)	4,224	4,686	5,168	5,691	6,323	7,299	7,882
GDP per capita (in US dollars)	3,032	3,268	3,511	3,949	4,771	5,827	na
Share of industry in GDP (in per cent)	21.8	20.7	20.4	20.3	20.3	20.7	na
Share of agriculture in GDP (in per cent)	4.3	4.9	4.7	4.5	4.3	5.3	na
Current account/GDP (in per cent)	-9.1	-6.4	-8.9	-6.5	-8.6	-12.4	-10.5
External debt - reserves (in US$ million)	2,981	3,851	4,421	5,729	7,708	8,898	na
External debt/GDP (in per cent)	52.9	60.9	67.6	75.7	82.6	80.0	na
External debt/exports of goods and services (in per cent)	131.1	143.7	163.6	182.1	194.5	181.1	na

[1] General government expenditure includes net lending.

[2] Weighted average interest rates in the interbank market.

[3] Includes non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

Lithuania

Key challenges

- Further improvements to public administration and the judiciary, as well as investments in the less developed regions of the country, are needed to support private sector growth and sustain productivity increases across the country.
- With the labour supply shrinking as a result of migration to neighbouring EU countries, further employment growth depends on sustained labour market flexibility and vocational training.
- The recent record of fiscal discipline needs to be maintained to keep the external position under control and to allow for EMU membership in the agreed timetable.

Country data	
Population (in millions)	**3.4**
Area ('000 sq. km)	**67.0**
GDP (in billion US$, 2004)	**22.3**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 12,994**
National currency	**Litas**

Progress in structural reform

Liberalisation and privatisation

The privatisation of national carrier Lithuanian Airlines (Lietuvos Avialinijos, LAL) was completed in June 2005. The airline was sold to Fima, a domestic company providing telecommunications and security services. Fima will hold 70 per cent of the stock and its partners – ZIA Valda, an investment and real estate development company, and Garantas, an insurance company – will hold 15 per cent each.

The sale of an 85.7 per cent stake in the power line construction company Elektros Tinklu Statyba was completed in February 2005. Important privatisations in 2004 included the sale of a 34 per cent stake in gas utility Lietuvos Dujos to Russia's Gazprom; 44.3 per cent of the National Stock Exchange of Lithuania; 32 per cent of the Central Securities Depository of Lithuania; 83.77 per cent of the beverage company Alita; and 100 per cent of the Lithuanian Film Studio. Total privatisation proceeds in 2004 amounted to LTL 410 million (€119 million).

Business environment and competition

The business environment is becoming more dynamic. According to the World Bank's *Doing Business* report, starting a business requires eight different procedures and takes an average of 26 days. Business registration costs are equal to 3.3 per cent of gross national income (GNI) per capita, lower than the average cost for OECD countries (6.5 per cent). There is no credit registry, but a private credit information bureau provides information on 4.4 per cent of the population. The cost of registering collateral is lower than in OECD countries.

Local banks and leasing companies have started to extend loans and leases to smaller companies, often supported through credit lines from international financial institutions. However, enterprise development is affected by shortcomings in public administration and the judiciary. Corruption, although lower than in most transition countries, is still relatively high compared with developed market economies. Development has also been uneven. The expansion of private enterprises and the restructuring of former state-owned companies in less developed regions remain key priorities.

Infrastructure

Russia's influence over the Lithuanian energy market is increasing. In 2004 Gazprom acquired a 34 per cent stake in the country's gas transmission and distribution monopoly Lietuvos Dujos (Lithuanian Gas). Russian investors have also expressed an interest in acquiring a stake in Mazeikiu Nafta, an oil refinery and transportation complex. Yukos International, a member of Yukos Group, is selling its 53.7 per cent stake in the complex. In an effort to gain control of Mazeikiu, the Lithuanian government, which currently owns 40.6 per cent, initiated negotiations with Yukos to acquire the Russian company's option for a further 9.7 per cent stake.

Following the full closure of the Ignalina nuclear power plant in 2009, Lithuania is expected to become a net importer of power from Russia, on which it already relies for natural gas. To reduce this dependence, the 1,800-MW Lithuanian Power Plant is being upgraded to run on several different fuels (natural gas, mazut and orimulsion) while complying with EU environmental directives. A power link with Poland is being discussed and a sea cable between Sweden and Lithuania is being studied. The government is also examining the possibility of building another nuclear plant, but this would be a costly and long-term option.

Social sector

Although unemployment remains high, the rate is gradually falling due to the pace of economic growth. In 2004 unemployment declined to 11.4 per cent. Labour supply and the structure of the labour force has been significantly affected by the continuing process of migration to neighbouring European countries, particularly among young people. In 2004 the 20 to 24-year-old age group recorded the sharpest drop in numbers within the labour force. Ireland, Sweden and the United Kingdom are the preferred destinations of these migrants. Labour outflows are set to continue as more European countries open their labour markets to Lithuanian citizens.

As the labour supply shrinks, real wages increase. According to Statistics Lithuania, average monthly real gross earnings grew by 7.2 per cent in 2004 and by 8.3 per cent year-on-year in the first quarter of 2005. Unless matched by productivity gains, these increases may affect the country's competitiveness in the long run.

Macroeconomic performance

Real economy

Real GDP grew by 6.7 per cent in 2004 and by 6.4 per cent year-on-year in the first half of 2005. The economy's performance was supported by a favourable external environment, which helped to lower interest rates and unemployment. This in turn resulted in strong growth in domestic consumption and investment demand. The slower pace of growth in the first months of 2005 has been attributable in part to the shut-down of the first block of the Ignalina nuclear power plant. However, growth is expected to pick up again in the course of the year on the back of investment-led productivity increases.

Economic policies

The costs of EU membership and changing tax policy contributed to a loosening of Lithuania's fiscal stance in 2004. The general government deficit widened to 2.5 per cent of GDP, up from 1.9 per cent the year before. Early in 2005 the parliament approved a decrease in the personal income tax rate from 33 to 27 per cent starting from July 2006, and then to 24 per cent in 2008. To compensate for the loss in revenues, additional taxes on profits and residential property used for commercial purposes will be introduced in 2006.

The currency board continues to enjoy broad support. Annual average inflation was moderate in 2004, reaching 1.2 per cent by the end of the year, but accelerated in the first half of 2005. Upward pressures on prices have been generated through rising excise taxes, administered prices, and oil and gas price increases. The authorities are aware of the risk to EU convergence that higher inflation poses. However, they remain convinced that inflation can be contained within the Maastricht limit.

External sector

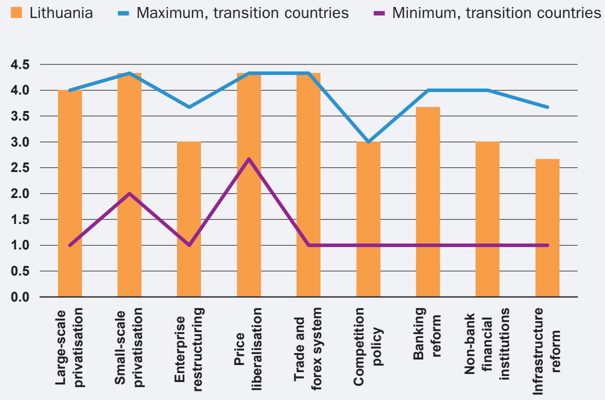
The current account deficit is large and widening. Following EU membership and expectations of strong future growth, investment rates continued to increase while the savings rate fell in 2004. As a result, the current account deficit widened to 7.1 per cent of GDP. This increase reflected changes in the trade and income balances, as imports grew faster than exports and profits on foreign direct investment (FDI) were repatriated.

Such trends are expected to continue and the current account deficit is likely to rise further in 2005. FDI financing accounted for only 25 per cent of the current account deficit in 2004, but is expected to increase in 2005 as a result of a greenfield investment in the PET plant at Klaipeda.

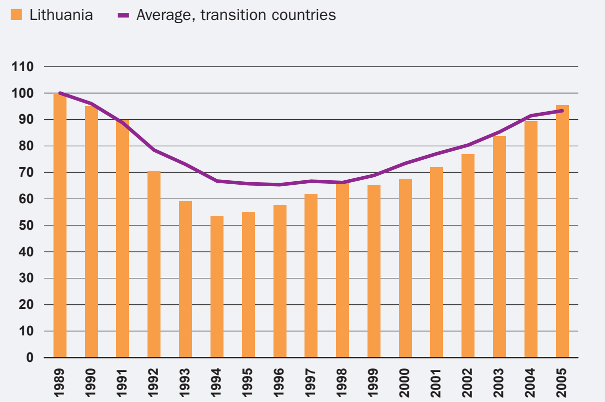
Outlook and risks

With continued strong internal demand, real GDP is projected to grow by 6.8 per cent in 2005. However, medium-term growth prospects depend on the country's ability to maintain fiscal discipline and address wide external deficits. The main risk is a further increase in the trade deficit, highlighting the need for continued tight fiscal policy. Failure to do so would put the country at risk of failing the Maastricht criteria and delaying EMU accession.

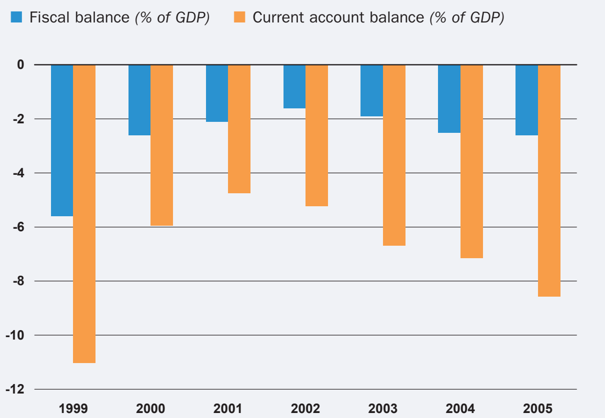
Transition indicators, 2005



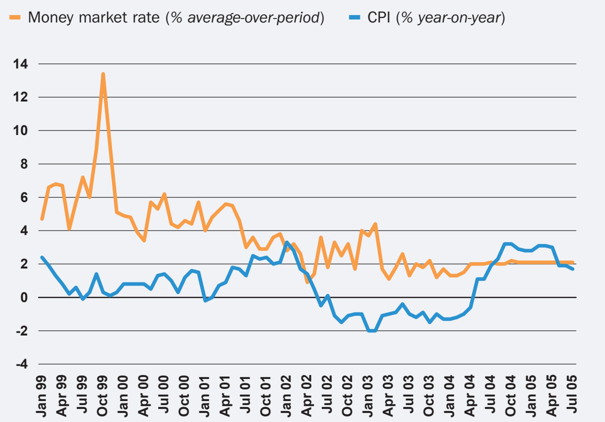
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **8 per cent**	Share of population living in poverty – **6.9 per cent** (2000)
Controls on inward direct investment – **no** [1]	Quality of insolvency law – **very low**	Independent electricity regulator – **partially**	Deposit insurance system – **yes**	Government expenditure on health – **4.2 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **advanced**	Separation of railway infrastructure from operations – **partially**	Quality of securities market laws – **high**	Government expenditure on education – **6.1 per cent of GDP**
Exchange rate regime – **currency board in ERM II**	Quality of corporate governance law – **high**	Quality of concession laws – **very high**	Private pension funds – **yes**	Share of power, water in total household expenditure – **3.8 per cent**
Wage regulation – **no**				
Tradability of land – **full** [2]				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	7.8	9.6	10.6	11.1	12.7	13.4	na
Private sector share in GDP (in per cent)	70.0	70.0	70.0	75.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.3	0.2	0.2	0.2	0.3	0.4	na
Share of industry in total employment (in per cent)	21.0	20.8	20.8	20.9	20.7	20.1	na
Change in labour productivity in industry (in per cent) [3]	-4.7	10.9	19.9	0.2	14.1	11.9	na
Investment/GDP (in per cent)	22.5	19.6	20.5	21.7	21.9	0.0	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.0	3.0	3.3	3.7	3.7	3.7	4.0
EBRD index of enterprise reform	2.7	2.7	2.7	3.0	3.0	3.0	3.0
Markets and trade							
Share of administered prices in CPI (in per cent)	16.2	18.1	20.4	21.5	23.5	19.8	na
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	1.0	1.0	1.0	na
Share of trade with non-transition countries (in per cent)	50.9	65.9	59.9	61.5	63.6	58.2	na
Share of trade in GDP (in per cent)	71.0	81.0	90.1	95.3	92.8	93.7	na
Tariff revenues (in per cent of imports) [4]	1.1	0.7	0.6	0.5	0.5	0.5	0.5
EBRD index of price liberalisation	4.0	4.0	4.0	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.0	4.0	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	2.3	2.7	3.0	3.0	3.0	3.0	3.0
Financial sector							
Number of banks (foreign-owned)	13 (4)	13 (6)	13 (6)	14 (7)	13 (7)	12 (6)	na
Asset share of state-owned banks (in per cent)	41.9	38.9	12.2	0.0	0.0	0.0	na
Asset share of foreign-owned banks (in per cent)	37.1	54.7	78.2	96.1	95.6	90.8	na
Non-performing loans (in per cent of total loans)	11.9	10.8	7.4	5.8	2.6	2.4	na
Domestic credit to private sector (in per cent of GDP)	10.9	10.0	11.4	13.9	19.9	25.1	na
Domestic credit to households (in per cent of GDP)	1.5	1.3	1.5	2.4	4.3	7.2	na
Of which mortgage lending (in per cent of GDP)	na	na	na	1.9	3.4	5.6	na
Stock market capitalisation (in per cent of GDP)	10.7	14.2	10.1	9.5	17.2	26.4	na
Stock trading volume (in per cent of market capitalisation)	49.0	15.0	15.0	18.0	8.0	10.0	na
Eurobond issuance (in per cent of GDP)	6.0	5.7	1.9	2.6	2.4	5.0	na
EBRD index of banking sector reform [5]	3.0	3.0	3.0	3.0	3.3	3.3	3.7
EBRD index of reform of non-bank financial institutions	2.7	3.0	3.0	3.0	3.0	3.0	3.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	31.2 (9.0)	32.1 (14.7)	31.3 (27.7)	27.0 (47.5)	25.3 (66.6)	23.8 (99.3)	na
Internet penetration rate (per 10,000 inhabitants)	38.4	48.2	95.5	157.7	203.8	274.3	na
Railway labour productivity (1989=100)	34.9	41.3	39.1	54.4	67.8	71.0	na
Residential electricity tariffs (in USc kWh)	na	6.3	6.3	7.9	9.4	9.7	na
Average collection rate, electricity (in per cent)	90	na	91	90	91	97	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.7	4.3	4.1	4.2	na	na	na
EBRD index of infrastructure reform	2.3	2.7	2.7	2.7	2.7	2.7	2.7
Electric power	2.3	3.0	3.0	3.0	3.0	3.3	3.3
Railways	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Water and waste water	2.7	3.0	3.3	3.3	3.3	3.3	3.3

1 There are controls for national security, defence and lotteries.
2 There is full tradability of non-agricultural land. Ownership of agricultural land, however, is constitutionally prohibited for foreigners and partially restricted for Lithuanian legal persons.
3 Data from 2000 onwards are based on the population census. Previous data from the labour force survey have not been recalculated.
4 Refers to all taxes on foreign trade.
5 Series has been revised.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	-1.7	3.9	6.4	6.8	9.0	6.7	6.8
Private consumption	4.0	5.9	3.7	5.8	11.1	9.3	na
Public consumption	-8.1	3.9	0.3	1.9	5.7	6.7	na
Gross fixed capital formation	-6.1	-9.0	13.5	8.7	11.4	23.0	na
Exports of goods and services	-16.8	9.8	21.2	19.5	6.0	4.3	na
Imports of goods and services	-12.4	4.7	17.7	17.6	8.8	13.4	na
Industrial gross output	-11.2	5.3	15.9	4.6	15.8	8.6	na
Agricultural gross output	-2.6	0.9	-4.6	6.1	2.2	na	na
Employment [1]			(Percentage change)				
Labour force (end-year)	-0.6	-2.0	-2.1	-0.3	0.7	-1.3	na
Employment (end-year)	-2.2	-4.0	-3.3	4.0	2.3	-0.1	na
			(In per cent of labour force)				
Unemployment (end-year)	14.6	16.4	17.4	13.8	12.4	11.4	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	0.8	1.0	1.5	0.3	-1.2	1.2	2.8
Consumer prices (end-year)	0.3	1.5	2.1	-1.0	-1.3	2.8	2.1
Producer prices (annual average)	1.7	16.0	-3.0	-2.8	-0.5	6.0	na
Producer prices (end-year)	19.5	2.6	-7.8	1.9	-0.2	6.8	na
Gross average monthly earnings in economy (annual average)	5.9	-1.5	1.4	3.2	4.2	8.5	na
Government sector			(In per cent of GDP)				
General government balance	-5.6	-2.6	-2.1	-1.6	-1.9	-2.5	-2.6
General government expenditure [2]	39.6	33.0	31.1	30.8	31.7	32.2	na
General government debt	23.0	24.3	23.4	22.8	21.9	19.6	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	7.7	16.5	21.4	16.9	18.2	24.1	na
Domestic credit (end-year)	24.5	1.7	13.7	22.3	42.4	28.6	na
			(In per cent of GDP)				
Broad money (M2, end-year)	20.7	23.0	26.2	28.7	31.5	35.2	na
Interest and exchange rates			(In per cent per annum, end-year)				
Interbank interest rate	7.7	10.4	5.5	10.0	4.3	3.0	na
Treasury bill rate (3-month maturity)	12.3	5.9	4.8	3.3	2.5	2.1	na
Deposit rate [3]	1.6	1.0	0.8	0.3	0.2	0.2	na
Lending rate [4]	10.1	10.7	8.1	6.1	5.1	5.6	na
			(Litai per US dollar)				
Exchange rate (end-year)	4.0	4.0	4.0	3.3	2.7	2.5	na
Exchange rate (annual average)	4.0	4.0	4.0	3.7	3.1	2.8	na
External sector			(In millions of US dollars)				
Current account	-1,194	-675	-574	-734	-1,218	-1,589	-2,025
Trade balance	-1,405	-1,104	-1,108	-1,337	-1,629	-2,316	-2,571
Merchandise exports	3,147	4,050	4,889	6,031	7,642	9,273	10,756
Merchandise imports	4,551	5,154	5,997	7,368	9,271	11,589	13,327
Foreign direct investment, net [5]	478	375	439	714	142	510	655
Gross reserves, excluding gold (end-year)	1,195	1,312	1,618	2,349	3,372	3,628	na
External debt stock [6]	4,540	4,884	5,268	6,199	8,338	10,466	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.7	2.7	2.9	3.4	3.9	3.3	na
			(In per cent of exports of goods and services)				
Debt service	20.5	20.5	15.5	39.1	19.7	16.6	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	3.5	3.5	3.5	3.5	3.5	3.4	na
GDP (in millions of litai)	43,359	45,526	48,379	51,633	55,737	61,908	64,440
GDP per capita (in US dollars)	3,086	3,260	3,477	4,066	5,281	6,454	na
Share of industry in GDP (in per cent)	27.2	26.9	27.8	27.2	28.9	29.7	na
Share of agriculture in GDP (in per cent)	7.4	7.0	6.3	6.2	5.6	5.2	na
Current account/GDP (in per cent)	-11.0	-5.9	-4.7	-5.2	-6.7	-7.1	-8.6
External debt - reserves (in US$ million)	3,345	3,573	3,650	3,849	4,966	6,838	na
External debt/GDP (in per cent)	41.9	43.0	43.6	44.1	45.8	47.0	na
External debt/exports of goods and services (in per cent)	107.1	95.6	87.1	82.5	88.2	89.0	na

[1] Data from 2000 based on the population census. Previous data from the labour force survey have not been recalculated.

[2] General government expenditure includes net lending.

[3] Average interest rate on demand deposits in litai.

[4] Average interest rate on loans in litai.

[5] Covers equity capital and reinvested earnings.

[6] Includes non-resident currency and deposits and loans to foreign subsidiaries.

Moldova

Key challenges

- Swift implementation of the Economic Growth and Poverty Reduction Strategy and the EU-Moldova Action Plan would facilitate improvements in the business environment and westward trade expansion.
- A new impetus for structural reforms is required to revive the privatisation programme, attract strategic investment and advance enterprise restructuring.
- Continued prudent monetary and fiscal policies, as well as a new IMF programme, would assist external debt restructuring and long-term debt sustainability.

Country data	
Population (in millions)	**3.9**
Area ('000 sq. km)	**33.8**
GDP (in billion US$, 2004)	**2.6**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 2,170**
National currency	**Lei**

Progress in structural reform

Liberalisation and privatisation

In February 2005 the EU and Moldova signed an action plan, which is widely seen as an opportunity to increase trade, attract more investment and expand the country's links with the EU. However, poor infrastructure, informal trade barriers and inappropriate quality standards and control institutions are hampering the westward expansion of trade.

Privatisation receipts in 2004 amounted to only US$ 8.2 million, while the revised budget for 2005 envisages a similar level of privatisation revenues. The government is reconsidering the privatisation strategy, which is delaying the implementation of the existing programme. This has raised concerns about the commitment of the authorities to support the private economy, as emphasised in the Economic Growth and Poverty Reduction Strategy (EGPRS).

Business environment and competition

The EGPRS and the EU-Moldova Action Plan call for a series of measures to foster effective competition and improve the business environment. The parliament has approved amendments to the company law, streamlining ownership and corporate governance regulations. The Guillotine Law aims to review more than 1,000 existing business regulations, with the ultimate goal of cancelling most of them and streamlining the rest. However, problems remain in the legal framework for bankruptcy, in particular the discretionary decisions of the Creditors Council to freeze or forgive debts of state-owned enterprises.

According to the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey, the business environment in Moldova has improved since 2002 in terms of access to finance, taxation, incidence of crime and, to a lesser extent, corruption. However, entrepreneurs still report major barriers relating to regulation, tax administration and state interference, as well as an inefficient judiciary and ineffective customs system.

Infrastructure

Following a failed privatisation attempt in 2004, one of the two electricity distribution companies in the north of the country is in financial difficulty, due largely to poor debt collection. The company is also monitored by the energy regulator ANRE for possible breaches of its licence. For a second year running, ANRE has decided against increasing electricity tariffs in 2005. The full liberalisation of the energy market has been postponed from 2006 to mid-2007.

The telecommunications sector has been developing rapidly since the liberalisation of the market in 2004. By mid-2005 the mobile ownership rate had exceeded fixed-line penetration. The interconnection framework has been improved, allowing alternative fixed-line operators to start offering services on a modest scale in Chisinau. However, there has been no further progress with the regulator's plan to rebalance tariffs for Moldtelecom, the dominant fixed-line operator. The privatisation of Moldtelecom is no longer a government priority. The first universal service pilot project has been implemented successfully in the district of Nisporeni.

There has been limited progress in municipal infrastructure reform. Although collection has improved, tariffs remain below cost-recovery levels, threatening the financial viability of the operators. The Chisinau municipal council has opposed tariff increases for water services and urban transport.

Financial sector

A recent IMF Financial System Stability Assessment has commended Moldova's framework of written rules and regulations supporting banks as largely consistent with international standards. However, it suggests that implementation is often lagging behind. Indicators of financial soundness are strong, but the banking system has a number of structural weaknesses. These relate to the growing role of the government in the financial system and the lack of transparency in the ownership of banks and their clients. A draft amendment to the law on financial institutions partially addresses some of these problems by reducing the significant ownership or controlling interest threshold from 10 per cent to 5 per cent for future shareholders only. It also requires banks to provide complete reports on ownership, introduce limits to offshore ownership and tightens the rules of board membership to reduce the potential for conflict of interest.

There has been further consolidation of the banking sector. The share of the largest five banks in total assets has increased to over 70 per cent. One small bank (Business Bank) initiated liquidation procedures in July 2005.

A new leasing law has replaced the 1996 version and broadens the range of goods that can be offered for lease. The law allows all citizens, not just entrepreneurs, to acquire leases for equipment ranging from factory tools to domestic appliances. It also removes a tax loophole that had placed an unnecessary burden on entrepreneurs opting to lease rather than buy equipment. A mortgage law is currently being prepared to boost the real estate market.

Macroeconomic performance

Real economy

The economy grew in real terms by 7.3 per cent in 2004, supported by rapid expansion in industry, agriculture and the service sector. A good harvest led to 20.4 per cent growth in agricultural output, while the textiles and chemical sectors recorded the highest growth rates within the manufacturing industry. On the demand side, private consumption continues to be the leading source of growth, fuelled by rising credit and remittances.

Economic policies

The National Bank of Moldova (NBM) provided a MDL 594 million (US$48 million) loan to the government in 2004 to service the external debt. This has slightly undermined the tight monetary policy of the NBM and its efforts to contain annual inflation, which remained at double-digit levels in 2004 for the second consecutive year. In the first half of 2005 cumulative inflation stood at 4.7 per cent, largely consistent with the government's inflation target of 8 to 10 per cent for the year overall. Despite persistent appreciation pressures from increasing remittance inflows, the exchange rate remained stable against the US dollar in the first half of the year.

The NBM was active on the foreign exchange market from mid-2004 to mid-2005, purchasing large amounts of foreign exchange to prevent further currency appreciation. In the second quarter of 2005, however, the NBM also increased its sterilisation operations to contain inflation. Fiscal policy remains tight. The consolidated budget recorded a surplus in 2004 and fiscal revenues in the first half of 2005 are 7.3 per cent ahead of target, mostly due to increased VAT revenues on imports.

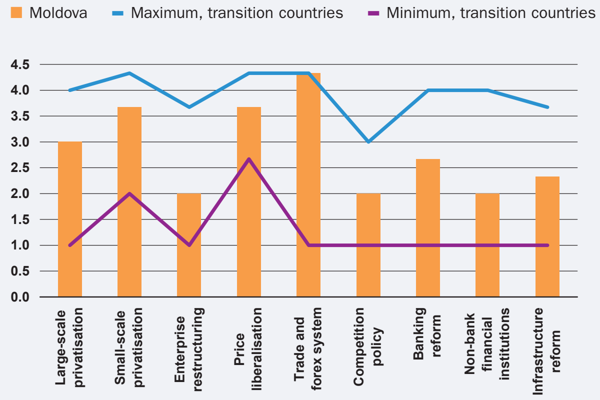
External sector

Strong export growth in 2004 was offset by the appreciation of the lei and higher consumption-led imports. However, the flow of recorded remittances continues to grow. The NBM estimates a 60 per cent year-on-year increase in remittances through the banking system in the first half of 2005. Reinvested earnings pushed up net foreign direct investment to US$148 million in 2004, the highest level ever recorded in Moldova. The external debt stock stood at US$1.92 billion (74 per cent of GDP) at the end of 2004, of which US$884 million is public issue or sovereign-guaranteed. No new sovereign debt was accumulated in 2004, but a number of agreements on rescheduling and buy-back of debt were signed. In the absence of an IMF programme, no progress has been achieved on restructuring the Paris Club debt.

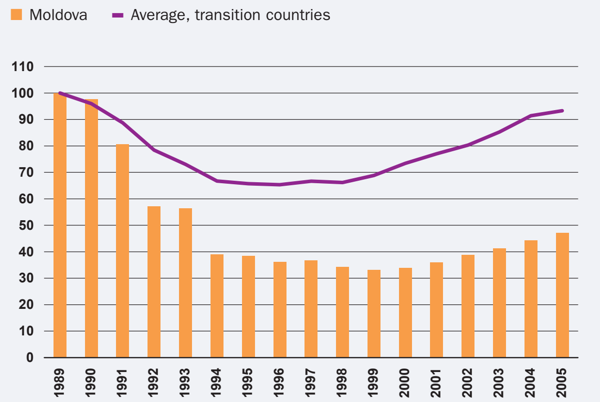
Outlook and risks

Moldova is heavily dependent on remittances and on agriculture and related industries. The economy continues to be vulnerable to external shocks. Although growth is likely to continue in the short term, long-term sustainability rests on the effective implementation of the reform agenda outlined in the EGPRS and the EU-Moldova Action Plan. Despite significant progress in restoring solvency, a longer-term solution to the country's external debt depends on continued prudent macroeconomic policies and restructuring deals with bilateral creditors.

