

Transition Report 2008

Growth 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 entrepreneurship in central eastern Europe and the Baltic states, south-eastern Europe, and the Commonwealth of Independent States and Mongolia. To perform this task effectively, the Bank needs to analyse and understand the process of transition. The purpose of the *Transition Report* is to advance this understanding and to share our analysis with our partners.

The responsibility for the content of the *Transition Report* is taken by the Office of the Chief Economist. The assessments and views expressed in the *Transition Report* are not necessarily those of the EBRD. All assessments and data in the *Transition Report* are based on information as of late October 2008.

Growth in transition

Contents

ii	Map of the transition countries
iv	Executive summary
vi	Foreword
1	Chapter 1: Reforms, growth and the macroeconomy
12	Annex 1.1: Macroeconomic performance tables
24	Annex 1.2: Telecommunications regulatory assessment
31	Annex 1.3: Sustainable energy in transition
37	Chapter 2: The global credit crisis and the transition region
49	Chapter 3: Fostering growth in transition economies
65	Chapter 4: Trade, product mix and growth
79	Chapter 5: Stimulating growth: the role for industrial policy
91	Country assessments
204	Methodological notes

Transition countries

GDP (in billion US\$, 2007)

Central eastern Europe and the Baltic states

1	Czech Republic*	174.6
2	Estonia	20.9
3	Hungary	138.4
4	Latvia	27.2
5	Lithuania	38.3
6	Poland	420.1
7	Slovak Republic	75.0
8	Slovenia	47.1

South-eastern Europe

9	Albania	10.8
10	Bosnia and Herzegovina	15.1
11	Bulgaria	39.6
12	Croatia	51.3
13	FYR Macedonia	7.7
14	Montenegro	3.5
15	Romania	165.7
16	Serbia	41.0

Commonwealth of Independent States and Mongolia

17	Armenia	9.5
18	Azerbaijan	31.3
19	Belarus	44.8
20	Georgia	10.2
21	Kazakhstan	103.8
22	Kyrgyz Republic	3.7
23	Moldova	4.4
24	Mongolia	3.9
25	Russia	1,288.6
26	Tajikistan	3.7
27	Turkmenistan	12.9
28	Ukraine	141.2
29	Uzbekistan	22.3

* From 2008, the EBRD no longer makes new investments in the Czech Republic or provides a country assessment in the *Transition Report*. However, parts of the Report refer to the Czech Republic, and the Report continues to provide data and projections on key macroeconomic variables in the country.





Executive summary

Chapter 1 Reforms, growth and the macroeconomy

The transition countries experienced strong economic growth in 2007, but this has slowed in 2008 and the region is increasingly feeling the effects of the global financial crisis. However, market-oriented reforms have continued to advance in most countries. For the transition region as a whole, the number of transition indicator upgrades exceeded last year's total, with significant advances in south-eastern Europe and, to a lesser extent, in the Commonwealth of Independent States and Mongolia (CIS+M). The Report finds a strong link between progress in transition and economic growth, but many countries still need to address fundamental structural reforms.

Average growth rates are expected to decline in 2008 by more than 1 percentage point, and are expected to fall further in 2009 by around 3 percentage points. The global liquidity crisis had a limited impact up to mid-2008, but by October 2008 it was clear that the credit boom of recent years was coming to an end. Inflationary pressures emerged across the region, especially in the CIS+M, but are starting to subside. Investor confidence has weakened and foreign direct investment flows this year and next are likely to be well below the record levels seen in 2007.

Inflation, which rose to double digits in many countries in the first half of 2008, continues to pose a threat to macroeconomic stability and sustainable growth. Rising inflation partly reflects higher global food and energy prices, but can also be traced partly to capacity constraints in the region's labour markets. Domestic monetary and fiscal policies have been important factors; countries with inflation-targeting strategies and flexible exchange rates have fared better recently than those with fixed or managed rates.

Chapter 2 The global credit crisis and the transition region

The turmoil in the financial markets over the last year is having an increasingly adverse effect on the transition countries. Most domestic and foreign-owned banks operating in the region remain susceptible to the broader loss of confidence and liquidity that has swept through financial markets and that may put solvency at risk. The crisis has already had a negative effect on access to foreign capital markets, leading to reduced capital flows to the region, shorter maturities and higher risk premiums. Syndicated lending by international banks also declined in all transition subregions in the first half of 2008 compared to a year earlier. While a temporary moderation in credit expansion in many transition countries is welcome, a sharp and disruptive fall in the availability of credit would pose significant risks to the region's growth potential.

The full impact of the financial turmoil will depend on the behaviour of parent banks and foreign direct investment in the coming year. In central eastern Europe and the Baltic states and south-eastern Europe, where foreign banks dominate, support from foreign parent banks is likely to be reduced as their balance sheets and capital adequacy are tested by the market. In the Commonwealth of Independent States and Mongolia, some countries already face international capital markets that are closed or greatly restricted, while others – including several smaller countries in Central Asia – have limited integration into global financial markets but are still being affected by contagion from neighbours, investors and trading partners.

Chapter 3

Fostering growth in transition economies

Improving and sustaining growth potential over the longer term remains a major challenge for the transition region. It is now widely accepted that the ability of an economy to innovate – whether by imitating existing technologies or inventing new ones – is central to this objective, and to achieve it, the promotion of competition and better-quality education are essential prerequisites.

If countries are to sustain higher productivity growth rates, they will need to entrench product market competition by removing barriers to entry and trade and by maintaining transparent and effective competition agencies. Within the transition region, this is particularly true for the resource-rich countries of the Commonwealth of Independent States and Mongolia. At the same time, the governments of the transition countries will need to invest more in quality education at all levels to ensure that workforce skills match the evolving technological demands of their economies. A more educated and skilled population will, by definition, be better able to adapt and contribute to growth and innovation. A complementary challenge will be to improve monitoring and evaluation systems in order to increase the effectiveness of educational investment.

While many transition countries face a macroeconomic situation that allows limited room for higher spending on education, there is scope for changing the overall composition of spending so that education receives greater attention and investment. In addition, the private sector's growing role in boosting training and skills acquisition would be strengthened if access to finance can be improved.

Chapter 4

Trade, product mix and growth

Economic growth is linked strongly to the sophistication and composition of the goods that a country produces. The product composition of a country's exports reveals the relative advantages of that country in the international economy in terms of its physical and human capital resources, as well as its level of technological development. Available evidence suggests that countries with solid export bases tend to perform better than those without, and that those economies with more sophisticated exports tend to grow faster.

This chapter analyses and compares the composition of the country-level export baskets in the transition region in terms of the sophistication of each country's products and the extent to which their exports are related. The results of the analysis reveal not only that most countries have experienced major changes in their patterns and structures of trade, but that there is also considerable variation in the extent to which individual countries have been able to upgrade and change their export baskets.

Many of the countries in central eastern Europe and the Baltic states, as well as in south-eastern Europe, have improved the value of their existing products and moved into new and higher-value exports. This is not, however, the case for a number of the resource-rich, commodity exporting countries of the Commonwealth of Independent States and Mongolia. They continue to have a limited capacity to move into more sophisticated products and so face major challenges in improving and diversifying their output mix.

Chapter 5

Stimulating growth: the role for industrial policy

A large number of transition countries have started pursuing various forms of industrial policy. They are doing this in the belief that market failures and other factors justify government intervention to improve the efficiency of firms and sectors, while achieving the structural change that more dynamic and productive activities require. This is despite the fact that industrial policy has had a very chequered history. The challenge for countries is not only to identify the particular market failures or constraints (typically relating to finance, infrastructure, innovation, information and human capital) that a given industrial policy aims to address, but also the appropriate instruments that need to be deployed.

Industrial policy can be either horizontal – affecting the business environment in which firms and industries operate – or vertical and hence targeted at specific firms, industries or sectors. There is relatively little disagreement about the role of horizontal policy but experience with vertical interventions has been very mixed. These interventions need to be designed carefully to avoid the pitfalls that weak institutional environments and poor governance pose.

There are, however, several areas where selective government intervention may be warranted – particularly in finance for innovative activities, assistance with forming agglomerations or clusters of economic activity, and building the key capabilities that countries need in order to diversify and improve the quality of their products. In designing interventions in these areas, priority should be given to activities that are, as far as possible, subject to some discipline from market competition and where private sector participation – for instance through co-financing – can be established. Experience suggests that the targeting of specific products or sectors should be avoided.

Foreword



“Despite the global crisis, growth prospects remain good but sustained reform will be critical.”

Erik Berglöv
Chief Economist

The past year has been a tumultuous one for the global economy. After a period of mounting pressures in the financial markets, the crisis originating in the advanced economies of the United States and Europe has finally hit the transition region with full force. The resilience of the countries in the region to the early phases of the crisis is a testament to their remarkable achievements in establishing credible macroeconomic frameworks and reforming their institutions. Yet as part of the process of integration with the international economy, their exposure to the current crisis has increased, albeit with varying degrees of vulnerability.

The manifestations of the crisis are everywhere. Stock markets have plunged and several countries have experienced rapid capital outflows and pressures on their currencies. Inter-bank rates have also increased markedly. Growth in the region as a whole fell from 7.5 per cent in 2007 – the highest that has been achieved since transition began – to a projected 6.3 per cent in 2008 with a further, significant fall expected in 2009. However, only some of this slowdown can be attributed to the financial crisis.

There are now increasing signs that the wider economy is being affected, with industrial production slowing down and even contracting in many countries. These developments stem not only from more expensive credit and a rapid reduction of growth in key export markets, but also increasingly from the shutdown of traditional lending channels. Lending by local banks, many of which are owned by parent banks based in western Europe – themselves adversely affected by the crisis – has widely contracted. In addition, governments themselves are being hit directly through lower ratings and speculation against individual currencies that in some cases have already forced governments to seek support from the International Monetary Fund and other agencies.

The depth and duration of the global crisis are still unclear, but the region is now bracing itself for higher unemployment and lower consumption growth. The focus of policy-makers has quickly shifted from containing inflationary pressures to protecting domestic financial institutions and mitigating the impact on the real economy. The scale of the crisis makes the policy response of individual governments difficult to design and coordinate with those of other affected countries. Nevertheless, despite these limitations the policy response has mostly been appropriate.

While the global financial crisis has unsurprisingly dominated the attention of policy-makers, there is a danger that this focus can divert needed attention away from the key long-term growth challenges that face individual countries and the region. The region's economy has expanded rapidly since 2000, but this growth came after a protracted period of recession. To put this in perspective, by the end of 2007 the Commonwealth of Independent States and Mongolia (CIS+M) on average had a GDP level roughly comparable (in real terms) to that reported in 1989. In central eastern Europe and the Baltic states (CEB), GDP was on average only 50 per cent higher than it had been in 1989, while in several countries in south-eastern Europe (SEE), it was significantly lower than in the pre-transition period. Therefore, while the acceleration in growth has been significant, the scope for the transition economies to grow further remains substantial. The analysis in the *Transition Report 2008* suggests that countries that have implemented key market-enabling and market-deepening reforms – such as price liberalisation, privatisation and financial sector reform – have reaped benefits in terms of growth.

The challenges now are to implement the often more difficult and protracted market-sustaining reforms (such as competition policy, governance and company restructuring) that are essential for long-term growth, while

trying to surmount the shorter-term pressures thrown up by events in the international economy. Failure to keep inflation under control and to ensure the stability and functioning of the financial system will make it hard, if not impossible, to implement effectively policies aimed at raising the long-term growth potential of these economies.

It is now widely accepted that the ability of an economy to innovate is central to its prosperity and dynamism. Innovation can involve both the successful adoption of existing technologies and the invention of new ones. In the transition region, the challenge to date has mostly been about the former strategy but, in the longer term, countries will want to develop their own innovations. This Report focuses on two features – competition and education – that are essential prerequisites for sustained growth. While competition can help motivate innovation through the adoption of existing technology or the creation of new products, there is nevertheless a need for a sub-structure of “capabilities” in an economy – meaning not only a good physical infrastructure and business climate but also appropriate skills and education among its workforce. Transition countries typically have higher levels of human capital than other countries at roughly comparable income levels, but they have often failed to build effectively on these foundations. The Report consequently proposes a variety of policies that can help extend investment in education and skills acquisition in the region, arguing that such investment can reap clear rewards in terms of innovation and growth. Building human capabilities will be a major determinant of the rate of subsequent growth and its sustainability.

The Report also explores what each country produces and, in particular, the composition of its exports. The latter provides a good indication of a country's relative advantage in the international economy. The results of the analysis for the transition region are broadly positive. Many countries – particularly in CEB – have changed their structure and direction of trade, improving the value

of existing products and moving into new and higher-value exports. This is not, however, the case for some of the commodity-exporting countries of the CIS+M, for which the need to improve and diversify their capabilities – not least through sustained investment in education – must be a central objective.

The challenge of sustaining long-term growth in the transition region raises important questions about the respective roles of government and the private sector. Many governments have, at one time or another, actively pursued various forms of industrial policy. Although the experience has often been quite negative, some recent instances show that there can be justification for selective industrial policy that goes beyond the implementation of so-called “horizontal” policies that aim to improve the business environment. Targeted or “vertical” policies can, for example, be deployed to address failures in markets or where there are benefits from the coordination of investment.

The Report's analysis focuses on several areas where intervention may be warranted in some transition countries, particularly finance for innovative activities, assistance with forming agglomerations or clusters of economic activity, and building the key capabilities that countries need to diversify and improve the quality of their products. However, to avoid the pitfalls that clearly exist, vertical industrial policy should be directed at activities that are as far as possible subject to the discipline of market competition and private sector participation, while avoiding targeting specific products. Moreover, recent experience in the transition countries shows that the way in which such interventions are designed will be critical to success or failure.

The *Transition Report* 2007 showed that many people in the region have found transition to be a very difficult experience but have remained optimistic about the future. The *Transition Report* 2008 provides further grounds for

optimism, as most transition countries have continued to make economic progress and have largely sustained the momentum of reforms necessary to reinforce future growth. Nevertheless, events that have originated outside the region, combined with shortcomings in policy and institutions within it, now pose major risks of instability and, in some cases, recession. Furthermore, implementation of more complex market-sustaining reforms will be essential if structural constraints are to be surmounted, while the quality of education must be raised to deliver lasting improvements in human capital and productivity.

Finding resources and political will to implement these needed reforms may prove more difficult in the current environment. Indeed, there is now some concern that economic reforms may be reversed and some of the cumulative achievements of the past two decades will be undone. This would be highly undesirable. Support for a sustained reform agenda – despite difficult economic times – remains a key objective of the EBRD.



In 2007 and the first half of 2008, the transition region continued to grow strongly and to advance reforms, but the global financial turmoil has begun to affect the region's economies. Growth in 2009 is likely to be well down on previous years, while inflationary pressures may have peaked. Reform challenges remain substantial in most of the region.

1

Reforms, growth and the macroeconomy

Featured

- 2 Progress in transition
- 7 Macroeconomic developments
- 8 Rising inflation and policy responses
- 10 Outlook
- 12 Annex 1.1: Macroeconomic performance tables
- 24 Annex 1.2: Telecommunications regulatory assessment
- 31 Annex 1.3: Sustainable energy in transition

Since 2000 the transition region has been one of the most dynamic emerging world markets. Strong economic growth and further progress in market-oriented reforms continued through 2007. Real GDP grew by 7.5 per cent over the year, with some of the poorest transition countries (in Central Asia and the Caucasus) leading the way. There were also tentative signs of a new commitment to the reform process in several countries where there had previously been hesitancy or inaction. Moreover, the region continued to attract foreign direct investment (FDI), with net inflows in 2007 reaching a record US\$ 88 billion (€65 billion).

Some of these achievements are now threatened by the tumultuous events that have occurred in 2008 in the global financial markets, and in particular by the wave of bank failures and effective nationalisation of major financial institutions that took place in September and October in the United States and other major world economies. Already during 2008 the macroeconomic performance of the transition region

has been less impressive than in 2007, and the short-term outlook is gloomier than at any time in the recent past. Most countries are growing at a slower rate, although only one – Estonia – is forecast to record negative growth for 2008 as a whole. Although the global liquidity crunch that began in mid-2007 initially had a limited impact on the region (see Chapter 2), the credit boom of recent years in central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and parts of the Commonwealth of Independent States and Mongolia (CIS+M) has started to slow sharply in some countries, with important knock-on effects on consumer confidence. Inflationary pressures re-emerged in the first half of 2008, even in CEB and SEE countries that have been used to low, single-digit inflation rates, and reached annual rates above 20 per cent in parts of the CIS+M.

While there has been no serious backtracking on reform in any transition country during the past year, there have been worrying instances of the state taking a more intrusive role in

key sectors of the economy, notably in Russia. In addition, the conflict between Georgia and Russia that erupted in August 2008 has also damaged confidence in the Russian market and greatly reduced short-term FDI prospects in Georgia and possibly other countries of the region as well.

This chapter summarises recent developments in transition-related reforms, presents the main macroeconomic results, analyses the problems posed by resurgent inflation and considers the outlook for 2009. Given the strong and robust links between reforms and economic performance, growth in the transition region is expected to continue over the medium and long term, but at a significantly reduced rate in the short term, possibly accompanied by downturns in several cases.

Progress in transition

After nearly two decades of transition, countries across the region vary enormously in the extent to which they have adopted market-based reforms and institutions and in their progress towards the standards of advanced market economies. The 10 countries that are members of the European Union – the CEB countries together with Bulgaria and Romania in SEE – are furthest along the transition path. The rest of SEE is catching up, particularly Croatia, which is at a fairly advanced state of negotiations for EU membership. Meanwhile, the largest variation in transition progress is in the CIS+M.

The 2007 *Transition Report* divided transition reforms into three stages:

- market-enabling, first-stage reforms – such as small-scale privatisation and the liberalisation of prices and exchange rates
- market-deepening, second-stage reforms – involving the privatisation of larger enterprises and the strengthening of financial institutions
- market-sustaining, third-stage reforms (the most difficult) – involving fundamental reforms to the governance of enterprises, the development of institutions to protect and promote competition, and a more commercial approach to the provision of infrastructure services.

Box 1.1

Link between reforms and growth

The 2004 *Transition Report* highlighted the strong link between progress in reform and subsequent economic growth. The link stood up to a variety of statistical tests, and remained valid even when allowing for the influence of factors such as differences in starting points for transition, post-recession recovery rates, fiscal policy, exposure to international markets and dependence on oil imports or exports.¹ To see whether the results from 2004 are still valid, the analysis has been repeated, incorporating four extra years of data.²

The main results are as follows. First, commitment to reform, as indicated by an increase in the average EBRD transition score, has a strong and positive effect on growth in the subsequent period. The quantitative impact appears to be even stronger than it was in 2004. As an illustration, if the EBRD index, which varies from 1 to 4.33, rises by 0.1 – from 3.0 to 3.1 for example – this would imply an increase in growth of more than 1 percentage point in each subsequent year.

Second, other variables are also important for growth. A country's starting point and the degree of potential for catch-up (captured by the extent to which economic activity fell during the recessionary years of early transition) are key drivers, as are oil dependence and external demand.

Third, the effect of the government's fiscal balance on growth is still positive but weaker than in the earlier research, suggesting that the benefits of fiscal discipline have diminished over time as countries have stabilised their economies effectively.

Fourth, it appears that third-stage (market-sustaining) reforms have the strongest impact on subsequent growth, followed by first-stage (market-enabling) and then second-stage (market-deepening) reforms. This is an important finding for those countries that are most advanced along the transition path, as third-stage reforms are the most difficult to implement, and reaching the standards of the hypothetical advanced market economy may take many years.

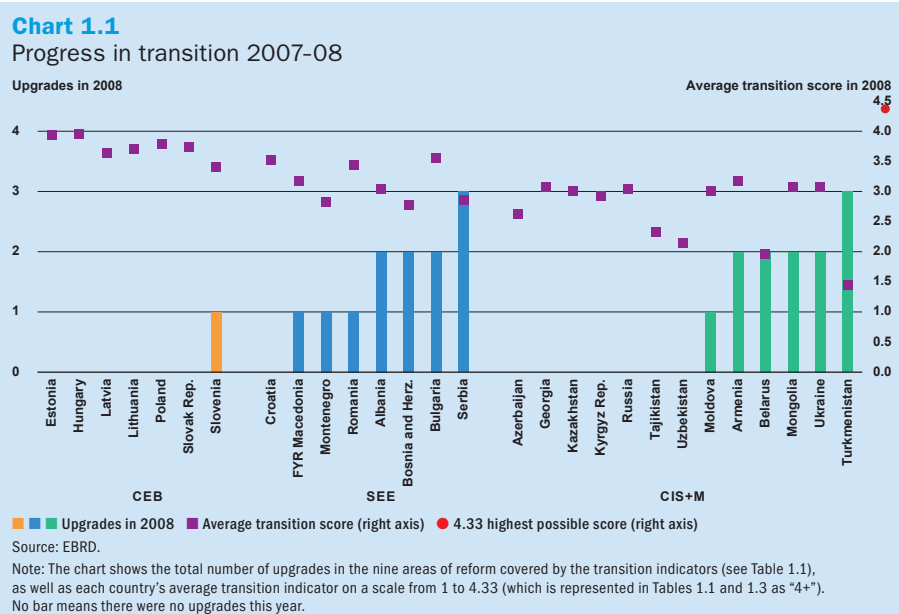
The more advanced the stage of transition, the more the onus is on market players rather than the state to move transition forward. The legacy of communism has left even the most advanced countries in the region with further work to do.

EBRD transition indicators

Each year the *Transition Report* provides a set of numerical scores, or transition indicators, that show where countries stand on the transition path. The scores for each indicator range from 1 to 4+, where 1 indicates little or no progress in transition and 4+ represents standards equivalent to those of a hypothetical advanced market economy. They reflect the assessments of EBRD economists, based on a set of objective criteria (see the methodological notes starting on page 204). The scores provide a guide as to how far a country has come in transition, allowing a comparison with neighbouring states and highlighting those areas where further effort is needed to bring standards up to the most advanced level. Also, recent research has established an important causal link between these scores and growth (see Box 1.1).

Table 1.1 on page 4 presents the scores for each of nine indicators, as well as an estimate of population and the private sector share of GDP. One of the indicators – for infrastructure development – has five subcomponents, and these are listed in Table 1.3 (see page 6). Twenty-three transition indicators have been upgraded this year, including two “double” upgrades, as indicated by an upward-pointing arrow(s) in Table 1.1. The justifications for the changes in transition indicators in each case are given in Table 1.2 on page 5. Table 1.4 on page 6 gives the reasons for changes in infrastructure transition scores. There have been no downgrades this year (see Chart 1.1).

The number of upgrades is higher than in the previous year, suggesting that there has been no slackening in the pace of transition over the past year. Some upgrades reflect a cumulative process of reform over several years, rather than a particular event in the past year. The regional variation in upgrades parallels that of recent years, with significant advances in SEE and, to a lesser extent, in the CIS+M, but little discernible progress in CEB.



Some of the most visible progress has occurred in two countries – Belarus and Turkmenistan – where, up to now, reform commitment has been limited or non-existent. After many years of stagnation, Turkmenistan has taken initial steps towards liberalisation by unifying the exchange rate and allowing partial foreign ownership of land. In Belarus the authorities have abolished the “golden share” rule that had allowed the government to take over the running of privatised enterprises. They have also implemented some privatisations. However, authoritarianism and the influence of the state remain pervasive in both countries.

At the sectoral level, there has been notable progress over the year in financial services. During the present decade, the level of financial intermediation has been transformed. The change has been particularly apparent in SEE, where foreign banks are competing vigorously to gain market share. Non-bank financial institutions have been slower to develop, although considerable progress has been recorded recently in Bulgaria and Romania. In Bulgaria there has been significant development of the insurance and leasing sectors, while in Romania pension reform has involved the introduction of privately managed pension funds.

Among the infrastructure subcomponents (see Table 1.3), the main advances have been in the telecommunications sector, which has attracted substantial foreign investment in recent years. However, the quality of regulation in this sector varies considerably (see Annex 1.2).

There has been a relative absence of transition indicator upgrades in CEB in recent years, the reason for which, according to many commentators, lies in a “reform fatigue” that set in after EU accession in May 2004. Yet all of these countries are at an advanced stage of transition and, in some respects, match the average standards in terms of institutional reforms of the EU-15 (the 15 member states prior to the 2004 expansion). Some second- and third-stage reforms are still needed in all cases. Further progress in the areas of corporate governance, competition policy, commercialisation of infrastructure and the development of non-bank financial services can be expected in the coming years, but meeting the requirements for more upgrades to the 4+ level will be burdensome. Governments in CEB are also engaged in other reforms – to the education and health, public administration, environmental and legal sectors – that are not reflected in the transition indicators.

Within SEE, Bosnia and Herzegovina, Montenegro and Serbia received six upgrades between them. This reflects the relatively low position of these countries on the transition ladder and the late starting point, rather than any strong reform push in the past

Table 1.1
Transition indicator scores, 2008

Country	Population mid-2008 (million)	Private sector share of GDP mid-2008 (EBRD estimate in per cent)	Enterprises			Markets and trade			Financial institutions		Infrastructure
			Large-scale privatisation	Small-scale privatisation	Governance and enterprise restructuring	Price liberalisation	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalisation	Securities markets and non-bank financial institutions	Overall 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+ ↑	3– ↑
Azerbaijan	8.4	75	2	4–	2	4	4	2	2+	2–	2
Belarus	9.7	30 ↑	2– ↑	2+	2– ↑	3–	2+	2	2	1	1
Bosnia and Herzegovina	3.8	60	3	3	2	4	4 ↑	2	3 ↑	2–	2+
Bulgaria	7.6	75	4	4	3–	4+	4+	3 ↑	4–	3 ↑	3
Croatia	4.4	70	3+	4+	3	4	4+	3–	4	3	3
Estonia	1.3	80	4	4+	4–	4+	4+	4–	4	4–	3+
FYR Macedonia	2.0	70 ↑	3+	4	3–	4+	4+	2+	3 ↑	2+	2+
Georgia	4.5	75	4	4	2+	4+	4+	2	3–	2–	2+
Hungary	10.0	80	4	4+	4–	4+	4+	3+	4	4	4–
Kazakhstan	15.7	70	3	4	2	4	4–	2	3	3–	3–
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	65	3	4 ↑	2	4	4+	2+	3	2	2+
Mongolia	2.7	75	3+	4	2	4+	4+	2+	3–	2+ ↑	2+ ↑
Montenegro	0.7	65	3+	4–	2	4	4	2–	3 ↑	2–	2
Poland	38.0	75	3+	4+	4–	4+	4+	3+	4–	4–	3+
Romania	21.7	70	4–	4–	3–	4+	4+	3–	3+	3 ↑	3+
Russia	142.2	65	3	4	2+	4	3+	2+	3–	3	3–
Serbia	9.9	60 ↑	3–	4–	2+	4	4– ↑	2	3 ↑	2	2+ ↑
Slovak Republic	5.4	80	4	4+	4–	4+	4+	3+	4–	3	3
Slovenia	2.0	70	3	4+	3	4	4+	3–	3+	3 ↑	3
Tajikistan	6.8	55	2+	4	2–	4–	3+	2–	2+	1	1
Turkmenistan	6.5	25	1	2+ ↑	1	3–	2 ↑↑	1	1	1	1
Ukraine	46.6	65	3	4	2	4	4+ ↑↑	2+	3	3–	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 204. 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". For example, in the CIS+M, "non-state sector" includes collective farms, as well as companies in which only a minority stake has been privatised. The arrows indicate a change from the previous year. One arrow indicates a movement of one point (from 4 to 4+, for example), two arrows a movement of two points. 1 to 2– is treated as one upgrade. Up arrows indicate upgrades. Population data for Serbia include Kosovo.

Table 1.2
Changes in transition scores

Country	Transition indicator	Change in score	Reason for upgrade
Albania	Large-scale privatisation	3 to 3+	Important advancements in large-scale privatisation, including the sale of an 85 per cent stake in the oil refinery ARMO.
	Banking reform and interest rate liberalisation	3- to 3	Transparency in banking has increased with the establishment of a new Credit Bureau and more effective implementation of the new banking law.
Armenia	Securities markets and non-bank financial institutions	2 to 2+	Cumulative improvements in the regulatory framework for the trading of securities.
Belarus	Large-scale privatisation	1 to 2-	Some important sales of state-owned enterprises have taken place.
	Governance and enterprise restructuring	1 to 2-	Abolition of the "golden share" rule for enterprises.
Bosnia and Herzegovina	Trade and foreign exchange system	4- to 4	Signing of the SAA and accession to the Central European Free Trade Agreement in 2007 indicate sustained commitment to liberal trade.
	Banking reform and interest rate liberalisation	3- to 3	Strong progress in the quality of the banking sector and increasing financial intermediation, particularly in the case of leasing and microfinance companies.
Bulgaria	Competition policy	3- to 3	Sustained enforcement action by the competition authority, and increased financial sanctions for infringement of competition law.
	Securities markets and non-bank financial institutions	3- to 3	Continued development of the insurance and leasing markets over the last year, and introduction of an improved trade platform on the Sofia Stock Exchange.
FYR Macedonia	Banking reform and interest rate liberalisation	3- to 3	Implementation of a new banking law and general improvements in financial practice of the banking sector.
Moldova	Small-scale privatisation	4- to 4	Increase in privatisation of small companies; the state sold a majority or full stake in several small enterprises and land plots.
Mongolia	Securities markets and non-bank financial institutions	2 to 2+	Seven initial public offerings have taken place this year, and the Financial Regulatory Commission, established in 2005, increased its activity.
Montenegro	Banking reform and interest rate liberalisation	3- to 3	Important credit growth, and implementation of sound regulatory measures that may facilitate an orderly slowdown in credit growth.
Romania	Securities markets and non-bank financial institutions	3- to 3	Privately managed compulsory pension funds have started to operate this year.
Serbia	Trade and foreign exchange system	3+ to 4-	The removal of the export ban on wheat and corn and the signing of the SAA indicate sustained commitment to liberal trade.
	Banking reform and interest rate liberalisation	3- to 3	Strong growth in financial intermediation and expansion of financial products within an improved regulatory framework.
Slovenia	Securities markets and non-bank financial institutions	3- to 3	Strengthening of the non-bank sector through the emergence and development of insurance and pension funds.
Turkmenistan	Small-scale privatisation	2 to 2+	Developments in land policy, including allowing partial foreign ownership of land.
	Trade and foreign exchange system	1 to 2	Unification of the exchange rate in May 2008.
Ukraine	Trade and foreign exchange system	4- to 4+	World Trade Organization accession in May 2008.

Source: EBRD.

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

Table 1.3
Infrastructure transition scores, 2008

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

Source: EBRD.

Note: The arrows indicate a change from the previous year. One arrow indicates a movement of one point (from 4 to 4+, for example). Up arrows indicate upgrades. Past scores for the following have been revised this year: the electric power indicator for Ukraine was upgraded to 3– from 2000 and to 3 from 2001;

the roads indicator for Bosnia and Herzegovina was upgraded to 2+ from 2005, resulting in an upgrade of the overall infrastructure indicator to 2+.

Table 1.4
Changes in infrastructure transition scores

Country	Transition indicator	Change in score	Reason for upgrade
Armenia	Railways	2 to 2+	Increased liberalisation with a concession by the Armenian Railways to a foreign strategic sponsor.
	Telecommunications	3– to 3	Following a decrease of cross-subsidies and strengthening of independent regulation, the government auctioned off its third large GSM mobile licence.
Croatia	Telecommunications	4– to 4	Since last year stronger competition has led to more price reductions and a larger choice of tariff packages for customers, and the main Croatian operator was further privatised.
Latvia	Telecommunications	3 to 3+	Prices dropped in spite of inflation, broadband competition has risen rapidly, and the government has agreed to a share swap with a Nordic firm for the majority of shares in the Latvian mobile telephone company.
Lithuania	Railways	2+ to 3–	Institutional reforms with regards to the establishment of the railway regulator and corporatisation of core railway businesses in 2006.
Mongolia	Telecommunications	3– to 3	Progress in commercialisation and regulations in the mobile market; the number of operators has increased from one to four, and all are private companies.
Russia	Electric power	3 to 3+	Abolition of the state-owned monopoly Unified Electricity System, and sector-wide privatisation of the state's stake in the unbundled generators (OGKs and TGKs).
	Telecommunications	3 to 3+	The Russian telecommunications sector has full (100 per cent) mobile penetration rates and has seen progress in commercialisation and regulation.
	Water and wastewater	2+ to 3–	Increased private sector participation; three Russian companies now operate over 30 municipal utilities.
Serbia	Telecommunications	2+ to 3–	Efforts in commercialisation have been sustained over the last three years and made way for more effective implementation of commercial regulation.
Slovenia	Telecommunications	3 to 3+	Increasing competition and private sector participation in the mobile network.
Tajikistan	Water and wastewater	1 to 2–	Corporatisation of a water company in Khujand, and good progress in tariff increases and participation of consumer groups in policy-making. Water utilities in other cities have mostly been corporatised.
Turkmenistan	Telecommunications	1 to 2–	For the first time the government sold a mobile licence to a private company (Russian MTS) in March 2008.

Source: EBRD.

Note: See Table 1.3 for infrastructure scores for all transition countries.

year. However, the signing by all three countries of Stabilisation and Association Agreements (SAAs) with the European Union is a positive signal of their commitment to further EU integration. Bulgaria and Romania have meanwhile been criticised by the European Commission for shortcomings in countering high-level corruption and (in the case of Bulgaria) organised crime, but reforms continue in both countries.

The CIS+M record over the past year is a mixed one. Several of the laggard countries have recently made some progress, but the failure of the more advanced reformers in the region to commit to further policy changes is worrying in terms of their longer-term prospects. Russia has advanced in several areas of infrastructure development, but state control over key enterprises and sectors has been maintained or even strengthened. In Ukraine the privatisation programme has been effectively stalled over the past year, while in Kazakhstan the state has increased its stake in the all-important mining sector.

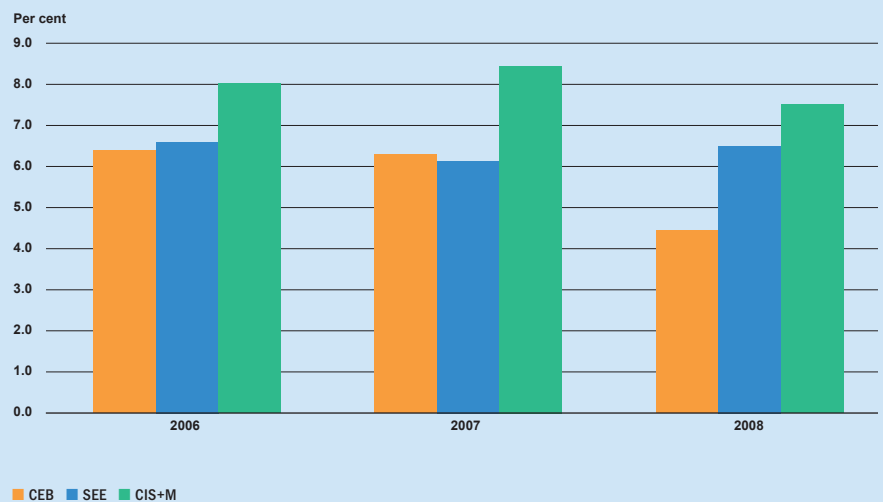
Macroeconomic developments

In 2007 the region's real GDP rose by 7.5 per cent, the highest growth rate since transition began, and continued to grow strongly in the first half of 2008. However, signs of a slowdown became clear in most parts of the region in the third quarter, and the international financial turmoil hit several countries with full force in October 2008.

Regional growth

Chart 1.2 shows the real growth rate by region for 2006 and 2007 and the forecast for 2008. CEB is set to record the biggest fall in growth in 2008, with the most visible slowdown occurring in the Baltic states. Estonia and Latvia in particular have experienced a significant loss of confidence associated with tighter lending conditions and a sharp drop in house prices. The Estonian economy has contracted in the first half of the year, while Latvia's GDP growth over the same period is only marginally positive. The Lithuanian economy, which has not been exposed to high current account deficits to the same extent, has weathered the regional downturn rather better, although its growth rate in the first half of the year is also down significantly compared to the same period in 2007. Elsewhere in

Chart 1.2
GDP growth, by region



CEB, growth in the Hungarian economy remained slow, after a painful fiscal adjustment in 2006, and is expected to slow even more as a result of tighter external financing and further fiscal consolidation. Other countries continue to perform robustly, mainly due to strong domestic demand.

Within SEE, preliminary data for Bulgaria show that GDP growth accelerated to more than 7 per cent year-on-year in the first half of 2008 from 6.2 per cent in 2007. Romania grew even more strongly, at nearly 9 per cent in the first half of 2008. While export growth was a key driver in both countries, consumption and especially investment also continued to expand. However, both countries recorded negative (year-on-year) industrial production growth in August 2008. Montenegro recorded the highest growth in SEE in 2007 at 10.3 per cent, while Serbia also grew strongly at 7.5 per cent in 2007, increasing to more than 8 per cent in the first quarter of 2008. In Serbia, a consumption boom fuelled inflation and a current account deficit (by mid-2008) of around 17 per cent of GDP. However, exports also increased quite rapidly (although from a low base) despite a strong real appreciation of the currency. The remaining countries in SEE have up to now maintained robust growth rates.

The CIS+M has for several years been the strongest performer in growth terms, although from the lowest base. The average weighted growth of 8.4 per cent

in 2007 was the highest since 2000. The growth rate in 2008 is likely to be at least 1 percentage point lower than in 2007. Signs of an economic slowdown this year were initially most apparent in Kazakhstan, where the effects of the international liquidity crunch have been especially pronounced in the non-hydrocarbon sector. In contrast, the Russian economy continued to power ahead in the first half of the year, supported by record oil prices. Since then, a combination of the August conflict with Georgia, a sharp fall in oil and metals prices and the deepening international financial crisis has triggered capital flight and a sharp reduction in portfolio inflows. Some sectors, notably construction, are already slowing down. Growth in Ukraine is undergoing an even shorter turnaround, and severe pressures on the currency (hryvnia) led the country to turn to the International Monetary Fund (IMF) for support in October.

Elsewhere in the CIS+M, a major concern is how both the August conflict between Georgia and Russia, and much slower growth in Russia and Ukraine, will affect short- and medium-term prospects for the region. For Georgia, the main risks lie in a probable sharp drop in FDI, which has to date been financing the large current account deficit, and in possible adverse effects on the banking sector through the withdrawal of deposits and an increase in bad loans. Real GDP growth in 2008 is still likely to be positive, but risks to growth and FDI financing in 2009 are high. The economic

Chart 1.3
Regional inflation, 1998-June 2008

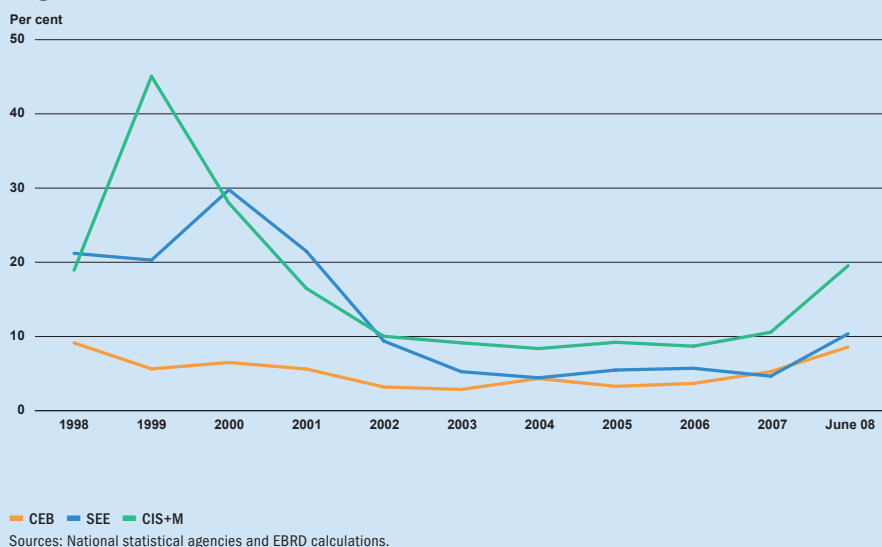


Chart 1.4
Inflation in selected countries by subcomponents
Average inflation in 2008 (H1), year-on-year

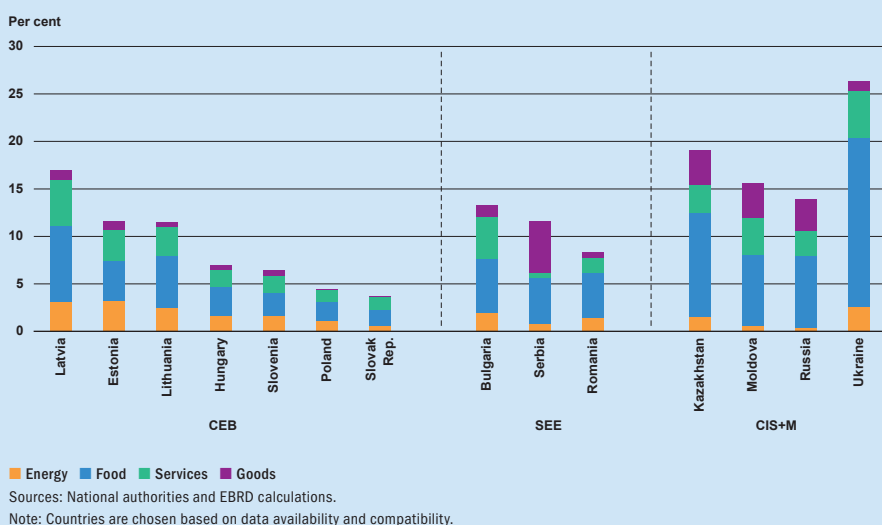
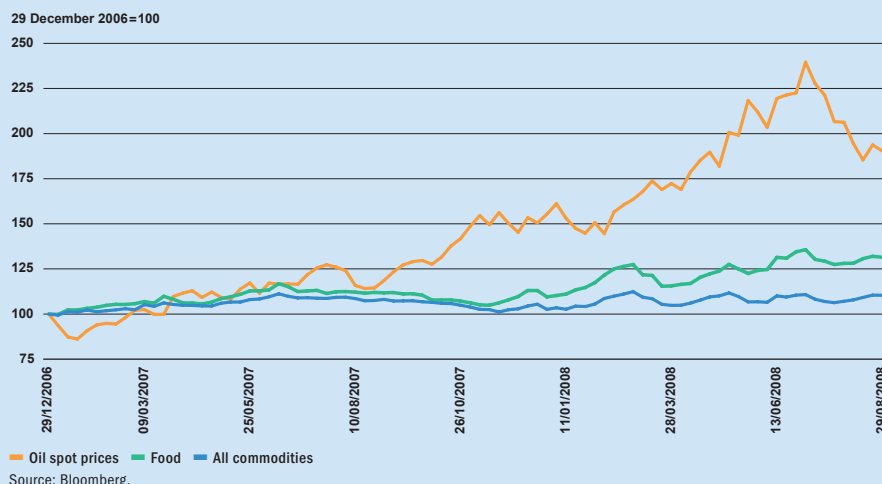


Chart 1.5
Global commodity prices, December 2006-August 2008



Note: Global commodity price indices (29 December 2006 = 100). The index for "all commodities" is based on the Jefferies CRB Index, which measures broad diversification for 19 commodities representing all commodity sectors – energies, base metals, precious metals, livestock, grains and soft commodities such as cocoa, coffee and sugar.

impact on the rest of the subregion has been limited so far, but the destruction of a railway bridge in the Georgian town of Kaspi and the temporary Russian occupation of the port of Poti have had a negative effect on exports from Armenia and Azerbaijan.

Rising inflation and policy responses

Over the past year, inflation has once again become a threat to macroeconomic stability and sustainable growth, reversing the trend of previous years. Chart 1.3 illustrates the inflation reversals since mid-2007 in the three subregions. A number of factors have contributed to lower inflation during the past decade, including: strong productivity growth and high rates of investment; globalisation resulting in lower import prices; an abundant labour supply that has reduced wage pressures; and sound macroeconomic policies. However, after several years of buoyant output levels, spurred in most countries by high capital inflows and rapid credit growth, capacity constraints have become increasingly evident. Moreover, significant commodity price increases have been recorded since mid-2007, particularly for energy and food products.

The country-specific inflation charts (from page 91) show that inflation rose to double-digit levels in 19 countries in the first half of 2008, compared with only five countries in June 2007. In mid-2008 it was particularly high in several Central Asian countries, typically reaching between 20 and 30 per cent, and was also high in Ukraine (approaching 30 per cent), Belarus, Bulgaria, Latvia, Moldova, Russia and Serbia (all at double-digit levels and averaging around 15 per cent). In general, countries with fixed exchange rates experienced a larger increase in inflation, while those with flexible exchange rates and inflation-targeting monetary policy frameworks have fared better. Various factors accounted for this sharp rise in inflation, particularly higher food and energy prices, tighter labour markets, and monetary and fiscal policies.

Food and energy prices

Chart 1.4 provides a breakdown of inflation by subcomponents (energy, food, services and goods) for selected transition countries since mid-2007. The impact of food price rises (which in some cases are partly driven by excise tax increases) is particularly evident.

The weight of food in the consumer price index (CPI) is higher in the transition economies than in more developed countries, given that income levels are lower. The weight of food in CEB is around 20 per cent on average, while in most CIS+M countries it is between 40 and 60 per cent. In contrast, price increases of (non-energy) industrial goods have generally been subdued due to international competition.

Chart 1.5 places the rise in food and energy prices in the context of overall commodity price increases since the end of 2007. Strong demand in emerging and developing countries has been the main impetus behind price increases of commodities. Due to limited spare oil-producing capacity and the negative effects of adverse weather in 2007 on agricultural production in many parts of the world (including in SEE), the global levels of commodity and oil prices almost reached record levels during 2008, although they started to decline later in the year. The expanding use of biofuels has also affected the supply of food products, while the introduction of measures to restrain trade by a number of countries (including Kazakhstan, Russia and Ukraine) in order to contain domestic prices has affected food supplies and prices elsewhere. Moreover, rising labour costs in most countries have affected the prices of processed foods for consumers significantly.

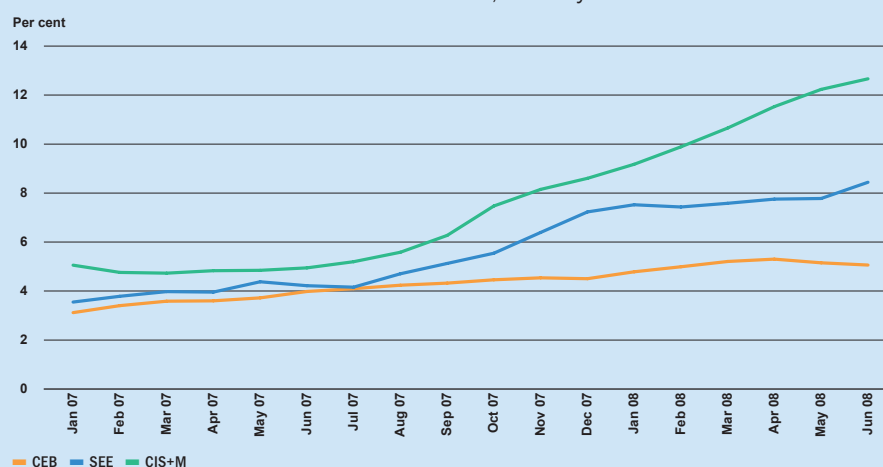
Core inflation and labour market constraints

Many central banks in the region focus less on the overall inflation rate and more on “core” or “underlying” inflation. This excludes volatile subcomponents of the CPI, such as seasonal or unprocessed food and energy, and administrative influences, such as changes in indirect taxes, which normally have only a temporary effect on inflation. Core inflation takes account of underlying pressures which necessitate counterbalancing policy measures. A pattern of rising underlying inflation has been apparent in many transition countries since the end of 2006, well before the rise in commodity prices from mid-2007 (see Chart 1.6). This suggests that the rise in inflation is not solely attributable to the direct effect of rising food and oil prices.

A key explanation for the rise in core inflation lies in capacity constraints in the region's labour markets. Employment has expanded rapidly in recent years and

Chart 1.6

Core inflation in selected transition countries, January 2007–June 2008

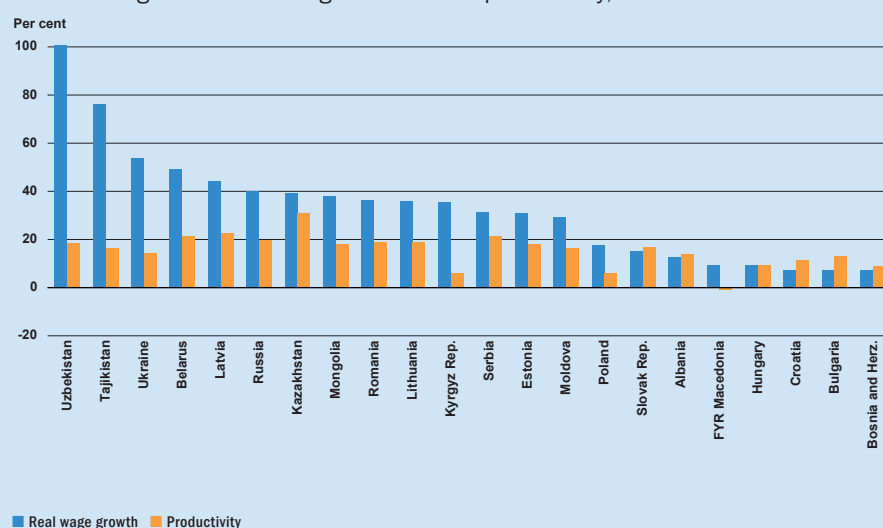


Sources: National statistical agencies and EBRD calculations.

Note: For CEB, Bulgaria and Romania, the chart shows the simple average of the harmonised index of consumer prices (HICP) inflation, excluding energy, unprocessed food, alcohol and tobacco. SEE includes Bulgaria, Croatia, Romania and Serbia. In the CIS+M, the simple average of core inflation in Russia and Ukraine as measured by national authorities is shown.

Chart 1.7

Cumulative growth of real wages and labour productivity, 2005–07



Sources: National authorities and EBRD calculations.

unemployment rates have fallen to historically low levels. In all but six transition countries, the unemployment rate in 2007 had fallen below 10 per cent, while in eight countries it was below 5 per cent. Strong demand for labour accounts for most of these developments, although demographic factors and migration have also played an important role; substantial labour emigration has been recorded in recent years in Bulgaria, Latvia, Lithuania, Moldova, Poland, Romania and the Caucasus region.

Tightening labour market conditions have led to greater wage pressures throughout the transition region. In most countries annual real wage growth has risen well above 10 per cent without corresponding labour productivity gains. In fact, a

significant gap has opened up since 2005 between real wage and labour productivity growth in most countries (see Chart 1.7). In sectors experiencing rapid growth but an insufficient supply of labour, such as construction and financial services, wage growth has been very marked. This in turn has resulted in rising unit labour costs which, combined with the effects of other rising costs of production, have put significant pressure on firms' profit margins and ultimately on prices, particularly in sectors with low competition. Although export growth held up relatively well until early 2008 in the transition region, sustained high inflation would eventually erode price competitiveness, in turn putting pressure on exchange rates.

Table 1.5

De facto exchange rate regimes and inflation rates

	Fixed exchange rate		Managed float or peg exchange rate		Floating exchange rate	
CEB	Estonia	11.4			Czech Republic	6.9
	Latvia	17.7			Hungary	6.7
	Lithuania	12.5			Poland	4.8
	Slovenia	5.0			Slovak Republic	3.6
SEE	Bulgaria	15.3	Croatia	7.6	Albania	4.0
	<i>Bosnia and Herzegovina</i>	11.4			Romania	8.6
	FYR Macedonia	8.7			Serbia	13.5
	Montenegro	13.8				
CIS+M	<i>Turkmenistan</i>	15.9	Azerbaijan	25.4	Armenia	9.7
			Belarus	16.0	Georgia	11.4
			Kazakhstan	20.0		
			Kyrgyz Republic	32.2		
			Moldova	15.7		
			Mongolia	26.2		
			Russia	15.1		
			Tajikistan	25.3		
			Ukraine	29.3		
			Uzbekistan	12.0		

Source: EBRD.

Note: Exchange rate regimes in 2007. Inflation rate refers to June 2008. In italicised countries, food accounts for more than 40 per cent of the consumer price index. Slovenia, which joined the eurozone in 2007, and Montenegro, which unilaterally adopted the euro in 2002, are treated here as having fixed exchange rates.

Domestic monetary and fiscal policies

Domestic economic policies have also been important factors in recent inflationary developments and differences across transition countries. As previously mentioned, countries with inflation-targeting strategies and flexible exchange rates have generally fared better in containing inflationary pressures than those with fixed or managed rates (see Table 1.5). This is partly because independent, inflation-targeting central banks, supported by well-defined institutional frameworks, have been able to react to rising inflationary pressures by increasing short-term nominal (and real) interest rates. Many transition countries consequently experienced a substantial appreciation of their exchange rates, which in turn helped contain imported inflation. In countries with fixed exchange rate regimes, however, opportunities for raising interest rates, and the effects that such a move would have, are more limited. As a result, real interest rates (that is, nominal rates adjusted for inflation) have fallen, leading to further upward pressures on credit growth, domestic demand and inflation.

Empirically, there is mixed evidence as to whether a fixed or flexible exchange rate system is more effective in the long term in containing inflation. The choice of monetary policy framework is largely governed by the sophistication of financial markets, openness to trade and structure of the economy. Smaller, open economies

often opt for a policy framework with fixed exchange rates in order to support trade and reduce financial disturbances. In the shorter term, fiscal policy measures are more important in containing inflation and stabilising the economy in countries with fixed exchange rates.

The fiscal response to rising inflation has generally been inadequate and often procyclical (that is, aligned with the overall economic cycle). In 2006 and 2007 fiscal balances have on average been in surplus in countries with fixed exchange rates, but mostly in deficit in countries with floating exchange rates. The slow fiscal response partly reflects the belief that the rise in inflation would be temporary and would not affect wage expectations. Also, the start of the credit turmoil in mid-2007 complicated policy action in many transition countries as it was widely viewed as deflationary. Growth, however, remained surprisingly resilient while inflation expectations continued to rise. Moreover, political pressures and an inability to rein in expenditure have played an important role in several cases, while the large externally financed public investment programme played an important role in Tajikistan in 2007.

Chart 1.8 shows the change in fiscal balance between 2006 and 2007. While some countries (such as Hungary) have made progress in implementing fiscal discipline and some (Poland and the Slovak Republic) have managed to

contain expenditures, a majority of countries have seen a drop in their fiscal balances, adding to inflationary pressures.

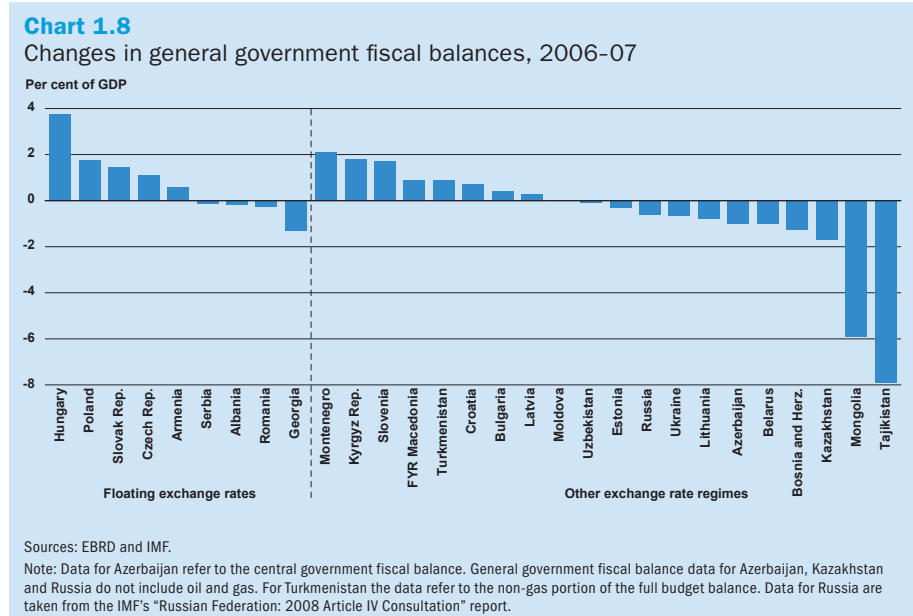
Outlook

After years of buoyant growth and progress in reform, the region now faces a more uncertain future than at any time since the Russian crisis in 1998. The growing integration of the region into the global economy has brought great benefits, but has also increased the exposure to world downturns and recessions. In addition, home-grown imbalances have risen sharply in many countries, implying a need for adjustment and a period of slower growth. As the global financial system experiences an unprecedented period of turbulence, output in the world's most advanced countries and regions (the eurozone, Japan, the United Kingdom and the United States) is expected to remain flat or to fall during the rest of 2008 and 2009. These developments will also affect average growth in the transition region, which, as of late October 2008, the EBRD expects to fall to 6.3 per cent in 2008 and 3.5 per cent in 2009 in the main scenario. These EBRD forecasts for 2009 are generally below those of other institutions (see Tables A.1.1.8 and A.1.1.9), all of which were produced earlier, and in some cases before the dramatic global events of September and October.

The slowdown in 2008 is expected to be the strongest in CEB (Estonia, Latvia and Lithuania in particular). However, annual real GDP growth this year is projected to hold up well in SEE, and even to accelerate in Romania, the largest SEE economy. In 2009 growth is projected to slow further in all three subregions in response to falling world demand, tight credit conditions and, for commodity exporting countries, lower commodity prices. Inflation is expected to rise in 2008 to 12.0 per cent on average across the transition region as a whole, before slowing to 8.4 per cent in 2009 (around 13.0 per cent in the CIS+M and around 5 per cent in SEE and CEB).

The risks of a more severe slowdown are much higher than they were a year ago, in light of the expansion of the global financial turmoil to emerging markets in October 2008 and continued large external imbalances in many countries. In a negative scenario, the effects of the protracted global financial crisis would be highly significant (the effects of tightening liquidity on the region are examined in greater detail in Chapter 2). In particular, some countries continue to run excessive current account deficits combined with high foreign currency debt and are therefore prone to significant output reductions if capital inflows fall off rapidly. While economic activity has remained surprisingly resilient in the past year in most transition countries, the slowdown in the Baltic states and the balance of payments pressures experienced by some countries recently, illustrate the vulnerability of many countries to tighter external financing, lower consumer confidence and declining asset prices. These risks are further enhanced by recessions that are under way or expected in many advanced countries and the associated deterioration in the outlook for exports.

There are several factors that mitigate both the risks that this negative scenario will occur and its consequences if it should do so. First, government debt levels have been falling continuously since 2000 from over 55 per cent of GDP to around 27 per cent in 2007 on average for the region as a whole. Second, business conditions have generally improved in recent years and labour markets are relatively flexible, which will allow for a faster adjustment and recovery to potential growth. Third, regional trade has been expanding rapidly in recent years, somewhat



reducing the vulnerability of economies to a slowdown in more advanced regions. The composition of exports in the transition region, dominated by lower value-added goods and commodities, may also be less sensitive in the context of a global slowdown in growth. Finally, for EU member and candidate (or potential candidate) countries, access to EU structural and pre-accession funds will be supportive of investment in the coming years.

As regards inflation, there are signs of a moderation of inflationary pressures. Commodity prices have recently declined sharply and may ease further as supply responses to earlier increases gain momentum, particularly in the food and metals sectors and as the world economy slows further. Favourable weather conditions are reportedly resulting in better harvests, just as global demand is easing, and the price of crude oil is expected to be much lower in 2009 than in 2008, although it could remain volatile. Core inflation will be more challenging to reduce, particularly in countries with fixed exchange rates. Reducing high wage growth and managing the public's inflation expectations, as well as avoiding second-round effects on wages, are top priorities for economic policy-makers. While capacity constraints should ease as growth slows, labour market tightness may remain a challenge in the medium term as demographic factors and emigration weigh on labour supply in the region. In the short term, a cyclical slowdown in the growth of labour productivity would also imply continued

upward pressures on companies' production costs. Failing to reduce the high wage growth in many countries to better reflect productivity growth implies further downside risks.

Most countries in the transition region still face fundamental reform challenges. The overall business environment, although improving, remains a hindrance for many enterprises, as highlighted by the World Bank *Doing Business 2009* report, which assigns a low ranking to many countries in the region. Prevailing labour market conditions have led to rising unit labour costs and point to the need for greater labour market mobility and increased labour force participation. Better standards of education are also essential (see Chapter 3). In addition, the institutional objectives and framework for monetary and fiscal policy may need to be reviewed in many countries and strengthened to support sustainable growth and low inflation.

Endnotes

- 1 See EBRD (2004) for a summary of these findings and Falcetti et al (2006) for more details on the methodological issues and econometric results.
- 2 Detailed results on the 2008 research are available on request from the EBRD.

References

- EBRD (2004), *Transition Report 2004*, pp. 3–16.
- E. Falcetti, T. Lysenko and P. Sanfey (2006), "Reforms and growth in transition: re-examining the evidence", *Journal of Comparative Economics*, Vol. 34, pp. 421–45.

Annex 1.1

Macroeconomic performance tables

The tables in this annex provide the most up-to-date information available at the time of publication. The cut-off date was mid-October 2008. There is still considerable variation in data quality across countries, and between different economic indicators. The data are based on a wide variety of sources, including national authorities, other international organisations and EBRD staff estimates. Data for 2008 are projections.