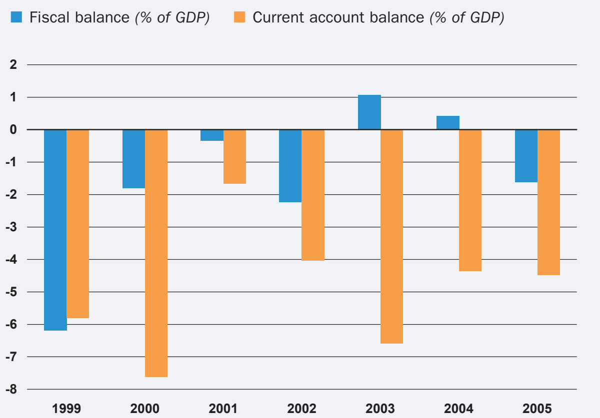
Transition indicators, 2005



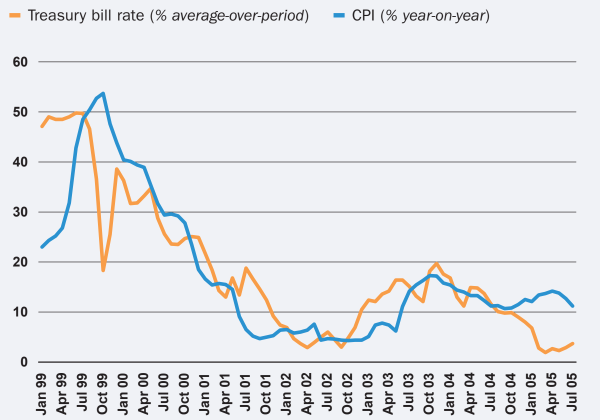
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **64.1 per cent** (2001)
Controls on inward direct investment – **yes**	Quality of insolvency law – **high**	Independent electricity regulator – **partially**	Deposit insurance system – **yes**	Government expenditure on health – **3.7 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **some defects**	Separation of railway infrastructure from operations – **no**	Quality of securities market laws – **low**	Government expenditure on education – **4.6 per cent of GDP**
Exchange rate regime – **floating**	Quality of corporate governance law – **high**	Quality of concession laws – **medium**	Private pension funds – **yes**	Share of power, water in total household expenditure – **5.3 per cent**
Wage regulation – **yes**				
Tradability of land – **full**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	6.0	12.4	12.9	13.5	13.9	14.2	na
Private sector share in GDP (in per cent) [1]	45.0	50.0	50.0	55.0	55.0	55.0	60.0
Private sector share in employment (in per cent)	na	na	na	na	60.0	60.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	10.7	11.0	11.0	11.4	12.1	na	na
Change in labour productivity in industry (in per cent)	-18.8	3.8	14.3	6.8	20.4	na	na
Investment/GDP (in per cent)	22.9	23.9	23.3	21.7	23.2	25.3	na
EBRD index of small-scale privatisation [1]	3.3	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	1.7	1.7	2.0
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	10.0	10.0	8.0	7.0	7.0	7.0	na
Share of trade with non-transition countries (in per cent)	40.3	44.0	42.9	43.4	37.0	37.3	na
Share of trade in GDP (in per cent)	92.7	96.8	97.7	102.1	112.8	105.9	na
Tariff revenues (in per cent of imports) [2]	3.6	2.4	2.1	2.4	2.4	2.4	na
EBRD index of price liberalisation	3.7	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of forex and trade liberalisation	4.0	4.0	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	20 (10)	20 (11)	19 (10)	16 (10)	16 (9)	16 (9)	na
Asset share of state-owned banks (in per cent)	7.9	9.8	10.2	13.4	15.5	17.6	na
Asset share of foreign-owned banks (in per cent)	34.4	39.8	34.9	36.7	35.2	33.6	na
Non-performing loans (in per cent of total loans)	29.3	20.6	10.4	7.6	6.4	6.9	na
Domestic credit to private sector (in per cent of GDP)	11.8	12.6	14.7	17.1	20.3	21.2	na
Domestic credit to households (in per cent of GDP)	1.1	1.1	1.2	1.3	1.6	2.0	na
Of which mortgage lending (in per cent of GDP)	0.5	0.5	0.7	0.9	1.0	1.1	na
Stock market capitalisation (in per cent of GDP)	32.3	30.3	24.0	24.9	24.7	22.4	na
Stock trading volume (in per cent of market capitalisation)	8.4	6.5	6.0	4.8	7.1	9.4	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.3	2.3	2.7	2.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	12.7 (0.4)	13.3 (3.2)	14.6 (5.1)	16.1 (7.7)	16.3 (8.2)	20.3 (18.5)	na
Internet penetration rate (per 10,000 inhabitants)	3.0	4.9	4.0	5.0	27.2	31.2	na
Railway labour productivity (1989=100)	15.6	18.7	23.3	27.5	29.5	31.0	na
Residential electricity tariffs (in USc kWh)	na	4.6	5.2	6.0	5.6	5.8	na
Average collection rate, electricity (in per cent)	na	55	na	99	100	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.7	1.9	1.9	2.1	na	na	na
EBRD index of infrastructure reform	2.0	2.3	2.3	2.3	2.0	2.0	2.3
Electric power	3.0	3.3	3.3	3.3	3.0	3.0	3.0
Railways	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Roads	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	2.3	2.3	2.3	2.3	2.3	2.3	2.7
Water and waste water	2.0	2.0	2.0	2.0	2.0	2.0	2.0

[1] The series has been revised.

[2] Refers to all taxes on foreign trade.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	-3.4	2.1	6.1	7.8	6.6	7.3	6.5
Private consumption	-13.8	27.6	6.1	5.9	18.5	6.9	na
Public consumption	-28.1	-17.9	-5.8	31.4	3.2	-17.5	na
Gross fixed capital formation	-14.7	-0.7	5.2	1.1	13.5	3.4	na
Exports of goods and services	-22.7	6.8	15.7	18.9	19.2	4.7	na
Imports of goods and services	-36.4	29.8	11.1	15.8	28.7	-1.7	na
Industrial gross output	-11.6	7.7	13.7	10.8	15.6	6.9	na
Agricultural gross output	-8.4	-3.3	6.4	3.4	-13.6	20.4	na
Employment			(Percentage change)				
Labour force (end-year)	1.4	-1.7	-2.3	-0.1	-8.8	-3.3	na
Employment (end-year)	-9.0	1.4	-1.0	0.4	-9.9	-3.4	na
			(In per cent of labour force)				
Unemployment (end-year) [1]	11.1	8.5	7.3	6.8	7.9	8.0	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	39.3	31.1	9.6	5.2	11.6	12.4	12.0
Consumer prices (end-year)	43.7	18.4	6.3	4.4	15.7	12.5	10.0
Producer prices (annual average)	44.0	28.5	12.3	4.7	7.8	5.6	na
Producer prices (end-year)	58.6	24.3	5.7	6.7	9.2	4.9	na
Gross average monthly earnings in economy (annual average)	21.6	33.9	33.3	27.2	28.8	23.9	na
Government sector			(In per cent of GDP)				
General government balance [2]	-6.2	-1.8	-0.3	-2.2	1.1	0.4	-1.6
General government expenditure [2]	36.6	34.5	29.4	31.5	33.3	35.7	na
General government debt [3]	103.3	91.7	78.4	73.1	58.9	46.0	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	33.3	39.0	37.8	30.4	24.4	44.7	na
Domestic credit (end-year)	18.1	14.4	29.6	25.2	24.3	25.8	na
			(In per cent of GDP)				
Broad money (M2, end-year)	14.7	15.7	18.2	20.0	20.4	25.4	na
Interest and exchange rates			(In per cent per annum, end-year)				
Refinancing rate	31.0	27.0	13.0	9.5	14.0	14.5	na
Interbank interest rate (up to 30-days maturity)	32.3	20.3	10.8	7.5	13.0	13.3	na
Deposit rate (1 year)	27.4	24.6	20.6	14.4	12.7	15.2	na
Lending rate (1 year)	35.5	33.3	28.5	23.1	19.2	21.0	na
			(Lei per US dollar)				
Exchange rate (end-year)	11.6	12.4	13.1	13.8	13.2	12.5	na
Exchange rate (annual average)	10.5	12.4	12.9	13.6	13.9	12.3	na
External sector			(In millions of US dollars)				
Current account	-68	-98	-25	-67	-130	-113	-135
Trade balance	-137	-294	-313	-378	-623	-758	-865
Merchandise exports	474	477	567	660	805	995	1,135
Merchandise imports	612	770	880	1,038	1,429	1,754	2,000
Foreign direct investment, net	38	127	102	132	71	148	120
Gross reserves, excluding gold (end-year)	186	222	229	269	302	470	na
External debt stock	1,495	1,721	1,675	1,815	1,925	1,924	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.8	2.7	2.5	2.5	2.1	2.6	na
			(In per cent of exports of goods and services)				
Debt service	32.5	16.8	13.4	13.8	12.2	8.5	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million) [4]	3.6	3.6	3.6	3.6	3.6	3.4	na
GDP (in millions of lei)	12,322	16,020	19,052	22,556	27,619	31,992	38,160
GDP per capita (in US dollars)	321	353	407	458	547	766	na
Share of industry in GDP (in per cent)	20.3	19.0	21.8	20.2	20.9	na	na
Share of agriculture in GDP (in per cent)	24.9	25.4	22.4	21.0	19.1	na	na
Current account/GDP (in per cent)	-5.8	-7.6	-1.7	-4.0	-6.6	-4.4	-4.5
External debt - reserves (in US$ million)	1,309	1,498	1,447	1,546	1,622	1,454	na
External debt/GDP (in per cent)	127.6	133.6	113.1	109.2	97.2	74.2	na
External debt/exports of goods and services (in per cent)	245.1	268.3	226.9	207.1	181.7	146.1	na

1 According to ILO methodology.

2 General government includes the state, local government, social security and healthcare.

3 Includes publicly guaranteed debt.

4 Excludes Transnistria.

Poland

Key challenges

- A reduction in administrative barriers and improvements in the legal framework are needed to increase the country's attractiveness to investors and maintain growth momentum.
- The ailing health care sector needs reform and commercialising to maintain standards of medical services and contain budgetary expenditures.
- Fiscal reforms leading to a reduction of the government deficit, preparation for membership in the Exchange Rate Mechanism II and a cut in unemployment remain macroeconomic priorities.

Country data	
Population (in millions)	**38.2**
Area ('000 sq. km)	**313.9**
GDP (in billion US$, 2004)	**241.8**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 12,876**
National currency	**Zloty**

Progress in structural reform

Liberalisation and privatisation

The government exceeded its privatisation revenues target for 2004, raising €2.3 billion compared with the planned €2.1 billion. Of this total, €1.8 billion was raised from selling a minority 38 per cent stake in the largest bank, PKO BP, on the Warsaw Stock Exchange. Privatisation slowed in 2005, due largely to political uncertainty over the elections. The most visible transactions were the sales of minority stakes in the petrol group Lotos in June 2005 and in the gas company PGNiG in September 2005. Privatisation plans for the mining and postal sectors continued to encounter opposition from the trade unions.

Significant progress has been made in restructuring the steel industry. In 2004 the sector became profitable again after years of losses and difficulties. There has also been a renewed momentum in the restructuring of public enterprises. The largest state-owned companies, including PKO BP, PZU and PKN Orlen, have initiated major restructuring and labour retrenchment plans to adapt to increasingly competitive economic conditions.

Following EU accession, Polish farmers increased their profitability, competitiveness and incomes, cementing the country's transformation from an importer to net exporter of agricultural products. State aid to the shipbuilding industry continued in 2005. Despite ambitious plans for employment reduction and restructuring, the mining sector also remains in need of reform.

Reform of the health care system has been slow, with its debt growing in 2004. Hospitals continue to operate with soft budget constraints and efforts to commercialise or privatise health care units have been fiercely opposed. A shortage of resources and lack of service improvements have resulted in public dissatisfaction and strikes by medical personnel. As a consequence, private health care is growing, with reportedly more than 600,000 people benefiting from private pre-paid packages.

Business environment and competition

Improvements in the business environment are needed to attract foreign investors. (Poland recently missed out on a number of high profile foreign investments.) Problems identified in the World Bank's report *Doing Business* included company registration, employment, real estate transactions, access to credit, wind-up costs and an inefficient judiciary. On the positive side, the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey revealed that corruption, crime and poor regulation are perceived as less significant obstacles to business activity than in 2002. This is despite the high-level scandals that have attracted wide press coverage and undermined trust in the political and business elites.

Infrastructure

Despite some improvements, motorway construction has yet to pick up. In the railway sector, steps have been taken to commercialise passenger services and involve local authorities in financing regional transport. The medium-term railway plan also envisages limited privatisation of the rolling stock, but the sector remains overstaffed and has a low labour efficiency. In May 2005 the licence for a fourth mobile telecommunications operator was awarded. The process underlined the weak regulatory system, with the regulator failing to commit to the enforcement of roaming agreements with existing operators. This follows a history of poor dealings with the dominant fixed-line operator TPSA, which has resulted in relatively poor competition in fixed-line services.

Financial sector

Following the privatisation of BGZ in 2004, nine of the 10 largest banks in Poland are majority foreign-owned. The country's largest bank, PKO BP, was partially privatised through an initial public offering (IPO) in November 2004. This left the state treasury with a 52 per cent stake after a further 10 per cent was sold to PKO BP employees. The IPO followed some restructuring which strengthened the bank's income-generation capacity and improved the quality of its assets.

Credit to households, driven by strong demand for housing and consumer loans, grew in the first half of 2005 at about 15 per cent year-on-year, contributing to the deepening of financial markets. Consumer regulation and protection are gaining momentum as the dedicated Banking Arbiter has become fully operational. The most significant regulatory risk comes from the recent introduction of interest rate controls through a ceiling on credit rates.

Private pension funds show some signs of over-liquidity, as stringent regulatory limits restrict them to investments in government bonds, listed shares and rated debt securities. During the first half of 2005, government bonds accounted for about 60 per cent of pension fund portfolios and the funds controlled about a third of the free float at the stock exchange.

Macroeconomic performance

Real economy

Year-on-year real GDP growth slowed to 2.1 per cent in the first quarter of 2005 from the 5.4 per cent achieved in 2004. Last year's growth was supported mainly by exports, while consumption and investment remained subdued. Total agricultural exports, for example, topped €5.22 billion in 2004, 30 per cent higher than in 2003.

Falling unemployment and improved retail sales in the second quarter of 2005 raise hopes for increased consumption in the future. Real GDP growth of around 3.5 per cent for 2005 overall is projected. Despite the recent decline, unemployment remained at 17.8 per cent of the labour force in August 2005, the highest level in the EU.

Economic policies

Although the economy has slowed in 2005, the general government deficit remained on target in the first half of the year. After reaching 3.9 per cent of GDP in 2004, the deficit should fall to around 3.7 per cent this year, according to ESA95 methodology. (This methodology allows for the exclusion of some pension reform costs from the general budget.)

Public debt has stabilised at just above 50 per cent of GDP, according to the government's definition, and is expected to increase slightly in the short term. Annual consumer price inflation declined to 1.6 per cent in August 2005, below the 2.5 per cent target rate of the National Bank of Poland. Between March and August, the Monetary Policy Council reduced the policy rate in five steps to 4.5 per cent, a historical low and down from 6.5 per cent at the beginning of the year.

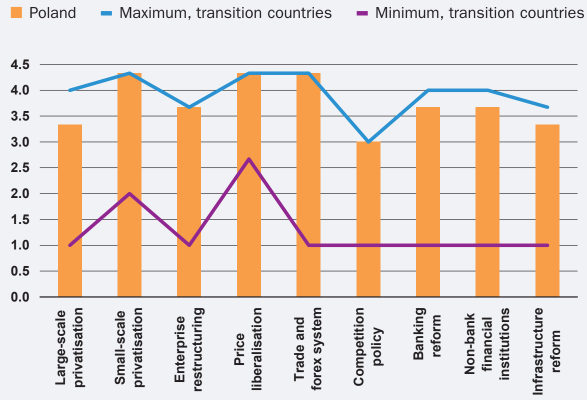
External sector

Strong export growth and a significant increase in net transfers in 2004 helped to bring the current account deficit down to 1.5 per cent of GDP, compared with 2.2 per cent in 2003. The cumulative current account deficit for the 12 months up to August 2005 turned positive, showing a surplus of 0.1 per cent of GDP. On the capital account, portfolio inflows continue to dominate. Foreign direct investments have also shown a recovery, supported by stronger economic growth and EU membership. External debt increased to 52 per cent of GDP by the end of 2004 and international reserves remained above four months of imports of goods and services.

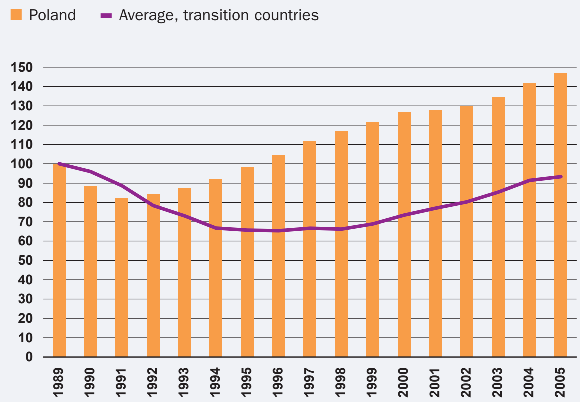
Outlook and risks

The outlook remains broadly positive, given the likely further improvements in key infrastructure sectors and the business environment. However, a number of risks remain. In the short term, the fiscal stance of the government is unclear pending the autumn parliamentary elections. Other risks stem from possible threats to exchange rate stability in the run-up to the adoption of the euro, which is expected around 2010. As foreign residents hold more than 40 per cent of government debt, fiscal reforms are crucial to reduce the risk of exchange rate volatility and destabilisation of the economy.

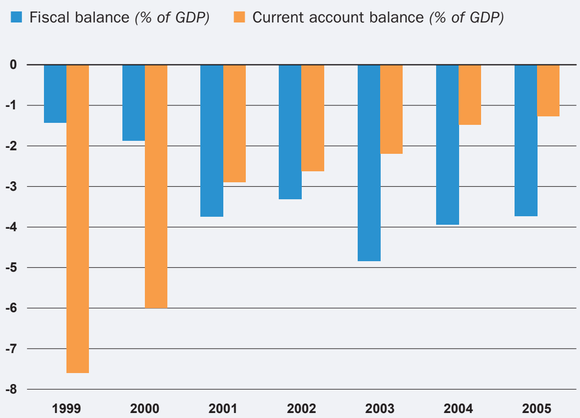
Transition indicators, 2005



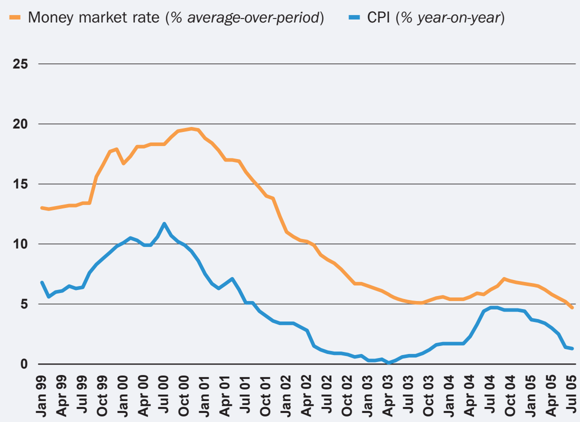
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **8 per cent**	Share of population living in poverty – **<2 per cent** (2001)
Controls on inward direct investment – **no** [1]	Quality of insolvency law – **medium**	Independent electricity regulator – **fully**	Deposit insurance system – **yes**	Government expenditure on health – **4.4 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **some defects**	Separation of railway infrastructure from operations – **fully**	Quality of securities market laws – **medium**	Government expenditure on education – **6.4 per cent of GDP**
Exchange rate regime – **floating**	Quality of corporate governance law – **high**	Quality of concession laws – **na** [2]	Private pension funds – **yes**	Share of power, water in total household expenditure – **7.5 per cent**
Wage regulation – **no**				
Tradability of land – **full except foreigners**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	7.3	11.0	11.8	12.2	12.7	13.8	na
Private sector share in GDP (in per cent)	65.0	70.0	75.0	75.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	70.9	72.1	73.1	69.5	70.2	71.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.5	2.2	2.3	2.4	2.5	3.6	na
Share of industry in total employment (in per cent)	21.7	23.3	22.3	23.0	22.4	22.3	na
Change in labour productivity in industry (in per cent)	9.1	10.4	4.4	3.7	12.4	11.6	na
Investment/GDP (in per cent)	25.4	24.7	20.7	18.9	18.9	20.0	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.3	3.3	3.3	3.3	3.3	3.3	3.3
EBRD index of enterprise reform	3.0	3.0	3.3	3.3	3.3	3.3	3.7
Markets and trade							
Share of administered prices in CPI (in per cent)	9.0	2.6	1.2	1.0	1.0	1.0	1.2
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	79.3	81.1	80.9	81.3	81.7	79.8	na
Share of trade in GDP (in per cent)	45.7	50.5	48.9	52.6	60.9	69.7	na
Tariff revenues (in per cent of imports)	3.3	2.8	2.4	1.7	1.7	0.9	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Financial sector							
Number of banks (foreign-owned) [3]	77 (39)	73 (46)	69 (46)	59 (45)	58 (46)	57 (44)	na
Asset share of state-owned banks (in per cent)	24.9	23.9	24.4	26.6	25.8	19.4	na
Asset share of foreign-owned banks (in per cent)	49.3	72.6	72.2	70.7	71.5	71.4	na
Non-performing loans (in per cent of total loans)	14.9	16.8	20.5	24.7	25.1	17.5	na
Domestic credit to private sector (in per cent of GDP)	19.0	20.8	21.6	22.4	23.3	22.5	na
Domestic credit to households (in per cent of GDP)	na	na	na	9.7	10.6	11.2	na
Of which mortgage lending (in per cent of GDP)	na	na	na	2.5	3.6	4.0	na
Stock market capitalisation (in per cent of GDP)	19.9	18.1	13.7	14.3	17.1	24.9	na
Stock trading volume (in per cent of market capitalisation)	46.0	50.0	26.0	29.0	27.0	33.0	na
Eurobond issuance (in per cent of GDP)	0.9	0.8	1.5	1.7	2.0	1.8	na
EBRD index of banking sector reform	3.3	3.3	3.3	3.3	3.3	3.3	3.7
EBRD index of reform of non-bank financial institutions	3.3	3.7	3.7	3.7	3.7	3.7	3.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	26.3 (10.2)	28.2 (17.4)	29.5 (25.9)	30.1 (36.0)	31.9 (45.1)	31.9 (59.9)	na
Internet penetration rate (per 10,000 inhabitants)	44.2	87.9	126.8	170.3	203.8	70.5	na
Railway labour productivity (1989=100)	78.4	84.3	86.7	99.1	101.3	103.3	na
Residential electricity tariffs (in USc kWh)	5.5	7.0	8.3	8.8	9.8	9.9	na
Average collection rate, electricity (in per cent)	na	na	na	90	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.9	4.3	4.4	4.6	na	na	na
EBRD index of infrastructure reform	3.0	3.3	3.3	3.3	3.3	3.3	3.3
Electric power	3.0	3.0	3.0	3.3	3.3	3.3	3.3
Railways	3.3	4.0	4.0	4.0	4.0	4.0	4.0
Roads	3.3	3.3	3.3	3.3	3.0	3.0	3.0
Telecommunications	3.3	4.0	4.0	4.0	4.0	4.0	4.0
Water and waste water	3.0	3.0	3.3	3.3	3.3	3.3	3.3

[1] Some sectoral restrictions.

[2] Poland has no specific concession law but partly conforms with internationally accepted principles on concession laws.

[3] Data for 2000 include Slaski Bank Hipoteczny SA, a banking organisation that previously did not file reports on ownership.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	4.1	4.0	1.0	1.4	3.8	5.4	3.5
Private consumption	5.2	2.7	2.0	3.3	3.1	3.4	na
Public consumption	1.0	1.6	0.6	0.6	0.2	1.4	na
Gross fixed capital formation	6.8	2.7	0.6	-5.8	-0.2	5.3	na
Exports of goods and services	1.0	17.5	8.0	5.0	6.0	7.0	na
Imports of goods and services	6.0	12.0	7.0	3.0	4.0	5.0	na
Industrial gross output	4.4	7.1	-0.5	2.0	8.7	9.7	na
Agricultural gross output	-5.2	-5.6	5.8	-1.9	-0.8	7.3	na
Employment			*(Percentage change)*				
Labour force (end-year)	-2.3	-6.1	1.8	-2.9	-3.4	-1.4	na
Employment (end-year)	-5.8	-9.4	-0.8	-4.5	-4.5	-1.2	na
			(In per cent of labour force)				
Unemployment (end-year)	13.4	16.4	18.5	19.8	19.2	19.0	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	7.3	10.1	5.5	1.7	0.7	3.5	2.2
Consumer prices (end-year)	9.8	8.6	3.4	0.7	1.7	4.4	1.3
Producer prices (annual average)	5.7	7.9	5.5	1.0	2.6	3.5	na
Producer prices (end-year)	8.1	5.7	5.0	2.2	3.7	4.0	na
Gross average monthly earnings in economy (annual average)	37.7	12.7	7.2	3.5	3.2	4.0	na
Government sector[1]			*(In per cent of GDP)*				
General government balance	-1.4	-1.9	-3.7	-3.3	-4.8	-3.9	-3.7
General government expenditure	40.3	41.0	43.0	43.4	44.2	44.6	na
General government debt	40.3	36.8	36.7	41.2	45.3	43.6	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	20.1	11.8	9.2	-2.6	5.6	7.3	na
Domestic credit (end-year)	27.2	13.6	9.2	5.3	8.9	3.2	na
			(In per cent of GDP)				
Broad money (M2, end-year)	41.2	41.5	43.2	40.9	41.4	40.9	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Rate on 28-day open market operations	16.5	19.0	11.5	6.8	5.3	6.5	na
3-months WIBOR	17.9	19.5	12.3	6.7	5.6	6.7	na
Deposit rate	12.9	14.3	7.9	4.2	2.9	3.8	na
Lending rate	20.3	21.5	16.2	11.6	9.6	10.4	na
			(Zlotys per US dollar)				
Exchange rate (end-year)	4.2	4.3	4.0	3.9	3.8	3.0	na
Exchange rate (annual average)	4.0	4.3	4.1	4.1	3.9	3.7	na
External sector			*(In millions of US dollars)*				
Current account	-12,487	-9,981	-5,376	-5,011	-4,599	-3,585	-3,724
Trade balance	-15,072	-12,307	-7,661	-7,249	-5,725	-5,584	-6,700
Merchandise exports	30,060	35,902	41,663	46,742	61,007	81,596	85,000
Merchandise imports	45,132	48,209	49,324	53,991	66,732	87,180	91,700
Foreign direct investment, net	7,239	9,327	5,804	3,901	3,927	5,353	6,431
Gross reserves, excluding gold (end-year)	27,314	27,466	26,564	29,794	34,168	36,783	na
External debt stock	65,365	69,465	71,971	84,875	105,853	126,689	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	6.3	5.8	5.5	5.7	5.3	4.4	na
			(In per cent of exports of goods and services)				
Debt service	12.9	13.6	13.0	11.7	8.9	8.3	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	38.7	38.6	38.6	38.2	38.2	38.2	na
GDP (in billions of zlotys)	653	724	761	781	816	885	939
GDP per capita (in US dollars)	4,255	4,310	4,811	4,999	5,479	6,324	na
Share of industry in GDP (in per cent)	29.7	29.5	27.0	26.5	26.6	28.0	na
Share of agriculture in GDP (in per cent)	3.2	3.0	3.2	2.7	2.6	2.5	na
Current account/GDP (in per cent)	-7.6	-6.0	-2.9	-2.6	-2.2	-1.5	-1.3
External debt - reserves (in US$ million)	38,051	41,999	45,407	55,081	71,685	89,906	na
External debt/GDP (in per cent)	39.7	41.7	38.7	44.3	50.4	52.3	na
External debt/exports of goods and services (in per cent)	170.1	150.0	140.0	149.5	146.6	133.4	na

[1] Calculated according to Eurostat methodology (ESA95).

Romania

Key challenges

- Although the business environment has improved in some areas, further measures are needed to reduce corruption, strengthen governance and increase the effectiveness of the judiciary.
- Ongoing efforts to curb domestic credit growth may be not as effective if reforms to regulate and supervise leasing activity are not introduced and implemented quickly.
- Reducing direct taxation, liberalising the capital account and introducing a formal inflation-targeting regime pose new monetary and fiscal challenges.

Country data

Population (in millions)	**21.7**
Area ('000 sq. km)	**238.0**
GDP (in billion US$, 2004)	**73.2**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 8,413**
National currency	**Romanian lei (Ron)**

Progress in structural reform

Liberalisation and privatisation

The privatisation of large state-owned enterprises continued in 2004. In December Austria's ÖMV gained majority control over the national oil and gas company SNP Petrom by subscribing to a capital increase of about € 830.6 million. This followed its purchase of a 33 per cent stake in July 2004 (Romania's largest privatisation to date). The next privatisation programme, ending in 2006, envisages the sale of the remaining 47 per cent stake in Romtelecom, Romania's largest telecommunications company, which is majority owned by Greece's OTE. By 2006 the government also plans to sell its share in Postelecom, another telecommunications operator, and to complete the privatisation of Radiocomunicaţii, the national radio communications company. However, many assets remaining in the hands of the privatisation agency are difficult to sell. Also, the liquidation of non-viable enterprises has been hindered by ineffective bankruptcy procedures.

Liberalisation of the capital account was resumed in April 2005 and is expected to be completed in September 2006. In April 2005 the Central Bank allowed non-residents access to lei-denominated time deposits. In July 2005 it allowed residents to open current and deposit accounts abroad.

Business environment and competition

In 2004 a new law on the registration and authorisation of businesses was adopted. Registration time was reduced to three days, except for businesses with strong environmental, health and safety impacts (where it should take about one month). Aspects of the Fiscal Procedure Codes and Labour Code continue to be the subject of controversy between the public and private sectors. The Labour Code, in particular, includes measures that the business community perceives as unnecessarily rigid, such as mandatory wage funds to pay workers in cases of bankruptcy. However, recent amendments to the Code have relaxed provisions on fixed-term contracts, collective dismissals and the redistribution of working hours. Social security contributions are also among the highest in the region and act as a disincentive for formalising the grey economy.

According to the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey, on average firms in Romania tend to see the judiciary and corruption as less problematic for their business than in 2002 when the survey was last conducted. Other indicators show a significant decline in the frequency and cost of corruption. However, the courts continue to be hindered by insufficient training for judges dealing with commercial matters. In particular, judges assigned to the Trade Registry rotate on a yearly basis and are unable to develop the expertise needed to deal with complex commercial issues. The judiciary has also been criticised by international organisations and the business community for its protracted procedures and its failure to ensure the proper protection of investments and contracts. In response to corruption allegations, a regional prosecutor was appointed in August 2005 to head the main anti-corruption office.

Infrastructure

Progress has been made with the privatisation of four of the eight electricity distribution companies and the two gas distributors. In April 2005 the government finalised the sale of a 51 per cent stake in Electrica Banat and Electrica Dobrogea to Enel of Italy for a total of € 112 million. German utility E.ON was the sole bidder for Electrica Moldova, which sold for € 100 million, while CEZ of the Czech Republic was selected to take over 51 per cent of Electrica Oltenia for a total of € 151 million. The remaining four electricity distribution companies are due for privatisation in 2006. In June 2005 the government sold 51 per cent of Distrigaz Sud, a natural gas distribution company, to Gaz de France for € 311 million. In October 2004 it had agreed to sell 51 per cent of Distrigaz Nord to Germany's Ruhrgas for € 303 million, but this has yet to be completed.

Financial sector

The Savings Bank (CEC) and Eximbank are the only two banks that remain majority state-owned. They account for about 8 per cent of total bank assets. Eximbank is being turned into an institution responsible for export credits and guarantees. The government is privatising CEC, for which nine letters of interest were received in August 2005, but has yet to make a decision on its future. Instead, the governement is selling its remaining stake in Banca Comerciala Romana. Bids have been received from 11 banks. Out of these, 10 banks were pre-qualified and nine are expected to submit complete bids by 17 October 2005.

In July 2005 the Central Bank introduced tighter measures to curb the high growth of domestic credit to the private sector. These included the extension of higher reserve requirements to long-term foreign liabilities. These measures are likely to affect some banks, but do not cover the leasing sector, which remains unregulated and unsupervised and is booming.

Macroeconomic performance

Real economy

In the first half of 2005 the economy grew by 4.9 per cent year-on-year (following record GDP growth of 8.3 per cent in 2004, boosted by a bumper harvest). On the demand side, growth in the first half of 2005 was driven by a 12 per cent increase in private consumption. This was fuelled by rapid credit expansion and the enforcement of a flat income and profit tax rate of 16 per cent from January 2005. Gross fixed capital formation grew by 7.6 per cent year-on-year, compared with 10 per cent in 2004. The strong agricultural performance of last year is unlikely to be repeated in 2005 because of flood damage.

Economic policies

Annual inflation fell to 8.7 per cent in March 2005, but picked up to 9.7 per cent in June 2005, due mainly to strong wage growth, increases in excise taxes and administered prices and a pro-cyclical fiscal policy. In August 2005 the monetary authorities completed their transition from an exchange rate-based monetary framework to a formal inflation-targeting regime. The gradual liberalisation of the capital account began in April 2005 and is due to be completed in September 2006. To discourage speculative short-term capital inflows and alleviate currency appreciation, the National Bank of Romania cut the policy interest rate by a cumulative 1,225 basis points between June 2004 and August 2005, reducing the interest rate differential with the eurozone. On 1 July 2005 the Romanian lei (RON) became the new official currency of Romania. The redenomination involves the exchange of ROL 10,000 for RON 1. The two sets of notes will co-exist for 18 months.

During negotiations to complete the second and third reviews under the precautionary Stand-By Arrangement with the IMF, an initial agreement was reached on a new 2005 budget deficit target of 0.7 per cent of GDP. The government subsequently increased the target to 1 per cent of GDP to deal with the costs of widespread flooding in the summer of 2005. Public sector wages were also raised. The government announced that it will focus its efforts on improving tax collection from the enterprise sector. No agreement has so far been reached with the IMF to complete the reviews, although talks are ongoing.

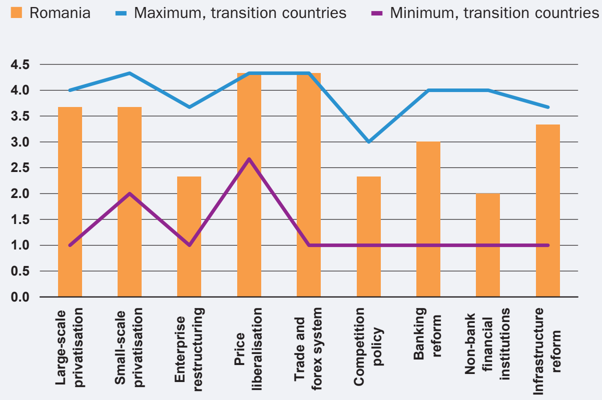
External sector

The trade deficit increased by almost 50 per cent year-on-year in the first six months of 2005 (to €3.1 billion), contributing to a current account deficit of €2.7 billion, up from €1.7 billion in the same period of 2004. Import growth, at 23 per cent year-on-year, outpaced export growth of 17 per cent. Higher imports of consumer goods (cars, processed food and beverages) reflected wage increases, lower taxation and a credit boom. Capital inflows are expected to remain strong in 2005, attracted by the full liberalisation of the capital account.

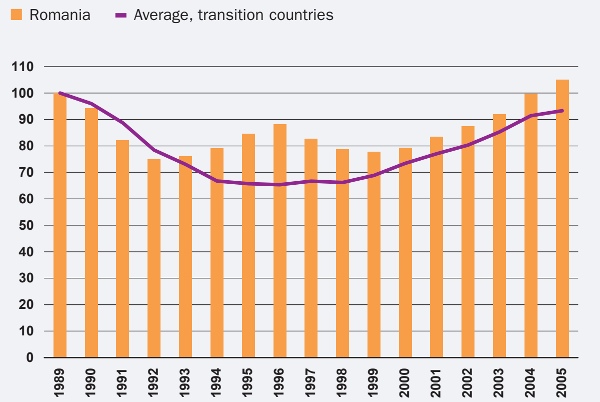
Outlook and risks

Strong economic growth is likely to continue in the run-up to EU accession. Private consumption, fuelling an import boom, has become the main driver, rather than investment. To improve competitiveness and attract higher foreign direct investment, the government will be well advised to reform the labour market by adopting business-friendly amendments to the Labour Code and by lowering social contributions, which remain high compared with neighbouring countries.

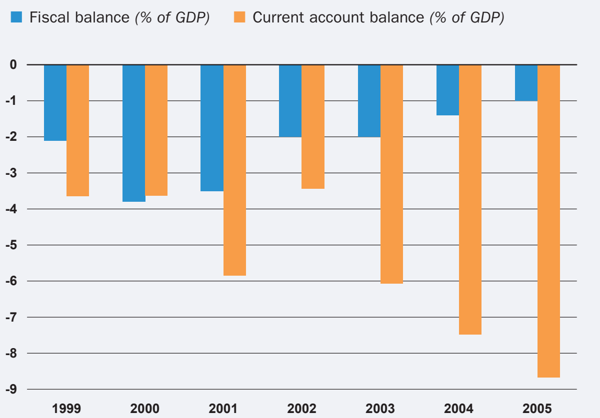
Transition indicators, 2005



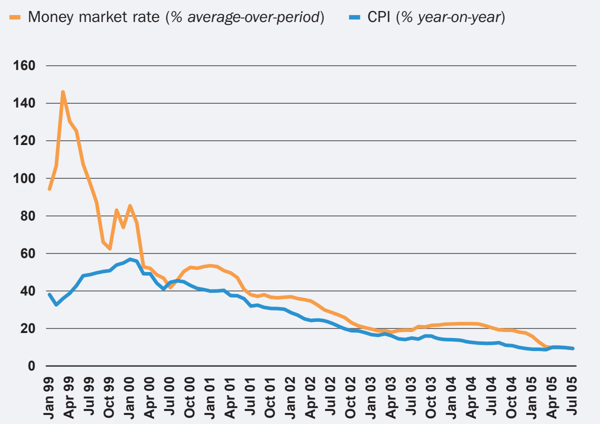
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **12 per cent**	Share of population living in poverty – **14.0 per cent** (2001)
Controls on inward direct investment – **no**	Quality of insolvency law – **high**	Independent electricity regulator – **fully**	Deposit insurance system – **yes**	Government expenditure on health – **0.7 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **advanced**	Separation of railway infrastructure from operations – **fully**	Quality of securities market laws – **medium**	Government expenditure on education – **3.2 per cent of GDP**
Exchange rate regime – **managed float**	Quality of corporate governance law – **low**	Quality of concession laws – **medium**	Private pension funds – **yes**	Share of power, water in total household expenditure – **4.8 per cent**
Wage regulation – **yes**				
Tradability of land – **limited de facto**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	7.6	8.2	8.5	8.9	9.1	9.7	na
Private sector share in GDP (in per cent)	60.0	60.0	65.0	65.0	65.0	70.0	70.0
Private sector share in employment (in per cent)	72.0	75.0	75.0	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	14.7	14.4	14.4	14.0	14.1	14.0	na
Share of industry in total employment (in per cent)	19.1	18.6	18.9	20.4	25.2	na	na
Change in labour productivity in industry (in per cent)	2.9	10.9	7.5	13.4	15.5	na	na
Investment/GDP (in per cent)	16.1	19.5	22.6	23.5	24.6	na	na
EBRD index of small-scale privatisation	3.7	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of large-scale privatisation	2.7	3.0	3.3	3.3	3.3	3.7	3.7
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.3
Markets and trade							
Share of administered prices in CPI (in per cent)	11.1	13.9	17.6	20.3	21.5	22.4	21.9
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	89.5	87.5	83.2	84.0	83.9	80.5	na
Share of trade in GDP (in per cent)	50.8	60.5	64.1	66.3	69.7	73.3	na
Tariff revenues (in per cent of imports)	5.5	3.3	2.2	1.7	1.8	1.5	na
EBRD index of price liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial sector							
Number of banks (foreign-owned)	34 (19)	33 (21)	33 (24)	31 (24)	30 (21)	32 (23)	na
Asset share of state-owned banks (in per cent)	50.3	50.0	45.4	43.6	40.6	7.5	na
Asset share of foreign-owned banks (in per cent)	43.6	46.7	51.4	52.9	54.8	58.5	na
Non-performing loans (in per cent of total loans)[1]	35.4	3.8	3.4	2.3	1.6	1.7	na
Domestic credit to private sector (in per cent of GDP)	8.1	7.2	7.7	8.3	9.5	10.0	na
Domestic credit to households (in per cent of GDP)	na	na	na	na	3.9	4.9	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	0.4	0.5	na
Stock market capitalisation (in per cent of GDP)	2.9	3.4	5.8	10.2	9.6	14.3	na
Stock trading volume (in per cent of market capitalisation)	61.0	23.0	16.0	23.0	9.0	12.0	na
Eurobond issuance (in per cent of GDP)	1.1	0.7	2.2	2.4	1.4	0.0	na
EBRD index of banking sector reform	2.7	2.7	2.7	2.7	2.7	3.0	3.0
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	16.7 (6.1)	17.5 (11.2)	18.4 (17.2)	19.4 (23.6)	20.5 (32.9)	19.7 (45.9)	na
Internet penetration rate (per 10,000 inhabitants)	16.2	18.5	20.7	18.9	22.6	22.0	na
Railway labour productivity (1989=100)	46.0	48.9	48.7	51.0	53.7	60.0	na
Residential electricity tariffs (in USc kWh)	4.1	5.5	5.7	7.0	8.1	8.6	na
Average collection rate, electricity (in per cent)	na	45	62	96	98	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.4	3.5	3.8	4.0	na	na	na
EBRD index of infrastructure reform	2.7	3.0	3.0	3.0	3.0	3.3	3.3
Electric power	2.7	3.0	3.0	3.0	3.0	3.3	3.3
Railways	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Roads	2.3	3.0	3.0	3.0	3.0	3.0	3.0
Telecommunications	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Water and waste water	2.3	3.0	3.0	3.0	3.0	3.3	3.3

[1] The large decrease of non-performing loans in 2000 is due to changes in loan classifications and the transfer of non-performing loans from Bancorex and Banca Agricola to the Banking Assets Recovering Agency.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP [1]	-1.2	1.8	5.3	4.9	5.2	8.3	5.5
Private consumption	-1.1	0.2	6.4	3.0	7.1	10.1	na
Public consumption	-19.1	20.4	-1.9	2.1	4.6	na	na
Gross fixed capital formation	-4.8	4.6	6.6	8.3	9.2	10.8	na
Exports of goods and services	9.7	23.9	10.6	16.9	11.1	na	na
Imports of goods and services	-5.1	29.1	17.5	12.1	16.3	na	na
Industrial gross output, unadjusted series	-8.8	8.2	8.2	6.0	3.1	5.3	na
Agricultural gross output	5.5	-14.1	22.7	-3.5	3.0	na	na
Employment			*(Percentage change)*				
Labour force (end-year)	-0.1	0.2	-1.2	-12.0	-1.6	na	na
Employment (end-year)	-0.6	-0.1	-0.6	-13.7	-0.1	na	na
			(In per cent of labour force)				
Unemployment (end-year) [2]	6.8	7.1	6.6	8.4	7.0	6.2	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	45.8	45.7	34.5	22.5	15.4	11.9	9.2
Consumer prices (end-year)	54.8	40.7	30.3	17.8	14.1	9.3	9.2
Producer prices (annual average)	44.5	53.4	40.3	24.5	19.6	18.6	na
Producer prices (end-year)	62.8	50.3	32.6	20.1	20.0	16.3	na
Gross average monthly earnings in economy (annual average)	44.3	46.9	48.9	27.3	23.6	22.5	na
Government sector			*(In per cent of GDP)*				
General government balance [3]	-2.1	-3.8	-3.5	-2.0	-2.0	-1.4	-1.0
General government expenditure	35.2	34.8	33.4	32.3	32.3	30.7	na
General government debt [3]	24.2	22.7	23.2	23.3	21.3	18.5	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	45.0	38.0	46.2	38.1	23.3	39.9	na
Domestic credit (end-year)	26.8	11.4	26.9	39.8	50.4	15.4	na
			(In per cent of GDP)				
Broad money (M2, end-year)	24.6	23.0	23.2	24.7	24.4	27.0	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	35.0	35.0	35.0	29.0	20.4	18.0	na
1-week BUBOR	68.9	47.3	39.3	20.0	21.4	17.8	na
Deposit rate (average)	45.4	32.4	26.2	18.4	10.8	11.3	na
Lending rate (average)	65.9	53.2	45.7	36.7	26.2	25.8	na
			(Lei per US dollar)				
Exchange rate (end-year) [4]	18.3	25.9	31.6	33.5	32.6	29.1	na
Exchange rate (annual average) [4]	15.3	21.7	29.1	33.1	33.2	32.6	na
External sector			*(In millions of US dollars)*				
Current account	-1,296	-1,347	-2,349	-1,573	-3,455	-5,468	-8,893
Trade balance	-1,092	-1,684	-2,969	-2,613	-4,465	-6,612	-9,543
Merchandise exports	8,503	10,366	11,385	13,869	17,627	23,518	27,516
Merchandise imports	9,595	12,050	14,354	16,482	22,092	30,130	37,060
Foreign direct investment, net	1,025	1,051	1,154	1,080	2,156	5,020	5,300
Gross reserves, excluding gold (end-year)	1,526	2,497	3,960	6,145	8,106	13,462	na
External debt stock	9,215	10,271	12,470	15,227	19,694	22,798	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	1.6	2.1	2.9	3.9	3.9	4.8	na
			(In per cent of exports of goods and services)				
Debt service [5]	29.0	25.9	21.1	18.9	17.8	19.9	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	22.5	22.4	22.4	21.8	21.7	21.7	na
GDP (in billions of lei) [4]	546	804	1,167	1,513	1,891	2,388	2,755
GDP per capita (in US dollars)	1,585	1,651	1,804	2,109	2,624	3,376	na
Share of industry in GDP (in per cent)	24.8	27.3	28.2	28.4	28.4	na	na
Share of agriculture in GDP (in per cent)	13.3	11.1	13.3	11.3	11.7	na	na
Current account/GDP (in per cent)	-3.6	-3.6	-5.8	-3.4	-6.1	-7.5	-8.7
External debt - reserves (in US$ million)	7,689	7,774	8,510	9,083	11,588	9,336	na
External debt/GDP (in per cent)	25.9	27.7	31.0	33.3	34.6	31.2	na
External debt/exports of goods and services (in per cent)	93.4	84.7	93.5	94.0	95.4	84.1	na

[1] From 2001 growth rates are calculated by the National Statistical Institute using a new methodology that complies with European standards of national accounting.

[2] Officially registered unemployed. According to ILO methodology, the rate of unemployment in Romania is lower than the official one.

[3] Calculated according to Eurostat methodology (ESA95).

[4] The Romanian lei was redenominated in July 2005. All data have been converted to new lei (RON).

[5] Debt service payments on private and public external debt.

Russia

Key challenges

- Increased state intervention has negatively impacted the business climate. A return to market-based reform and private initiative is crucial to strengthen business confidence and attract investment, especially into the non-extractive sectors.
- Faster reform of natural monopolies and other infrastructure services would generate investment and efficiency gains in long-neglected areas of the economy.
- Containing the pace of fiscal policy relaxation amid continued strong capital inflows and oil-related revenues is essential to limit the impact on inflation and real rouble appreciation.

Country data

Population (in millions)	**144.9**
Area ('000 sq. km)	**17,075**
GDP (in billion US$, 2004)	**582.3**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 9,721**
National currency	**Rouble**

Progress in structural reform

Liberalisation and privatisation

State intervention in the economy and centralisation of decision-making has increased over the past year. The scope of the private sector has been scaled back as the state reasserted control over Gazprom (and its various banking and media holdings), Gutabank and the bulk of assets owned by the Yukos oil company. The process of market liberalisation has also suffered a setback through a wide-ranging and selective campaign by the tax authorities to recover unpaid back taxes, and through the use of state-owned enterprises as tools for policy implementation. In addition, high-ranking state officials have been appointed to the boards of state-owned enterprises and there has been a tightening of regulations in sectors considered "strategic" by the authorities.

The adverse impact on the general business climate has been partially offset by the country's continued robust macroeconomic performance and the abundant liquidity stemming from substantial capital inflows. Russia has been given an investment grade rating by the three commercial rating institutions, and Russian companies and banks increasingly have access to international capital markets. However, the returning confidence may owe more to the surge in oil prices than to institutional fundamentals. Tough administrative reforms were at the top of the agenda of the new government. However, progress so far has been mixed and the process appears to have stalled. Judicial reform has also come to a halt. Corruption, according to several sources, continues to be a systemic and, in some spheres, growing problem.

Infrastructure

Progress in infrastructure reform was limited over the past year. Gas sector reform has remained off the policy agenda. Power sector restructuring advanced, with some delay, through the continued unbundling of vertically integrated regional utilities and the creation of wholesale generation companies. Follow-on legislation to the 2003 law on telecommunications was adopted, affecting primarily the liberalisation of long-distance telecommunications. The government also issued three new licences in May 2005 to alternative long-distance operators. This is expected to erode Rostelekom's current monopoly in that segment of the market. However, the formal opening of the long-distance market has been postponed to early 2006. The privatisation of the national telecommunications holding Svyazinvest, which dominates the fixed-line and long-distance markets through its regional subsidiaries and Rostelekom, remains on hold.

Financial sector

Substantial reforms have been made in the banking sector, following the turbulent summer of 2004 in which some private banks faced severe liquidity pressures. The sector resumed its rapid expansion in terms of assets, deposits, capital and loans to the private sector. In April 2005 the government and the Central Bank of Russia (CBR) adopted a new medium-term banking sector strategy. The first round of reviews under the deposit insurance system ended with 835 (or 75 per cent) of the applicants qualifying for participation by April 2005.

The CBR has also tightened the regulatory and supervisory framework. It has introduced more stringent requirements for capital, new principles of loss provisioning, daily monitoring of financial ratios, and has shifted from compliance-based to risk-based supervision. Acceptance of international financial reporting standards (IFRS) has become obligatory for banks from 2005, though full compliance has not yet been achieved. New legislation affecting the banking sector which has been adopted or is under parliamentary consideration includes a law on credit bureaux, a law on consolidated reporting, syndication, mergers and acquisitions, and a law governing the transparency of ownership of banks.

Social sector

The decision in 2004 to replace a wide range of in-kind social benefits with cash payments was a major step in reforming the inefficient and untargeted Soviet era social welfare system. However, the flawed implementation of this reform, which came into effect at the beginning of 2005, has had some negative social consequences. The public was not involved in open debate over the measures. Also, some of the regions were not technically prepared, while others simply did not have the funds to finance the new arrangements. This led to widespread protest in many Russian regions in January 2005. The monetisation of social benefits has since started to work more efficiently. It has also proved beneficial for the market-based development of sectors such as railways, telecommunications, local bus transport and pharmaceutical distribution.

Macroeconomic performance

Real economy

The economic slowdown in 2004 continued in the first half of 2005. Oil production and exports slowed sharply. The influence of traditional growth drivers also petered out as the real effective exchange rate continued to appreciate while capacity constraints increased. Real GDP increased by 5.6 per cent year-on-year and industrial activity by only 4 per cent, against 7.6 per cent and 7.3 per cent respectively for the same period in 2004. Investment growth also declined, although a pick-up was observed in mid-2005. However, the pace of the slowdown has been moderated by the demand side impact of increasing oil prices.

Economic policies

Government revenues remain highly buoyant on the back of a 36 per cent increase in the world prices of Russia's major export commodities during the first half of 2005. The federal budget surplus reached US$33.5 billion in the first half of this year, nearly three times the level recorded in the same period in 2004. The authorities now expect a full-year budget surplus of 7 per cent of GDP, against an initial target of 1.5 per cent. Stabilisation fund assets increased by US$2.8 billion in the first half of 2005 to reach US$21.6 billion. This was despite the use of US$15.1 billion of assets to pre-pay some of the US$40 billion Paris Club debt. The authorities also fully repaid the US$3.3 billion debt to the IMF. Inflationary pressures continued to increase, with the consumer price index rising by 13.3 per cent year-on-year by July 2005. This reflected the impact of money supply expansion — fuelling consumption while output slowed — and of increases in regulated prices such as tariffs of the natural monopolies.

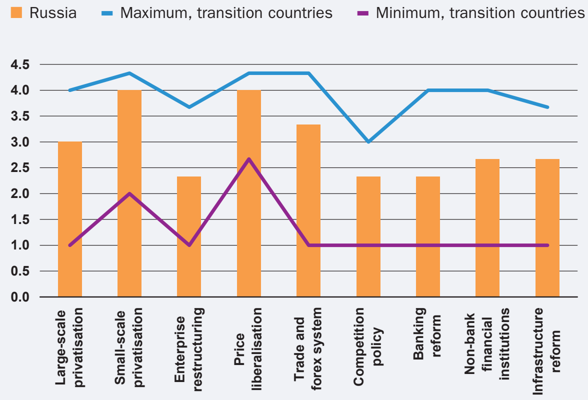
External sector

High commodity prices drove the current account surplus to US$46.6 billion by July 2005 compared with US$26.3 billion at end-June 2004. This suggests that the full-year surplus will reach around 12 per cent of GDP. International reserves of the CBR reached another record high of US$151.6 billion by end-June 2005, an increase of 21.7 per cent compared with end-2004. Despite political uncertainty, the CBR estimates that gross foreign direct investment inflows reached a record US$9.3 billion in the first half of 2005. This contributed to an almost 50 per cent reduction of net private capital outflows to US$5.6 billion.

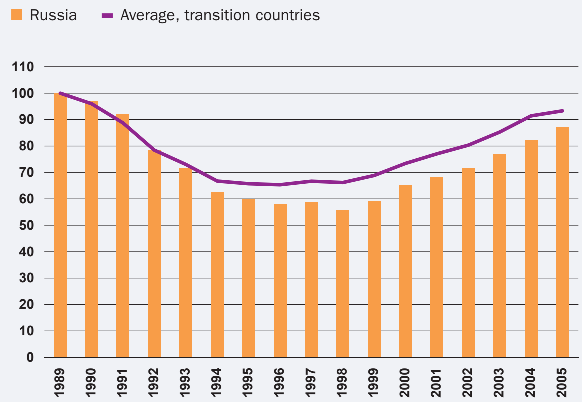
Outlook and risks

Despite continued high commodity prices, real growth is expected to be about 6 per cent in 2005 (down from 7.1 per cent in 2004). Medium-term prospects depend on whether investors' confidence and reform momentum can be restored. However, disagreements among senior policy makers are sending conflicting signals about the government's future policy and reform priorities and casting doubts on their capacity to implement proposed measures to improve the investment climate. With strong inflationary pressures, the key short and medium-term policy risks are complacency in a high oil price environment and fiscal loosening (the 2006 budgetary expenditures are projected to increase by over 40 per cent in nominal rouble terms). In addition, as fiscal policy is being relaxed it is becoming increasingly difficult to balance simultaneously anti-inflationary and exchange rate targets as monetary policy cannot achieve both.

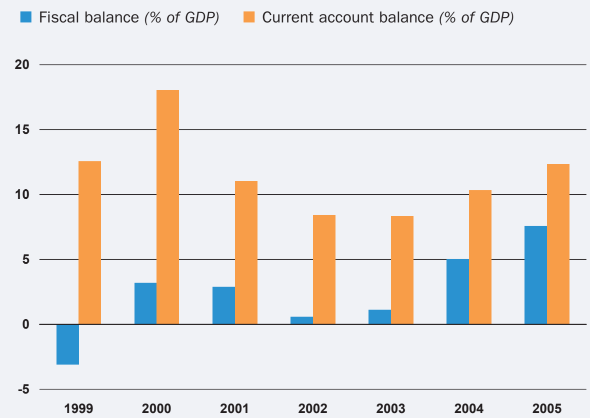
Transition indicators, 2005



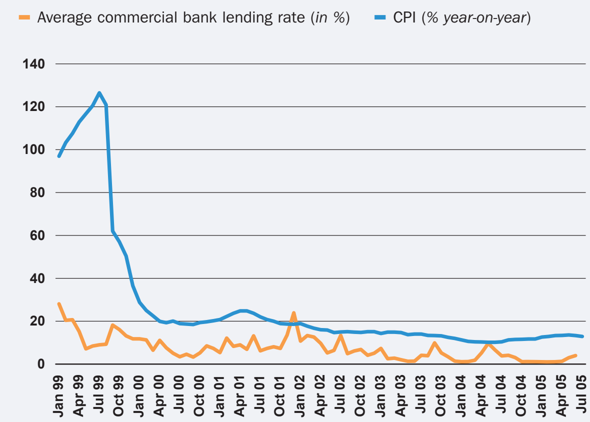
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full** Controls on inward direct investment – **no** [1] Interest rate liberalisation – **full** Exchange rate regime – **managed float** Wage regulation – **no** Tradability of land – **limited de facto**	Competition office – **yes** Quality of insolvency law – **medium** Secured transactions law – **malfunctioning** Quality of corporate governance law – **high**	Independent telecoms regulator – **no** Independent electricity regulator – **no** Separation of railway infrastructure from operations – **partially** Quality of concession laws – **medium**	Capital adequacy ratio – **8 per cent** Deposit insurance system – **yes** Quality of securities market laws – **medium** Private pension funds – **yes**	Share of population living in poverty – **7.5 per cent** (2002) Government expenditure on health – **3.4 per cent of GDP** Government expenditure on education – **3.4 per cent of GDP** Share of power, water in total household expenditure – **6.6 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	3.6	3.9	4.3	4.7	5.4	na	na
Private sector share in GDP (in per cent)	70.0	70.0	70.0	70.0	70.0	70.0	65.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP) [2]	5.3	na	na	na	na	na	na
Share of industry in total employment (in per cent)	22.4	22.7	20.6	19.5	na	na	na
Change in labour productivity in industry (in per cent)	10.2	10.1	5.0	6.8	na	na	na
Investment/GDP (in per cent)	14.8	18.7	21.9	20.0	20.4	21.1	na
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	3.3	3.3	3.3	3.3	3.3	3.3	3.0
EBRD index of enterprise reform	1.7	2.0	2.3	2.3	2.3	2.3	2.3
Markets and trade							
Share of administered prices in CPI (in per cent)	13.0	13.0	13.0	13.0	13.0	13.0	13.0
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Share of trade with non-transition countries (in per cent)	68.7	66.6	63.8	70.3	69.5	67.5	na
Share of trade in GDP (in per cent)	58.7	57.7	50.8	48.7	49.0	48.1	na
Tariff revenues (in per cent of imports) [3]	8.9	18.5	21.1	16.9	19.4	25.4	na
EBRD index of price liberalisation	3.3	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	2.3	2.3	2.7	3.0	3.3	3.3	3.3
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial sector							
Number of banks (foreign-owned)	1,349 (32)	1,311 (33)	1,319 (35)	1,329 (37)	1,329 (41)	1,299 (42)	na
Asset share of state-owned banks (in per cent)	na	na	na	na	na	na	na
Asset share of foreign-owned banks (in per cent)	10.6	9.5	8.8	8.1	7.4	na	na
Non-performing loans (in per cent of total loans)	28.1	16.1	12.2	11.4	10.4	49.9	na
Domestic credit to private sector (in per cent of GDP)	13.1	13.3	16.5	17.7	21.0	24.6	na
Domestic credit to households (in per cent of GDP)	0.5	0.5	0.8	1.0	1.9	3.2	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	0.1	na
Stock market capitalisation (in per cent of GDP)	41.2	15.3	26.0	36.6	51.0	44.4	na
Stock trading volume (in per cent of market capitalisation)	6.0	37.0	39.0	30.0	36.5	53.0	na
Eurobond issuance (in per cent of GDP)	0.0	1.8	0.4	0.9	1.9	2.9	na
EBRD index of banking sector reform	1.7	1.7	1.7	2.0	2.0	2.0	2.3
EBRD index of reform of non-bank financial institutions	1.7	1.7	1.7	2.3	2.7	2.7	2.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	21.0 (0.9)	21.8 (2.2)	22.7 (5.3)	24.2 (12.0)	26.0 (25.0)	25.3 (51.6)	na
Internet penetration rate (per 10,000 inhabitants)	6.3	22.5	24.1	27.9	42.2	59.2	na
Railway labour productivity (1989=100)	72.1	78.8	85.0	90.1	101.6	108.1	na
Residential electricity tariffs (in USc kWh)	na	na	na	na	2.7	3.2	na
Average collection rate, electricity (in per cent) [4]	na	85	na	102	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.6	1.7	1.8	1.9	na	na	na
EBRD index of infrastructure reform	2.3	2.3	2.3	2.3	2.3	2.7	2.7
Electric power	2.0	2.0	2.0	2.3	3.0	3.0	3.0
Railways	2.3	2.3	2.3	2.3	2.3	2.7	2.7
Roads	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Telecommunications	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Water and waste water	2.3	2.3	2.3	2.3	2.3	2.3	2.3

1 FDI in non-financial companies requires an authorisation from the Central Bank of Russia.

2 Expenditures on national economy of the consolidated budget (including industry, agriculture, the energy sector and housing subsidies of regional budgets).