Table A.1.1.1	Growth in real GDP
Table A.1.1.2	GDP growth by components in selected countries
Table A.1.1.3	Inflation
Table A.1.1.4	General government balances
Table A.1.1.5	General government expenditure
Table A.1.1.6	Current account balances
Table A.1.1.7	Foreign direct investment
Table A.1.1.8	GDP growth forecasts for 2008
Table A.1.1.9	GDP growth forecasts for 2009
Table A.1.1.10	Average annual inflation forecasts for 2008
Table A.1.1.11	Average annual inflation forecasts for 2009

Table A.1.1.1

Growth in real GDP (in per cent)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Estimated level of real GDP in 2007
												Estimate	Projection	
Central eastern Europe and the Baltic states														(1989=100)
Czech Republic	4.2	-0.7	-0.8	1.3	3.6	2.5	1.9	3.6	4.5	6.3	6.8	6.6	4.1	139
Estonia	5.0	10.8	5.4	-0.1	9.6	7.7	7.8	7.1	7.5	9.2	10.4	6.3	-1.0	150
Hungary	1.3	4.6	4.8	4.2	5.2	4.1	4.1	4.2	4.8	4.0	4.1	1.1	1.7	135
Latvia	3.9	8.4	4.7	3.3	6.9	8.0	6.5	7.2	8.7	10.6	12.2	10.3	0.4	124
Lithuania	5.1	8.5	7.5	-1.5	4.1	6.6	6.9	10.3	7.3	7.9	7.7	8.8	3.9	116
Poland	6.2	7.1	5.0	4.5	4.3	1.2	1.4	3.9	5.3	3.6	6.2	6.6	5.3	169
Slovak Republic	6.1	4.6	4.2	1.5	2.0	3.4	4.8	4.8	5.2	6.6	8.5	10.4	7.3	154
Slovenia	3.7	4.8	3.9	5.4	4.1	3.1	4.0	2.8	4.3	4.3	5.9	6.8	4.3	151
<i>Average¹</i>	4.9	5.1	3.9	3.5	4.3	2.5	2.6	4.2	5.2	4.9	6.4	6.3	4.3	151
South-eastern Europe														
SEE-3														
Bulgaria	-9.4	-5.6	4.0	2.3	5.4	4.1	4.5	5.0	6.6	6.2	6.3	6.2	6.0	107
Croatia	5.9	6.8	2.5	-0.9	2.9	4.4	5.6	5.3	4.3	4.3	4.8	5.6	3.8	111
Romania	3.9	-6.1	-4.8	-1.1	2.1	5.7	5.1	5.2	8.5	4.2	7.9	6.0	7.5	120
SEE-5														
Albania	9.1	-10.9	8.6	13.2	6.5	7.1	4.2	5.8	5.7	5.7	5.5	6.0	6.1	152
Bosnia and Herzegovina	86.0	37.0	15.6	9.6	5.5	4.3	5.5	3.0	6.3	3.9	6.7	6.8	6.0	79
FYR Macedonia	1.2	1.4	3.4	4.3	4.5	-4.5	0.9	2.8	4.1	4.1	3.7	5.1	5.3	96
Montenegro	13.9	4.2	4.0	-6.7	3.1	1.1	1.9	2.5	4.4	4.2	8.6	10.3	7.0	85
Serbia	7.8	10.1	1.9	-18.0	5.2	5.1	4.5	2.4	9.3	6.3	5.5	7.5	7.0	68
<i>Average¹</i>	2.1	1.3	0.6	-2.2	3.7	4.7	4.9	4.6	7.1	4.8	6.6	6.2	6.5	111
Commonwealth of Independent States and Mongolia														
Russia	-3.6	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.1	6.4	7.4	8.1	7.3	102
Western CIS and the Caucasus														
Armenia	5.9	3.3	7.3	3.3	5.9	9.6	13.2	13.9	10.1	14.0	13.2	13.8	10.0	143
Azerbaijan	0.8	6.0	10.0	11.0	11.1	9.9	10.6	11.2	10.2	24.3	30.5	23.4	20.0	160
Belarus	2.8	11.4	8.4	3.3	5.8	4.7	5.0	7.0	11.4	9.4	9.9	8.2	9.0	146
Georgia	10.5	10.6	2.9	3.0	1.9	4.7	5.5	11.1	5.9	9.6	9.4	12.4	2.0	60
Moldova	-5.9	1.6	-6.5	-3.4	2.1	6.1	7.8	6.6	7.4	7.5	4.8	3.0	6.0	51
Ukraine	-10.0	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.6	12.1	2.7	7.3	7.6	6.0	68
Central Asia														
Kazakhstan	0.5	1.7	-1.9	2.7	9.8	13.5	9.8	9.3	9.6	9.7	10.7	8.9	4.3	136
Kyrgyz Republic	7.1	9.9	2.1	3.7	5.4	5.3	0.0	7.0	7.0	-0.2	3.1	8.2	6.5	95
Mongolia	2.4	4.0	3.5	3.2	1.1	1.0	4.0	5.9	10.1	7.3	8.6	9.9	8.6	153
Tajikistan	-4.4	1.7	5.3	3.7	8.3	10.2	9.1	10.2	10.6	6.7	7.0	7.8	5.0	56
Turkmenistan	-6.7	-11.3	6.7	16.5	18.6	20.4	15.8	17.1	14.7	13.0	11.4	11.6	12.0	204
Uzbekistan	1.6	2.5	4.3	4.3	3.8	4.1	4.0	4.2	7.7	7.0	7.3	9.5	8.0	150
<i>Average¹</i>	-3.5	1.4	-3.9	5.3	9.1	6.1	5.3	7.8	8.0	6.7	8.0	8.5	7.3	102
All transition countries														
<i>Average¹</i>	0.2	2.7	-0.8	3.6	6.1	4.4	4.1	5.9	6.7	5.8	7.3	7.5	6.3	113

Note: Data for 1996-2006 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 2007 are preliminary actuals, mostly official government estimates. Data for 2008 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.1.1.2

GDP growth by components in selected countries (real change, in per cent)

	2004	2005	2006	2007		2004	2005	2006	2007
				<i>Estimate</i>					<i>Estimate</i>
Bulgaria					Lithuania				
Real GDP growth	6.6	6.2	6.3	6.2	Real GDP growth	7.3	7.9	7.7	8.8
Private consumption	5.3	5.5	8.5	5.1	Private consumption	12.2	12.1	11.8	11.5
Public consumption	6.8	4.1	-2.5	3.4	Public consumption	7.7	3.6	5.5	3.8
Gross fixed capital formation	13.5	23.3	14.7	21.7	Gross fixed capital formation	15.5	10.9	17.4	15.8
Exports of goods and services	12.7	8.5	8.7	5.2	Exports of goods and services	4.4	17.7	12.2	4.7
Imports of goods and services	14.5	13.1	14.0	9.9	Imports of goods and services	14.9	17.2	13.8	9.1
Croatia					Poland				
Real GDP growth	4.3	4.3	4.8	5.6	Real GDP growth	5.3	3.6	6.2	6.6
Private consumption	4.8	3.4	3.5	6.2	Private consumption	4.7	2.1	5.0	5.0
Public consumption	-0.3	0.8	2.2	3.4	Public consumption	3.1	5.2	6.1	5.8
Gross fixed capital formation	5.0	4.8	10.9	6.5	Gross fixed capital formation	6.4	6.5	14.9	17.6
Exports of goods and services	5.7	4.6	6.9	5.7	Exports of goods and services	14.0	8.0	14.6	8.4
Imports of goods and services	4.6	3.5	7.3	5.8	Imports of goods and services	15.8	4.7	17.3	12.2
Czech Republic					Romania				
Real GDP growth	4.5	6.3	6.8	6.6	Real GDP growth	8.5	4.2	7.9	6.0
Private consumption	2.9	2.5	5.4	5.9	Private consumption	14.6	9.9	12.4	11.0
Public consumption	-3.5	2.9	-0.7	0.5	Public consumption	-4.9	8.5	-3.1	5.6
Gross fixed capital formation	3.9	1.8	6.5	5.8	Gross fixed capital formation	11.1	12.7	19.3	28.9
Exports of goods and services	20.7	11.6	15.8	14.6	Exports of goods and services	13.9	7.7	10.6	8.8
Imports of goods and services	17.9	5.0	14.2	13.8	Imports of goods and services	22.1	16.0	22.4	26.1
Estonia					Russia				
Real GDP growth	7.5	9.2	10.4	6.3	Real GDP growth	7.1	6.4	7.4	8.1
Private consumption	6.7	10.6	15.1	8.9	Private consumption	12.1	11.8	11.2	12.8
Public consumption	3.0	1.6	2.6	4.8	Public consumption	2.1	1.3	2.5	5.0
Gross fixed capital formation	4.4	9.9	22.4	7.8	Gross fixed capital formation	12.6	10.6	17.7	20.8
Exports of goods and services	16.6	20.5	8.3	1.5	Exports of goods and services	11.8	6.5	7.3	6.4
Imports of goods and services	15.5	16.3	17.1	2.8	Imports of goods and services	23.3	16.6	21.9	27.3
Hungary					Slovak Republic				
Real GDP growth	4.8	4.0	4.1	1.1	Real GDP growth	5.2	6.6	8.5	10.4
Private consumption	2.5	3.4	1.9	0.7	Private consumption	4.6	6.5	5.6	7.1
Public consumption	1.8	2.4	4.3	-7.4	Public consumption	-2.0	3.5	10.1	0.7
Gross fixed capital formation	7.9	8.5	-6.2	1.5	Gross fixed capital formation	4.8	17.6	8.4	7.9
Exports of goods and services	15.0	11.3	18.6	15.9	Exports of goods and services	7.4	13.9	21.0	16.0
Imports of goods and services	13.7	7.0	14.8	13.1	Imports of goods and services	8.3	16.1	17.7	10.4
Latvia					Slovenia				
Real GDP growth	8.7	10.6	12.2	10.3	Real GDP growth	4.3	4.3	5.9	6.8
Private consumption	9.1	11.3	21.4	14.0	Private consumption	2.7	2.6	2.9	5.0
Public consumption	2.1	2.7	4.9	4.8	Public consumption	3.4	3.3	4.1	2.5
Gross fixed capital formation	23.8	23.6	16.3	8.4	Gross fixed capital formation	5.6	3.8	10.4	11.9
Exports of goods and services	9.4	20.3	6.6	11.1	Exports of goods and services	12.4	10.6	12.5	13.8
Imports of goods and services	16.6	14.8	19.3	15.0	Imports of goods and services	13.3	6.7	12.2	15.7

Note: Data for 2004-06 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 2007 are preliminary actuals, mostly official government estimates.

Table A.1.1.3

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

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007 <i>Estimate</i>	2008 <i>Projection</i>
Central eastern Europe and the Baltic states													
Czech Republic	8.9	8.4	10.6	2.1	3.8	4.7	1.8	0.1	2.8	1.9	2.5	2.8	6.3
Estonia	23.1	11.2	8.1	3.3	4.0	5.8	3.6	1.3	3.0	4.1	4.4	6.6	10.7
Hungary	23.6	18.3	14.3	10.0	9.8	9.2	5.3	4.7	6.8	3.6	3.9	8.0	6.3
Latvia	25.0	17.6	8.4	4.7	2.4	2.5	1.9	2.9	6.2	6.8	6.5	10.1	15.8
Lithuania	24.6	8.9	5.1	0.8	1.0	1.5	0.3	-1.1	1.2	2.7	3.8	5.7	11.1
Poland	19.9	14.9	11.8	7.3	10.1	5.5	1.9	0.8	3.5	2.2	1.2	2.5	4.3
Slovak Republic	5.8	6.1	6.7	10.6	12.0	7.3	3.3	8.5	7.5	2.5	4.5	2.8	4.3
Slovenia	9.9	8.4	8.0	6.2	8.9	8.4	7.5	5.6	3.6	2.5	2.5	3.6	6.1
<i>Median</i> ¹	21.5	10.1	8.3	5.5	6.5	5.7	2.6	2.1	3.6	2.6	3.9	4.7	6.3
<i>Mean</i> ¹	17.6	11.7	9.1	5.6	6.5	5.6	3.2	2.9	4.3	3.3	3.7	5.3	8.1
South-eastern Europe													
SEE-3													
Bulgaria	123.0	1,082.0	22.2	0.7	9.9	7.4	5.9	2.3	6.1	5.0	7.3	8.4	12.4
Croatia	3.5	3.6	5.7	4.0	4.6	3.8	1.7	1.8	2.1	3.3	3.2	2.9	6.5
Romania	38.8	154.8	59.1	45.8	45.7	34.5	22.5	15.4	12.0	9.5	6.9	4.8	7.2
SEE-5													
Albania	12.7	33.2	20.6	0.4	0.1	3.1	5.2	2.4	2.9	2.4	2.4	2.9	4.0
Bosnia and Herzegovina	na	na	-0.3	3.4	5.0	3.2	0.4	0.6	0.4	3.8	6.1	4.9	7.5
FYR Macedonia	2.3	2.6	-0.1	-0.7	5.8	5.5	1.8	1.2	-0.4	0.5	3.2	2.3	8.4
Montenegro	80.2	23.4	32.4	67.6	97.1	22.6	16.0	6.7	2.4	2.3	3.0	4.2	8.0
Serbia	94.3	18.3	30.0	41.1	70.0	91.8	19.5	11.7	10.1	16.5	12.7	6.7	10.5
<i>Median</i> ¹	38.8	23.4	21.4	3.7	7.9	6.5	5.6	2.4	2.7	3.6	4.7	4.5	7.8
<i>Mean</i> ¹	50.7	188.3	21.2	20.3	29.8	21.5	9.1	5.3	4.5	5.4	5.6	4.6	8.1
Commonwealth of Independent States and Mongolia													
Russia	47.8	14.7	27.6	86.1	20.8	21.6	15.7	13.7	10.9	12.7	9.7	9.0	13.0
Western CIS and the Caucasus													
Armenia	18.7	14.0	8.7	0.7	-0.8	3.1	1.1	4.7	7.0	0.6	2.9	4.3	6.5
Azerbaijan	19.7	3.5	-0.8	-8.5	1.8	1.5	2.8	2.2	6.7	9.6	8.3	16.7	19.5
Belarus	52.7	63.9	72.9	293.7	168.6	61.1	42.5	28.4	18.1	10.3	7.0	8.4	15.3
Georgia	39.4	7.1	3.6	19.2	4.1	4.6	5.7	4.9	5.7	8.4	9.2	9.3	9.0
Moldova	23.5	11.8	7.7	39.3	31.1	9.6	5.2	11.6	12.5	12.0	12.8	12.3	13.5
Ukraine	80.0	15.9	10.6	22.7	28.2	12.0	0.8	5.2	9.0	13.5	9.1	12.8	24.8
Central Asia													
Kazakhstan	39.1	17.4	7.1	8.3	13.2	8.4	5.9	6.4	6.9	7.6	8.6	10.8	17.5
Kyrgyz Republic	31.9	23.4	10.5	35.9	18.7	6.9	2.0	3.1	4.1	4.3	5.6	10.2	24.4
Mongolia	46.9	36.6	9.4	7.6	11.6	8.0	0.3	5.1	8.3	12.7	5.1	9.0	29.4
Tajikistan	418.5	88.0	43.2	27.5	32.9	38.6	12.2	16.4	7.2	7.3	10.0	13.2	21.9
Turkmenistan	992.4	83.7	16.8	24.2	8.3	11.6	8.8	5.6	5.9	10.7	8.2	6.3	13.0
Uzbekistan	54.0	70.9	29.0	29.1	25.0	27.3	27.3	11.6	6.6	10.0	14.2	12.3	11.8
<i>Median</i> ¹	46.9	17.4	10.5	24.2	18.7	9.6	5.7	5.6	7.0	10.0	8.6	10.2	15.3
<i>Mean</i> ¹	143.4	34.7	18.9	45.1	28.0	16.5	10.0	9.1	8.4	9.2	8.5	10.4	16.9
All transition countries													
<i>Median</i> ¹	28.5	16.7	10.5	8.3	9.9	7.4	5.2	4.9	6.2	5.0	6.1	6.7	10.7
<i>Mean</i> ¹	84.3	66.5	16.9	27.3	22.5	14.9	7.9	6.3	6.2	6.5	6.4	7.4	12.0

Note: Data for 1996-2006 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 2007 are preliminary actuals, mostly official government estimates. Data for 2008 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.

Table A.1.1.4

General government balances (in per cent of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
												<i>Estimate</i>	<i>Projection</i>
Central eastern Europe and the Baltic states													
Czech Republic	-3.3	-3.8	-5.0	-3.7	-3.7	-5.7	-6.8	-6.6	-2.9	-3.6	-2.7	-1.6	-2.0
Estonia	-0.4	1.9	-0.3	-3.7	-0.6	0.3	0.4	1.8	1.7	1.9	3.6	3.3	-1.8
Hungary	-4.7	-6.2	-8.2	-5.5	-2.9	-4.0	-9.0	-7.2	-6.4	-7.8	-9.2	-5.5	-3.4
Latvia	-0.5	1.4	0.0	-3.9	-2.8	-2.1	-2.3	-1.6	-1.0	-0.4	-0.2	0.0	-2.0
Lithuania	-3.3	-11.9	-3.1	-2.8	-3.2	-3.6	-1.9	-1.3	-1.5	-0.5	-0.5	-1.2	-1.0
Poland	-4.9	-4.6	-4.3	-2.3	-3.0	-5.1	-5.0	-6.3	-5.7	-4.3	-3.8	-2.0	-2.5
Slovak Republic	-1.3	-5.2	-5.0	-7.1	-12.2	-6.5	-8.2	-2.7	-2.4	-2.8	-3.6	-2.2	-2.5
Slovenia	0.3	-1.1	-0.7	-0.6	-3.7	-4.0	-2.5	-2.7	-2.2	-1.4	-1.2	0.5	-0.5
<i>Average</i> ¹	-2.3	-3.7	-3.3	-3.7	-4.0	-3.8	-4.4	-3.3	-2.6	-2.4	-2.2	-1.1	-2.0
South-eastern Europe													
SEE-3													
Bulgaria	-10.3	-0.3	1.7	0.4	-0.5	1.9	-0.1	0.0	1.4	1.8	3.0	3.4	3.7
Croatia	-0.4	-1.3	-3.5	-8.2	-7.5	-6.8	-4.9	-6.2	-4.8	-4.0	-3.0	-2.3	-2.0
Romania	-3.9	-4.5	-3.2	-4.5	-4.6	-2.1	-2.0	-1.5	-1.2	-1.2	-2.2	-2.5	-2.8
SEE-5													
Albania	-9.7	-12.4	-11.8	-12.1	-7.5	-6.9	-6.1	-4.9	-5.1	-3.5	-3.3	-3.4	-5.2
Bosnia and Herzegovina	-3.9	-0.4	-0.1	-4.0	-4.7	2.2	-4.2	1.6	1.5	2.1	2.6	1.3	-2.3
FYR Macedonia	-1.4	-0.4	-1.7	0.0	2.5	-6.3	-5.7	-0.6	0.4	0.3	-0.3	0.6	-1.5
Montenegro	na	na	na	na	-4.0	-2.0	-1.9	-3.1	-1.9	2.1	4.2	6.3	0.9
Serbia	na	na	na	na	-1.0	-6.2	-43.0	-1.1	0.9	0.9	-2.6	-2.7	-2.5
<i>Average</i> ¹	-4.9	-3.2	-3.1	-4.7	-3.4	-3.3	-8.5	-2.0	-1.1	-0.2	-0.2	0.1	-1.5
Commonwealth of Independent States and Mongolia													
Russia	-9.4	-8.5	-8.1	-3.1	3.2	2.7	0.6	1.4	4.9	8.1	8.4	5.1	5.2
Western CIS and the Caucasus													
Armenia	-8.5	-5.8	-4.9	-7.2	-6.4	-3.8	-0.4	-1.1	-1.8	-2.6	-2.8	-2.2	-2.6
Azerbaijan	-2.4	-4.0	-3.9	-4.7	-0.6	-0.4	-0.5	-0.8	1.0	2.6	-0.2	2.4	29.1
Belarus	-1.5	-0.7	-1.0	-2.0	-0.1	-1.9	-2.1	-1.7	0.0	-0.7	1.4	0.4	0.4
Georgia	-7.3	-6.7	-5.4	-6.7	-4.0	-1.9	-2.0	-2.5	2.3	-1.5	-3.0	-4.2	-6.5
Moldova	-8.0	-10.5	-7.4	-6.2	-1.8	-0.3	-2.2	1.0	0.4	1.5	-0.3	-0.3	-1.4
Ukraine	-3.2	-5.4	-2.5	-2.3	-1.1	-0.9	0.1	-0.7	-4.4	-2.3	-1.4	-2.0	-1.2
Central Asia													
Kazakhstan	-5.3	-7.0	-8.0	-5.2	-1.0	1.8	1.0	2.7	2.5	5.8	7.2	5.2	6.7
Kyrgyz Republic	-9.5	-9.2	-9.5	-13.1	-10.4	-5.6	-5.3	-4.7	-4.4	-3.4	-2.5	-0.7	-1.3
Mongolia	-6.5	-7.9	-12.4	-10.6	-6.1	-4.7	-5.2	-3.7	-1.9	2.6	8.1	2.2	1.5
Tajikistan	-5.8	-3.3	-3.8	-3.1	-5.6	-3.2	-2.4	-1.8	-2.4	-2.9	1.7	-6.2	-7.2
Turkmenistan	0.3	-0.2	-2.6	0.0	-0.3	0.6	0.2	-1.3	1.4	0.8	5.3	3.9	4.3
Uzbekistan	-7.9	-2.2	-3.8	-3.0	-2.5	-1.3	-1.9	0.1	0.6	1.2	5.2	5.1	5.0
<i>Average</i> ¹	-5.8	-5.5	-5.6	-5.2	-2.8	-1.5	-1.5	-1.0	-0.1	0.7	2.1	0.7	2.5
All transition countries													
<i>Average</i> ¹	-4.5	-4.5	-4.4	-4.6	-3.3	-2.6	-4.3	-1.9	-1.1	-0.4	0.3	0.0	0.2

Note: Data for 1996-2006 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 2007 are preliminary actuals, mostly official government estimates. Data for 2008 represent EBRD projections.

¹ Unweighted average for the region.

Table A.1.1.5

General government expenditure (in per cent of GDP)

	2001	2002	2003	2004	2005	2006	2007 <i>Estimate</i>
Central eastern Europe and the Baltic states							
Czech Republic	44.5	46.3	47.3	45.1	45.0	43.8	42.4
Estonia	35.1	35.6	34.6	33.9	33.9	33.4	34.3
Hungary	47.3	51.4	49.1	48.9	50.0	51.8	50.1
Latvia	34.6	35.6	34.8	35.8	35.6	37.9	38.0
Lithuania	36.8	34.8	33.2	33.4	33.6	33.9	35.6
Poland	43.8	44.2	44.6	42.6	43.3	43.8	42.6
Slovak Republic	44.4	44.9	40.2	37.8	38.1	37.2	36.9
Slovenia	47.6	46.3	46.4	45.8	45.2	44.5	42.1
<i>Average</i> ¹	41.8	42.4	41.3	40.4	40.6	40.8	40.3
South-eastern Europe							
SEE-3							
Bulgaria	40.4	39.3	40.6	39.1	38.9	37.0	39.1
Croatia	50.7	50.7	51.3	49.5	48.5	47.8	48.3
Romania	38.8	39.6	33.6	33.6	33.5	35.3	36.9
SEE-5							
Albania	31.9	30.9	29.0	29.6	28.5	29.0	29.1
Bosnia and Herzegovina	46.5	48.8	39.9	39.0	40.0	42.3	44.1
FYR Macedonia	40.3	40.5	34.5	33.2	34.9	33.7	34.2
Montenegro	39.9	45.5	46.6	40.5	39.1	42.5	45.2
Serbia	39.6	43.0	41.4	40.3	40.4	44.0	44.0
<i>Average</i> ¹	41.0	42.3	39.6	38.1	38.0	39.0	40.1
Commonwealth of Independent States and Mongolia							
Russia	34.6	37.1	35.7	33.6	31.5	31.2	33.0
Western CIS and the Caucasus							
Armenia	20.9	19.3	18.9	17.1	17.6	18.5	19.6
Azerbaijan	18.7	27.7	28.5	25.9	22.7	27.4	27.4
Belarus	46.8	46.6	47.7	46.0	48.0	48.0	49.6
Georgia	18.2	17.8	18.7	19.4	24.9	29.2	33.5
Moldova	29.4	31.5	33.1	35.1	37.0	40.1	41.9
Ukraine	34.4	35.6	37.2	41.5	44.1	44.6	44.3
Central Asia							
Kazakhstan	23.0	21.0	22.3	22.7	22.3	20.2	24.4
Kyrgyz Republic	26.0	28.1	27.2	27.7	28.1	28.9	31.5
Mongolia	38.2	39.0	37.1	35.0	27.5	28.5	38.4
Tajikistan	18.4	19.2	19.1	20.3	23.0	21.9	27.8
Turkmenistan	21.1	18.1	19.4	18.9	19.7	14.9	13.3
Uzbekistan	35.8	37.6	33.4	31.6	29.5	29.2	32.7
<i>Average</i> ¹	28.1	29.1	29.1	28.8	28.9	29.4	32.1
All transition countries							
Average ¹	35.4	36.4	35.4	34.6	34.6	35.2	36.6

Note: Data for 2001-06 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 2007 are preliminary actuals, mostly official government estimates. General government expenditure includes net lending.

¹ Unweighted average for the region.

Table A.1.1.6

Current account balances (in per cent of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
												<i>Estimate</i>	<i>Projection</i>
Central eastern Europe and the Baltic states													
Czech Republic	-6.7	-6.3	-2.1	-2.4	-4.7	-5.3	-5.7	-6.3	-5.2	-1.6	-3.2	-2.6	-2.9
Estonia	-8.6	-11.4	-8.6	-4.4	-5.3	-5.2	-10.7	-11.4	-11.8	-9.9	-16.8	-18.0	-11.2
Hungary	-4.0	-4.5	-7.2	-7.8	-8.4	-6.0	-7.0	-7.9	-8.6	-7.6	-7.5	-6.4	-5.7
Latvia	-4.9	-5.5	-9.7	-9.0	-4.7	-7.5	-6.7	-8.2	-12.8	-12.4	-22.7	-23.9	-12.1
Lithuania	-8.8	-9.8	-11.6	-10.9	-5.9	-4.7	-5.2	-6.9	-7.7	-7.2	-10.8	-13.7	-13.9
Poland	-2.1	-3.7	-4.0	-7.4	-5.8	-2.8	-2.5	-2.1	-4.0	-1.2	-2.7	-4.1	-5.2
Slovak Republic	-9.9	-9.1	-9.2	-5.3	-3.5	-8.3	-7.9	-5.9	-7.8	-8.5	-7.0	-5.3	-5.0
Slovenia	0.3	0.3	-0.7	-4.1	-3.2	0.2	1.1	-0.8	-2.7	-1.7	-2.6	-4.2	-3.6
<i>Average</i> ¹	-5.6	-6.3	-6.6	-6.4	-5.2	-5.0	-5.6	-6.2	-7.6	-6.3	-9.2	-9.8	-7.5
South-eastern Europe													
SEE-3													
Bulgaria	1.7	10	-0.5	-5	-5.6	-5.9	-2	-5.1	-6.8	-12.5	-17.9	-21.7	-21.2
Croatia	-5.0	-12.6	-6.8	-7.7	-2.8	-3.7	-8.6	-7.2	-5.0	-6.3	-7.9	-8.6	-9.9
Romania	-7.3	-6.1	-6.9	-3.6	-3.6	-5.8	-3.4	-5.8	-8.4	-10.2	-11.8	-14.4	-13.3
SEE-5													
Albania	-7.3	-11.5	-6.7	-7.6	-4.6	-7.4	-9.5	-7.0	-5.9	-8.7	-6.5	-10.6	-10.7
Bosnia and Herzegovina	-24.0	-26.6	-8.5	-9.8	-16.4	-18.8	-19.3	-19.5	-16.4	-17.5	-8.5	-12.8	-14.7
FYR Macedonia	-7.7	-7.7	-7.5	-0.9	-1.9	-7.1	-9.5	-4.0	-8.4	-2.7	-0.9	-3.2	-9.7
Montenegro	na	na	na	na	-4.5	-14.6	-12.3	-6.8	-7.2	-8.6	-24.7	-32.5	-36.8
Serbia	-9.6	-6.5	-4.2	-4.4	-2.4	2.4	-4.1	-7.5	-13.5	-8.4	-9.8	-12.9	-17.3
<i>Average</i> ¹	-8.5	-8.7	-5.9	-5.6	-5.2	-7.6	-8.6	-7.9	-9.0	-9.4	-11.0	-14.6	-16.7
Commonwealth of Independent States and Mongolia													
Russia	2.8	0.0	0.1	12.6	18.0	11.1	8.4	8.2	10.2	11.0	9.5	6.1	6.4
Western CIS and the Caucasus													
Armenia	-18.2	-18.0	-22.1	-16.6	-14.6	-9.4	-6.2	-6.7	-4.5	-3.9	-1.4	-3.6	-3.5
Azerbaijan	-25.8	-23.1	-30.7	-13.1	-3.5	-0.9	-12.3	-27.8	-29.8	1.3	17.7	28.8	39.5
Belarus	-3.6	-6.1	-6.7	-1.6	-3.2	-3.3	-2.2	-2.4	-5.2	1.4	-3.9	-6.6	-7.0
Georgia	-9.1	-10.6	-8.9	-7.7	-4.4	-6.5	-5.8	-7.4	-8.3	-9.8	-13.7	-19.7	-20.6
Moldova	-11.1	-14.2	-19.7	-5.8	-7.6	-1.7	-4.0	-6.6	-2.2	-8.1	-11.7	-15.2	-15.3
Ukraine	-2.7	-2.7	-3.1	5.2	4.7	3.7	7.5	5.8	10.5	2.9	-1.5	-4.2	-6.5
Central Asia													
Kazakhstan	-3.6	-3.6	-5.5	-1.4	2.0	-6.3	-4.2	-0.9	1.1	-1.9	-2.3	-7.0	3.8
Kyrgyz Republic	-23.0	-7.8	-22.2	-14.7	-4.3	-1.5	-4.0	1.7	4.9	2.8	-3.1	-0.2	-4.3
Mongolia	-2.8	4.7	-6.7	-5.8	-5.0	-6.6	-8.5	-6.8	1.5	1.3	7.0	2.6	-8.7
Tajikistan	-7.8	-4.0	-7.3	-0.9	-1.6	-5.0	-3.6	-1.3	-3.9	-2.7	-2.8	-11.2	-9.7
Turkmenistan	0.1	-24.8	-34.3	-23.3	13.6	3.2	13.0	5.2	1.2	10.8	32.8	31.7	26.4
Uzbekistan	-7.8	-5.4	-0.9	-2.0	2.7	-1.5	1.4	8.9	9.9	13.1	17.2	19.1	17.7
<i>Average</i> ¹	-8.7	-8.9	-12.9	-5.8	-0.2	-1.9	-1.6	-2.3	-1.1	1.4	3.4	1.6	1.4
All transition countries													
<i>Average</i> ¹	-7.7	-8.1	-9.4	-5.9	-3.0	-4.3	-4.6	-4.9	-5.1	-3.7	-4.1	-6.0	-6.0

Note: Data for 1996-2006 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 2007 are preliminary actuals, mostly official government estimates. Data for 2008 represent EBRD projections.

¹ Unweighted average for the region.

Table A.1.1.7
Foreign direct investment (net inflows recorded in the balance of payments)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	Cumulative FDI inflows per capita (1989-2007 (in US\$ min))	Cumulative FDI inflows per capita (US\$)	FDI inflows per capita 2006	2007	FDI inflows (in per cent of GDP)
Central eastern Europe and the Baltic states																			
Czech Republic	2,531	1,280	1,259	3,575	6,220	4,942	5,474	8,282	1,814	3,941	11,630	4,598	7,930	5,500	65,782	6,337	447	764	4.2
Estonia	199	111	130	574	222	324	343	153	763	698	2,249	673	1,115	1,050	8,001	5,960	500	831	4.1
Hungary	4,772	3,335	3,715	3,070	3,060	2,151	3,573	2,722	479	3,405	5,586	3,640	2,197	2,000	48,557	4,829	361	219	3.2
Latvia	245	379	515	303	331	400	114	250	254	528	585	1,491	1,913	2,000	7,635	3,347	650	838	7.5
Lithuania	72	152	328	921	478	375	439	715	142	510	689	1,551	1,409	1,100	7,841	2,322	457	417	5.2
Poland	3,617	4,445	4,863	6,049	7,239	9,327	5,804	3,901	4,284	11,761	6,951	10,727	17,976	13,700	99,771	2,621	281	472	3.1
Slovak Republic	194	199	84	374	701	1,897	1,520	4,130	1,913	3,052	2,279	3,797	2,881	3,000	23,579	4,366	704	534	6.8
Slovenia	161	167	303	221	59	71	226	1,508	-174	281	-67	-215	-353	632	2,482	1,241	-107	-176	-0.6
<i>Total</i>	11,790	10,068	11,196	15,086	18,309	19,486	17,492	21,660	9,474	24,175	29,902	26,261	35,068	29,182	263,649	3,616	360	481	4.2
South-eastern Europe																			
SEE-3																			
Bulgaria	98	138	507	537	802	998	803	876	2,070	2,879	4,003	7,333	8,154	8,364	29,444	3,854	952	1,067	23.2
Croatia	101	466	348	842	1,392	1,105	1,398	553	1,927	732	1,551	3,212	4,644	4,806	18,515	4,168	723	1,045	7.5
Romania	417	415	1,267	2,079	1,025	1,051	1,154	1,080	2,156	6,368	6,587	10,957	9,818	11,553	44,894	2,069	504	452	8.9
SEE-5																			
Albania	89	97	42	45	51	143	207	135	178	324	258	315	641	484	2,655	830	98	200	3.5
Bosnia and Herzegovina	0	0	0	100	90	146	119	266	382	708	579	710	2,023	1,200	5,124	1,348	187	532	5.8
FYR Macedonia	10	11	30	128	32	175	441	106	118	322	94	424	321	434	2,234	1,117	212	160	6.7
Montenegro	na	na	na	na	na	na	10	84	44	63	482	585	717	827	1,986	3,009	887	1,087	21.7
Serbia	na	0	740	113	112	50	165	475	1,365	966	1,550	4,264	2,195	3,100	11,995	1,599	569	293	13.9
<i>Total</i>	715	1,127	2,933	3,844	3,505	3,669	4,297	3,574	8,240	12,363	15,104	27,799	28,512	30,768	116,847	2,294	545	560	11.4
Commonwealth of Independent States and Mongolia																			
Russia	1,460	1,656	1,681	1,492	1,102	-463	216	-72	-1,769	1,662	119	10,753	6,800	5,000	25,045	176	76	48	1.1
Western CIS and the Caucasus																			
Armenia	25	18	52	221	122	104	70	111	121	217	252	340	455	482	2,117	658	106	141	5.3
Azerbaijan	330	627	1,115	1,023	510	149	299	1,048	2,353	2,351	458	-1,301	-5,201	-2,018	3,784	451	-155	-619	-6.2
Belarus	15	105	350	201	443	119	96	453	170	163	303	351	1,769	1,706	4,564	473	36	183	1.0
Georgia	6	54	236	221	62	153	80	122	335	420	529	1,115	1,536	1,227	4,877	1,079	247	340	14.3
Moldova	25	23	78	75	38	127	102	132	71	146	199	223	443	600	1,724	502	66	129	6.5
Ukraine	257	516	581	747	489	594	769	698	1,411	1,711	7,533	5,737	9,218	9,500	31,070	674	123	200	5.3
Central Asia																			
Kazakhstan	963.9	1,137	1,320	1,143	1,468	1,278	2,861	2,164	2,213	5,436	2,123	6,630	7,100	3,400	37,888	2,504	439	470	8.2
Kyrgyz Republic	61	31	83	87	38	-7	-1	5	46	132	43	182	208	224	961	183	35	40	6.4
Mongolia	10	16	20	19	34	40	43	78	132	129	258	290	328	688	1,413	514	107	119	9.2
Tajikistan	10	18	18	25	21	24	10	36	32	272	55	66	160	180	775	121	10	25	2.3
Turkmenistan	233	108	108	62	125	131	170	276	226	354	418	731	856	1,200	3,928	604	112	124	7.0
Uzbekistan	-24	90	167	140	121	75	83	65	70	187	88	195	739	918	2,095	77	7	27	1.1
<i>Total</i>	3,372	4,398	5,809	5,455	4,574	2,323	4,796	5,116	5,411	13,179	12,377	25,311	24,411	23,107	120,221	428	90	87	4.7
All transition countries																			
Total	15,877	15,592	19,938	24,385	26,388	25,477	26,585	30,350	23,125	49,717	57,383	79,372	87,991	83,057	500,717	1,237	196	217	6.4

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.1.1.1.8
GDP growth forecasts for 2008 (in per cent)

	Average ¹	Range ²	EBRD (Oct 2008)	European Union (Apr 2008)	IMF (Oct 2008)	OECD (May 2008)	United Nations DESA ⁴ (Oct 2008)	CSFB ⁵ (Oct 2008)	Dun & Bradstreet (Sep 2008)	Economist Intelligence Unit (Aug 2008)	Global Insight, Inc. ⁶ (Jul-Aug 2008)	IMH ⁷ (Sep 2008)	JP Morgan (Oct 2008)	Kopint-Tark ⁸ (Sep 2008)	Vienna Institute ⁹ (June 2008)	Business Monitor Online (Sep 2008)
Central eastern Europe and the Baltic states																
Czech Republic	4.5	0.8	4.1	4.7	4.0	4.5	4.1	na	4.8	4.5	4.6	4.8	4.3	4.5	4.7	4.3
Estonia	-0.5	4.2	-1.0	2.7	-1.5	na	-1.0	na	-0.5	-1.5	-1.5	0.4	na	-1.0	0.5	-1.1
Hungary	2.0	0.9	1.7	1.9	1.9	2.0	2.0	1.9	2.0	2.0	1.7	2.6	1.8	2.2	2.5	1.7
Latvia	0.9	4.7	0.4	3.8	-0.9	na	-0.6	na	2.0	-0.4	0.5	1.6	na	0.0	2.5	1.3
Lithuania	5.0	2.2	3.9	6.1	3.9	na	5.0	na	6.0	5.3	4.2	5.5	na	5.0	6.0	4.2
Poland	5.4	0.9	5.3	5.3	5.2	5.9	5.4	5.2	5.2	5.0	5.3	5.8	5.0	5.5	5.5	5.4
Slovak Republic	7.3	1.3	7.3	7.4	7.4	7.3	7.8	na	7.2	7.0	7.0	7.7	6.5	7.5	7.5	7.6
Slovenia	4.5	0.8	4.3	4.2	4.3	na	4.2	na	4.5	4.5	4.5	4.8	na	5.0	4.3	5.0
Average	3.6	2.0	3.3	4.5	3.0	4.9	3.4	3.6	3.9	3.3	3.3	4.2	4.4	3.6	4.2	3.5
Weighted average ³	4.5	1.1	4.3	4.7	4.2	na	4.5	na	4.6	4.3	4.4	5.0	na	4.6	4.8	4.5
South-eastern Europe																
SEE-3																
Bulgaria	6.0	1.0	6.0	5.8	6.3	na	6.5	na	5.7	6.0	5.7	6.6	5.9	6.0	6.0	5.6
Croatia	4.3	1.0	3.8	4.5	3.8	na	4.3	na	4.5	4.6	4.2	4.2	na	4.8	4.2	4.4
Romania	7.6	3.2	7.5	6.2	8.6	na	8.0	8.0	5.8	8.0	6.8	9.0	8.5	8.0	6.5	7.8
SEE-5																
Albania	6.0	0.5	6.1	na	6.1	na	6.0	na	6.0	6.0	5.6	na	na	na	5.8	6.0
Bosnia and Herzegovina	5.4	1.5	6.0	na	5.5	na	5.2	na	5.5	5.0	6.0	na	na	na	4.5	5.8
FYR Macedonia	1.4	5.3	5.3	4.8	5.5	na	5.0	na	5.0	5.0	4.1	na	na	na	5.0	5.0
Montenegro	6.7	1.6	7.0	na	7.5	na	6.8	na	na	7.0	6.8	na	na	na	6.0	5.9
Serbia	6.1	2.0	7.0	na	6.0	na	6.3	na	6	6.5	5.0	na	na	6.5	5.0	6.5
Average	5.9	1.5	6.1	5.3	6.2	na	6.0	8.0	5.5	6.0	5.5	6.6	7.2	6.3	5.4	5.9
Weighted average ³	6.5	2.2	6.5	na	7.0	na	6.8	na	na	6.8	5.9	na	na	na	5.8	6.6
Commonwealth of Independent States and Mongolia																
Russia	7.3	0.7	7.3	7.7	7.0	7.5	7.2	7.0	7.0	7.4	7.3	7.5	7.4	7.4	7.3	7.5
Western CIS and the Caucasus																
Armenia	9.8	1.2	10.0	na	10.0	na	10.0	na	na	9.0	10.2	na	na	na	na	9.6
Azerbaijan	17.0	6.5	20.0	na	16.0	na	17.0	na	17.0	13.5	16.7	na	na	na	na	18.6
Belarus	8.5	2.5	9.0	na	9.2	na	9.5	na	7.0	9.0	8.0	na	na	na	na	7.8
Georgia	6.0	6.5	2.0	na	3.5	na	5.5	na	8.5	7.0	8.4	na	na	na	na	6.8
Moldova	5.6	2.0	6.0	na	6.5	na	4.5	na	na	6.5	5.5	na	na	na	na	4.6
Ukraine	6.3	1.1	6.0	na	6.4	na	6.8	5.7	6.0	6.2	6.4	na	6.3	6.4	6.5	6.4
Central Asia																
Kazakhstan	5.1	1.7	4.3	na	4.5	na	4.5	5.0	6.0	5.3	5.5	na	5.0	na	5.5	5.5
Kyrgyz Republic	6.3	1.9	6.5	na	7.5	na	6.0	na	6.8	6.0	5.9	na	na	na	na	5.6
Mongolia	9.1	1.9	8.6	na	9.0	na	na	na	na	na	8.4	na	na	na	na	10.3
Tajikistan	5.3	1.0	5.0	na	6.0	na	5.0	na	5	5.5	5.9	na	na	na	na	5
Turkmenistan	8.2	8.0	12.0	na	10.8	na	7.0	na	8	4.0	7.8	na	na	na	na	7.8
Uzbekistan	8.0	2.2	8.0	na	8.0	na	8.0	na	7.0	8.5	9.2	na	na	na	na	7.6
Average	7.9	2.9	8.1	7.7	8.0	7.5	7.6	5.9	7.8	7.3	8.1	7.5	6.2	6.9	6.4	7.9
Weighted average ³	7.3	1.1	7.3	na	7.1	na	na	na	na	na	7.4	na	na	na	na	7.5
All transition countries																
Average	6.2	2.3	6.2	5.0	6.1	5.4	5.9	5.5	5.9	5.8	6.1	5.0	5.6	4.8	5.0	6.2
Weighted average ³	6.3	1.2	6.3	na	6.2	na	na	na	na	na	6.2	na	na	na	na	6.4

¹ Note: All forecasts quoted here were published or reported to the EBRD between April and October 2008. 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 delays between preparation and publication of forecasts.

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 2007.

⁴ United Nations, Department of Economic and Social Affairs (DESA).

⁵ Credit Suisse First Boston.

⁶ Global Insight Inc. was formerly DRI-WIEFA.

⁷ Institute for Economic Research, Halle, Germany.

⁸ Institute for Economic and Market Research Information, Hungary.

⁹ Vienna Institute for International Economic Studies (WIIW).

Table A.1.1.1.9
GDP growth forecasts for 2009 (in per cent)



	Average ¹	Range ²	EBRD (Oct 2008)	European Union (Apr 2008)	IMF (Oct 2008)	OECD (May 2008)	United Nations DESA ⁴ (Oct 2008)	CSFBS ⁵ (Oct 2008)	Dun & Bradstreet (Sep 2008)	Economist Intelligence Unit (Aug 2008)	Global Insight, Inc. ⁶ (Jul-Aug 2008)	IWH ⁷ (Sep 2008)	JP Morgan (Oct 2008)	Kopint-Tark ⁸ (Sep 2008)	Vienna Institute ⁹ (June 2008)	Business Monitor Online (Sep 2008)
Central eastern Europe and the Baltic states																
Czech Republic	4.2	4.0	2.5	5.0	3.4	4.8	3.6	na	5.5	4.9	5.0	4.8	1.5	4.2	5.0	4.3
Estonia	1.7	4.5	-0.2	4.3	0.5	na	0.5	na	1.5	0.4	1.9	2.6	na	3.0	2.0	2.5
Hungary	2.5	3.3	0.5	3.2	2.3	3.1	2.7	2.1	3.0	3.0	2.1	3.8	1.0	2.8	3.4	2.2
Latvia	0.7	4.7	-0.9	2.5	-2.2	na	1.0	na	2.0	0.5	-1.5	2.5	na	1.0	1.0	1.5
Lithuania	3.3	4.8	0.7	3.7	0.7	na	4.0	na	3.0	4.4	2.1	5.5	na	3.5	5.5	3.0
Poland	4.4	2.5	2.8	5.0	3.8	5.0	4.6	4.4	4.4	3.8	4.6	5.3	3.5	4.7	5.3	4.6
Slovak Republic	5.4	5.0	2.0	6.2	5.6	6.1	6.3	na	6.5	5.2	5.5	6.0	1.5	5.8	6.0	6.5
Slovenia	4.0	2.0	3.0	3.8	3.7	na	4.0	na	4.0	3.5	4.3	5.0	na	4.5	4.3	4.3
Average	3.3	3.9	1.4	4.2	2.2	4.8	3.3	3.3	3.7	3.2	3.0	4.4	1.9	3.7	4.1	3.6
Weighted average ³	3.9	3.3	2.2	4.6	3.3	na	4.0	na	4.4	3.8	4.0	4.9	na	4.2	4.8	4.1
South-eastern Europe																
SEE-3																
Bulgaria	5.0	2.5	3.8	5.6	4.2	na	5.4	na	5.0	5.6	4.9	5.5	3.5	5.6	6.0	5.2
Croatia	4.3	2.2	2.8	5.0	3.7	na	4.2	na	4.5	4.5	4.4	4.6	na	4.8	4.5	4.7
Romania	5.1	4.5	4.0	5.1	4.8	na	6.0	6.0	4.0	5.8	5.6	7.0	2.5	5.4	5.0	5.3
SEE-5																
Albania	5.8	0.8	6.0	na	6.3	na	5.5	na	5.6	6.0	5.8	na	na	na	6.0	5.5
Bosnia and Herzegovina	5.3	1.5	4.5	na	5.0	na	5.5	na	5.8	5.0	5.8	na	na	na	5.0	6.0
FYR Macedonia	5.1	2.3	5.0	5.5	5.0	na	5.0	na	5.5	4.8	3.7	na	na	na	6.0	5.5
Montenegro	5.5	1.0	5.0	na	5.0	na	6.0	na	na	5.5	6.0	na	na	na	6.0	5.1
Serbia	5.6	2.3	4.0	na	6.0	na	6.0	na	5.5	6.0	6.0	na	na	5.8	5.0	6.3
Average	5.2	2.1	4.4	5.3	5.0	na	5.5	6.0	5.1	5.4	5.3	5.7	3.0	5.4	5.4	5.5
Weighted average ³	5.1	3.3	3.9	na	4.8	na	5.6	na	na	5.5	5.4	na	na	na	5.1	5.4
Commonwealth of Independent States and Mongolia																
Russia	6.0	3.3	4.0	7.3	5.5	6.5	6.5	5.0	6.2	6.5	6.4	7.0	4.0	6.7	6.8	5.5
Western CIS and the Caucasus																
Armenia	8.0	1.5	8.3	na	8.0	na	8.5	na	na	7.0	8.2	na	na	na	na	8.2
Azerbaijan	13.9	6.9	15.0	na	16.4	na	15.5	na	12.5	9.5	13.9	na	na	na	na	14.5
Belarus	6.6	4.2	7.2	na	8.0	na	8.5	na	6.4	4.5	4.3	na	na	na	na	7.4
Georgia	6.4	4.0	4.0	na	4.0	na	7.0	na	7.9	8.0	5.8	na	na	na	na	7.8
Moldova	5.5	2.9	4.1	na	6.5	na	5.5	na	na	5.5	7.0	na	na	na	na	4.5
Ukraine	4.2	5.0	1.0	na	2.5	na	5.5	2.8	5.0	5.5	4.9	na	2.5	5.3	6.0	5.5
Central Asia																
Kazakhstan	5.7	5.2	4.5	na	5.3	na	5.5	5.0	7.7	6.1	6.5	na	2.5	na	6.5	7.5
Kyrgyz Republic	5.9	2.6	5.8	na	6.7	na	7.0	na	6.4	6.3	4.6	na	na	na	na	4.4
Mongolia	9.8	7.0	8.0	na	8.1	na	na	na	na	na	8.0	na	na	na	na	15.0
Tajikistan	6.5	2.6	6.0	na	7.0	na	7.0	na	7.0	5.0	7.6	na	na	na	na	6.0
Turkmenistan	8.8	5.5	12.0	na	10.3	na	6.5	na	7.0	10.0	7.4	na	na	na	na	8.1
Uzbekistan	7.4	1.5	7.0	na	7.5	na	6.7	na	6.5	8.0	7.4	na	na	na	na	8.0
Average	7.3	4.0	6.7	7.3	7.4	6.5	7.5	4.3	7.3	6.8	7.1	7.0	3.0	6.0	6.4	7.9
Weighted average ³	6.1	3.6	4.2	na	5.6	na	na	na	na	na	6.4	na	na	na	na	5.9
All transition countries																
Average	5.6	3.5	4.6	4.8	5.3	5.1	5.7	4.2	5.5	5.4	5.5	5.0	2.5	4.5	5.0	6.0
Weighted average ³	5.3	3.5	3.5	na	4.8	na	na	na	na	na	5.5	na	na	na	na	5.3

Note: All forecasts quoted here were published or reported to the EBRD between April and October 2008. 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 delays between preparation and publication of forecasts.

¹ The number at the bottom of this column is calculated as 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 2007.

⁴ United Nations, Department of Economic and Social Affairs (DESA).

⁵ Credit Suisse First Boston.

⁶ Global Insight Inc. was formerly DRI-WEFA.

⁷ Institute for Economic Research, Halle, Germany.

⁸ Institute for Economic and Market Research Information, Hungary.

⁹ Vienna Institute for International Economic Studies (WIIW).

Table A.1.1.1.10

Average annual inflation forecasts for 2008 (change in the average consumer price level, in per cent)

	Average ¹	Range ²	EBRD (Oct 2008)	European Union (Apr 2008)	IMF (Oct 2008)	OECD (May 2008)	United Nations DESA ³ (Oct 2008)	CSFB ⁴ (Oct 2008) ⁵	Dun & Bradstreet (Sep 2008)	Economist Intelligence Unit (Aug 2008)	Global Insight, Inc. ⁶ (Jul-Aug 2008)	IWH ⁷ (Sep 2008)	JP Morgan (Oct 2008)	Kopint-Tarki ⁸ (Sep 2008)	Vienna Institute ⁹ (June 2008)	Business Monitor Online (Sep 2008)
Central eastern Europe and the Baltic states																
Czech Republic	6.3	1.6	6.3	6.2	6.7	6.8	5.6	na	6.1	6.7	6.7	6.2	6.5	6.6	6.0	5.2
Estonia	10.5	1.7	10.7	9.5	10.2	na	11.0	na	11.0	10.5	10.8	10.7	na	10.5	11.0	9.3
Hungary	6.4	1.4	6.3	6.3	6.3	6.3	6.2	5.3	6.3	6.6	6.7	6.6	6.4	6.5	6.6	6.7
Latvia	15.5	4.5	15.8	15.8	15.9	na	15.0	na	15.0	15.8	16.4	16.0	na	15.0	17.0	12.6
Lithuania	10.8	3.1	11.1	10.1	11.3	na	11.0	na	10.0	11.0	11.4	11.5	na	11.5	11.0	8.4
Poland	4.3	0.9	4.3	4.3	4.0	4.5	4.3	3.9	4.8	4.4	4.6	4.3	4.3	4.3	4.0	4.3
Slovak Republic	4.0	1.7	4.3	3.8	3.9	4.0	4.4	na	3.7	4.2	4.0	4.5	4.3	3.8	3.8	2.9
Slovenia	6.0	1.2	6.1	5.4	5.9	na	5.2	na	6.0	6.0	6.2	6.4	na	6.2	6.0	6.1
Average	7.9	2.0	8.1	7.7	8.0	5.4	7.8	4.6	7.9	8.2	8.4	8.3	5.4	8.1	8.2	6.9
South-eastern Europe																
SEE-3																
Bulgaria	12.2	3.3	12.4	9.9	12.2	na	12.0	na	11.5	12.4	12.6	12.8	12.6	13.2	12.0	12.5
Croatia	6.1	2.8	6.5	5.9	7.0	na	6.4	na	4.2	5.9	6.8	6.4	na	6.8	5.5	5.6
Romania	8.2	10.5	7.2	7.6	8.2	na	8.0	8.1	7.0	8.0	14.9	7.7	8.5	8.4	8.0	4.4
SEE-5																
Albania	4.1	2.8	4.0	na	4.0	na	4.2	na	6.0	4.0	3.6	na	na	na	4.1	3.2
Bosnia and Herzegovina	7.4	3.5	7.5	na	8.5	na	8.0	na	5.0	8.0	8.0	na	na	na	6.5	8.0
FYR Macedonia	7.3	4.6	8.4	6.0	8.5	na	4.8	na	7.0	8.0	8.0	na	na	na	6.0	9.4
Montenegro	8.0	4.6	8.0	na	9.2	na	8.8	na	na	8.5	9.6	na	na	na	5.0	7.1
Serbia	10.5	6.1	10.5	na	10.7	na	10.3	na	8.5	11.0	12.2	na	na	12.5	12	6.4
Average	8.0	4.8	8.1	7.4	8.5	na	8.2	8.1	7.0	8.2	9.1	9.0	10.6	10.2	7.4	7.1
Commonwealth of Independent States and Mongolia																
Russia	13.4	4.0	13.0	11.0	14.0	13.0	13.5	14.0	12.5	14.1	13.9	14.0	14.2	13.3	15	12.0
Western CIS and the Caucasus																
Armenia	7.7	6.2	6.5	na	9.4	na	7.5	na	na	10.0	8.9	na	na	na	na	3.8
Azerbaijan	19.2	8.7	19.5	na	22.4	na	20.0	na	20.0	22.9	15.5	na	na	na	na	14.3
Belarus	13.6	4.5	15.3	na	15.3	na	12.5	na	11.0	15.5	11.3	na	na	na	na	14.0
Georgia	9.6	5.7	9.0	na	10.0	na	11.5	na	8.5	11.3	11.1	na	na	na	na	5.8
Moldova	13.2	4.6	13.5	na	13.7	na	14.0	na	na	14.5	13.5	na	na	na	na	9.9
Ukraine	23.5	7.3	24.8	na	25.3	na	23.5	21.4	22.0	24.9	24.8	na	24.8	25.0	18	24.0
Central Asia																
Kazakhstan	15.2	8.2	17.5	na	17.6	na	12.0	12.6	10.5	18.6	18.7	na	16.0	na	11.0	17.0
Kyrgyz Republic	23.5	8.3	24.4	na	24.5	na	22.5	na	20.0	22.5	28.3	na	na	na	na	22.6
Mongolia	22.2	15.5	29.4	na	26.0	na	na	na	na	na	13.9	na	na	na	na	19.6
Tajikistan	21.8	5.0	21.9	na	21.6	na	25.0	na	20	21	20.3	na	na	na	na	23.1
Turkmenistan	17.5	34.0	13.0	na	13.0	na	12.0	na	10.9	18.0	44.9	na	na	na	na	11.0
Uzbekistan	12.4	4.5	11.8	na	11.1	na	12.0	na	15.0	14.5	10.5	na	na	na	na	11.8
Average	16.4	9.0	16.9	11.0	17.2	13.0	15.5	16.0	15.0	17.3	18.1	14.0	18.3	19.2	14.7	14.5
All transition countries																
Average	11.7	5.9	12.0	7.8	12.3	6.9	11.2	10.9	10.5	12.1	12.9	8.9	10.8	10.3	8.9	10.4

Note: All forecasts quoted here were published or reported to the EBRD between April and October 2008. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

¹ The number at the bottom of this column is calculated as 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 United Nations, Department of Economic and Social Affairs (DESA).

⁴ Credit Suisse First Boston.

⁵ Year-on-year inflation, December to December.

⁶ Global Insight Inc. was formerly DRI-WEFA.

⁷ Institute for Economic Research, Halle, Germany.

⁸ Institute for Economic and Market Research Information, Hungary.

⁹ Vienna Institute for International Economic Studies (WIIW).

Table A.1.1.1.1

Average annual inflation forecasts for 2009 (change in the average consumer price level, in per cent)

	Average ¹	Range ²	EBRD (Oct 2008)	European Union (Apr 2008)	IMF (Oct 2008)	OECD (May 2008)	United Nations DESA ³ (Oct 2008)	CSFB ⁴ (Oct 2008) ⁵	Dun & Bradstreet (Sep 2008)	Economist Intelligence Unit (Aug 2008)	Global Insight, Inc. ⁶ (Jul-Aug 2008)	IWH ⁷ (Sep 2008)	JP Morgan (Oct 2008)	Kopint-Tarki ⁸ (Sep 2008)	Vienna Institute ⁹ (June 2008)	Business Monitor Online (Sep 2008)
Central eastern Europe and the Baltic states																
Czech Republic	3.3	3.0	3.1	2.7	3.4	2.9	4.7	na	3.5	3.3	3.1	3.7	1.7	3.6	2.8	4.0
Estonia	6.6	2.9	5.9	5.1	5.1	na	6.0	na	7.0	6.8	7.5	8.0	na	5.5	8.0	8.0
Hungary	4.1	1.3	4.0	3.7	4.1	3.7	3.9	3.7	4.2	4.2	4.1	4.5	4.0	4.2	3.8	5.0
Latvia	8.8	7.5	8.6	8.5	10.6	na	7.0	na	6.5	8.0	9.2	9.8	na	7.5	14	7.2
Lithuania	7.2	3.0	6.9	7.2	6.2	na	7.0	na	6.0	8.0	7.3	7.3	na	7.5	9.0	6.0
Poland	3.6	3.0	3.6	3.4	3.3	5.5	3.6	3.2	3.4	4.0	4.0	4.0	3.2	3.7	2.5	2.7
Slovak Republic	3.5	1.4	3.5	3.2	3.6	3.6	3.8	na	3.0	4.2	3.4	4.4	3.2	3.7	3.0	3.0
Slovenia	3.8	2.3	3.5	3.3	3.3	na	3.2	na	3.5	3.5	4.1	4.8	na	4.0	3.5	5.5
Average	5.1	3.1	4.9	4.6	5.0	3.9	4.9	3.5	4.6	5.2	5.4	5.8	3.0	5.0	5.8	5.2
South-eastern Europe																
<i>SEE-3</i>																
Bulgaria	7.4	3.9	7.2	5.9	7.0	na	5.2	na	6.0	8.0	9.1	7.8	7.9	8.0	8.0	8.6
Croatia	3.8	2.3	4.1	3.0	4.9	na	3.9	na	2.6	3.1	4.5	3.5	na	4.5	4.0	3.9
Romania	5.8	3.4	5.0	4.8	6.6	na	5.0	5.6	4.5	5.2	7.9	7.0	7.0	5.9	7.0	4.5
<i>SEE-5</i>																
Albania	3.3	3.6	3.0	na	3.0	na	3.2	na	5.6	3.5	3.3	na	na	na	3.1	2.0
Bosnia and Herzegovina	4.5	3.7	5.0	na	5.2	na	4.5	na	2.9	5.0	4.5	na	na	na	2.5	6.2
FYR Macedonia	3.8	3.0	3.5	2.7	3.0	na	5.0	na	2.5	5.2	3.4	na	na	na	3.0	5.5
Montenegro	5.5	3.5	6.0	na	5.2	na	6.0	na	na	6.0	6.5	na	na	na	3.0	6.0
Serbia	7.1	5.0	7.0	na	7.5	na	7.0	na	5.0	7.2	6.6	na	na	6.8	10.0	6.4
Average	5.1	3.5	5.1	4.1	5.3	na	5.0	5.6	4.2	5.4	5.7	6.1	7.5	6.3	5.1	5.4
Commonwealth of Independent States and Mongolia																
Russia	10.9	4.0	11.0	9.5	12.0	10.0	9.5	11.0	9.0	11.5	11.5	10.5	12.5	11.0	13	11.0
<i>Western CIS and the Caucasus</i>																
Armenia	5.3	2.3	5.0	na	5.0	na	4.5	na	na	6.7	6.2	na	na	na	na	4.5
Azerbaijan	16.7	10.0	20.0	na	20.0	na	18.5	na	18.0	17.9	12.6	na	na	na	na	10.0
Belarus	10.3	8.7	15.6	na	9.6	na	8.5	na	8.4	15.0	6.9	na	na	na	na	8.0
Georgia	7.4	4.1	8.0	na	7.6	na	6.0	na	7.5	9.2	8.7	na	na	na	na	5.1
Moldova	9.5	2.5	9.8	na	9.7	na	8.0	na	na	10.5	9.9	na	na	na	na	9.3
Ukraine	15.6	11.0	20.0	na	18.8	na	15.0	16.5	9.0	14.9	14.1	na	18.0	13.0	14	17.8
<i>Central Asia</i>																
Kazakhstan	9.3	10.9	8.3	na	9.8	na	10.0	10.3	3.0	13.9	11.8	na	9.0	na	9.5	7.7
Kyrgyz Republic	14.4	12.4	12.4	na	12.2	na	12.0	na	12.0	10.0	22.4	na	na	na	na	19.5
Mongolia	16.9	12.9	19.7	na	18.8	na	na	na	na	na	8.1	na	na	na	na	21.0
Tajikistan	14.7	4.2	15.2	na	15.5	na	15.0	na	12.5	14.0	14.0	na	na	na	na	16.7
Turkmenistan	12.6	8.1	na	na	12.0	na	10.0	na	9.9	14.0	18.0	na	na	na	na	11.5
Uzbekistan	11.9	7.3	10.9	na	10.6	na	10.0	na	17.0	14.0	9.7	na	na	na	na	10.8
Average	12.0	7.6	13.0	9.5	12.4	10.0	10.6	12.6	10.6	12.6	11.8	10.5	13.2	12.0	12.2	11.8
All transition countries																
Average	8.2	5.2	8.4	4.8	8.4	5.1	7.4	8.4	6.9	8.5	8.4	6.3	7.4	6.4	6.5	8.2

¹ Note: All forecasts quoted here were published or reported to the EBRD between April and October 2008. 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.