3 Refers to all taxes on international trade.

4 Numbers greater than 100 per cent reflect collection of several years worth of payments.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	6.4	10.0	5.1	4.7	7.3	7.1	6.0
Private consumption	-2.9	7.3	10.1	8.5	7.5	11.3	na
Public consumption	3.1	1.9	-0.8	2.6	2.2	2.3	na
Gross fixed capital formation	6.3	21.5	10.3	2.8	12.8	10.8	na
Exports of goods and services	11.3	9.4	4.2	10.3	12.5	12.3	na
Imports of goods and services	-17.1	31.5	18.7	14.6	17.7	23.5	na
Industrial gross output	11.0	11.9	4.9	3.7	7.0	7.3	na
Agricultural gross output	4.1	7.7	7.5	1.5	1.5	2.9	na
Employment			*(Percentage change)*				
Labour force (end-year)	-0.3	0.4	-1.9	1.1	0.8	1.5	na
Employment (end-year)	-1.4	3.2	-0.3	2.3	0.2	2.0	na
			(In per cent of labour force)				
Unemployment (end-year)	12.9	10.2	8.7	8.8	8.6	8.5	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	86.1	20.8	21.6	15.7	13.7	11.0	12.8
Consumer prices (end-year)	36.8	20.1	18.6	15.0	12.0	11.7	11.7
Producer prices (annual average)	58.9	46.6	19.2	14.0	15.6	24.0	na
Producer prices (end-year)	67.3	31.6	10.7	17.1	13.1	28.8	na
Gross average monthly earnings in economy (annual average)	42.7	42.5	45.7	34.5	24.8	24.0	na
Government sector [1]			*(In per cent of GDP)*				
General government balance	-3.1	3.2	2.9	0.6	1.1	5.0	7.6
General government expenditure	36.7	33.7	34.6	37.0	35.6	33.6	na
General government debt	90.0	62.5	48.2	41.4	32.4	25.9	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	57.2	62.4	40.9	32.4	50.5	35.8	na
Domestic credit (end-year)	36.1	12.1	27.0	26.5	26.5	18.9	na
			(In per cent of GDP)				
Broad money (M2, end-year)	14.6	15.7	18.0	19.7	24.3	26.0	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Central Bank refinance rate (uncompounded)	55.0	25.0	25.0	21.0	16.0	13.0	na
Treasury bill rate (all maturities)	25.5	18.2	14.7	15.0	4.5	4.5	na
Deposit rate	8.5	4.2	5.2	4.3	4.4	3.8	na
Lending rate	31.3	18.2	16.5	15.0	12.4	10.0	na
			(Roubles per US dollar)				
Exchange rate (end-year)	26.8	28.2	30.1	31.8	29.5	27.8	na
Exchange rate (annual average)	24.6	28.1	29.2	31.3	30.7	28.8	na
External sector			*(In millions of US dollars)*				
Current account	24,615	46,839	33,934	29,116	35,845	59,936	87,500
Trade balance	36,014	60,171	48,120	46,335	60,493	87,145	112,000
Merchandise exports	75,551	105,033	101,884	107,301	135,929	183,452	230,000
Merchandise imports	39,537	44,862	53,764	60,966	75,436	96,307	118,000
Foreign direct investment, net	1,102	-463	216	-72	-1,769	2,132	5,000
International reserves, excluding gold (end-year)	8,457	24,264	32,542	44,054	73,175	120,809	na
External debt stock	177,100	160,027	152,491	147,541	175,270	192,966	na
			(In months of imports of goods and services)				
International reserves, excluding gold (end-year)	1.9	4.8	5.3	6.3	8.6	11.2	na
			(In per cent of exports of goods and services)				
Public debt service [2]	17.5	10.3	15.2	11.7	12.6	9.2	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	145.6	145.2	144.4	145.2	144.9	144.9	na
GDP (in billions of roubles)	4,823	7,306	8,944	10,831	13,243	16,752	20,031
GDP per capita (in US dollars)	1,347	1,789	2,123	2,380	2,978	4,012	na
Share of industry in GDP (in per cent)	30.8	38.6	36.5	34.8	34.9	36.0	na
Share of agriculture in GDP (in per cent)	7.7	6.4	6.8	5.7	5.4	5.0	na
Current account/GDP (in per cent)	12.6	18.0	11.1	8.4	8.3	10.3	12.3
External debt - reserves (in US$ million)	168,643	135,763	119,949	103,487	102,095	72,157	na
External debt/GDP (in per cent)	90.3	61.6	49.7	42.7	40.6	33.2	na
External debt/exports of goods and services (in per cent)	209.3	139.6	134.6	122.0	115.3	94.7	na

[1] General consolidated government includes the federal, regional and local budgets and extra-budgetary funds, and excludes transfers.

[2] Data for 1999 show debt service due. Debt service paid was 14.2 per cent.

Serbia and Montenegro

Key challenges

- Financial and commercial discipline in state-owned enterprises and public utilities needs to be improved and the ambitious restructuring plans implemented.
- The authorities must build on the momentum of recent years in terms of privatisation and enhanced financial intermediation to ensure a well-capitalised, competitive banking sector.
- Although GDP growth in 2004 was strong, inflation and the current account deficit were at high levels. Reducing these will require prudent monetary and fiscal policies and a careful monitoring of the rapid level of credit expansion.

Country data

Population (in millions)	**10.6 (including Kosovo)**
Area ('000 sq. km)	**102.0**
GDP (in billion US$, 2004)	**23.9**
GDP per capita in 2004 at current international US$ (PPP)	**na**
National currency	**Dinar (Serbia); euro (Montenegro)**

Progress in structural reform

Liberalisation and privatisation

Serbia and Montenegro's integration into international organisations has advanced gradually during 2005. In April the European Council approved a feasibility study for negotiations on a Stabilisation and Association Agreement. This follows the EU's adoption in late-2004 of a "twin-track" strategy for the two republics which provides for separate negotiations on economic policies. Formal talks began in October 2005. Meanwhile, the two republics have agreed to withdraw their joint application to the World Trade Organization and to apply separately for membership.

Tax reform advanced significantly in Serbia in 2005 with the adoption and successful implementation of a value added tax (VAT) replacing the sales tax. The standard rate is 18 per cent. In July 2005 the Serbian parliament extended the range of goods and services for which a reduced rate of 8 per cent would apply. Both republics have very low corporate tax rates: 10 per cent in Serbia and 9 per cent in Montenegro.

The foreign trade regime has become increasingly liberalised, including the abolition of virtually all import and export quotas. However, significant import tariffs on some goods remain in Serbia. In mid-2005 the parliament approved a realignment of tariffs, raising them on many agricultural goods and decreasing them on other, mainly intermediate products.

The pace of privatisation in Serbia has picked up since the middle of 2004. By mid-2005 around 1,250 enterprises had been privatised successfully. The privatisation programme for socially owned companies is scheduled for completion by end-2006. The privatisation law was amended in June 2005 to allow the government to write off the debts of selected companies to facilitate their sale. In Montenegro an agreement was reached in August 2005 between the government and a subsidiary of the Russian aluminium firm Rusal on the sale of 65.4 per cent of KAP, the largest industrial concern in the republic.

Business environment and competition

In both republics government subsidies to loss-making enterprises remain significant, but are on a declining trend. Restructuring plans for eight large state-owned companies in Serbia, which still rely heavily on state subsidies, are in various stages of preparation and implementation. These include the oil company NIS, for which the tender for a privatisation adviser was launched in September 2005. A new bankruptcy law entered into force in Serbia in February 2005. Implementation began in April with the start of bankruptcy proceedings against three socially owned, loss-making companies.

Infrastructure

In January 2005 a majority stake in the fixed-line telecommunications operator Telekom Montenegro was sold to a consortium led by Matav of Hungary. The sale represents the largest privatisation to date in Montenegro. Little progress has been made in this sector in Serbia. The monopoly of the fixed-line provider Telekom Serbia (TS) expired in mid-2005, but is continuing. However, a tender for an adviser to develop a privatisation strategy for TS was launched in May 2005. Meanwhile, the full privatisation of the mobile company Mobtel remains blocked by a legal dispute over the exact share of the state in the company's capital.

Reforms in other infrastructure sectors such as roads, railways and power are advancing slowly. Energy prices in Serbia were raised again by nearly 10 per cent in July 2005. While privatisation of the state-owned power company EPS is not envisaged in the near future, the company was legally unbundled into two companies, which will function as separate entities from the beginning of 2006.

Financial sector

Financial intermediation in both republics has advanced rapidly over the past year. In Serbia credit to the non-government enterprise sector rose by more than 50 per cent between end-2003 and end-2004. Interest rates on loans have fallen due to increased competition. Bank privatisation has advanced in 2005 with the sale of several banks to foreign investors. Others are being tendered.

In Montenegro bank privatisation will be virtually complete once the sale of Podgoricka Banka, planned for the second half of 2005, takes place. Confidence in the Serbian banking sector should also be enhanced by the recent creation of a new deposit insurance agency and the introduction of substantially higher limits for deposit insurance.

Macroeconomic performance

Real economy

The economy grew in 2004 by an estimated 7 to 8 per cent in real terms, supported by almost 20 per cent growth in the large agricultural sector and expansion in industry and services. However, there were signs of a significant slowdown in the first half of 2005. Industrial production fell by an estimated 2 per cent compared with the first six months of 2004. Also, agriculture is unlikely to sustain its 2004 level of growth. Nevertheless, the improved business climate (including a significant reduction recently in the number of days needed to open a business) and expansion of credit are encouraging small enterprise development.

Economic policies

Macroeconomic policies in both republics are guided by prudent fiscal and monetary policies. They are also constrained by concerns over high inflation (in Serbia) and external imbalances. In Serbia annual inflation rose to above 13 per cent by end-2004 and to around 17 per cent by mid-2005. This led the National Bank of Serbia in May 2005 to raise reserve requirements on enterprise foreign exchange deposits from 21 to 26 per cent, with a further increase to 29 per cent in August. The exchange rate against the euro remains broadly stable in real terms and is backed by comfortable levels of foreign reserves. Inflation is low in Montenegro where the euro is the sole legal currency. On the fiscal side, both republics are performing at, or above, target. In Serbia a revised budget for 2005 was passed by parliament in July, envisaging a surplus for the full year of about 2 per cent of GDP. The IMF's three-year Extended Arrangement remains on track and has been extended until the end of 2005.

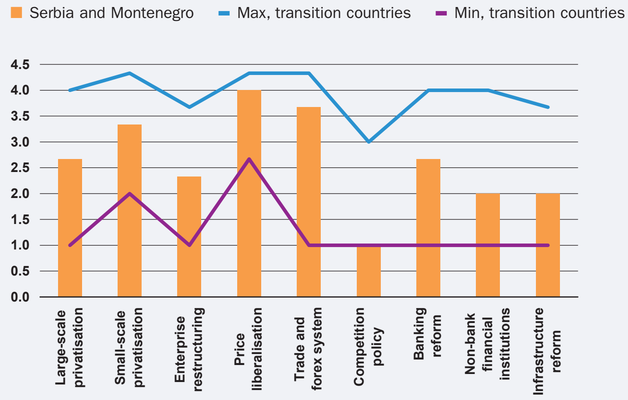
External sector

The current account deficit (including grants) rose in 2004 to more than 13 per cent of GDP. This reflected a boom in imports, financed largely by the expansion of bank credit. On the capital account side, foreign direct investment (FDI) fell last year to around US$1 billion. However, prospects for enhanced FDI in 2005 are good, especially given the strong inflows (much of it privatisation-related) into the Serbian banking sector. In Montenegro FDI is on course for a record year following the privatisation of Telekom Montenegro and the agreement to sell KAP. Overall, access to international markets is improving. Exports grew in the first half of the year by an estimated 52 per cent. In July 2005 Serbia received an upgrade in sovereign rating from Standard and Poor's, from B+ to BB-, putting it one level below Montenegro.

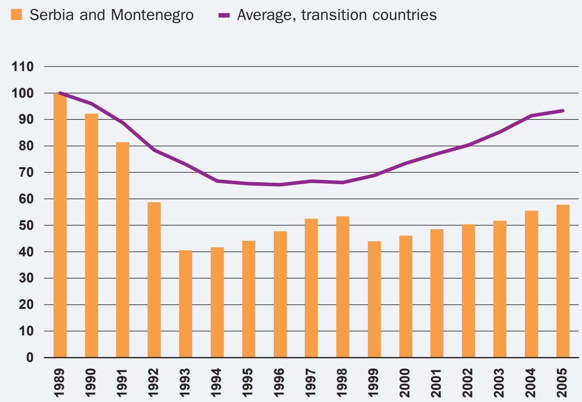
Outlook and risks

The long-term future of the Serbian and Montenegrin economies looks bright, but the interim outlook is dampened by political uncertainty. Possible elections in Serbia (expected once a new constitution is approved) and the likelihood of a referendum in Montenegro on independence in spring 2006 may distract attention from urgent reforms to large enterprises, public administration and the pension system. Debt servicing will continue to be a challenge over the next few years, with debt sustainability requiring significant annual real GDP and export growth.

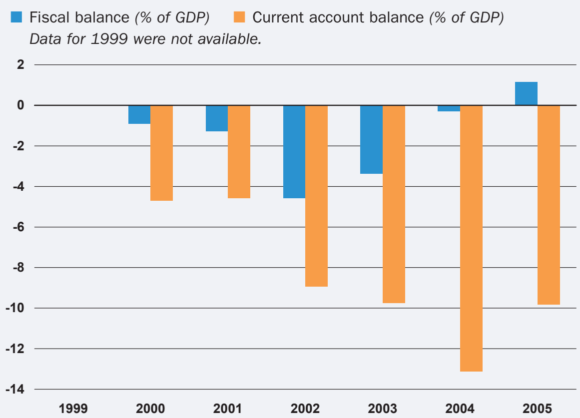
Transition indicators, 2005



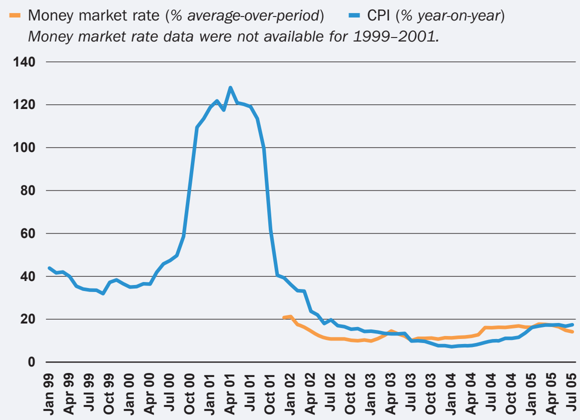
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full** Controls on inward direct investment – **no** Interest rate liberalisation – **full** Exchange rate regime – **managed float (Serbia); euro (Montenegro)** Wage regulation – **no** Tradability of land – **limited de jure**	Competition office – **no** Quality of insolvency law – **high** Secured transactions law – **some defects** [1] Quality of corporate governance law – **medium**	Independent telecoms regulator – **no** Independent electricity regulator – **partially** Separation of railway infrastructure from operations – **no** Quality of concession laws – **medium**	Capital adequacy ratio – **8 per cent** Deposit insurance system – **yes** Quality of securities market laws – **medium** Private pension funds – **no**	Share of population living in poverty – **na** Government expenditure on health – **na** Government expenditure on education – **na** Share of power, water in total household expenditure – **9.3 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.0	0.0	2.2	6.5	7.1	na
Private sector share in GDP (in per cent)	na	40.0	40.0	45.0	45.0	50.0	55.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	na	2.1	3.1	4.4	3.5	3.1	na
Share of industry in total employment (in per cent)	35.1	na	na	na	na	na	na
Change in labour productivity in industry (in per cent)	-16.4	na	na	na	na	na	na
Investment/GDP (in per cent)	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.3	3.3
EBRD index of large-scale privatisation	1.0	1.0	1.0	2.0	2.3	2.3	2.7
EBRD index of enterprise reform	1.0	1.0	1.0	2.0	2.0	2.0	2.3
Markets and trade							
Share of administered prices in CPI (in per cent)	25.6	10.3	11.0	11.0	11.2	11.2	9.2
Number of goods with administered prices in EBRD-15 basket	13.0	1.0	2.0	3.0	4.0	3.0	na
Share of trade with non-transition countries (in per cent)[2]	80.0	73.2	78.1	82.9	79.3	na	na
Share of trade in GDP (in per cent)	28.6	81.0	59.2	56.3	53.6	66.5	na
Tariff revenues (in per cent of imports)	na	5.1	4.9	6.7	6.9	5.4	na
EBRD index of price liberalisation	2.3	2.3	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	1.0	1.0	3.0	3.3	3.3	3.3	3.7
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Financial sector							
Number of banks (foreign-owned)	75 (3)	81 (3)	54 (8)	50 (12)	47 (16)	43 (11)	na
Asset share of state-owned banks (in per cent)	89.0	90.9	68.0	35.6	34.1	23.4	na
Asset share of foreign-owned banks (in per cent)	0.4	0.5	13.2	27.0	38.4	37.7	na
Non-performing loans (in per cent of total loans)	10.2	27.8	24.4	28.5	23.8	22.4	na
Domestic credit to private sector (in per cent of GDP)	9.8	7.6	5.6	na	na	na	na
Domestic credit to households (in per cent of GDP)	na	na	na	na	na	na	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	1.0	1.0	1.0	2.3	2.3	2.3	2.7
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.7	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	21.4 (5.7)	22.6 (12.3)	22.9 (18.7)	23.3 (25.7)	24.3 (33.8)	25.5 (45.0)	na
Internet penetration rate (per 10,000 inhabitants)	12.6	17.5	14.7	15.8	18.4	26.2	na
Railway labour productivity (1989=100)	25.1	39.9	41.2	45.1	50.3	62.6	na
Residential electricity tariffs (in USc kWh)	4.0	1.1	2.0	3.6	5.2	5.3	na
Average collection rate, electricity (in per cent)	na	na	74	84	87	94	na
GDP per unit of energy use (PPP in US dollars per kgoe)	na	na	na	na	na	na	na
EBRD index of infrastructure reform	1.7	2.0	2.0	2.0	2.0	2.0	2.0
Electric power	2.0	2.0	2.0	2.0	2.3	2.3	2.3
Railways	na	na	2.0	2.3	2.3	2.3	2.3
Roads	1.7	2.0	2.0	2.3	2.3	2.3	2.3
Telecommunications	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Water and waste water	1.7	2.0	2.0	2.0	2.0	2.0	2.0

[1] Serbia only.

[2] For some years data were unavailable for important trading partner countries, such as Bosnia and Herzegovina, Croatia and FYR Macedonia. As a result, the share of trade with non-transition countries for these years has been over-estimated.

	1999	2000	2001	2002	2003	2004 *Estimate*	2005 *Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	-18.0	5.0	5.5	3.8	2.7	7.2	4.0
Industrial gross output	-24.4	11.1	0.0	1.7	-2.7	7.5	na
Agricultural gross output	-2.0	-13.7	23.2	3.0	-6.0	19.4	na
Employment			*(Percentage change)*				
Labour force (end-year)	-7.6	-2.4	1.8	1.4	2.7	-0.1	na
Employment (end-year)	-8.7	-2.6	0.2	-1.7	-1.3	-0.1	na
			(In per cent of labour force)				
Unemployment (end-year)	25.5	25.6	26.8	29.0	31.7	31.7	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	37.1	60.4	91.1	21.2	11.3	9.5	16.2
Consumer prices (end-year)	36.5	113.5	39.0	14.2	7.6	13.6	14.0
Producer prices (annual average)	44.2	44.5	na	na	na	na	na
Gross average monthly earnings in economy (annual average) [1]	18.2	83.3	129.6	51.7	25.3	23.7	na
Government sector			*(In per cent of GDP)*				
General government balance	na	-0.9	-1.3	-4.6	-3.4	-0.3	1.2
General government expenditure	na	37.6	40.2	47.8	46.5	45.5	na
Monetary sector [2]			*(Percentage change)*				
Broad money (M2, end-year)	67.6	58.5	67.6	73.4	26.7	30.3	na
Domestic credit (end-year)	130.1	58.2	-54.3	48.6	6.4	61.9	na
			(In per cent of GDP)				
Broad money (M2, end-year)	21.0	16.9	14.0	18.8	20.1	22.1	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	26.3	26.3	16.4	9.5	9.0	8.5	na
Deposit rate	13.1	8.3	4.1	2.6	2.7	3.6	na
Lending rate (long-term)	45.4	77.9	32.5	19.2	14.2	14.6	na
			(Dinars per US dollar)				
Exchange rate (official, end-year) [3]	11.7	66.5	67.7	59.0	54.6	57.9	na
Exchange rate (official, annual average)	11.1	54.9	66.8	64.2	57.5	58.7	na
External sector			*(In millions of US dollars)*				
Current account	-764	-327	-528	-1,384	-1,996	-3,129	-2,507
Trade balance	-1,619	-1,788	-2,834	-3,908	-4,887	-7,434	-7,065
Merchandise exports	1,676	1,923	2,003	2,412	3,054	4,219	5,503
Merchandise imports	3,295	3,711	4,837	6,320	7,941	11,653	12,568
Foreign direct investment, net	112	25	165	562	1,405	1,028	1,600
Gross reserves, excluding gold (end-year)	289	516	1,169	2,280	3,557	4,302	na
External debt stock	10,744	11,403	11,948	11,839	14,303	14,876	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	1.0	1.5	2.7	4.0	4.9	4.0	na
			(In per cent of exports of goods and services)				
Debt service [4]	4.7	2.2	3.9	5.6	10.8	16.5	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	8.4	8.3	8.3	8.3	8.3	8.3	na
GDP (in billions of dinars)	193	382	772	995	1,178	1,400	1,700
GDP per capita (in US dollars)	2,071	834	1,386	1,861	2,462	2,864	na
Share of industry in GDP (in per cent)	25.5	na	na	na	na	na	na
Share of agriculture in GDP (in per cent)	25.1	na	na	na	na	na	na
Current account/GDP (in per cent)	-4.4	-4.7	-4.6	-8.9	-9.7	-13.1	-9.8
External debt - reserves (in US$ million)	10,455	10,887	10,779	9,559	10,746	10,574	na
External debt/GDP (in per cent)	61.8	164.0	103.5	76.4	69.7	62.4	na
External debt/exports of goods and services (in per cent)	500.4	447.7	435.6	365.3	341.8	252.3	na

Note: Data exclude Kosovo.

[1] Net wages.

[2] Data refer to Serbia only.

[3] The exchange rate regime was unified in December 2000. The unofficial rate in October 2000 was 30 dinars: 1 deutschmark (DM), compared with an official rate of 6 dinars: 1 DM.

[4] Serbia and Montenegro was in default of virtually all of its external debt between 1999 and 2001.

Slovak Republic

Key challenges

- Despite substantial reform progress in the network industries, the liberalisation and regulation of the telecommunications sector remains a key challenge.
- While the business environment is generally favourable and open, a more diversified inflow of foreign direct investment would avoid over-concentration in the automotive industry.
- Buoyant investment and household consumption are promoting growth, but a tighter fiscal stance is needed to reduce inflation and the current account deficit. This will enable the smooth transition into the Exchange Rate Mechanism II and provide buffers against potential negative shocks.

Country data	
Population (in millions)	**5.4**
Area ('000 sq. km)	**49.0**
GDP (in billion US$, 2004)	**41.1**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 14,549**
National currency	**Koruna**

Progress in structural reform

Liberalisation and privatisation

The privatisation of the remaining large state-owned companies resumed in the second half of 2004. In late 2004 the government announced its intention to complete the sales of Slovak Telekom (majority-owned by Deutsche Telekom) and the regional energy distribution companies in 2005–06. In January 2005 Austrian Airlines announced the injection of €2.8 million of fresh capital in Slovenske Aerolonie, increasing its share in the domestic airline to 62 per cent. The sale of a 66 per cent stake in the dominant electricity generator Slovenske Elektrarne to Italy's ENEL for €840 million was agreed in February 2005 and the deal could be finalised before the end of the year. The government also initiated the sale of majority stakes in several district heating plants and of 66 per cent stakes in the country's two international airports at Bratislava and Kosice.

Business environment and competition

The vehicle and transport equipment industry accounts for almost a third of the country's total exports and a fifth of industrial production. In late 2004 Ford-Getrag announced an investment worth between €300 million and €400 million to produce gear boxes. In May 2005 Korean tyre producer Hankook announced a €500 million investment linked to the development of Hyundai-Kia's assembly plants. However, the investment is now being reconsidered following the government's refusal to grant the generous incentives Hankook sought. The production of cars could reach close to a million units per year by 2006-08. This would include the output of Volkswagen (which has been in the country since the early 1990s), Peugeot-Citroën and Hyundai-Kia. Newly introduced investment incentives should support future inflows of foreign direct investment (FDI) in more diversified sectors and contribute to job creation, particularly in poorer regions.

Infrastructure

In June 2004 the government announced the division of the public railway company Zeleznicna Spolocnost (ZSSK) into separate passenger and freight transport entities. The government also announced its plans to privatise the freight entity (ZSSK Cargo) in 2005. In June 2005 potential investors were requested to submit preliminary bids for a 100 per cent stake in the company.

ZSSK Cargo recorded a net profit of SKK 423 million (€11.1 million) during its first year of operation and holds a 20 per cent share in the cargo transportation market. Originally, the company was expected to post a loss of SKK 137 million (€3.6 million) in its first year. The privatisation attracted strong interest from pan-European transport operators.

In December 2004 the European Commission criticised the slow and inconsistent liberalisation of the telecommunications sector, which allowed Slovak Telekom to preserve its monopoly in the fixed-line market. In May 2005 Slovak Telekom was fined SKK 885 million (€22 million) by the Anti-Monopoly Office for abusing its dominant position and restricting access to the local network for alternative operators. In the same month the Anti-Monopoly Office started investigating Slovak Telekom and mobile operators Orange Slovensko and T-Mobile Slovensko. This followed complaints that the three operators had concluded an illegal agreement on the interconnection of their networks.

Social sector

The new second pillar of the pension system, consisting of mandatory pension funds, is proving more popular than expected. While only 35 to 40 per cent of the active population were expected to join the second pillar by the end of 2005, this benchmark had already been reached by the first quarter. By May 2005 the new system had attracted 825,000 people.

According to the Ministry of Finance, this uptake will increase the cost to the 2005 government budget by almost two-thirds, from 0.5 to 0.8 per cent of GDP. The government has set aside the revenues from the privatisation of the 49 per cent share in gas utility Slovensky Plynarensky Priemysel (worth SKK 71.2 billion or €1.8 billion) to cover the cost of the pension reform.

In parallel, a new indexation system of pensions became effective on 1 July 2005. Under the previous system, pensions were indexed to price inflation and average wage growth. The new indexation scale is differentiated according to the size of a pension relative to the average wage. In 2005 the lowest pensions (up to 25 per cent of the average wage) will be indexed to nominal wages. Starting from 2006 they will be indexed to a combination of nominal wage growth and inflation. The largest pensions (over 100 per cent of the average nominal wage) will not be adjusted. Pensions falling between these two brackets will be raised according to a varying formula including wage and price inflation.

Macroeconomic performance

Real economy

Real GDP year-on-year growth fell slightly to 5 per cent in the first half of 2005 from 5.5 per cent for 2004 as a whole. Growth at the beginning of the year was still being supported by FDI-driven gross fixed capital formation and robust private consumption. Gross fixed capital formation consumption increased by 8.6 per cent in the first half of 2005. Household consumption grew by 5.6 per cent in the same period reflecting both strong real wage growth and employment growth. Growth of government consumption remained only 1.2 per cent, while the contribution of net exports was negative. Both export and import growth decelerated in the first half of 2005.

Economic policies

In 2004 the general government deficit stood at 3.3 per cent of GDP (excluding a one-off unbudgeted payment of health sector debt which amounted to 0.8 per cent of GDP). This was well below the official target of 4 per cent of GDP. For 2005 the government is targeting a fiscal deficit of 3.4 per cent of GDP (or 4.2 per cent if second-pillar pension costs are included). Significant currency appreciation from strong capital inflows has played an important role in bringing inflation down over the past year. In addition, the fall in inflation during the first half of 2005 reflects the influence of the previous year's increases in indirect taxes and regulated prices, as well as falling food prices and strong retail competition. Despite continued increases in oil prices, annual average inflation is forecast to fall to 2.4 per cent this year from 7.5 per cent in 2004. In response to these trends, the Central Bank cut key interest rates by another 100 basis points in March 2005. In addition, the Central Bank introduced a new inflation targeting framework in 2005 which is likely to increase policy transparency and contribute to more forward-looking inflation expectations that could help break the inertia seen in nominal wage increases.

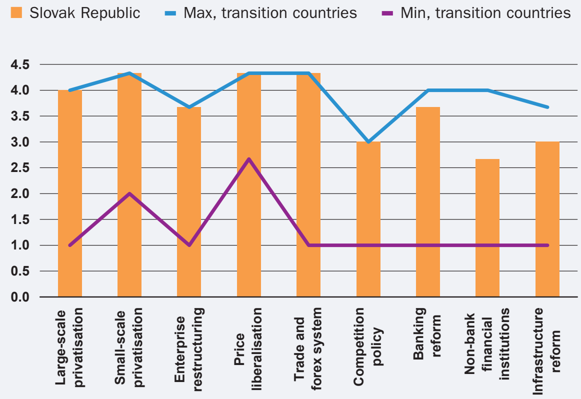
External sector

According to preliminary data, the current account deficit for the first five months of 2005 amounted to US$1.2 billion. The forecast for the full-year deficit is about 5.4 per cent of GDP, compared with 3.5 per cent in 2004. The expected increase is due to the acceleration of private consumption and higher imports of capital goods. However, net FDI inflows are likely to increase to US$1.8 billion in 2005 from US$1.1 billion in 2004 if the privatisation of the electricity generator Slovenske Elektrarne is completed by the end of the year. Net FDI inflows would therefore cover a substantial portion of the current account deficit.

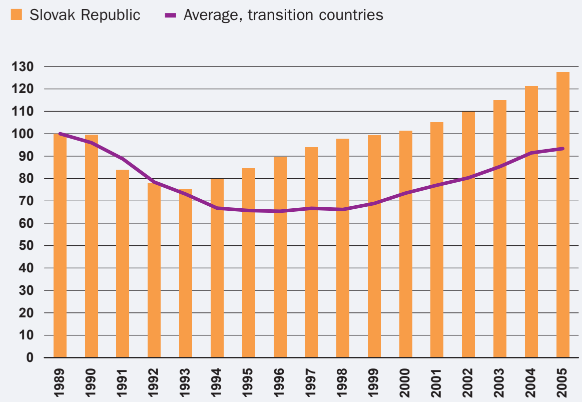
Outlook and risks

Annual real growth of around 5 to 6 per cent is forecast in the medium term. However, pension reform and pending elections in 2006 could pose risks to the government's fiscal adjustment strategy. The government aims to join the Exchange Rate Mechanism II (ERM II) in early 2006 and to adopt the euro in January 2009. This timetable will require the maintenance of sound fiscal policies and the continuation of structural reforms to enhance the flexibility of the economy. Progress in reducing the rate of disinflation could be jeopardised by increasing demand pressures and further rises in oil and regulated prices.