² The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.

³ Data show the difference between the highest and the lowest of the forecasts.

⁴ United Nations, Department of Economic and Social Affairs (DESA).

⁵ Credit Suisse First Boston.

⁶ Year-on-year inflation, December to December.

⁷ Global Insight Inc. was formerly DRI-WEFA.

⁸ Institute for Economic Research, Halle, Germany.

⁹ Institute for Economic and Market Research Information, Hungary.

¹⁰ Vienna Institute for International Economic Studies (WIIW).

Annex 1.2

Telecommunications regulatory assessment

The telecommunications sector is being transformed by new technology, structural change and economic forces. Government policy-makers and sector regulators have sought to liberalise their markets, but some countries have been more successful than others.

In mid-2008 the EBRD conducted an in-depth assessment of the telecommunications sector in its countries of operations. The objectives were to encourage, influence and provide guidance for ongoing and future legal reform and to help the Bank measure legal risk in those countries and in specific investment activities. The assessment was based on a World Trade Organization (WTO) reference paper and on recognised EU regulatory processes (see “Regulatory benchmarks” below).

The assessment results indicate that the EU framework is the main influence on telecommunications regulation in the countries of central eastern Europe and the Baltic states (CEB) and south-eastern Europe (SEE). However, policy-makers and market regulators in the Commonwealth of Independent States and Mongolia (CIS+M) have yet to fully embrace the necessary independent regulation and competitive safeguards to complete the liberalisation of the sector. Nevertheless, continuing growth of mobile services and strong demand for broadband services provide significant investment prospects in the region.

Regulatory benchmarks

To promote a competitive approach for all telecommunications markets and to accelerate the liberalisation process, the WTO in 1997 reached a binding agreement on members’ commitments,¹ an important element of which was a reference paper defining a set of regulatory principles for the establishment of fair market conditions.² Then, in 1998, the European Union made full liberalisation a legal obligation for all member states and since then its policy and regulatory framework has become increasingly recognised as the global benchmark.³

The EBRD assessment model

The assessment model is based on the WTO reference paper, although many of the specific indicators are drawn from the examples provided by the EU regulatory framework. The model for each country comprises the following elements:

- institutional framework, covering regulatory independence and dispute resolution and appeal
- market access conditions
- operational environment, covering competitive safeguards and interconnection access.

A further element to the model assesses whether a country distorts the market when it promotes a more universal telecommunications service.

The individual country assessments are presented in the form of “spider” diagrams (see Chart A.1.2.1 on pages 26 and 27), which include six main group indicators (defined on page 25). For each indicator, the diagram presents the scores as fractions of the maximum achievable rating. The scores begin at zero at the centre of the chart and reach 1.00 at the outside so that, in the overall chart, the wider the coloured “web” the better the scores in the assessment. The model assigns 32 points to the institutional framework, 30 points to market access and 38 points to the operational environment.

Although there is a rough equivalence between these three main categories, slightly more weight has been attributed to the operational environment because this defines the ability of operators to compete in a fair market that is protected against the abuse of a dominant position. The institutional framework, which oversees compliance with laws and regulations, has second priority as it is essential that this function is carried out in an impartial manner. Slightly less weight has been given to market access conditions because barriers to entry, or complex authorisation procedures, which may prevent operators from participating in the market, also prevent them from making investments.

The six group indicators (and point-scoring potential) in the spider diagrams are detailed below.

1. Regulatory independence (maximum 22 points)

This indicator measures the level of freedom (from political or ownership interests) that a national telecommunications regulatory authority can use to establish and maintain a competitive market. A country's legal framework should include a regulatory authority that is independent from the operators, reasonably free from political pressure and with sufficient powers to regulate the market.

2. Dispute resolution and appeal (maximum 10 points)

This indicator measures the efficiency of the procedures for settling competitive disputes between market players that would otherwise lead to market distortions. A national regulatory authority (NRA) should have the power to resolve commercial disputes between operators and there should be a reasonably efficient appeal mechanism. A country's scoring is reduced if the appeal procedure takes too long or if the appeal mechanism is not being used.

3. Market access (wired) (maximum 20 points)

This is a measurement of the ease of market entry for operators wishing to provide telecommunications services over physical (wired) networks. In telecommunications, services can be provided over physical connections (wired) or by using the radio spectrum (for example, mobile phones). Since radio frequencies can be a scarce resource, different regulations need to apply to ensure fair access for a fully competitive market. This indicator rates the authorisation framework for networks and services that do not depend on scarce resources. A country's scoring is reduced if services are not open to competition, if there are high licensing fees or if authorisation procedures are not plain and transparent.

4. Market access (radio) (maximum 10 points)

This indicator measures the ease of market entry for operators wishing to provide telecommunications services using radio frequencies or other nationally scarce resources. The regulatory framework should ensure non-discriminatory access to the radio spectrum. This indicator also considers whether other scarce resources (such as blocks of telephone numbers) are available to all operators.

5. Significant market power and safeguards (maximum 20 points)

This is a measure of the effectiveness of competitive safeguards in place to ensure that existing operators with significant market power (SMP), do not abuse their position to the detriment of smaller competing operators. Competitive safeguards should protect new entrants against the anti-competitive practices of an incumbent operator(s) with SMP, including an objective procedure for identifying the existence of SMP. This indicator assigns a higher value if this procedure is based on a formal market analysis according to competition law principles, and a lesser value if a simpler procedure based on market share is used. It looks for specific implementation (in legal provisions and in practice) of facilities that improve a consumer's competitive choice, such as the ability to keep their existing phone number when they change operator, or the ability to choose the cheapest operator for making different types of calls.

6. Interconnection and special access (maximum 18 points)

This indicator measures the effectiveness of regulations designed to ensure that consumers can exercise real competitive choice between different operators for different services. It gives points for the existence of a reference interconnection offer (RIO – an inter-operator agreement enabling customers of one operator to make calls to customers of another operator) that is approved by the NRA and published.

A country's scoring is reduced, however, if the legal framework does not set out a requirement for non-discrimination for RIO usage or if there is little evidence that the RIO is being used. Similarly, the indicator looks for the existence of a reference unbundling offer (RUO – a special type of inter-operator agreement that allows a new operator to rent subscriber access facilities from the incumbent operator in order to provide competitive services) and assigns value where an RUO has been approved and additional points if it is actually used to provide services by alternative operators.

Another measure, universal service, is not shown on the spider diagrams and takes into account the effectiveness of universal service regulation. The WTO and EU frameworks leave individual countries to define their universal service policy. Where one exists, the assessment model looks at whether it is being implemented in a technologically and competitively neutral manner.

Data collection

The assessment relied on data from a variety of sources, notably existing EU reports on telecommunications and an EU-funded project that is assessing the sector in SEE countries.⁴ For the CIS+M, the assessment used questionnaires and face-to-face interviews with government and sector regulatory officials and market operators in each country.

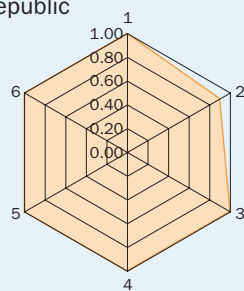
Chart A.1.2.1

Quality of telecommunications regulatory frameworks in transition countries

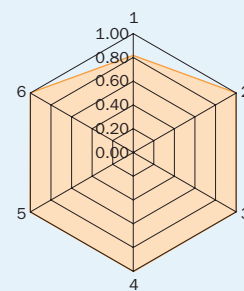
1 = Regulatory independence
 2 = Dispute resolution and appeal
 3 = Market access (wired)
 4 = Market access (radio)
 5 = SMP and safeguards
 6 = Interconnection and special access
 (see explanation on page 25)

CEB

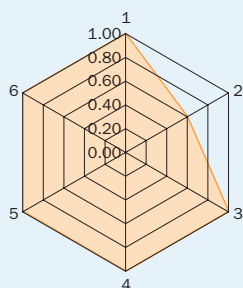
Czech Republic



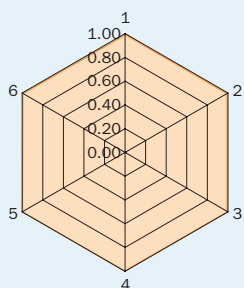
Estonia



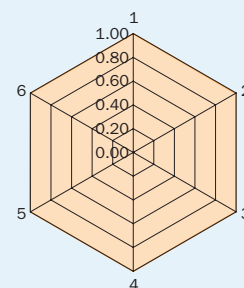
Hungary



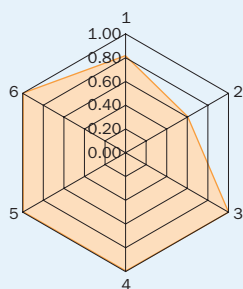
Latvia



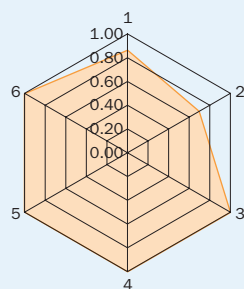
Lithuania



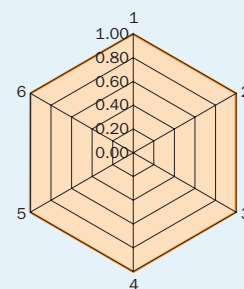
Poland



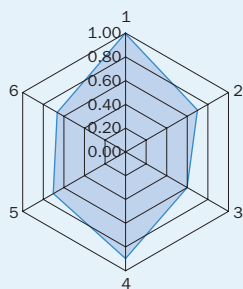
Slovak Republic



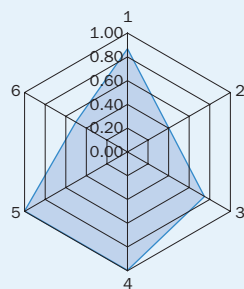
Slovenia

**SEE**

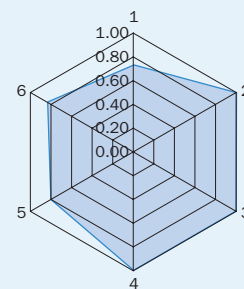
Albania



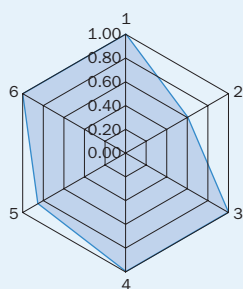
Bosnia and Herzegovina



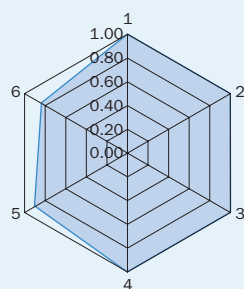
Bulgaria



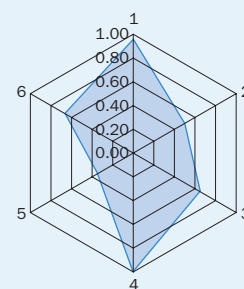
Croatia



FYR Macedonia



Montenegro

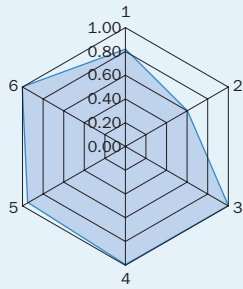


Source: EBRD, Telecommunications regulatory assessment, 2008.

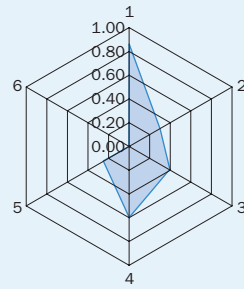
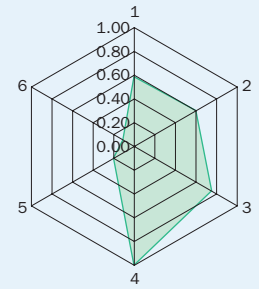
Note: The diagrams show the combined quality of institutional framework, market access and operational environment when benchmarked against international standards issued by the

WTO and the European Union. The extremity of each axis represents an ideal score of 100 per cent, that is, full compliance with international standards. The fuller the "web", the closer the overall telecommunications regulatory framework of the country approximates these standards.

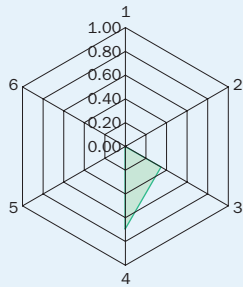
Romania



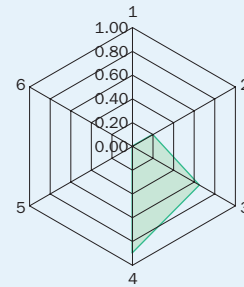
Serbia

CIS+M
Armenia

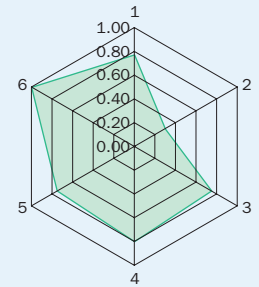
Azerbaijan



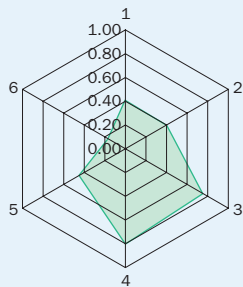
Belarus



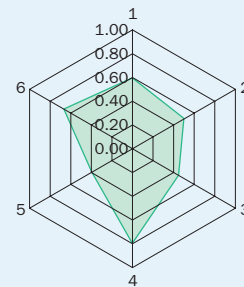
Georgia



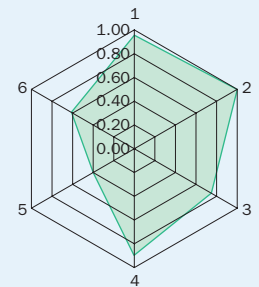
Kazakhstan



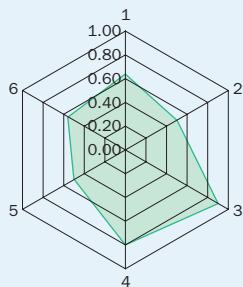
Kyrgyz Republic



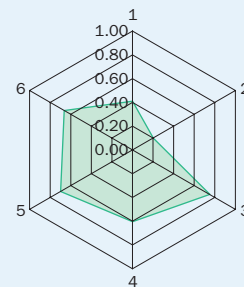
Moldova



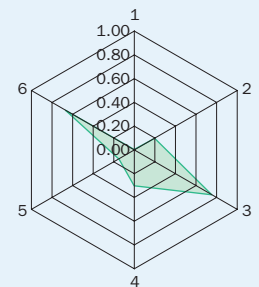
Mongolia



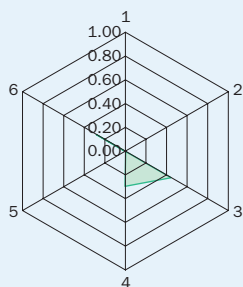
Russia



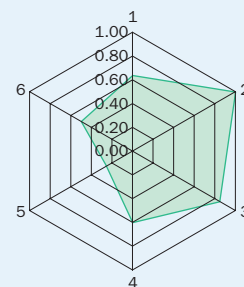
Tajikistan



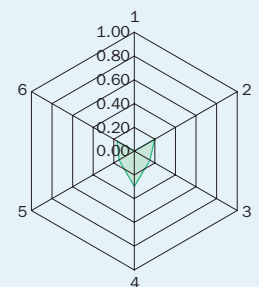
Turkmenistan



Ukraine



Uzbekistan



A diagram for the Czech Republic has been included for comparison purposes, although the Czech Republic has graduated from the EBRD, meaning that the EBRD no longer makes any new investments in the country.

Table A.1.2.1

Quality of telecommunications regulatory frameworks in transition countries/
Compliance with WTO and EU standards

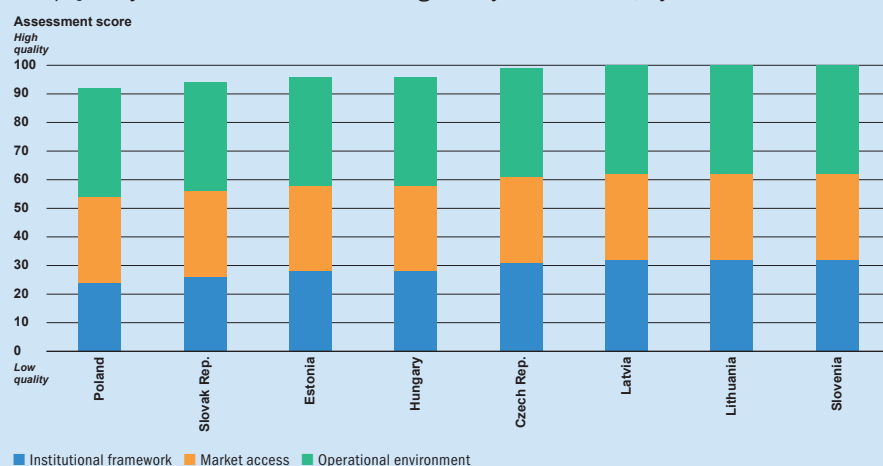
Full compliance	High compliance	Medium compliance	Low compliance
Croatia	Albania	Armenia	Azerbaijan
Czech Republic	Bosnia and Herzegovina	Kyrgyz Republic	Belarus
Estonia	Bulgaria	Moldova	Kazakhstan
FYR Macedonia	Georgia	Mongolia	Serbia
Hungary		Montenegro	Tajikistan
Latvia		Russia	Turkmenistan
Lithuania		Ukraine	Uzbekistan
Poland			
Romania			
Slovak Republic			
Slovenia			

Source: EBRD, Telecommunications Regulatory Assessment, 2008.

Note: The results for Serbia do not include Kosovo. Assessed separately, Kosovo achieves medium compliance, its main shortcomings being in the area of interconnection, special access and competitive safeguards.

Chart A.1.2.2

CEB/Quality of telecommunications regulatory frameworks, by indicator



■ Institutional framework ■ Market access ■ Operational environment

Source: EBRD, Telecommunications Regulatory Assessment, 2008.

Note: The chart shows the score for each country in the region for quality of institutional framework, market access and operational environment when benchmarked against international standards issued by the WTO and the European Union. Combined scores are calculated on a scale of 0 to 100, with a score of 90 or more indicating full compliance with international standards.

Results

Country scores in the assessment reflect the level of compliance with the defined regulatory benchmarks for implementation of a liberalised telecommunications market. Full compliance in Table A.1.2.1 means an assessment score of 90–100, high compliance scores 75–89, medium compliance 50–74 and low compliance under 50. (It is possible to have full compliance even if a country is marked down on some of the indicators.)

All countries in CEB are members of the European Union and have harmonised their legislation with the *acquis communautaire*, the body of law that countries must adopt to become EU members. Latvia, Lithuania and Slovenia

received maximum 100 per cent ratings (see Chart A.1.2.2). Although the others achieved between 90 per cent and 99 per cent because of some remaining issues with implementation, they were still judged to have achieved full compliance under this assessment.

In SEE, Croatia, FYR Macedonia and Romania achieved full compliance, having aligned their frameworks with the EU *acquis communautaire* (see Box A.1.2.1 for more detail on Croatia and Box A.1.2.2 for a case study on Romania). Bulgaria achieved less than full compliance due to remaining concerns about regulatory independence and weaknesses in its market review implementation. Albania and Bosnia and Herzegovina achieved high compliance. In the medium

compliance category, Montenegro had weaknesses in its identification of, and remedies for, market dominance. Serbia was in low compliance because its licensing regime is not yet developed and it has insufficient competitive safeguards (see Chart A.1.2.3).

No countries in the CIS+M region achieved full compliance and only Georgia achieved a high compliance ranking, scoring well on market access conditions and regulatory independence, but with some weaknesses regarding competitive safeguards (see Chart A.1.2.4 on page 30). In Moldova the regulatory framework is undergoing a radical overhaul and past performance may not be a relevant indicator for the future. In addition to Moldova, another five countries of the CIS+M achieved medium compliance – Armenia, the Kyrgyz Republic, Mongolia, Russia and Ukraine – where market access was generally good, but most had weaknesses in their institutional framework or operational environment (see Box A.1.2.3 on page 30 for more information on Mongolia). Russia has implemented relevant competitive safeguards in a strong market and Ukraine scored highly on dispute resolution and appeal mechanisms. The six other countries of the subregion were grouped in the low compliance category, mainly because regulatory provisions remain insufficiently independent of government.

Conclusions

Advances in telecommunications technology have produced significant consumer and economic benefits over the last 10 years. For example, mobile networks have overtaken fixed-line penetration and the growth in broadband services is having a significant impact on every aspect of domestic and business life.

Regulatory progress across the EBRD's countries of operations remains variable. The countries of CEB have already achieved regulatory effectiveness and their markets are operating efficiently. SEE is fast catching up, as are some countries of the CIS+M. Other countries have been slower to adopt regulatory reform. Although the approaches to sector policy and regulation still vary regionally, the overall impetus is towards greater liberalisation. Competition has generally become the accepted tenet in all telecommunications markets.

The European Union's implementation of a common telecommunications regulatory framework has demonstrated how successfully such an approach to market regulation can be applied across different countries with variable initial market characteristics.

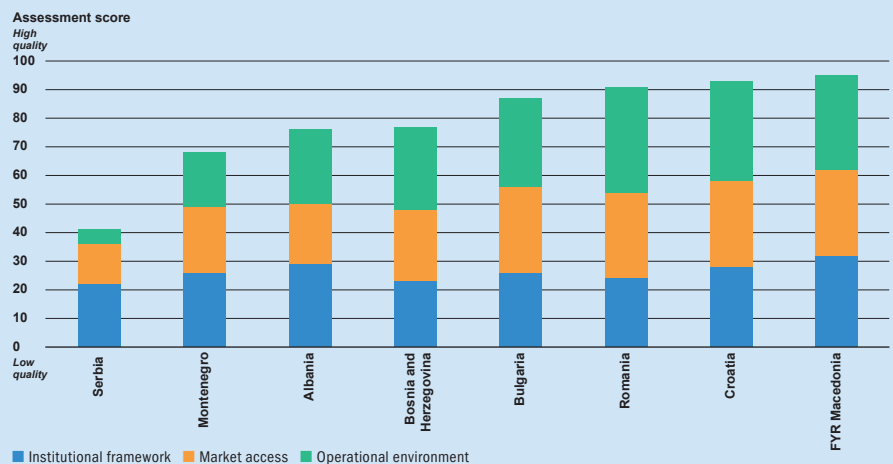
In SEE countries the adoption of the EU framework has been viewed as a defining step towards better functioning markets, as well as being an essential part of the EU accession process. The progress that some countries in this region have made in recent years has been remarkable, given their earlier records of relatively low investment and poor economic management.

In the CIS+M, only Georgia achieved a high compliance rating in the assessment, while Armenia, the Kyrgyz Republic, Moldova, Mongolia, Russia and Ukraine achieved medium compliance. In the low compliance CIS+M countries – Azerbaijan, Belarus, Kazakhstan, Tajikistan, Turkmenistan and Uzbekistan – progress towards market liberalisation and better regulation lags significantly behind the European Union and is also slower than in SEE. Low compliance in the CIS+M is the result of its continuing with policies of “managed competition” (allowing competitors into the market only under strict state-controlled terms) rather than adopting policies of full liberalisation.

The EBRD will continue to provide CIS+M policy-makers and regulators in the telecommunications sector with technical assistance to create the conditions for competitive markets. The main focus of these efforts should be towards greater independence of regulation, with appropriate accountability and effective competitive safeguards. The European Union and SEE experience has shown how this promotes more consumer choice, faster growth in new services and better value for money.

Chart A.1.2.3

SEE/Quality of telecommunications regulatory frameworks, by indicator



Source: EBRD, Telecommunications Regulatory Assessment, 2008

Note: The chart shows the score for each country in the region for quality of institutional framework, market access and operational environment when benchmarked against international standards issued by the WTO and the European Union. Combined scores are calculated on a scale of 0 to 100, with a score of 90 or more indicating full compliance with international standards.

Box A.1.2.1

Case study: Croatia

Croatia in the 1980s had a more advanced telephone network than the rest of communist central Europe. Although damaged in the early 1990s, the network was quickly repaired and modernised, but the country's delay in achieving normal diplomatic relations with the European Union denied it access to aid programmes that provided information on liberalisation policy to EU aspirants. A deal in 1999 to privatise the network under the control of Deutsche Telekom (the German telecommunications giant) and the delay in establishing a suitable regulatory regime put back full liberalisation for five years. However, a credible independent regulator was created in 2004 and a third mobile operator was licensed. Full alignment of Croatian law with EU requirements was finally achieved in 2008. Nevertheless, while the fixed-line telecommunications market remains dominated by one operator and Croatia's development of broadband penetration lags behind that of its peers, the regulator must further promote the full benefits of competition in this sector.

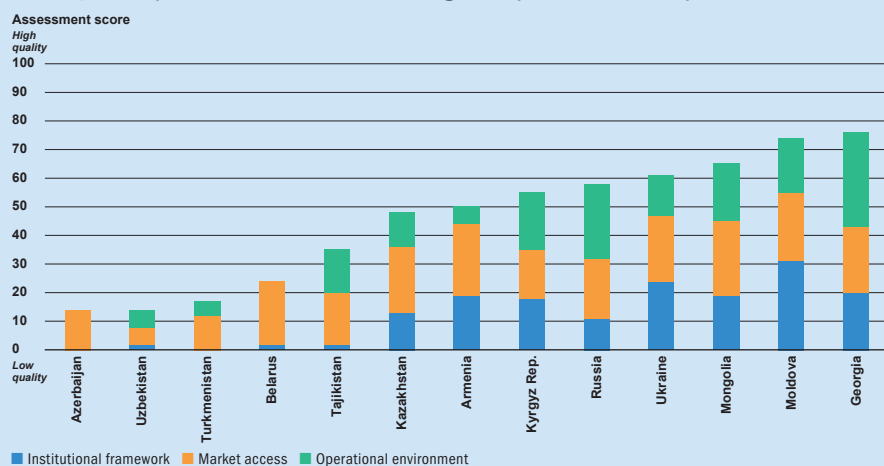
Box A.1.2.2

Case study: Romania

Romania emerged from the communist era with one of the lowest fixed-line network penetration rates (about 20 per cent) and one of the lowest levels of GDP per capita in Europe. However, the authorities implemented full liberalisation of the telecommunications sector from 2003, based on EU regulatory guidelines, and the country has become a regional leader in mobile as well as broadband penetration. Romania is seeking to extend modern telecommunications to its remote areas, by establishing village “telecentres” based on competitive tendering. Each telecentre is equipped with at least two telephones, two computers with internet connection and a fax machine, and the services are offered to the whole community at affordable tariffs. The regulatory authority, ANRCTI, describes the telecentres as “the outpost of the communications infrastructure that facilitates the deployment of the networks to individual households”. By May 2008, 350 telecentres were already functional and ANRCTI had organised tenders for the installation of further telecentres in 633 localities.

Chart A.1.2.4

CIS+M/Quality of telecommunications regulatory frameworks, by indicator



Source: EBRD, Telecommunications Regulatory Assessment, 2008.

Note: The chart shows the score for each country in the region for quality of institutional framework, market access and operational environment when benchmarked against international standards issued by the WTO and the European Union. Combined scores are calculated on a scale of 0 to 100, with a score of 90 or more indicating full compliance with international standards.

Box A.1.2.3**Case study: Mongolia**

Mongolia has the lowest population density in the world. Its 2.7 million people occupy a vast territory. Rural inhabitants, numbering just over 1 million, are spread very thinly. About a third of these live in 330 district centres (called soum). The rest are largely nomadic herders who move between different summer and winter locations. Access to telecommunications services has been extremely limited in the remote areas, given the challenging geography, nomadic lifestyle of the rural population, government ownership and incumbent control of the long-distance transmission network. To encourage wider network delivery, one-off subsidies have been awarded by competitive tender to licensed operators who take on the investment risks of expanding their networks. They receive the subsidy on meeting service targets. The universal access programme has set specific targets, such as: having at least one mobile or wireless operator in each soum centre; offering a broadband wireless internet service in some soum centres; and having at least a public access telephone service in the country's 1,500 remote herder communities. To help finance network expansion into rural areas, the country has a universal service obligation fund. Operators contribute to the fund through a 2 per cent levy on their taxable income.

Endnotes

- 1 These are the specific commitments on telecommunications made by WTO participant countries with respect to the reference paper on basic telecommunications services annexed to the 4th protocol of the General Agreement on Trade in Services of 15th February 1997.
- 2 See World Trade Organization (1996).
- 3 See European Commission (2008a).
- 4 See European Commission (2008b).

References

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European Commission (2008b), *Supply of services in monitoring regulatory and market developments for electronic communications and information society services in enlargement countries*. Available at http://ec.europa.eu/information_society/activities/internationalrel/dialogue_coop/enlargement/Enlargement%20Countries%20Monitoring%20Report%201.pdf.

World Trade Organization (1996), Reference paper on basic telecommunications services. Available at www.wto.org/english/news_e/pres97_e/repap-e.htm.

Annex 1.3

Sustainable energy in transition

One of the biggest challenges facing the transition region is how to achieve a reliable, affordable and sustainable supply of energy which is produced, distributed and consumed in a way that does not undermine long-term growth potential or the energy security of future generations.

This annex looks at how governments across the transition region can integrate the modern policy goals of energy efficiency, promotion of renewable sources and the mitigation of environmental damage into the core business of the energy and other sectors. It analyses the likely effects of existing policies on future climate change and summarises the main risks facing the region. It then formulates an Index of Sustainable Energy (ISE) for each country as a measure of both the sustainability of its energy management practices and the potential for improvement.

Energy and pollution intensities

The legacy of central planning, with its absence of market prices, reliance on energy-intensive industry and, in some countries, abundance of energy resources, combined to make energy usage in the transition region wasteful and carbon-intensive. This has contributed to looming power shortages in many regions and concerns over energy security in the countries that have not been generously endowed with resources. Countries in the Commonwealth of Independent States and Mongolia (CIS+M) have reduced their energy intensity by about one-third (from a very high level) since 1994. However, at purchasing power parities (PPP) these countries still use over three times as much energy to produce a unit of gross GDP as in western Europe, and 2.7 times more than the average in the Organisation for Economic Co-operation and Development (OECD).¹ In contrast, new EU member states have significantly decreased their energy intensity to a level that is still higher than the EU-15 (the 15 members before expansion in 2004) but that converges with the OECD average.

Reducing energy intensity and increasing efficiency is only part of the challenge. Carbon intensity (emissions per unit of GDP at PPP) of industrial production is also a major concern. Russia is the third largest global emitter of carbon dioxide from the combustion of fossil fuels. Kazakhstan, Poland and Ukraine rank among the top 25 countries for global carbon emissions. Overall, the transition region, with only 6.5 per cent of the global population and 6 per cent of global GDP, accounts for about 12 per cent of global greenhouse emissions according to the latest available comparable data.² Also,

of the world's 20 most carbon-intensive economies, 13 are from the transition region with GDP at current exchange rates (or eight if GDP is converted to PPP).³ Nevertheless, due to the sharp fall in output following the collapse of communism and the subsequent restructuring towards more service-oriented economies, the transition region is the only part of the world that has significantly decreased carbon emissions since 1990 (the United Nations Framework Convention on Climate Change base year).

Climate change impact

According to the most reliable scientific estimates of long-term climate change, the transition region will experience an increase in extreme weather events if global carbon emissions are not contained at sustainable levels. South-eastern Europe (SEE) will be most affected, with yearly rainfall dropping by up to 40 per cent⁴ and annual mean temperatures increasing by 4–5°C. Less rainfall and much warmer temperatures will lead to higher risks of water scarcity, droughts, heatwaves, forest fires, biodiversity losses, soil and ecosystem degradation, and eventually desertification. More violent spells of rainfall will increase erosion, loss of organic matter from soil and risks of flash floods. Less water will be available for hydropower and for cooling thermal power plants, particularly during hot summers, and the risk of power disruptions will rise as the summer heat pushes up demand for air-conditioning. Agricultural yields could drop sharply as temperatures rise and water becomes scarcer.

The impact elsewhere will also be serious, though possibly less severe than in SEE. In central eastern Europe and the Baltic states (CEB), the annual mean temperature increase is projected at 3–4°C. Annual mean rainfall could increase by up to 10 per cent, while the frequency of extreme weather events, such as violent storms, winds and heavy rains, could increase the risks of flooding and damage to homes and infrastructure. However, the expected effects on agriculture will vary, with some areas benefiting from longer growing seasons while others suffer from droughts, diseases and soil erosion. Russia may also benefit from warmer temperatures and increased agricultural production, although the long-term effects in this sector are expected to be negative.

There is little detailed information for Central Asia and the Caucasus. However, this is likely to be one of the most severely affected areas in the transition region because of the relative reliance on agriculture, high level of climate change effects, lack of data and reliable projections, and weak economic situation. Central Asia's arid lands are crucially dependent on water stored in the region's glaciers, which are estimated to have shrunk by 25 per cent in the last 50 years and are projected to shrink by another 25 per cent over the next 20 years.⁵

Monitoring progress: the Index of Sustainable Energy

Mitigating these adverse outcomes is a major challenge. The key to sustainable energy is to bring about a systemic change of market incentives that will influence the behaviour of energy producers and users. Without them, energy systems will remain generally wasteful and unable to sustain long-term economic growth, and sustainable projects will continue to be perceived as isolated, optional measures that can only be implemented with government subsidies.

The effectiveness of investment projects and other initiatives depends critically on the nature of market incentives and quality of institutions. The shift of systemic incentives requires new laws, regulations and institutions (such as energy efficiency agencies and renewable energy associations) that can introduce stable market incentives – for example, through cost-reflective tariffs, green certificates (that is, certificates that show the origin of electricity generated), carbon taxes and other price-correcting instruments. The basic building blocks of a sustainable energy reform agenda include policies to strengthen market forces and targeted enabling regulation. Distorted price signals, the absence of competitive energy markets and an uncertain regulatory regime will perpetuate the problem of under-investment in sustainable energy.

In order to monitor progress towards sustainable energy, the EBRD's Office of the Chief Economist has developed an index for each country called the Index of Sustainable Energy.⁶ The ISE allows policy-makers and other sector

stakeholders to measure both the sustainability of existing energy management practices and the potential for improvement. It is a composite index of (i) institutions (ii) market incentives and (iii) outcomes in three areas relevant to the use of energy and its effects: energy efficiency (EE), renewable energy (RE) and climate change (CC). The Index tracks institutions and outcomes related to sustainable energy.

For each of the three areas – EE, RE and CC – the indicator provides a marker of where each country stands in terms of institutions and incentives and the potential for further improvement in terms of sustainable energy outcomes. The indicator ranges on a scale from 0.0 to 1.0. A value of 0.0 is the lowest in terms of sustainable energy (meaning an absence of institutions and market mechanisms, coupled with the worst outcomes in terms of energy efficiency, renewable energy generation and carbon intensity). A maximum score of 1.0 denotes an economy with strong sustainable energy institutions and market mechanisms that also ranks in the top 20 per cent in terms of sustainable energy outcomes.

The basic structure of the indicator relies on three pillars – institutions, market incentives and outcomes – within each of the EE, RE and CC components. These pillars, described below in more detail, form the basis of a sustainable energy system. The three components are given equal weight in the scoring process, and within each component the simple average of the score is calculated across the three pillar dimensions.

Institutions

This part of the indicator measures the development of key institutions that enable and promote sustainable energy investment. These institutions provide the incentives and constraints for suppliers and consumers to make energy investment and consumption choices. There are four main components of the institutional set-up:

Laws

The indicator tracks specific laws on the books related to energy efficiency and renewable energy, such as those that support renewable technologies, compel minimum standards in various areas of energy use, provide guidance for sectoral

targets in terms of energy savings, and provide incentives and penalties for achieving desirable targets. In terms of climate change, the indicator monitors the stage of institutional development in implementing the Kyoto Protocol. The indicator does not, at this stage, comprise an element of legal effectiveness or enforcement.

Agencies

Energy efficiency agencies or renewable energy associations can help an economy deliver sustainable energy investments. The indicator tracks whether such agencies exist and assesses their quality and functions. It distinguishes between autonomous entities and departments within governments. The quality of institutions is assessed through employment staffing levels and skills, and through budget and project implementation capacity. Four functions are assessed: advising government, policy drafting, policy implementation and funding for projects.

Policies

In addition to laws that set the legal framework, specific policies on sustainable energy are also important. The indicator tracks the existence of such policies, how comprehensively they cover the spectrum of potential energy uses and their specific targets. For renewable energy, the indicator assesses the existence of specific sectoral regulations, such as renewables obligations, licensing for green generators and priority access to the grid. The existence of emissions targets and allocation plans is tracked under the climate change policies.

Projects

The indicator assesses project implementation capacity, recording the number of energy efficiency and renewables projects where possible and expenditure data if available.

Market incentives

In the context of transition to a market-based economy, the indicator tracks pricing and other mechanisms that encourage energy savings, renewable energy generation and reductions in greenhouse gas emissions.

Energy pricing

Charging end-users cost-reflective tariffs for energy use is a key driver of rational energy use. Electricity tariffs are used as a proxy for the country's energy pricing policy as they are normally the same across that country. While gas tariffs are also important (as gas is an important primary energy source), they are highly correlated with electricity tariffs and so electricity prices are a reasonably good proxy for incentives. Tariffs for heating are also relevant, but these are most often set locally with considerable variation within each country, and demand is often independent of tariffs (for example, in supply-driven district heating systems where users are charged normative fees regardless of actual consumption). The ISE distinguishes between energy-exporting and energy-importing countries that face different break-even tariffs for electricity.

Enforcement

The indicator also assesses the effective enforcement of the pricing policies through the collection rates of electricity bills. In addition, transmission and distribution losses in the electricity system are also integrated to assess the wastage in the country's energy system.

Renewables

For renewable energy, the focus is on the tariff support mechanism adopted by the country. The scoring ranks tradeable green certificate schemes as the most market-friendly mechanisms for renewable support, while feed-in tariff systems receive partial credit. There are many countries that have no support for renewables.

Carbon taxes or emissions trading mechanisms

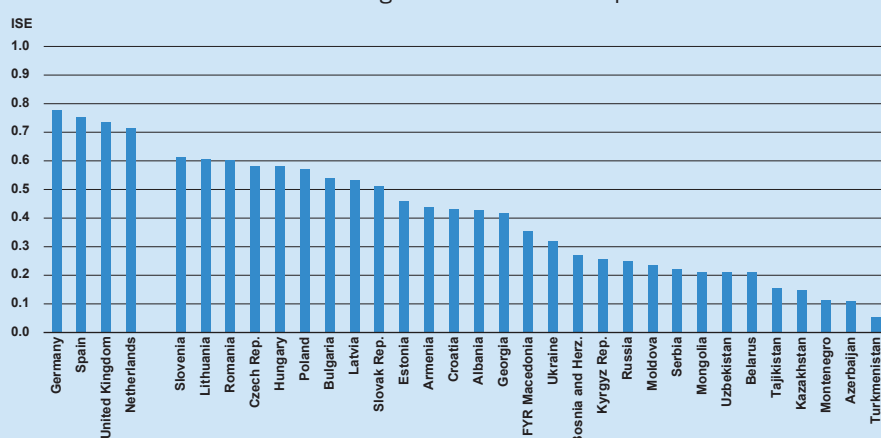
The existence of carbon taxes or market-based carbon finance mechanisms is assessed and scored. In the absence of a carbon tax, countries can accumulate points for implementing cap and trade mechanisms (prevalent in the European Union) or having effectively implemented Joint Implementation (JI) or Clean Development Mechanism (CDM) projects.⁷

Outcomes

Measures of sustainable energy outcomes are an indication of how well countries rank against each other. More importantly, they provide an indication of how much room for improvement there is in each

Chart A.1.3.1

ISE scores across the transition region and relevant comparator countries



Source: EBRD calculations based on energy data up to 2007.

Note: The Index ranges from 0.0 to 1.0, with 0.0 representing a lack of institutions and market incentives to implement sustainable energy solutions coupled with poor energy outcomes (high carbon and energy intensity and no or little renewable energy).

country. The technique adopted in this context is a comparison of each country with the world leaders. Therefore, the key outcomes for evaluation are the ranking position of each country in terms of energy intensity of the economy compared with other countries in the world.

Three measures are used: the energy intensity of the economy (adjusted for PPP); the carbon intensity of the economy (adjusted for PPP); and the share of electricity generated from renewable resources. There are two important caveats: outcome measures do not account for differences in climate or economic structures; and hydroelectricity (including large-scale hydroelectric power plants) is included in the renewables generation, as data availability at this stage does not allow a distinction between renewable electricity from large hydropower plants and genuine renewable energy sources.⁸

Results

The indicator shows that there is considerable variation between countries in the transition region. However, all of them can improve on sustainable energy outcomes if institutions are properly designed, and create the correct incentives for individuals and organisations. Chart A.1.3.1 shows the aggregate ISE scores for the 29 countries in transition and four comparator countries in western Europe.⁹ There is a wide variation in scores across the region. Nine of the 10 new

EU member states (the exception being Estonia) score close to each other above 0.5. This compares with substantially higher scores for the western European counterparts, which score between 0.7 and 0.8.

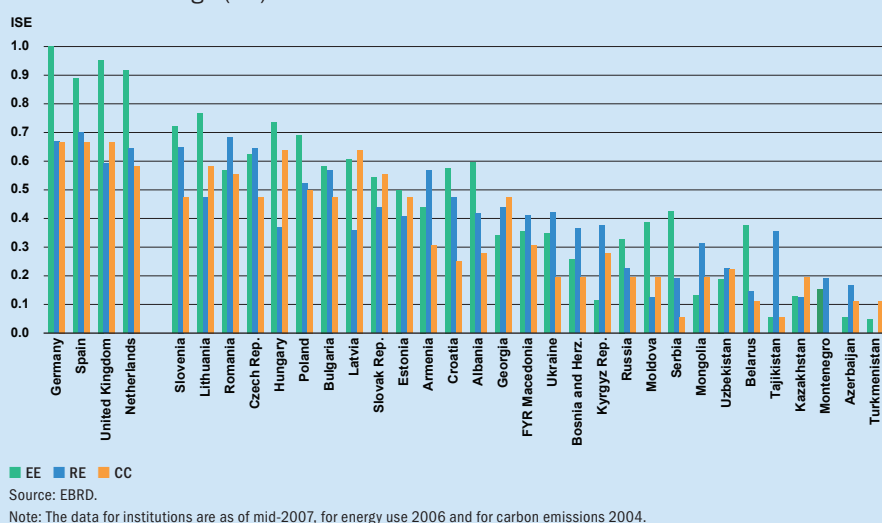
Some countries in SEE, such as Croatia, score close to the group of new EU member states. Several Western Balkan countries are mostly clustered together with some CIS+M states in the Caucasus. Most CIS+M countries, however, record a score of 0.3 or below. This is true for energy-rich states (Azerbaijan, Kazakhstan, Russia and Turkmenistan) and energy-importing Central Asian republics (such as the Kyrgyz Republic and Tajikistan).

Breaking the indicator down into its three components – EE, RE and CC – as shown in Chart A.1.3.2 on page 34 sheds more light on the performance of each country.

The regional leaders in energy efficiency are the new EU member states (Hungary, Lithuania, Poland and Slovenia), reflecting a better institutional set-up, good market incentive mechanisms and favourable outcomes (relatively low energy intensity). At the other end of the scale, some countries have yet to implement basic institutions and continue to be very energy-intensive. They also lack basic incentives for energy savings, since effective tariffs charged to users remain very low. Overall, the scope for improvement to catch up with the

Chart A.1.3.2

ISE scores for energy efficiency (EE), renewable energy (RE) and climate change (CC)



Outcome indicators (carbon intensity of GDP) are poor in the transition region, despite good hydroelectric power resources and a reasonably high share of nuclear energy.

Institutions versus outcomes

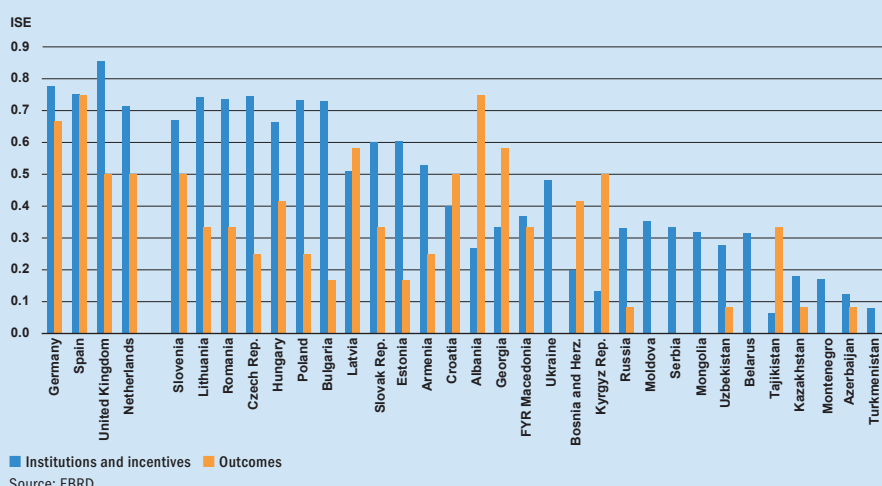
The relationship between the institutional framework and energy outcomes is a complex one. The creation of a suitable institutional environment does not lead immediately to improvements in outcomes. On the contrary, it takes time for emerging institutions, policies and incentives to be enforced effectively, while energy outcomes may also respond slowly.

Similarly, good energy outcomes as measured by the ISE may arise independently of the creation of sound institutions and policies, and they should not necessarily be seen as evidence that all is well in the energy sector more broadly. Some countries may have a high share of renewable energy resources in their energy balance due to their location (in mountainous areas abundant in rivers and with few large dams inherited from central planning). They may, however, have done little to strengthen their institutional framework and may still be suffering from serious energy supply problems. In the future, as an ISE time series is developed, it may become possible to investigate the relationship between institutions, policies and outcomes more systematically.

Nevertheless, breaking the ISE down into institutional (institutions and market incentives) and outcome measures reveals a number of important findings (see also Chart A.1.3.3).

Chart A.1.3.3

Institutions and market incentives versus outcomes



advanced market economies in western Europe is still very large across the entire transition region.

Regarding renewable energy, all countries in the transition region have much to do, although some are performing relatively well compared with advanced economies. Among the leading countries, the relatively high scores are generated either by a mix of reasonably good institutions and market incentives (such as green certificates) with good outcomes (as in Romania) or strong institutional and market incentive systems with a poorer outcome indicator (as in the Czech Republic). In the poorly performing countries, the score is generally driven by the exploitation

of hydropower resources in large plants. However, the institutional set-up for renewables is absent and no market mechanisms have yet been introduced to foster the renewables industry.

Transition countries on average tend to score poorly on tackling climate change. This is despite the fact that the new EU member states benefit from the institutional framework of the Kyoto Protocol and the EU emissions trading scheme, which provide market-based mechanisms for emissions allocation. It is important to note, however, that a few countries (particularly Hungary and Latvia) are on par with, or close to, comparator countries in western Europe.

- First, the scale of the central planning legacy is substantial in terms of inefficient use of energy, leaving considerable scope for improving outcomes across the entire region.
- Second, some countries in the region, particularly the new EU member states and a few others (for example, Armenia, Moldova and Ukraine), have made substantial progress in establishing a supportive institutional framework and implementing effective price incentives to encourage sustainable energy outcomes. Nevertheless, substantive differences in outcomes compared with western European countries persist.

- Third, in a group composed largely of the Western Balkan and CIS+M countries, institutions and outcomes are lagging behind substantially. The initial task of setting up institutions and incentives is yet to be implemented, while the poor outcome measures reflect the legacy of the Soviet economic model and its associated distortions in the energy sector.
- Lastly, a number of countries – Albania, Bosnia and Herzegovina, Georgia, the Kyrgyz Republic and Tajikistan – score relatively well in terms of outcomes despite their less advanced institutional structure. This is mainly due to (i) the large amount of renewable resources and their extensive use in large hydroelectric power plants (in Albania and Georgia, the share of electricity generated from renewable sources exceeds 80 per cent) and (ii) an economic structure with little energy-intensive industry.

Conclusions

The shift to sustainable energy will be neither quick nor easy. Many countries still struggle to align their immediate energy needs to feed short-term growth with their long-term aim of a sustainable energy supply and broader economic development. Creating a sustainable energy infrastructure will require a thorough overhaul of the centralised, energy-intensive production and consumption patterns inherited from the communist past. The move to sustainable energy will also require a new awareness and skills among policy-makers, project developers and financial institutions.

The transition to sustainable energy will not be possible with outdated and complacent policies. A major acceleration of investment in energy efficiency and new clean capacity may not materialise unless changes are made in the policy framework to provide incentives to millions of market players, from project owners and developers, suppliers of technology and financial institutions to energy consumers. In this respect, the countries in the transition region differ greatly, ranging from those CEB countries that have largely taken on the European Union's enabling conditions, to those in the CIS+M where little has changed since Soviet times, keeping long-term sustainability off the mainstream energy policy agenda.

Endnotes

- 1 Data from Enerdata, World Energy Database, December 2007.
- 2 Data were collected in 2004 for the United Nations by the Carbon Dioxide Information Analysis Center (CDIAC), which is an organisation within the United States Department of Energy.
- 3 See Energy Information Administration (2005). GDP data at market exchange rates.
- 4 See European Commission (2007).
- 5 See Eurasian Development Bank (2008) and Magrath (2004).
- 6 Devised by Alex Chirmiciu, with assistance from Elcin Akcura and Claudia Reitmaier. See EBRD (2007).
- 7 Joint Implementation and the Clean Development Mechanism are two flexible project-based mechanisms for emissions reductions allowed under the Kyoto Protocol.
- 8 Large hydroelectric power plants are widely distinguished from "genuine" renewable sources because they may cause significant environmental degradation that could threaten the renewability of affected bodies of water. Genuine renewable energy sources are dispersed and do not affect the stock of the relevant resource.
- 9 Chart A.1.3.1 includes ISE scores for the Czech Republic, which has graduated from the EBRD, meaning that the EBRD no longer makes new investments there.

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The turmoil in the international financial markets over the last year is having an increasingly adverse effect on the transition countries. As a result, the expansion of credit from domestic banks to the private sector is slowing, and sharply reduced external credit is implying shorter maturities and higher risk premiums. The full impact of the financial turmoil will depend on the behaviour of parent banks and foreign direct investment in the coming year.

2

The global credit crisis and the transition region

Featured

- 38 Changes in international debt flows
- 40 Syndicated lending
- 42 Inflation and domestic bank funding
- 42 Monetary policy responses and their impact on domestic credit
- 46 Outlook and policy implications

The transition region has undergone a rapid expansion of the financial sector in recent years. In many countries, this has included huge growth in lending at rates that are unsustainable. This can be attributed to a combination of factors, including the low levels of financial intermediation that existed until quite recently in many countries, as well as benign external financial conditions.¹

However, since mid-2007 the financial and macroeconomic environment has significantly worsened. Until the third quarter of 2008, debt markets continued to function normally, albeit with higher risk premiums, shorter maturities and reduced flows into the region. Following the dramatic global events of September/October 2008, flows of bonds and syndicated loans to the transition region have dried up, leaving parent bank financing of subsidiaries and foreign direct investment (FDI) as the main sources of private financing.

Notwithstanding these dramatic changes of October 2008, the “credit boom” in the transition region still seemed to be under way in several countries. Recent data on credit extended to the private sector (for the second quarter of 2008) showed annual growth rates of around 50 per cent in Bulgaria, Romania, Russia and Ukraine. By contrast, funding problems and stricter lending standards led to a sharp deceleration in growth of credit in Estonia and Latvia, as well as in Kazakhstan. Following the events of September/October 2008, a much broader slowdown in credit growth appears likely in the near future,

given sharply reduced funding from both domestic and external sources. More moderate credit growth may allow financial institutions to strengthen their risk management systems and lending capacity, which in many cases have both been strained in recent years. Yet, this next part of the credit cycle also carries the risk of sharp and disruptive falls in credit growth that would have an impact on industries that rely heavily on external funding. Asset prices could also be affected, as is already evident in the property sectors of various countries.

This chapter examines how credit growth in the region has been affected by the developments in international credit markets, as well as higher inflation until September 2008. It begins by assessing three aspects of the changed funding environment for banking sectors:

- the general reduction in capital flows to the region
- the changing nature of international syndicated lending to the region
- the impact of inflation on bank funding from deposits and domestic bond markets.

It then reviews the policy response, particularly regarding the tightening of prudential norms on bank funding and lending, and concludes with an outlook for the region in light of the most recent events.

Changes in international debt flows

Many transition countries have come to depend on being able to borrow on the international markets. This reflects their persistent current account financing needs, and the increasing shares of banking system liabilities sourced abroad. These factors have raised risks for both the stability of exchange rate regimes and the banking sectors. Nevertheless, there is considerable variation in how the different types of capital flows to the region have been affected so far by events in the advanced capital markets.

There are three main types of international debt flows to the transition region:

- bond issues (in the eurobond and domestic markets) purchased by foreigners
- lending by groups of banks with the aim of sharing credit risk (syndicated lending)
- other bilateral bank lending (primarily to the subsidiaries of foreign banks).

International bank lending – both through syndicates and bilateral lending – accounted for most gross capital flows to the transition region.² Syndicated lending and, even more so, lending between international banking groups and their foreign subsidiaries, have both tended to be less sensitive to changes in perceived risks compared to bond flows, not least because they offer greater scope for monitoring the borrower.³

Table 2.1 and Chart 2.1 show that this pattern also applies to the transition economies. While the issuance of government bonds has increased, bond issues by the private sector have declined sharply since 2007.⁴ The J.P. Morgan Emerging Europe bond index spread – a key measure of international risk aversion – widened dramatically in October 2008. International bond issues by the private sector contracted sharply, from a total of almost US\$ 40 billion to just under US\$ 12 billion between the first and second halves of 2007, before recovering somewhat in the first half of 2008. This decline was particularly large for the banks in Kazakhstan, Russia and Ukraine; Kazakhstan, in particular, experienced a near cessation in issuance in the second half of 2007, which has since only partially been reversed. In contrast, syndicated loan

Table 2.1
International bond issuance by transition countries

		Volume (in US\$ billion)			Number		
		2007 (H1)	2007 (H2)	2008 (H1)	2007 (H1)	2007 (H2)	2008 (H1)
Bank	Total EBRD region	23.7	5.8	12.8	66	15	21
	of which CEB	3.1	1.1	3.2	8	4	5
	Russia	11.3	3.5	7.3	34	6	13
	Kazakhstan	6.9	0.3	2.1	13	1	2
	Ukraine	1.7	0.5	0.3	7	3	1
Corporate	Total EBRD region	14.7	6.1	6.7	32	13	16
	of which CEB	1.2	0.2	0.0	5	3	0
	Russia	12.0	5.5	6.0	22	8	13
	Kazakhstan	1.1	0.0	0.0	3	0	0
	Ukraine	0.2	0.5	0.2	1	2	1

Source: J.P. Morgan.

Note: Subtotals omit the SEE and other CIS+M countries, where bond issuance has been negligible.

flows have declined much more mildly (indeed, in one region – south-eastern Europe (SEE) – syndicated loan flows even increased). However, the drop in the absolute level of syndicated loan flows between the first and second halves of 2007 was significant, at about US\$ 25 billion, and it continued to drop in the first half of 2008.

Flows of international bank loans to the transition region have been particularly stable when focusing on all cross-border lending by banks, including both syndicated and bilateral lending. Indeed, data from the Bank for International Settlements (BIS) show an increase in net cross-border lending to the transition region from US\$ 77 billion in the first half of 2007 to about US\$ 100 billion in both the second half of 2007 and the first half of 2008. This resilience is largely because of international banks lending to their subsidiaries and branches in the transition region. Foreign banks are estimated to account for about 45 per cent of total bank assets in the region, one-half of which is controlled by the seven largest international banking groups.⁵ The parent banks of these foreign-owned subsidiaries have, in general, been less exposed to the financial instruments – such as collateralised debt obligations – that lie at the heart of the crisis.

Moreover, these bank groups – such as Raiffeisen Zentralbank (RZB) of Austria and UniCredit of Italy – are committed to their highly profitable operations in the region, and have shown this commitment over the past year through financial support in the form of credit lines, subordinated debt and capital injections. Rebrandings of subsidiary networks have also helped integration with the parent group, and underline how closely the reputation of the parent bank has become aligned with that of its subsidiaries.