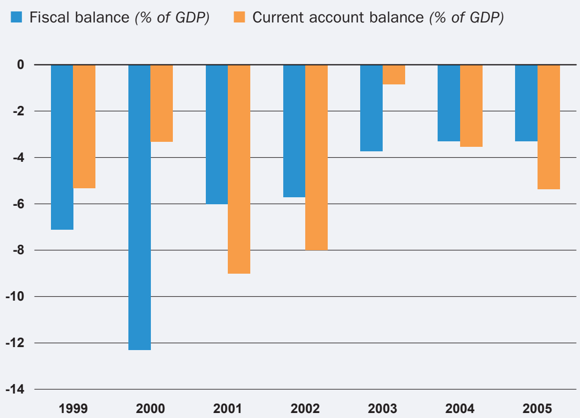
Transition indicators, 2005



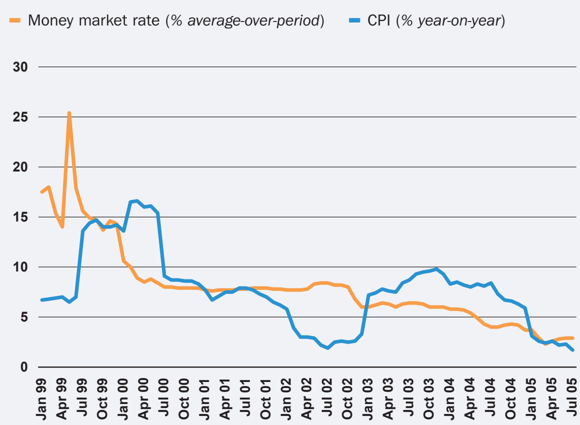
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **8 per cent**	Share of population living in poverty – **2.4 per cent** (1996)
Controls on inward direct investment – **no**	Quality of insolvency law – **medium**	Independent electricity regulator – **fully**	Deposit insurance system – **yes**	Government expenditure on health – **5.5 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **advanced**	Separation of railway infrastructure from operations – **fully**	Quality of securities market laws – **medium**	Government expenditure on education – **4.0 per cent of GDP**
Exchange rate regime – **managed float**	Quality of corporate governance law – **medium**	Quality of concession laws – **medium**	Private pension funds – **yes**	Share of power, water in total household expenditure – **15.7 per cent**
Wage regulation – **no**				
Tradability of land – **full except non-EU foreigners**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	11.4	15.4	19.3	34.0	35.0	na	na
Private sector share in GDP (in per cent)	75.0	80.0	80.0	80.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	70.0	75.0	75.0	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.7	2.4	2.3	1.6	1.7	1.6	na
Share of industry in total employment (in per cent)	24.4	25.3	29.4	29.8	29.2	29.2	na
Change in labour productivity in industry (in per cent)	3.9	-3.1	5.8	4.3	6.3	2.9	na
Investment/GDP (in per cent)	27.6	26.1	30.0	29.3	25.1	27.0	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of enterprise reform [1]	3.0	3.0	3.0	3.3	3.3	3.3	3.7
Markets and trade							
Share of administered prices in CPI (in per cent)	17.8	17.8	17.8	21.1	20.7	19.9	na
Number of goods with administered prices in EBRD-15 basket	4.0	3.0	3.0	3.0	3.0	2.0	na
Share of trade with non-transition countries (in per cent)	62.0	64.0	62.0	63.5	66.1	62.6	na
Share of trade in GDP (in per cent)	105.3	114.8	140.4	127.3	135.7	138.6	na
Tariff revenues (in per cent of imports) [2]	2.7	2.2	0.5	0.5	0.5	na	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.3	4.3	4.3	4.3
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Financial sector							
Number of banks (foreign-owned)	25 (10)	23 (13)	21 (12)	20 (15)	21 (16)	21 (16)	na
Asset share of state-owned banks (in per cent)	50.7	49.1	4.9	1.9	1.5	1.3	na
Asset share of foreign-owned banks (in per cent)	24.1	42.7	78.3	84.1	96.3	96.7	na
Non-performing loans (in per cent of total loans)	32.9	26.2	24.3	11.2	9.1	7.2	na
Domestic credit to private sector (in per cent of GDP)	39.1	33.6	28.2	24.6	24.9	25.8	na
Domestic credit to households (in per cent of GDP)	4.3	4.4	5.5	5.6	7.1	8.8	na
Of which mortgage lending (in per cent of GDP)	0.0	0.1	0.5	1.0	2.2	2.9	na
Stock market capitalisation (in per cent of GDP)	3.8	3.9	3.3	7.0	7.6	9.5	na
Stock trading volume (in per cent of market capitalisation)	60.0	130.0	141.0	179.0	29.0	20.0	na
Eurobond issuance (in per cent of GDP)	5.0	5.6	1.2	0.0	3.6	2.9	na
EBRD index of banking sector reform	2.7	3.0	3.3	3.3	3.3	3.7	3.7
EBRD index of reform of non-bank financial institutions	2.3	2.3	2.3	2.3	2.7	2.7	2.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	30.7 (12.3)	31.4 (20.5)	28.9 (39.9)	26.8 (54.4)	24.1 (68.4)	23.1 (79.1)	na
Internet penetration rate (per 10,000 inhabitants)	55.2	70.2	134.9	159.9	212.2	226.3	na
Railway labour productivity (1989=100)	54.5	61.0	66.9	60.6	60.5	61.5	na
Residential electricity tariffs (in USc kWh)	3.5	4.9	5.7	7.1	10.9	13.7	na
Average collection rate, electricity (in per cent)	na	na	102	95	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.4	3.5	3.5	3.8	na	na	na
EBRD index of infrastructure reform	2.0	2.0	2.3	2.7	3.0	3.0	3.0
Electric power	2.0	2.0	3.0	4.0	4.0	4.0	4.0
Railways	2.0	2.3	2.3	2.7	2.7	2.7	3.0
Roads	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Telecommunications	2.3	2.3	3.0	3.3	3.3	3.3	3.3
Water and waste water [1]	2.3	2.3	2.3	2.3	2.7	2.7	2.7

1 Series has been revised.

2 Refers to import tariffs, customs duties and import surcharge.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	1.5	2.0	3.8	4.6	4.5	5.5	5.3
Private consumption	3.2	-0.8	4.7	5.5	-0.6	3.5	na
Public consumption	-7.1	1.6	4.6	4.9	2.7	1.2	na
Gross fixed capital formation	-19.6	-7.2	13.9	-0.6	-1.5	2.5	na
Exports of goods and services	5.0	13.7	6.3	5.6	22.5	11.4	na
Imports of goods and services	-6.7	10.5	11.0	5.5	13.6	12.7	na
Industrial gross output	-2.1	8.6	7.0	7.2	5.4	4.1	na
Agricultural gross output	1.0	3.2	-4.0	10.9	na	na	na
Employment			(Percentage change)				
Labour force (end-year)	0.9	2.0	-4.5	-6.6	-0.5	1.0	na
Employment (end-year)	-1.8	-1.4	-12.0	0.5	0.9	1.3	na
			(In per cent of labour force)				
Unemployment (end-year)	19.2	17.9	19.8	17.9	17.4	17.5	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	10.6	12.0	7.3	3.0	8.5	7.5	2.4
Consumer prices (end-year)	14.2	8.3	6.2	3.3	9.3	5.9	3.2
Producer prices (annual average)	3.8	9.8	6.6	2.1	8.3	2.6	na
Producer prices (end-year)	7.7	9.1	3.4	2.3	8.7	5.9	na
Gross average monthly earnings in economy (annual average)	7.2	6.5	8.2	9.3	6.3	10.2	na
Government sector [1]			(In per cent of GDP)				
General government balance [2]	-7.1	-12.3	-6.0	-5.7	-3.7	-3.3	-3.3
General government expenditure	56.9	59.9	51.5	50.9	39.2	48.0	na
General government debt	47.2	49.9	48.7	43.3	42.6	43.6	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	13.0	15.4	11.9	3.4	5.6	5.8	na
Domestic credit (end-year)	7.5	9.1	13.3	-12.7	15.0	10.9	na
			(In per cent of GDP)				
Broad money (M2, end-year)	62.4	61.3	72.1	64.0	61.8	59.3	na
Interest and exchange rates			(In per cent per annum, end-year)				
Refinancing rate	8.7	8.0	7.8	6.5	6.0	4.0	na
3-month BRIBOR	14.3	7.9	7.8	6.0	6.0	3.7	na
Deposit rate [3]	9.9	5.6	4.8	3.5	3.0	2.0	na
Lending rate [3]	13.5	10.8	9.8	8.8	7.2	7.4	na
			(Korunas per US dollar)				
Exchange rate (end-year)	42.1	48.6	48.2	41.1	33.6	28.5	na
Exchange rate (annual average)	41.4	46.2	48.4	45.3	36.8	32.3	na
External sector			(In millions of US dollars)				
Current account	-1,083	-713	-1,756	-1,939	-276	-1,447	-2,508
Trade balance	-1,103	-917	-2,135	-2,131	-637	-1,456	-2,623
Merchandise exports	10,197	11,870	12,632	14,365	21,843	27,754	33,305
Merchandise imports	11,301	12,786	14,766	16,497	22,480	29,210	35,928
Foreign direct investment, net	701	2,058	1,460	4,007	549	1,259	1,800
Gross reserves, excluding gold (end-year)	3,366	4,077	4,189	9,196	12,149	14,913	na
External debt stock	10,518	10,804	11,269	13,188	18,090	23,695	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.1	3.4	3.0	5.9	5.7	5.5	na
			(In per cent of exports of goods and services)				
Debt service due	16.8	17.4	19.5	11.7	11.6	2.9	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	5.4	5.4	5.4	5.4	5.4	5.4	na
GDP (in billions of korunas)	844	992	944	1,099	1,201	1,325	1,429
GDP per capita (in US dollars)	3,780	3,974	3,615	4,506	6,073	7,639	na
Share of industry in GDP (in per cent)	24.6	25.9	26.0	25.9	26.0	26.0	na
Share of agriculture in GDP (in per cent)	4.0	5.2	4.8	5.1	5.0	5.0	na
Current account/GDP (in per cent)	-5.3	-3.3	-9.0	-8.0	-0.8	-3.5	-5.4
External debt - reserves (in US$ million)	7,152	6,727	7,080	3,993	5,941	8,782	na
External debt/GDP (in per cent)	51.5	50.3	57.7	54.4	55.4	57.7	na
External debt/exports of goods and services (in per cent)	86.3	76.5	74.5	76.9	72.0	75.3	na

1 General government includes central government, municipalities and extra-budgetary funds.

2 The general government balance excludes privatisation revenues and is calculated according to Eurostat methodology (ESA95).

3 Weighted average over all maturities.

Slovenia

Key challenges

- The privatisation of large companies in sectors including insurance and banking remains a priority to improve efficiency and productivity across the economy.
- Accession to the European Union has made the liberalisation and better regulation of network industries, particularly telecommunications and power, even more pressing.
- Following entry into the Exchange Rate Mechanism II, continued fiscal restraint and a reduction in inflation are necessary in the run-up to adoption of the euro in early 2007.

Country data

Population (in millions)	**2.0**
Area ('000 sq. km)	**20.5**
GDP (in billion US$, 2004)	**32.2**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 20,853**
National currency	**Tolar**

Progress in structural reform

Liberalisation and privatisation

The privatisation of large companies, suspended ahead of general elections in October 2004, has recommenced with a focus on the financial sector. Resistance to the sale of profitable state-owned companies has hindered restructuring, competition and new foreign direct investment (FDI).

The government still has large holdings in banking and insurance, telecommunications, aluminium and steel. The merger of Slovenia's second largest bank, NKBM, with the postal bank was cleared by the Competition Protection Office and the Bank of Slovenia in September 2004. In May 2005 the Minister of Finance called for the privatisation of NKBM to Slovenian institutional investors or foreign investors.

The partial privatisation through demutualisation of Triglav, Slovenia's dominant insurance company, was suspended in late February 2005 after the government decided to commission a new valuation of the company. In March the Ministry of Economy announced its intention to draft a strategy for the long-delayed privatisation of Telekom Slovenije, which is majority-owned by the state.

Business environment and competition

Despite some progress, the business environment still faces a number of obstacles. For example, the time-scale for setting up a business is more than double the OECD average and 50 per cent higher than the regional average, according to the World Bank's *Doing Business* report. Also, the time taken to enforce a contract is double the regional average and there are limited industrial sites available and cumbersome administrative procedures at the local government level. Respondents to the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey suggested that the constraints of labour regulation have worsened since 2002.

The struggle for ownership of Slovenia's second largest brewery, Pivovarna Union, was settled when Slovenia's other leading brewery, Lasko, acquired the minority stake of Belgium's InBev. The deal pitched the competition authority against the administrative court, with the competition authority requesting the divestiture of selected brands. This demand, however, was overturned by the administrative court, raising concerns about differing interpretations of the law on take-overs. By leaving unaddressed allegations of concerted control of Union by Lasko with third parties, the episode also raised concerns about the commitment of the authorities to encourage foreign investment.

Infrastructure

In February 2005 the European Commission decided to open a formal investigation into Slovenia's system of preferential dispatching of electricity to boost the use of renewable energy. The investigation will assess whether the price, determined by the state, for the purchase of renewable energy sources by network operators is compatible with the EU's state aid regulation.

In December 2004 the European Commission criticised the telecommunications regulator for accumulated delays in the full transposition of the EU's *acquis communautaire* and for its lack of effective regulation. The Commission argued that these factors limited competition, particularly in the areas of fixed-line and internet services. The Slovenian Competition Protection Office also concluded in November 2004 that Telekom Slovenije was abusing its dominant position in the broadband internet market.

The telecommunications regulator has requested Telekom Slovenije to open its local fixed-line network after Voljatel became the country's second licensed national telecommunications operator in January 2005. In June 2005 a mobile provider, Vega, filed against the regulator and Telekom Slovenije's mobile operator Mobitel for lack of proper market regulation and obstructing competition.

Social sector

Figures published in October 2004 confirmed that the proportion of the population at risk of poverty declined from 14 per cent in 1998 to 11.9 per cent in 2004, in parallel with a reduction in unemployment. In July 2005 the government amended the pensions law to index pensions to wage growth. This move, according to the IMF, will result in additional pension obligations of about 1 per cent of annual GDP in seven years' time.

Amendments in 2005 to the health care and insurance law may extend free health care to an estimated 100,000 of Slovenia's poorest inhabitants depending on the outcome of ongoing negotiations. This would be funded by savings generated from the tightening of access to benefits for the long-term unemployed.

Macroeconomic performance

Real economy

Real GDP grew by 4.2 per cent in 2004, almost double the rate in 2003. This reflected a sustained growth of domestic consumption and investment and of exports. Exports registered a 12.5 per cent increase measured in euros. Private consumption increased by 3.3 per cent, although this was less than expected because rapid private sector credit growth did not fully translate into higher domestic demand.

Total investment rose by 9.2 per cent in 2004, with gross fixed capital formation up by 5.9 per cent. Real GDP growth declined to 2.6 per cent year-on-year in the first quarter of 2005 as private consumption and investment slowed, although it then picked up to 5.2 per cent year-on-year in the second quarter of 2005.

Economic policies

Slovenia's macroeconomic policy is focused on the planned adoption of the euro in early 2007. The Maastricht criteria for long-term interest rates, the fiscal deficit and debt ratios — but not inflation — have already been met. However, the average inflation rate continued to fall to 3.6 per cent in 2004 and an average of 2.45 per cent in the first six months of 2005, down from 5.6 per cent in 2003. This was due mainly to the slower rate of depreciation of the tolar and to further (but limited) wage de-indexation in the public and private sectors. Wage indexation remains a pressing policy issue and negotiations on a new public sector wage structure have yet to be concluded. In 2004 the general government deficit was 1.9 per cent of GDP (using ESA95 methodology), slightly lower than in 2003.

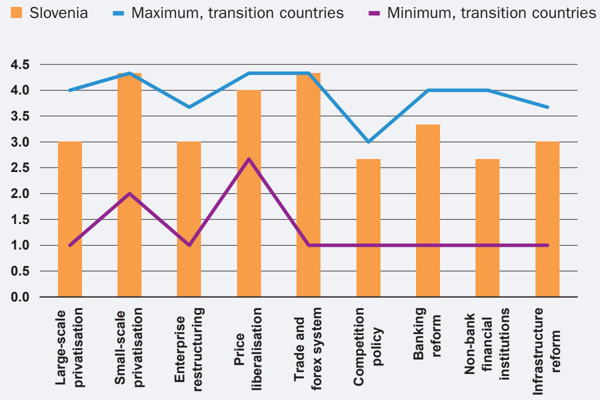
External sector

The current account remained close to balance in 2004, followed by a small surplus in the first half of 2005. The trade deficit widened slightly in 2004, when strong export growth was more than offset by a deterioration in the terms of trade due to higher oil and commodity prices. External debt had risen to 60 per cent of GDP by end-2004. However, other debt indicators, such as the net debt position and debt maturity ratios, suggest that this level is manageable.

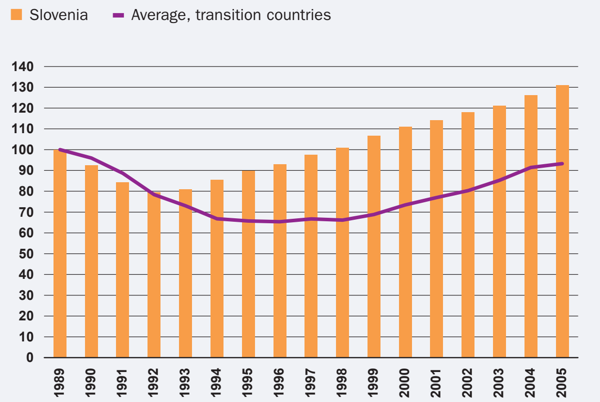
Outlook and risks

The real growth rate is expected to moderate to around 4 per cent in 2005–06 due to a slowdown in inventory accumulation and in fixed investment. Stronger growth over the medium term will require improved competitiveness through labour market liberalisation and a further opening up of the economy to foreign capital and know-how. The impact of Slovenia's ageing population — it has the highest proportion of elderly people among the new EU member states — on public finances is a major concern for the longer term. Pension payments are projected to increase from the already high level of 13 per cent of GDP in 2005 to 18 per cent in 2020.

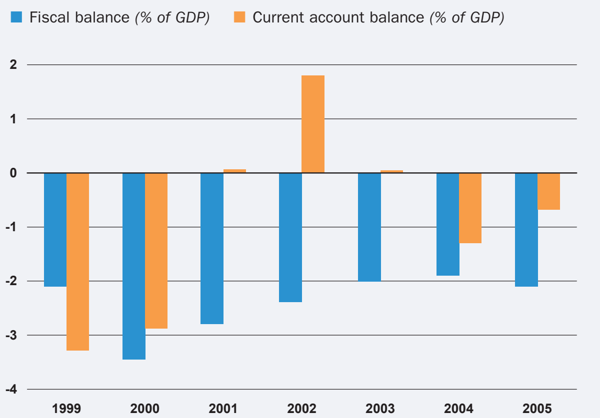
Transition indicators, 2005



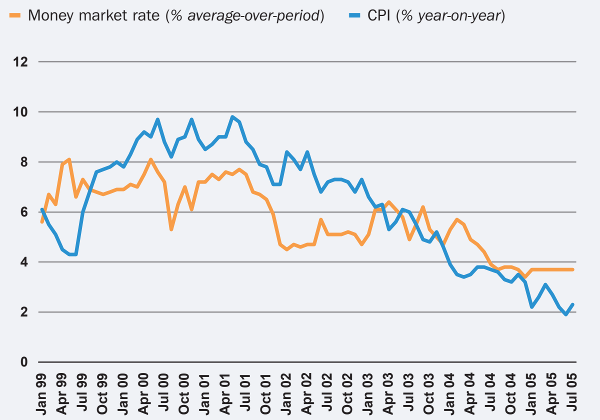
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **fully**	Capital adequacy ratio – **8 per cent**	Share of population living in poverty – **<2 per cent** (1998)
Controls on inward direct investment – **no** [1]	Quality of insolvency law – **low**	Independent electricity regulator – **fully**	Deposit insurance system – **yes**	Government expenditure on health – **na**
Interest rate liberalisation – **full**	Secured transactions law – **inefficient**	Separation of railway infrastructure from operations – **fully**	Quality of securities market laws – **high**	Government expenditure on education – **na**
Exchange rate regime – **managed float in ERM II**	Quality of corporate governance law – **medium**	Quality of concession laws – **na** [2]	Private pension funds – **yes**	Share of power, water in total household expenditure – **12.0 per cent**
Wage regulation – **yes**				
Tradability of land – **full except non-EU foreigners**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.2	2.3	2.4	4.6	4.7	na	na
Private sector share in GDP (in per cent)	60.0	65.0	65.0	65.0	65.0	65.0	65.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	1.6	1.5	1.4	1.2	1.5	na	na
Share of industry in total employment (in per cent)	37.8	37.4	38.2	38.5	36.3	na	na
Change in labour productivity in industry (in per cent)	5.7	7.3	-1.3	0.8	8.8	na	na
Investment/GDP (in per cent)	27.3	27.1	24.3	23.5	25.0	26.6	na
EBRD index of small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of enterprise reform	2.7	2.7	2.7	3.0	3.0	3.0	3.0
Markets and trade							
Share of administered prices in CPI (in per cent)	14.3	13.7	13.2	14.0	15.4	16.1	16.7
Number of goods with administered prices in EBRD-15 basket	2.0	1.0	1.0	1.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	75.5	73.1	76.7	77.6	77.7	na	na
Share of trade in GDP (in per cent)	86.7	98.2	98.5	95.8	95.3	103.7	na
Tariff revenues (in per cent of imports)	2.5	1.7	1.2	1.2	1.2	na	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	4.3	4.3	4.3	4.3	4.3	4.3	4.3
EBRD index of competition policy	2.3	2.7	2.7	2.7	2.7	2.7	2.7
Financial sector							
Number of banks (foreign-owned) [3]	31 (5)	28 (6)	24 (5)	22 (6)	22 (6)	22 (7)	na
Asset share of state-owned banks (in per cent)	42.2	42.5	48.9	13.3	12.8	12.6	na
Asset share of foreign-owned banks (in per cent)	4.9	15.3	15.2	16.9	18.9	20.1	na
Non-performing loans (in per cent of total loans)	9.3	9.3	10.0	10.0	9.4	7.5	na
Domestic credit to private sector (in per cent of GDP)	35.8	38.5	40.2	40.3	43.2	48.3	na
Domestic credit to households (in per cent of GDP)	11.1	11.4	10.9	10.6	10.9	12.3	na
Of which mortgage lending (in per cent of GDP)	1.5	1.7	1.8	2.0	2.3	2.8	na
Stock market capitalisation (in per cent of GDP)	11.8	13.7	14.7	19.1	17.0	27.5	na
Stock trading volume (in per cent of market capitalisation)	2.0	21.0	31.0	23.5	13.0	15.0	na
Eurobond issuance (in per cent of GDP)	2.2	2.0	3.0	0.0	0.0	0.7	na
EBRD index of banking sector reform	3.3	3.3	3.3	3.3	3.3	3.3	3.3
EBRD index of reform of non-bank financial institutions	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	37.3 (31.8)	38.6 (61.2)	40.2 (73.7)	40.5 (83.5)	40.7 (87.1)	40.9 (94.1)	na
Internet penetration rate (per 10,000 inhabitants)	118.0	109.5	148.2	179.3	214.8	269.7	na
Railway labour productivity (1989=100)	118.4	123.0	122.7	135.7	150.3	163.2	na
Residential electricity tariffs (in USc kWh)	10.0	8.9	8.7	9.3	11.5	12.9	na
Average collection rate, electricity (in per cent)	99	na	na	97	93	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.9	5.1	5.1	5.3	na	na	na
EBRD index of infrastructure reform [4]	2.7	2.7	3.0	3.0	3.0	3.0	3.0
Electric power	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Railways	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Roads	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Telecommunications	2.3	2.3	3.0	3.0	3.0	3.0	3.0
Water and waste water [4]	3.3	3.3	3.3	3.3	3.3	3.3	3.3

1 Direct investment by non-residents in the production or trading of armaments and military equipment requires a government licence.

2 Slovenia has no specific concession law but largely conforms with internationally accepted principles on concession laws.

3 Two foreign branches are included in the figure.

4 Series has been revised.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	5.6	4.1	2.7	3.5	2.7	4.2	3.8
Private consumption	5.9	0.7	2.3	1.3	3.5	3.3	na
Public consumption	2.9	2.6	3.9	3.2	1.6	1.7	na
Gross fixed capital formation	21.0	1.8	0.4	0.9	7.1	5.9	na
Exports of goods and services	1.6	13.0	6.3	6.7	3.2	12.6	na
Imports of goods and services	8.0	7.6	3.0	4.9	6.8	12.4	na
Industrial gross output	-0.5	6.3	3.1	2.5	1.4	4.8	na
Agricultural gross output [1]	-2.1	-1.0	-2.5	1.1	-8.2	2.3	na
Employment [2]			*(Percentage change)*				
Labour force (mid-year)	-2.0	0.0	0.9	0.9	-0.3	3.0	na
Employment (mid-year)	-1.7	0.2	2.2	0.9	-1.1	3.7	na
			(In per cent of labour force)				
Unemployment (mid-year)	7.4	7.2	5.9	5.9	6.7	6.1	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	6.1	8.9	8.4	7.5	5.6	3.6	2.5
Consumer prices (end-year)	8.0	8.9	7.0	7.2	4.7	3.2	2.2
Producer prices (annual average)	2.1	7.6	9.0	5.1	2.5	4.3	na
Producer prices (end-year)	3.5	9.2	7.5	3.7	2.1	4.9	na
Gross average monthly earnings in economy (annual average) [3]	9.6	10.6	11.9	9.7	7.5	5.7	na
Government sector [4]			*(In per cent of GDP)*				
General government balance	-2.1	-3.4	-2.8	-2.4	-2.0	-1.9	-2.1
General government expenditure	41.9	48.2	47.9	48.1	48.2	47.7	na
General government debt	24.9	27.4	28.1	29.5	29.3	29.5	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	11.8	9.7	27.4	25.1	5.2	4.0	na
Domestic credit (end-year)	21.3	20.6	23.2	11.5	13.8	19.8	na
			(In per cent of GDP)				
Broad money (M2, end-year)	38.1	38.0	43.3	48.5	47.2	45.5	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Discount rate	8.0	10.0	11.0	10.0	6.0	4.0	na
Interbank market rate (average)	6.9	7.2	4.7	4.7	4.7	3.4	na
Deposit rate (31-90 days)	9.6	10.9	8.5	7.6	4.8	3.2	na
Lending rate (short-term working capital)	15.2	16.3	13.7	11.8	9.9	8.0	na
			(Tolars per US dollar)				
Exchange rate (end-year)	196.8	235.6	250.9	226.2	189.4	176.2	na
Exchange rate (annual average)	181.8	222.7	243.0	240.2	207.1	192.4	na
External sector			*(In millions of US dollars)*				
Current account	-699	-549	12	398	13	-416	-234
Trade balance	-1,235	-1,140	-617	-248	-623	-1,258	-1,384
Merchandise exports	8,623	8,807	9,346	10,471	12,916	16,064	17,670
Merchandise imports	9,858	9,947	9,963	10,719	13,539	17,322	19,054
Foreign direct investment, net	59	71	226	1,489	-139	277	346
Gross reserves, excluding gold (end-year)	4,115	4,376	5,747	8,168	9,629	10,189	na
External debt stock	8,100	8,516	9,283	11,664	16,630	20,945	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	4.3	4.6	6.0	7.9	7.4	6.1	na
			(In per cent of exports of goods and services)				
Debt service [5]	8.0	11.8	9.2	10.3	14.0	15.8	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in billions of tolars)	3,875	4,252	4,762	5,314	5,749	6,191	6,587
GDP per capita (in US dollars)	10,724	9,595	9,905	11,088	13,949	16,172	na
Share of industry in GDP (in per cent)	27.3	26.9	27.5	27.9	28.1	28.2	na
Share of agriculture in GDP (in per cent)	3.2	2.8	2.4	2.7	2.2	2.3	na
Current account/GDP (in per cent)	-3.3	-2.9	0.1	1.8	0.0	-1.3	-0.7
External debt - reserves (in US$ million)	3,985	4,140	3,536	3,496	7,001	10,756	na
External debt/GDP (in per cent)	38.0	44.6	47.4	52.7	59.9	65.1	na
External debt/exports of goods and services (in per cent)	77.2	79.6	82.2	91.2	105.9	107.3	na

1 Agricultural value-added.
2 Based on labour force survey data.
3 Data for enterprises employing three or more persons.
4 General government includes central government, municipalities and extra-budgetary funds. Data calculated according to Eurostat methodology (ESA95) from 2000. 1999 shows general government balance.
5 Long-term debt only in 1999.

Tajikistan

Key challenges

- The restructuring and commercialisation of large, strategic state-owned enterprises need to be accelerated to attract foreign investors.
- To take full advantage of large-scale foreign investment commitments, the power sector needs to be reformed by separating policy making from operations, unbundling business units, strengthening the regulatory framework and improving the tariff structure.
- Strengthening the tax and customs administration under the new tax code is key to increasing tax revenues and achieving sustainable public finances.

Country data	
Population (in millions)	**6.5**
Area ('000 sq. km)	**143.1**
GDP (in billion US$, 2004)	**2.1**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 1,181**
National currency	**Somoni**

Progress in structural reform

Liberalisation and privatisation

During 2004, 138 medium-sized enterprises were privatised (above the target of 110), generating TJS 36 million (about US$12 million) in revenue. The authorities have accelerated the programme further in 2005. By mid-2005, around 8,300 entities were privatised out of the total 8,991 subject to privatisation. Most of them were small-scale enterprises. The remaining state-owned entities are mainly large strategic enterprises or ones in financial difficulty that are unattractive to investors.

For the large strategic enterprises, a special committee was established to formulate concrete plans for restructuring and future private sector participation by the end of 2005. The process of land privatisation has been slower than anticipated and the long-standing issue of farmers' indebtedness remains unresolved. To date, 1,800 dehkan (privately owned) farms have been created, but most of them do not have land certificates.