During the credit market disruption some international banks sought to expand their regional networks by acquiring or setting up new establishments. Notable acquisitions of systemically important banks by major global banks from outside the region include Rosbank in Russia, and ATF Bank and Bank CenterCredit (BCC) in Kazakhstan. RZB also intends to establish a new subsidiary in Kazakhstan. However, while the parent banks have reported relatively little direct exposure to toxic financial instruments (as of early October 2008),

Chart 2.1

Volumes of syndicated borrowing and bond issuance, 2007 to mid-2008

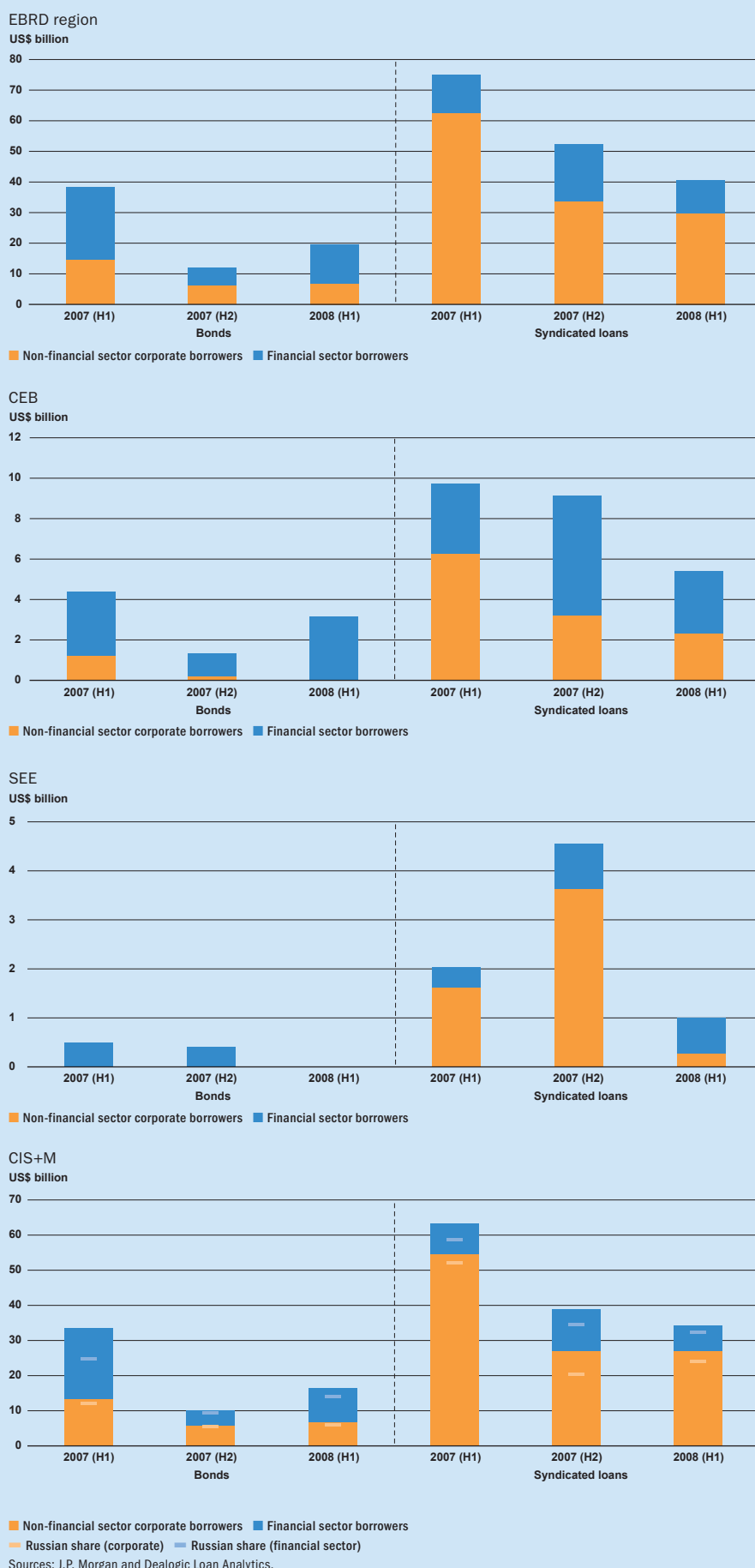


Chart 2.2
Syndicated borrowing by subregion, 2000-08

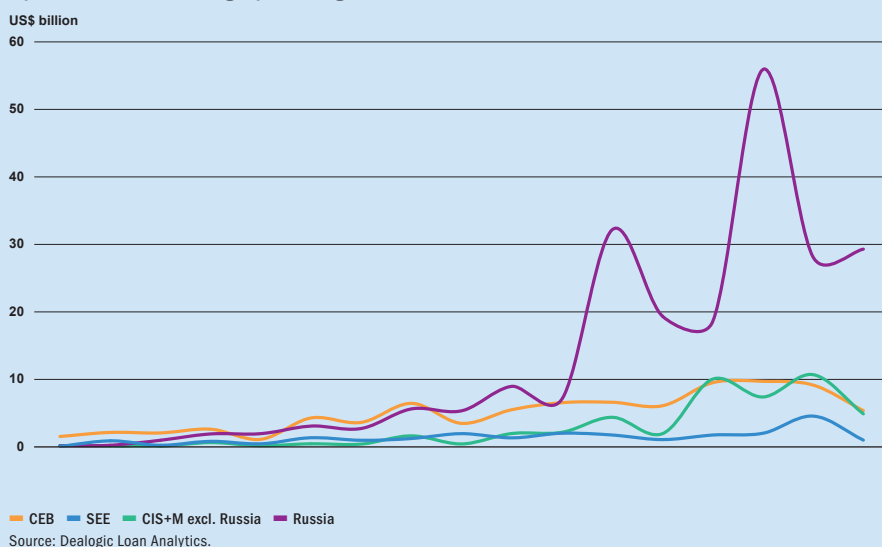
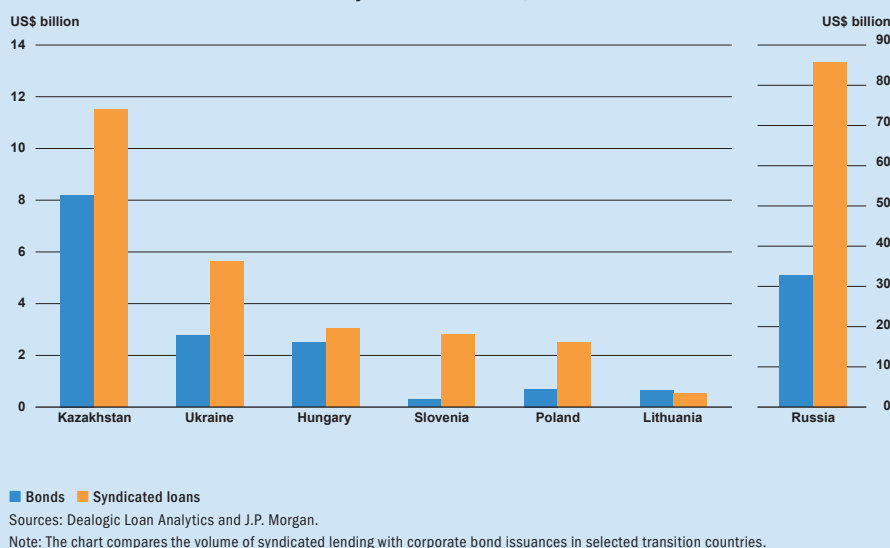


Chart 2.3
Volume of bond issuances and syndicated loans, 2007



they, like other European financial institutions, are not immune to seizures in the inter-bank market and to a more generalised loss of confidence. These tensions could have significant consequences for their own levels of activity and, ultimately, for that of their subsidiaries, in some cases leading to expansion plans in the region being abandoned.

Syndicated lending

To understand better how lending has evolved in response to shocks to the financial system, this section looks at syndicated lending. Bank lending between unaffiliated parties occurs primarily in the form of syndicated loans (although during the credit crunch,

bilateral loans have again increased in importance). Syndicated loans are provided by a group of lenders with a view to sharing and diversifying credit risk. In some ways they combine the characteristics of public financing, such as bonds, with more traditional relationship-based bank lending, and might therefore be expected to be less volatile than bond funding. However, as confirmed by the present market upheaval, syndicated lending to emerging markets tends to decline significantly during episodes of financial market turmoil, since it is a form of foreign currency lending that depends on the availability of liquidity in the main inter-bank markets.⁶ The changing volume, composition and nature of this component of international capital

flow allow deeper insights into how the credit crunch has affected the availability of funding to the private sector in the various transition countries. This is particularly important in countries with only a limited foreign bank presence.⁷

Syndicated lending in transition countries has been on a gradual upward trend since the 1990s, interrupted only by the 1998 Russian financial crisis and the 2001-02 global slowdown. Recent growth has been driven by companies in the Commonwealth of Independent States and Mongolia (CIS+M), particularly Russia, which accounted for almost 60 per cent of all syndicated borrowing in the transition region during 2000-08 (see Chart 2.2).⁸ In many transition countries, syndicated lending has surpassed the issuance in international corporate bond markets (see Chart 2.3). Borrowing has been concentrated in the natural resource sectors (oil, gas and mining) as well as the financial services sector. Russian, Kazakh and Ukrainian banks in particular have been borrowing heavily in the syndicated loan market – a development spurred by stronger inter-bank competition and an accompanying increase in bank lending that could not be fully funded by domestic deposits. Unlike in many other transition countries, the presence of foreign strategic investors has so far been limited in these three countries. Parental intra-bank funding has consequently been less readily available, making the syndicated loan market an attractive complement to domestic funding.

Since August 2007 international banks have become less willing to extend syndicated loans to borrowers in the transition region (and in developed markets, such as the European Union and the United States). Chart 2.4 compares the situation over the last year with the 12 months before the onset of the credit crunch. Total lending has decreased, particularly in the CIS+M (except for Russia) and, to a lesser extent, in central eastern Europe and the Baltic states (CEB). In the transition region as a whole there has also been a move towards fewer, but larger, syndications. This has been contrary to developments in, for instance, the United States, the EU-15 (the 15 member states before the 2004 expansion) and Latin America. Faced with higher funding uncertainty, banks have also become more reluctant to commit their capital for longer periods. This has resulted in the average loan

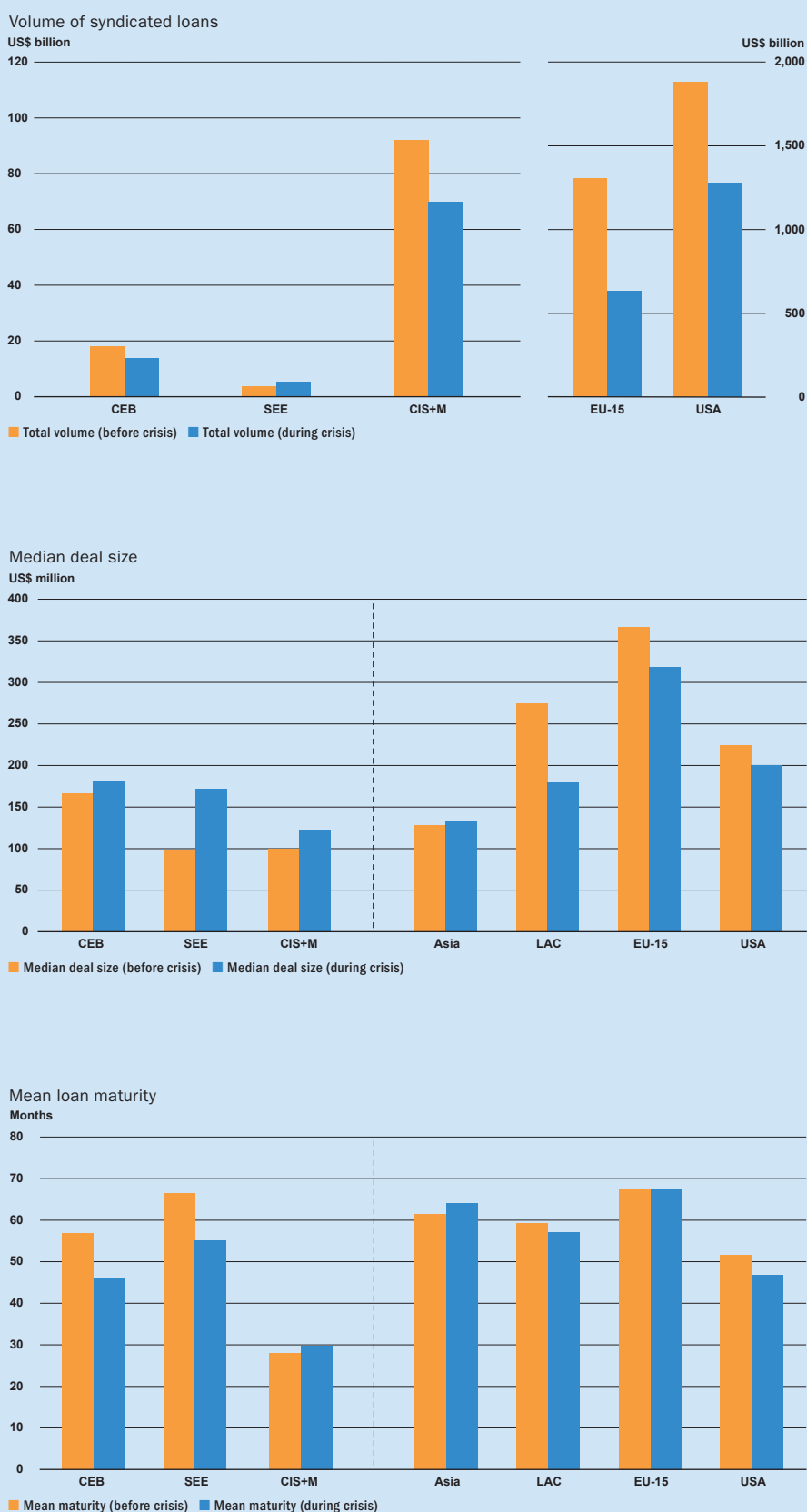
maturity dropping by about four to five months across most of the transition region.⁹

In percentage terms, syndicated borrowing has contracted most markedly in Azerbaijan, Hungary and Latvia (see Chart 2.5 on page 42). Syndicated borrowing by banks has declined particularly sharply in Kazakhstan, Latvia and Romania, which have all experienced an unsustainable boom in externally fuelled bank lending in recent years. Russian and Ukrainian banks have also been forced to reduce their syndicated borrowing from abroad, but to a lesser extent, although more recently, market access for banks in these countries has declined sharply as well. This reflects the fact that the balance sheets of most banks in these countries were initially less leveraged at the onset of the credit crisis, and were therefore seen as less vulnerable to risks associated with borrowers' abilities to renew loans when they fall due for repayment.

Banks have also gradually begun to pass on the increase in their own funding costs to borrowers. This is evident in the sharp increase in spreads or margins that are charged over benchmark interest rates, mostly Libor (the London inter-bank offered rate), as well as in the total "drawn return", a pricing measure that not only includes the spread but also fees and other charges that the borrower has to pay to the arranging banks (see Chart 2.6 on page 42). Average funding costs continued to decrease during the second half of 2007, as some potential borrowers, confronted with higher spreads, decided to postpone syndications. However, when it became clear that the credit crunch would involve a more sustained reassessment of global risk perceptions, borrowers began to accept an increase in funding costs on the syndicated loan market.

As a result of the credit crunch, there has been a sharp increase in the average credit rating of borrowers, which assesses their ability to meet their debt obligations in the syndicated loan market. This reflects a "flight to quality" among lenders with only better-quality borrowers able to access financing (see the red ellipses in Chart 2.7). A similar development was seen during 2001-02 in the wake of the global economic slowdown. Since then, the average quality of corporate borrowers in transition countries had been gradually decreasing, reflecting the fact that

Chart 2.4
Impact of the credit squeeze on syndicated borrowing

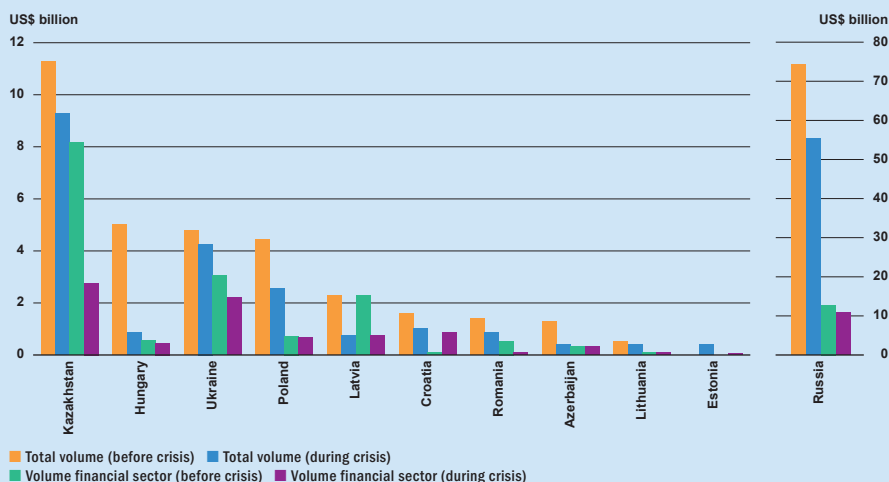


Source: Dealogic Loan Analytics.

Note: The chart shows the three transition subregions and selected comparator countries and regions. For comparative purposes the beginning of the crisis is taken as August 2007 and the analysis is limited to the 12 months before and the 12 months after this point, that is, August 2006-July 2007 and August 2007-July 2008. LAC = Latin America and the Caribbean.

Chart 2.5

Volume of syndicated borrowing in selected transition countries

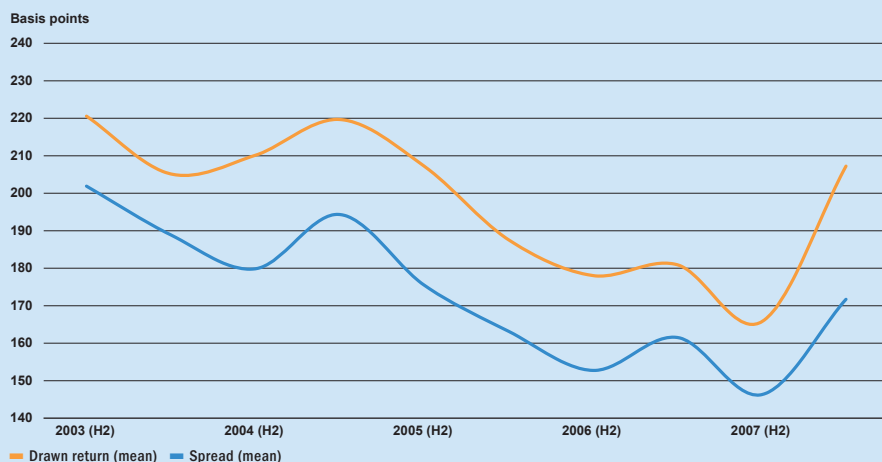


Source: Dealogic Loan Analytics.

Note: For comparative purposes the beginning of the crisis is taken as August 2007 and the analysis is limited to the 12 months before and the 12 months after this point, that is, August 2006-July 2007 and August 2007-July 2008.

Chart 2.6

Development of the funding costs of syndicated loans in transition countries

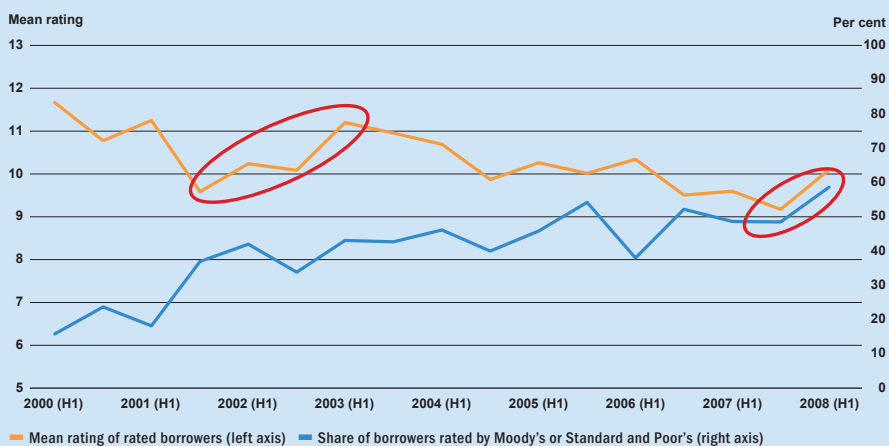


Source: Dealogic Loan Analytics.

Note: Drawn return is a funding cost measure that reflects the annual return in basis points that will accrue to a senior providing bank in the syndication if the loan facility is fully drawn throughout its life. It is calculated from the yearly weighted average margin, the annual utilisation fee, the highest participation fee spread over the maturity of the facility and the annual facility and/or underwriting fee.

Chart 2.7

Average rating of borrowers in transition countries, 2000 to mid-2008



Source: Dealogic Loan Analytics, EBRD calculations.

Note: Ratings are an average of Standard and Poor's and Moody's ratings. They range between 0 and 21. Higher ratings reflect higher borrower quality. Investment grade ratings range between 21 (AAA) and 12 (BBB-), non-investment-grade ratings between 11 (BB+) and 0 (DDD). The red ellipses indicate the periods during which a "flight to quality" occurred, that is, when lenders focused their activities on better-quality borrowers.

lenders from developed countries, profiting from abundant liquidity, were increasingly willing to take on emerging market risk. The onset of the global liquidity crisis seems to have reversed this trend, at least in the medium term, as many lenders have been forced to become more selective in their choice of borrowers. The credit crunch has also affected the structure of the lending syndicates themselves (see Box 2.1 on page 44).

Inflation and domestic bank funding

In addition to lower international debt flows, the funding of the banking sector in the transition region was also affected by the rapid rise in inflation (see Chapter 1), mainly through its effects on domestic deposits. Chart 2.8 presents data on real deposit rates and nominal deposit growth in selected countries in SEE and the CIS+M. As inflation increased, inflation-adjusted returns on bank deposits fell sharply, for the most part, into negative territory (the two upper graphs). At the same time, deposit growth has declined, though it remains positive in nominal terms (and generally in real terms) – see the two lower graphs.

The fact that nominal returns on bank deposits are not adjusted fully in line with inflation is due to a number of reasons. At short maturities, central banks in the region have allowed a decline in real interest rates. Moreover, banks always need to hold part of their assets in cash. Such cash holdings are in effect taxed by inflation, and part of this burden is borne by depositors. Banks are also reluctant to raise deposit rates aggressively as this could signal funding problems. Empirical studies have indeed shown that constraints on bank funding and credit expansion become more pronounced when the inflation rate goes above 15 per cent.¹⁰ This suggests that all CIS+M countries, and several in SEE, have reached, or are not far from, a point where high inflation is likely to depress credit growth.

Monetary policy responses and their impact on domestic credit

Banking sectors in the transition region have been affected not only by more constrained access to external capital markets and a slowdown in deposit growth, but also by changes in monetary and regulatory policies. Chapter 1 showed that, despite the rapid rise

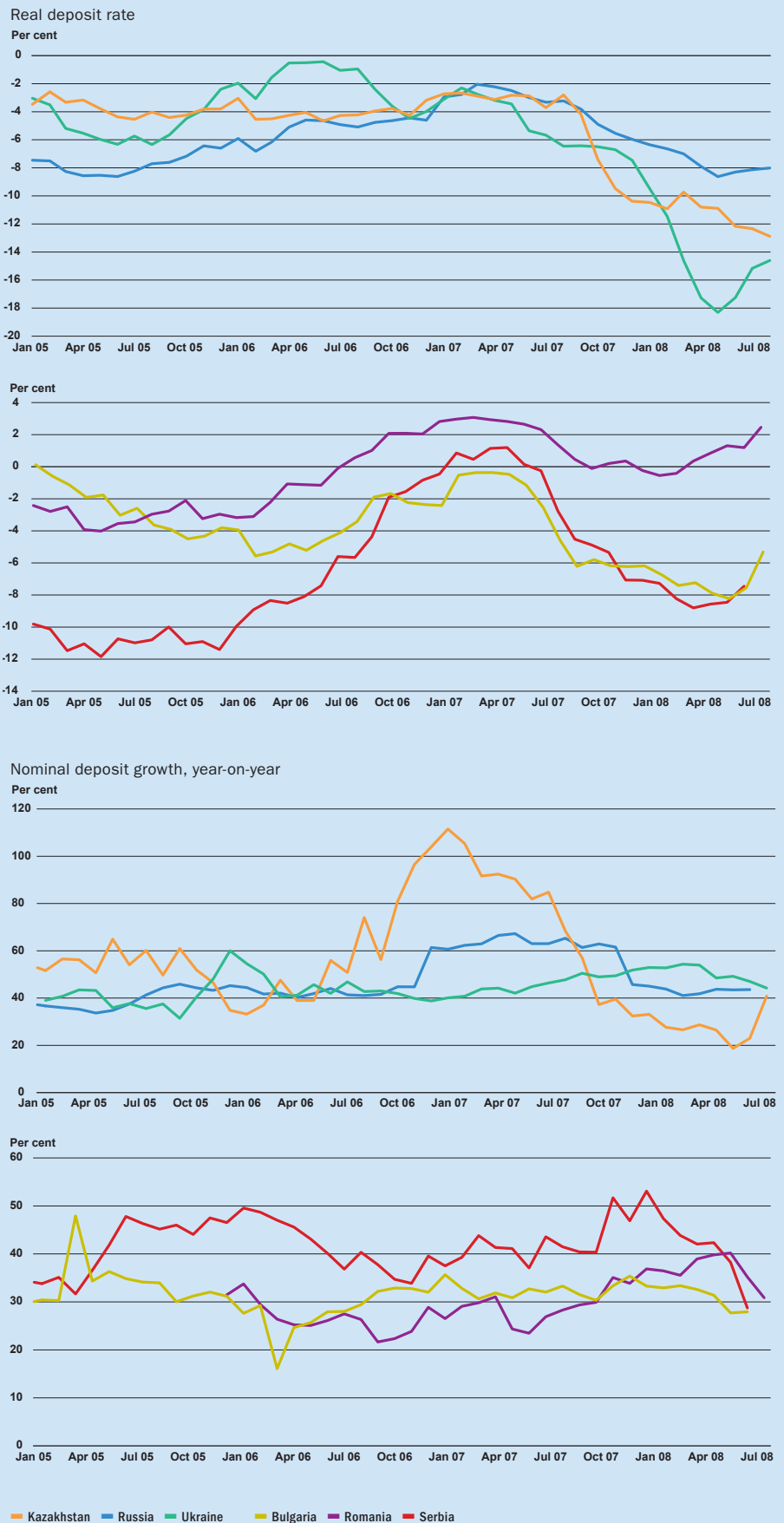
in inflationary pressures, fiscal policy has generally continued to stimulate aggregate demand, leaving the main responsibility for combating inflation to central banks. The disruptions in international credit markets since mid-2007 have complicated this task, as central banks have been forced to pursue the conflicting objectives of ensuring banking system stability through liquidity injections, and addressing inflationary pressures.

Where banking sector stability was at risk, this became the priority for monetary policy in a number of countries. For example, the National Bank of Kazakhstan (NBK) provided additional liquidity to the banking system of about US\$ 3 billion at the end of summer 2007. It also supported the Kazakh currency (the tenge) against the US dollar, sheltering bank balance sheets from the severe impact that a large depreciation would have had. Fiscal support, particularly to contain defaults in the struggling property sector, further stabilised the system. The overall result was that credit expansion rapidly decelerated, while inflation persisted at 20 per cent until mid-2008.

In Russia, the central bank has adhered to a relatively rigid exchange rate peg, thereby supporting a very rapid expansion of money supply and bank credit, as evident in the highly negative real interest rates for bank funding. Despite the rapid rise in inflation since mid-2007, exchange rate flexibility was only marginally increased in July 2008, and prudential restrictions imposed on banks remained relatively undemanding. When Russia experienced substantial capital outflows and ensuing periods of tight liquidity on the domestic money markets, the Central Bank of Russia (CBR) responded by injecting up to 1 trillion roubles (around US\$ 40 billion) of short-term liquidity into the banking sector. In the autumn of 2007, the CBR increased the range of acceptable collateral for bank refinancing and, when a third wave of capital outflows hit the banking sector in September 2008, it substantially reduced reserve requirements. The authorities also announced uncollateralised credit lines by the CBR to financial institutions, and a credit line financed out of official reserves to the state development bank with a view to refinancing private external debt obligations. Total additional support made available to the banking sector through the government and the CBR was estimated at over 10 per cent of GDP.

Chart 2.8

Real deposit interest rates and growth in bank deposits by households, January 2005–August 2008



Source: ISI Securities.

Note: The graphs show the most recent data available. However, data for Romania's deposit growth before December 2005 are unavailable.

Box 2.1

How the credit crunch has affected the organisation of syndicated lending¹¹

Syndicates consist of two main categories of participants: arrangers and fund providers. Arrangers are hired by the borrower to structure and market the loan and usually sell the largest part of the loan to the second group of syndicate members – the fund providers.

The international credit crisis provides an opportunity to analyse how banks strategically adjust their lending behaviour in response to a sharp increase in lending risks. Such risks include credit, market and liquidity risks and, in the case of syndicates, underwriting risks (the risk that arrangers cannot sell the loan on to other financial institutions). Banks can decide to simply diversify some of the additional risk by increasing the number of syndicate members. Alternatively, they may decide to decrease the number of syndicate members, as a smaller number of arrangers may make coordination easier, free-riding behaviour among arrangers less likely, and the evaluation and monitoring of borrowers therefore more effective. A smaller number of arranging banks often also means that each arranger keeps a larger share of the loan on its own balance sheet.¹² In times of increased uncertainty, with a reduced appetite among providing banks for participating in syndicated loans,

this may be particularly important as it signals the commitment of the arranger and its belief in the quality of the borrower.

The following analysis of data on syndicated loans extended to private borrowers in transition countries between August 2006 and July 2008 aims to determine whether there has been a significant change in the average number of arrangers, providers and total syndicate members as a result of the credit crisis. To isolate the specific impact of the crisis, the analysis also takes account of other potential determinants of syndicate structure, such as loan volume and the type of industry to which the borrower belongs.¹³

The empirical results in Table 2.1.1 show that in the year since the crisis began, bank syndicates providing loans to companies in transition countries consisted of fewer members than syndicates for similar loans in the year before (on average about 2.5 fewer). All else being equal,¹⁴ banks have reacted to the credit crunch by reducing the average syndicate size, both through a reduction in arrangers and, in particular, through a reduction in the number of providers.¹⁵ The reduction in arrangers is in line with earlier empirical evidence that shows that syndicates tend to

be smaller and more concentrated when there is heightened uncertainty about borrower quality.

The number of providers declined, on average, twice as fast as the number of arrangers. This sharp reduction is an indication that the pool of providers has shrunk considerably. During the last couple of years, an increasing number of national and international banks were interested in buying chunks of many syndicated loans from various regions in the world. The problems that many of these banks have since experienced in attracting funding have led some of them to refocus on core business areas. This development has made the role of arranging banks more difficult, as they have been confronted with a smaller number of retail banks that are interested in buying parts of the syndications that they arrange and often (explicitly or implicitly) underwrite. Many lead arrangers have reacted by offloading unsold underwriting positions into the secondary syndicated loan market. To a certain extent, this has only worsened their problems in the primary market, as smaller provider banks have gradually started to opt out of primary syndications because they have in some cases been able to get better prices in secondary transactions.

Table 2.1.1
Impact of the credit crunch on syndication structure

	No. of arrangers	No. of providers	No. of all participants
Credit crunch ¹	–***	–**	–**
Loan amount	+***	+***	+***
Loan maturity	–**	n.s.	–*
Rated ²	+	+	+
Secured ³	n.s.	n.s.	n.s.
Guaranteed ³	–***	n.s.	–*
Observations ⁴	765	765	765

Sources: J.P. Morgan, Dealogic Loan Analytics and authors' calculations.

Note: All estimations include variables that indicate borrower industry, borrower region and the use of the loan (general use, refinancing, mergers and acquisitions).

1 Credit crunch – distinguishes between the pre-crisis period (August 2006–July 2007) and the period of the crisis which, for comparison purposes, is August 2007–July 2008.

2 Rated – measures if the borrower was rated by Moody's rating agency at the time of syndication.

3 Secured and guaranteed – indicate whether the loan is secured by collateral and a guarantee, respectively.

4 Observations – refers to the number of loans.

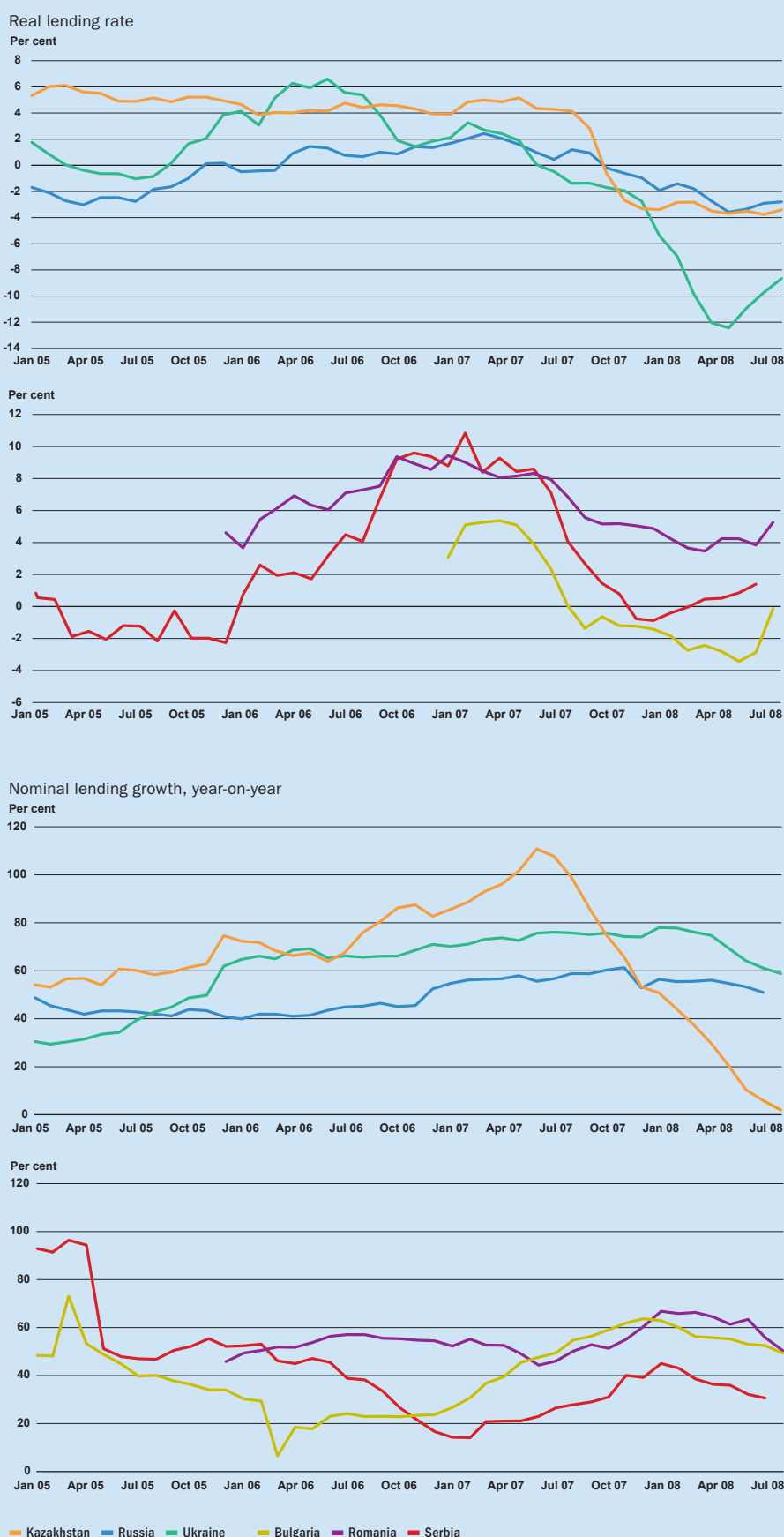
Standard errors are robust and clustered by sector. The results are robust to the specific choice of periods and/or regression methodologies (Ordinary Least Squares (OLS), Poisson or tobit). + or – indicates whether the number of syndicate members was positively or negatively associated with the particular determinant. * indicates significance at the 10 per cent level; ** 5 per cent level; and *** 1 per cent level. N.s. indicates that the particular determinant is not statistically related to the number of syndicate members.

Where systemic risk for the banking sector has not risen appreciably, central banks have given priority to monetary tightening. In CEB and SEE, where foreign bank ownership is generally very high, few of these concerns constrained central banks. However, given the rigid exchange rate regimes of several CEB and SEE countries, and the high degree of foreign currency substitution in the financial system, conventional interest rate increases were often deemed unsuitable. Alternative measures, in particular prudential restrictions on banks' balance sheet management, have been regularly chosen as a substitute. These measures, which are normally adopted to address systemic banking sector risks, are usually ineffective in restraining credit growth, as they can be easily circumvented by alternative financial institutions in the country, or by direct borrowing from abroad. This is the experience in Bulgaria and Romania, where credit growth in mid-2008 remained near annual rates of 50 per cent despite tighter prudential restrictions on bank lending over the previous year. More direct administrative measures, such as bank-by-bank credit limits, were also adopted, for instance in Croatia, although they have somewhat distorted competition in the financial sector.

As of October 2008, only four transition countries – Estonia, Kazakhstan, Latvia and, to a lesser extent, Lithuania – could be described as being in, or close to, a “credit crunch”, that is, a severe reduction in the supply of credit relative to national income. In other countries credit growth has proven surprisingly resilient or moderated only slightly. In addition to the factors described earlier in this chapter – such as the stabilising effect that foreign ownership of the banking sector has on bank lending – the credit expansion reflects the failure of policy-makers to keep inflation under control, with the resulting drop in real borrowing rates stimulating demand for credit (see Chart 2.9). Nevertheless, banks in many transition countries face acute funding problems after the dramatic global events of September/October 2008, underlining the fact that the period of rapid credit growth is coming to an end.

Chart 2.9

Borrowing rates and demand for credit, January 2005–August 2008



Outlook and policy implications

The credit crisis in the US and European banking systems is expected to last into 2009 and possibly beyond. This is likely given the persistent symptoms of continuing market stress, such as the still dysfunctional inter-bank markets, the constrained capital base of banks following substantial write-downs, and concerns over looming problems in bank assets as the business cycle takes a downturn. In addition to these severe financial market disruptions, there is a clear risk that capital flows to emerging markets will fall in line with the reduced growth or recession in the advanced market economies and the increase in risk aversion that has been evident throughout the credit crisis. The impact of these events on individual transition countries will depend on the extent and nature of financial integration that these countries have with international capital markets.

There is a first group of countries in CEB and SEE, where in many cases more than 80 per cent of all banking assets are now in the hands of a small number of large foreign banks, most of which are headquartered in western Europe. The parent banks have so far been supportive of their subsidiaries and branches in the region, which in many cases are among the most profitable parts of their networks.

However, in the short term at least, future support may be sharply reduced for a number of reasons. First, although the major regional banks that are active in the transition region have recorded relatively minor write-downs and losses from the credit crisis to date (and have been able to raise additional capital to cover a large part of such losses), the unfolding nature of the financial crisis and its contagion mean that further exposure to non-performing assets is possible. The experience of earlier financial crises suggests that where parent banks record significant losses, this generally leads to a reduction in funding to their subsidiaries.¹⁶ Second, the general tightening of liquidity conditions in European inter-bank markets is likely to affect lending to bank subsidiaries in the region, and this could aggravate the reduction in syndicated lending that was already

evident in September 2008. Third, major European banks are now raising their lending standards generally in their home countries. Empirical studies indicate that lending to emerging markets, including to subsidiaries, will be reduced as lending standards rise, whatever the perceived prospects for growth in those emerging markets.¹⁷ Fourth, following coordinated interventions of western European governments in their banking sectors in mid-October 2008, the behaviour of parent banks towards their subsidiaries may also depend on the actions of national authorities in the home countries. Close coordination between home and host country regulators will be needed to ensure that measures to stabilise banks in western Europe take into account the effects on subsidiaries in the transition region.

A second group of countries, including Kazakhstan, Russia and Ukraine, have been increasingly integrated into the global financial markets, but mainly through raising cross-border debt funding in the form of eurobonds and bank loans. Many of these countries now face international financial markets that are closed or restricted and this is likely to severely affect the growth of domestic credit. The experience of Kazakhstan is instructive, as this country was perhaps most directly affected when the credit crunch first erupted in August 2007. At that point, the Kazakh banking system had leveraged itself substantially with foreign wholesale borrowing in order to sustain the credit boom of the preceding years. Since then, Kazakh banks have not been able to increase their foreign borrowing further. In fact, they have mainly substituted maturing debt by shorter-term syndications, trade finance facilities and short-term bilateral loans. Against this background, domestic credit growth has come to a halt and this has contributed to a halving of economic growth in 2008. A further deterioration in international financial markets would mean banks are no longer allowed to replace maturing debt with new (short-term) loans. At that point unwinding foreign exposures would accelerate the credit-induced growth slowdown.

Finally, there is a group of transition countries with only very limited integration with international financial markets. Many of these countries –

such as the Kyrgyz Republic, Mongolia and Tajikistan – may nevertheless still be affected by the credit crunch. Kazakh and Russian banks are likely to transmit the tighter liquidity in their home markets to Central Asia. The five Kazakh bank subsidiaries in the Kyrgyz Republic, for instance, completely stopped lending for between two and eight months in 2007, as funding from their parent banks was constrained. Kazakh banks also significantly reduced the tenor and volume of their funding of Tajik commercial banks, leading to a reduction in new disbursements in Tajikistan.

There are also other channels through which the credit crunch is being transmitted. For example, the slump in construction in Kazakhstan and Russia – where many migrant workers are employed – is likely to lead to a slowdown in workers' remittances. In addition, a wider slowdown both in and outside the region will affect demand for these countries' exports. More specifically, microfinance organisations that are particularly prominent in Central Asia will be vulnerable to a reduction in funding from foreign investment funds.

The rapid deterioration in financial markets since September 2008, coupled with the broad withdrawal by investors from emerging market credit, has sharply raised risks for the transition countries. A key risk is a slowdown in retail credit, which would restrain the growth in consumption, although it would also mitigate some of the broader macroeconomic vulnerabilities and external financing requirements. A second channel would lie in credit constraints hitting the corporate sector. Firms that, because of their sector, age or other features are reliant on external funding, will be particularly exposed. Increased funding costs – local and international – are likely to affect the ability of firms to invest and may raise the number of corporate defaults in sectors that have expanded too rapidly and are, at the same time, highly dependent on credit. Such sectors include real estate and construction.

The extent to which the wider financial crisis is transmitted to the transition countries is therefore unlikely to follow a single path or pattern but will depend on various factors. What is clear, however, is that the general level of risk and the likelihood of a significant slowdown have risen substantially. Very rapid credit growth in many transition countries in recent years has raised questions about the quality of bank portfolios and internal risk management systems. While tighter policy and stricter prudential regulations were deemed necessary to bring about more sustainable rates of credit expansion, the deterioration in the overall financing environment could now result in a lasting and substantial slowdown in credit expansion. If so, the consequences for the overall growth of economies in the transition region will undoubtedly be severe.

Endnotes

- 1 See EBRD (2005); the analysis found that even at the end of 2004, credit levels in most transition countries were below their "equilibrium" level based on their economic fundamentals.
- 2 The IMF *World Economic Outlook* (April 2008) estimates net private capital flows to the transition region (other than direct investment and investment in securities, such as bonds or equities) at US\$ 195 billion in 2007, compared with total net capital flows of US\$ 285 billion.
- 3 This is also true for foreign direct investment (FDI – a financial flow between a company and its foreign-owned subsidiary, which captures all debt flows to foreign bank subsidiaries). FDI has so far varied little throughout the disruption to international credit markets.
- 4 Bond issues by governments in the first eight months of 2008 exceeded those in all of 2007, according to Fitch Ratings (2008).
- 5 See Unicredit (2008).
- 6 See IMF (2003); 90 per cent of syndicated loans in transition countries are denominated in foreign currency, mainly US dollars (56 per cent) and euros (34 per cent).
- 7 The analysis in this section uses information from the Dealogic Loan Analytics database on 1,710 syndicated loans in 17 transition countries – Azerbaijan, Belarus, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Romania, Russia, Serbia, the Slovak Republic, Slovenia and Ukraine – for the period 2000–08. In other transition countries the number of syndications in that period was fewer than 10 per country.
- 8 The first half of 2007 saw the auction of the assets of the Yukos oil company in Russia, which prompted its competitors Rosneft and Gazprom to raise US\$ 22 billion and US\$ 5.5 billion respectively in the syndicated loan market.
- 9 A regression analysis in which maturity is explained by a crisis variable and various other determinants, such as loan volume and the type of industry of the borrower, confirms a significant negative effect of the crisis on the average maturity of about five months.
- 10 See Boyd et al (2001).
- 11 For a broader analysis of the impact of the credit crunch on the syndicated loan market worldwide, see De Haas and Van Horen (2008).
- 12 See Esty and Megginson (2003) and Sufi (2007).
- 13 Econometric results confirm that larger loans tend to need more arrangers and providers. For these larger loans, each arranger usually works with a network of providing banks that only partly overlaps with the provider networks of other arrangers. Larger loans also tend to require relatively more arrangers in developing countries (including transition countries) compared to developed countries. This means that in developing countries in particular, adding arrangers to the syndicate may make the on-selling of the syndicated loan easier.
- 14 The "all else being equal" condition is important because the underlying data show that during the crisis the average loan size has increased (see Chart 2.4). Since there is a strong positive correlation between loan size and syndicate size, at first sight syndicate size has increased during the crisis. The analysis in this section shows, however, that, given a certain loan size, lenders have significantly reduced the number of banks involved in the syndication process.
- 15 During the crisis the number of arrangers has declined much more sharply in transition and other developing countries than in developed countries. This seems to imply that monitoring of borrowers is particularly important in developing countries.
- 16 For instance, when Bankgesellschaft Berlin experienced large losses on its East German property portfolio in 1999 it started a strategic reorientation in which it sold its holdings in Zivnostenka Banka in the Czech Republic as well as Direktbank and Inteligo Financial Services in Poland. Similarly, when sharp declines in Japanese stock prices in 1990 started to eat into Japanese banks' capital, Japanese bank branches in the United States had to reduce their credit supply as well.
- 17 See World Bank (2008).

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The ability of an economy to innovate, whether by imitating existing technologies or inventing new ones, is central to sustaining growth over the long term. Promoting competition and improving the quality of education are essential prerequisites for growth. Greater public spending on education and an enhanced role for the private sector can help boost training and skills acquisition.

3

Fostering growth in transition economies

Featured

- 50 Overview of growth in the transition countries
- 50 Framework for designing growth-enhancing policies
- 53 Policies for growth
- 61 Financing reform
- 62 Conclusions

Deep and protracted recession in the transition countries in the 1990s has since given way to strong growth that has been largely sustained. However, improving the region's growth potential in the longer term remains a major challenge. This chapter provides a general framework for designing policies that are growth-enhancing, while focusing on specific policies relating to competition and education that will be essential if the region's aspirations are to be realised.

Since the late 1980s the prevailing view as to which policies are most conducive to good growth performance has been known as the Washington Consensus. This view asserts that, irrespective of a country's geographical location or current level of development, the appropriate policy package to achieve growth is to liberalise trade and competition, privatise state-owned firms and maintain a stable macroeconomic environment. In addition, it highlights the importance of property rights protection and enforcement of contracts as essential preconditions for entrepreneurship and growth to flourish. More recently, however, this view has been challenged. For example, it has been argued that countries in South-east Asia have grown rapidly over the past 40 years without fully liberalising trade, while China has made huge economic strides without privatising its large state enterprises.¹

A new report by the Commission on Growth and Development, commissioned by the World Bank, known as the Spence Report,² has put forward policy recommendations that are somewhat different from the Washington Consensus and take into account the particular circumstances faced by countries or regions. It emphasises the common role that education, trade, competition and labour market mobility play in fostering growth across a wide range of countries, and stresses the importance of government commitment to pursuing growth-enhancing policies in the long term.

Policies such as those advocated in the Spence Report are likely to foster long-term growth in the transition countries, although several crucial factors must be kept in mind. The different subregions – central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent

States and Mongolia (CIS+M) – had very different starting points in transition in terms of income, education and infrastructure. They have also differed substantially in the extent to which they have been integrated into the European Union, have been able to develop market institutions, and in terms of their labour mobility and savings rates. Another factor is the level of dependence on natural resources; countries that rely heavily on such resources tend to suffer from high exchange rates that reduce the scope for economic diversification. More importantly, and particularly when they are non-democratic, resource-rich countries also tend to have higher levels of corruption, poorer governance and public spending priorities that can adversely affect growth.

Education and competition are also among the main policy areas considered by the Spence Report. There is now an extensive empirical literature showing that both education and competition matter for growth, even when taking account of institutions.³ In particular, the potential growth-enhancing effect of education has been well studied using datasets with large numbers of countries.⁴ The growth-enhancing effect of competition has also been emphasised in recent cross-country and cross-sector analysis.⁵ Education and competition are areas where substantial progress is needed in the transition countries to catch up with average Organisation for Economic Co-operation and Development (OECD) standards, and that are clearly susceptible to changes in policy preferences and design.

Overview of growth in the transition countries

Table 3.1 indicates the growth experience of the three transition subregions, the OECD countries and some selected benchmark countries before, during and after the Russian financial crisis in 1998. Growth in the transition economies has recently been substantially higher than in OECD countries and above the world average in the short term (the three-year average), as well as in the medium term (the six-year average). This is because they are middle-income countries catching up with the more advanced economies in respect of capital investment and knowledge acquisition.

They grow faster because it is usually easier to imitate existing technologies that have been pioneered elsewhere than to innovate. In addition, increasing the stock of capital in a poor or middle-income country raises output by more than it does in a country that has already accumulated a lot of capital.

Among the transition economies, real GDP per capita is highest in CEB. However, this still only represented 55 per cent of the OECD average in 2006; equivalent figures for SEE were 27 per cent, CIS+M resource-rich countries 23 per cent and CIS+M non-resource-rich countries 12 per cent. Recent GDP growth rates have been highest in those countries with the lowest level of GDP, signifying the scope for these economies to catch up. In addition, growth rates in the CIS+M have been high since 2000, mainly on account of the rising price of energy over the past decade.

It should be noted that growth rates in transition economies, with the possible exception of some resource-rich CIS+M countries, remain below the 8-10 per cent growth rates experienced by China and India, and are more in line with the second wave of emerging Asian economies such as Indonesia, Malaysia or Thailand.

Framework for designing growth-enhancing policies

The starting point for analysing growth at country level has commonly been to view the flow of domestic output as being generated from a given stock of factors of production, particularly capital and labour, and their respective productivity levels. A country with limited capital can grow faster by accumulating more capital, whereas a country that has already accumulated capital does not gain much by increasing its rate of accumulation. Eventually, accumulating more capital will entail more capital depreciation than it can generate in terms of added output.

Table 3.1
Level of GDP per capita and average annual growth rates between 1991 and 2006

Country groups	Indicator	1991	1996	2000	2003	2006
CEB	GDP per capita (real)	11,026	10,860	12,835	14,722	17,853
	3 yr av. annual growth in %	-4.1	4.2	4.8	6.8	
	6 yr av. annual growth in %	0.3	4.4	5.8		
SEE	GDP per capita (real)	6,688	5,980	6,608	7,475	8,929
	3 yr av. annual growth in %	-1.9	4.4	3.7	5.9	
	6 yr av. annual growth in %	-0.2	4.2	4.8		
CIS+M, non-resource-rich	GDP per capita (real)	3,876	2,139	2,515	3,127	4,061
	3 yr av. annual growth in %	-16.4	3.2	7.3	8.1	
	6 yr av. annual growth in %	-8.0	4.5	7.7		
CIS+M, resource-rich	GDP per capita (real)	6,232	3,885	4,549	5,696	7,612
	3 yr av. annual growth in %	-12.2	3.5	7.8	11.9	
	6 yr av. annual growth in %	-6.6	5.8	9.9		
Non-OECD	GDP per capita (real)	5,380	6,018	6,359	7,124	6,763
	3 yr av. annual growth in %	2.8	4.1	3.5	5.5	
	6 yr av. annual growth in %	3.9	3.8	4.4		
OECD	GDP per capita (real)	23,640	25,615	29,207	30,306	32,566
	3 yr av. annual growth in %	2.1	3.7	2.0	3.3	
	6 yr av. annual growth in %	2.8	3.3	2.6		
Emerging Asia	GDP per capita (real)	3,245	4,529	4,646	5,112	5,951
	3 yr av. annual growth in %	8.9	2.2	5.5	7.2	
	6 yr av. annual growth in %	8.2	3.7	6.3		
Selected countries						
Finland	GDP per capita (real)	21,697	22,598	27,239	28,716	32,002
	3 yr av. annual growth in %	-0.4	5.1	2.0	4.0	
	6 yr av. annual growth in %	2.1	4.1	3.0		
France	GDP per capita (real)	25,038	26,061	29,165	29,702	31,005
	3 yr av. annual growth in %	0.9	3.0	1.3	2.1	
	6 yr av. annual growth in %	1.4	2.6	1.7		
Russia	GDP per capita (real)	11,963	7,589	8,613	10,298	12,711
	3 yr av. annual growth in %	-11.9	0.8	5.7	6.7	
	6 yr av. annual growth in %	-7.0	3.7	6.2		
Ukraine	GDP per capita (real)	7,369	3,540	3,690	4,778	6,020
	3 yr av. annual growth in %	-15.6	-1.8	8.0	7.3	
	6 yr av. annual growth in %	-12.0	2.5	7.6		
China	GDP per capita (real)	1,188	2,018	2,674	3,406	4,501
	3 yr av. annual growth in %	13.8	8.2	9.1	10.4	
	6 yr av. annual growth in %	11.9	8.4	9.8		
India	GDP per capita (real)	1,191	1,483	1,710	1,931	2,393
	3 yr av. annual growth in %	5.6	5.9	5.8	8.9	
	6 yr av. annual growth in %	6.0	5.1	7.3		

Source: Authors' calculations using World Development Indicators, 2008.

Note: Real GDP per capita is based on purchasing power parity 2005 US dollar exchange rates. CIS+M non-resource-rich countries are: Armenia, Belarus, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan and Ukraine. CIS+M resource-rich countries are: Azerbaijan, Kazakhstan, Russia, Turkmenistan and Uzbekistan. OECD and non-OECD exclude transition countries and emerging Asia covers China, India, Indonesia, Malaysia and Thailand. The average growth rates are calculated to show the unweighted average of the subsequent years; for example, the three-year average growth in per cent in 2003 is the average growth between 2003 and 2005.

Chart 3.1
R&D expenditure as a share of GDP

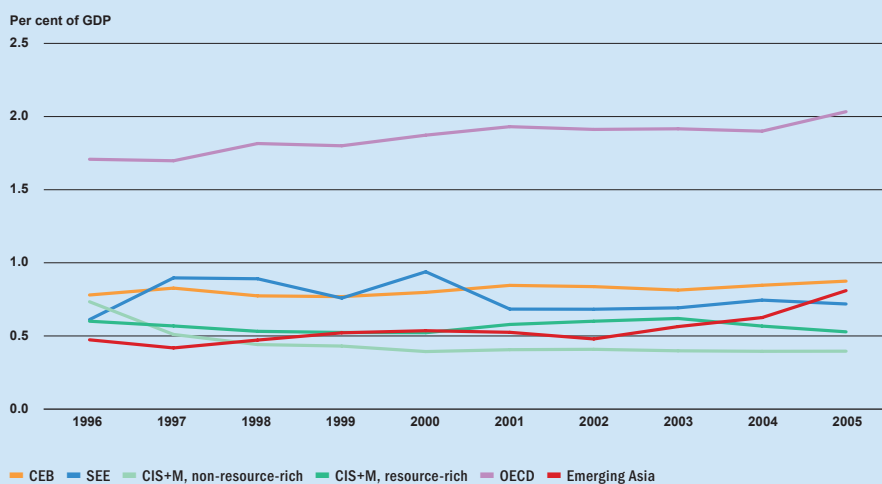
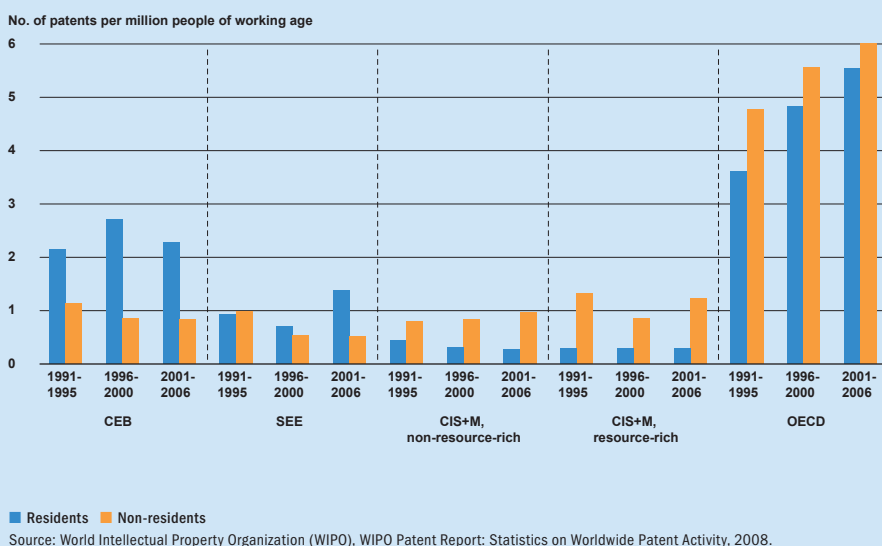


Chart 3.2
Average annual number of patent registrations



More recently, new growth theory has linked productivity growth to innovation.⁶ Innovation in turn is motivated by the prospect of above-normal returns that successful innovators can realise. The theory suggests that innovation, and therefore productivity growth, should always be fostered by:

- better protection of intellectual property rights to allow successful innovators to benefit from their endeavours
- financial sector development, as tight credit constraints will limit entrepreneurs' ability to finance new innovative projects

- better education, as this will improve the ability to innovate and/or imitate leading-edge technologies
- macroeconomic stability, which allows for a lower, risk-adjusted interest rate that will enable entrepreneurs to invest more in growth-enhancing projects.

Another important feature of innovation is what the Austrian economist Joseph Schumpeter referred to as "creative destruction" – that is, innovations displacing old products or old technologies. Therefore, faster growth typically implies a higher rate of turnover of firms, as the process of creative

destruction generates the entry of new innovators and the exit of old ones. Indeed, competition is likely to enhance growth because it enables this process of turnover.

Overall spending on research and development (R&D) and the number of patent registrations are good indicators of the level of innovative activity in a country.⁷ Charts 3.1 and 3.2 show that, for both indicators, transition countries lag well behind the OECD average. Also, while income levels are catching up, this is not yet the case for investment in innovation. In contrast to emerging Asia, where R&D has been rising in recent years, transition countries have not raised their innovative activity (Chapter 5 discusses this further).

There are a number of ways in which a country can increase its productivity growth. One is to imitate more advanced technologies that have been invented elsewhere. Another is to make a leading-edge domestic innovation that builds on and extends the limits of international technology standards. A country that is far from the "technological frontier" can make substantial leaps forward in productivity growth each time it imitates leading technologies developed elsewhere.⁸ However, a country that lies closer to the technological frontier will need to rely primarily on new innovations, which are more difficult to generate, in order to grow further.

The imitation of existing technologies occurred widely in Japan and Europe after 1945 and more recently in the economies of the so-called Asian Tigers, such as China, Korea and Taipei China. Imitation has tended to occur where:

- large firms can take advantage of economies of scale
- there is limited labour mobility between firms, so that workers' skills remain largely specific to their firm
- there is limited competition and entry, allowing large firms to survive longer and make long-term investments in capital and labour
- financial systems can provide long-term bank finance.

In contrast, countries that innovate at the technological frontier have tended to require:

- higher labour market mobility, so that innovating firms that enter new markets can more easily find workers who match their needs
- more intense product market competition and low entry barriers
- more focus on tertiary and, particularly, graduate education, with universities that can produce researchers and generate the basic science that firms harness to innovate
- a bigger role for non-bank finance and stock markets that can help select the most promising innovative projects to finance.

The overall effect of competition or entry on growth at country level therefore depends on the proximity of local industries to their respective technological frontiers, and on the technological level of new entrants.

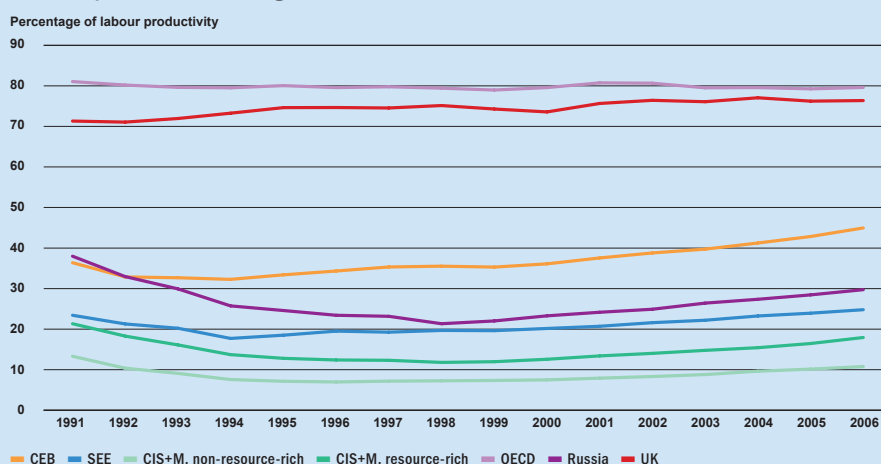
Chart 3.3 illustrates the proximity of the transition countries to the technological frontier, using the United States⁹ as the benchmark, and comparing labour productivity¹⁰ for the transition region relative to the United States. The transition region as a whole is lagging below the frontier by a long way – with a range of 12–42 per cent of labour productivity levels in the United States in 2006. This indicates that most countries can still benefit substantially by imitating frontier technologies. However, the gap has been narrowing over the last few years, particularly in CEB, where several countries are close to the frontier and need to focus on new innovations to generate further growth. The chart indicates that there is also considerable variation within the group of transition countries. Whether a country can benefit more from imitation or from new innovation, competition and education remain two key policy areas. They improve the necessary labour market skills and set the right incentives for firms to imitate or innovate.

Policies for growth

Competition and entry

This section focuses on the related issues of competition and market entry and looks at how the framework

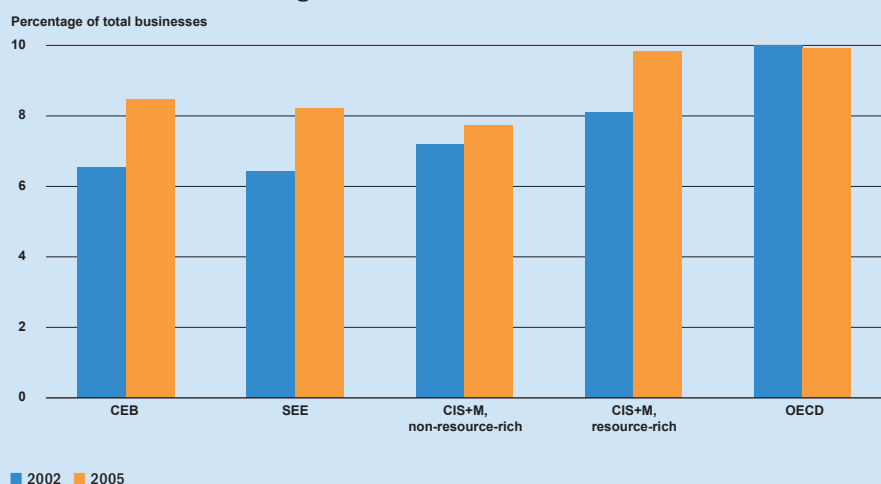
Chart 3.3
Proximity to the technological frontier



Source: Authors' calculations using World Development Indicators, 2008.

Note: Proximity to the technological frontier is measured as the ratio of labour productivity to US labour productivity. Labour productivity is measured over real GDP (purchasing power parity) by output per labour force participant (aged 15–64). OECD data exclude the transition countries.

Chart 3.4
Rate of businesses entering the market



Source: World Development Indicators, 2008.

Note: The rate of businesses entering the market is measured by the number of new registrations as a percentage of total businesses. OECD data exclude the transition countries.

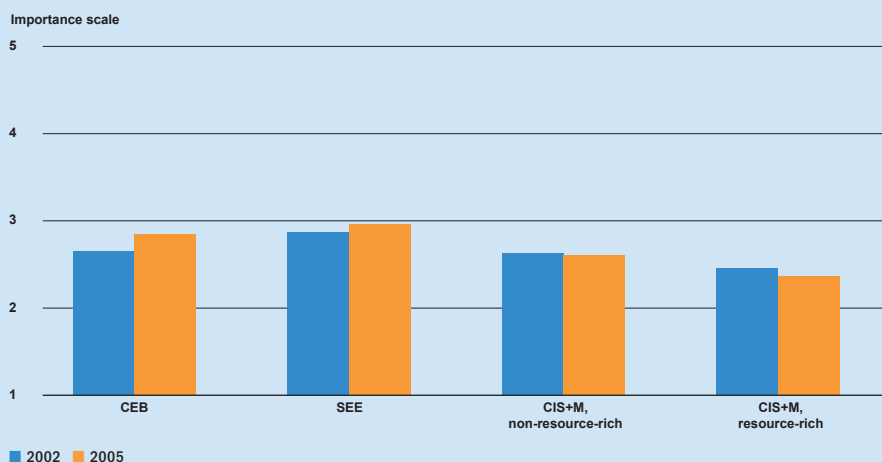
outlined previously can be translated into more specific policies to encourage growth. It provides some evidence regarding the number of market entrants and competition in the transition countries and then considers the appropriate policy response.

In this section, it will be argued that product market competition enhances innovation, labour productivity and growth.¹¹ Existing levels of product market competition (as inversely measured by profit margins,¹² for example) are significantly below OECD averages. Policies to encourage product market competition are

therefore likely to have positive pay-offs both for old firms, where competition can be a substitute for effective corporate governance, and for new firms, where these policies spur innovation by increasing incremental profits that result from getting ahead of their competitors.

Chart 3.4 shows entry rates in the transition countries, measured as new registrations as a percentage of total businesses. When compared with the OECD average, it can be seen that entry rates were higher in 2005 than in 2002 but are still below OECD levels. This can partly be attributed to barriers in the

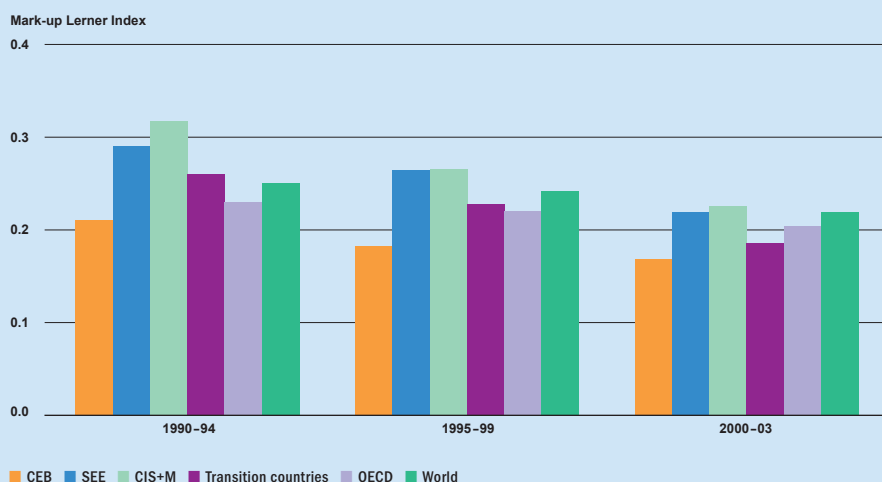
Chart 3.5
Importance of competition from imports



Source: EBRD-World Bank Business Environment and Enterprise Performance Survey, 2002 and 2005.

Note: Firms were asked the question: "How important is competition from imports in the market for your main product line or main line of services in the domestic market?" and were asked to reply on a scale of importance from 1 = not important to 5 = extremely important. Data for the CIS+M exclude Turkmenistan.

Chart 3.6
Evolution of manufacturing mark-ups



Source: United Nations Industrial Development Organization (UNIDO) industry level panel 1998-2007.

Note: The Lerner Index measures the pricing power - or industry mark-up - as the difference between value added and the total wage bill expressed as a share of gross output. The data show annual industry sector averages. OECD data exclude the transition countries.

business environment that deter new entrants. Such barriers range from limits on the availability of credit to levels of taxation and regulatory impediments.

A recent study has found that credit constraints, particularly in western Europe, tend to act as the main barrier to the entry and post-entry growth of very small firms.¹³ This is also relevant for the transition countries, since small firms regularly report access to finance as a major impediment to their business activity and growth potential.¹⁴

Turning to competition, evidence from the EBRD-World Bank Business Environment and Enterprise Performance Survey

(BEEPS), covering over 20,000 firms in 26 transition countries, gives some indication of the extent of competition, focusing on trade and imports. Chart 3.5 presents the survey results, which show how important competition from imported goods is for producers of similar domestic goods across the three subregions. Competition between imported and domestic products has become more intense over time in CEB and SEE, but less so in the CIS+M. This is due mainly to the recent increasing trade integration of the CEB and SEE subregions with the rest of the world (principally through the EU accession process), but also because of increasing intra-regional trade. With the exception of commodity-induced

trade in the resource-rich countries, the CIS+M region shows lower internal and external trade integration (see also Chapter 4).

Focusing on manufacturing industries in the subregions, SEE and the CIS+M have lower levels of product market competition than the OECD average. The extent of competitive pressure in an industry is indicated by the pricing power that is evident. Pricing power - or industry mark-up - can be measured directly using the Lerner Index. This is measured as the difference between value added and the total wage bill expressed as a share of gross output.

Chart 3.6 shows the evolution of mark-ups since the start of transition. It reveals that they have declined over time throughout the whole region, and that CIS+M and SEE countries generally have higher mark-ups than OECD countries, the world average and CEB. This can be explained by a number of factors, including regulated product markets as well as low levels of diversification away from commodities in the resource-rich CIS+M countries. Reducing mark-ups through increased foreign competition, either by further trade integration or direct entry of foreign firms, can help boost innovation and productivity growth.¹⁵

Chart 3.7 uses BEEPS data to assess the impact of competition on product innovation. It shows that both domestic and foreign competition have a larger impact in non-resource-rich countries than in resource-rich countries. It can also be seen that pressure tends to come more from domestic than foreign competition. These findings may in turn reflect the fact that: (i) although foreign competitors might be more challenging to local incumbents in terms of technological sophistication, most firms compete mainly with their domestic counterparts (which may also reflect a lack of trade integration and additional barriers to entry for foreign firms); and (ii) firms in resource-rich countries are more likely to benefit from government subsidies that partly shield them from the effects of competition.

Recent evidence indicates that product market competition and entry have a positive and significant effect on productivity growth in emerging market economies, such as India and South

Africa.¹⁶ It appears that the same is also true in transition countries; Chart 3.8 shows that lower competitive pressure is indeed associated with lower productivity growth. The relationship is in fact stronger for the transition countries than for the OECD economies (as can be seen by the relative slope of the two lines in the chart). Therefore, even though transition countries are not that close to the world technology frontier, they are close enough for competition to be growth-enhancing.

This analysis suggests that insufficient competition leads to less intense innovation, which in turn slows the speed at which productivity catches up with the technological frontier. Too little product market competition also directly affects labour productivity growth.¹⁷ This is true not only for countries closer to the frontier – such as the OECD – but also for transition countries.

In the light of this discussion, the obvious question to ask is how transition countries can ensure that sufficient product market competition occurs and that it in turn translates into labour market productivity and, ultimately, into overall economic growth. There is an important role in this respect for effective institutions, such as competition authorities. In a 2007 competition survey, the EBRD measured the efficiency and effectiveness of these institutions. Chart 3.9 on page 56 shows: the overall expenditure on competition regulation and enforcement as a share of GDP; the EBRD score for competition for 2007 (calculated as one of the transition indicators between 1 and 4+ detailed in Chapter 1); and an index that covers the efficiency of enforcement, with a focus on competition authority decisions relating to market dominance.

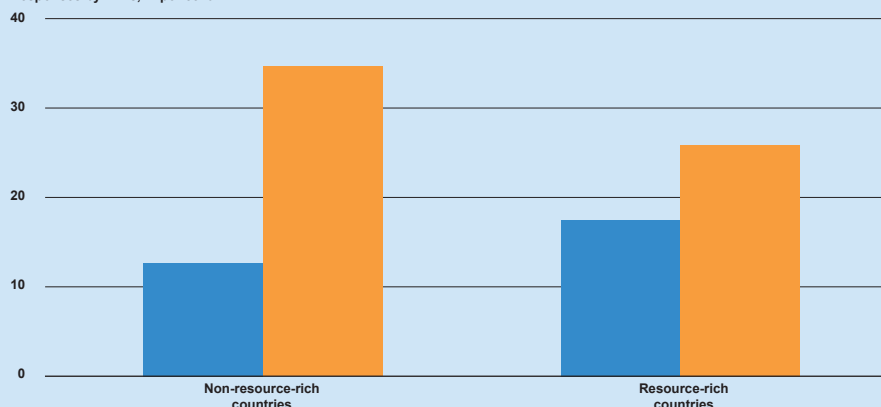
With the exception of spending, the indicators are higher for the CEB countries than for the rest of the transition region. This has been driven partly by the EU accession process of the CEB region and some SEE countries, which has standardised competition legislation and enforcement procedures. SEE lags behind CEB in terms of contract enforcement processes (delays being primarily due to case backlog and an insufficient number of judges), even though overall expenditure is high.

Chart 3.7

Importance of competition for the development of new products

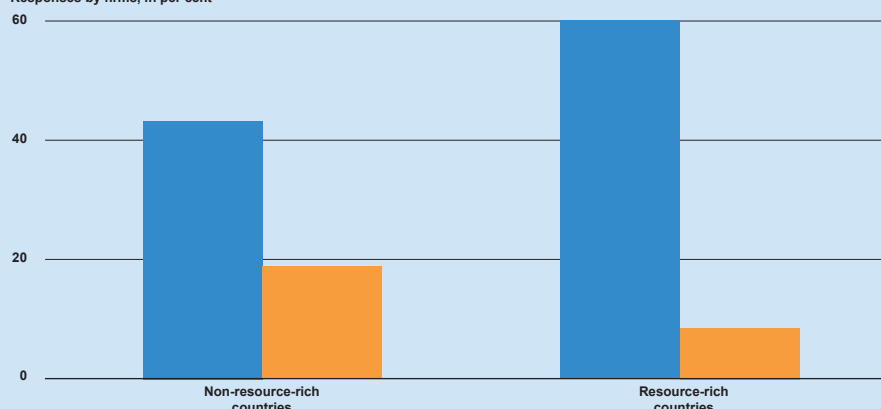
Domestic competition

Responses by firms, in per cent



Foreign competition

Responses by firms, in per cent



■ Not at all important ■ Very important

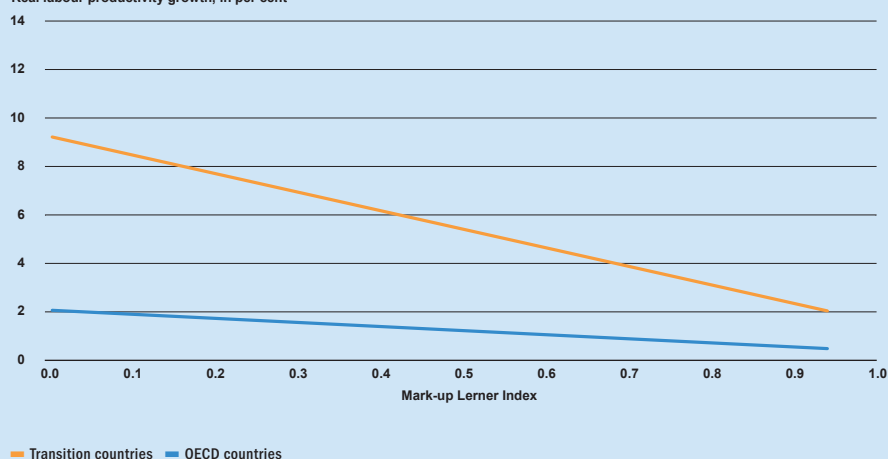
Source: BEEPS 2005.

Note: The chart shows the proportion of firms claiming that domestic or foreign competition is (i) not at all important, or (ii) very important for the development of new products.

Chart 3.8

Labour productivity growth and manufacturing mark-ups, 1990–2003

Real labour productivity growth, in per cent



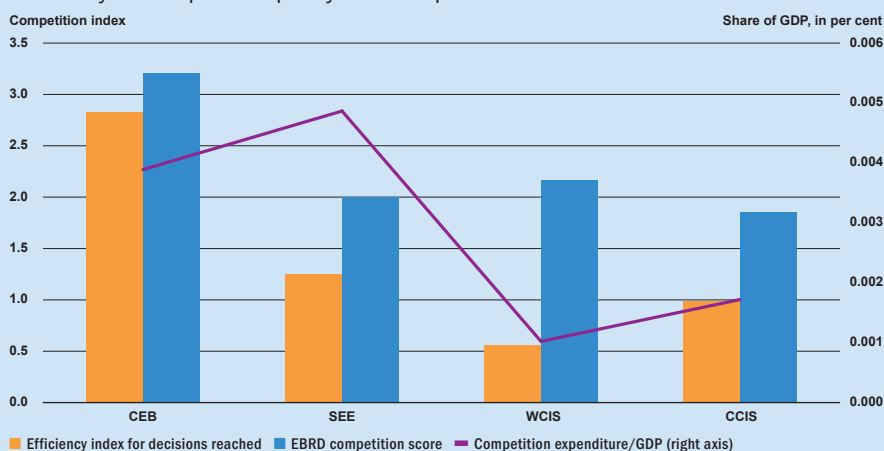
— Transition countries — OECD countries

Sources: UNIDO, Vienna Institute for International Economic Studies industry statistics and authors' calculations.

Note: The chart depicts linear predicted values from regression results of labour productivity growth on the Lerner Index, Lerner Index squared, accounting for year, industry and countries. Regressions were run separately for OECD and transition countries.

Chart 3.9

Efficiency of competition policy and competition institutions

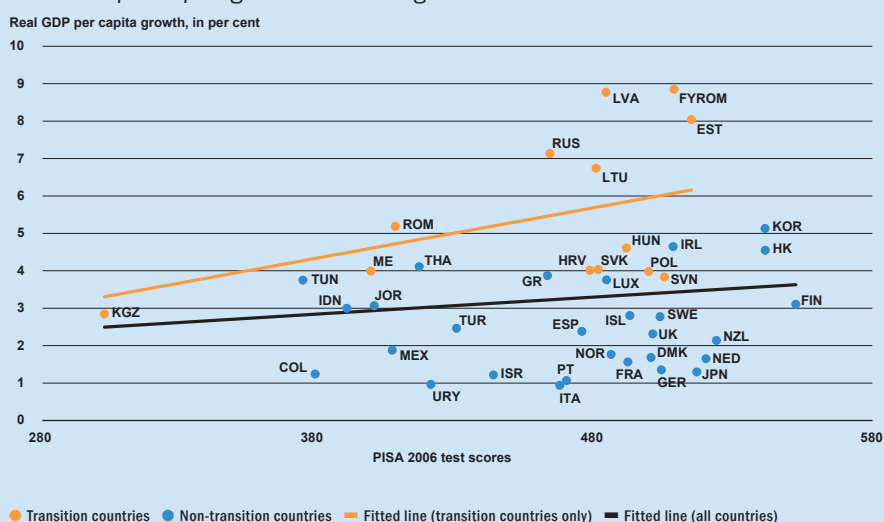


Source: EBRD competition survey 2007.

Note: The efficiency index is the ratio of decisions regarding market dominance or motions reached, relative to new cases opened. WCIS – Western CIS countries (Belarus, Moldova, Russia and Ukraine). CCIS – Caucasus and Central Asian countries (Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan, Turkmenistan and Uzbekistan). The efficiency index and competition expenditure excludes Armenia, Belarus, the Czech Republic, Georgia, Latvia, Mongolia and Turkmenistan.

Chart 3.10

Real GDP per capita growth and average PISA 2006 test scores



Sources: World Development Indicators, 2008 and OECD.

Note: The chart shows predicted PISA 2006 results based on a regression of PISA 2006 results on mean GDP per capita growth. Countries shown are: Colombia (COL), Croatia (HRV), Denmark (DMK), Estonia (EST), Finland (FIN), France (FRA), FYR Macedonia (FYROM), Germany (GER), Greece (GR), Hong Kong (HK), Hungary (HUN), Iceland (ISL), Indonesia (IDN), Ireland (IRL), Israel (ISR), Italy (ITA), Japan (JPN), Jordan (JOR), Republic of Korea (KOR), Kyrgyz Republic (KGZ), Latvia (LVA), Lithuania (LTU), Luxembourg (LUX), Mexico (MEX), Montenegro (ME), the Netherlands (NED), New Zealand (NZL), Norway (NOR), Poland (POL), Portugal (PT), Romania (ROM), Russia (RUS), Slovak Republic (SVK), Slovenia (SVN), Spain (ESP), Sweden (SWE), Thailand (THA), Tunisia (TUN), Turkey (TUR), United Kingdom (UK) and Uruguay (URY).

Experience from other emerging countries has shown that independent and transparent competition authorities can exercise a positive influence on product market competition. Rather than narrowly focusing on curbing the dominance of firms already in the market, competition authorities need to employ a broader approach that keeps entry and exit barriers consistently low and gives incentives to firms to innovate. This means adopting a broad-based approach with deregulation at its core.

This will include clear and quick licensing procedures and eliminating as much bureaucratic blockage as possible. For registration requirements, a “one-stop shop” system and/or (ideally) online registration can significantly reduce the number of transactions and the time spent on related processes. An applicant might then submit one form containing all the information required by various agencies to a single entity. Although some transition countries have moved towards such a system,

registration requirements in the CIS+M are still cumbersome. There are also large differences across SEE countries in the indicators that measure institutional conditions for product market competition.¹⁸

Another important element in ensuring ease of entry and subsequent product market competition is the cost of construction licences and, more generally, property rights, registration and collateralisation. The World Bank's *Doing Business 2009* report documents large differences across countries. For example, registering a property takes between three days in Lithuania and 128 days in Bosnia and Herzegovina (the OECD average being 30 days), while costs vary from 0.03 per cent of the property value in Georgia to 11 per cent in Hungary.

In addition to their traditional role of investigating anti-competitive practices by firms, competition authorities also have important functions in holding to account, and if necessary filing cases against, local and regional government bodies whenever they restrict competition. Therefore, the case-by-case investigation of violations of competition law needs to be accompanied by actions that help to cultivate entrepreneurial activity and provide functional support to new firms.

Education

Using a large number of countries and data points for the period 1960-92, research has shown that education enhances growth.¹⁹ A higher level of education encourages innovation, as a more educated population is better equipped to contribute to innovation. In addition, a higher average level of education is crucial for the successful imitation and faster adaptation of existing modern technologies.

Most existing studies on education and growth measure education in terms of spending (the proportion of aggregate GDP devoted to education) or in terms of attainment (the proportion of the working age population that has achieved particular qualifications). More recently, research has been extended to include measures of the quality of education.²⁰

Using internationally comparable test scores measuring the quality of students' cognitive skills, a positive and significant correlation between long-term growth

Table 3.2
Expenditure per student at different education levels and gross enrolment rates

Country groups	Indicator	Primary education		Secondary education		Tertiary education	
		1999-2002	2003-06	1999-2002	2003-06	1999-2002	2003-06
CEB	Expenditure per student	17.4	19.2	21.9	22.9	27.8	24.9
	Gross enrolment rates	101.5	99.5	95.4	98.3	47.4	58.9
SEE	Expenditure per student	13.0	16.4	17.5	18.7	31.3	26.6
	Gross enrolment rates	100.2	99.7	83.2	87.4	28.3	33.8
CIS+M, non-resource-rich	Expenditure per student	10.1	13.0	12.9	17.4	29.9	26.5
	Gross enrolment rates	102.2	98.8	82.6	87.0	35.3	41.0
CIS+M, resource-rich	Expenditure per student	8.2	8.2	14.7	9.9	14.6	10.0
	Gross enrolment rates	100.6	104.5	86.5	90.9	22.7	34.6
OECD	Expenditure per student	18.7	19.7	24.1	25.0	35.8	34.8
	Gross enrolment rates	103.2	102.9	109.8	107.6	54.1	61.6
Selected countries							
Finland	Expenditure per student	17.6	18.5	25.9	29.4	38.8	37.2
	Gross enrolment rates	100.7	101.0	124.2	118.7	83.6	88.3
France	Expenditure per student	17.4	17.6	28.2	28.9	29.1	32.2
	Gross enrolment rates	106.2	106.1	109.5	110.4	53.0	55.1
United States	Expenditure per student	19.9	21.6	23.6	25.1	28.0	25.3
	Gross enrolment rates	100.3	98.8	94.0	93.9	73.1	81.8

Source: World Development Indicators, 2008.

Note: The numbers are four-year annual averages. Gross enrolment rate is the ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to the level of education shown. Numbers above 100 are due to population growth. Expenditure per student is given as a percentage of GDP per capita. For definitions of CIS+M non-resource-rich countries, resource-rich countries and OECD, see Table 3.1.

and the quality of education for a large sample of countries has been identified (see Chart 3.10).

The same research (using information for 50 countries over the period 1960-2000) finds that countries with better test scores have significantly higher annual growth rates in GDP per capita. More specifically, an increase in test results by 100 points²¹ is associated with an increase in annual growth rates of 1.3 to 2.0 percentage points. Furthermore, a reform that would improve students' outcomes by 50 points over a period of 20 years would, on average, increase GDP by around 5 per cent and over a period of 75 years by 36 per cent.²²

Other complementary research has also analysed the relationship between growth and the composition of education spending.²³ Results show that the closer a country's or region's productivity is to the technological frontier, the more growth-enhancing it becomes to invest in higher education, and particularly in postgraduate education and research.

The further a country or region is from the frontier, the more growth-enhancing it is to invest in primary, secondary and undergraduate education, which is more likely to make a difference in terms of the country's ability to imitate existing technologies.²⁴

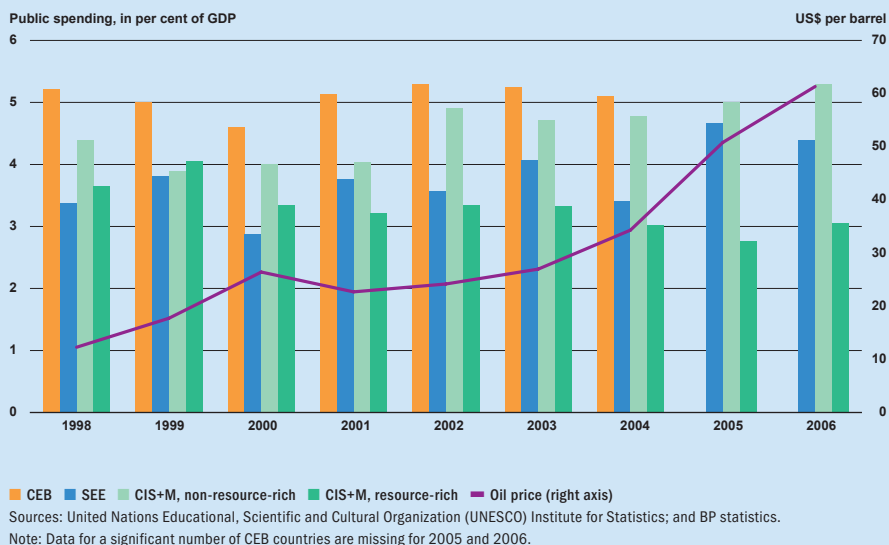
However, the complexity of the relationships and the differences among the transition countries call for a careful, country-based interpretation of these results before drawing strong policy recommendations. Suggesting that transition countries focus on primary and secondary education simply because they are not near to the technological frontier would be problematic. For example, without a good tertiary education sector, India would not have been able to develop its dynamic service sector. While some of the poorer transition countries can increase their growth potential by investing more in the quality of primary and secondary education, the region should not neglect investment in undergraduate education that will ensure better

teacher quality and other desirable workforce characteristics that are likely to aid growth.²⁵

Turning to the actual evolution of education spending and quality in the transition countries, Table 3.2 gives expenditure and enrolment rates across the different groups of transition economies as well as the OECD over the period 1999-2006.²⁶

The table shows that the proportion of expenditure on tertiary education has decreased over the past decade in all transition regions, but has remained virtually constant for OECD countries. Transition countries spend less per student than the OECD average, and have lower enrolment rates. Expenditure per student in primary and secondary education (percentage of per capita GDP) has mostly remained the same or increased over the same period, although CIS+M resource-rich countries reduced spending on each student in secondary education between 1999-2002 and 2003-06. There are large differences

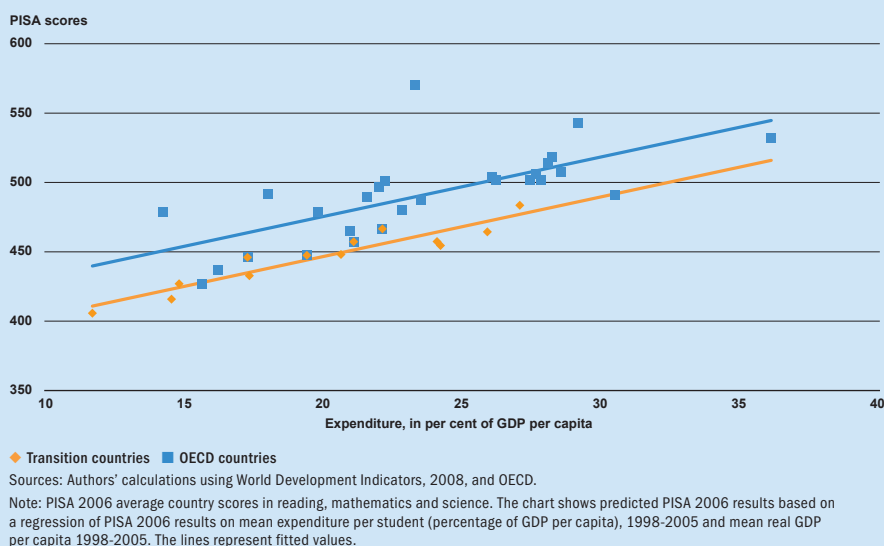
Chart 3.11
Public spending on education and oil prices



across the transition subregions: resource-rich countries devote the least expenditure to tertiary and primary education, and they have much lower enrolment rates at tertiary level than non-resource-rich countries.

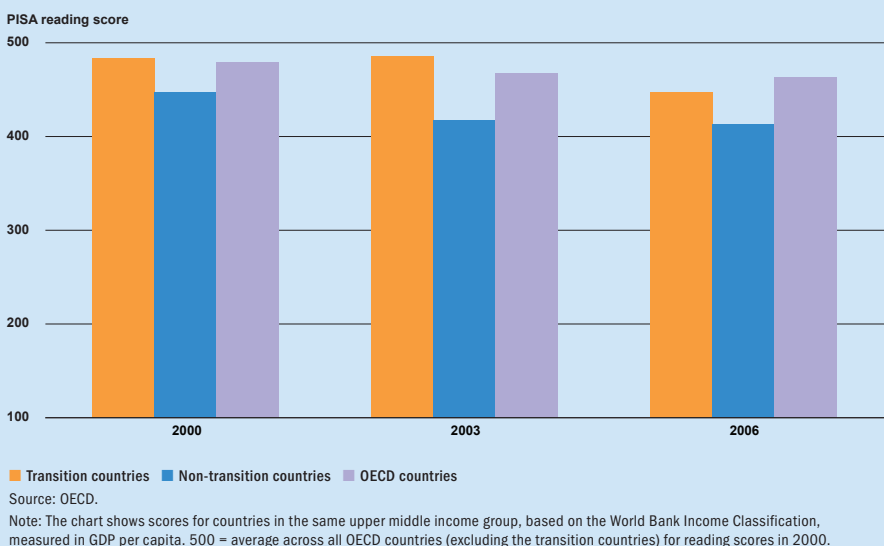
Chart 3.11 shows that resource-rich countries decreased the proportion of total public expenditure on educational institutions at a time when oil prices started to rise, while the non-resource-rich CIS+M and SEE regions increased their shares. This implies that countries with sharply rising resource flows have as yet failed to use those new resources to raise funding for education, and therefore have missed an opportunity to address shortcomings in their educational systems at a time of buoyant export revenues.

Chart 3.12
Expenditure per student in secondary education and PISA outcomes



Whatever the level of spending as a share of national income, a key question is whether these expenditures and student enrolment numbers actually achieve the intended educational outcomes. One indicator that is comparable over a large set of transition and non-transition countries is the Programme for International Student Assessment (PISA) test score that measures reading, science and mathematics achievement in a standardised fashion.²⁷ Chart 3.12 links PISA test scores to secondary education spending, and shows a positive and significant relationship, in particular for transition countries. Therefore, when taking account of income levels, increasing educational expenditure in the transition countries does appear to be associated with improved quality of education.

Chart 3.13
Reading scores across countries



Nevertheless, the quality of education for all transition countries still remains below the OECD average (see Table 3.3). Furthermore, there are significant differences across the transition region. While student performance in CEB countries in 2006 was close to the OECD average, the average test scores were relatively low in SEE and lowest in the CIS+M countries. However, when compared to countries with similar GDP per capita levels, transition countries perform generally better than their peers (see Chart 3.13). Some countries, such as Latvia and Poland, achieved substantial improvements in student performance between 2000 and 2006.

Table 3.3
Average PISA test scores across regions, 2000-06

Average PISA scores in different regions in 2006					
		CEB	SEE	CIS+M	OECD
	Mathematics	498	426	421	498
	Science	504	439	395	500
	Reading	485	414	359	493
Average PISA scores for different subjects					
Results for selected countries		2000	2003	2006	
Estonia	Mathematics	na	na	515	
	Science	na	na	531	
	Reading	na	na	501	
	Problem solving	na	na	na	
Finland	Mathematics	536	544	548	
	Science	538	548	563	
	Reading	546	543	547	
	Problem solving	na	548	na	
France	Mathematics	517	511	496	
	Science	500	511	495	
	Reading	505	496	488	
	Problem solving	na	519	na	
Latvia	Mathematics	463	483	486	
	Science	460	489	490	
	Reading	458	491	480	
	Problem solving	na	483	na	
Poland	Mathematics	470	490	495	
	Science	483	498	498	
	Reading	479	497	508	
	Problem solving	na	487	na	
Romania	Mathematics	na	na	415	
	Science	na	na	418	
	Reading	na	na	396	
	Problem solving	na	na	na	
Russia	Mathematics	478	468	476	
	Science	460	489	480	
	Reading	462	442	440	
	Problem solving	na	479	na	
OECD average	Mathematics	500	500	498	
	Science	500	500	500	
	Reading	500	494	492	
	Problem solving	na	500	na	

Source: OECD.

Note: The transition countries participating in PISA 2006 were: the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia (CEB); Bulgaria, Croatia, Montenegro, Romania and Serbia (SEE); and Azerbaijan, the Kyrgyz Republic and Russia (CIS+M). OECD average excludes the transition countries.

Box 3.1**Raising educational standards in Estonia**

Estonia participated in PISA for the first time in 2006. It not only came first among participating transition countries, but also scored above the OECD average in all three major categories – mathematics, science and reading. Estonia's education system has gone through significant changes since a new law took effect in 1992, with emphasis on teacher qualifications, school autonomy coupled with external monitoring, investment in information technology, and frequent exchanges with Finland – the top-performing country in PISA.

Investment in teacher training has been increased and stricter teaching standards have been introduced to ensure that only those with accepted pedagogical qualifications may teach. As early as 1994, Soviet-style teaching institutions were replaced with a Western system of credits and degree attainment. This has been coupled with extensive teacher evaluation, whereby the staff members of each school are appraised externally in cooperation with the department of education of the relevant county and representatives of the local community. Every educational institution is also obliged to develop a system of internal evaluation. The National Examination and Qualification Centre (NEQC) ensures that quality standards are sustained, including for external evaluation. Within the national curriculum framework, schools also have considerable autonomy. However, this has not led to significant differences in school performance in the 2006 PISA results, but high scores across all schools.

The Estonian experience suggests that quality and equity can be reconciled. For five out of seven of the countries with the highest mean PISA science score of over 530 (Finland, Canada, Japan, Hong Kong-China and Estonia), less than 10 per cent of the variation in student performance was explained by student background. This suggests that quality and equity in education can be jointly achieved.

The full scope for improvement in cognitive skills in the transition countries becomes evident when results are not only compared with those in the OECD, but also with top-scoring comparator countries such as Finland. Table 3.3 shows the mean scores of the PISA tests in mathematics, science and reading skills. For example, in 2006 Finland's students achieved the highest score on the science scale with 563 points (63 points above the OECD average). The top performer among the transition countries was Estonia, with average student test scores of 515 and 531 points for mathematics and science respectively (see also Box 3.1). Russia was the leading country in the CIS+M, although the performance of the Russian students in mathematics, science and reading was below the OECD average. The scoring gaps between Russia and the overall PISA leaders, such as Finland, range from 72 points for mathematics up to 107 points on the reading scale, while the corresponding differences with the best performing transition country (Estonia) are smaller but still amount to 39 and 61 points. The considerable gap between the transition and top-performing countries indicates the potential for improving educational quality and, ultimately, the growth potential of the transition region.

The significant differences in test scores reveal the high potential for future improvements in the quality of cognitive skills in the transition countries. This in turn would have a strong impact on long-term economic growth. Based on the regression results underlying Chart 3.10, Russia, for example, could achieve higher long-term annual GDP growth rates of between 0.065 and 1 percentage point, merely by catching up with the top PISA performers among the transition countries.²⁸

In terms of policy, the transition countries need to invest more overall in education, but in a way that links that investment to quality improvement. Without such investment, countries will not be able to effectively imitate technological innovations produced elsewhere. Alongside this challenge, better monitoring and evaluation systems would increase the effectiveness of investment in education. Further

participation in school-based, national and international assessments such as PISA will also help policy-makers by clarifying their countries' relative educational performance.²⁹

Although Chart 3.12 indicates that higher expenditure per student tends to be associated with better student performance, the aggregate results mask considerable differences between countries. Studies analysing the effect of school inputs and resources – typically teacher-to-student ratios, class sizes, textbook provision, teacher training and experience, monitoring of schools, school facilities and administration – provide mixed evidence on successful strategies aimed at improving educational outcomes that would apply to all countries. Overall, however, there needs to be better use and targeting of educational investment, improvements in teacher quality, increased accountability to parents, students and national educational authorities, and adherence to standards. Transparency through public participation and feedback mechanisms is important for delivering and regulating the educational sector effectively. In the transition countries, there has been a notable lack of such consultation. One way to promote accountability in the education system is through decentralisation and improvements in local school management practices.

Another issue of concern to policy-makers relates to good and equal access to education. A student's background seems to be a predominant factor in educational performance in the transition countries, and much more so than school resources or institutional settings.³⁰ This highlights the need for policy reforms to help secure funding and improve access to education (including pre-primary education) for children from less well-off families. Furthermore, poorer regions need to be assisted with financial transfers from central government. Achieving equity in the financing of education can be helped through the use of funding formulae based on expenditures per student. This can help combat poverty by targeting public educational resources at the poor.³¹

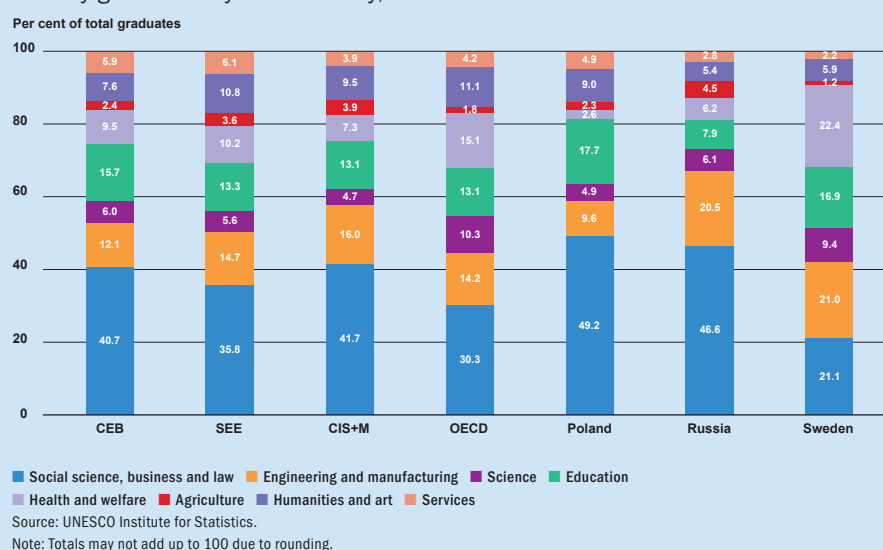
The PISA results (in Table 3.3) show that students in transition countries lag behind in terms of problem-solving skills and applying knowledge in new areas. Changes in the school curriculum at primary and secondary level and in vocational education are therefore needed to enhance critical thinking and provide children with more general and relevant skills. In this context, the curriculum for secondary education plays a crucial role, since it has a dual purpose of linking directly to the labour market as well as preparing students for tertiary education.³² Chart 3.14 suggests that the transition countries have a higher proportion of social science graduates at tertiary level than the OECD average and some selected comparator countries (such as Sweden). In terms of vocational training, transition countries have a legacy of a very narrowly defined curriculum and need to broaden and update it to increase the relevance of vocational training programmes. Involving private businesses more in designing training programmes will be important.

The wider problem of skills mismatch in the labour market remains an important issue that needs to be addressed by policy. The Life in Transition Survey (LiTS), carried out in 2006 by the EBRD and World Bank, found that one-third of all employees did not work in jobs corresponding to their educational attainment.³³ This mismatch was most prevalent in the CIS+M. The problem is not unique to transition countries, but it highlights the need to invest in more lifelong learning and retraining to help workers and firms continually upgrade their skills. Providing tax incentives for workers and firms to take up training opportunities has generally proved more fruitful than attempts to set up publicly managed training programmes.

Financing reform

Promoting and enforcing competition generally makes larger demands on political will and reform capacity than on government budgets. However, entrenching educational reforms that are important for long-term sustainable growth is more financially taxing. While the private sector has its part to play, governments are crucial in ensuring access to, and the quality of, formal education.

Chart 3.14
Tertiary graduates by field of study, 2003–04



For many governments of the transition countries, the scope for increasing spending on education is limited by their overall debt levels, as well as current budget deficits, their capacity to tax their citizens and their ability to raise funds on international capital markets. However, there may be room for countries to run counter-cyclical fiscal policies³⁴ and continue investing during an economic downturn. As with spending on R&D, experience suggests that pro-cyclical spending on education should be avoided. For the non-resource-rich transition countries in particular, counter-cyclical spending would best take the form of debt finance. Moreover, there is undoubted scope to change the composition of spending, with a greater share being allocated to education on the grounds that it enhances growth.

The situation facing the resource-rich countries of the CIS+M is rather different. There is potential to finance growth-enhancing reforms, even at the current levels of tax revenue and enforcement. One approach may be through devoting a greater share of commodity revenues to particular policy areas, especially when resources have been accumulated in stabilisation funds (as in Azerbaijan, Kazakhstan and Russia). Such accumulated revenues have been used for general budget support rather than for specific purposes, but a case can be made for targeting them at policy areas, such as education, that are expected

to have positive consequences for long-term growth. Indeed, the previous section showed that as resource prices – as indicated by oil prices in Chart 3.11 – rise, the actual share of spending on education has tended to fall in resource-rich countries. This represents an undesirable outcome given the already relatively low levels of expenditure. Better targeting of resources in a medium-term financing framework might help rectify this.

While governments have a major role to play in ensuring quality and access to formal education, the private sector is also crucial in helping to match formal skills to labour market requirements. This can be done through internships, informal on-the-job training or university scholarship funding. Such firm- and/or industry-specific investment promotes skills that increase both labour productivity and labour mobility and therefore has positive direct spillovers to the whole economy.

However, to invest in training and skills enhancement, firms need to be able to access medium-term credit. There is widespread evidence that, despite changes in bank ownership and the growth in non-bank finance, firms in the transition region still find it difficult to access formal credit markets. For firms that are relatively far from the technological frontier, better availability of bank credit will be crucial. For firms closer to the frontier, innovation will be

riskier than imitation and such firms will typically have less tangible capital that could be used as collateral in case of repayment default. Equity financing can compensate the financier for this added risk, typically by letting them get a higher share of returns.

Conclusions

Selective government intervention can substantially increase long-term growth prospects of the transition countries and help them to catch up with the technological frontier. There are two areas where policy can be particularly effective, namely competition and the quality of education. If transition countries are to achieve and sustain higher growth rates in the long term, they will need to ensure competition by continuing to remove entry and trade barriers (for domestic and foreign firms) and by strengthening (in some cases establishing) transparent and effective competition agencies. This is particularly true for the CIS+M resource-rich countries. The transition countries collectively need to invest more in the quality of primary and secondary education, as well as in tertiary (especially undergraduate) education so as to improve the quality of skills available to the economy. Paradoxically, it is the resource-rich CIS+M countries that suffer most from insufficient investment in education and problems with the quality of educational services.

Finally, there may be scope for macroeconomic policies that involve a greater share of spending on these key areas. Investment in education can help ensure long-term sustainable growth by developing the human capital necessary for the effective use and adaptation of available technology. It is also a precondition for being able to innovate as part of the process of catching up with the technological frontier. For education, the private sector's role in boosting training and skills acquisition will also benefit from an overall growth of the financial system and fewer constraints on access to finance.

Endnotes

- 1 These are principally Hong Kong, Singapore, South Korea and Taipei China; see Hausmann, Rodrik and Velasco (2005).
- 2 See Commission on Growth and Development (the Spence Report) (2008).
- 3 See Aghion and Howitt (2006).
- 4 For example, see Barro and Sala-i-Martin (1995).
- 5 See Aghion and Bloom et al (2005).
- 6 For a more detailed discussion, see Aghion and Howitt (2006).
- 7 Patent applications are filed with a national patent office for exclusive rights to an invention (product or process) that provides a new way of doing something or offers a new technical solution to a problem.
- 8 The technological frontier is the existing international limit of technological capabilities in a specific sector. In most empirical analyses, current US technology is used as a proxy for this technological frontier.
- 9 The United States is commonly used in the literature as the benchmark, although this would not be necessarily the most appropriate benchmark for all industries or firms individually.
- 10 Labour productivity is measured over real GDP (purchasing power parity) by output per labour force participant (aged 15-64).
- 11 See Carlin et al (2004) and Aghion et al (2002).
- 12 The higher the remaining profit margins of a given firm, the higher that firm's market power and thus the lower the overall level of competition in that particular market.
- 13 See Aghion, Fally and Scarpetta (2007).
- 14 See, for example, EBRD (2006).
- 15 It can be argued that increased competition should discourage innovation and growth, as it reduces the rewards that accrue to successful innovators. However, this effect may be dominated by increased competition, which may encourage firms to innovate precisely in order to escape competition.
- 16 See Nickell (1996), Blundell et al (1999), and Aghion, Braun and Fedderke (2007).
- 17 The underlying analysis regressed industry level labour productivity growth separately on industry level mark-ups and mark-ups squared, controlling for year, industry and country effects.
- 18 See World Bank (2008).
- 19 See Benhabib and Spiegel (1994), drawing on seminal work by Nelson and Phelps (1966).
- 20 See Hanushek and Kimko (2000) and Hanushek and Woessmann (forthcoming).
- 21 This is equivalent to one standard deviation in the PISA results for OECD countries.
- 22 See Hanushek and Woessmann (forthcoming). The long-term effects are based on simulations.
- 23 See Aghion et al (forthcoming).
- 24 What is true between countries is also true between regions within a country. For example, it has been shown that an additional US\$ 1,000 per person in research education spending raises a US state's productivity growth rate by 0.27 per cent if the state is at the frontier, whereas it raises it by only 0.09 per cent if the state is far from the technological frontier; see Aghion and Boustan et al (2005) and Vandenbussche et al (2006).
- 25 See also the World Bank (2000, 2005 and 2006).
- 26 Gross enrolment rate is the ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to the level of education shown.
- 27 The PISA study was carried out by the OECD in 2000, 2003 and 2006. It is one of the few sources of international comparative data on education across regions (including a number of transition countries), measuring educational quality by testing the mathematics, science and reading skills of a sample of 15-year-old students. The PISA surveys make a particular effort to assess students' skills in application and synthesis of concepts – the generic skills that are most relevant to the needs of the global economy. See Mertaugh and Hanushek (2005).
- 28 Based on the regression results underlying Chart 3.10. This result is very similar in magnitude to the effect Hanushek and Woessmann find in their (forthcoming) analysis for non-transition countries.
- 29 See World Bank (2006).
- 30 See Ammermueller, Heijke and Woessmann (2005).
- 31 See World Bank (2000).
- 32 See World Bank (2006).
- 33 See EBRD (2007). The survey also found that around half of respondents favoured additional government investment in education as one of their top priorities.
- 34 Counter-cyclical in this context means continuing investments independent of the economic cycle, that is, committing a similar amount of resource to education in both boom and in downturn times. Pro-cyclical investments are aligned with the overall economic cycle, increasing in boom periods and decreasing in economic downturns.

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Countries with solid export bases tend to perform better than those without, and economies with more sophisticated exports tend to grow faster. Most transition countries have experienced major changes in their patterns and structures of trade. However, while some countries have improved the value of their existing products and moved into new and higher-value exports, others face major challenges in improving and diversifying their economies.

4

Trade, product mix and growth

Featured

- 66 Trade profile of the transition countries
- 68 Export sophistication
- 69 Export connectedness
- 74 Export quality
- 74 Implications for growth
- 76 Conclusions

Experience suggests that countries that are successful exporters tend to grow faster than those that are not. What a country exports, and to whom, shows the areas in which an economy can compete in the global market. The composition of a country's exports will also be linked to the potential for future growth. This can come about through improving the quality of existing exports or by moving into new products.

This chapter looks at the opportunities for future export growth in the transition countries. The product composition of exports reveals the relative advantages of an economy in terms of its natural, physical or human capital resources, as well as its level of technological development. In general, richer countries can export more sophisticated or technologically advanced goods to wherever there is a market for them. Moreover, exports are a good indicator of a country's comparative advantage, as domestic sales may be sheltered by transport costs, public procurement or the preferences of consumers in domestic markets.

The chapter starts with a profile of the scale, direction and composition of exports from the transition countries.¹ It goes on to consider the sophistication of each country's export offering compared with that of other countries in the region and internationally. Sophistication encompasses numerous characteristics, such as technological or skills content, and is therefore measured by the wages each country can afford to pay rather than by selecting one particular characteristic. How countries have done in terms of upgrading their export packages is then examined in detail. The chapter introduces the

concept of "connectedness" and the mix of products or "product space". Connectedness is whether a country's exports rely on inputs (that is, the necessary elements for the production of certain goods, such as human capital, infrastructure and regulatory requirements) that are also used by many other goods. These ideas help to understand why some countries have had an easier time upgrading to new, relatively more sophisticated activities than others. It is argued that a country's product mix can therefore have important implications for its future opportunities for growth. The chapter then introduces a third dimension: the quality or value generated by existing export sectors. The price per unit of output that is received is related to that found for other countries. Large gaps between prices reveal a lower level of quality in the country's export package, which can be a problem but can also be a sign that there is room for improvement within the structure of existing exports. A final section considers some of the broader implications of the analysis.

Trade profile of the transition countries

This section provides an overview of the scale and composition of exports from the transition countries, focusing on exports to the EU-15 (the 15 member states prior to the 2004 expansion) as well as between and within central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States and Mongolia (CIS+M). The data used relate to 1995 and 2005. In all regions there has been a significant increase in the ratio of exports to GDP – a simple measure that summarises the

relative importance of trade to a country's economy. By 2005 this ratio averaged over 0.5 in CEB, around 0.3 in SEE and 0.4 in the CIS+M. Most countries in all regions have seen an increase in this ratio since 1995.

Table 4.1 shows that, by 2005, the EU-15 was the main trading partner for all three transition regions. The share of exports going to the EU-15 everywhere increased between 1995 and 2005, generally at the expense of exports to the CIS+M. Meanwhile, CIS+M exports also saw a significant reorientation. In 1995 the CIS+M countries exported more to each other than to the EU-15, while a decade later intra-CIS+M exports amounted to less than half (47 per cent) of exports to the EU-15. For all three regions, exports to CEB and SEE did increase in value, but remained roughly stable as a share of total exports.

Composition of trade

At the one-digit level – which splits industrial production into 10 broad categories – the bulk of the increase of exports to the EU-15 from CEB has come from relatively high-value manufacturing industries and accounted for over 80 per cent of exports in 2005. The composition of SEE exports to the EU-15 was similarly dominated by manufacturing, while those from the CIS+M to the EU-15 were predominantly raw materials (and increasingly so since 2000). Table 4.2 shows that in 2005 all the top 10 industries exporting from CEB to EU-15 were in manufacturing. The top two industries in 2005 – road vehicles and electrical machinery – were already big exporters a decade earlier. The rest of the top five were relatively small in 1995, indicating that there has been significant change in the composition of exports from CEB. Intra-CEB trade and trade with the CIS+M followed a relatively similar pattern, although new and higher-value industries appear rather lower in the rankings than for exports to the EU-15.

For SEE, as with CEB, the top 10 industries exporting to the EU-15 are all in manufacturing. However, these industries tend to be less skill-intensive in SEE and the change in the industry composition of exports has been less dynamic than in CEB. The same industries occupy the top six rankings in 2005 as in 1995. The content of exports to CEB was not substantially different.

Table 4.1

Directional composition of exports from CEB, SEE and the CIS+M (% of total exports)

	Exporting region					
	CEB		SEE		CIS+M	
	1995	2005	1995	2005	1995	2005
Export partner						
CEB	16	16	7	8	10	10
SEE	3	4	9	10	2	3
CIS+M	10	6	9	3	29	18
EU-15	59	63	50	55	28	38
Rest of world	12	12	26	24	31	31

Source: International Monetary Fund (IMF) Direction of Trade Statistics Database.

Note: The table refers to exports of goods. Column totals may not add up to 100 due to rounding.

Table 4.2

Top 10 two-digit exporting industries from CEB, SEE and the CIS+M, by regional export partner

Export partner	Rank in 2005	Exporting region					
		CEB		SEE		CIS+M	
		Top 10 two-digit export industries by value	Rank in 1995	Top 10 two-digit export industries by value	Rank in 1995	Top 10 two-digit export industries by value	Rank in 1995
EU-15	1	Road vehicles	3	Clothing and accessories	1	Petroleum	1
	2	Electrical machinery/apparatus	2	Electrical machinery/apparatus	6	Non-ferrous metals	3
	3	Telecoms and sound equipment	23	Footwear	2	Iron and steel	4
	4	Power generating machines	21	Iron and steel	3	Cork and wood	7
	5	General industrial machinery	11	Non-ferrous metals	4	Non-metal mineral manufacturing	45
	6	Metals manufacturing (not elsewhere specified)	5	Furniture/bedding	5	Organic chemicals	8
	7	Furniture/bedding	6	Road vehicles	22	Metalliferous ore	5
	8	Office machines	36	Other transport equipment	14	Coal/coke	18
	9	Clothing and accessories	1	General industrial machinery	13	Clothing and accessories	9
	10	Misc. manufactured goods	12	Textiles/fabrics	9	Inorganic chemicals	6
CEB	1	Road vehicles	2	Electrical machinery/apparatus	4	Petroleum	1
	2	Iron and steel	1	Non-ferrous metals	2	Iron and steel	4
	3	Petroleum	4	Clothing and accessories	7	Metalliferous ore	3
	4	Electrical machinery/apparatus	6	Iron and steel	21	Gas, natural and manufactured	2
	5	Telecoms and sound equipment	26	Petroleum	1	Cork and wood	28
	6	Metals manufacturing (not elsewhere specified)	8	Power generating machines	33	Organic chemicals	7
	7	Misc. manufactured goods	10	Road vehicles	5	Inorganic chemicals	9
	8	Power generating machines	24	Metalliferous ore	44	Fertiliser	14
	9	General industrial machinery	13	Metals manufacturing (not elsewhere specified)	13	Non-ferrous metals	5
	10	Paperboard	9	General industrial machinery	11	Coal/coke	13
SEE	1	Road vehicles	2	Petroleum	1	Petroleum	2
	2	Electrical machinery/apparatus	4	Iron and steel	2	Iron and steel	6
	3	Iron and steel	3	Cereals	3	Coal/coke	20
	4	Metals manufacturing (not elsewhere specified)	10	Non-metal mineral manufacturing	6	Metalliferous ore	12
	5	Paperboard	1	Non-ferrous metals	5	Fertilisers	18
	6	Misc. manufactured goods	14	Metals manufacturing	11	Power generating machines	53
	7	Essential oils/perfumes	13	Electrical machinery/apparatus	8	Non-ferrous metals	9
	8	Non-metal mineral manufacturing	15	Misc. manufactured goods	23	Road vehicles	3
	9	Petroleum	16	Metalliferous ore	19	Organic chemicals	19
	10	Medicines and pharmaceuticals	5	Vegetables and fruit	9	Other transport equipment	17
CIS+M	1	Road vehicles	1	Petroleum	2	Special transactions	2
	2	Electrical machinery/apparatus	8	Medicines and pharmaceuticals	6	Petroleum	4
	3	Medicines and pharmaceuticals	2	Road vehicles	20	Iron and steel	3
	4	General industrial machinery	9	General industrial machinery	12	Road vehicles	13
	5	Misc. manufactured goods	13	Misc. manufactured goods	18	Metalliferous ore	7
	6	Paperboard	28	Metalliferous ore	53	Other transport equipment	17
	7	Metals manufacturing (not elsewhere specified)	25	Electrical machinery/apparatus	9	Electrical machinery/apparatus	10
	8	Special industrial machinery	18	Beverages	3	General industrial machinery	8
	9	Telecoms and sound equipment	22	Special industrial machinery	19	Power generating machines	11
	10	Non-metal mineral manufacturing	20	Metals manufacturing (not elsewhere specified)	17	Special industrial machinery	12

Key: Two-digit Standard International Trade Classification (SITC) codes.

One-digit code	Group description
0-2	Food, beverages and crude materials
3	Fuels/lubricants
5-6	Chemicals and manufactured goods
7-8	Machinery transport equipment and miscellaneous manufactured goods
9	Goods and transactions not classified

Source: United Nations Commodity Trade Statistics Database (UN Comtrade), SITC revision 3 two-digit industry codes.

Note: Two-digit industry codes take the base one-digit codes (which split industrial production into 10 broad categories coded 0-9) and then subdivide each one-digit category into 10 more detailed categories running from 0-99.

Box 4.1

Measuring export sophistication

Calculating export sophistication, denoted by EXPY, is a two-stage process. The first stage is to measure the income level associated with each product in the world, termed “PRODY”. The PRODY of a particular product is the GDP per capita of the typical country that exports that good. Typical GDP is calculated by weighting the GDP per capita of all countries exporting the good. The weight given to each country is based on “revealed comparative advantage”, defined as the share of its exports that comes from that good relative to the “average” country. The PRODY for a single product – butter, for example – is calculated by weighting the GDP per capita of all countries exporting butter. The weight given to each country depends on the share of butter in its total exports, and how this compares to the average country. Therefore, a product that typically makes up a large percentage of a poor country’s export basket will have stronger weights towards poor countries’ GDP per capita. This will be less the case for a product that makes up a small percentage of a poor country’s exports but is a significant component of many rich countries’ export baskets.

The second stage is to measure the income associated with a country’s export basket as a whole; this is its EXPY. From the first stage, each product that a country exports will have a PRODY. The EXPY is calculated by weighting these PRODY by the share that each good contributes to total exports. If butter makes up 15 per cent of a country’s exports, its PRODY will be given a weight of 0.15. Countries whose export baskets are made up of “rich-country goods” will have a higher EXPY, while export baskets made up of “poor-country goods” will have a lower EXPY.

The leading export industry for the CIS+M to all markets was petroleum. Exports of manufactured goods to CEB and the EU-15 remained very limited. Manufacturing industries in the CIS+M continue to be oriented towards less advanced export markets.

In summary, CEB has conducted an increasing amount of trade with the EU-15 and appears to be converging with the EU-15 export structure. The composition of export flows has become more sophisticated, as exemplified by large increases in exports of high-value manufactured goods. Increases in sophistication have been positively linked to the level of development of the destination market. SEE exports have shown a slow reorientation towards western Europe since 2000, but the composition remains dependent on the trading partner and there still seems to have been a limited capability to produce goods for advanced markets. Finally, the CIS+M has become increasingly reliant on the export of petroleum and raw materials. There was no increase in the sophistication of the export basket and no significant emergence of new manufacturing industries. Furthermore, intra-CIS+M trade has been very different from exports with the rest of the world, with a large component of relatively high-value manufactured goods. However, these trade flows appear to be based on historical relationships and the geographical isolation of some parts of the region, rather than on the competitiveness and sophistication of its manufacturing sector.

Export sophistication

When analysing the content of a country’s export basket, there are many broad measures of technological sophistication.² These tend to use definitions of sophistication whose links with economic growth may be quite tenuous. The measure of export sophistication, termed “EXPY”, used in this analysis does not suffer such shortcomings as it is not based on an assumed level of technology content or value. In addition, it has robust causal links with growth. Instead of determining a product’s sophistication based on its customs classification, an approach based on actual trade patterns – an outcomes-based approach – is taken. Products that are typically exported by rich countries are considered to be more sophisticated than those exported by poor countries. For example, a product

exported primarily by rich countries, such as aircraft, would have a higher value, while a less sophisticated product exported primarily by poor countries, such as jute, would have a lower value.³ (See Box 4.1 for how these measures are constructed.) In this analysis, it is not surprising to find that rich countries have a high EXPY and poor countries have a low EXPY. This is by construction. What is more interesting is that there is significant variance. Among countries with the same level of GDP per capita, some have an export basket that is much more sophisticated than others. India, China and Indonesia have baskets much more typical of rich countries than might be expected given their level of income. This variance can have important consequences for growth. Countries that have managed to develop a sophisticated export range relative to their income level grow faster, while countries specialising in relatively unsophisticated exports suffer poorer economic performance.⁴

Chart 4.1 shows the export sophistication related to income per capita for most of the transition countries in 2005, along with some comparator countries. The higher income transition countries – Croatia, the Czech Republic, Estonia, Hungary, Poland, the Slovak Republic and Slovenia – tend to have quite a high EXPY compared with other countries with a similar level of income. There is a fairly high level of export sophistication among these countries as far back as 1992, and their relative standing has increased even further over the past 10 years (see Chart 4.2).

Below the higher income countries in Chart 4.1 is a second transition tier composed of Belarus, Bulgaria, Lithuania, Romania, Russia and Ukraine. With the exception of Russia, these countries have also enjoyed some EXPY growth since 1999. The export sophistication of Belarus and Ukraine is higher than would be predicted by their level of GDP per capita, while the export sophistication of Albania, Lithuania and Russia is slightly lower. However, in the case of Ukraine, this is not because it has upgraded its export basket significantly between 1992 and 2005, but rather that there has been a significant decline in GDP per capita over that period. Among the last tier of countries – Albania, Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova and Mongolia – export sophistication remains low.

Although Azerbaijan, Georgia and Moldova have been improving, Armenia and Kazakhstan have fallen behind and Mongolia continues to be the weakest performer.

Despite the fact that only merchandise exports are considered, Chart 4.1 nevertheless shows that India's EXPY ranking is exceptional. While India has been noted particularly for growth in its service industries, its merchandise export basket is also typical of a much richer country. For example, India has a more sophisticated basket than Argentina, which is more than twice as rich in per capita terms. China and Thailand also have sophisticated export baskets given their level of development.

In summary, there is considerable variation in the EXPY performance of the transition countries. The CEB countries are rapidly upgrading their exports, while SEE and the CIS+M are doing so rather more slowly. Within the CIS+M, the Caucasus and Central Asian economies are lagging behind. The reason why some countries have had an easier time than others in transforming their export baskets is examined below.

Export connectedness

It is commonly argued that a country's ability to transform its structure of production and move to more sophisticated, rich-country products is a consequence of a changing comparative advantage due to accumulation of the factors of production. However, there are many reasons why structural transformation may be more complicated than this argument suggests.⁵ Some recent investigations of structural change over time have found that the process appears to favour "nearby" products – that is, products requiring a similar set of inputs – in a highly heterogeneous mix of products. This insight is based on the idea that every product involves inputs, such as knowledge, physical assets, labour training requirements, infrastructure needs, property rights, regulatory requirements or other public goods⁶ that are specific to that activity; infrastructure for oil is very different from infrastructure for cheese, for example. Established industries tend to have overcome the many potential failures involved in assuring the presence of the necessary inputs. This means that the costs of introducing and producing nearby products will be lower.