Business environment and competition

Reform and restructuring of the cotton sector is progressing slowly. Cotton farmers can now choose from several cotton gins when selling their crop. (Previously all cotton was controlled by a regional monopoly.) Similarly there is now competition among exporters at the regional level (up to 10 per region). Competition among financial institutions has also increased to some extent. A number of new players have entered the market that was previously dominated by CreditInvest (formerly part of the Agroinvest Bank) which had provided 90 per cent of cotton finances.

In recent years some progress has been made in improving the business environment, including the introduction of a simplified tax system, preferential taxation for foreign investors and measures to fight corruption. The 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey showed a reduction in the perceptions of corruption, regulations, inadequate infrastructure and access to finance as obstacles to doing business.

Infrastructure

The government is stepping up efforts to mobilise foreign investment in infrastructure. In the energy sector, a number of sizeable investment commitments have been made recently. The Tajik government signed investment agreements with representatives of the Russian state-owned energy company RAO UES and with the Russian aluminium giant Rusal for a total of US$1.57 billion over seven years. This includes investment in the completion of the Rogun and Sangtuda hydropower stations.

In addition to its participation in the Rogun project, Rusal has also signed an agreement to invest US$600 million in the modernisation of Tadaz, a major aluminium smelter, and the construction of a new aluminium plant in the south. Iran has also committed finance for the completion of Sangtuda II and is providing financial and technical assistance for the construction of the Anzob tunnel (linking north and south Tajikistan). Despite these new investment commitments, the energy sector remains unreformed. The separation between policy making and operations remains weak, the incumbent state-owned power company BarakTojik remains a vertically integrated monopoly, and electricity tariffs remain below cost-recovery levels.

Financial sector

Reforms in the financial sector have gathered pace. In 2004 the deposit insurance scheme became partially operational. Also, the minimum capital requirement was raised from US$2 million to US$5 million starting in January 2005 for the largest banks, and for all banks starting in January 2006. There are 12 banks (including one state-owned bank), six credit unions and seven non-bank financial institutions. Two weaker banks have entered a restructuring process. The Central Bank granted two new banking licences in 2004 (in both cases to banks with foreign participation).

More recently, two additional foreign banks expressed an interest in obtaining a new licence. This is related to the government's promise to liberalise regulations on foreign ownership in the banking sector. If enacted, the new regulations will eliminate the limit on foreign ownership of capital in the banking sector (now set at 35 per cent of the sector's capital) and allow foreign citizens to serve as corporate secretaries. As confidence in the banking sector has increased, domestic credit has grown substantially from 2004. Moreover, the quality of banking assets appears to be improving as the non-performing loan ratio has declined to 11 per cent. Nevertheless, banking sector assets are concentrated in a few key sectors.

Macroeconomic performance

Real economy

The economy continues to expand rapidly, albeit from a low base. Real GDP grew by 8.1 per cent during the first half of 2005, following five consecutive years of more than 8 per cent growth. Domestic demand has been fuelled by strong wage growth and increasing remittances, while rapid export growth of 15 per cent in 2004 was driven by the rising output of aluminium. There is also encouraging evidence of economic diversification and productivity increases in other sectors, particularly in the services sector.

Economic policies

In recent years monetary policy has focused mainly on achieving price stability, with increasing success. The end-year inflation rate dropped from 13.7 per cent in 2003 to 5.7 per cent in 2004. However, inflationary pressures re-emerged in early 2005, following rises in utility prices, public sector wages, pensions and prices of imported food and oil. The Central Bank has adopted a more flexible exchange rate policy and stopped unsterilised foreign exchange operations since mid-2004. In December 2004 the authorities adopted unrestricted convertibility of the domestic currency for current account transactions (an obligation under Article VIII of the IMF's statutes).

Fiscal policy has remained prudent and largely consistent with the objectives set out in Tajikistan's Poverty Reduction Strategy Paper (PRSP) adopted in July 2002, with outlays mainly limited to social sector expenditures. A substantial increase in public sector wages, introduced in early 2005, was designed to retain qualified personnel and to strengthen the delivery of social services. On the revenue side, a new tax code which took effect in 2005 has simplified the tax structure, eliminated a number of distortions and exemptions, and is expected to raise tax revenues from their current low level.

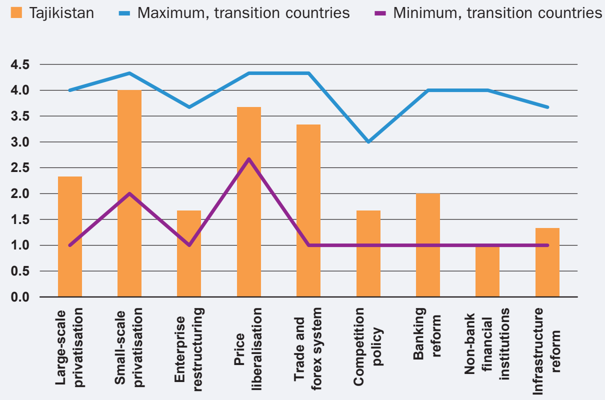
External sector

Public external debt has been restructured substantially in the past year. After a series of bilateral debt reduction agreements, the level had declined to US$895 million by mid-2005, equivalent to just under 40 per cent of GDP. Russia, the largest bilateral creditor, has written off US$306 million of debt, primarily as part of debt-equity swaps in which ownership of a hydropower station and the Nurek space tracking station was transferred. The trade deficit increased in 2004. However, this increase was largely offset by the growth in workers' remittances, which increased from US$189 million in 2003 to US$313 million in 2004. Foreign direct investment increased significantly to US$272 million in 2004 from just US$32 million in 2003, although most of this was related to debt-equity swaps.

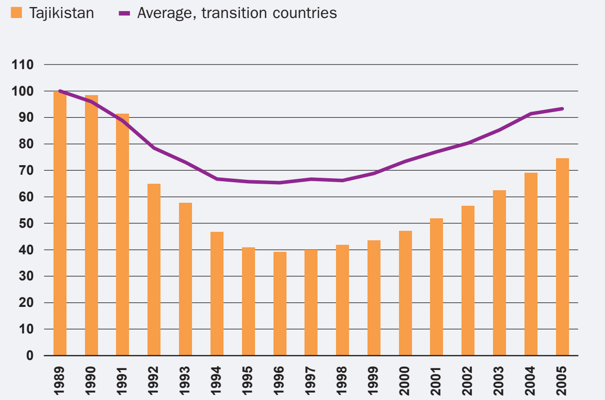
Outlook and risks

Strong growth is expected to continue in the medium term. Large-scale investment commitments in the energy and aluminium sectors made by Russia and Iran are likely to stimulate overall production and provide opportunities for closer bilateral trade and business links. However, the country will remain dependent on a few key sectors — aluminium, cotton and power — which can suffer from large price and demand fluctuations. It also remains vulnerable to terms of trade shocks, in particular from prices for food stuffs and oil products.

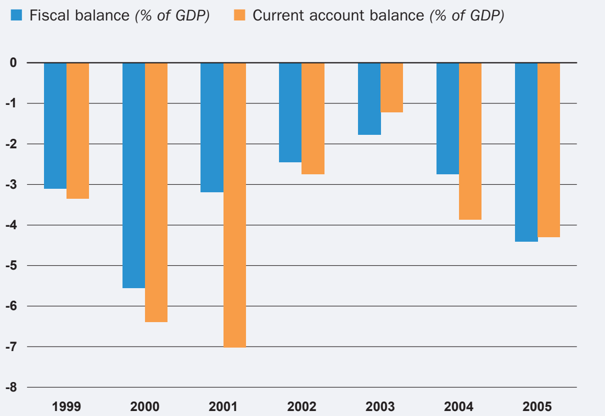
Transition indicators, 2005



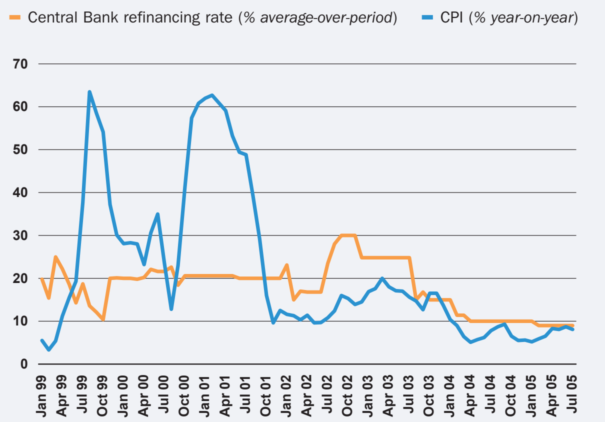
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full** Controls on inward direct investment – **no** [1] Interest rate liberalisation – **full** Exchange rate regime – **managed float** Wage regulation – **yes** Tradability of land – **limited de facto**	Competition office – **yes** Quality of insolvency law – **very low** Secured transactions law – **malfunctioning** Quality of corporate governance law – **very low**	Independent telecoms regulator – **no** Independent electricity regulator – **no** Separation of railway infrastructure from operations – **no** Quality of concession laws – **very low**	Capital adequacy ratio – **12 per cent** Deposit insurance system – **yes** Quality of securities market laws – **very low** Private pension funds – **yes**	Share of population living in poverty – **42.8 per cent** (2003) Government expenditure on health – **1.0 per cent of GDP** Government expenditure on education – **2.6 per cent of GDP** Share of power, water in total household expenditure – **6.0 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	3.6	4.6	4.9	5.8	6.3	6.7	na
Private sector share in GDP (in per cent)	40.0	40.0	45.0	50.0	50.0	50.0	50.0
Private sector share in employment (in per cent)	63.0	60.0	62.8	65.3	63.0	63.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.8	0.7	0.5	0.5	0.4	0.7	na
Share of industry in total employment (in per cent)	7.7	6.9	6.7	6.6	6.1	5.7	na
Change in labour productivity in industry (in per cent)	16.8	21.2	12.5	7.2	16.6	22.9	na
Investment/GDP (in per cent)	19.1	21.7	15.8	13.9	13.1	14.9	16.5
EBRD index of small-scale privatisation	3.0	3.3	3.7	3.7	3.7	3.7	4.0
EBRD index of large-scale privatisation	2.3	2.3	2.3	2.3	2.3	2.3	2.3
EBRD index of enterprise reform	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Markets and trade							
Share of administered prices in CPI (in per cent)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	36.2	33.4	38.3	32.7	46.3	45.4	na
Share of trade in GDP (in per cent)	125.1	164.7	135.2	126.6	116.0	104.4	na
Tariff revenues (in per cent of imports)	2.1	1.8	2.8	2.6	2.3	2.6	na
EBRD index of price liberalisation	3.7	3.7	3.7	3.7	3.7	3.7	3.7
EBRD index of forex and trade liberalisation	2.7	3.3	3.3	3.3	3.3	3.3	3.3
EBRD index of competition policy	2.0	2.0	1.7	1.7	1.7	1.7	1.7
Financial sector							
Number of banks (foreign-owned)	19 (3)	16 (3)	15 (3)	14 (3)	15 (4)	12 (3)	na
Asset share of state-owned banks (in per cent)	6.9	6.8	4.8	4.5	6.1	12.2	na
Asset share of foreign-owned banks (in per cent)	60.9	71.9	70.3	1.8	3.6	6.2	na
Non-performing loans (in per cent of total loans)	15.8	10.8	12.5	84.2	73.6	18.7	na
Domestic credit to private sector (in per cent of GDP)	4.6	11.3	13.6	11.5	10.5	na	na
Domestic credit to households (in per cent of GDP)	na	na	na	na	0.5	na	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.7	1.7	2.0	2.0
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	3.5 (0.0)	3.6 (0.0)	3.7 (0.0)	3.7 (0.2)	3.7 (0.7)	3.8 (0.7)	na
Internet penetration rate (per 10,000 inhabitants)	0.4	0.4	0.5	0.5	0.1	0.2	na
Railway labour productivity (1994=100)	62.9	62.9	57.2	50.3	47.3	38.0	na
Residential electricity tariffs (in USc kWh)	0.4	0.4	0.5	0.5	0.5	0.6	na
Average collection rate, electricity (in per cent)	na	na	na	65	73	85	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.3	1.7	1.8	1.9	na	na	na
EBRD index of infrastructure reform	1.0	1.0	1.0	1.0	1.0	1.3	1.3
Electric power	1.0	1.0	1.0	1.0	1.0	1.7	1.7
Railways	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Roads	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Telecommunications	1.0	1.0	2.3	2.3	2.3	2.3	2.3
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0

[1] Approval from the National Bank of Tajikistan is required.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			(Percentage change in real terms)				
GDP	3.7	8.3	10.2	9.1	10.2	10.6	8.0
Industrial gross output	5.0	10.3	14.4	6.3	9.9	13.8	na
Agricultural gross output	3.8	12.4	11.0	14.0	9.1	11.3	na
Employment			(Percentage change)				
Labour force (end-year)	-3.5	0.2	4.3	1.7	1.5	-0.7	na
Employment (end-year)	-3.3	0.4	4.8	1.5	1.7	-0.7	na
			(In per cent of labour force)				
Unemployment (end-year) [1]	3.0	2.7	2.3	2.5	2.2	2.2	na
Prices and wages			(Percentage change)				
Consumer prices (annual average)	27.6	32.9	38.6	12.2	16.3	7.1	7.9
Consumer prices (end-year)	30.1	60.8	12.5	14.5	13.7	5.6	10.2
Producer prices (annual average)	41.2	43.5	28.7	10.1	15.0	17.1	na
Producer prices (end-year)	64.0	33.9	9.4	19.0	14.1	15.1	na
Gross average monthly earnings in economy (annual average)	35.2	25.8	50.6	38.6	36.9	36.3	na
Government sector [2]			(In per cent of GDP)				
General government balance	-3.1	-5.6	-3.2	-2.5	-1.8	-2.7	-4.4
General government expenditure	14.9	19.2	18.4	19.2	19.1	20.7	na
General government debt	113.5	124.5	97.0	78.8	63.0	39.4	na
Monetary sector			(Percentage change)				
Broad money (M2, end-year)	24.5	70.1	40.0	39.7	29.3	14.3	na
Domestic credit (end-year)	23.4	14.5	95.0	14.0	-6.5	52.7	na
			(In per cent of GDP)				
Broad money (M2, end-year)	6.7	8.5	8.6	9.0	8.2	7.2	na
Interest and exchange rates			(In per cent per annum, end-year)				
Monetary policy rate	20.1	20.6	23.4	21.0	15.0	10.0	na
Deposit rate (up to 3 months)	11.4	41.3	25.5	12.1	14.6	12.4	na
Lending rate (up to 3 months)	30.6	18.3	21.3	12.1	15.6	19.8	na
			(Tajik somoni per US dollar)				
Exchange rate (end-year) [3]	1.4	2.2	2.5	3.0	2.9	3.0	na
Exchange rate (annual average) [3]	1.2	1.8	2.4	2.8	3.1	3.0	na
External sector			(In millions of US dollars)				
Current account	-36	-63	-74	-33	-19	-80	-99
Trade balance	-27	-46	-121	-124	-204	-332	-376
Merchandise exports	666	788	652	699	799	915	985
Merchandise imports	693	834	773	823	1,003	1,247	1,361
Foreign direct investment, net	21	24	9	36	32	272	40
Gross reserves, excluding gold (end-year)	58	87	96	96	135	189	na
External debt stock	1,233	1,226	1,022	1,010	1,031	823	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	0.9	1.2	1.4	1.2	1.4	1.6	na
			(In per cent of exports of goods and services)				
Debt service	6.6	9.2	16.6	14.7	6.7	7.2	na
Memorandum items			(Denominations as indicated)				
Population (end-year, million)	6.2	6.2	6.3	6.4	6.5	6.5	na
GDP (in millions of somoni)	1,345	1,807	2,512	3,345	4,758	6,158	7,250
GDP per capita (in US dollars)	174	160	168	187	239	319	na
Share of industry in GDP (in per cent) [4]	21.3	23.9	22.7	22.1	20.9	19.6	na
Share of agriculture in GDP (in per cent) [4]	18.7	27.0	26.5	26.3	25.2	21.6	na
Current account/GDP (in per cent)	-3.4	-6.4	-7.0	-2.7	-1.2	-3.9	-4.3
External debt - reserves (in US$ million)	1,175	1,139	926	914	896	634	na
External debt/GDP (in per cent)	113.5	124.5	97.0	84.0	66.3	39.7	na
External debt/exports of goods and services (in per cent)	170.4	143.4	142.5	131.3	117.8	82.9	na

[1] Officially registered unemployed. The World Bank estimates the true unemployment rate in 2000 was more than 30 per cent of the labour force.

[2] Includes externally financed public investment programmes.

[3] Tajik roubles (until October 2000) have been converted to somoni.

[4] Figures are based on current prices. Variations in the shares reflect changes in relative prices.

Turkmenistan

Key challenges

- The state's dominant role in the economy continues to hamper investment and private initiative. The easing of state control over capital, prices and trade is essential for sustainable growth in the longer term.
- Improvements in fiscal transparency and better management of hydrocarbon revenues are needed to shore up public finances and deliver the benefits of natural resource wealth to the population.
- The economy continues to be vulnerable to external shocks and gas pipeline access, while long-term economic prospects are clouded by the highly centralised economy, a weak business environment and dual exchange rate system.

Country data

Population (in millions)	**6.5**
Area ('000 sq. km)	**488.0**
GDP (in billion US$, 2004)	**5**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 5,326**
National currency	**Manat**

Progress in structural reform

Liberalisation and privatisation

The government has maintained its state-controlled economic development strategy, based on central management over capital allocations, domestic prices and foreign trade. The strategy is in accordance with the long-term development programme adopted in 2003. There have been no substantial changes in the currency market and financial system, which are highly controlled and distorted. The difference between the official exchange rates and the parallel currency market remain large (more than fivefold). Also, directed lending continues and the two biggest state-owned banks control more than 80 per cent of banking assets.

Some progress has been made in the agriculture sector. Following disappointing cotton harvests for a number of years, a new land code was adopted in October 2004. It allows farmers to lease plots of land up to three hectares in size for up to 10 years. However, the new code also created a state agriculture company to control all agriculture-related resources and facilities. This could limit the positive impact of the liberalisation of the land market.

Business environment and competition

In the past year the largest foreign investment was by UAE-based Dragon Oil. It provided US$167 million of equity finance in May 2005 to double the production of the Cheleken oil field. There have also been a number of smaller investments, particularly in the textile sector from Turkey. Nevertheless, despite rich natural resources and low tax rates, foreign direct investment (FDI) in Turkmenistan remains limited due to the poor business environment. Net FDI flows stand at around 7 per cent of GDP and are concentrated in the oil and gas and textile sectors.

A survey of the business environment for small and medium-sized enterprises (SMEs) was conducted by the US Agency for International Development (USAID) during 2004. It concluded that Turkmenistan remained the most difficult environment in Central Asia. According to the survey, 98 per cent of SMEs had difficulties with transactions in foreign currency (up from 83 per cent in 2001). Only 2.5 per cent of exporters said that they were free to sell their products abroad, while 19.5 per cent said that they were free to set prices. The government has often emphasised the role of the private sector, but few measures have been taken in recent years to facilitate this.

Infrastructure

Much attention has been paid to increasing gas production and gas transport capacity by mobilising external finance. However, the government's attempts to lure foreign investors have been unsuccessful due to the difficult business environment, lack of available finances for large projects and Russia's monopoly in the sector. The Trans Afghanistan Pipeline (TAP) project, supported by the Asian Development Bank, made moderate progress recently due to demand growth in Pakistan. However, the feasibility of the project remains questionable given security concerns in Afghanistan and the uncertain potential of Turkmen gas reserves.

Until 2004 the US-based Barash Communication Technologies (BCTI) had a 10-year exclusivity agreement in the small mobile telecommunications market (the mobile penetration rate is only around 0.2 per cent). Following the expiry of this agreement, the government established a state-run mobile company in March 2005 and reduced BCTI's market share to 97 per cent. Subsequently, in June 2005 Russian mobile operator Mobile Tele System (MTS) acquired a 51 per cent stake of BCTI. In the postal sector, the government decided not to extend existing licences of all the foreign postal services companies (including Germany's DHL) beyond April 2005, thereby creating a state monopoly.

Social sector

The health care system has deteriorated mainly through lack of funding and policy failures. Following the lay-off of 12,000 medical staff in 2003, an additional 15,000 workers lost their jobs in late 2004. The positions were filled by untrained soldiers from the army, which immediately deteriorated medical services. Moreover, the government cancelled a number of free medical services in December 2004, which could have serious implications for older people and those living in rural areas. In addition, it was announced in February 2005 that all small regional hospitals would be closed except for new diagnostic centres. These changes will make it difficult for most people to access proper medical services, particularly in the rural areas.

Macroeconomic performance

Real economy

Real GDP growth in 2004 was estimated at around 7.2 per cent, although official statistics reported that the economy expanded by 21 per cent. The main driving force behind this growth appears to have been state-led investments (up 15 per cent). Production in the power sector grew by 10 per cent. In contrast, the production of gas and oil was almost unchanged and cotton production increased by only 3 per cent. A similar level of real GDP growth is expected in 2005 on the back of high hydrocarbon prices and ongoing public investment programmes.

Economic policies

The government continues to conduct fiscal policy in a non-transparent manner, with large, off-balance sheet fiscal operations. While official statistics reported that the budget deficit was less than 1 per cent of GDP in 2004, the continued contraction of public service provisions suggests that budgetary shortcomings are becoming more serious. At the same time, the government increased public sector wages by 50 per cent in January 2005. To simplify the tax system and strengthen administration, the government introduced a new tax code in November 2004. The number of taxes was reduced from 17 to 11, and the rates of income tax, value added tax and profit tax were all reduced significantly. However, a large number of tax exemptions remain in place, limiting revenue increases. Annual inflation is expected to be around 8 to 11 per cent in 2005, although no official data about inflation or money supply are available.

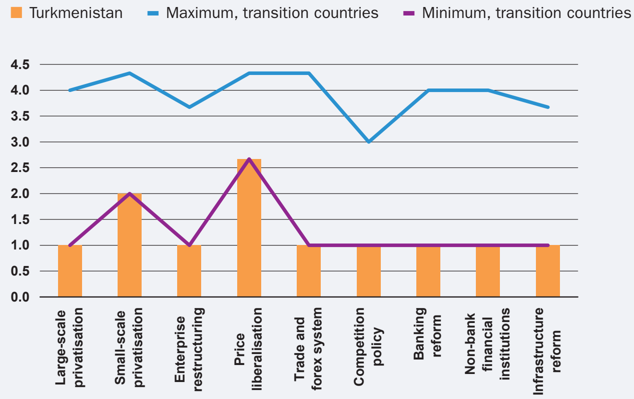
External sector

The main development on the current account in 2004 was a 33 per cent increase in imports. This was mainly due to higher imports of capital goods and raw materials for public sector construction projects. Total exports remained stagnant. As a result, the trade surplus was cut in half, while the current account balance recorded an estimated deficit of around 1 per cent of GDP (down from an 8.8 per cent surplus in 2003). Nevertheless, the balance of payments seems sustainable given the high level of gross international reserves and limited external debts.

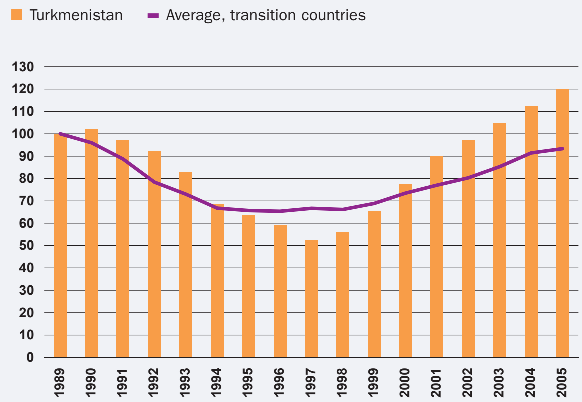
Outlook and risks

The long-term gas supply agreement with Russia and favourable international oil prices may underpin annual real GDP growth of 5 to 7 per cent over the medium term. However, the economy will remain highly dependent on the hydrocarbon sector. This dependence, and the almost total lack of market-oriented reforms, leave the economy vulnerable to external shocks and gas pipeline constraints. Competition from Kazakhstan and Uzbekistan for use of the Central Asia Centre (CAC) pipeline to export gas is increasing. The prospects for gas export growth will therefore depend on upgrading the pipeline and greater regional cooperation on access. Continued public imbalances and opaque fiscal management may erode public sector stability.

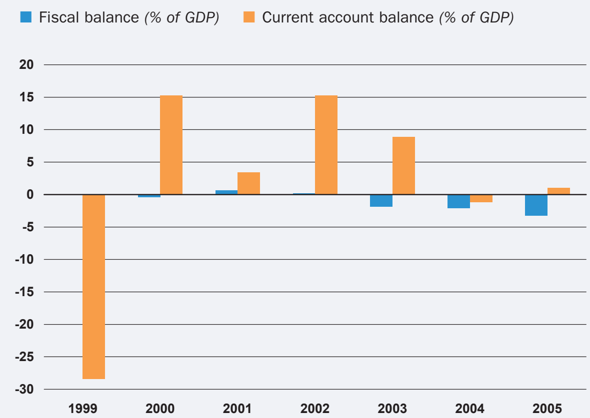
Transition indicators, 2005



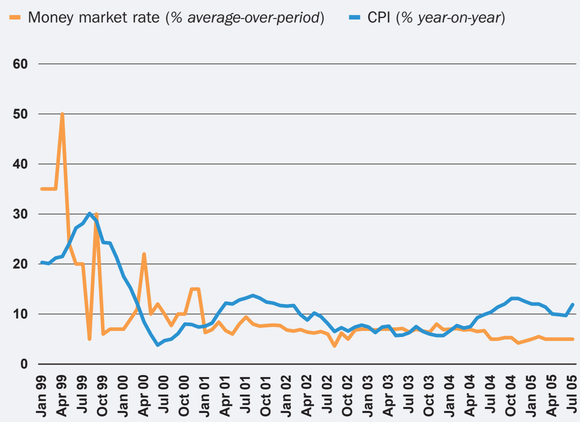
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **limited**	Competition office – **no**	Independent telecoms regulator – **no**	Capital adequacy ratio – **10 per cent**[2]	Share of population living in poverty – **44 per cent** (1998)
Controls on inward direct investment – **no**[1]	Quality of insolvency law – **very low**	Independent electricity regulator – **no**	Deposit insurance system – **no**	Government expenditure on health – **3.7 per cent of GDP**
Interest rate liberalisation – **limited de jure**	Secured transactions law – **malfunctioning**	Separation of railway infrastructure from operations – **no**	Quality of securities market laws – **very low**	Government expenditure on education – **7.6 per cent of GDP**
Exchange rate regime – **fixed**	Quality of corporate governance law – **low**	Quality of concession laws – **low**	Private pension funds – **no**	Share of power, water in total household expenditure – **0.3 per cent**
Wage regulation – **yes**				
Tradability of land – **limited de jure**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	0.3	0.6	0.6	0.6	0.6	0.6	na
Private sector share in GDP (in per cent)	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	12.6	11.9	na	na	na	na	na
Change in labour productivity in industry (in per cent)	11.0	33.0	na	na	na	na	na
Investment/GDP (in per cent)	40.7	36.4	34.0	32.3	34.4	33.5	na
EBRD index of small-scale privatisation	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of large-scale privatisation	1.7	1.7	1.0	1.0	1.0	1.0	1.0
EBRD index of enterprise reform	1.7	1.0	1.0	1.0	1.0	1.0	1.0
Markets and trade							
Share of administered prices in CPI (in per cent)	6.8	6.8	6.8	6.8	6.7	6.7	na
Number of goods with administered prices in EBRD-15 basket	4.0	4.0	4.0	4.0	4.0	4.0	na
Share of trade with non-transition countries (in per cent)	61.0	51.3	59.5	56.8	54.3	51.7	na
Share of trade in GDP (in per cent)	126.1	157.4	138.3	122.8	136.8	144.5	na
Tariff revenues (in per cent of imports)[3]	0.5	na	na	na	na	na	na
EBRD index of price liberalisation	2.7	2.7	2.7	2.7	2.7	2.7	2.7
EBRD index of forex and trade liberalisation	1.0	1.0	1.0	1.0	1.0	1.0	1.0
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Financial sector							
Number of banks (foreign-owned)	13 (4)	13 (4)	13 (4)	13 (4)	12 (4)	11(4)	na
Asset share of state-owned banks (in per cent)	96.9	97.1	96.5	95.7	96.1	na	na
Asset share of foreign-owned banks (in per cent)	1.6	1.3	1.3	1.7	1.6	na	na
Non-performing loans (in per cent of total loans)	0.5	0.2	0.3	0.3	0.3	na	na
Domestic credit to private sector (in per cent of GDP)	1.7	2.4	2.1	2.2	2.6	na	na
Domestic credit to households (in per cent of GDP)	na	na	na	na	na	na	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0
EBRD index of reform of non-bank financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	8.2 (0.1)	8.2 (0.2)	8.0 (0.2)	7.7 (0.2)	7.7 (0.2)	7.7 (0.2)	na
Internet penetration rate (per 10,000 inhabitants)	0.9	2.3	3.4	4.2	1.1	1.2	na
Railway labour productivity (1991=100)	26.9	27.3	26.9	32.7	34.3	34.0	na
Residential electricity tariffs (in USc kWh)[4]	0.5	0.5	0.5	0.5	na	na	na
Average collection rate, electricity (in per cent)	na	30	na	63	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	0.9	1.2	1.3	1.5	na	na	na
EBRD index of infrastructure reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Electric power	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Railways	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Roads	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Telecommunications	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Water and waste water	1.0	1.0	1.0	1.0	1.0	1.0	1.0

[1] Investors are required to register with the State Service for Foreign Investments.

[2] Calculated with a risk weight of zero for all loans to state-owned enterprises. These are assumed to be implicitly guaranteed by the state.

[3] Refers to differential excise taxes on imports; Turkmenistan does not levy import tariffs.