Chart 4.1

Transition countries' EXPY and GDP per capita, 2005

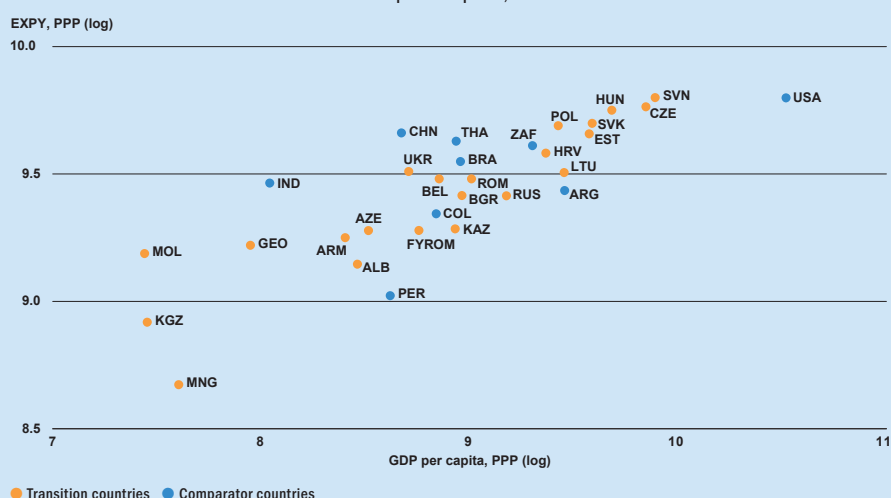
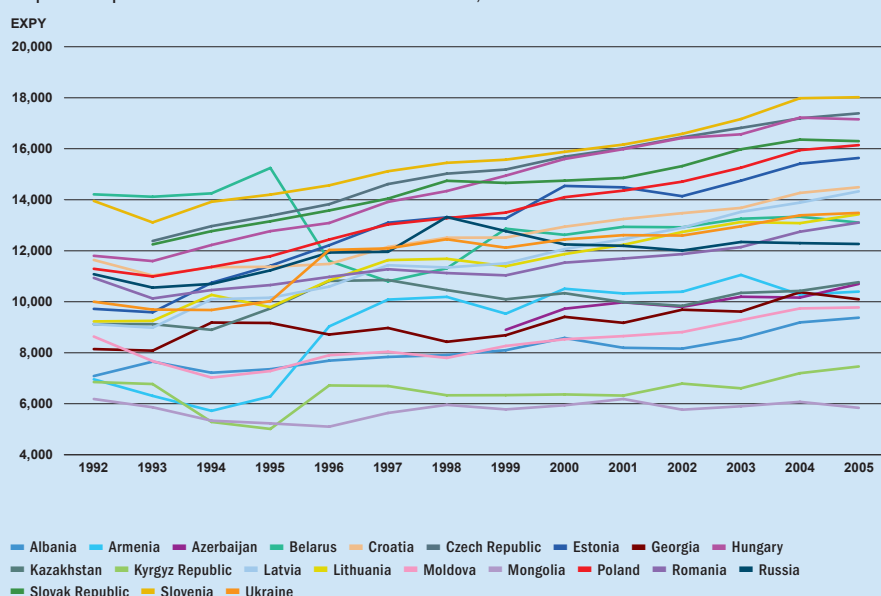


Chart 4.2

Export sophistication in transition countries, 1992–2005



Source: Authors' calculations using Feenstra (2005) and UN Comtrade.

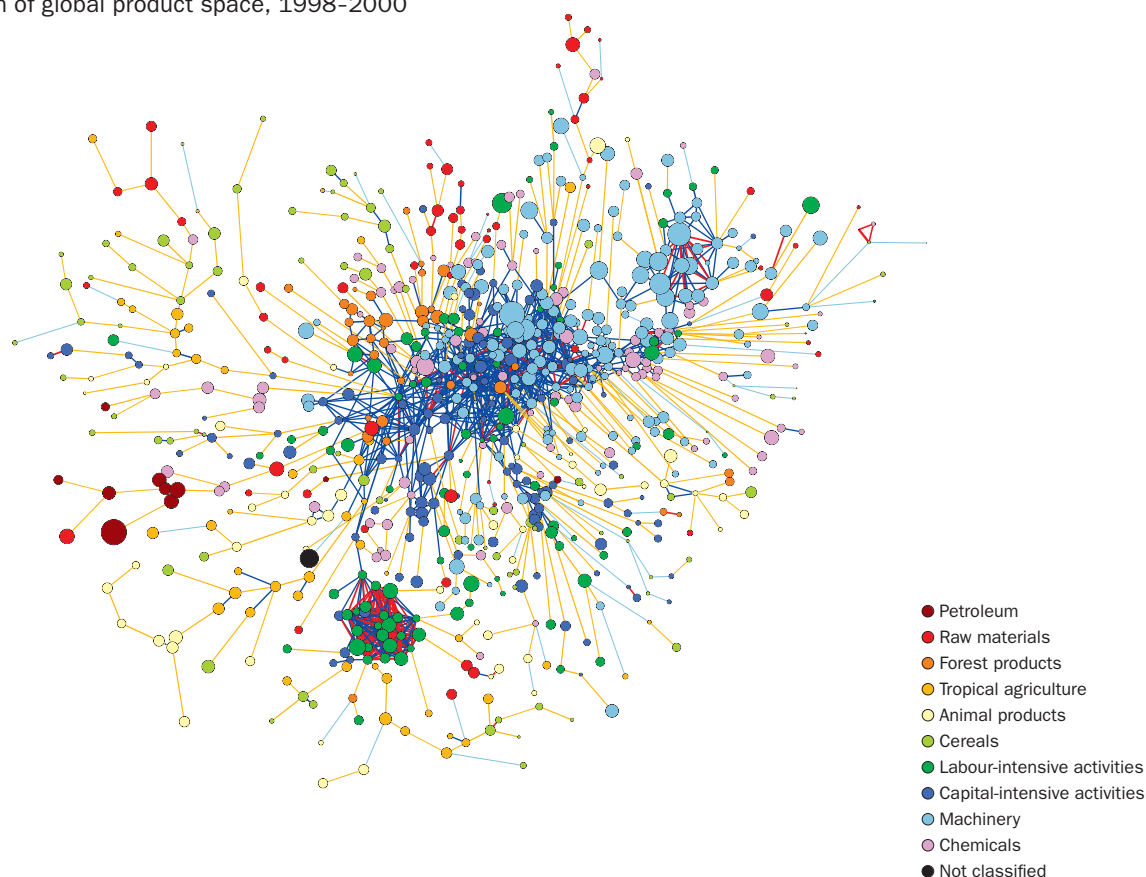
Note: There are no data for the Czech Republic and the Slovak Republic for 1992, as the countries officially separated from each other on 1 January 1993. Data for Azerbaijan are incomplete before 1999, and so prior observations are excluded. See Box 4.1 for how EXPY is calculated.

In contrast, firms that venture into new products unrelated to an existing industrial structure may well find it much harder to secure the requisite inputs. For example, they might not find workers with the necessary experience or appropriate suppliers. Sector-specific infrastructure needs, such as cold storage transportation systems, regulatory services or research and development capabilities, may not be

adequate or available. In short, the assets and capabilities needed to produce one good are generally likely to be imperfect substitutes for those needed to produce another. Barriers to the emergence of new export activities will therefore tend to be less challenging for nearby products that only require relatively slight adaptations to existing capacity. Hence, the success of a new export product or industry will depend

Chart 4.3

Visual representation of global product space, 1998–2000



Source: Hidalgo et al (2007).

on how well it matches with existing production and input capabilities, and the match should be better if nearby products are already being produced.

For the following analysis, it is necessary to have a measure of distance between products. An outcomes-based measure of the distance between products is used, instead of relying on prior beliefs to determine which product-level characteristics matter for distance. In particular, the distance between each pair of products is given by the probability that countries in the world export both – the outcome – rather than on technical similarity between products.⁷ If two goods need the same set of capabilities, this should show up in a higher probability of a country having a comparative advantage in both goods. These pair-wise distances create a vast network or “product space”. This product space is based on the relationships between products, calculated across all countries in the world; that is, there is a single

product space for all countries at any point in time. Countries occupy different positions within this space.

The space is mapped using the tools of network analysis to give a better sense of its structure (see Chart 4.3). It is composed of two features: the “skeleton” and the “tissue”. To create the skeleton, each product is drawn as a node and connected to its single nearest neighbour. Proximity – or the strength of links between products – is shown by the colour of the link. A light-blue link indicates a proximity of under 0.40, a beige link a proximity between 0.40 and 0.55, a dark-blue link between 0.55 and 0.65, and a red link greater than 0.65.⁸ The second step is to add the tissue, which involves drawing links between each product and all other products with which it has a proximity of at least 0.55. Each product will therefore have exactly one link on the skeleton, but may have zero, one or many links from the tissue construction stage. It is important to

keep in mind that physical distance does not mean anything in this map; rather proximity is indicated by the intensity with which links are coloured.

Chart 4.3 shows the resulting map. Each node is a product, with its size determined by its share of world trade and colour determined by its commodity group.⁹ This gives a sense of which products are more important in world trade and which types of products make up different portions of the space. Products that have more connections of a stronger colour are more connected in this space. Multiple links indicate multiple products with proximity above 0.55.

The product space is highly heterogeneous. There are peripheral products that lie on the outer edges of the space and have only weak connections to other sectors. Many of these are raw materials and agricultural products. There are also

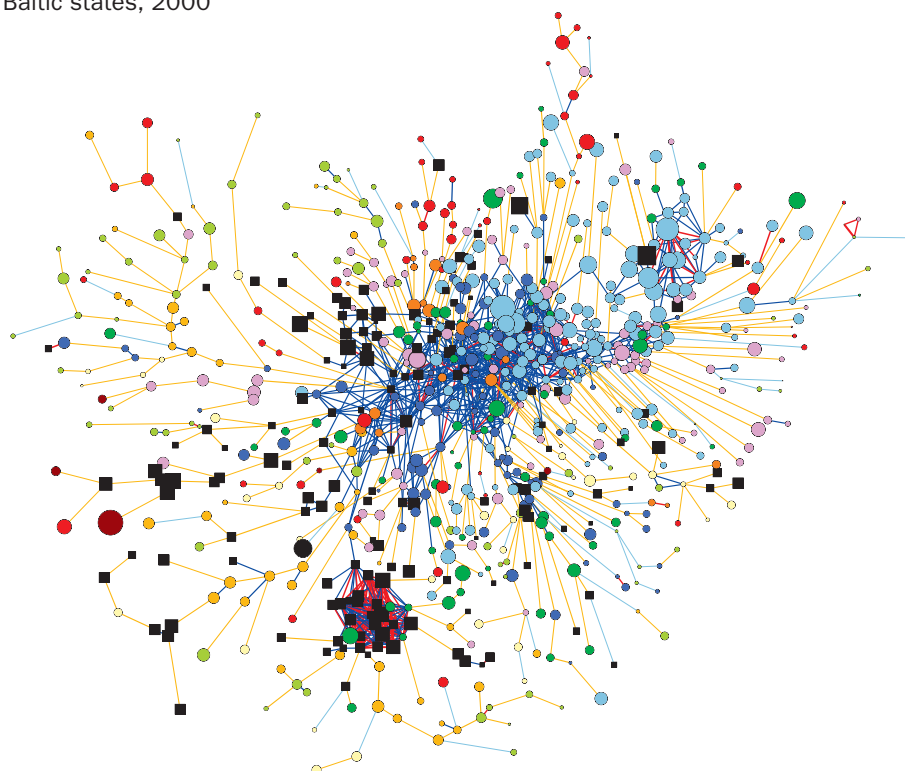
some weak clusters of peripheral products, such as petroleum (the large red nodes on the left side of the network), animal products (the pale yellow nodes below petroleum products) and labour-intensive activities, principally garments (the very dense cluster of green nodes at the bottom of the network). In addition to the loosely connected periphery with some clusters, the space features a densely connected industrial core. This consists mainly of machinery and other capital-intensive goods, but also includes other sectors, such as some forestry products.

The structure of the product space can be understood in terms of the similarity of capabilities required across products. The set of human capital, physical capital, institutions and infrastructure required to produce, for example, seafood or petroleum may be fairly specific to those activities and not easily redeployed to other activities. Conversely, once a country develops the capabilities to stitch t-shirts, it will be easy to stitch other garments, resulting in a tightly connected garments cluster. However, these capabilities cannot be easily redeployed to, for instance, industrial chemicals or the manufacture of machines (as the Central American and Caribbean economies have found) and therefore this cluster is on the periphery of the overall space.

The heterogeneous structure of the product space has important implications for structural change. If a country is specialised in a peripheral part of the space, there are few products that are nearby and require similar capabilities to produce them. That country will therefore face a harder time changing its export mix and moving to new products. However, if it is producing goods in a dense part of the space, then the process of structural change should be much easier because the set of acquired capabilities can be more easily redeployed.¹⁰ A country's ability to upgrade to new, more sophisticated rich-country products is likely to be strongly determined by the connectedness of its export basket in the product space.

To get a preliminary idea of how the transition countries are deployed in this product space, in the following series of charts (Charts 4.4–4.9) a black square

Chart 4.4
Baltic states, 2000

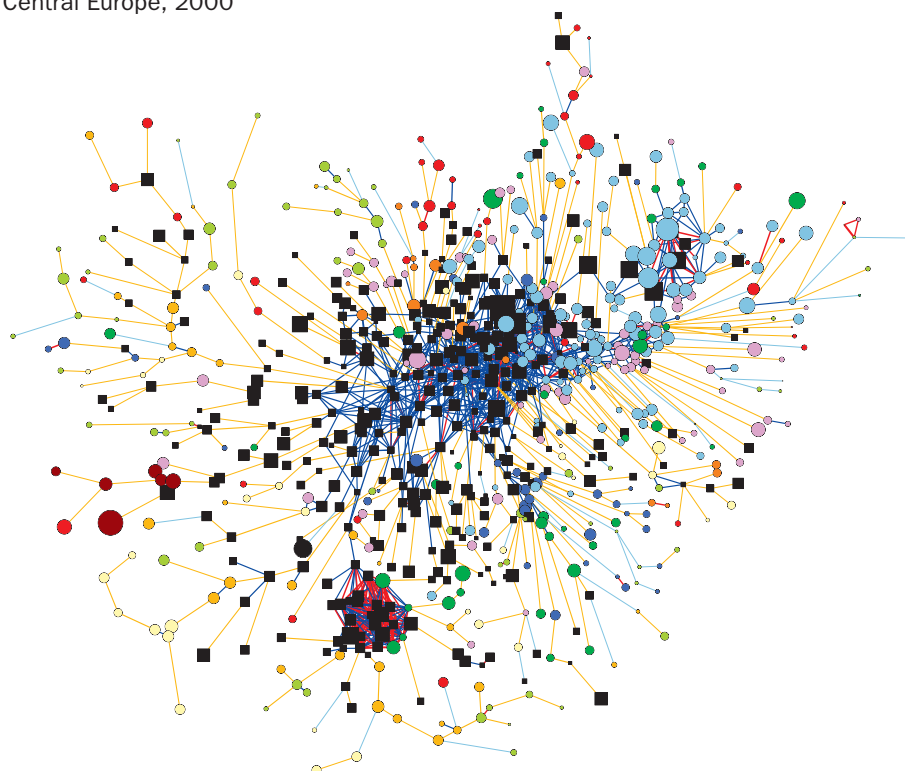


Countries: Estonia, Latvia and Lithuania.

Source: Hausmann and Klinger (2008).

Note: A black square signifies a country's comparative advantage in exporting that product. For legend see Chart 4.3.

Chart 4.5
Central Europe, 2000

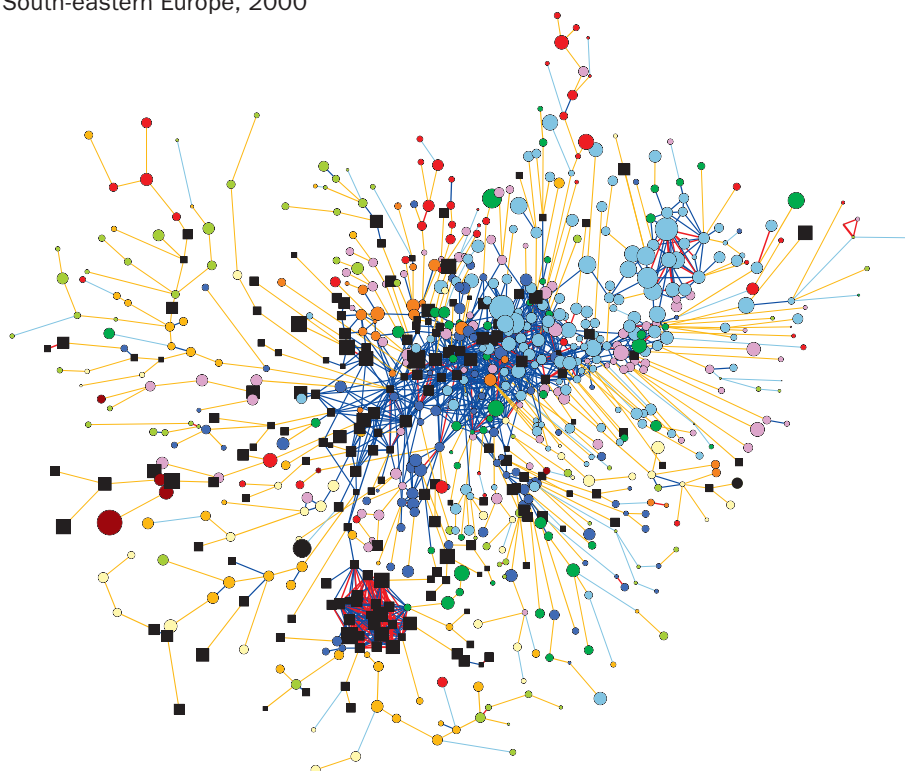


Countries: Czech Republic, Hungary, Poland, Slovak Republic and Slovenia.

Source: Hausmann and Klinger (2008).

Note: A black square signifies a country's comparative advantage in exporting that product. For legend see Chart 4.3.

Chart 4.6
South-eastern Europe, 2000

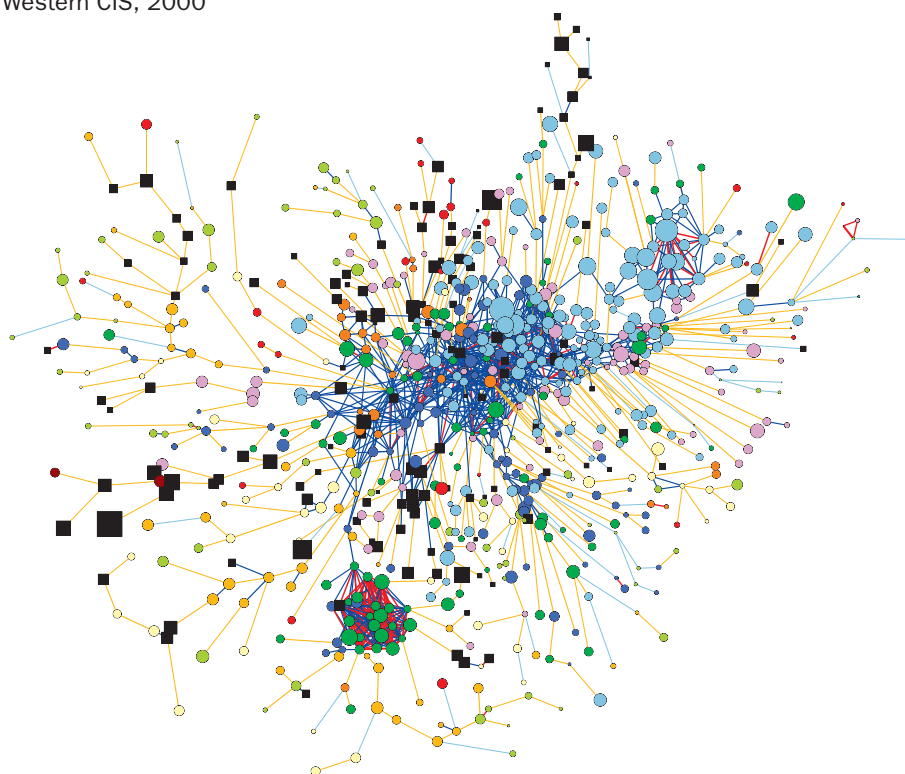


Countries: Albania, Bulgaria, Croatia and FYR Macedonia.

Source: Hausmann and Klinger (2008).

Note: A black square signifies a country's comparative advantage in exporting that product. For legend see Chart 4.3.

Chart 4.7
Western CIS, 2000



Countries: Belarus, Moldova, Russia and Ukraine.

Source: Hausmann and Klinger (2008).

Note: A black square signifies a country's comparative advantage in exporting that product. For legend see Chart 4.3.

has been placed over each product in which a country has achieved a comparative advantage. If a country has few black squares concentrated in a peripheral part of the space, it will have a harder time moving to new export activities compared to a country specialised in the core of the space. The transition countries are aggregated into six regional groups (with the countries composing each group identified below each chart).

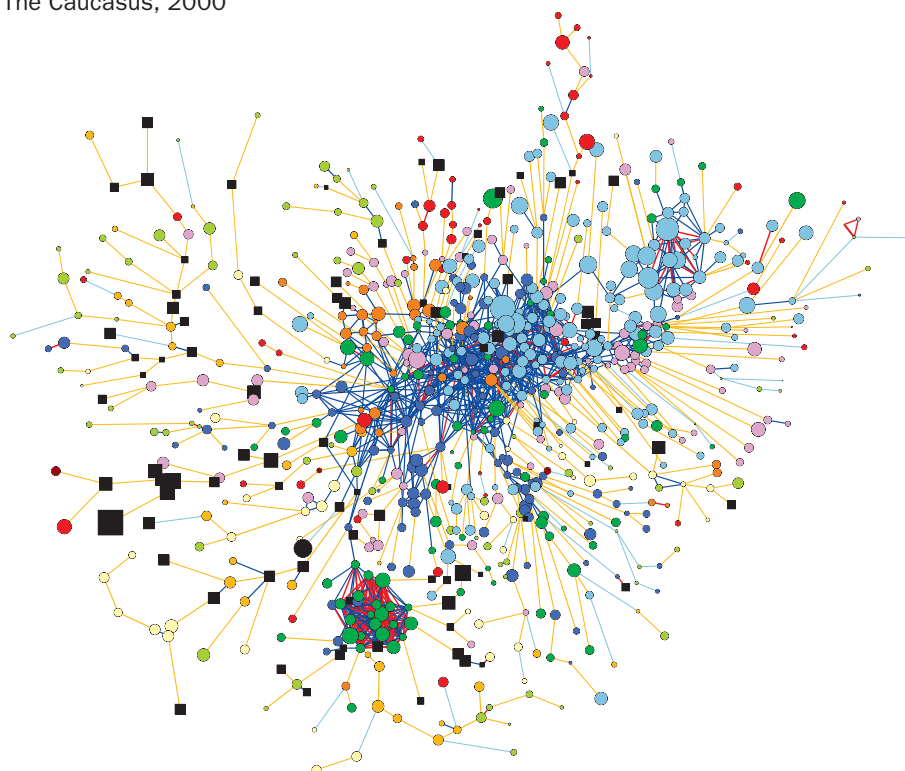
The charts show remarkably different structures of production across the regional groupings. The Baltic states have occupied the garments cluster, as well as some seafood and raw material activities on the periphery, and some forestry and electronics sectors closer to the industrial core. Central European states have dominated the industrial core, as have SEE countries to a lesser extent. Central Asia and the Caucasus have highly peripheral productive structures, with significant concentration in the poorly connected petroleum sector. The same is true for the western CIS countries, although they are relatively better connected than Central Asia and the Caucasus.

The extent to which a country's export basket is connected can also be measured using a concept termed "open forest". For each country there are two groups of products. The first are those which they produce and which form part of the export basket. All these products can be plotted in the product space. The second are all those goods that are not exported. These goods will not be plotted on the product space, and so the nodes representing these products will be "unoccupied". Each unoccupied node, or non-exported product, has a PRODY. The open forest measure weights these PRODYs by the distance to existing export products, calculated by the proportion of countries in the world that produce both.¹¹ Open forest values will therefore depend on the PRODY of goods that are not exported, and their distance to existing export goods or industries.¹² Countries that already have a high level of open forest will tend to enjoy faster subsequent growth in export sophistication, as they can more easily move to new sectors.

Chart 4.10 on page 75 shows the value of open forest against GDP per capita for most of the transition countries, as well as some comparator countries. These results show that the transition countries with high and rapidly growing export sophistication, such as the Czech Republic, Poland, the Slovak Republic and Slovenia, have very well connected export baskets. Moreover, this was true relatively early on in the time-scale, as suggested by the subsequent modest growth rates in open forest. These countries are in the same category of connectedness as China, India and Thailand. Their rapid movement to new, more sophisticated export sectors is not surprising as other countries across the world exporting similar products have been able to export a wide range of additional goods.

While the Baltic states, Bulgaria, Croatia, Hungary and Romania have enjoyed moderate improvement in their location in the product space, other countries with a similar level of GDP per capita – for example, Belarus, FYR Macedonia, Russia and Ukraine – are in a much sparser part of the product space. Russia has an export basket that is relatively unconnected considering its level of development. It could be that, because Russia is the largest of the transition countries, it has a larger domestic market and therefore measurements based on exports (such as product sophistication and open forest) will be biased downwards. However, Chart 4.10 clearly shows that Russia is an outlier compared to other big economies with large domestic markets, such as Brazil, China and India. It is the actual goods that Russia exports and their implications for structural change, and not because of market size, that accounts for Russia being specialised in a sparse part of the product space. Russia's situation is partly due to its concentration in hydrocarbons, which are a peripheral good in the product space. This is because oil pipelines, oil property rights, hydrocarbon engineers and the other capabilities required for this sector are very specialised and cannot easily be redeployed to new activities. The peripheral nature of hydrocarbons is also why the other oil exporters in the

Chart 4.8
The Caucasus, 2000

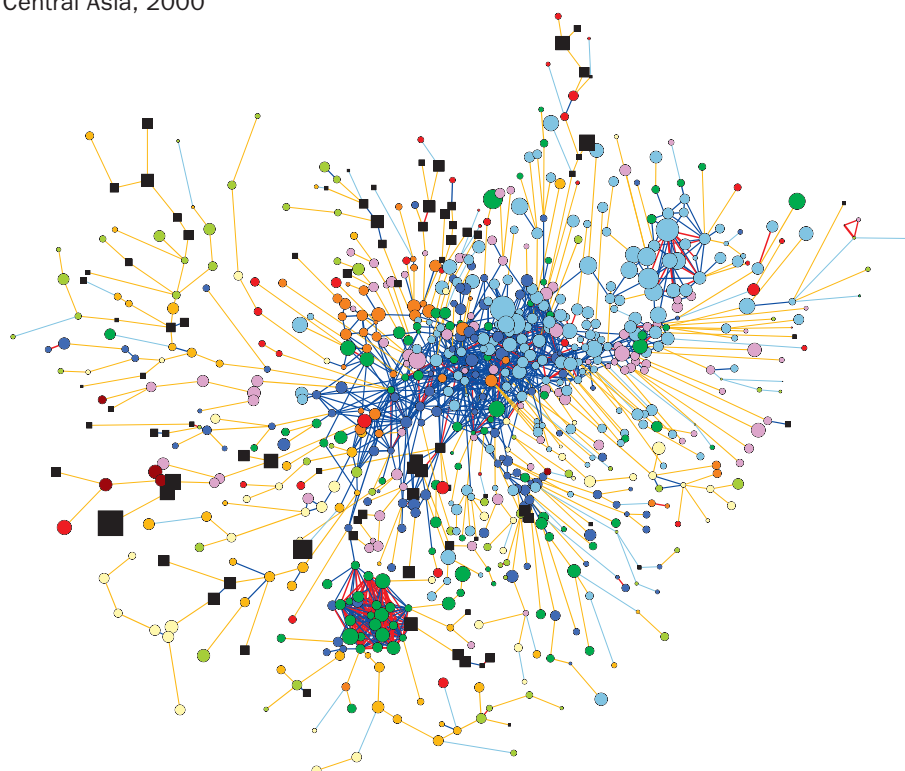


Countries: Armenia, Azerbaijan and Georgia.

Source: Hausmann and Klinger (2008).

Note: A black square signifies a country's comparative advantage in exporting that product. For legend see Chart 4.3.

Chart 4.9
Central Asia, 2000



Countries: Kazakhstan, Kyrgyz Republic, Mongolia, Tajikistan and Turkmenistan.

Source: Hausmann and Klinger (2008).

Note: A black square signifies a country's comparative advantage in exporting that product. For legend see Chart 4.3.

region – Azerbaijan and Kazakhstan – have an even lower level of open forest. Venezuela has been added to show that a low open forest is common to oil exporters outside of the transition region as well. However, there are notable exceptions, such as Indonesia and Mexico, where experience has shown that it is possible to diversify beyond oil exports and move into other activities that are much more central in the product space, and have brought rapid structural change and export upgrading.

Among the low-income transition countries, there is significant variation in export connectedness. Albania and Moldova are in a reasonably well-connected part of the product space given their level of development, as are Georgia and the Kyrgyz Republic, whose connectedness has improved over the past decade. Armenia and Mongolia, however, are in a very sparse area, suggesting that structural change will be relatively difficult.

Export quality

In addition to sophistication and connectedness, recent research has shown that export quality is important for growth. Within product lines, there is remarkable cross-country variation in unit values (the value of a good expressed in a common metric) earned on world markets.¹³ However, unlike the process of moving to new products, upgrading quality in existing products seems to be a more automatic process. Countries converge in quality (measured by unit prices) with the international leaders at an annual rate of 5–6 per cent unconditionally.¹⁴ That is to say, once a country is able to successfully enter a new export sector, in which its goods will be of a lower quality than its competitors', that country then has a relatively open channel of growth through increasing product and market awareness and upgrading the quality of products. The implication is that countries with larger overall unit value gaps across their export basket enjoy more rapid subsequent growth.

Chart 4.11 shows unit value gaps for most of the transition countries at the end of the 1990s, the most recent years available in the dataset.¹⁵ On the left are the gaps for the transition countries and on the right are the median values by global region. A larger value indicates a greater gap between world unit prices and the unit prices earned by that country or region.

Europe and Central Asia has very high unit value gaps (exceeded only by East Asia and the Pacific), meaning that the price per unit fetched for exports from countries in that region tends to be significantly lower than prices on world markets. This suggests that there is room for export growth through improving competitiveness and quality in existing product lines. In comparison, the African and Latin American countries have smaller unit value gaps, and therefore little scope to upgrade quality in existing export sectors. The only option for these regions is to move to new export sectors, which seems to be a much more difficult process.

Looking at individual transition countries, it is clear that growth through quality upgrading is not open to all. Mongolia, in particular, but also Albania, Croatia, Hungary, Lithuania, Moldova, Romania, Russia and Slovenia have comparatively small value gaps, suggesting that they have less scope to grow through upgrading existing products and must instead move to new products. Bulgaria, Estonia, Poland, the Slovak Republic and Tajikistan have moderate value gaps, while Armenia, Azerbaijan, the Czech Republic, the Kyrgyz Republic, Latvia and Ukraine earn a significantly lower value per unit for their main export products, indicating a need to improve competitiveness and quality.

Implications for growth

This section considers two dimensions of structural transformation: growing in existing sectors and moving to new sectors. First, countries can simply export more of the same products or upgrade quality within products. The suitability of this dimension depends on how much scope there is to upgrade quality within the existing export basket, and whether the basket is sophisticated enough relative to GDP per capita to sustain growth. The other dimension for growth is by moving from existing products to new products. If the existing export basket is in a central part of the product space, the open forest measures will be high, as unoccupied nodes will have high proximity. There is therefore an apparent path towards new products. The appropriate policy for countries in these circumstances is likely to be the use of industrial policy that gives priority to horizontal or non-targeted policies where the government is focused on providing the sector-specific public goods that emerging activities may require (see Chapter 5 for a fuller discussion).¹⁶ However, if the existing export basket is intensive in capabilities that are not easily redeployed to alternative products, then there is not an obvious path to other parts of the product space. For countries in this position, with low open forest, there are no new export options using similar inputs, and movements to new activities will require a longer period of adaptation.¹⁷ A reactive industrial strategy may have little effect, as new activities require a completely new set of capabilities. The challenges of how to design industrial policy are taken up in detail in the next chapter.

These two dimensions are summarised for most of the transition countries in Chart 4.12. The vertical axis represents how easy it will be for the country to grow by moving to new products and the horizontal axis represents how easy it will be to grow by increasing quality or quantity in existing sectors.

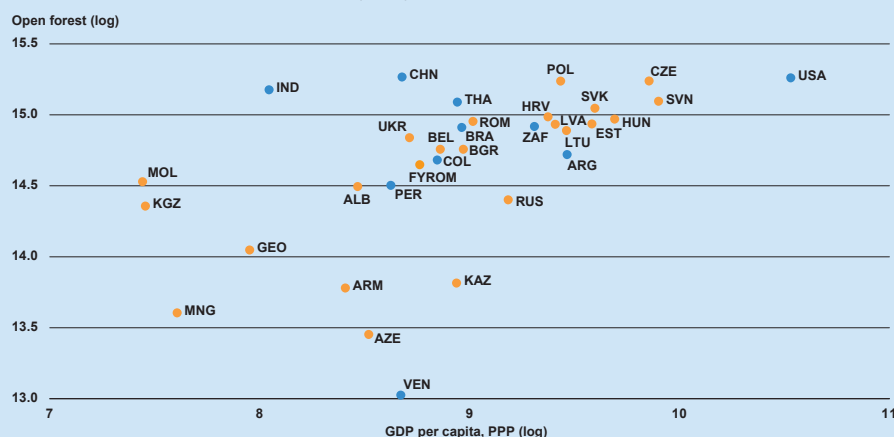
There are a significant number of countries in the upper right quadrant of the chart, including the Czech Republic, Estonia, Hungary, Latvia, Poland, the Slovak Republic and Slovenia – which have a high open forest, meaning that there are many nearby export activities that are likely to emerge naturally over time. Moreover, these countries have sophisticated export baskets with quality gaps to exploit, suggesting they can grow in existing export sectors. There is, therefore, ample opportunity to grow in both dimensions for these countries. Any combination of improved competitiveness in existing activities and responsiveness to the needs of newly emerging export activities will be appropriate.

In Armenia, and to a lesser extent Ukraine, the export basket is not that well connected, so moving to new activities is unlikely to be easy. However, these countries have a relatively sophisticated export basket for their level of development, along with large unit value gaps in existing products. This means that there is room to grow through improving quality and efficiency in existing activities. Increasing competitiveness, rather than moving to new export sectors, may be sufficient.

Such a strategy would, however, be less appropriate for Albania, Bulgaria, FYR Macedonia, the Kyrgyz Republic and Moldova, as these countries have unsophisticated export baskets with few unit value gaps to exploit. Their only option for export growth is to move to new activities. However, unlike Armenia and Ukraine, they are not in a sparse part of the product space given their level of GDP per capita and, as countries with high open forest, will be able to move more easily to new export activities. Moreover, there should be new activities either already emerging in these countries and/or incentives and opportunities in place for them to emerge. Croatia, Lithuania and Romania are in a similar category. They have slightly more scope to grow in existing exports, although not nearly as much as countries such as the Czech Republic or Poland. Significantly, they do have

Chart 4.10

Open forest and GDP per capita (PPP) for transition countries, 2005

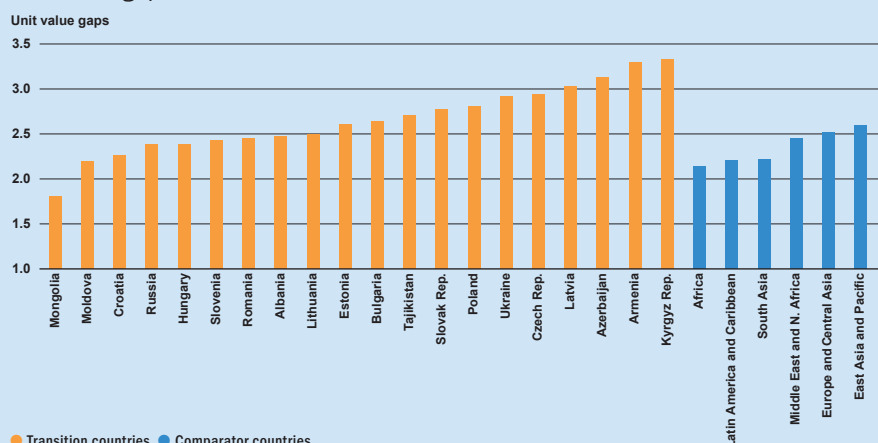


● Transition countries ● Comparator countries

Source: Author's calculations using UN Comtrade.

Note: GDP per capita is expressed in natural logarithms. For country abbreviations see Chart 4.1, except for Venezuela (VEN).

Chart 4.11
Unit value gaps



● Transition countries ● Comparator countries

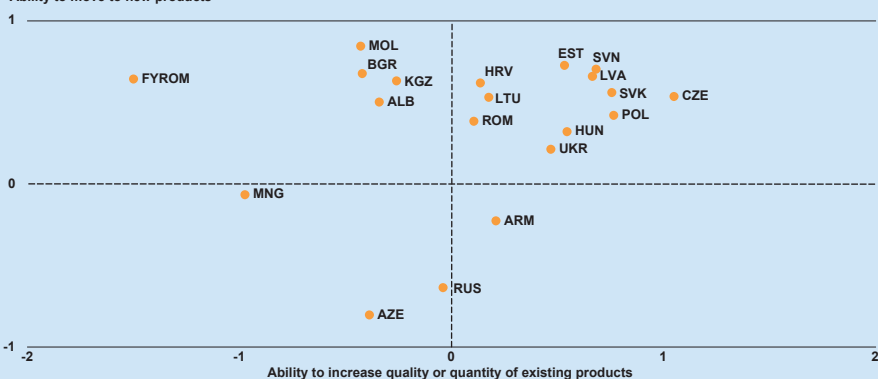
Source: Author's calculations using Hausmann, Hwang and Rodrik (2007).

Note: Values are 1998–2000 averages. The y-axis gives the relationship between countries' or regions' non-commodity – or differentiated – goods' prices per unit relative to prices per unit for countries of the Organisation for Economic Co-operation and Development (OECD). For example, 2.0 indicates that a country or region secured prices for its goods that were one-half of the OECD's. For further details see the background paper by Hausmann and Klinger (2008).

Chart 4.12

Ability to move to new products and upgrade existing products

Ability to move to new products



Source: Authors' calculations using UN Comtrade, World Development Indicators and Hausmann, Hwang and Rodrik (2007).

Note: The vertical axis indicates the ease with which countries can move to new products. It is the country's open forest, controlling for level of development and size. The horizontal axis indicates whether countries can grow through existing products. It is a combination of the room to grow with the existing export basket (high EXPY compared to GDP per capita) and improve the quality of existing products. It is measured as the product of EXPY (controlling for GDP per capita) and unit value gaps. This means that countries that are higher on the horizontal axis have more and better new export opportunities nearby, and countries further to the right on the horizontal axis have more growth opportunities in existing exports. For more details, see Hausmann and Klinger (2008). See Chart 4.1 for a key to the country abbreviations.

relatively well-connected export baskets, but need to increase their responsiveness to newly emerging activities in the private sector.

The lower left quadrant in the chart presents the countries with the greatest challenges. Azerbaijan, Mongolia and Russia have unsophisticated and highly unconnected export baskets, with few opportunities to move to new products or to upgrade quality within existing sectors. Nevertheless, moving to new activities is precisely what is needed, although few countries in the world have been able to make such a transformation successfully. This is due to a variety of factors, including problems with developing a wider range of capabilities necessary to support a shift into a different and more sophisticated product mix simultaneously. Structural change is difficult to design and implement, particularly given the limitations of institutional capacity and the significant risk that the actions of government will be counterproductive.

Conclusions

This chapter has broadened discussion of the factors behind growth in the transition region to encompass what these countries trade. A country's exports – more specifically, the composition of the export basket and its sophistication – provide an indication of where it can compete in international markets. The transition countries have recently undergone major changes, not least to their structures of production and trade, but there is also considerable variation in the extent to which individual countries have been able to upgrade and change their export baskets.

If a country's initial export basket is more sophisticated, future growth is likely to accelerate as that country's level of income converges with that of its competitors. Indeed, many transition countries have more sophisticated export baskets than might have been expected given their levels of income. However, this is not true for some countries, such as Kazakhstan and Russia.

Many transition countries still have the dual options of growing by improving the quality of their export products and moving from existing to new products. The analysis has shown large variations in the mix of products and the associated distribution of clusters of products across the transition countries. Some countries – those in central Europe, for instance – produce related clusters of goods, making opportunities for growth and diversification relatively easy. In Russia, however, not only are there few clusters but they are also not closely connected to each other. These differences have profound implications for future growth.

A number of the resource-rich economies of the transition region, where the ability to move easily to new products is limited, face challenges because of problems with coordination and the need to develop simultaneously a wider range of capabilities that could support a shift into a different and more sophisticated product mix.

Endnotes

- 1 The data exist for merchandise exports but not for services, which have to remain outside the scope of the chapter.
- 2 See, for instance, Lall (2000).
- 3 For more detail and the mechanics of calculating EXPY, see Hausmann, Hwang and Rodrik (2007).
- 4 See Hausmann, Hwang and Rodrik (2007).
- 5 See Arrow (1962), Bardhan (1970), Jaffe (1986), Jaffe, Trajtenberg and Henderson (1993), Hausmann and Klinger (2006 and 2007) and Hidalgo et al (2007).
- 6 Public goods are non-excludable (that is, everyone has access to them, irrespective of whether they have been paid for) and are non-rival in consumption, meaning that consumption by one person does not diminish the amount for consumption by others. Examples include flood defences and street lighting. In most cases these goods are provided by the government, or not at all.
- 7 This takes the minimum of the pair-wise conditional probabilities. See Hausmann and Klinger (2006).
- 8 This measure of proximity is the probability that a country exports both goods, and therefore it lies between 0 and 1.
- 9 See Leamer (1984). For example, all raw materials are represented by red nodes. Nodes will vary in size, with bigger nodes having a higher share of world trade. The colours of the links from these nodes to other nodes depend on proximity.
- 10 This has been established in Hausmann and Klinger (2006 and 2007), and is remarkably powerful and robust. Even if the product space is measured across all countries as far back as 1975, those distances are highly significant determinants of how the structure of production in any particular country will change over more than 20 years.
- 11 It can also be the probability that a country exports both.
- 12 The complete formula for open forest can be found in Hausmann and Klinger (2006).
- 13 See Schott (2004).
- 14 See Hausmann, Hwang and Rodrik (2007).
- 15 These results are not driven by the large depreciations in exchange rates that occurred around this time.
- 16 See Hausmann, Rodrik and Sabel (2007).
- 17 See Hidalgo et al (2007).

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A large number of transition countries have pursued various forms of industrial policy, despite the fact that this policy has had a very chequered history. While there is relatively little disagreement about the role of horizontal policy measures, vertical interventions to support specific firms or industries need to be designed carefully to avoid the pitfalls that weak institutional environments and poor governance pose.

5

Stimulating growth: the role for industrial policy

Featured

- 80 Defining industrial policy
- 81 The mechanics of industrial policy: a review of experience
- 83 Industrial policy in the transition countries
- 84 Finance, clustering and diversification
- 87 Investing in innovation
- 88 Conclusions

There have been significant differences in growth and structural change across the transition countries. A common question is the possible role of industrial policy in helping to pursue these two objectives. In particular, a number of the resource-rich economies of the Commonwealth of Independent States and Mongolia (CIS+M) face major challenges in diversifying production and trade due to their existing structure of output and capabilities.

It is evident how successfully China, India and other developing nations have moved into new higher-value products and services, such as software development, and how rapidly some European countries, for example Finland and Ireland, have transformed their production and trade structures over the last 20 years. A number of transition countries have consequently begun to consider ways of emulating these achievements. To bring about structural change, many countries have formulated national innovation strategies and adopted a more activist role for the state using instruments of industrial policy.

In light of the analysis in Chapter 4, this chapter examines the feasibility of these aspirations and policies. While central eastern Europe and the Baltic states (CEB) and much of south-eastern Europe (SEE) appear to be making progress, albeit at varying speeds, structural change in the CIS+M may require a more interventionist approach and a reassessment of the feasible industrial policy options. This chapter draws extensively on recent comparative experience. The main focus is on the role that well-designed industrial policy can play, but also the likely pitfalls, particularly in the presence of weak institutions. Particular attention is paid to designing industrial policy that is consistent with market-based discipline. In addition, the chapter considers how government policy can boost innovation, which will be important for long-term growth.

Defining industrial policy

Industrial policy has at least one of two broad aims. The first is to improve the efficiency of individual firms and sectors, which normally involves restructuring and investment. This is relevant in the transition countries given the legacy of inefficient state-owned firms. The second is to achieve structural change, using

policies that favour more dynamic and productive activities generally, irrespective of the sector or industry in question.¹ In either instance, the policies adopted can be horizontal or vertical in nature.

Horizontal policies provide the framework in which firms and industries operate and where market mechanisms ultimately determine survival and prosperity. They commonly include the protection of property rights and improvement of the transparency of commercial and other transactions. Some may be more specific, including providing incentives for foreign direct investment (FDI) and developing national research strategies.

Vertical policies are targeted at specific firms, industries or sectors. Used widely throughout the developed and developing world, they have included loans for working capital and/or fixed assets, selective subsidies to sectors or regions, infrastructure provision, tax incentives for sectors and/or regions and trade protection.² Interventions have been designed to support either failing industries or those deemed to have promise. Other targeted policies have included the establishment of export-processing or special economic zones (SEZs), as well as the provision of specific incentives for foreign investors.³ This reflects the belief that exports tend to lead growth and that exporting and FDI can deliver wider benefits for the economy. Vertical policies can also be pursued without necessarily abandoning market mechanisms.⁴ For example, government funding and non-pecuniary support may be allocated to specific sectors but distributed on the basis of some competitive process, such as auctions or co-financing.⁵

There is a range of motivations for pursuing industrial policy but, in general, market failures have been identified as the main reason. Such failures can include lack of information or discrepancies in access to information by contracting parties, which result in a divergence between the private and social returns. For example, investment in research and development (R&D) will carry a risk of failure. If that is the outcome, an investing firm alone bears the cost. By contrast, when investment is successful, that firm is unable to capture its full value to the market as other firms can use the new information without fully compensating the innovator. The returns to the investing

firm will therefore be lower than to the market as a whole, reducing incentives to pursue further innovation.

There is also the potential for coordination failures, where a project or industry may require simultaneous and large investments upstream and/or downstream, or where there may be wider effects – or spillovers – from new activities. Such failures may also motivate intervention. An example of a spillover is where learning may be acquired through experience – so-called “learning by doing” – and where accumulated skills may in the future be used in other industries but where individual firms will not take this wider benefit into account. Coordination may also be warranted to address problems of entry into new activities if large fixed costs exist that may deter potential entrants.⁶ Additionally, private producers may often require highly specific inputs, such as legislation, accreditation, R&D or infrastructure, that will need to be provided through public sources. Reallocation of knowledge and resources across sectors – a key feature of a dynamic economy and highly relevant to transition economies – may similarly be impeded by a lack of information and other market failures. Indeed, the evidence from developing countries more generally suggests that this is likely to be the case.⁷

Although market failures – particularly in developing countries – have been pervasive, experience with industrial policy has also been very chequered. Use of trade protection, in particular, has largely been an inefficient and ineffective way of boosting local industry. Furthermore, industrial policy has been widely used to subsidise failing firms while attempts to identify promising ventures (or to “pick winners”) have rarely succeeded. Reasons for this have commonly included government deficiencies resulting from self-interested behaviour (or rent-seeking) by officials and short-term decision-making in response to the electoral cycle. In addition, widespread regulatory problems have allowed favoured industries to influence policy in a self-interested manner. Given this background, aversion to the use of targeted policies was widespread.

More recently, this view has been reconsidered in the light of experience with reform in the transition countries and evidence of substantial market failures and resource misallocation.⁸ Moreover, evidence from East Asia and elsewhere shows that industrial policy can play a role in securing more rapid and sustainable economic development, providing not only the necessary coordination and financing to fuel growth in the quantity of capital and labour, but also helping to ensure the provision of adequate infrastructure and access to export markets.⁹ Nevertheless, while such strategies resulted in accelerating growth, there were also less benevolent consequences. In particular, coordination was associated with lending to related parties, shortcomings in governance and weak management of risk.¹⁰ Furthermore, the corollaries of coordination (such as long-term relationships between banks, large firms and the state), while possibly appropriate for periods of extensive growth, may not necessarily be so for economies needing to shift to greater innovation-led growth.

The retreat from market fundamentalism to a greater acceptance of state intervention has been echoed in the transition countries, where a growing number of governments are turning to industrial policy. The East Asian experience has been widely cited by policy-makers in the CIS+M – not least in Russia – as a desirable model. Yet, while it may be generally accepted that horizontal policies can play a role, vertical or targeted interventions remain more problematic and need to be carefully designed.

The mechanics of industrial policy: a review of experience

Industrial policy can take many forms and use a wide range of instruments. The policy-maker's key challenge is to identify the particular constraints that a given industrial policy aims to address and what instruments to deploy.

Table 5.1 relates a range of constraints that have been used to motivate recourse to industrial policy as well as the types of instruments that can be used to address those constraints. It concentrates on five key areas: finance, infrastructure, information, innovation and human capital. The emphasis is on targeted policies, but the table also lists some horizontal policy options.

Table 5.1
Industrial policy: constraints and instruments

Constraint	Instruments
Finance	- Direct loans/grants that are: – directed towards firms, sectors or regions – allocated directly or indirectly through agencies with a degree of independence.
	Restructuring funds.
	Credit lines to banks/credit institutions.
	- Tax incentives: – horizontal tax incentives that apply to all sectors – more specific tax incentives that apply to individual regions or sectors.
	- Venture capital funds/private equity: – support for the establishment of funds and the initial provision of equity – governance framework.
Infrastructure	Direct public investment in physical infrastructure, including roads, railways and airports.
	Mixed finance vehicles, including PFIs/PPPs (private finance initiatives/public-private partnerships).
	Tax incentives to invest in communal resources.
	Setting up of technology parks.
	Creation of, and investment in, special economic zones to attract investors, including FDI.
Information	- Help in building long-term relationships (for example, the model of East Asian economies, such as Japan): – between the public and private sectors – between firms within industries and between industries – by creating incentives for mutually beneficial information sharing.
	Advisory and business services for domestic firms and potential foreign investors.
	Export/trade promotion and marketing, with the aim of improving access to foreign markets.
Innovative capacity	Supply side – encouraging the generation and supply of innovation: - Direct public funding of R&D: – allocated directly by government or indirectly through an organisation – assigned or tendered for in a competitive process.
	Tax incentives for R&D.
	Legal protection for innovation through patenting and intellectual property rights protection.
	Raising the level of innovation-related human capital.
	Demand side – measures to match innovations to markets: Venture capital finance and management to enable investment in innovation.
	- Improving the quality of business management through – business schools – business incubators.
Human capital	Direct training programmes.
	Subsidies for skills acquisition.
	- Investment in education: – directly or through PFIs – towards particular sectors or aimed at raising the general level of human capital.
	Bursaries for foreign study (as in China and Singapore, for example).

Finance

The diversity of instruments is evident in the case of finance or credit constraints. Governments can use direct loans or grants, whether to banks or firms, sectors or regions, as well as tax incentives. There is also the option of using public resources to fund non-bank finance, such as venture capital funds. If designed properly, the latter may be susceptible to market discipline, which can help limit the scope for inefficiency and abuse.

The case of Israel offers some interesting insight. The country has been successfully developing an export-oriented, high-technology group of firms, or cluster, since 1990. Industrial policy has played an important role in three complementary ways: by improving the business environment, by providing assistance for innovation and start-up enterprises not targeted at any particular sector, and by sector-specific support for high-tech industry.¹¹ In particular, the Yozma programme launched by the government in 1992 aimed to encourage venture capital into Israel, to invest in high-tech industry and to promote local venture capital activity. Yozma ended up investing around US\$ 80 million in 10 funds, with international venture capital firms matching these investments. By 1997 a self-sustaining venture capital industry had been established and the government liquidated its holding in Yozma.¹² Israel's industrial strategy had several key attributes, including:

- the adoption of sound horizontal policies
- the targeted or vertical components being in sectors where Israel had developed an advantage, not least in defence-related research and skills
- a focus on activities subject to strong market discipline, while being mindful of the needs of the international venture capital industry.

How this experience may be applied in the context of the transition countries is explored later in this chapter.

Infrastructure

In infrastructure financing, the extent to which public resources and management dominate varies according to the type of financing option. While evidence suggests that mixed-finance models can be appropriate for large infrastructure projects, it depends very much on the quality of institutions and regulation.¹³

Investment in technology parks and SEZs normally involves giving priority to specific types of activities, such as software development, and hence greater targeting. The objective of such interventions is mostly to induce the clustering of similar firms and skills. Clustering is widely thought to be desirable because it can reduce search costs for both markets and inputs; it can reduce transaction costs due to closer proximity and better information flows; and it can help improve monitoring and coordination. As a result, clustering can lead to improvements in productivity. In order to induce clustering, for example, SEZs were operating in 135 countries by 2006. They have usually been set up to develop and diversify exports, create jobs and pilot new policies and ideas. Their success hinges heavily on the strength of their institutional and regulatory framework and on the package of incentives. Experience suggests that they are likely to be most successful when well integrated with the rest of the economy. Although it is difficult to quantify the benefits, it does seem that SEZs (as in China) can be successful in attracting FDI and expanding and diversifying exports.¹⁴

Information

Experience in East Asia has emphasised the role that long-term relationships between government and major economic actors can play in addressing gaps in information and in ensuring coordinated responses. Information-enhancing interventions can, however, take many forms. They can range from relatively "soft" actions, such as trade promotion and attempts to promote national branding – a feature of policy in China, for example – to more ambitious interventions aimed at sponsoring greater strategic collaboration between private and public institutions. These can include the creation and use of business councils and strategic partnerships between private and public institutions whether at national, local or sector level. The broad picture that emerges, however, is that there is more than one approach to minimising shortcomings in information across countries. This is partly because of the large differences in the organisation and quality of institutions across countries.

Innovative capacity

Regarding innovation, supply-side policy can take the form of direct spending on R&D by public or quasi-public institutions, providing tax incentives (either generally or for specific sectors) and ensuring adequate intellectual property rights protection (IPRP) or safeguards for innovators.

These interventions have all been widely used in developed market economies. Some emerging economies have gone further. In China, for example, the government has played a key role in the development of high-tech industry. In addition to aiding the acquisition of foreign technology through FDI and encouraging clustering through SEZs, there has also been a dramatic increase in the funding and promotion of R&D.¹⁵ This has resulted in a rapid growth of high-tech manufacturing; China has become the world's largest exporter of information and communications technology (ICT) goods. The sector is, however, mostly foreign-owned and considerably less R&D-intensive than in more advanced economies. Also, while R&D inputs in China have increased rapidly over the past decade, R&D output has remained relatively low and focused on the development of existing products rather than new ideas. Low returns to R&D, and lower than expected spillovers from FDI, stem from weaknesses in horizontal policy, such as the lack of transparency regarding ownership and corporate governance, as well as financing constraints and inadequate IPRP. These weaknesses are reflected in the relatively slow growth and immaturity of the software sector.¹⁶ Chinese software firms remain mostly small and under-capitalised, offering unsophisticated products and services.¹⁷ Furthermore, most banks and non-bank institutions are not attuned to providing financing for this sector, and the education system is better suited to producing engineers rather than programmers. China's failure to safeguard intellectual property rights has also undermined the willingness to innovate.

In contrast, the spectacular growth of India's software economy seems more attributable to the fact that the government largely ignored the sector in its formative years rather than to targeted policies.¹⁸ As such, it was

able to develop with a strong, competitive export focus on a sophisticated overseas client base.

Among western European countries, for example, Finland has promoted itself as an attractive location for internationally competitive companies.¹⁹ It has put a national innovation system (NIS) at the centre of its science and technology policy and directed increased public R&D spending towards commercially viable projects. A 40 per cent share of R&D grants has been directed through a semi-autonomous agency, Tekes, to technology programmes. As in Israel, industrial policy has largely favoured improvements in the business environment for innovation and product development, in part by providing additional public financing. In the transition region, Estonia, Latvia and Lithuania have dramatically increased their R&D activity in the past decade and are moving towards this type of model.

Policies aimed at the demand side, specifically to improve the commercialisation of innovations, have been adopted less often as they imply attention to the management of innovating firms and the provision of skills that governments generally do not have or know how to exploit.

Human capital

Chapter 3 has already highlighted the importance of investing in human capital for sustaining growth and this has been a common factor enabling countries to move into new, higher-value products and services. Although that investment has been made largely by the public sector (for example, in China and India), governments have increasingly adopted strategies that include private education and training provision.

Experience from Asia suggests that scholarships for top students to study abroad have helped to enhance skill levels without leading to a “brain drain” (the loss of skilled workers through emigration), as graduates have increasingly returned home after studies while the benefits from being abroad have also shown up in access to commercial or other networks.²⁰

In some countries – China, Kazakhstan and Singapore, for instance – scholarships for studying abroad have required students to return to their home country for a specific period after graduation.

More generally, the main government contribution to the rise of India’s software sector has been its human capital policy – particularly the earlier emphasis on building a strong tertiary sector around the natural sciences and management, and the later willingness to allow private training and educational services providers to enter the market for skills acquisition and upgrading.²¹

Overview

Pulling together this review of experience, a number of points bear emphasis. The first is the importance of a good framework (or horizontal policies), particularly regarding investment in education and human capital where the state is likely to play a major role. The second is the role that competitive pressure can play in disciplining industrial policy interventions and limiting the dissipation of resources. The third is that financing for risky innovative projects may often not be well addressed by conventional financial institutions, such as banks, although simply setting up public financing channels can have major pitfalls. A more promising avenue is the provision of public financing to institutions that respond to market discipline and where decision-making on resource allocation is as transparent as possible. The fourth point is that the idea of governments being able to best pick winners has weak foundations, and much adverse experience. The fifth is that the policy armoury will change over time; economies in the process of catching up will require different types of interventions from those that are more technologically advanced.²²

Industrial policy in the transition countries

Given the legacy of communism in the transition countries, markets have had to be built. Often this has not been possible to achieve quickly. Therefore, while it might generally be more appropriate to give priority to the development of markets (such as financial markets), the time factor and the possible persistence of market failures may also justify the selective use of industrial policy.

Nevertheless, a proper diagnosis of the source of the market failure will be essential. For example, if lack of investment in a transition country is mainly attributable to poor intellectual property rights and a bad business

environment, using horizontal tax incentives will be inappropriate and may even open additional channels for corruption and abuse. Similarly, the view that credit constraints for private firms limit entrepreneurial activity (see Chapter 3) may not be best addressed by using public resources to boost credit to firms. If financing is deterred because investors do not have confidence in the extent of control or supervision exerted over entrepreneurs, a better approach would be to address the shortcomings in regulation. The actual policy design will therefore depend on the sources of market failure and a case-by-case diagnosis, rather than a general presumption that the failure is best addressed by an activist industrial strategy.

Industrial policy in a variety of guises has actually been widely pursued in the transition countries since the early 1990s. In CEB and SEE the focus has mostly been on encouraging R&D, attracting FDI, supporting innovation in small and medium-sized enterprises (SMEs), and improving the general business environment.²³ Attempts at picking winners have largely been discarded and the emphasis placed on improving horizontal policies. Although remnants of traditional sectoral support to failing or restructuring industries remain (for example, in the large coal sector in Poland), the scale has declined dramatically over the last decade.

In the CIS+M, governments faced with major constraints to structural change, quality upgrading and innovation have experimented more widely with industrial strategy, including the use of vertical policies. In countries such as Belarus and Uzbekistan, public subsidies, directed credits and other instruments for supporting loss-making firms have been widely applied. Even in countries where a more ambitious set of policies has been attempted, experience has been very mixed (see Box 5.1 on page 84). The weakness of institutions and governance has highlighted the classic problem of industrial policy: the pervasive risk of government failure in the implementation of policy.

Box 5.1

The experience of industrial policy in Ukraine

Attempts at policy-making and implementation in Ukraine have been characterised more by ineffective institutions and poor design than by any central vision for the future shape of the economy. Policy has focused exclusively on the supply side and almost entirely on financing. In the perceived absence of bank funding, government policies have aimed to replace the market by financing science and technology (S&T) and selected innovation projects directly. The allocation of funding to recipients and projects has been micro-managed. For such an approach to work, political and economic institutions would have to have been effective and decision-making processes transparent, both of which have been absent in Ukraine.

Funding of innovation

The State Agency for Investments and Innovations (SAII) was established at the end of 2005. It incorporated the National Innovation Company (NIC) that had been created in 1999 to replace the State Innovation Fund (SIF) set up in 1992. The SIF had provided long-term, low-interest loans to projects across Ukraine. However, most projects were unsuccessful and default rates were high, leaving a portfolio of bad debt. The balance sheet of the SIF deteriorated further when the government siphoned off funds to finance the budget deficit. As a result, the NIC was only able to lend money with the proceeds from reclaimed debts. Under the NIC and SAII, organisations have been allocated funding for basic R&D in block grants in a process that is meant to be competitive.²⁴ However, the framework stipulates over 120 priority areas, while the process of resource allocation has been far from transparent. Laws that have been introduced with the objective of stimulating innovation have also been badly designed.²⁵

Support for innovation

Sixteen technology parks in 10 regions have been established since 2000. Activities were to include: the formation of a support system for small businesses; organisation of business activities in S&T and the involvement of higher education institutions; selection of foreign partners for cooperation; training in innovative management and marketing; tax incentives for the importation of materials and equipment; and improved access to credit. However, there were a number of problems arising from some parks being set up in response to lobbying from powerful local business people and politicians, and with parks being frequently used for tax evasion. In early 2005 all privileges were withdrawn by the government, causing eight parks to cease operations completely. Ukraine's national innovation system remains a complex muddle of overlapping policies, incentives, state agencies and ministries. It is almost wholly focused on the supply side, with scant attention paid to the demand for innovation from industry.

For risky, innovative projects governments have historically experimented with various approaches, such as setting up development banks and using dedicated lines of credit through public or private financial institutions. However, international experience suggests that innovative projects may be better suited to financing through more unorthodox, non-bank channels, particularly venture capital.²⁶ This is partly because venture capitalists can provide operational and management experience as well as finance. The Israeli case detailed on page 82 (and the example of the US Small Business Innovation Programme²⁷) show that with careful design a government can play a positive role in the development of a venture capital industry. This has inspired a number of transition countries, particularly Russia, to attempt a similar course. However, early attempts have not been successful, largely because critical elements of design have been ignored (see Box 5.2).

The most significant initiative, at least in terms of financing, has been the creation of a Russian nanotechnology fund (Rosnanotekh). It was set up in 2007 with an initial capital injection of around €4 billion, a sum equivalent to the United States' spending level on nanotechnology. The motivation for the fund appears to have been the inability of Russian researchers to translate their findings into business propositions.²⁸ The fund has been designed to support not only R&D and training, but also to provide financial backing to innovative projects. A similar but smaller special investment fund has also been set up for ICT. The state's share is intended to decline over time and the fund should be privatised at some point in the future. These funds are sector-specific. However, experience suggests that this is likely to be problematic, especially if the sectors, or activities that they aim to finance, have not reached some minimum thresholds of activity and investment.

Finance, clustering and diversification

This section does not provide a comprehensive overview of industrial policy in the transition region, but rather concentrates on three areas or objectives that evidence and current priorities suggest are important – finance, clustering and diversification – and how good practice may be achieved. The focus is largely on the CIS+M, where there is potentially a greater role for vertical policy components and where some governments have embraced their adoption, particularly in these three areas.

Finance

Access to credit is a key concern for all emerging markets: domestically sourced available credit may be scarce, while foreign investors may be wary of local governance. Where credit is available, the selective availability of information has frequently led to a misallocation of funds, as lenders favour established and large firms over start-up enterprises. This makes it difficult to secure backing for innovative projects and may be particularly acute in cases where an explicit objective is the diversification of the economy.

In Kazakhstan the government has launched the Kazakh Fund for Sustainable Development (Kazyna). The ambitious aims range from providing long-term debt and equity financing to venture capital and grants for R&D using a variety of local institutions. The fund also has a wide remit, with up to 12 priority areas for support, ranging from petrochemicals to textiles and machinery. The venture capital component – the National Innovation Fund – aims to invest in venture capital funds by taking a

minority stake. By 2008 it had invested in five local and five foreign funds. Other objectives include investing in the infrastructure to support innovation, principally technology parks, as well as direct investment in specific innovative projects and applied R&D. It is too early to evaluate performance, but the selection of transactions and the integrity of those selections will require close monitoring. There is a lack of priorities, which suggests that it will be hard to build a critical mass of activity and which may adversely affect the fund's ability to pursue larger and more effective R&D.

In both the Russian and Kazakh cases, the ways in which the venture capital funds have been designed have been problematic. There has also been a questionable assumption that finance, rather than management and business skills, is the principal constraint and bottleneck to be addressed by these funds. Weaknesses in management training and skills in the transition countries remain a fairly pervasive problem, which will be important in determining the success or failure of a project. Experience elsewhere shows that funds often take seats on a company's board and can also be actively involved in recruiting management.²⁹ This sort of activist role is likely to be appropriate in the CIS+M.

Clustering

As already indicated, governments can use SEZs as an effective tool for developing clusters. The key elements of a successful SEZ framework include:

- the promotion of private rather than public development of the zones
- clear definition of the rights and obligations of governments and zone developers
- the flexibility to allow a range of commercial activities as well as manufacturing activities.³⁰

SEZs are operating widely and often successfully in CEB.³¹ In the CIS+M, however, attempts at setting them up have faced problems with inadequate public sector management and poor location and infrastructure.³²

Russia is in the process of creating a system of SEZs for the third time. Previously, the zones failed as growth in technology-based investment was undermined by rampant tax abuse, fraud and corruption. The government appears to have learned from these experiences, passing a law in 2005 that placed emphasis on creating an enabling environment rather than on tax exemptions.³³ Similarly, Ukraine established 16 technology parks in the early part of this decade, although in 2005 all privileges were withdrawn (see Box 5.1).

When designing SEZs, experience suggests that CIS+M governments should avoid using uncompetitive fiscal incentives, restrictive controls on SEZ activity, cumbersome regulations and weak administrative bodies. They should also avoid preventing goods that are processed in SEZs from being included in bilateral trade agreements. Fiscal incentives are increasingly convergent across countries, making tax incentives ineffective. Damaging restrictive controls include performance requirements, inappropriate application of extraterritorial rules, the restrictive treatment of real assets and the prevention of private sector development of zones.

Diversification

Diversification has been given high priority in a number of transition countries, particularly the resource-rich economies of the CIS+M.³⁴ This has been associated with an activist industrial policy. However, resorting to vertical policies to promote new products will probably fail, particularly given the relatively fragile institutions that exist in these countries. The perennial problem of how to select those products would also remain.³⁵

An alternative focus might be on capabilities rather than products. As argued in Chapter 4, what a country produces reflects the array of capabilities that it possesses (such as workers' skills, quality of management or infrastructure). New products that draw on existing capabilities are more likely to succeed than those that rely on capabilities yet to be acquired. However, if existing capabilities support products with relatively low value, the question remains as to whether an industrial policy that is designed to create capabilities that are absent may be warranted and, if so, through which

Box 5.2

Designing an intervention: the case of the Russian Venture Company

The Russian Venture Company (RVC) was launched by the Ministry of Science and Technology in 2006 with an initial capitalisation of €0.4 billion (or 15 billion roubles). It aimed to take stakes of 49 per cent in up to 15 venture capital funds, with the state's returns capped at 3 per cent.

The fund was initially created to mimic the Israeli model, but its actual design was ultimately tailored to meet local constraints. The initial design drew heavily on the experience and ways of working of the international venture capital industry with its particular sequence of funding, management incentive structure and governance framework. For example, it is standard practice for funds to be released incrementally and associated with specific targets and objectives. In the final Russian design, however, all funding had to be provided at the outset of the project, although this requirement was subsequently relaxed.

Internationally, venture capital funds are almost always located offshore, in one of a few jurisdictions where legal and regulatory procedures have been tried and tested. By contrast, the Russian government stipulated that its funds had to be located onshore and operate under general investment fund legislation, which is not well tailored to the needs of the venture capital industry. It is also common practice for managerial remuneration to be linked to equity or options in an attempt to align the interest of employees and investors, but this was problematic under Russian law and the incentive structure was adjusted accordingly.

The lack of demand for Russian venture capital funds is the best indication as to the impact of these modifications. While the initial plan was for RVC to provide capital for up to 15 venture capital funds, only three came forward in the first round of bidding, of which two collapsed or were withdrawn before capital was transferred. The clear lesson of the RVC experiment is that, while the motivation for the funds may have been appropriate, the design was not.

Table 5.2
Gross expenditure on R&D in transition and selected other countries, 2005

Country	GERD as % of GDP	Total GERD per capita (US\$ PPP)	GERD by sector (%)		
			Business enterprise	Government	Higher education
CEB					
Czech Republic	1.4	287.6	64.5	18.7	16.4
Estonia	0.9	155.0	45.1	11.3	43.4
Hungary	0.9	160.3	44.2	29.0	26.1
Latvia	0.6	73.8	40.7	18.7	40.6
Lithuania	0.8	106.6	20.4	25.0	54.6
Poland	0.6	76.9	31.8	36.4	31.6
Slovak Republic	0.5	81.0	49.8	29.7	20.4
Slovenia	1.5	336.5	58.8	24.2	16.7
SEE					
Bulgaria	0.5	45.3	21.5	66.8	10.5
Croatia	1.0	129.1	41.3	24.0	34.6
FYR Macedonia	0.3	18.2	12.1	46.2	41.6
Romania	0.4	38.5	49.7	34.2	13.7
Serbia and Montenegro	1.4	121.0	5.7	45.6	48.6
CIS+M					
Armenia	0.2	8.9	0.0	93.0	7.0
Azerbaijan	0.2	10.1	20.9	72.6	6.5
Belarus	0.7	57.8	44.4	38.6	17.0
Georgia	0.2	6.2	0.0	73.2	26.8
Kazakhstan	0.3	24.6	39.3	46.7	13.7
Kyrgyz Republic	0.2	3.4	39.2	52.8	7.9
Mongolia	0.3	6.7	1.6	73.0	25.4
Russia	1.1	125.9	68.0	26.1	5.8
Tajikistan	0.1	1.4	0.0	93.1	6.9
Ukraine	1.0	57.8	62.2	32.6	5.2
Selected European and emerging countries					
Finland	3.5	1,061.0	70.8	9.6	19.0
France	2.1	651.5	62.6	18.6	18.6
Germany	2.5	755.6	69.3	14.1	16.5
Italy	1.1	304.0	50.4	19.4	30.2
United Kingdom	1.8	556.7	63.8	11.6	24.6
China	1.3	54.1	68.3	21.8	9.9
India	0.7	13.4	19.8	75.3	4.9
Israel	4.5	1,050.5	76.5	9.0	14.5

Source: UNESCO R&D Spending Database.

Note: Serbia and Montenegro data were gathered through surveys conducted during or before 2006, at which time Serbia and Montenegro was a single member state of UNESCO and thus are presented as such in this table. After declaration of its status as an independent state in June 2006, Montenegro became UNESCO's 192nd member state on 1 March 2007. Data for India are for 2004. Data are not available for Albania, Bosnia and Herzegovina, Moldova, Turkmenistan and Uzbekistan.

mechanisms. There is the usual problem as to which capabilities should be given priority, and while some capabilities are interchangeable (such as general education), others can be highly specific (vocational education, for instance).

Previous sections of this chapter can provide some guidance. Targeted interventions aimed at building sectoral capabilities have generally been hard to achieve. Where there has been some success, as in the Israeli example cited earlier, it has been because policy was targeted at sectors where a minimum

core of capabilities had already been developed. Moreover, the Israeli case was more about providing assistance to a range of sectors. In the context of the resource-rich transition countries with their weak institutions and governance, the need to avoid targeting specific capabilities is clear.

In the case of human capital – a key element in India's route to diversification – the situation is rather different. Governments have a major role to play in financing and regulating educational institutions. Evidence shows that improvements in the level and distribution of financing are required in most transition countries. There may also be scope for giving priority to particular educational institutions and subjects, such as science and technology. The Indian case shows that complementary policies facilitating entry by private educational and research institutions are also desirable.

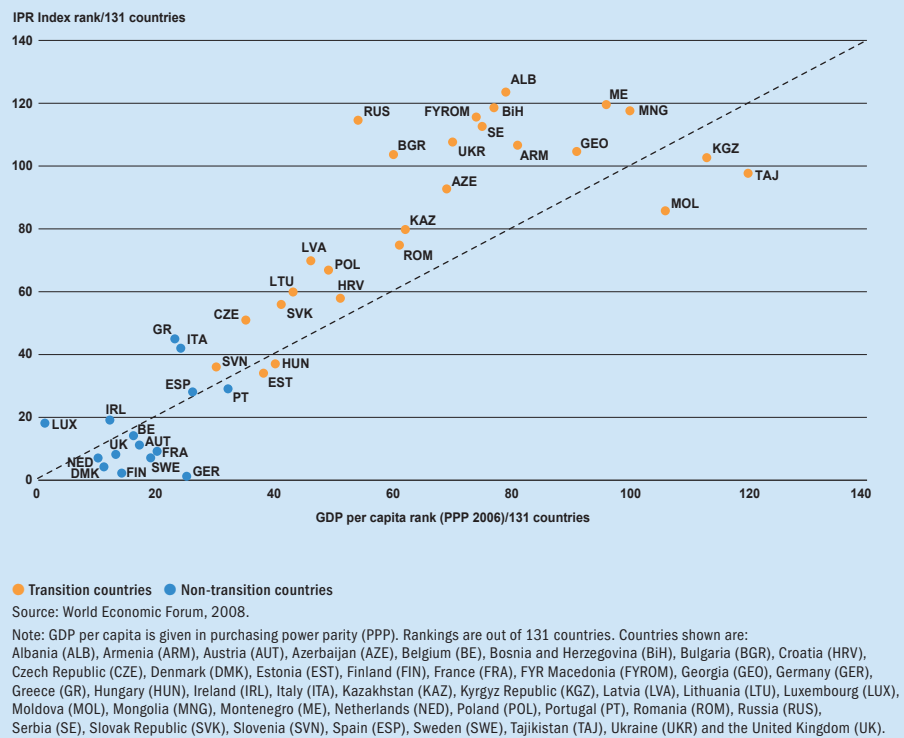
As discussed earlier, credit constraints for new, risky sectors and capabilities can potentially be addressed through public support for non-bank finance vehicles, but only if properly designed and subjected, as far as possible, to market discipline and regulation. It may be wise to give priority to funding projects that are going to be subject to competition in export markets and where the scope for wasting resources is more limited. In general, sector-neutral rather than sector-specific approaches are preferred. Also, support to infrastructure projects that help spatial and skill clustering and, in effect, help coordinate the growth of new capabilities will be relevant. Financing and management need not, however, be uniquely public. Indeed, mixed financing models will be an attractive approach. Investment in capabilities through education programmes that are broadly relevant to a range of sectors has an important role in the policy armoury as well.

Investing in innovation

This section examines the wider issue of how governments of the transition countries can help foster innovation that will be important for sustaining long-term growth (see Chapter 3). Table 5.2 covers gross expenditure on R&D (GERD) in most of the transition countries and a breakdown of the source of that spending in 2005. In CEB, GERD averages less than 1 per cent of GDP, but with large variation across countries. There are similarly large differences in the source of spending: the Baltic states have higher percentages of R&D originating from higher education institutions. In SEE, most countries have lower spending per head than in CEB and the share of business and enterprise R&D is lower than in CEB. In the CIS+M,

Chart 5.1

Rankings of GDP per capita and intellectual property rights protection, 2006



R&D expenditures per capita were generally very low and most R&D is by the government. The table also shows that relative to western European countries, the transition countries have consistently lower spending on R&D. Compared with China and India, however, spending is roughly comparable as a share of GDP, at least for CEB.

Policies that support innovation

Comparative experience for innovation suggests that there is no single route to success.³⁶ However, governments can play a critical role by providing the commercial and legal framework, particularly through policies that foster market competition and so create incentives for innovation. IPRP is particularly important.

Chart 5.1 relates the World Economic Forum's ranking of IPRP to the ranking of GDP per capita (in purchasing power parity, PPP). Rankings are such that the most advanced countries have the lowest (smallest) numerical rank. Most transition countries are above the 45 degree line, indicating that their IPRP rank is lower than would be predicted from their income per capita. Further policies to strengthen market framework conditions may therefore be necessary, and are unlikely to be contested.

There are, however, specific policy instruments that governments have adopted to boost innovation.

Publicly funded research

A central strand of innovation policy is the financing of basic research through universities and other research institutions. For businesses, the main role of universities is to provide trained graduates armed with new techniques and skills that firms are generally unable to provide themselves. However, cases where university researchers make a discovery and the practical importance is then recognised by business are relatively rare. Evidence suggests that publicly supported research at universities is most effective for basic and generic science and technology where output has a large public benefit element.³⁷ Public funding of private sector research has often just substituted for private sector investment.

Governments are also increasingly realising that the university research they support should be used to generate economic returns. In the advanced market economies, universities have become increasingly involved in product development, with increases in university licensing, spin-off developments and funding from the private sector.

The scale of this activity has been affected by the extent of investment in innovative research – one widely cited example is the way in which defence spending had major, positive consequences for ICT-related research and, ultimately, diffusion of ICT in the United States. It is also recognised, however, that providing the incentives for the commercialisation of innovative ideas can play a crucial role. The Bayh-Dole Act (1980) in the United States was instrumental in helping researchers patent and commercialise research that had been supported by public resources.³⁸

There are also opportunities for governments to structure markets through interventions that address specific market failures or problems with coordination. One such area is in the setting of standards where government intervention may be more efficient than market-based solutions. Nevertheless, there remains scope for manipulation and abuse; for example, the Chinese have often tried to use standard setting as a way of diluting competition in favour of preferred local companies and systems.³⁹

There are clear limits to the effectiveness of government funding for innovation. In much of the CIS+M, R&D is dominated by the public sector and there is a risk that private sector investment will be crowded out and that dynamic sectors will be deprived of researchers and expertise. Furthermore, inadequate links between research organisations and the market will tend to limit the commercial applicability of innovative output; the Chinese government has invested heavily in R&D, but output has been low.

Fiscal support for private innovation

All countries in the Organisation for Economic Co-operation and Development (OECD) provide a mixture of direct, indirect and public-private partnership measures to support private innovative activity. Direct support takes the form of competitive grants and subsidised or guaranteed loans. Although these remain important in many countries, the focus has shifted towards indirect measures, where the government has no role in selecting the recipients. Most indirect measures allow firms and the market to determine what research takes

place and how funds are distributed. Governments do not, therefore, face the usual problems with incomplete information associated with direct public support. R&D tax incentives – the most common form of indirect support – are used by almost all countries, and aim to realign social and private returns to R&D.⁴⁰ Tax incentives generally take the form of tax credits, which reduce a firm's tax liability, or tax allowances, which provide an additional deduction from taxable income.⁴¹

Experience also indicates that cooperation between the public and private sectors in R&D programmes can yield positive results. Public-private partnerships (in areas such as health care, transport and environmental protection) can also contribute to science and innovation systems and increase the leverage of public support to business R&D through cost and risk sharing.⁴²

However, transition countries, particularly in the CIS+M, do not have a good record of fostering private sector innovation. Tax concessions have been widely abused and the process of allocating funding has often not been competitive or transparent. While advanced market economies have used competitive processes or the market to allocate support, deficiencies in markets and governance suggest that most transition countries should avoid or severely limit the use of fiscal support programmes while trying to ensure maximum simplicity and transparency in design for those programmes that are adopted.

Conclusions

This chapter has examined the rationale for industrial policy. It has argued that, in common with many OECD economies, the use of horizontal policies to support investment and innovation is an important tool in the policy armoury. In the transition countries, however, where market failures and other constraints are significant, there can be justification for also using targeted or vertical policies. Targeted policies drawing on public resources can be helpful in promoting the growth of new activities by improving credit and infrastructure in particular (through non-bank financing instruments, such as venture capital funds, and through SEZs). The use of autonomous or

semi-autonomous institutions funded with public resources can also be an effective way of ensuring good governance and a greater degree of market supervision than with purely public institutions.

However, such interventions must be designed carefully to avoid the pitfalls that weak institutions and poor governance pose, particularly in the CIS+M. This implies relying as much as possible on design mechanisms that incorporate elements of market discipline. In the case of venture capital funds, for instance, this would give priority to the creation of general – that is, non-sector-specific – funds that use resources for purposes determined as far as possible by commercial prospects. Where feasible, use of co-financing with private sector institutions can promote this basic objective while also helping to ensure good governance. Wherever possible, supporting projects that are in competitive markets, particularly export markets, can be an important check on the possible misallocation of resources. In contrast, supply-driven allocations of resources, particularly from public institutions, have a long history of failure.

In summary, an intellectual and practical case can be made for selecting certain aspects of industrial policy, but the difference between success and failure comes down to the detailed design of this policy and its effective implementation. For these reasons, vertical or targeted policies are likely by definition to be far more problematic in countries with weak institutional environments.

Endnotes

- 1 See Rodrik (2007) and Pack and Saggi (2006).
- 2 For a list, see Rodrik (2007) Table 4.2.
- 3 A notable example in the transition context was the case of the carmaker Skoda in the Czech Republic, where the Volkswagen group received substantial incentives to acquire and invest in the company in the early 1990s.
- 4 As argued in Pelkmans (2006).
- 5 Rodrik (2007) gives a wider perspective on industrial policy that embraces both horizontal and vertical policies and portrays industrial policy in terms of a discovery process in which firms and governments learn about underlying costs and opportunities and engage in strategic coordination.
- 6 See Aghion and Howitt (2008).
- 7 See Banerji and Duflo (2005).
- 8 The World Bank *Growth Report* (2008) argues that there can be a role for governments in jump-starting industries in export sectors. However, it goes on to emphasise that such policy should always be temporary.
- 9 See, among other things, World Bank (1989) and Stiglitz (1996).
- 10 See, for example, Chopra et al (2001).
- 11 See Khavul (2005).
- 12 Between 1992 and 2002 the venture capital industry mobilised nearly US\$ 9.5 billion for investment in Israeli firms.
- 13 See EBRD, *Transition Report* (2007), Chapter 5.
- 14 See Foreign Investment Advisory Service (FIAS), (2008).
- 15 See Linden (2004).
- 16 See OECD (2007a).
- 17 See Saxenian and Quan (2005).
- 18 See Desai (2005).
- 19 See Yla-Anttila and Palmberg (2007).
- 20 See Docquier et al (2001) and Commander et al (2008).
- 21 The most commonly cited examples are the creation of the Indian Institutes of Technology and Management from the 1950s onwards.
- 22 For economies that do not use leading technologies and hence are far from the technological frontier, large investment in R&D is likely to be ineffective. The emphasis should be more on improving the efficiency of existing industries. Economies close to the frontier will also need to pursue restructuring to ensure that they stay at or near the frontier while relying on innovation to extend the frontier.
- 23 For a discussion of industrial policy in SEE, see OECD (2006a). For the evolution of policy in CEB see Torok (2007).
- 24 See Lenchuk (2006).
- 25 See Yergorov (2008).
- 26 See Kortum and Lerner (2000).
- 27 See Lerner (1999) for an examination of the experience of this programme, which was explicitly aimed at boosting the venture capital industry and entrepreneurship.
- 28 In terms of research capabilities, the Russian Academy of Sciences has been publishing the *Journal of Nano and Microsystem Technique* since 1999.
- 29 See Gompers and Lerner (2001) for a review of venture capital experience.
- 30 For a detailed framework see FIAS (2008).
- 31 Hungary, the Czech Republic and Poland have the third, sixth and 11th highest number of SEZs in emerging markets, according to FIAS (2008).
- 32 See FIAS (2008), p. 44.
- 33 See World Bank (2006).
- 34 Imbs and Wacziarg (2003) find that as developing countries grow they tend to diversify production and this diversification only ceases at relatively high income levels.
- 35 For Russia, Hausmann and Klinger (2008) find that the products that are relatively close to existing products and have high strategic value are a very heterogeneous mix, and include metals, agricultural products, timber, aviation and railway locomotives.
- 36 Innovation is composed of three related processes: (i) the production of scientific and technical knowledge; (ii) the transformation of knowledge into products; and (iii) the response to, and influence of, market demand. See Pavitt (2005).
- 37 See OECD (2006b) and OECD (2007c).
- 38 See Lach and Schankerman (2003).
- 39 See Linden (2004).
- 40 See OECD (2007b) and OECD (2007c).
- 41 The number of OECD countries providing such support has increased steadily since 2000. In 2006, 12 OECD countries offered R&D tax credits, while seven offered tax allowances. Revenue losses due to R&D incentives amounted to around US\$ 1 billion (PPP) in France and the United Kingdom, US\$ 2.3 billion in Canada and over US\$ 5 billion in the United States. See Warda (2006).
- 42 See OECD (2007c), p. 21.

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Country assessments

This part of the *Transition Report* contains a country-by-country review of reform progress and macroeconomic developments in the transition region from mid-2007 to the third quarter of 2008.

The data tables include indicators of structural, institutional and macroeconomic developments that help to describe transition in a particular country. However, they 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 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 and other information was late October 2008. As noted elsewhere in the Report, a number of dramatic events occurred in global financial markets in September and October 2008, many of which have important implications for the transition region. The country assessments and data projections for 2008 have tried to take account of these implications as of late October. Any subsequent major developments up to mid-November are reflected to the extent possible in the Chief Economist’s foreword (see page vi) and in Chapters 1 and 2.

Albania

Key developments and challenges

Albania's business climate improved considerably over the past year. However, further strengthening of the rule of law and stepping up the process of obtaining construction permits and processing of ownership claims are required in order to attract higher levels of foreign investment.

Before its privatisation, KESH should carry out further measures to increase bill collection rates and reduce electricity losses. This would make the company more attractive to potential buyers, enhance reliability of supply and reduce the government's quasi-fiscal losses.

Significant progress has been achieved in privatising large-scale enterprises. Ensuring transparent concession procedures for the construction of new infrastructure – namely power, ports and roads – is important.

Country data

Population (in millions)	3.2
Area ('000 sq km)	28.7
GDP (in billion US\$, 2007)	10.8
Average transition score (scale: 1 to 4.33)	3.04

Progress in structural reform

Business environment and competition

Important progress has been made over the past year in improving the business climate. This is reflected in the World Bank's *Doing Business 2009* report, which ranks Albania 86th out of 181 countries (up from 135th in the previous year) and places it as second top reformer globally with regard to business environment reforms implemented over the past year. The new national business registration centre led to a substantial reduction in the time required to register a business from eight days in June 2007 to only one day, at substantially lower costs. In January 2008 a 10 per cent corporate income tax replaced the 20 per cent rate on profits. The amendments to the bankruptcy law approved in May 2008 are expected to address the current procedural and administrative bottlenecks in the bankruptcy process. There has also been progress in the protection of investor rights with the introduction of a new company law strengthening the protection of minority shareholders. While preparations for defining property rights have advanced, processing ownership claims and permits remains slow. This, together with remaining weaknesses in the judiciary, hampers the development of a more favourable climate for business and investment.

Infrastructure

The energy sector continues to lack adequate capacity for sufficient electricity supply and the power distribution network remains well below international standards. The government

has increased public investment to upgrade the country's infrastructure, although the gaps in infrastructure provision are still very large. An increase in residential electricity tariffs of almost 20 per cent was implemented in March 2008, which should help to improve the state-owned power utility KESH before it is privatised. However, large energy imports, technical losses and poor bill collection rates continue to cause cash flow problems for KESH. The tender for the privatisation of 76 per cent of the shares of the distribution arm of KESH is moving ahead; in September 2008 the government announced that the Czech power utility CEZ has been selected as the winner in the tender for a controlling stake in the power distribution company OSSH, which has been spun off from KESH. CEZ's plan entails a reduction of technical losses from 32 per cent of total supply at the end of 2008 to just 15 per cent by 2014. The government aims to finalise the privatisation process before the end of 2008.

Good progress has also been made in the privatisation of other large-scale infrastructure enterprises. The tender for the sale of an 85 per cent stake in the oil refinery ARMO was concluded in June 2008 for a price of €127.75 million. The privatisation contract with the winning bidder, a consortium comprising the US-based Refinery Associates of Texas and the Swiss-based Anika Enterprises and Mercuria Energy Group, was signed in August 2008. In early 2008 the government approved the bid submitted by a Greek-led consortium, including the engineering company Atermon and consultants Roder & Blackwell, to modernise the Fier power plant, Albania's sole existing thermal power station. The consortium will operate the facility under a 35-year concession. In July 2008 it was announced that Austria's largest power generation and transmission company, Verbund, had won a tender to construct a hydropower plant on the River Drin, one of Albania's main sources of power generation. The new plant will have a total capacity of 48 megawatts (MW) and an estimated construction cost of around €160 million.

Financial sector

Albania's banking sector generally remains solvent, liquid and profitable, although the development of the sector is still at an early stage. Total assets of the financial system have grown and were around 79 per cent of GDP at the end of 2007. Over 70 per cent of credits to the non-government sector are denominated in foreign currency (mainly euros), exposing banks to potential currency risk. A merger in January 2008 reduced the number of commercial banks operating in Albania from 17 to 16, of which 15 are fully or partly foreign-owned. The commercial banking sector is dominated by a few large banks, such as Raiffeisen International, Intesa Sanpaolo and Société Générale. The implementation of the banking law has led to improvements in supervision, licensing and foreign branch regulations as well as risk and prudential management. Further improvement in the transparency of the banking system resulted from the establishment of a new credit bureau/registry, which came into operation on 1 January 2008.

The non-bank financial sector is still in its infancy. However, the securities markets legislation has been strengthened and there was progress over the past year in implementing measures to enhance the supervisory capacity of the Financial Supervisory Authority.

Macroeconomic performance

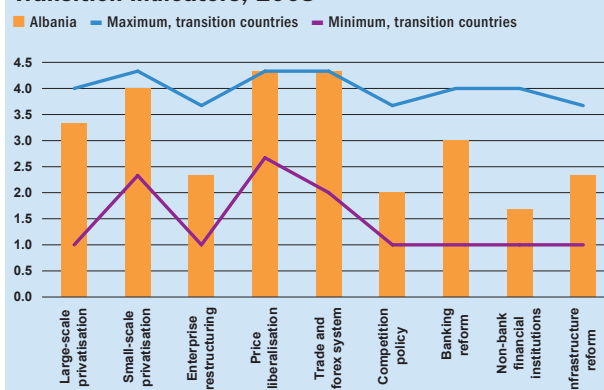
Real GDP growth was strong at 6 per cent in 2007 and is becoming broader based. Buoyant industrial production, the opening of new mines, a resurgence of construction activity and a strong performance from both the export and tourism sectors offset the drought-related declines in electricity generation and agricultural production. Monetary tightening has been essential in achieving low inflation and slowing the rapid expansion of credit to the private sector, which rose by around 50 per cent in 2007. Inflation was below 3 per cent in 2007 and remains among the lowest in the region in the first half of 2008, despite temporary deviations from the Bank of Albania's 2 to 4 per cent target range, mainly due to higher food and energy prices as well as the increase in electricity tariffs in March 2008.

The 2008 budget foresees a general government deficit of 5.2 per cent of GDP, allowing for the temporary acceleration in capital spending for large infrastructure projects. The current account deficit widened to 10.6 per cent of GDP in 2007 as a result of higher import spending on electricity, food, fuels and machinery for the construction of large road projects. Exports rose by 24 per cent in 2007, reflecting both the rapid expansion of new export products, such as chromium and oil, and the solid performance of traditional exports such as textiles and footwear. However, the growth of imports was even higher so the trade deficit remained above 25 per cent of GDP in 2007. The inadequate transport system continues to hinder trade. Foreign direct investment (FDI) rose strongly in 2007, reflecting inflows from the privatisation of Albtelecom and investments in the financial, manufacturing and construction sectors. However, at 6 per cent of GDP in 2007, FDI inflows are still low by regional standards.

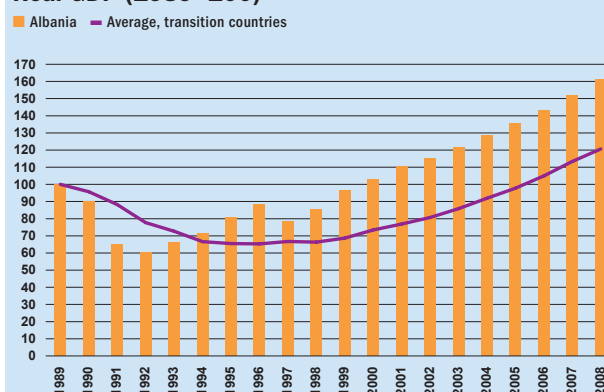
Outlook and risks

Growth of GDP is expected to remain at around 6 per cent in 2008. Rising agriculture and electricity production is projected to offset a reduction in the growth of output from the industrial and mining sectors. Sustaining this level of GDP growth over the medium term will depend on a continuation of the recent improvements in the business environment and infrastructure upgrades, which could eventually allow Albania to expand its export markets and attract more foreign investors. Reducing the fast rate of credit growth is a significant challenge, particularly if the large-scale process of property restitution and compensation currently under way leads to an expansion of available collateral. Political stability, continued support from abroad and the successful implementation of the Stabilisation and Association Agreement with the European Union are other factors influencing the economic outlook.

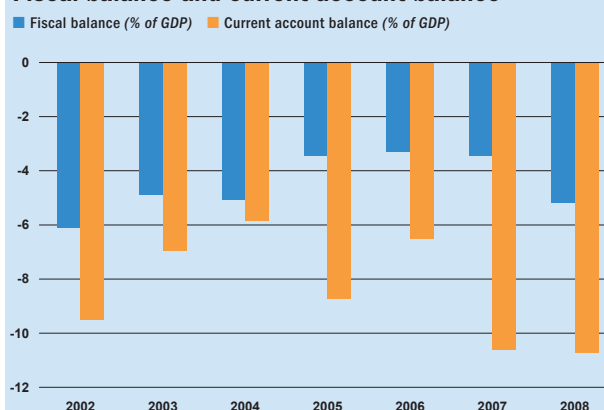
Transition indicators, 2008



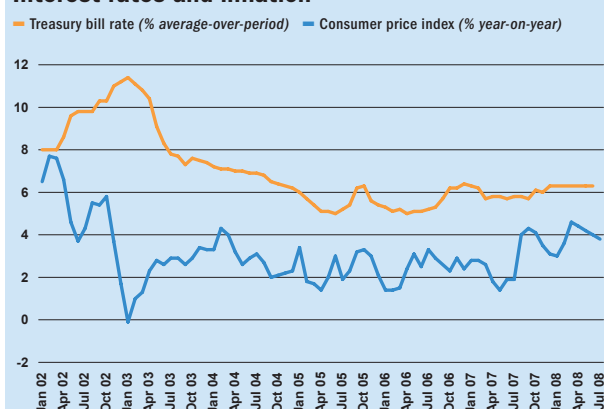
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – high	Capital adequacy ratio – 12 per cent	Share of population living in poverty – 18.5 per cent (2005)
Controls on inward direct investment – no	Secured transactions law – advanced	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 2.5 per cent of GDP (2007)
Interest rate liberalisation – full	Quality of corporate governance law – low	Separation of railway infrastructure from operations – no	Quality of securities market laws – low	Government expenditure on education – 3.2 per cent of GDP (2007)
Exchange rate regime – managed float		Independence of the road directorate – partial	Private pension funds – yes	Household expenditure on power and water – 5.0 per cent
Wage regulation – no		Quality of concession laws – high		
Tradeability of land – limited de facto				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	9.3	9.4	11.3	11.4	11.7	13.0	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)	1.0	0.7	0.7	0.4	0.4	0.4	na
Share of industry in total employment (in per cent)	7.6	7.3	8.2	8.0	7.9	na	na
Change in labour productivity in industry (in per cent)	-4.6	33.0	2.1	13.2	13.6	na	na
Investment/GDP (in per cent)	24.5	23.4	23.8	24.2	24.7	25.4	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.3
<i>EBRD index of enterprise reform</i>	2.0	2.0	2.0	2.0	2.3	2.3	2.3
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	0.0	0.0	0.0	0.0	0.0	0.0	na
Share of trade with non-transition countries (in per cent)	90.6	88.2	87.6	84.2	82.4	84.9	na
Share of trade in GDP (in per cent)	40.9	39.0	38.1	37.7	40.5	46.7	na
Tariff revenues (in per cent of imports)	6.4	6.4	6.2	5.6	4.9	2.7	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	1.7	1.7	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	13 (12)	15 (13)	16 (14)	16 (14)	17 (14)	17 (15)	na
Asset share of state-owned banks (in per cent)	54.1	51.9	6.7	7.7	0.0	0.0	na
Asset share of foreign-owned banks (in per cent)	45.9	47.1	93.3	92.3	90.5	94.2	na
Non-performing loans (in per cent of total loans)	5.6	4.6	4.2	2.3	3.1	3.4	na
Domestic credit to private sector (in per cent of GDP)	6.2	7.3	9.2	14.9	21.4	29.6	na
Domestic credit to households (in per cent of GDP)	na	na	2.8	4.6	7.3	10.6	na
Of which mortgage lending (in per cent of GDP)	na	na	1.4	1.9	4.3	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	na	na	na	na
<i>EBRD index of banking sector reform</i>	2.3	2.3	2.7	2.7	2.7	2.7	3.0
<i>EBRD index of reform of non-bank financial institutions</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	7.1 (27.6)	8.3 (35.8)	8.6 (39.5)	11.3 (48.9)	11.3 (60.4)	11.3 (72.1)	na
Internet users (per 100 inhabitants)	0.4	1.0	2.4	6.0	15.0	15.0	na
Railway labour productivity (1989=100)	39.8	39.4	35.0	28.6	35.5	34.5	na
Residential electricity tariffs (USc kWh)	4.2	4.1	5.3	5.9	6.6	7.7	na
Average collection rate, electricity (in per cent)	93	92	76	74	68	76	na
GDP per unit of energy use (PPP in US dollars per kgoe)	6.6	6.8	7.6	7.2	na	na	na
<i>EBRD index of infrastructure reform</i>	2.0	2.0	2.0	2.0	2.0	2.3	2.3
<i>Electric power</i>	2.3	2.3	2.7	2.7	2.7	2.7	2.7
<i>Railways</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Roads</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Telecommunications</i>	3.0	3.0	3.0	3.0	3.0	3.3	3.3
<i>Water and waste water</i>	1.0	1.0	1.7	1.7	1.7	1.7	1.7

Macroeconomic indicators	2002	2003	2004	2005	2006	2007 <i>Estimate</i>	2008 <i>Projection</i>
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	4.2	5.8	5.7	5.7	5.5	6.0	6.1
Private consumption	7.6	11.1	9.4	6.0	7.2	na	na
Public consumption	5.6	-1.9	7.4	2.6	1.4	na	na
Gross fixed capital formation	4.5	18.0	2.7	4.9	9.3	na	na
Exports of goods and services	26.1	19.5	16.6	18.1	14.9	na	na
Imports of goods and services	24.5	12.7	6.4	14.0	7.0	na	na
Industrial gross output	-5.1	29.0	14.1	11.7	12.1	14.0	na
Agricultural gross output	2.1	2.9	6.3	0.9	3.0	-1.9	na
Employment¹	<i>(Percentage change)</i>						
Labour force (end-year)	-0.8	-0.3	-0.1	-0.3	0.0	-0.3	na
Employment (end-year)	0.0	0.7	0.5	0.1	0.3	0.4	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	15.8	15.0	14.4	14.1	13.8	13.2	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)	5.2	2.4	2.9	2.4	2.4	2.9	4.0
Consumer prices (end-year)	1.7	3.3	2.2	2.0	2.5	3.1	3.5
Producer prices (annual average)	6.4	6.2	10.8	5.1	0.1	4.1	na
Producer prices (end-year)	11.1	4.4	12.3	1.5	0.2	6.6	na
Gross average monthly earnings in economy (annual average)	11.6	12.0	2.8	5.0	7.5	8.1	na
Government sector	<i>(In per cent of GDP)</i>						
General government balance	-6.1	-4.9	-5.1	-3.5	-3.3	-3.4	-5.2
General government expenditure	30.9	29.0	29.6	28.5	29.0	29.1	na
General government debt	65.6	60.7	57.7	58.2	56.1	52.8	na
Monetary sector	<i>(Percentage change)</i>						
Broad money (M2, end-year)	6.4	7.6	12.0	8.9	12.1	4.5	na
Domestic credit (end-year)	10.7	8.7	8.8	16.1	19.6	23.2	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	52.1	50.4	52.1	52.3	53.6	51.0	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>						
Refinancing rate ²	8.5	6.5	5.3	5.0	5.5	6.3	na
Treasury bill rate (3-month maturity)	11.1	7.3	6.2	5.4	6.4	6.3	na
Deposit rate (1 year)	9.3	7.6	6.0	5.6	5.5	6.0	na
Lending rate (1 year) ³	16.0	10.5	13.7	12.2	11.2	13.6	na
	<i>(Leks per US dollar)</i>						
Exchange rate (end-year)	134.0	106.4	92.6	98.1	94.1	82.9	na
Exchange rate (annual average)	140.2	121.3	102.8	98.1	98.1	90.4	na
External sector	<i>(In millions of US dollars)</i>						
Current account	-422.1	-398.7	-427.7	-726.3	-591.0	-1,150.7	-1,457.2
Trade balance	-1,155.1	-1,336.2	-1,583.0	-1,821.3	-2,089.0	-2,899.0	-3,581.5
Merchandise exports	330.3	447.2	601.0	656.3	793.0	1,079.0	1,349.4
Merchandise imports	1,485.4	1,783.5	2,184.0	2,477.6	2,882.0	3,978.0	4,930.9
Foreign direct investment, net	135.0	178.0	323.9	258.4	314.6	640.9	483.7
Gross reserves, excluding gold (end-year)	838.8	979.6	1,357.3	1,404.6	1,768.6	2,103.7	na
External debt stock	1,180.0	1,566.4	1,898.9	1,866.8	2,381.2	2,856.3	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	4.9	4.5	5.0	4.4	4.9	4.3	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	6.8	5.0	4.1	3.9	4.7	4.0	na
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million)	3.2	3.2	3.2	3.2	3.2	3.2	na
GDP (in billions of leks)	622.7	694.1	750.8	814.8	891.0	979.0	1,072.0
GDP per capita (in US dollars)	1,389.7	1,806.1	2,282.8	2,594.9	2,838.5	3,383.2	na
Share of industry in GDP (in per cent)	6.9	8.7	10.0	10.6	11.0	10.3	na
Share of agriculture in GDP (in per cent)	23.4	23.5	22.3	20.7	19.8	21.0	na
Current account/GDP (in per cent)	-9.5	-7.0	-5.9	-8.7	-6.5	-10.6	-10.7
External debt - reserves (in US\$ million)	341.2	586.8	541.6	462.2	612.5	752.5	na
External debt/GDP (in per cent)	26.6	27.4	26.0	22.5	26.2	26.4	na
External debt/exports of goods (in per cent)	128.9	134.2	118.8	100.9	105.9	94.4	na

¹ Figures do not include emigrant workers abroad.² The figures show the repo rate of the central bank.³ 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 developments and challenges

Anti-competitive behaviour among importing companies means that consumers are not benefiting from the appreciation of the dram in the form of lower import prices. Lower barriers to entry and better enforcement of anti-competitive measures by the Competition Commission are important for the development of the tradeable sector.

The purchase of the Armenian Stock Exchange by Nasdaq-OMX may create funding opportunities for larger enterprises. Banking sector growth could accelerate if a larger proportion of remittances were intermediated through banks.

Despite gradual monetary tightening and a moderate fiscal stance, inflation remains high. Higher tax compliance is vital to contain inflation, while the government's ambitious tax reform agenda needs to be supported by adequate funding at all relevant administrative levels.

Country data

Population (in millions)	3.2
Area ('000 sq km)	29.8
GDP (in billion US\$, 2007)	9.5
Average transition score (scale: 1 to 4.33)	3.18

Progress in structural reform

Business environment and competition

The business environment continued to improve in 2007. The procedures for registering property and licensing are more straightforward than in other countries in the Commonwealth of Independent States and Mongolia (CIS+M). Nevertheless, the tax and customs administration is still a weak point and corruption remains a serious problem. In August 2008 the parliament approved amendments to a dozen laws related to tax collection and scrapped, among other things, the exemption from VAT and other taxes for small retail traders in non-agricultural sectors. Meanwhile the government had merged the State Tax Service (STS) and the State Customs Committee (SCC) with a view to streamlining tax collection. These reforms also include VAT thresholds and provide small businesses with simplified tax assessment procedures.

The improved competition regulatory framework that came into force in April 2007 granted the Competition Commission additional rights of inspection and imposed stricter sanctions for infringements of the Commission's rules. However, the Commission continues to maintain a low profile and there has so far been very little actual enforcement. In particular, in the import sector existing monopolies remain unregulated, thus limiting competition.

Infrastructure

Investment in energy infrastructure is still urgently needed, especially in rural areas. The government recently secured concessional bilateral financing from Germany's KfW for Armenia's largest hydroelectric plant, Gurmush, and for building two high-voltage power transmission lines in Shirak in the north of the country and further into Georgia. This would create a joint South Caucasus electricity transmission system that could potentially be linked to Russia and Iran. An international tender for the contract of a third mobile operator in Armenia was launched in May 2008 and has attracted 17 bidders. The country's new mobile operator is expected to enter the Armenian market in the fourth quarter of 2008. This should lead to further reductions in end-user tariffs.

Financial sector

The banking sector has continued to grow, mainly because of a rapid expansion of consumer lending and mortgage financing, and it remains well capitalised and well regulated. The government has also adopted a new consumer credit law to increase market transparency and consumer protection. The comparatively strong regulatory system has improved banks' corporate governance, and lower liquidity ratio requirements for banks have freed up resources for lending. The increase in foreign ownership in the banking sector and the potential capital support from foreign parent banks provide for strong expansion possibilities. An increase in reserve requirements on foreign currency deposits from 8 to 12 per cent (introduced by the central bank) and a new law on cash transaction limits are intended to support the de-dollarisation of the economy. These measures resulted in the share of dram-denominated loans and deposits increasing by around 14 percentage points over 2007.

The purchase of the Armenian Stock Exchange by Nasdaq-OMX in November 2007 is in principle a positive development as it may open up funding opportunities for larger enterprises. The government has supported stock-market capitalisation through a recent legislative package on capital market development that includes tax breaks for companies that list on the stock exchange.

Social sector

Poverty in Armenia has been reduced on the back of sustained strong growth and low unemployment. The proportion of the population living below the poverty line declined to approximately 29 per cent in 2007, with the share of those in extreme poverty declining to 6.5 per cent. This can be partially attributed to increases in wages and social transfers and the continuing large flows of remittances from workers living abroad. The government has also set out a new poverty reduction strategy for 2008-11, focusing on improving social safety nets and implementing a new multi-pillar pension system in January 2010. The abolition of the gas subsidy in May 2008 for households and enterprises has led to an increase in retail gas prices from 59 drams per cubic metre (about 19 US cents) to 84 drams (about 27 US cents). This subsidy was originally introduced to relieve the burden for private citizens and industry following the drastic April 2006 price increases on gas supplies. The original gas subsidy of US\$ 189 million was transferred to ArmRosGazprom (ARG) as partial compensation for the low tariff, but this had run out by early 2008.

Macroeconomic performance

Real GDP rose by 13.8 per cent in 2007 and by 10.3 per cent (year-on-year) in the first half of 2008. The non-tradeables sector was the main driver of growth, in particular construction and financial services. Remittances and inflows of foreign direct investment (FDI) continued to fuel domestic demand. Output in manufacturing declined slightly in the first half of the year and surging imports helped to widen considerably the trade and current account deficits. The continuing closure of the Turkish and Azeri borders has been a major impediment to Armenian traders. The weak performance of the industrial sector was mainly because of poorly performing mining enterprises and large falls in production in the machine-building and jewellery sectors. The resumption of the supply of Russian raw diamonds to Armenia, following a new trade agreement in 2007, seems to have halted the decline of Armenia's diamond processing industry, which remains an important contributor to overall growth.

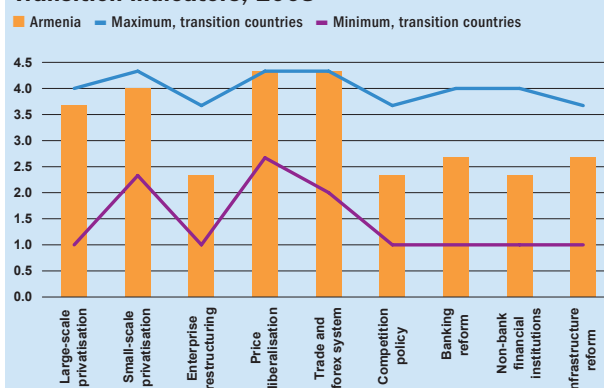
Despite a gradual tightening of monetary policy (the central bank raised the refinancing rate in several stages to 7.75 per cent in September 2008 from 4.5 per cent in June 2007), containing inflation remains a challenge. Changes to the refinancing rate have a limited effect on inflation, given the low level of banking intermediation and the underdeveloped money market. Although the annual consumer price inflation rate has briefly decelerated since April, it was 11.8 per cent (year-on-year) in August 2008, and exceeded the central bank's inflation target of 4 per cent (+/- 1.5 per cent) by a large margin. The government is now aiming for a year-end inflation rate of 7.5 per cent.

Public finances remained sound with a general government deficit of 2.2 per cent in 2007 and a budgeted deficit of 2.6 per cent for 2008. In 2007 tax revenue exceeded expectations, mainly because of a 50 per cent increase in VAT collections, reflecting both an increasing number of unprocessed VAT refunds and advance tax payments.

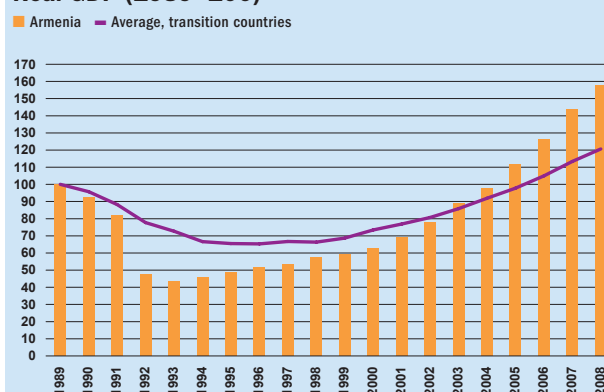
Outlook and risks

Strong economic growth should continue into the first half of 2009, especially if the government maintains its structural reform agenda and prudent fiscal and monetary policies. The Georgia-Russia conflict – while disrupting trade flows in the short term – is not expected to have a significant impact beyond 2008. Growth is expected to moderate only slightly in the medium term. A major challenge will be to contain inflationary pressures, which stem from various sources, including higher international food and commodity prices – in particular higher gas prices from 2009 onwards – and the end of the domestic gas subsidy. The pension reform and targeted income support to the poor to compensate for the removal of the gas subsidy will also put pressure on the budget. Sustaining a sound fiscal policy will require further measures to improve tax compliance and adequate funding at all administrative levels to ensure the government's tax reform agenda is implemented effectively. The continued closure of the Turkish and Azeri borders highlights the need to enforce competition more strictly and attract more foreign investment into the tradeable sector.

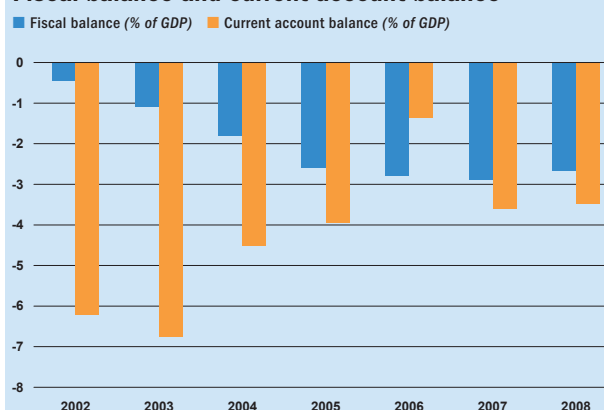
Transition indicators, 2008



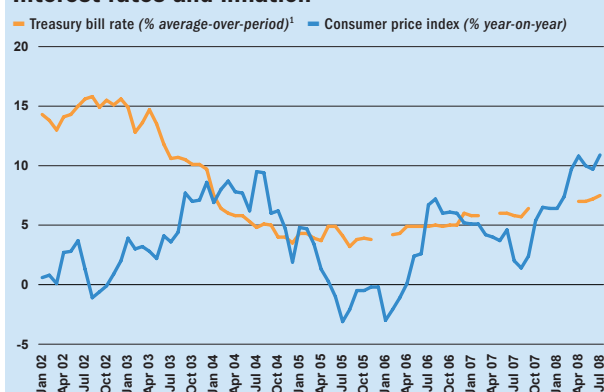
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



¹ Data were not available for January 2006, April 2007 and between October and April 2008.

Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – full	Competition office – yes	Telecoms regulatory assessment compliance – medium	Capital adequacy ratio – 12 per cent	Share of population living in poverty – 29.0 per cent (2007)
Controls on inward direct investment – no	Secured transactions law – malfunctioning	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 1.5 per cent of GDP (2006)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – no	Quality of securities market laws – medium	Government expenditure on education – 2.7 per cent of GDP (2006)
Exchange rate regime – floating		Independence of the road directorate – no	Private pension funds – no	Household expenditure on power and water – 6.8 per cent
Wage regulation – no		Quality of concession laws – very low ¹		
Tradeability of land – full except foreigners				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP) ²	9.5	10.2	10.2	na	na	na	na
Private sector share in GDP (in per cent)	70.0	70.0	75.0	75.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	74.0	76.0	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.6	0.9	1.0	0.6	na	na	na
Share of industry in total employment (in per cent)	12.9	na	na	na	na	na	na
Change in labour productivity in industry (in per cent)	36.0	na	na	na	na	na	na
Investment/GDP (in per cent)	21.7	24.2	22.0	23.2	na	na	na
<i>EBRD index of small-scale privatisation</i>	3.7	3.7	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.3	3.3	3.3	3.7	3.7	3.7	3.7
<i>EBRD index of enterprise reform</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Markets and trade							
Share of administered prices in CPI (in per cent)	8.1	8.7	8.0	8.0	8.1	8.1	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)	76.4	77.0	73.6	69.3	59.5	58.2	na
Share of trade in GDP (in per cent)	58.8	65.1	54.1	53.0	45.9	40.4	na
Tariff revenues (in per cent of imports)	1.9	1.6	2.0	2.3	na	na	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.0	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Financial sector							
Number of banks (foreign-owned)	20 (8)	19 (8)	20 (9)	21 (10)	21 (10)	22 (12)	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)	54.2	51.8	56.7	48.7	45.8	49.0	na
Non-performing loans (in per cent of total loans)	4.9	4.9	2.1	2.1	2.6	2.5	na
Domestic credit to private sector (in per cent of GDP)	6.9	6.0	7.2	8.1	8.7	na	na
Domestic credit to households (in per cent of GDP)	1.5	1.8	2.6	3.3	4.1	6.4	na
Of which mortgage lending (in per cent of GDP)	na	na	na	0.5	0.9	1.7	na
Stock market capitalisation (in per cent of GDP)	1.0	1.0	0.5	0.9	0.8	1.0	na
Stock trading volume (in per cent of market capitalisation)	5.6	2.9	7.0	3.6	9.4	5.5	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	na	na	na	na
<i>EBRD index of banking sector reform</i>	2.3	2.3	2.3	2.7	2.7	2.7	2.7
<i>EBRD index of reform of non-bank financial institutions</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.3
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	17.8 (2.3)	18.6 (3.8)	19.1 (6.7)	19.7 (10.5)	19.7 (10.5)	19.7 (10.5)	na
Internet users (per 100 inhabitants)	2.0	4.6	5.0	5.3	5.8	5.8	na
Railway labour productivity (1989=100)	20.6	23.5	29.1	26.9	27.6	34.6	na
Residential electricity tariffs (USc kWh)	4.3	4.3	4.6	5.4	5.9	7.1	na
Average collection rate, electricity (in per cent)	92	96	96	102	99	99	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.2	4.7	5.0	4.9	na	na	na
<i>EBRD index of infrastructure reform</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.7
<i>Electric power</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3
<i>Railways</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.3
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	2.3	2.3	2.3	2.3	2.7	2.7	3.0
<i>Water and waste water</i>	2.0	2.0	2.0	2.0	2.0	2.3	2.3

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

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

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	13.2	13.9	10.1	14.0	13.2	13.8	10.0
Private consumption	10.3	11.5	16.3	7.6	13.3	16.1	na
Public consumption	2.5	21.9	17.0	21.9	13.3	24.2	na
Gross fixed capital formation	38.1	30.0	21.9	46.8	41.2	21.3	na
Exports of goods and services	33.6	30.6	0.0	23.7	-4.0	-2.6	na
Imports of goods and services	17.0	28.1	-1.1	20.6	7.5	18.3	na
Industrial gross output	14.4	15.3	2.1	7.5	-0.9	2.6	na
Agricultural gross output	4.5	4.0	14.5	11.2	0.4	9.6	na
Employment							
<i>(Percentage change)</i>							
Labour force (end-year)	-12.2	-0.6	-0.5	0.6	0.5	-1.1	na
Employment (end-year)	-12.5	0.5	-4.6	2.6	-0.3	0.1	na
<i>(In per cent of labour force)</i>							
Unemployment (annual average) ¹	10.8	10.1	9.7	7.9	7.4	6.7	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	1.1	4.7	7.0	0.6	2.9	4.3	6.5
Consumer prices (end-year)	2.0	8.6	1.9	-0.2	5.2	6.6	7.0
Producer prices (annual average)	3.6	8.9	-13.3	7.7	0.9	0.6	na
Producer prices (end-year)	0.9	21.1	25.3	-4.0	na	na	na
Gross average monthly earnings in economy (annual average)	12.2	26.7	23.7	23.9	22.9	20.9	na
Government sector²							
<i>(In per cent of GDP)</i>							
General government balance	-0.4	-1.1	-1.8	-2.6	-2.8	-2.2	-2.6
General government expenditure	19.3	18.9	17.1	17.6	18.5	19.6	na
General government debt	46.6	40.9	51.5	39.7	34.2	20.0	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	34.0	10.4	22.3	27.8	32.9	42.3	na
Domestic credit (end-year)	-6.3	-10.1	41.2	54.6	8.7	78.4	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	15.6	14.4	15.0	16.3	18.2	21.4	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Refinancing rate	13.5	7.0	3.8	3.5	4.1	4.8	na
Money market rate	12.3	7.5	4.2	3.2	na	5.1	na
Deposit rate	9.6	6.9	4.9	5.8	na	6.2	na
Lending rate	21.1	20.8	18.6	18.0	16.5	17.5	na
<i>(Drams per US dollar)</i>							
Exchange rate (end-year)	584.9	566.0	486.3	450.2	363.5	304.2	na
Exchange rate (annual average)	573.4	578.8	533.5	457.8	416.0	342.1	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-147.9	-189.4	-161.7	-193.1	-87.0	-341.0	-437.0
Trade balance	-368.8	-434.1	-457.9	-588.0	-902.0	-1,332.0	-1,623.0
Merchandise exports	513.8	696.1	738.3	1,005.0	1,019.0	1,242.0	1,429.0
Merchandise imports	882.5	1,130.2	1,196.3	1,593.0	1,921.0	2,574.0	3,052.0
Foreign direct investment, net	111.0	121.0	217.0	252.0	340.0	455.0	482.0
Gross reserves, excluding gold (end-year)	415.6	502.0	547.8	669.5	1,071.9	1,246.0	na
External debt stock	1,026.0	1,788.1	1,868.0	1,860.2	2,052.7	2,200.0	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	4.5	4.3	4.3	4.0	5.4	4.8	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	10.1	15.6	9.7	4.6	4.2	3.1	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	3.2	3.2	3.2	3.2	3.2	3.2	na
GDP (in billions of drams)	1,362.5	1,624.6	1,907.9	2,244.0	2,665.0	3,233.0	3,805.2
GDP per capita (in US dollars)	740.3	873.9	1,112.8	1,510.0	1,989.4	2,936.4	na
Share of industry in GDP (in per cent)	18.9	19.9	19.7	na	na	na	na
Share of agriculture in GDP (in per cent)	23.4	21.3	22.5	na	na	na	na
Current account/GDP (in per cent)	-6.2	-6.7	-4.5	-3.9	-1.4	-3.6	-3.5
External debt - reserves (in US\$ million)	610.4	1,286.1	1,320.2	1,190.7	980.7	954.0	na
External debt/GDP (in per cent)	43.2	63.7	52.2	38.0	32.0	23.3	na
External debt/exports of goods and services (in per cent)	147.1	197.9	189.7	139.1	147.7	133.3	na

¹ Registered unemployed only.² Central government account only.

Azerbaijan

Key developments and challenges

The establishment of a “one-stop shop” for business registration and fewer licensing requirements have improved the business environment. Ongoing efforts to align the customs legislation with World Trade Organization requirements are crucial for developing the trade sector and the non-oil economy more generally.

Further efforts are needed to contain the risks associated with rapid credit growth. These should include tightening regulatory requirements, strengthening bank supervision and improving the risk management skills of banks.

Reducing inflation remains a major challenge in view of the large foreign currency inflows, increased fiscal expenditures and high international food prices. The central bank has already taken some measures to contain inflation but a combination of tighter fiscal policy and nominal currency appreciation would also help to dampen inflationary pressures.

Country data

Population (in millions)	8.4
Area ('000 sq km)	86.6
GDP (in billion US\$, 2007)	31.3
Average transition score (scale: 1 to 4.33)	2.63

Progress in structural reform

Liberalisation and privatisation

The government recently accelerated its efforts to join the World Trade Organization (WTO). The fifth meeting of the working party on accession was held in May 2008, the previous meeting having been in March 2006. Some progress has been made since then in implementing the government's 2006 action plan, especially the legislative changes necessary to meet WTO requirements.

The main outstanding issues concern market access in communications and financial services, and the regulation of monopolies. Import barriers and limiting subsidies to the agricultural sector are also areas of discussion. Bilateral negotiations are progressing and the government expects the working party to meet again by the end of 2008. As yet, no official date has been set for accession.

Business environment and competition

Some important steps have been taken to improve the business environment, as recognised by the World Bank's *Doing Business 2009* report, which ranks Azerbaijan as the top reformer of the year among the 181 economies evaluated. “One-stop shops” were set up in January 2008 to simplify registration and licensing procedures for businesses and consequently the number of registered companies has already risen significantly. Electronic filing of tax returns was recently introduced and procedures for the registration of real estate were simplified.

As of January 2008 the use of international financial reporting standards (IFRS) was made compulsory for all large companies. Finally, as part of the fight against corruption, state officials and civil servants are now obliged to declare publicly their income every year. Implementation of the legislative changes is still at an early stage, however, and the business environment for non-oil related business remains difficult. The strong position of monopolies and the restricted entry into various economic sectors is limiting competition, while bureaucratic delays and corruption remain widespread.