[4] Average retail tariff.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	16.5	18.6	15.9	8.1	7.7	7.2	7.0
Private consumption	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na
Exports of goods and services	61.7	92.6	4.8	13.0	4.0	na	na
Imports of goods and services	10.9	14.9	20.1	-3.7	4.3	na	na
Industrial gross output	13.0	29.0	13.6	5.1	7.6	5.0	na
Agricultural gross output	35.0	17.0	8.0	-6.6	8.3	4.9	na
Employment			*(Percentage change)*				
Labour force (end-year)	-1.6	3.1	5.0	2.6	7.2	4.8	na
Employment (end-year)	0.7	3.0	2.0	2.5	2.2	na	na
			(In per cent of labour force)				
Unemployment [1]	na	na	na	na	na	na	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	24.2	8.3	11.6	8.7	6.5	10.0	10.5
Consumer prices (end-year)	21.2	7.4	11.7	7.8	5.7	12.5	10.0
Producer prices (annual average)	na	na	na	na	na	na	na
Producer prices (end-year)	na	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	22.1	80.4	47.1	8.2	69.2	12.0	na
Government sector [2]			*(In per cent of GDP)*				
General government balance	0.0	-0.4	0.7	0.2	-1.8	-2.1	-3.2
General government expenditure	22.7	26.7	22.6	21.1	26.3	28.0	na
General government debt	na	na	na	na	na	na	na
Monetary sector			*(Percentage change)*				
Broad money (M3, end-year)	21.8	94.6	16.7	1.5	40.9	20.0	na
Domestic credit (end-year)	26.9	24.4	7.7	-2.9	-0.6	5.0	na
			(In per cent of GDP)				
Broad money (M3, end-year)	14.9	21.7	17.2	15.2	18.9	19.2	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinance rate	27.0	20.0	12.0	12.0	10.0	5.0	na
Interbank market rate	27.0	15.0	7.7	7.0	6.9	4.6	na
Deposit rate (up to 1 year) [3]	28.6	22.8	16.9	17.8	15.4	11.3	na
Lending rate (up to 1 year) [3]	38.7	27.9	26.7	21.9	20.4	17.3	na
			(Manats per US dollar)				
Exchange rate (end-year) [4]	8,200	9,790	10,060	10,150	10,390	10,540	na
Exchange rate (annual average)	8,524	8,479	9,828	10,098	10,034	10,375	na
External sector			*(In millions of US dollars)*				
Current account	-571	411	116	583	385	-57	56
Trade balance	-210	766	515	1,030	966	550	737
Merchandise exports	1,164	2,508	2,623	2,862	3,468	3,870	4,721
Merchandise imports	1,374	1,742	2,108	1,832	2,502	3,320	3,984
Foreign direct investment, net	125	131	170	276	226	330	330
Gross reserves, excluding gold (end-year) [5]	1,555	1,808	2,055	2,346	2,673	2,706	na
External debt stock	2,026	2,184	1,865	1,660	1,519	1,500	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	9.1	9.2	9.1	11.8	9.7	7.7	na
			(In per cent of exports of goods and services)				
Debt service [6]	28.5	14.2	17.3	14.3	11.6	9.2	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	5.2	5.4	5.6	5.8	6.2	6.5	na
GDP (in billions of manats)	17,158	22,900	33,623	38,611	43,775	51,619	61,032
GDP per capita (in US dollars)	387	503	607	661	704	765	na
Share of industry in GDP (in per cent)	33.6	37.2	38.0	38.0	38.5	na	na
Share of agriculture in GDP (in per cent)	27.8	27.3	26.0	21.0	18.0	na	na
Current account/GDP (in per cent)	-28.4	15.2	3.4	15.2	8.8	-1.1	1.0
External debt - reserves (in US$ million)	471	376	-190	-686	-1,154	-1,206	na
External debt/GDP (in per cent)	100.7	80.9	54.5	43.4	34.8	30.1	na
External debt/exports of goods and services (in per cent)	147.2	78.7	64.8	53.9	40.7	35.7	na

[1] Every Turkmen citizen is guaranteed employment. Therefore no official unemployment data are available.

[2] Significant off-budget expenditures occur through extra-budgetary funds and lending.

[3] Unweighted average deposit and lending rates for individuals (in local currency) of state commercial banks.

[4] Turkmenistan operates a dual exchange rate system. The series refers to a weighted average between the official exchange rate and the commercial rate (given as the black market rate). Weights are variable depending on official and shuttle trade.

[5] Includes foreign exchange reserves of the Central Bank plus the foreign exchange reserve fund.

[6] Excludes rescheduled amounts.

Ukraine

Key challenges

- The review of past privatisations should be conducted swiftly and transparently and corporate legislation should be strengthened to restore business confidence and stimulate new investment.
- Further steps are needed to reduce excessive regulations, ease the high tax burden and strengthen tax administration, which are perceived as the main obstacles to doing business in Ukraine.
- A coordinated effort to tighten monetary and fiscal policy is required to combat inflation and safeguard macroeconomic stability in a weaker external environment.

Country data	
Population (in millions)	**47.3**
Area ('000 sq. km)	**603.7**
GDP (in billion US$, 2004)	**65**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 6,414**
National currency	**Hryvnia**

Progress in structural reform

Liberalisation and privatisation

One of the guiding principles of the new government's policies has been the drive towards greater integration into European political and economic structures and the world economy. The country's aspirations for World Trade Organization (WTO) membership by end-2005, however, depend on further progress in bilateral negotiations and the parliament's approval of the remaining bills in the WTO-related legislation package. As of July 2005 Ukraine had signed 37 out of 50 WTO country bilateral protocols. Before the summer recess, the parliament had passed eight of the 14 trade-related bills. These included the key measure on protection of intellectual property rights, which could pave the way for a bilateral agreement with the United States.

Revenues from privatisation peaked at UAH 9.4 billion (US$1.7 billion) in 2004, well in excess of the budgeted UAH 5.2 billion, following the sale of controlling stakes in a number of strategic large enterprises. However, some of these sales have been controversial and their conduct and legality are under review.

In June 2005 the Commercial Court of Appeal in Kiev ruled that the 2004 sale of a 93 per cent stake in Kryvorizhstal, Ukraine's largest steel mill, was illegal and returned the shares to the state. A new privatisation tender has been opened. The successful realisation of this sale is key to meeting this year's privatisation revenue target of UAH 7 billion (US$1.4 billion) and to boosting investor confidence. Receipts from privatisation totalled only UAH 658 million by the end of July.

Business environment and competition

Public administration reform and the fight against corruption have been key reform priorities since the beginning of 2005. According to official sources, about 18,000 civil servants in the public administration have been dismissed and the customs administration reformed. However, there is still some way to go before a stable and transparent tax and business regulatory framework is in place. Tax administration and the regulatory burden rank among the top three obstacles to doing business in Ukraine, according to the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey.

Amendments to the 2005 budget law, approved in March 2005, have significantly changed the tax regime and the social security system for entrepreneurs. The amendments include reducing the type of activities eligible for value added tax (VAT) exemption and the single-stage elimination of tax holidays and preferential tax treatment in special economic zones (SEZs) and priority development territories. Although these measures helped to close tax loopholes and create a level playing field for entrepreneurs, they may damage legitimate domestic and foreign businesses whose investments in SEZs were conditional on receiving tax concessions. Changes to the system of simplified taxation for SMEs were introduced and then later reversed by Presidential decree in June 2005.

Financial sector

The liquidity crisis in the fourth quarter of 2004, caused by a run on bank deposits during the November presidential election, was dealt with swiftly by the National Bank of Ukraine (NBU). Most of the emergency measures introduced to maintain the banks' liquidity, such as limits on currency exchange and withdrawals by companies and individuals, had been removed by the end of 2004. By mid-2005 bank lending had recovered to its pre-crisis level, thanks to growth of 17.4 per cent year-on-year in real terms. Bank liquidity was boosted by 20.3 per cent real growth in deposits over the same period.

In April 2005 the NBU took steps to further liberalise the currency regime by abolishing the mandatory sale of 50 per cent of export proceeds. Also, in July 2005 the parliament approved in its first reading new legislation permitting branches of foreign banks to operate more freely in the country. The measure could stimulate competition and increase efficiency in the banking system.

At the end of August 2005 Raiffeisen International Bank-Holding announced the acquisition of a 93.5 per cent stake in Aval Bank, the second largest Ukrainian bank controlling about 8.7 per cent of total bank assets. The purchase, which is subject to the approval of regulatory authorities, is expected to be completed by October.

Macroeconomic performance

Real economy

Real GDP growth slowed to 4 per cent year-on-year in the first half of 2005 from 12.1 per cent in 2004. While growth last year was fuelled by a commodity export boom, domestic consumption has become the main driver in 2005 on the back of wage and pension increases. Investment activity, which dropped in the last quarter of 2004, is still subdued because of uncertainty over the business environment, in particular concerning the revision of past privatisations. Industrial output and construction slowed in the first half of 2005, while value-added in agriculture recorded a modest increase.

Economic policies

Consumer price inflation rose to 14.9 per cent year-on-year in August 2005, due to higher oil and food prices and the effects of a looser fiscal policy before the 2004 elections. In an attempt to curb inflation, the NBU raised the discount rate to 9.5 per cent in August and announced that the mandatory reserve requirement on call deposits would increase from 7 to 8 per cent as of September.

The exchange rate has been stable since the 5 per cent nominal revaluation in April 2005. The March amendments to the 2005 budget law have led to a fiscal tightening and substantial broadening of the tax base. However, arrears on VAT refund claims increased to over UAH 3 billion (US$620 million) in the first half of 2005. The revised 2005 budget also entails a significant increase in social expenditures, especially pensions and minimum wages.

External sector

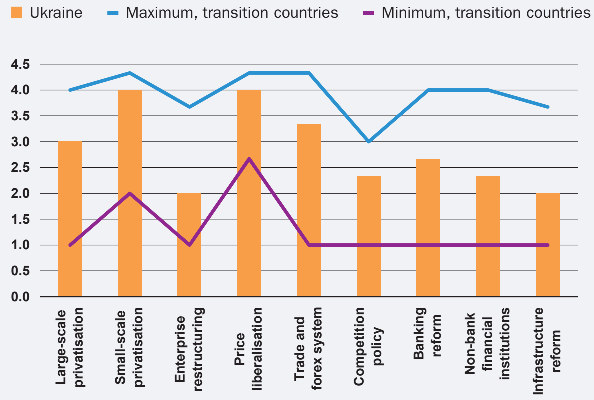
Real exchange rate appreciation and weaker external demand for Ukraine's metals contributed to a deceleration in export growth in the first half of 2005. Fuelled by an increase in average real incomes, import demand grew faster than exports, causing the trade surplus to shrink by half in the first half of 2005 compared with the same period in 2004. Gross reserves rose steadily last year, peaking at US$12.5 billion in mid-September. After a dip in late-2004, they reached US$14.2 billion (more than four months of import coverage) by the end of August 2005.

Outlook and risks

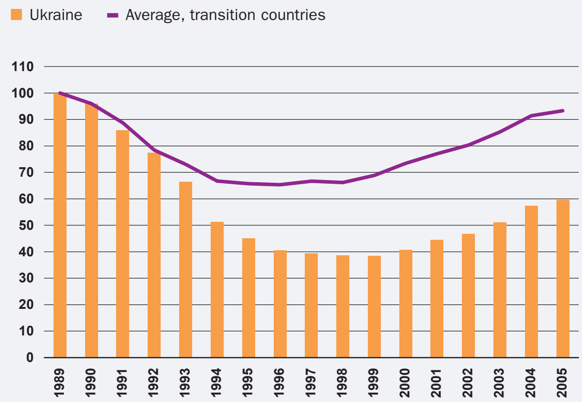
The long-term outlook for democratic stability and reform improved following the "Orange revolution" in December 2004. However, there has been a lack of policy cohesion among the pro-reform parties and the government was reshuffled in September 2005. Short-term policy challenges remain. Annual inflation is at double-digit levels and economic growth is expected to slow to about 4 to 5 per cent in 2005-06 after two years of very strong performance.

The main short-term risk is that monetary policy will not be tightened sufficiently and fiscal policy will be loosened ahead of the 2006 parliamentary elections. The external position remains vulnerable to a fall in commodity prices and higher oil and gas prices. However, the prospects of future WTO membership and enhanced trade cooperation with the EU should prompt market diversification.

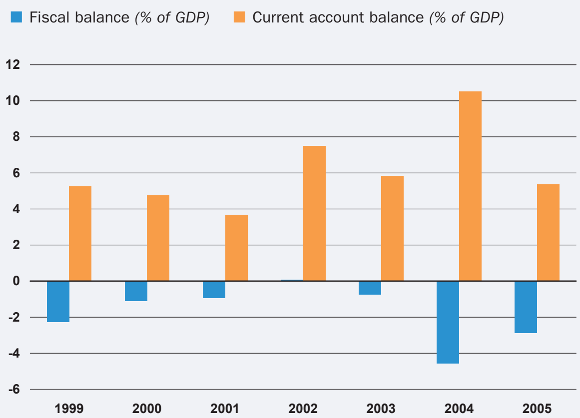
Transition indicators, 2005



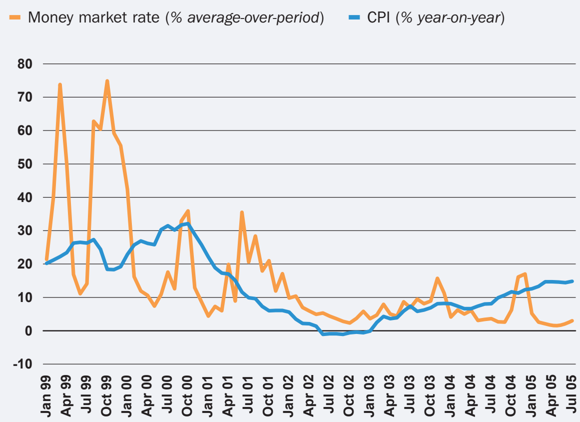
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – **full**	Competition office – **yes**	Independent telecoms regulator – **no**	Capital adequacy ratio – **10 per cent**	Share of population living in poverty – **31.4 per cent** (1999) [2]
Controls on inward direct investment – **no** [1]	Quality of insolvency law – **very low**	Independent electricity regulator – **no**	Deposit insurance system – **yes**	Government expenditure on health – **3.5 per cent of GDP**
Interest rate liberalisation – **full**	Secured transactions law – **some defects**	Separation of railway infrastructure from operations – **no**	Quality of securities market laws – **medium**	Government expenditure on education – **5.1 per cent of GDP**
Exchange rate regime – **managed float**	Quality of corporate governance law – **very low**	Quality of concession laws – **medium**	Private pension funds – **yes**	Share of power, water in total household expenditure – **3.2 per cent**
Wage regulation – **no**				
Tradability of land – **limited de facto**				

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.9	4.3	5.5	6.0	7.1	9.5	na
Private sector share in GDP (in per cent)	55.0	60.0	60.0	65.0	65.0	65.0	65.0
Private sector share in employment (in per cent)	20.5	25.8	30.5	35.6	37.7	na	na
Budgetary subsidies and current transfers (in per cent of GDP) [3]	na	1.4	1.3	1.2	na	na	na
Share of industry in total employment (in per cent)	20.4	19.5	21.0	20.4	20.0	na	na
Change in labour productivity in industry (in per cent)	13.4	19.9	4.4	9.4	17.9	na	na
Investment/GDP (in per cent)	17.5	19.8	21.8	20.2	20.3	na	na
EBRD index of small-scale privatisation	3.3	3.3	3.3	3.7	4.0	4.0	4.0
EBRD index of large-scale privatisation	2.3	2.7	3.0	3.0	3.0	3.0	3.0
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	3.0	3.0	6.0	6.0	na
Share of trade with non-transition countries (in per cent)	57.4	52.0	49.6	47.5	52.9	48.3	na
Share of trade in GDP (in per cent)	82.7	98.1	89.3	86.4	96.3	97.4	na
Tariff revenues (in per cent of imports) [4]	2.4	2.4	2.7	3.0	3.0	3.4	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	3.0	3.0	3.0	3.0	3.0	3.0	3.3
EBRD index of competition policy	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial sector							
Number of banks (foreign-owned)	161 (15)	154 (14)	152 (16)	157 (15)	158 (19)	160 (19)	na
Asset share of state-owned banks (in per cent)	12.5	11.9	11.8	12.0	9.8	8.0	na
Asset share of foreign-owned banks (in per cent)	10.5	11.1	12.1	12.3	12.1	12.1	na
Non-performing loans (in per cent of total loans)	34.2	32.5	na	na	32.7	35.4	na
Domestic credit to private sector (in per cent of GDP)	8.6	9.9	11.9	na	na	na	na
Domestic credit to households (in per cent of GDP)	na	na	na	na	na	na	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	4.5	6.0	3.6	7.5	8.7	18.0	na
Stock trading volume (in per cent of market capitalisation)	8.8	20.0	14.0	15.0	3.0	3.0	na
Eurobond issuance (in per cent of GDP)	0.9	0.0	0.0	1.2	2.4	3.6	na
EBRD index of banking sector reform	2.0	2.0	2.0	2.3	2.3	2.3	2.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.3	2.3
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	19.9 (0.4)	20.7 (1.6)	21.2 (4.4)	21.6 (8.4)	22.4 (13.4)	25.2 (28.5)	na
Internet penetration rate (per 10,000 inhabitants)	5.8	7.3	11.6	14.3	18.3	27.0	na
Railway labour productivity (1989=100)	41.7	44.9	46.5	49.9	56.5	60.1	na
Residential electricity tariffs (in USc kWh)	na	2.7	2.6	2.7	2.7	2.7	na
Average collection rate, electricity (in per cent)	84	na	78	83	94	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.4	1.6	1.7	1.8	na	na	na
EBRD index of infrastructure reform	1.7	2.0	2.0	2.0	2.0	2.0	2.0
Electric power	2.3	3.0	3.3	3.3	3.3	3.3	3.3
Railways	1.0	2.0	2.0	2.0	2.0	2.0	2.0
Roads	1.0	2.0	2.0	2.0	2.0	2.0	2.0
Telecommunications	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water	1.7	1.7	1.7	1.7	1.7	1.7	1.7

1 Registration of foreign investment is required.

2 Based on international poverty line. The poverty rate based on the national poverty line in 2002 was 28.1 per cent.

3 Refers to consumer and producer subsidies.

4 Refers to taxes on international trade and transactions.

	1999	2000	2001	2002	2003	2004 *Estimate*	2005 *Projection*
Output and expenditure			*(Percentage change in real terms)*				
GDP	-0.2	5.9	9.2	5.2	9.4	12.1	4.0
Private consumption	-2.2	2.3	9.0	9.0	12.1	14.5	na
Public consumption	-7.9	1.0	10.4	-6.7	14.8	5.4	na
Gross fixed capital formation	0.1	12.4	6.2	3.4	15.8	10.0	na
Exports of goods and services	-2.2	21.5	3.5	7.4	10.3	10.0	na
Imports of goods and services	-16.7	23.8	6.0	3.3	16.4	9.5	na
Industrial gross output	4.0	13.2	14.2	7.0	15.8	12.5	na
Agricultural gross output	-6.9	9.8	10.2	1.2	-11.0	19.1	na
Employment			*(Percentage change)*				
Labour force (end-year)	0.2	0.3	-0.1	0.5	0.3	0.0	na
Employment (end-year)	-2.5	-1.2	1.7	0.3	0.5	na	na
			(In per cent of labour force)				
Unemployment (end-year)	4.3	4.2	3.7	3.8	3.6	3.5	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	22.7	28.2	12.0	0.8	5.2	9.0	14.1
Consumer prices (end-year)	19.2	25.8	6.1	-0.6	8.2	12.3	13.0
Producer prices (annual average)	31.1	20.8	8.7	3.0	7.6	20.4	na
Producer prices (end-year)	15.7	20.6	0.9	5.7	11.1	24.1	na
Gross average monthly earnings in economy (annual average)	16.3	29.2	35.2	20.9	22.9	27.9	na
Government sector [1]			*(In per cent of GDP)*				
General government balance	-2.3	-1.1	-0.9	0.1	-0.7	-4.6	-2.9
General government expenditure	34.1	34.5	34.4	35.6	37.7	40.2	na
General government debt	51.0	45.9	36.9	33.5	29.3	26.0	na
Monetary sector			*(Percentage change)*				
Broad money (M2, end-year)	40.7	45.3	43.2	42.3	46.9	32.8	na
Domestic credit (end-year)	30.5	23.1	18.7	28.9	39.6	22.8	na
			(In per cent of GDP)				
Broad money (M2, end-year)	16.6	18.5	22.1	28.5	35.8	36.4	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	45.0	27.0	12.5	7.0	7.0	9.0	na
Deposit rate [2]	20.7	13.7	11.0	7.9	7.0	7.8	na
Lending rate [2]	55.0	41.5	32.3	25.4	17.9	17.4	na
			(Hryvnias per US dollar)				
Exchange rate (end-year)	5.2	5.4	5.3	5.3	5.3	5.3	na
Exchange rate (annual average)	4.1	5.4	5.4	5.3	5.3	5.3	na
External sector			*(In millions of US dollars)*				
Current account	1,658	1,481	1,402	3,173	2,891	6,804	4,300
Trade balance	244	779	198	710	-269	3,741	1,500
Merchandise exports	13,189	15,722	17,091	18,669	23,739	33,432	35,000
Merchandise imports	12,945	14,943	16,893	17,959	24,008	29,691	33,500
Foreign direct investment, net	489	594	769	698	1,411	1,711	900
Gross reserves, excluding gold (end-year)	1,046	1,353	2,955	4,241	6,731	9,302	na
External debt stock [3]	13,532	11,819	12,098	12,771	14,578	20,157	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	0.8	0.9	1.7	2.4	2.9	3.2	na
			(In per cent of exports of goods and services)				
Debt service [4]	15.9	10.4	8.7	5.7	6.3	4.8	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	49.4	48.9	48.5	48.0	47.6	47.3	na
GDP (in billions of hryvnias)	130	170	204	226	264	345	409
GDP per capita (in US dollars)	639	639	785	883	1,041	1,370	na
Share of industry in GDP (in per cent)	27.2	26.7	27.1	30.5	31.0	30.0	na
Share of agriculture in GDP (in per cent)	11.7	14.4	14.4	13.4	13.0	13.5	na
Current account/GDP (in per cent)	5.2	4.7	3.7	7.5	5.8	10.5	5.4
External debt - reserves (in US$ million)	12,486	10,466	9,143	8,530	7,847	10,855	na
External debt/GDP (in per cent)	42.8	37.8	31.8	30.1	29.4	31.1	na
External debt/exports of goods and services (in per cent)	79.3	60.5	57.4	54.7	50.4	50.7	na

[1] General government includes the state, municipalities and extra-budgetary funds.

[2] Weighted average over all maturities.

[3] Includes public and publicly guaranteed debt and an estimate of the stock of private debt (in both cases medium and long-term debt only).

[4] Refers to payments on official debt only.

Uzbekistan

Key challenges

- Excessive licensing requirements on private entrepreneurs and restrictions on external and domestic trade must be eliminated to revive private sector investment.
- The financial system needs reforming, including the restructuring, commercialisation and eventual privatisation of the state-owned banks. In addition, regulations that discriminate against the use of cash or ration access to cash deposited with commercial banks should be eliminated.
- While the current macroeconomic situation is fairly benign, long-term growth prospects depend on comprehensive domestic reforms and the opening of the economy.

Country data

Population (in millions)	**26.0**
Area ('000 sq. km)	**448.9**
GDP (in billion US$, 2004)	**12.2**
GDP per capita in 2004 at current international US$ (PPP)	**US$ 1,867**
National currency	**Sum**

Progress in structural reform

Liberalisation and privatisation

There has been limited progress in the liberalisation of the economy in 2004 and early 2005. Some restrictions in bilateral trade with Kazakhstan were lifted in late 2004. However, broader regional cooperation – for instance, with the Ministerial Conference on Central Asia Economic Cooperation – remains limited. Uzbekistan is pursuing membership of the World Trade Organization (WTO), but this process is still at a very early stage. A number of recent measures, such as substantial excise duties on imported products, appear to run counter to WTO principles.

The government has continued to maintain a unified exchange rate regime, following the adoption of current account convertibility in October 2003. Foreign investors report a much improved availability of foreign exchange, although access to foreign currency for the import of certain goods is still occasionally disrupted. The ease of access that private individuals have to foreign exchange, however, was undermined through the rationing of domestic currency in circulation. This system was further tightened when the Central Bank issued new regulations on prioritising the uses of cash released by commercial banks and on the daily surrender of cash by retail enterprises.

Privatisation revenues in 2004 were estimated at €57 million, mainly from the sale of small enterprises. The government also opened up a number of enterprises to private investment (through a process technically described as privatisation by the Uzbek authorities). Cooperative farms are being transformed into private leaseholds. Although this may have contributed to greater productivity, the authorities still control most of the allocation of crops, prices of the principal inputs and the procurement of the harvest.

Private property rights have again come under threat since the government announced an increase in the controlling majority of its shares in a number of recently privatised agricultural enterprises.

Infrastructure

The government has taken steps to reduce the quasi-fiscal deficit in the energy sector. Payment discipline in the sector has been strengthened through investment in metering equipment and the introduction of pre-payment requirements. Tariffs of the state-owned electricity provider have been raised in three successive steps, and are close to covering officially estimated production costs. Reform in the telecommunications sector has stagnated. The state-owned Uzbektelecom has been decreed the sole provider of telecommunications connections into and out of the country, further undermining competition in the sector.

Financial sector

The financial system remains largely dysfunctional. Depositors' confidence in the banking system is low, given the tightened restrictions on cash withdrawals. Furthermore, the tax authorities have the right to debit individual accounts without the account holder's prior permission. At the end of 2004 a number of decrees on the introduction of cashless payments systems were passed.

While the authorities have since scaled back these measures, uncertainty about the use of domestic currency has increased and public confidence has been further undermined. Also, the licence of the largest private bank in the country was withdrawn in late 2004, adding to the private sector's concerns about the lack of transparency and predictability in the banking system.

Credit to entities other than the consolidated government remains low at an estimated 24 per cent of GDP. The access of many SMEs and micro enterprises to finance has been further impeded by the multiple regulatory and licensing requirements that potential borrowers have to document to banks.

The banking sector remains highly concentrated. The top two state-owned banks account for 60 to 70 per cent of total bank assets and are essentially unreformed. Official data suggest that asset quality is good, with less than 2 per cent of assets classified as doubtful or in loss at the end of 2003. However, independent assessments suggest that, following the major devaluation and period of low economic growth, a much larger part of the portfolio is doubtful – in particular the assets that had previously been guaranteed or been the result of government intervention. Over the past two years the government has imposed tight restrictions on the extension of further sovereign guarantees.

The government has also introduced a fully funded pillar for the pension system. However, it is unclear whether the designated state-owned bank will have the capacity to handle the large number of new accounts. Also, the fiscal costs of adopting this system are likely to be substantial for a number of years.

Macroeconomic performance

Real economy

Uzbekistan's economic performance in 2004 was supported by strong world prices for its commodity exports, the highly favourable external environment and productivity gains in the agricultural sector. IMF estimates for real GDP growth in 2004 are close to the official figure of over 7 per cent. The acceleration in growth has in large been driven by net exports. These grew by nearly 22 per cent in volume terms, supported by a further slight real depreciation of the sum. (There had been a substantial decline in the national currency following the unification of exchange rates in 2003.) Traditional resource-based sectors, such as gold and cotton, and industrial sectors dominated by state-owned enterprises underpinned the expansion of exports. Domestic consumption remained subdued, however, according to national accounts and household surveys.

Economic policies

The government has maintained a fairly disciplined fiscal policy, recording a slight surplus in the consolidated budget in 2004. However, the budget adopted for 2005 envisages a deficit of over 3 per cent of GDP. On the monetary side, the Central Bank continues to target a gradual depreciation of the nominal sum rate (after the decline in 2003). In 2004 there was a significant reserve accumulation of over US$0.5 billion to US$2.1 billion by the end of the year, equivalent to over six months of imports.

Given the very limited sterilisation instruments in the country, this was reflected in a substantial expansion of broad money (at about 40 per cent). Price pressures became evident in the second half of 2004 and independent estimates of annual inflation – at about 15 per cent – are considerably above the official figure. These trends indicate that the intensified rationing of domestic currency in the banking system is an ineffective instrument for reining in price pressures.

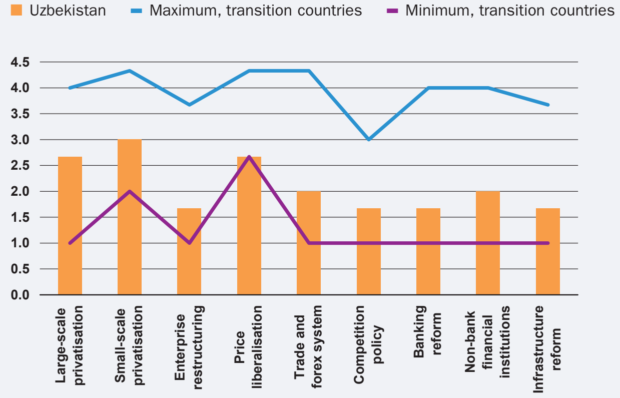
External sector

Strong export growth supported a current account surplus of about 10 per cent of GDP in 2004. Despite some substantial medium-term commitments by foreign investors in the resources sector, foreign direct investment has remained low relative to the size of the economy in 2004 at US$187 million. Through stringent control of external public and publicly guaranteed borrowing, the external debt-to-GDP ratio declined to about 37 per cent at end-2004. Debt service payments are projected to decline in absolute terms over the next few years.

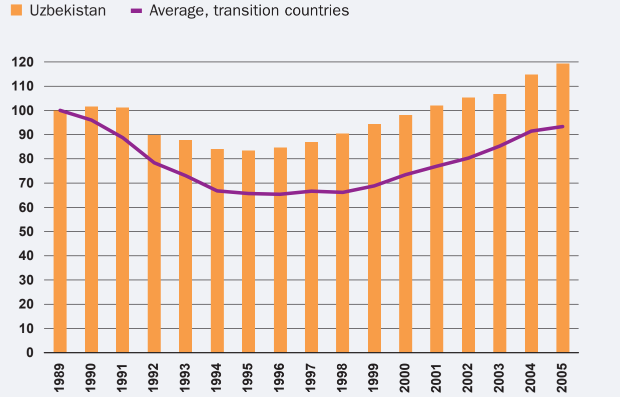
Outlook and risks

The fairly benign macroeconomic situation is unlikely to be sustainable in the medium term, as the government continues to rule out fundamental market-oriented reform. Last year's growth in the industrial sector was largely underpinned by state-directed credit, tax preferences and prohibitive external tariffs. The distorted allocation of resources is likely to be reflected in a substantial bad loan problem in the large state-owned banks, whose solvency and access to external credit are increasingly at risk.

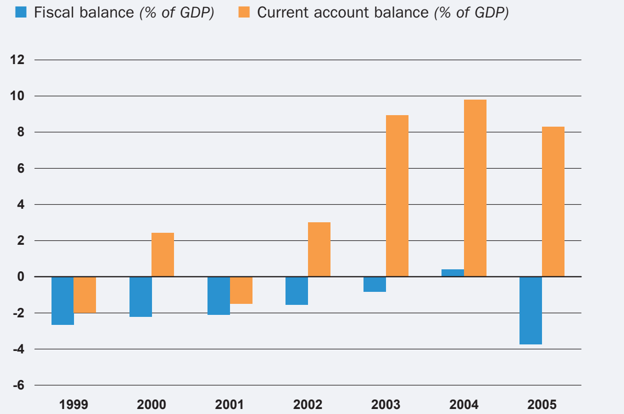
Transition indicators, 2005



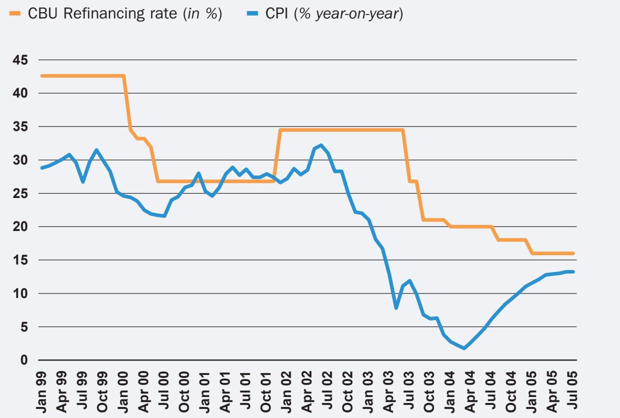
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation

Current account convertibility – **full**

Controls on inward direct investment – **yes**

Interest rate liberalisation – **limited de jure**

Exchange rate regime – **managed float**

Wage regulation – **yes**

Tradability of land – **limited de facto**

Business environment and competition

Competition office – **yes**

Quality of insolvency law – **low**

Secured transactions law – **malfunctioning**

Quality of corporate governance law – **medium**

Infrastructure

Independent telecoms regulator – **no**

Independent electricity regulator – **no**

Separation of railway infrastructure from operations – **partially**

Quality of concession laws – **low**

Financial sector

Capital adequacy ratio – **8 per cent**

Deposit insurance system – **yes**

Quality of securities market laws – **medium**

Private pension funds – **no**

Social reform

Share of population living in poverty – **28 per cent** (2002)

Government expenditure on health – **2.2 per cent of GDP**

Government expenditure on education – **5.6 per cent of GDP**

Share of power, water in total household expenditure – **5.2 per cent**

	1999	2000	2001	2002	2003	2004	2005
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.6	2.8	2.9	3.5	4.0	4.7	na
Private sector share in GDP (in per cent)	45.0	45.0	45.0	45.0	45.0	45.0	45.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.9	2.2	2.1	1.9	2.1	2.2	na
Share of industry in total employment (in per cent)	12.7	12.7	12.7	12.7	12.4	12.7	na
Change in labour productivity in industry (in per cent)	0.3	-0.6	1.8	0.7	2.5	na	na
Investment/GDP (in per cent)	17.1	19.6	20.0	na	na	na	na
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of large-scale privatisation	2.7	2.7	2.7	2.7	2.7	2.7	2.7
EBRD index of enterprise reform	2.0	1.7	1.7	1.7	1.7	1.7	1.7
Markets and trade							
Share of administered prices in CPI (in per cent)	60.0	53.0	53.0	53.0	53.0	53.0	na
Number of goods with administered prices in EBRD-15 basket	9.0	8.0	8.0	8.0	8.0	8.0	na
Share of trade with non-transition countries (in per cent)	53.5	45.3	48.4	48.6	na	54.1	na
Share of trade in GDP (in per cent)	65.0	59.6	69.5	55.8	57.1	60.0	na
Tariff revenues (in per cent of imports) [1]	1.3	2.6	1.9	2.8	3.8	3.1	na
EBRD index of price liberalisation	2.7	2.7	2.7	2.7	2.7	2.7	2.7
EBRD index of forex and trade liberalisation	1.0	1.0	1.7	1.7	1.7	1.7	2.0
EBRD index of competition policy	2.0	2.0	2.0	2.0	1.7	1.7	1.7
Financial sector							
Number of banks (foreign-owned)	35 (5)	34 (6)	38 (6)	35 (6)	33 (5)	31 (5)	na
Asset share of state-owned banks (in per cent)	65.8	77.5	80.4	73.7	70.0	67.6	na
Asset share of foreign-owned banks (in per cent)	2.0	2.2	2.4	3.2	4.3	4.4	na
Non-performing loans (in per cent of total loans)	0.1	0.0	na	na	na	na	na
Domestic credit to private sector (in per cent of GDP)	na	na	na	0.0	0.0	na	na
Domestic credit to households (in per cent of GDP)	na	na	na	na	na	na	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	1.9	1.0	0.6	0.4	0.2	0.0	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
EBRD index of banking sector reform	1.7	1.7	1.7	1.7	1.7	1.7	1.7
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	6.6 (0.2)	6.7 (0.2)	6.7 (0.5)	6.7 (0.7)	6.7 (1.3)	6.7 (2.1)	na
Internet penetration rate (per 10,000 inhabitants)	0.1	0.1	0.1	0.1	0.4	1.1	na
Railway labour productivity (1989=100)	26.0	33.7	35.5	51.1	51.8	47.9	na
Residential electricity tariffs (in USc kWh)	1.2	1.0	1.0	1.2	1.7	na	na
Average collection rate, electricity (in per cent)	90	na	na	72	95	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	0.7	0.7	0.8	0.8	na	na	na
EBRD index of infrastructure reform	1.3	1.3	1.7	1.7	1.7	1.7	1.7
Electric power	1.0	1.0	2.0	2.0	2.0	2.0	2.3
Railways	2.0	2.3	2.7	2.7	2.7	2.7	2.7
Roads	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Telecommunications	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Water and waste water	1.0	1.0	1.0	1.7	1.7	1.7	1.7

[1] Refers to custom duties and export taxes.

	1999	2000	2001	2002	2003	2004 Estimate	2005 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP [1]	4.3	3.8	4.1	3.1	1.5	7.4	4.0
Industrial gross output	1.2	1.3	2.7	3.4	2.8	5.4	na
Agricultural gross output	5.9	3.2	4.1	6.0	5.9	10.1	na
Employment			*(Percentage change)*				
Labour force (end-year)	1.0	1.1	1.5	3.1	3.1	3.1	na
Employment (end-year)	1.0	1.1	1.5	2.4	2.7	3.4	na
			(In per cent of labour force)				
Unemployment (end-year) [2]	0.4	0.4	0.4	0.4	0.3	0.3	na
Prices and wages			*(Percentage change)*				
Consumer prices (annual average)	57.3	49.2	47.5	44.3	14.8	8.8	10.0
Consumer prices (end-year)	26.0	28.2	26.4	24.4	7.7	15.5	7.0
Producer prices (annual average)	38.0	61.1	42.2	na	na	na	na
Producer prices (end-year)	34.5	70.2	44.0	12.2	8.0	6.5	na
Gross average monthly earnings in economy (annual average)	33.4	47.4	58.2	111.8	28.2	39.7	na
Government sector [3]			*(In per cent of GDP)*				
General government balance	-2.6	-2.2	-2.1	-1.5	-0.8	0.4	-3.7
General government expenditure	32.0	30.2	36.0	37.2	33.9	32.0	na
General government debt	11.8	16.6	24.3	22.4	19.1	19.4	na
Monetary sector			*(Percentage change)*				
Broad money (M3, end-year)	32.1	37.1	54.3	29.7	27.2	47.8	na
Domestic credit (end-year)	34.5	88.8	90.8	40.9	3.9	6.8	na
			(In per cent of GDP)				
Broad money (M3, end-year)	13.6	12.2	12.4	10.6	10.3	12.2	na
Interest and exchange rates			*(In per cent per annum, end-year)*				
Refinancing rate	42.6	26.8	26.8	34.5	20.0	20.0	na
Treasury bill rate (3-month maturity)	16.5	17.1	17.1	17.1	na	na	na
Deposit rate (1 year)	13.5	18.8	21.2	26.0	na	na	na
Lending rate (1 year)	32.7	27.6	27.6	33.4	na	na	na
			(Sums per US dollar)				
Exchange rate (end-year) [4]	348.4	631.3	937.6	1,068.3	979.0	1,056.6	na
Exchange rate (annual average) [4]	257.2	360.7	646.3	885.0	995.5	999.2	na
External sector			*(In millions of US dollars)*				
Current account	-164	218	-113	252	882	1,193	1,137
Trade balance	203	494	186	324	836	1,202	1,189
Merchandise exports	2,790	2,935	2,740	2,510	3,240	4,263	4,709
Merchandise imports	2,587	2,441	2,554	2,186	2,404	3,061	3,520
Foreign direct investment, net	121	75	83	65	70	187	250
Gross reserves, excluding gold (end-year)	763	684	1,212	1,215	1,659	2,147	na
External debt stock	4,805	4,418	4,279	4,260	4,426	4,498	na
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	2.9	2.8	4.6	5.4	6.4	6.5	na
			(In per cent of exports of goods and services)				
Debt service	17.8	25.5	26.2	23.3	22.5	17.4	na
Memorandum items			*(Denominations as indicated)*				
Population (end-year, million)	24.3	24.7	24.9	25.6	26.0	26.0	na
GDP (in billions of sums)	2,129	3,256	4,925	7,450	9,838	12,190	14,704
GDP per capita (in US dollars) [5]	340	366	306	329	380	470	na
Share of industry in GDP (in per cent)	14.3	14.2	14.1	14.5	15.0	17.0	na
Share of agriculture in GDP (in per cent)	29.0	30.1	30.0	30.1	28.8	27.0	na
Current account/GDP (in per cent)	-2.0	2.4	-1.5	3.0	8.9	9.8	8.3
External debt - reserves (in US$ million)	4,042	3,734	3,067	3,045	2,767	2,351	na
External debt/GDP (in per cent)	58.1	48.9	56.2	50.6	44.8	36.9	na
External debt/exports of goods and services (in per cent)	155.4	131.4	133.7	142.7	117.2	93.0	na

[1] EBRD estimate. Official figures are considerably higher, at 4.2 per cent in 2001 and 2002, 4.3 per cent in 2003, and 7.6 per cent in 2004.

[2] Officially registered unemployed. No labour force survey estimates were available.

[3] Includes extra-budgetary funds, but excludes local government.

[4] Dual exchange rates were in operation until October 2003. Data show a weighted average of the official, bank and parallel market rates.

[5] Calculated at the weighted exchange rate.

Methodological notes

Transition indicators

The transition indicator scores in Chapter 1 reflect the judgement of the EBRD's Office of the Chief Economist about country-specific progress in transition. The scores are based on the following classification system, which was originally developed in the 1994 *Transition Report*, but has been refined and amended in subsequent Reports.

"+" and "–" ratings are treated by adding 0.33 and subtracting 0.33 from the full value. Averages are obtained by rounding down. For example, a score of 2.6 is treated as 2+, but a score of 2.8 is treated as 3-.

Overall transition indicators

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 with 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 Comprehensive programme under implementation.

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; little action taken to strengthen competition and corporate governance.

3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (for example, privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).

4 Substantial improvement in corporate governance and significant new investment at the enterprise level, including minority holdings by financial investors.

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 Some lifting of price administration; state procurement at non-market prices for the majority of product categories.

3 Significant progress on price liberalisation, but state procurement at non-market prices remains substantial.

4 Comprehensive price liberalisation; state procurement at non-market prices largely phased out; only a small number of administered prices remain.

4+ Standards and performance typical of advanced industrial economies: complete price liberalisation with no price control outside housing, transport and natural monopolies.

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 and current account convertibility.

4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership in WTO.

Competition policy

1 No competition legislation and 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 (for example, 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.

Infrastructure reform

Infrastructure reform ratings are calculated as the average of five indicators covering electric power, railways, roads, telecommunications, water and waste water. The classification system used for these five indicators is detailed below.

Infrastructure transition indicators

Electric power

1 Power sector operates as government department with few commercial freedoms or pressures. Average prices well below costs, with extensive cross-subsidies. Monolithic structure, with no separation of different parts of the business.

2 Power company distanced from government, but there is still political interference. Some attempt to harden budget constraints, but effective tariffs are low. Weak management incentives for efficient performance. Little institutional reform and minimal, if any, private sector involvement.

3 Law passed providing for full-scale restructuring of industry, including vertical unbundling through account separation and set-up of regulator. Some tariff reform and improvements in revenue collection. Some private sector involvement.

4 Separation of generation, transmission and distribution. Independent regulator set up. Rules for cost-reflective tariff-setting formulated and implemented. Substantial private sector involvement in distribution and/or generation. Some degree of liberalisation.

4+ Tariffs cost-reflective and provide adequate incentives for efficiency improvements. Large-scale private sector involvement in the unbundled and well-regulated sector.

Fully liberalised sector with well-functioning arrangements for network access and full competition in generation.

Railways

1 Monolithic structure operated as government department, with few commercial freedoms. No private sector involvement and extensive cross-subsidisation.

2 Rail operations distanced from state, but weak commercial objectives. Some business planning, but targets are general and tentative. No budgetary funding of public service obligations. Ancillary businesses separated, but little divestment. Minimal private sector involvement.

3 Commercial orientation in rail operations. Freight and passenger services separated and some ancillary businesses divested. Some budgetary compensation available for passenger services. Improved business planning with clear investment and rehabilitation targets, but funding unsecured. Some private sector involvement in rehabilitation and/or maintenance.

4 Railways fully commercialised, with separate internal profit centres for freight and passenger services. Extensive market freedoms to set tariffs and investments. Implementation of medium-term business plans. Ancillary industries divested. Private sector participation in freight operation, ancillary services and track maintenance.

4+ Separation of infrastructure freight and passenger operations. Full divestment and transfer of asset ownership implemented or planned, including infrastructure and rolling stock. Rail regulator established and access pricing implemented.

Roads

1 Minimal degree of decentralisation and no commercialisation. All regulatory, road management and resource allocation functions centralised at ministerial level. New investments and road maintenance financing dependent on central budget allocations. Road user charges not based on the cost of road use. Road construction and maintenance undertaken by public construction units. No public consultation in the preparation of road projects.

2 Moderate degree of decentralisation and initial steps in commercialisation. Road/highway agency created. Improvements in resource allocation and public procurement. Road user charges based on vehicle and fuel taxes, but not linked to road use. Road fund established, but dependent on central budget. Road construction and maintenance undertaken primarily by corporatised public entities, with some private sector participation. Minimal public consultation/participation on road projects.

3 Fair degree of decentralisation and commercialisation. Regulation and resource allocation functions separated from road maintenance and operations. Level of vehicle and fuel taxes related to road use. Private companies able to provide and operate roads under negotiated commercial contracts. Private sector participation in road maintenance and/or through concessions to finance, operate and maintain parts of highway network. Limited public consultation/participation and accountability on road projects.

4 Large degree of decentralisation. Transparent methodology used to allocate road expenditures. Track record in competitive procurement of road design, construction, maintenance and operations. Large-scale private sector participation in construction, operations and maintenance directly and through public-private partnerships. Substantial public consultation/participation and accountability on road projects.

4+ Fully decentralised road administration. Commercialised road maintenance operations competitively awarded to private companies. Road user charges reflect the full costs of road use and associated factors, such as congestion, accidents and pollution. Widespread private sector participation in all aspects of road provision. Full public consultation on new road projects.

Telecommunications

1 Little progress in commercialisation and regulation. Minimal private sector involvement and strong political interference in management decisions. Low tariffs, with extensive cross-subsidisation. Liberalisation not envisaged, even for mobile telephony and value-added services.

2 Modest progress in commercialisation. Corporatisation of dominant operator and some separation from public sector governance, but tariffs are still politically set.

3 Substantial progress in commercialisation and regulation. Telecommunications and postal services fully separated; cross-subsidies reduced. Considerable liberalisation in the mobile segment and in value-added services.

4 Complete commercialisation, including privatisation of the dominant operator; comprehensive regulatory and institutional reforms. Extensive liberalisation of entry.

4+ Effective regulation through an independent entity. Coherent regulatory and institutional framework to deal with tariffs, interconnection rules, licensing, concession fees and spectrum allocation. Consumer ombudsman function.

Water and waste water

1 Minimal degree of decentralisation; no commercialisation. Services operated as vertically integrated natural monopolies by government ministry or municipal departments. No financial autonomy and/or management capacity at municipal level. Low tariffs, low cash collection rates and high cross-subsidies.

2 Moderate degree of decentralisation; initial steps towards commercialisation. Services provided by municipally owned companies. Partial cost recovery through tariffs; initial steps to reduce cross-subsidies. General public guidelines exist regarding tariff-setting and service quality, but both under ministerial control. Some private sector participation through service or management contacts, or competition to provide ancillary services.

3 Fair degree of decentralisation and commercialisation. Water utilities operate with managerial and accounting independence from municipalities, using international accounting standards and management information systems. Operating costs recovered through tariffs, with a minimum level of cross-subsidies. More detailed rules drawn up in contract documents, specifying tariff review formulae and performance standards. Private sector participation through the full concession of a major service in at least one city.

4 Large degree of decentralisation and commercialisation. Water utilities managerially independent, with cash flows — net of municipal budget transfers — that ensure financial viability. No cross-subsidies. Semi-autonomous regulatory agency able to advise and enforce tariffs and service quality. Substantial private sector participation through build-operator-transfer concessions, management contacts or asset sales in several cities.

4+ Water utilities fully decentralised and commercialised. Fully autonomous regulator exists with complete authority to review and enforce tariff levels and quality standards. Widespread private sector participation via service/management/lease contracts. High-powered incentives, full concessions and/or divestiture of water and waste-water services in major urban areas.

Definitions and data sources for structural indicators box

Liberalisation and privatisation

Current account convertibility

Options: full (full compliance with Article VIII of the IMF Agreement); limited (restrictions on payments or transfers for current account transactions).

Source: IMF Annual Report on exchange arrangements and exchange restrictions.

Controls on inward direct investment

Options: yes (controls on foreign ownership, and/or minimum capital requirements); no (no restrictions on inward foreign direct investment, except in some cases on arms production and military equipment).

Source: IMF Annual Report on exchange arrangements and exchange restrictions.

Interest rate liberalisation

Options: full (banks 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 highly illiquid money or credit markets); limited de jure (restrictions on banks to set interest rates through law, decree or central bank regulation).

Source: EBRD staff assessments.

Exchange rate regime

Options: currency board; fixed; fixed with band; crawling peg; crawling peg with band; managed float; floating.

Source: IMF Annual Report on exchange arrangements and exchange restrictions.

Wage regulation

Restrictions or substantial taxes on the ability of some enterprises to adjust the average wage or wage bill upward. Options: yes; no.

Source: EBRD staff assessments.

Tradability of land

Options: full (no substantial restrictions on 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 tradability of land, for example, limited enforceability of land rights, a non-existent land market, or significant obstruction by government officials); limited de jure (legal restrictions on tradability of land rights); no (land trade prohibited).

Source: EBRD staff assessments.

Business environment and competition

Competition office

Competition or anti-monopoly office exists separately from any ministry, though it may not be fully independent. Options: yes; no.

Source: EBRD staff assessments.

Quality of insolvency law

Level of compliance of insolvency laws with international standards, such as the World Bank's *Principles and guidelines for effective insolvency and creditor rights systems*, the UNCITRAL working group on legislative guidelines for insolvency law, and others. Options: very high; high; medium; low; very low.

Source: EBRD Legal Sector Assessment 2004.

Secured transactions law

Level of reform assessed in relation to the *EBRD model law on secured transactions* and the *EBRD ten core principles of secured transactions laws*. Options: advanced; some defects; inefficient; malfunctioning.

Source: EBRD Regional Survey of Secured Transactions 2005.

Quality of corporate governance law

Level of compliance of corporate governance laws with international standards, such as the *OECD principles of corporate governance*. Options: very high; high; medium; low; very low.

Source: EBRD Legal Sector Assessment 2005.

Infrastructure

Independent telecommunications regulator

Options: fully (institutional, financial, managerial and decision making independence granted); partially (some elements of independence, but not all four dimensions); no (no regulator with institutional independence).

Source: EBRD staff assessments.

Independent electricity regulator

Options: fully (institutional, financial, managerial and decision making independence granted); partially (some elements of independence, but not all four dimensions); no (no regulator with institutional independence).
Source: EBRD staff assessments.

Separation of railway infrastructure from operations

Separate entities responsible for track infrastructure and for freight and passenger operations. Options: fully (institutional separation); partially (accounting only); no.
Source: EBRD staff assessments.

Quality of concession laws

Level of compliance of concession laws with international standards, in particular the *UNCITRAL Legislative guide on privately financed* infra*structure projects*. Options: very high; high; medium; low; very low.
Source: EBRD Legal Sector Assessment 2005.

Financial sector

Capital adequacy ratio

Ratio of bank regulatory capital to risk-weighted assets; regulatory capital includes paid-in capital, retentions and some forms of subordinated debt.
Source: EBRD staff assessments.

Deposit insurance system

Deposits in all banks covered by formal deposit insurance scheme. Options: yes; no.
Source: EBRD staff assessments.

Quality of securities market laws

Level of compliance of securities market laws with international standards, mainly the objectives and principles of securities regulation issued by the International Organization of Securities Commissions (IOSCO). Options: very high; high; medium; low; very low.
Source: EBRD Legal Sector Assessment 2004.

Private pension funds

Options: yes; no.
Source: EBRD staff assessments.

Social reform

Share of population living in poverty

Percentage of population living on less than US$2 a day per person (in 1985 US$ at purchasing power parity). Selected years.
Source: World Bank World Development Indicators.

Government expenditure on health

Expenditures by general government, excluding state-owned enterprises, on health services including hospitals, clinics, public health, medicaments, medical equipment and applied research related to the sector. Expenditures are expressed as percentage of GDP. Latest available year.
Source: National statistics.

Government expenditure on education

Expenditures by general government, excluding state-owned enterprises, on education services including pre-primary and primary education, secondary and tertiary education, and subsidiary services to education. Expenditures are expressed as percentage of GDP. Latest available year.
Source: National statistics.

Share of power, water in total household expenditure

Share of total household expenditures used on electric power and water/waste-water services. Estimate based on the poorest 10 per cent of households (lowest income decile). Latest available year.
Source: EBRD staff estimates, based on household survey data.

Definitions and data sources for structural indicators table

Enterprises

Privatisation revenues (cumulative, in per cent of GDP)

Government revenues from cash sales of enterprises, not including investment commitments.
Sources: National authorities and IMF country reports.

Private sector share in GDP (in per cent)

Private sector share in GDP represents rough EBRD estimates, based on available statistics from both official (government) 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.
Source: EBRD staff estimates.

Private sector share in employment (in per cent)

Private sector share in employment represents rough EBRD estimates, based on available statistics from both official (government) and unofficial sources. The underlying concept of private sector employment includes employment in private registered companies, as well as in private entities engaged in informal activity in those cases where reliable information on informal activity is available.
Source: EBRD staff estimates.

Budgetary subsidies and current transfers (in per cent of GDP)

Budgetary transfers to enterprises and households, excluding social transfers.

Sources: National authorities and IMF country reports.

Share of industry in total employment (in per cent)

Industry includes electricity, power, manufacturing, mining and water.

Sources: ILO, Labour Statistics Yearbook, UN, National Account Statistics, national statistical publications and IMF country reports.

Change in labour productivity in industry (in per cent)

Labour productivity is calculated as the ratio of industrial production to industrial employment. Changes in productivity are calculated on the basis of annual averages.

Sources: National statistical publications and IMF country reports.

Investment/GDP (in per cent)

Gross domestic investment consists of additional outlays to the economy's fixed assets, plus net changes in inventory levels. Fixed assets include: land improvements (fences, ditches, drains, etc.); plant, machinery and equipment purchases; and the construction of roads, railways, schools, offices, hospitals, private residential dwellings, commercial and industrial buildings, etc. Inventories are stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales and "work in progress". Net acquisitions of valuables are also considered capital formation.

Source: See the macroeconomic indicators tables.

Markets and trade

Share of administered prices in CPI (in per cent)

Administered prices are those prices subject to regulation by the state.

Sources: EBRD survey of national authorities and IMF country reports.

Number of goods with administered prices in EBRD-15 basket

EBRD-15 basket consists of flour/bread, meat, milk, gasoline/petrol, cotton textiles, shoes, paper, cars, television sets, cement, steel, coal, wood, rents, intercity bus service.

Source: EBRD survey of national authorities.

Share of trade with non-transition countries (in per cent)

Ratio of merchandise exports and imports with non-transition economies to total trade (exports plus imports).

Source: IMF Directions of Trade Statistics.

Share of trade in GDP (in per cent)

Ratio of exports plus imports to GDP.

Source: See the macroeconomic indicators tables.

Tariff revenues (in per cent of imports)

Tariff revenues include all revenues from international trade. Imports are those of merchandise goods.

Sources: National authorities and IMF country reports.

Financial sector

Number of banks (foreign-owned)

Number of commercial and savings banks, excluding cooperative banks. Foreign-owned banks are defined as those with foreign ownership exceeding 50 per cent, end-of-year.

Source: EBRD survey of central banks.

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

Share of majority state-owned banks' assets in total bank sector assets. The state includes 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 per cent, end-of-year.

Source: EBRD survey of central banks.

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

Share of total bank sector assets in banks with foreign ownership exceeding 50 per cent, end-of-year.

Source: EBRD survey of central banks.

Non-performing loans (in per cent of total loans)

Ratio of non-performing loans to total loans. Non-performing loans include sub-standard, doubtful and loss classification categories of loans, but excludes loans transferred to a state rehabilitation agency or consolidation bank, end-of-year.

Source: EBRD survey of central banks.

Domestic credit to private sector (in per cent of GDP)

Ratio of total outstanding bank credit to private sector at end-of-year, including households and enterprises, to GDP.

Source: EBRD survey of central banks.

Domestic credit to households (in per cent of GDP)

Ratio of total outstanding bank credit to households, at end-of-year, to GDP.

Source: EBRD survey of central banks.

Mortgage lending (in per cent of GDP)

Ratio of mortgage lending to households, at end-of-year, to GDP.

Source: EBRD survey of central banks.

Stock market capitalisation (in per cent of GDP)

Market value of all shares listed on the stock market, calculated by multiplying the share price by the number of shares outstanding; presented as a percentage of GDP, end-of-year. Listed domestic companies are the domestically incorporated companies listed on the country's stock exchanges at end-of-year.

Source: Standard & Poor's/IFC Emerging Stock Markets Factbook, Federation of Euro-Asian Stock Exchanges and local stock exchanges.

Stock trading volume (in per cent of market capitalisation)

Total value of shares traded during the period, divided by the average market capitalisation for the period.

Source: World Bank World Development Indicators, Standard & Poor's/IFC Emerging Stock Markets Factbook and local stock exchanges.

Eurobond issuance (in per cent of GDP)

Total value of the bond issuance (including sovereign, municipality and corporate issuance) denominated in a currency different to that of the country in which the bond was issued.
Source: JP Morgan.

Infrastructure

Fixed-line (mobile) penetration rate (per 100 inhabitants)

Fixed line refers to the number of telephone lines connecting a customer to the public switched telephone network (PSTN). Mobile refers to the number of cellular mobile telephone subscribers.
Source: International Telecommunications Union.

Internet penetration rate (per 10,000 inhabitants)

Internet penetration rate is calculated as the number of Internet hosts (number of computers directly linked to the worldwide Internet network) per 10,000 inhabitants.
Source: International Telecommunications Union.

Railway labour productivity (1989=100)

Productivity measured as the ratio of the number of traffic units (passenger-kilometres plus freight tonne-kilometres) and the total number of railway employees.
Sources: National authorities and World Bank.

Residential electricity tariffs, US cents per kilowatt-hour

Average tariff paid by residential consumers; where data on residential tariffs are not available, average retail tariff.
Sources: International Energy Agency, Energy Regulators Association and EBRD survey of national authorities.

Average collection rate, electricity (in per cent)

Collection rate is defined as the ratio of total electricity payments received in cash and total electricity charges.
Source: EBRD survey of national authorities.

GDP per unit of energy use (PPP in US dollars per kgoe)

PPP of GDP per kilogram of oil equivalent for commercial energy use. GDP is converted to international US dollars using purchasing power parity exchange rates.
Source: World Bank World Development Indicators.

Definitions and data sources for macroeconomic indicators table

Data represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank and other sources. Data for the current year are EBRD staff estimates.

Output and expenditure

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. Some countries 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 sourced from statistical offices or the 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 in 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 extra-budgetary funds, incorporated 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 is the sum of money in circulation outside banks and demand deposits other than those of the central government. It also includes quasi-money (time, savings and foreign currency deposits of the resident sectors other than the central government). Data sourced from the IMF, International Financial Statistics and monetary authorities.

Interest and exchange rates

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 sourced from the IMF, International Financial Statistics and monetary authorities.

External sector

Trade data in many countries can differ between balance of payments and customs statistics, because of differences in recording and of informal border trade, which is typically not recorded by customs statistics. Trade data are on a balance of payments basis as published by the monetary authorities and in IMF country reports.

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The *Transition Report* offers an in-depth analysis of economic progress in 27 countries from central Europe to central Asia. Drawing on the EBRD's experience as one of the largest investors in the region, the Report provides comprehensive analysis of the transition from central planning to market economies.

Over the past year significant progress has been achieved by many transition countries. But to what extent is progress in the transition countries still hampered by poor economic governance and widespread corruption? And how do firms in the region view the business environment and their prospects for growth?

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The Report analyses what kinds of firms are particularly affected by a difficult business environment and compares the transition countries with mature market economies. The high costs of business regulation, a poor institutional framework, weak property rights and an unstable macroeconomic environment all emerge from the survey as major obstacles to doing business in transition countries.

The Report also takes a close look at the performance of enterprises in the region. It assesses what types of firms – private or state-owned, foreign or domestic – have been the most successful in increasing their sales and improving efficiency and highlights the main factors that influence a firm's performance.

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