Financial sector

Bank lending grew by 77 per cent in real terms in 2007 and 55 per cent annually as of the end of June 2008. With this rapid expansion of credit comes an increased risk of poorer loan quality, as banks stretch their capacity to screen and monitor borrowers properly. Against this background the National Bank of Azerbaijan (NBA) introduced prudential measures that became effective from July 2008 to stem credit growth. These include a 5 per cent reserve requirement on all foreign borrowings, an increase in the required collateral ratio from 120 to 150 per cent and an increase in loan loss provisioning requirements.

While these measures may to some extent restrict banks' foreign borrowing, Azeri banks still have relatively limited exposure to the international credit market, with foreign liabilities accounting for about 19.5 per cent of total liabilities in June 2008. To date the international liquidity crisis has had a limited impact on the sector, partly because there has been a substantial increase in bank deposits from corporates as a result of their higher profitability. Overall, deposits grew by more than 51 per cent in 2007 and by about 78 per cent year-on-year in the first half of 2008, enabling bank lending to grow by about 80 per cent year-on-year in nominal terms by the end of June 2008.

The non-bank financial sector remains largely underdeveloped. Aggregate gross insurance premiums, although growing, were still less than 0.6 per cent of GDP in the first half of 2008. The leasing market has started to operate only recently and many non-bank financial products remain unavailable for companies and households. The authorities are improving the regulatory framework for non-bank financial institutions. For example a new insurance law, which came into effect in March 2008, has removed the restrictions on the share of foreign ownership in an insurance company (which was limited to 49 per cent).

Macroeconomic performance

Real GDP rose by 23.4 per cent in 2007 after a record 30.5 per cent in 2006. High economic growth continued in the first half of 2008, reaching 16.5 per cent. As in earlier years, the rapid expansion of oil production and exports were the main drivers of growth. The industrial sector, which is dominated by the energy sector, grew by about 17.3 per cent in the first half of 2008. Agricultural production also grew significantly, by 10.7 per cent, and the non-oil sector grew by almost 15.4 per cent, as the telecommunications and construction sectors in particular benefited from growth in the oil sector.

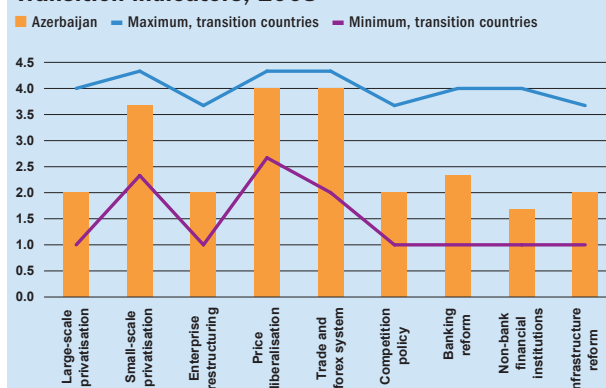
Inflation remains high due to rising international food prices, surging oil exports and a substantial fiscal expansion that has fuelled domestic demand. In addition, the monetary base doubled in 2007 due to large unsterilised purchases of foreign exchange by the NBA. Year-end annual consumer price inflation was 19.6 per cent in 2007 and remained high at 20.8 per cent in the year to July 2008. As part of its efforts to lower inflation, the NBA raised its refinancing rate from 13 per cent at the end of 2007 to 15 per cent in June 2008. In an attempt to slow imported inflation and reduce the impact of the weaker dollar on domestic inflation, the NBA switched the targeted currency from the US dollar (effective peg) to a currency basket that currently comprises 70 per cent US dollars and 30 per cent euros. Large foreign currency inflows caused a real exchange rate appreciation of about 16.5 per cent during 2007 (equivalent to a 9 per cent real effective exchange rate appreciation) and about 5 per cent in the first half of 2008, further threatening the competitiveness of non-oil sectors, in the absence of significant productivity-enhancing reforms.

Government finances remain strong, supported by booming oil revenues. Fiscal revenues increased by about 53 per cent and despite a 43 per cent increase in expenditures, mainly on long-term infrastructure investments and social goals, the consolidated central government budget recorded a surplus of about 2.4 per cent of GDP in 2007. Reflecting continued increased revenues, the recent amendment of the state budget for 2008 in May envisages an increase of 82 per cent in budget expenditures (a significant increase on the 35 per cent envisaged in the original budget) with a projected state budget deficit of 1.8 per cent of GDP. The consolidated budget surplus, including the State Oil Fund, is expected to reach about 29 per cent of GDP.

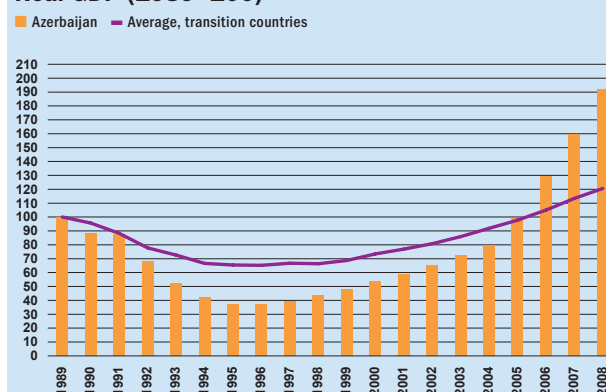
Outlook and risks

High economic growth and further large trade surpluses are expected in the short to medium term as oil and gas output is set to continue rising. Economic diversification remains a major challenge as the economy, which is increasingly reliant on the energy sector, becomes more vulnerable to potential energy shocks. This is particularly important with the growing geopolitical risks of energy transport routes via Georgia. Given the large and increasing capital flows and a limited availability of monetary sterilisation tools, real exchange rate appreciation (through either nominal appreciation or higher inflation, or both) is inevitable. A tighter fiscal policy will be necessary to control inflation over the medium term. A large currency appreciation, while contributing to lower inflation, would have a negative impact on the competitiveness of the non-oil sector unless further reforms are undertaken to improve the business environment and company performance.

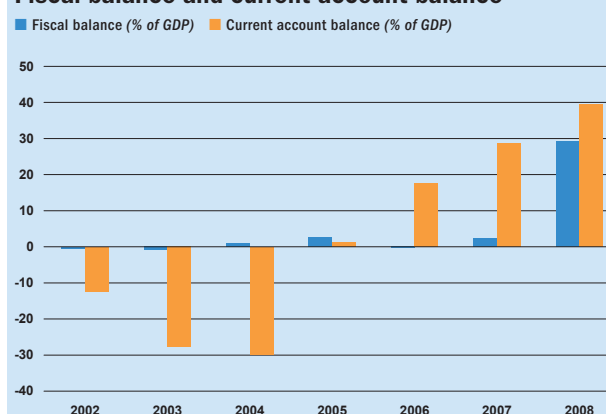
Transition indicators, 2008



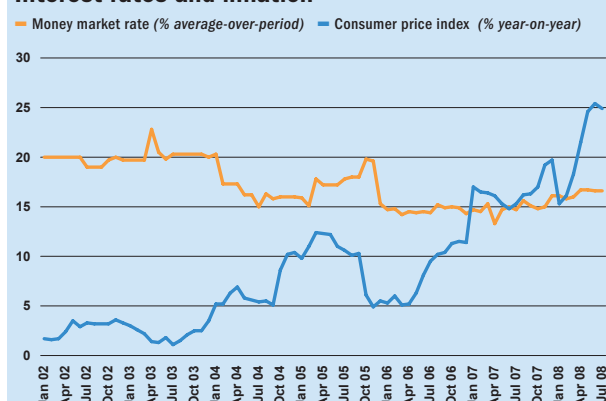
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – low	Capital adequacy ratio – 12 per cent	Share of population living in poverty – <2.0 per cent (2002)
Controls on inward direct investment – no	Secured transactions law – malfunctioning	Independence of the electricity regulator – no	Deposit insurance system – yes	Government expenditure on health – 1.0 per cent of GDP (2005)
Interest rate liberalisation – full	Quality of corporate governance law – very low	Separation of railway infrastructure from operations – no	Quality of securities market laws – low	Government expenditure on education – 2.8 per cent of GDP (2005)
Exchange rate regime – managed float		Independence of the road directorate – full	Private pension funds – no	Household expenditure on power and water – 3.5 per cent
Wage regulation – no		Quality of concession laws – very low ¹		
Tradeability of land – limited de jure				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.4	2.6	3.0	3.2	na	na	na
Private sector share in GDP (in per cent)	60.0	60.0	60.0	60.0	60.0	75.0	75.0
Private sector share in employment (in per cent)	68.0	68.5	68.4	68.1	68.0	67.5	67.0
Budgetary subsidies and current transfers (in per cent of GDP)	11.9	12.1	10.7	7.7	7.1	6.5	na
Share of industry in total employment (in per cent)	6.8	6.7	6.9	7.0	7.1	7.1	na
Change in labour productivity in industry (in per cent)	1.7	5.9	1.3	29.7	31.9	23.5	na
Investment/GDP (in per cent)	34.6	53.2	58.0	41.5	29.9	20.1	na
<i>EBRD index of small-scale privatisation</i>	3.7	3.7	3.7	3.7	3.7	3.7	3.7
<i>EBRD index of large-scale privatisation</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>EBRD index of enterprise reform</i>	1.7	2.0	2.0	2.0	2.0	2.0	2.0
Markets and trade							
Share of administered prices in CPI (in per cent)	6.0	6.0	7.0	na	na	na	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)	75.0	70.0	67.4	66.9	71.9	76.5	na
Share of trade in GDP (in per cent)	66.2	73.5	84.4	90.6	87.1	87.2	na
Tariff revenues (in per cent of imports)	9.1	6.0	4.9	8.4	9.0	13.5	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	3.7	3.7	3.7	4.0	4.0	4.0	4.0
<i>EBRD index of competition policy</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	46 (4)	46 (4)	44 (5)	44 (5)	44 (5)	44 (6)	na
Asset share of state-owned banks (in per cent)	63.1	55.3	56.1	55.2	51.0	42.4	na
Asset share of foreign-owned banks (in per cent)	4.1	5.2	5.8	6.6	6.1	7.5	na
Non-performing loans (in per cent of total loans)	19.7	14.6	14.5	14.9	12.0	8.1	na
Domestic credit to private sector (in per cent of GDP)	5.5	6.6	8.9	9.2	11.7	15.2	na
Domestic credit to households (in per cent of GDP)	1.4	2.0	3.0	3.1	4.1	5.8	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	0.3	0.7	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	na	na	na	na
<i>EBRD index of banking sector reform</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>EBRD index of reform of non-bank financial institutions</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	11.2 (9.6)	11.3 (12.7)	12.1 (17.4)	13.0 (26.7)	14.0 (39.2)	14.8 (50.8)	na
Internet users (per 100 inhabitants)	3.6	4.2	4.9	8.1	9.8	12.2	na
Railway labour productivity (1989=100)	29.4	31.9	32.0	39.9	45.0	41.6	na
Residential electricity tariffs (USc kWh)	2.0	2.0	2.0	2.2	2.2	7.3	na
Average collection rate, electricity (in per cent)	45	21	27	26	na	55	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.0	2.1	2.3	2.8	na	na	na
<i>EBRD index of infrastructure reform</i>	1.7	1.7	2.0	2.0	2.0	2.0	2.0
<i>Electric power</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Railways</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	1.0	1.0	1.7	1.7	1.7	1.7	1.7
<i>Water and waste water</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7

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

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	10.6	11.2	10.2	24.3	30.5	23.4	20.0
Private consumption	13.1	6.0	6.9	6.3	18.9	3.8	na
Public consumption	0.5	11.1	4.6	1.9	16.9	27.0	na
Gross fixed capital formation	64.8	72.6	13.0	-0.5	15.2	3.5	na
Exports of goods and services	14.0	9.2	-9.0	52.7	73.7	66.6	na
Imports of goods and services	48.4	45.6	-9.5	-1.9	20.1	11.5	na
Industrial gross output	3.6	6.1	5.7	33.5	36.6	25.0	na
Agricultural gross output	6.4	5.6	4.6	7.5	0.9	4.0	na
Employment							
<i>(Percentage change)</i>							
Labour force (end-year)	0.4	0.6	1.7	1.1	9.2	0.7	na
Employment (end-year)	0.3	0.6	1.7	1.1	3.2	1.0	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	1.4	1.4	1.4	1.4	6.8	6.5	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	2.8	2.2	6.7	9.6	8.3	16.7	19.5
Consumer prices (end-year)	3.3	3.6	10.4	5.5	11.4	19.7	22.0
Producer prices (annual average)	-2.3	16.1	12.9	10.6	17.7	12.8	na
Producer prices (end-year)	7.2	11.2	21.9	10.8	17.1	11.3	na
Gross average monthly earnings in economy (annual average)	21.3	21.4	26.2	21.9	19.8	24.9	na
Government sector							
<i>(In per cent of GDP)</i>							
General government balance ¹	-0.5	-0.8	1.0	2.6	-0.2	2.4	29.1
General government expenditure	27.7	28.5	25.9	22.7	27.4	27.4	na
General government debt	20.5	20.0	18.6	14.2	10.8	9.4	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	15.6	27.9	31.9	15.8	168.3	83.3	na
Domestic credit (end-year)	85.9	13.2	60.2	52.9	63.6	96.5	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	6.7	7.3	8.0	6.3	11.3	14.5	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Refinance rate (6 months)	7.0	7.0	7.0	9.0	9.5	13.0	na
Interbank interest rate (3 months) ²	19.7	20.3	16.6	15.3	14.3	16.1	na
Deposit rate	8.7	9.5	9.2	8.5	10.6	12.1	na
Lending rate	17.4	15.5	15.7	17.0	17.7	19.5	na
<i>(Manats per US dollar)</i>							
Exchange rate (end-year) ³	1.0	1.0	1.0	0.9	0.9	0.8	na
Exchange rate (annual average) ³	1.0	1.0	1.0	0.9	0.9	0.9	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-770.0	-2,020.7	-2,588.0	167.0	3,707.0	9,013.0	19,442.2
Trade balance	482.0	-97.7	162.0	3,299.0	7,745.0	15,224.0	25,616.0
Merchandise exports	2,305.0	2,625.0	3,743.0	7,649.0	13,014.0	21,269.0	33,498.7
Merchandise imports	1,823.0	2,722.7	3,581.0	4,350.0	5,269.0	6,045.0	7,882.7
Foreign direct investment, net	1,048.0	2,353.0	2,351.0	458.0	-1,300.9	-5,200.6	-2,018.0
Gross reserves, excluding gold (end-year) ⁴	721.0	803.0	1,075.0	1,178.0	2,500.0	4,273.0	na
External debt stock	2,602.5	2,744.3	3,488.8	4,345.3	4,865.9	5,835.1	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	2.8	2.0	2.0	2.0	3.8	5.8	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	4.4	5.2	3.6	1.3	1.1	0.8	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	8.2	8.3	8.3	8.4	8.4	8.4	na
GDP (in billions of manats)	6.1	7.1	8.5	12.5	18.7	26.9	40.2
GDP per capita (in US dollars)	760.5	880.9	1,050.9	1,576.8	2,497.9	3,729.6	na
Share of industry in GDP (in per cent)	37.4	37.2	38.3	47.5	57.3	59.1	na
Share of agriculture in GDP (in per cent)	13.8	12.2	10.8	9.0	6.7	5.9	na
Current account/GDP (in per cent)	-12.3	-27.8	-29.8	1.3	17.7	28.8	39.5
External debt - reserves (in US\$ million)	1,881.5	1,941.3	2,413.8	3,167.3	2,365.9	1,562.1	na
External debt/GDP (in per cent)	41.7	37.7	40.2	32.8	23.2	18.6	na
External debt/exports of goods and services (in per cent)	97.6	89.8	82.4	52.2	35.5	26.3	na

¹ 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.

² 90-day interbank offer rate in manats, nominal.

³ In January 2006 Azerbaijan introduced a new currency denomination. One new manat is equal to 5,000 old manat. All data are retrospectively converted in new manat.

⁴ By end-December 2007 there were additional foreign exchange assets of approximately US\$ 3.1 billion in the State Oil Fund.

Belarus

Key developments and challenges

Credit growth has been robust, supported by stronger competition among banks. As the development of the financial system gains momentum, the government should accelerate privatisation in the banking sector to promote the efficient allocation of capital in the economy.

Following the abolition of the “golden share”, further improvements in the business climate, such as simplified taxation and effective protection of property rights, are needed to attract foreign direct investment (FDI). More FDI would help to promote growth and finance the current account deficit.

The danger of rapidly rising inflation calls for tighter monetary policy and fiscal restraint. The government's continued use of administered wage increases and the current relatively loose monetary policy risk exacerbating inflationary pressures originating from higher food and fuel prices.

Country data

Population (in millions)	9.7
Area ('000 sq km)	207.6
GDP (in billion US\$, 2007)	44.8
Average transition score (scale: 1 to 4.33)	1.96

Progress in structural reform

Liberalisation and privatisation

The price of imported Russian gas rose further from US\$ 100 per 1,000 cubic metres in 2007 to US\$ 128 by mid-2008.

Although the price increase was less than most analysts had initially expected, it still put substantial pressure on the government to raise additional external financing. In 2007 these pressures contributed to the completion of a number of privatisations, including sales of majority stakes in medium-sized banks, the second largest telecommunications operator and a bicycle manufacturer. As a result, net FDI amounted to nearly US\$ 1.8 billion, equivalent to 4 per cent of GDP, the highest levels recorded in Belarus in recent years. In 2008 Gazprom purchased a further 12.5 per cent stake in the gas pipeline operator Beltransgaz under the terms of the joint venture agreed in May 2007 (Gazprom now owns 25 per cent of Beltransgaz and the sale of a further 25 per cent is to be completed in two instalments in 2009-10). Further privatisations in the corporate sector are likely. In July 2008 the government named 147 industrial and agribusiness enterprises where state-owned stakes can be sold in 2008-10, although many key arrangements remain unclear.

Good progress has been made in introducing more transparent market mechanisms for the sale of forestry and wood processing products. Forests cover 38 per cent of the

country's surface, although the forestry and wood sector accounts for less than 2 per cent of GDP, so the potential of this industry is substantial. Trading of wood via the commodity exchange, launched in 2005, has been greatly increased and ad hoc normative prices of logged and standing wood are gradually being replaced with prices calculated on the basis of commodity exchange quotations. However, a number of state-sponsored enterprises may be allowed to retain preferential access to cheaper supplies of wood.

Business environment and competition

During the last year the authorities have stepped up their efforts to attract investment. Most importantly, the “golden share” rule, which granted the state the right to take over the management of privatised enterprises, was fully abolished in March 2008 (it had been abolished in the banking sector in August 2006). This should enhance the likelihood of foreign investment in any future privatisations.

Furthermore, registration procedures for small and medium-sized enterprises (SMEs) have been simplified, and concessions and tax exemptions have been granted to IT firms and to companies operating in small and medium-sized towns. The rate of turnover tax has been reduced from 3.9 per cent to 2 per cent and the authorities are considering further reductions. In July 2008 the government announced that progressive personal income tax, with the highest marginal rate of 30 per cent, will be replaced with a flat 12 per cent tax starting in 2009.

However, there has been limited overall improvement in the country's investment climate. The enterprise sector continues to experience a number of significant problems, including excessive and arbitrary regulation, limited opportunities for consultation with government and the obligation for enterprises to fulfil various targets for production, exports and wage growth, among others. In addition, there is substantial scope for further simplifying taxation.

Financial sector

Credit to enterprises and consumers increased by 56 per cent in the 12 months to July 2008, and amounted to some 29 per cent of GDP. Despite tighter conditions in the international financial markets, Belarussian banks benefited from uninterrupted access to external borrowing, although at a higher cost, reflecting investors' increased aversion to risk globally.

The authorities intend to sell substantial stakes, and possibly majority control, in two large state-owned banks, Belpromstroibank and Belinvestbank (ranked 4th and 5th respectively by total assets) to foreign investors over the next few years. Minority stakes in the two largest banks, Belarusbank and Belagroprombank, may also be sold. The envisaged privatisations will boost competition in the sector, although the banks that are likely to remain under majority state control currently account for approximately 60 per cent of all banking assets and are likely to retain their dominant position in the sector. The third largest bank, Priorbank, majority-owned by Raiffeisen Group, to date remains the only private bank among the top five.

Macroeconomic performance

Real GDP growth remained robust at 8.2 per cent in 2007 and 10.3 per cent in the first seven months of 2008, supported by strong demand from Russia for Belarussian exports and continued growth in consumption, which reflects the rapid expansion of credit. The government has also continued to stimulate domestic demand through centrally managed wage increases and directed lending, the latter focused on priority sectors and enterprises, including subsidised loans for agricultural and export-oriented enterprises. Inflation edged up to 16.3 per cent in the year to July 2008 as food prices continued to rise, gas price increases were passed on to enterprises and the de facto peg to the weakening US dollar was maintained (until recently).

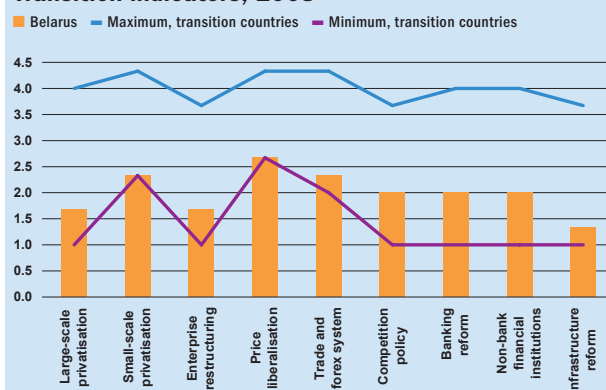
As a result of a strong demand for imports the current account turned into deficit in 2006. External imbalances have risen further as the cost of imports soared in 2007, only partially offset by higher prices and volumes of goods exported to Russia. A 15-year stabilisation loan of US\$ 1.5 billion (2.6 per cent of GDP) granted by Russia in December 2007 on favourable terms has helped to maintain exchange rate stability and accumulate international reserves. External debt increased from 18.4 per cent of GDP at the end of 2006 to 28.4 per cent at the end of 2007; a significant part of this increase is accounted for by state-owned banks.

Despite the higher cost of energy and a reduction in the tax burden, the government recorded a fiscal surplus of 0.4 per cent of GDP in 2007, on the back of the continued strong economic performance and increases in the proceeds from export duties on refined oil products. Enterprises have largely been able to pass higher fuel costs on to consumers and to increase export prices (producer prices were raised by 31 per cent between December 2006 and July 2008).

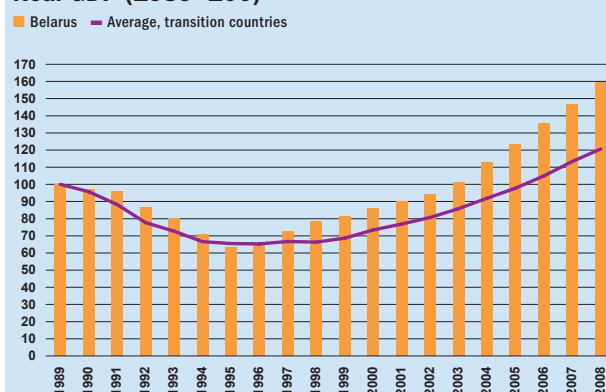
Outlook and risks

In the short term, rising inflation poses an increasing risk, given the combination of a surge in energy and food prices and a relatively loose monetary policy. In the medium term, widening current account deficits, reflecting the likelihood of a further deterioration in the terms of trade and continued rapid growth of consumption, could lead to vulnerabilities to external shocks. The current account deficit is projected to widen further from an estimated 6.6 per cent of GDP (US\$ 2.9 billion) in 2007 to 7 per cent of GDP in 2008. Despite a substantial increase in FDI inflows, much of the external financing needs have been recently covered by sovereign and non-sovereign borrowing, resulting in a rapid growth of external debt, albeit from a low base. A sustainable external financing strategy would require continued efforts to attract FDI by improving the business environment for private investors, streamlining taxation and phasing out excessive regulation. Substantial investment and deep enterprise restructuring will be essential to reduce the energy intensity of output and maintain the competitiveness of exports.

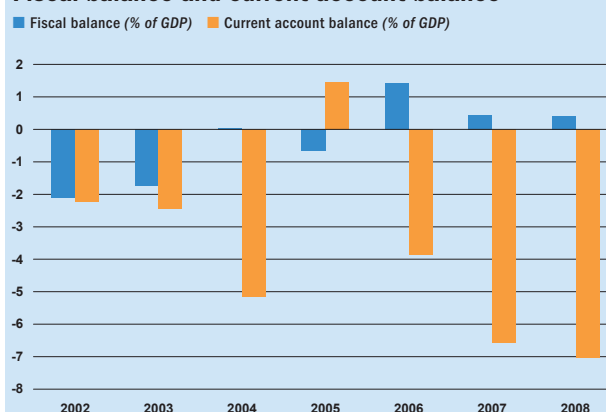
Transition indicators, 2008



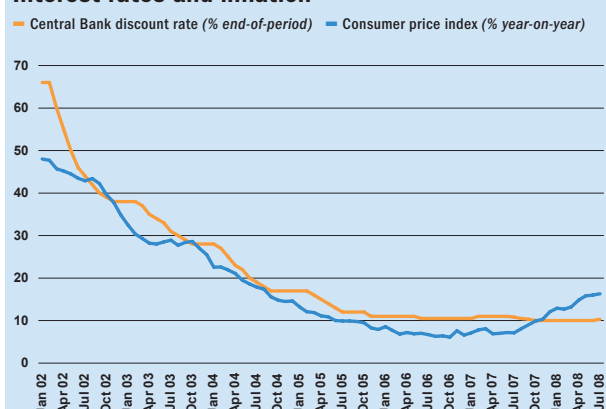
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – low	Capital adequacy ratio – 8 per cent ¹	Share of population living in poverty – <2.0 per cent (2002)
Controls on inward direct investment – yes	Secured transactions law – malfunctioning	Independence of the electricity regulator – no	Deposit insurance system – yes	Government expenditure on health – 4.5 per cent of GDP (2007)
Interest rate liberalisation – limited de facto	Quality of corporate governance law – very low	Separation of railway infrastructure from operations – no	Quality of securities market laws – very low	Government expenditure on education – 5.8 per cent of GDP (2007)
Exchange rate regime – crawling peg		Independence of the road directorate – no	Private pension funds – no	Household expenditure on power and water – 4.0 per cent
Wage regulation – yes		Quality of concession laws – low		
Tradeability of land – limited de jure				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.8	2.9	3.0	3.1	2.9	5.5	na
Private sector share in GDP (in per cent)	25.0	25.0	25.0	25.0	25.0	25.0	30.0
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)	18.9	18.6	18.0	19.4	19.1	21.2	na
Share of industry in total employment (in per cent)	24.6	24.4	24.5	24.4	24.3	24.2	na
Change in labour productivity in industry (in per cent)	9.0	9.2	15.9	10.0	10.7	8.6	na
Investment/GDP (in per cent)	22.2	26.6	30.5	28.5	30.4	33.2	na
<i>EBRD index of small-scale privatisation</i>	2.0	2.3	2.3	2.3	2.3	2.3	2.3
<i>EBRD index of large-scale privatisation</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.7
<i>EBRD index of enterprise reform</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.7
Markets and trade							
Share of administered prices in CPI (in per cent)	24.0	21.0	24.0	27.0	27.0	30.0	na
Number of goods with administered prices in EBRD-15 basket	6.0	4.0	5.0	6.0	6.0	7.0	na
Share of trade with non-transition countries (in per cent)	26.8	27.3	27.0	34.6	35.6	32.4	na
Share of trade in GDP (in per cent)	115.4	120.1	130.3	108.8	113.5	117.8	na
Tariff revenues (in per cent of imports) ²	3.3	4.1	3.1	4.7	4.4	10.3	na
<i>EBRD index of price liberalisation</i>	2.7	2.7	2.7	2.7	2.7	2.7	2.7
<i>EBRD index of forex and trade liberalisation</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>EBRD index of competition policy</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	28 (12)	30 (17)	32 (19)	30 (18)	30 (18)	27 (16)	na
Asset share of state-owned banks (in per cent)	61.9	61.6	70.2	75.2	79.0	76.5	na
Asset share of foreign-owned banks (in per cent)	8.1	20.4	20.0	16.2	14.7	19.7	na
Non-performing loans (in per cent of total loans) ³	10.2	5.8	4.7	3.4	2.9	2.0	na
Domestic credit to private sector (in per cent of GDP)	9.1	11.7	14.0	15.9	20.2	25.0	na
Domestic credit to households (in per cent of GDP)	1.8	2.8	3.9	5.0	6.9	8.3	na
Of which mortgage lending (in per cent of GDP)	1.6	2.1	2.5	3.1	3.8	4.6	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	na	0.0	na	na	na	na
<i>EBRD index of banking sector reform</i>	1.7	1.7	1.7	1.7	1.7	2.0	2.0
<i>EBRD index of reform of non-bank financial institutions</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	29.9 (4.7)	31.1 (11.3)	32.4 (22.8)	33.7 (42.0)	34.7 (61.4)	37.9 (61.4)	na
Internet users (per 100 inhabitants)	9.0	16.3	25.1	34.8	56.5	61.9	na
Railway labour productivity (1989=100)	38.3	40.1	41.5	40.9	42.5	43.9	na
Residential electricity tariffs (USc kWh)	1.6	3.1	3.3	3.6	4.1	5.0	na
Average collection rate, electricity (in per cent) ⁴	98	103	101	100	101	101	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.3	2.5	2.8	3.1	na	na	na
<i>EBRD index of infrastructure reform</i>	1.3	1.3	1.3	1.3	1.3	1.3	1.3
<i>Electric power</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Railways</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Roads</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Telecommunications</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Water and waste water</i>	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 bank's operation.² Refers to taxes on international trade.³ Change in methodology of definition of non-performing loans from 01 January 2007.⁴ The collection rates are for residential electricity and heating combined. Numbers higher than 100 reflect collection of arrears.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	5.0	7.0	11.4	9.4	9.9	8.2	9.0
Private consumption	11.4	7.4	9.6	15.0	14.6	11.3	na
Public consumption	0.3	0.3	-0.2	0.6	0.2	0.5	na
Gross fixed capital formation	6.7	20.6	19.9	19.5	26.5	15.1	na
Exports	na	na	na	na	na	na	na
Imports	na	na	na	na	na	na	na
Industrial gross output	4.5	7.1	15.9	10.5	11.3	10.2	na
Agricultural gross output	0.7	6.6	12.6	1.7	6.0	4.1	na
Employment							
<i>(Percentage change)</i>							
Labour force (end-year)	-0.4	-0.5	-1.2	0.0	0.9	1.3	na
Employment (end-year)	-0.8	-1.0	-0.5	0.8	1.2	1.7	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	2.9	3.0	1.9	1.5	1.2	1.0	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	42.5	28.4	18.1	10.3	7.0	8.4	15.3
Consumer prices (end-year)	34.8	25.4	14.4	8.0	6.6	12.1	15.9
Producer prices (annual average)	40.4	37.5	24.1	12.1	8.3	16.4	na
Producer prices (end-year)	42.6	28.1	18.8	10.0	9.0	17.1	na
Gross average monthly earnings in economy (annual average)	53.8	32.5	38.6	33.4	25.5	20.3	na
Government sector							
<i>(In per cent of GDP)</i>							
General government balance	-2.1	-1.7	0.0	-0.7	1.4	0.4	0.4
General government expenditure	46.6	47.7	46.0	48.0	48.0	49.6	na
General government debt	11.0	10.4	8.9	8.3	8.8	11.6	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M3, end-year)	50.3	56.3	44.1	42.2	39.3	40.0	na
Domestic credit (end-year)	54.6	64.7	39.1	34.8	53.2	22.2	na
<i>(In per cent of GDP)</i>							
Broad money (M3, end-year)	15.0	16.8	17.7	19.3	22.1	25.5	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Refinancing rate	38.0	28.0	17.0	11.0	10.5	10.0	na
Treasury bill rate (3-month maturity)	na	na	na	na	na	na	na
Deposit rate (1 year) ¹	26.9	17.4	12.7	9.2	7.7	8.1	na
Lending rate (1 year) ²	36.9	24.0	16.9	11.4	8.8	8.5	na
<i>(Belarussian roubles per US dollar)</i>							
Official exchange rate (end-year)	1,920.0	2,156.0	2,170.0	2,152.0	2,140.0	2,150.0	na
Official exchange rate (annual average)	1,790.9	2,051.3	2,160.3	2,153.8	2,144.6	2,146.0	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-326.4	-434.4	-1,193.3	435.5	-1,431.2	-2,944.2	-4,013.0
Trade balance	-914.3	-1,255.6	-2,271.8	-637.6	-2,269.0	-3,984.4	-5,688.2
Merchandise exports	7,964.7	10,072.9	13,942.2	16,108.8	19,834.7	24,380.4	38,277.2
Merchandise imports	8,879.0	11,328.5	16,214.0	16,746.4	22,103.7	28,364.8	43,965.4
Foreign direct investment, net	453.3	170.3	162.5	302.5	351.0	1,768.9	1,706.2
Gross reserves, excluding gold (end-year)	417.4	461.5	690.8	1,106.5	1,067.2	4,182.0	na
External debt stock	3,308.3	4,174.9	4,935.4	5,168.4	6,785.7	12,719.2	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	0.5	0.5	0.5	0.7	0.5	1.7	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	7.1	13.7	11.7	12.4	16.6	14.4	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	9.9	9.8	9.8	9.8	9.7	9.6	na
GDP (in billions of Belarussian roubles)	26,138.3	36,564.8	49,991.8	65,067.0	79,231.4	96,047.7	121,442.7
GDP per capita (in US dollars)	1,474.4	1,809.9	2,361.4	3,096.9	3,808.5	4,639.6	na
Share of industry in GDP (in per cent)	29.6	30.8	32.7	33.1	32.2	31.6	na
Share of agriculture in GDP (in per cent)	11.8	10.2	10.3	9.8	9.3	8.8	na
Current account/GDP (in per cent)	-2.2	-2.4	-5.2	1.4	-3.9	-6.6	-7.0
External debt - reserves (in US\$ million)	2,890.9	3,713.4	4,244.6	4,061.9	5,718.5	8,537.2	na
External debt/GDP (in per cent)	22.7	23.4	21.3	17.1	18.4	28.4	na
External debt/exports of goods and services (in per cent)	35.6	36.1	31.5	28.4	30.5	46.0	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.

Bosnia and Herzegovina¹

Key developments and challenges

Public institutions remain inefficient and unwieldy, and there has been little progress in constitutional reform over the past year. Unlocking this process is vital for a more streamlined state, long-term prosperity and social cohesion.

The quality of the business environment is improving but remains one of the most problematic in the region. Further efforts are needed to tackle bureaucracy, including simplifying the procedures for registering businesses and obtaining licences, and reducing petty corruption.

The economy continues to grow robustly but fiscal performance has worsened over the past year, particularly in the FBH, which faces liquidity problems. The framework for a more coordinated approach to fiscal policy is in place but it remains to be fully applied.

Country data

Population (in millions)	3.8
Area ('000 sq km)	51.0
GDP (in billion US\$, 2007)	15.1
Average transition score (scale: 1 to 4.33)	2.78

Progress in structural reform

Liberalisation and privatisation

Bosnia and Herzegovina has progressed over the past year in terms of enhancing formal links with the European Union and integrating into regional trade structures, but serious challenges lie ahead in achieving further progress in these areas. A Stabilisation and Association Agreement with the European Union was initialled in December 2007 and signed in June 2008, following a commitment by the authorities in both Entities to implement reform of the police service. However, there has been little progress in the past year in moving towards a more efficient constitutional structure.

Meanwhile, the country's participation in the expanded Central European Free Trade Agreement (CEFTA) was ratified in September 2007, but the House of Representatives almost immediately imposed import duties on meat and dairy products from Croatia and Serbia. These were subsequently removed in July 2008.

The privatisation process in the FBH continues to proceed very slowly, although there are tentative signs of progress in selected areas. The flagship sale of 88 per cent of aluminium company Aluminij Mostar, one of the largest companies in the country and a key source of export revenue, remains stalled because of the inability of the government and the winning bidder to agree on a long-term electricity price contract.

However, a tender was launched for the sale of 49 per cent of the national airline, BH Airlines, and three bids were received by the deadline of the end of July 2008. Meanwhile, in the RS, the government announced in April 2008 its plans to sell several state-owned manufacturing companies.

Business environment and competition

Private sector development has advanced in recent years, with a vibrant and growing small and medium-sized enterprise (SME) sector. However, surveys continue to show that the country's business environment is problematic. In the latest World Bank *Doing Business 2009* scores, where countries are ranked on the ease of doing business, Bosnia and Herzegovina ranks 119th out of 181 countries, the worst score in south-eastern Europe. The survey identifies licensing and business registration as particular problems, although there has been progress in simplifying registration procedures recently. The Foreign Investor Council "White Paper" of 2007 identified construction permissions and procedures as a particular burden for foreign investors. Nevertheless, the level of foreign investment has risen sharply over the past two years, reflecting both progress in privatisation in the RS and a more favourable perception of BH as an investment destination.

Infrastructure

The FBH government has taken some steps towards privatising telecommunications companies BH Telecom and HT Mostar. A privatisation plan was announced in May 2008, with the government stating its intention to sell majority stakes in both companies. However, previous attempts to sell these companies have encountered resistance.

In the roads sector there is no agreement between the Entities on how to proceed with investments into Corridor Vc – the branch of the fifth Pan-European corridor – even though both Entities are interested in exploring the use of public-private partnerships. Meanwhile, in February 2008 the RS government announced that it would award a concession contract to Strabag of Austria, through direct negotiations, for the construction of a network of motorways around the RS, although the agreement was still not signed as of early October. There has also been some progress in recent months regarding the corporatisation of the FBH motorways agency. The new law to establish the agency was submitted to parliament in mid-2008. The agency will rely primarily on toll revenues to cover operational and maintenance costs. In the railways sector, progress with restructuring and ensuring the independence of the railway regulator has been very slow over the past year.

Financial sector

The banking sector continued to strengthen in BH during 2007. Assets and capital grew significantly in 2007 and several new banks were established (although the total number of banks at the end of 2007, at 32, remained the same as the previous year). However, overall bank profitability fell in the first quarter of 2008 and the cost of funding has increased. The Entity banking agencies still operate independently of each other but they have both signed a Memorandum of Understanding on coordinating with the central bank. In addition, they have begun to supervise micro credit and leasing companies, which have expanded their activities significantly in recent years.

Macroeconomic performance

The economy has continued to grow strongly over the past year. Real GDP growth is estimated at 6.8 per cent in 2007 and has continued at a similar pace in the first half of 2008, driven by strong growth in the construction and financial sectors, and in exports. The industrial sector has also been performing well in 2008, particularly in the RS energy and mineral sectors, reflecting the benefits of new investment associated with recent privatisations and restructuring.

Two of the main short-term macroeconomic challenges are inflation and the fiscal accounts. As of mid-2008 the inflation rate in both Entities was around 8 per cent, which is not particularly high by regional standards, but well above the prevailing level in recent years. High international oil prices and rising food costs are key factors, but domestic pressures from high public spending and credit growth are also important drivers. One major concern is the level of consolidated public spending which has been increasing as a percentage of GDP and is currently around 44 per cent. This was mainly because of higher spending following promises made to various social groups, such as war veterans and invalids, in the run-up to elections in late 2006, especially in the FBH, where the budget encountered particular liquidity difficulties in mid-2008.

On the external side the current account deficit rose by more than four percentage points in 2007 to nearly 13 per cent of GDP. Nevertheless, exporters are increasingly finding new markets, with the total level of exports up 18 per cent year-on-year in the first half of 2008, continuing the strong export growth pattern of recent years. On the capital account the main development in recent years has been the huge surge in foreign direct investment (FDI), driven in part by several big-ticket deals, but also by growing investor interest in the country. Although FDI in the first half of 2008 was only €300 million, down significantly on flows in the comparable period of 2007 (which was around €850 million), it remains encouraging, given the absence of major privatisations this year.

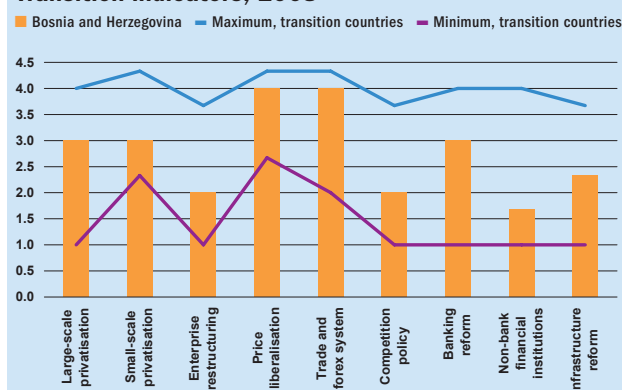
Outlook and risks

The macroeconomic outlook for Bosnia and Herzegovina remains broadly favourable, provided that internal and regional stability is maintained. Annual growth rates of around 6 per cent are feasible over the medium term, driven by strong private sector activity and the ongoing development of the SME sector, although with more than half of exports going to the EU, a slowdown there would also affect growth in BH.

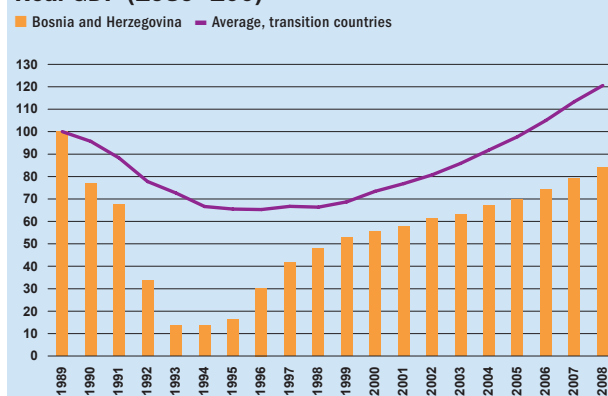
However, constitutional reform is vital, not just for the country's political future, but also for long-term economic development and prosperity. Ultimately, Bosnia and Herzegovina cannot move forward effectively towards European integration without creating a more efficient state. In the shorter term the currency board will continue to guide a prudent monetary policy but the fiscal pressures are likely to remain strong; dealing with these will require political leadership and a willingness to cooperate at various levels. The establishment of the Fiscal Council, which met for the first time in September 2008, should help improve fiscal coordination across the board.

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.

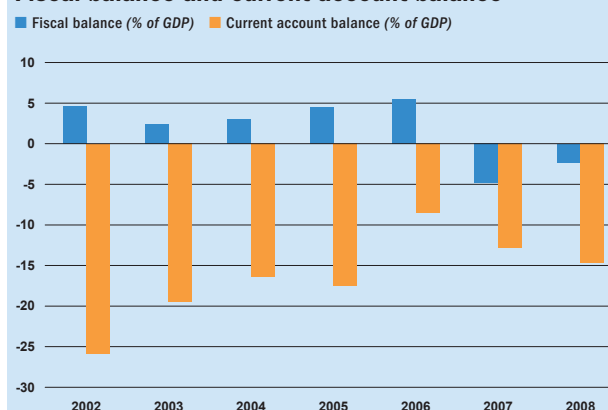
Transition indicators, 2008



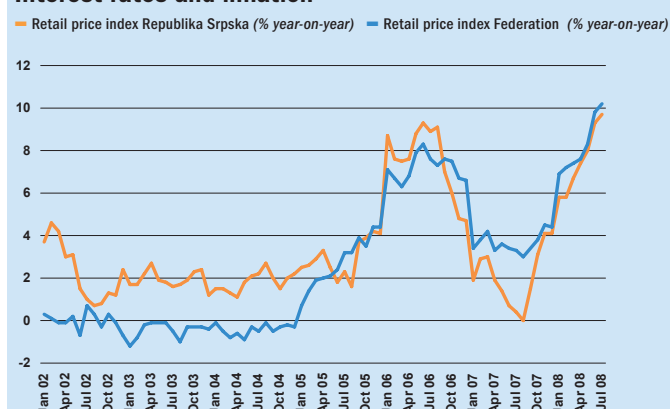
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – high	Capital adequacy ratio – 12 per cent	Share of population living in poverty – 18 per cent (2004)
Controls on inward direct investment – yes ¹	Secured transactions law – modern/some defects	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 6.1 per cent of GDP (2007)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – partial	Quality of securities market laws – medium	Government expenditure on education – 5.2 per cent of GDP (2007)
Exchange rate regime – currency board pegged to euro		Independence of the road directorate – full	Private pension funds – no	Household expenditure on power and water – 4.9 per cent
Wage regulation – no		Quality of concession laws – medium		
Tradeability of land – limited de jure				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.6	2.6	2.6	2.9	3.0	11.0	na
Private sector share in GDP (in per cent)	45.0	50.0	50.0	55.0	55.0	60.0	60.0
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	5.9	5.4	5.4	5.5	5.1	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)	20.4	19.9	27.1	27.0	21.6	21.4	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	2.3	2.3	2.3	2.7	2.7	3.0	3.0
EBRD index of enterprise reform	1.7	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 ²	5.0	5.0	5.0	5.0	4.0	6.0	na
Share of trade with non-transition countries (in per cent) ³	50.8	49.6	48.5	47.4	45.5	45.0	na
Share of trade in GDP (in per cent)	90.0	84.9	87.2	91.4	90.2	93.7	na
Tariff revenues (in per cent of imports)	7.2	6.4	5.1	na	na	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	3.0	3.7	3.7	3.7	3.7	3.7	4.0
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.7	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	40 (21)	37 (19)	33 (17)	33 (20)	32 (22)	32 (21)	na
Asset share of state-owned banks (in per cent)	6.2	5.3	4.0	3.6	3.2	1.9	na
Asset share of foreign-owned banks (in per cent)	76.7	79.7	80.9	90.9	94.0	93.8	na
Non-performing loans (in per cent of total loans)	11.5	8.4	6.1	5.4	4.1	3.0	na
Domestic credit to private sector (in per cent of GDP)	11.7	14.1	17.1	20.9	23.4	25.4	na
Domestic credit to households (in per cent of GDP)	10.0	12.9	15.2	17.6	19.6	20.6	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)	na	na	23.7	36.2	59.8	71.8	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	na	na	na	na
EBRD index of banking sector reform	2.3	2.3	2.7	2.7	2.7	2.7	3.0
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)	23.7 (19.6)	24.5 (28.1)	24.6 (36.4)	24.8 (40.8)	25.3 (48.3)	27.1 (62.3)	na
Internet users (per 100 inhabitants)	2.6	3.9	15.1	20.6	24.3	26.8	na
Railway labour productivity (1996=100)	134.5	136.3	256.0	480.7	481.4	447.3	na
Residential electricity tariffs (USc kWh)	6.0	7.1	7.3	6.4	7.4	8.6	na
Average collection rate, electricity (in per cent)	86	90	93	96	98	98	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.4	4.5	4.7	4.7	na	na	na
EBRD index of infrastructure reform	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Electric power	3.0	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	2.0	2.0	2.0	2.3	2.3	2.7	2.7
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 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.

³ For some years data were unavailable for important trading partners such as Croatia, FYR Macedonia, Montenegro and Serbia. As a result the share of trade with non-transition countries for these years has been over-estimated.

Macroeconomic indicators	2002	2003	2004	2005	2006	2007 <i>Estimate</i>	2008 <i>Projection</i>
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	5.5	3.0	6.3	3.9	6.7	6.8	6.0
Total consumption	na	na	na	32.7	0.1	na	na
Gross fixed capital formation	na	na	na	6.3	-13.4	na	na
Industrial gross output	11.5	3.8	7.2	6.4	5.5	na	na
Agricultural gross output	na	na	13.3	5.8	6.1	na	na
Employment	<i>(Percentage change)</i>						
Labour force (end-year)	-0.7	0.8	1.6	0.5	9.6	1.6	na
Employment (end-year)	-2.0	-1.0	0.2	2.1	4.3	4.5	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	41.0	42.1	42.9	42.0	44.8	43.2	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)							
Federation (KM based)	-0.2	0.1	-0.3	3.0	6.0	1.9	8.5
Republika Srpska (KM based)	1.7	1.8	1.9	5.2	6.4	1.1	8.0
Consumer prices (end-year)							
Federation (KM based)	-0.7	0.3	-0.3	4.4	4.5	5.5	7.5
Republika Srpska (KM based)	2.4	1.3	2.2	3.7	4.6	4.3	7.0
Gross average monthly earnings in economy (annual average)							
Federation	8.7	8.6	1.9	4.6	8.0	9.8	na
Republika Srpska	18.7	9.3	11.6	10.0	12.2	10.3	na
Government sector	<i>(In per cent of GDP)</i>						
General government balance	-0.1	0.7	1.5	2.1	2.6	1.3	-2.3
General government expenditure	48.8	39.9	39.0	40.0	42.3	44.1	na
Monetary sector	<i>(Percentage change)</i>						
Broad money (M2, end-year)	8.6	8.4	24.3	18.2	24.7	21.6	na
Domestic credit (end-year)	27.7	20.7	16.3	27.6	22.3	29.7	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	39.5	37.9	43.3	47.7	52.7	56.6	na
Exchange rates	<i>(KM per US dollar)</i>						
Exchange rate (end-year)	1.9	1.5	1.4	1.6	1.5	1.3	na
Exchange rate (annual average)	2.1	1.7	1.6	1.5	1.6	1.4	na
External sector	<i>(In millions of US dollars)</i>						
Current account	-1,194.3	-1,628.6	-1,639.3	-1,913.2	-1,040.3	-1,939.4	-2,550.0
Trade balance	-3,340.9	-4,156.9	-4,569.7	-4,898.9	-4,298.1	-5,703.9	-6,500.0
Merchandise exports	1,110.2	1,476.7	2,086.7	2,555.3	3,381.4	4,243.3	5,500.0
Merchandise imports	4,451.1	5,633.6	6,656.4	7,454.2	7,679.5	9,947.2	12,000.0
Foreign direct investment, net	266.0	381.8	708.3	579.1	710.4	2,022.6	1,200.0
Gross reserves, excluding gold (end-year)	1,196.0	1,611.0	2,208.0	2,686.0	3,496.0	4,686.0	na
External debt stock	3,636.6	4,518.1	5,106.1	5,658.7	6,136.8	7,345.0	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	3.0	3.2	3.7	4.0	5.2	5.4	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	8.7	4.0	3.1	2.7	2.6	2.3	na
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million) ¹	3.8	3.8	3.8	3.8	3.8	3.8	na
GDP (in millions of markas)	12,829.0	14,505.0	15,786.0	16,928.0	19,121.0	21,641.0	22,000.0
GDP per capita (in US dollars)	1,625.9	2,203.2	2,638.1	2,880.9	3,227.0	3,985.3	na
Share of industry in GDP (in per cent)	na	16.1	16.4	16.3	16.0	16.3	na
Share of agriculture in GDP (in per cent)	na	8.1	8.9	8.7	8.5	7.9	na
Current account/GDP (in per cent)	-19.3	-19.5	-16.4	-17.5	-8.5	-12.8	-14.7
External debt - reserves (in US\$ million)	2,440.6	2,907.1	2,898.1	2,972.7	2,640.8	1,814.0	na
External debt/GDP (in per cent)	58.9	54.0	50.9	51.7	50.0	48.5	na
External debt/exports of goods and services (in per cent)	253.5	205.6	173.1	161.2	135.8	116.6	na

¹ Excludes refugees abroad.

Bulgaria

Key developments and challenges

Although the economy has grown strongly post EU accession, the main challenge is to improve its flexibility and competitiveness further. This includes promoting education, skill development and labour market flexibility, strengthening the efficiency and effectiveness of public administration, as well as stepping up the fight against corruption and organised crime.

The quality of national and municipal infrastructure lags behind most of the European Union. Substantial investment, as well as a more commercial and decentralised approach, are needed to increase efficiency and quality in the provision of services.

The levels of inflation and the current account deficit are both high by regional standards. It is important to maintain the strong fiscal discipline of recent years, reduce credit growth to a sustainable level and make further efforts to attract foreign direct investment that will enhance the country's export capacity.

Country data

Population (in millions)	7.6
Area ('000 sq km)	111.0
GDP (in billion US\$, 2007)	39.6
Average transition score (scale: 1 to 4.33)	3.56

Progress in structural reform

Business environment and competition

Conditions for doing business in Bulgaria have improved in several respects over recent years. The country is ranked 45th out of 181 countries in the World Bank's *Doing Business* 2009 report, placing it once again at the top of south-eastern Europe and above a number of other EU countries. In January 2008 the "one-stop shop" for registering new businesses was introduced and in June the parliament approved a reduction in the minimum amount of capital required to register limited liability and joint-stock companies.

There is still a need to promote labour market flexibility and skill development to ease the labour shortages that have started to emerge. Another area, identified in the most recent European Commission (EC) progress report, is the need to strengthen state institutions, such as public administration and law enforcement; ensure effective market competition; combat corruption and organised crime; and develop the independence and capacity of the judiciary. In July 2008 the EC temporarily suspended disbursements under some of the remaining pre-accession programmes pending an investigation by the Bulgarian authorities into allegations of serious irregularities in the management of these programmes.

Infrastructure

Significant progress has been made in the energy sector in terms of meeting EU accession requirements, and the relevant regulation that allows for full market opening has been in place since July 2007. The Bobov Dol power plant was privatised in June 2008 and the recent privatisation of district heating companies is now mostly complete, with the exception of Shoumen EAD and Pernik EAD, which are still in the process of being sold. However, important challenges remain. These include effectively opening the electricity distribution market and promoting energy efficiency in view of Bulgaria's high energy intensity. Both effective market opening and improved energy efficiency depend on a level of electricity tariffs that is sufficient for investment purposes.

The government has consolidated its energy assets into a holding company, the Bulgarian Energy Holding, composed of the state gas company Bulgargaz, the power grid operator NEK, Kozloduy nuclear power plant, Maritza-Iztok II thermal power plant, and the Mini Maritza Iztok (Maritza Iztok mines).

Investment needs in municipal infrastructure, as required by EU environmental directives, remain substantial. This is also the case in Bulgaria's water and wastewater sector, which is predominantly government owned. To speed up the pace of investment, the government is setting up a fund for project development support and co-financing. A new Water and Wastewater Act is being prepared, which is expected to increase municipalities' influence over water operations and improve contractual arrangements between water operators and relevant stakeholders.

Financial sector

The financial sector in general is sound. Most of the banking sector is foreign-owned, it has a high level of capitalisation and the portfolio quality is generally strong. Competition in the banking sector has increased in recent years. Banks now offer mortgages and consumer loans to the private sector on increasingly longer maturities. The increase in reserve requirements from 8 to 12 per cent, introduced by the central bank in September 2007, and the turbulent credit markets have resulted in higher funding costs for Bulgarian banks and financing rates have started to rise. The current climate has also led to more prudent lending procedures among banks and credit growth has declined from 63 per cent in 2007 to 47 per cent year-on-year at the end of September 2008. It is expected to decelerate further by year-end. In response to the financial turmoil in other European countries and its effect on the Bulgarian inter-bank money market in September and October this year, the central bank temporarily softened the reserve requirement by allowing 50 per cent of banks' assets held in cash to be considered as part of the required reserves.

Macroeconomic performance

GDP grew by a robust 6.2 per cent in 2007 and further by 7.1 per cent in the year to the first half of 2008. These strong growth rates have been driven primarily by investments and to some extent by increased exports. The introduction of a 10 per cent income tax rate at the beginning of the year, strong employment growth and substantial wage increases, and the continued rapid growth of credit are also contributing to economic growth by stimulating private consumption and investment. Growth is expected to remain high in the second half of the year on account of significant agricultural output in the third quarter and a strong government investment programme planned for the fourth quarter.

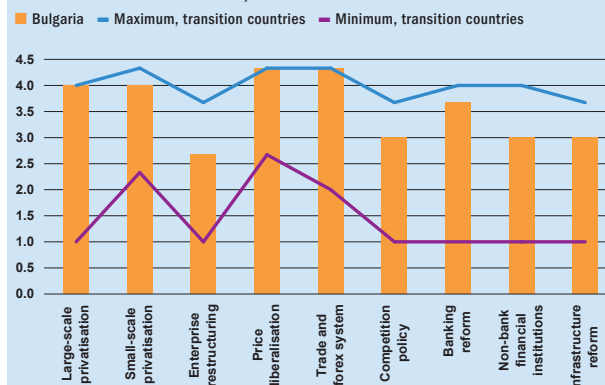
Inflation has picked up significantly over the last year, peaking at 14.7 per cent in June 2008. This was mainly due to higher global energy and food prices, compounded by a poor harvest in 2007, but it also reflects a tighter labour market (unemployment was below 6 per cent in mid-2008), with increased wage demands illustrated by an average nominal wage growth of 24 per cent year-on-year in the first half of 2008. However, inflation has started to decline in the second half of the year, to 11.2 per cent in August, and on current trends is expected to return to single digits by the end of the year. Another concern is the current account deficit, which remained high at 21.8 per cent of GDP in 2007. Most of the deficit reflects increased imports associated with an investment boom in the country, as well as significant foreign funding of private consumption. The financing of the current account deficit has been supported in the short term by very strong flows of net foreign direct investment (FDI) over the last few years. However, figures indicate that FDI may not be able to keep pace with the dynamics of the current account as they covered only 63 per cent of the current account deficit during the first six months of 2008.

The authorities have conducted prudent fiscal policies in recent years, reflecting their firm commitment to maintaining the currency board until the euro is adopted. Despite the trend towards lower tax rates over the past two years, government revenues have exceeded targets, contributing to a general government surplus of 3.8 per cent of GDP in 2007 and 3.5 per cent of the estimated full year GDP during the first six months of 2008.

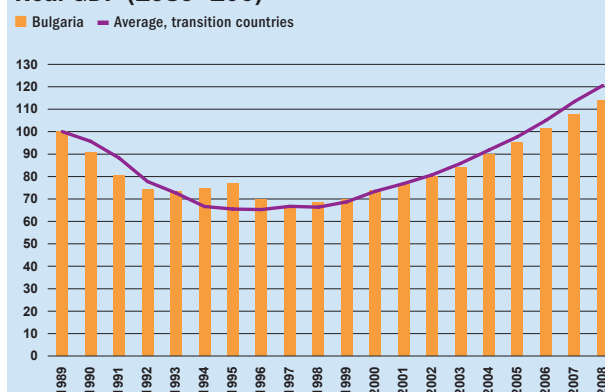
Outlook and risks

Bulgaria has promising long-term prospects, with a favourable geographical position and a track record as a regional energy hub. Real GDP is expected to grow by 6 per cent in 2008. However, some moderation of this high growth must be expected in the medium term, and significant challenges remain to be addressed. The current tightness in the labour market is putting pressure on wages and inflation, both of which adversely affect competitiveness and the country's ability to attract FDI. To maintain competitiveness, therefore, it will be important to enhance the flexibility of the labour market through increased geographical mobility and measures to improve skills. Further efforts are needed to contain the current account deficit within sustainable limits, especially in the current global financial crisis and the resulting slowdown in FDI and general investor activity in the region. Swift progress in the areas identified by the recent EU progress report is needed to allow the country to take full advantage of the substantial EU funds that will be made available in the coming years.

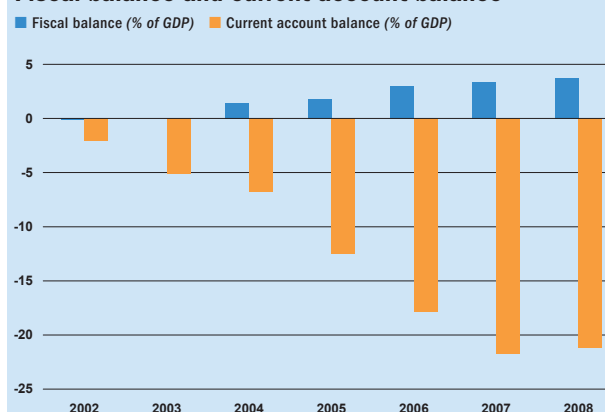
Transition indicators, 2008



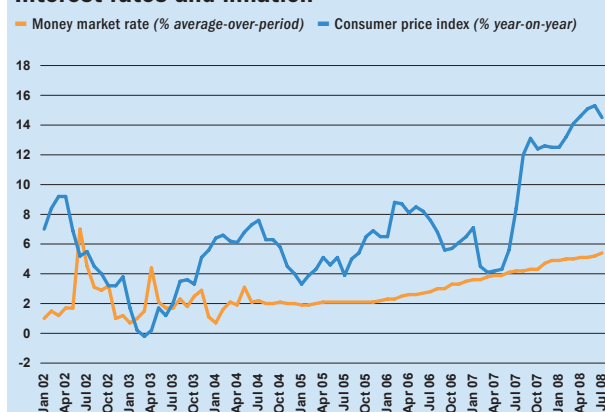
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – high	Capital adequacy ratio – 12 per cent	Share of population living in poverty – 6.1 per cent (2003) ¹
Controls on inward direct investment – no	Secured transactions law – advanced	Independent electricity regulator – full	Deposit insurance system – yes	Government expenditure on health – 2.7 per cent of GDP (2006)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – full	Quality of securities market laws – high	Government expenditure on education – 4.2 per cent of GDP (2005)
Exchange rate regime – currency board		Independence of the road directorate – full	Private pension funds – yes	Household expenditure on power and water – 11.2 per cent
Wage regulation – yes		Quality of concession laws – medium		
Tradeability of land – full within EU				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	13.8	15.0	18.0	21.4	22.8	23.7	na
Private sector share in GDP (in per cent)	70.0	75.0	75.0	75.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	63.0	65.0	69.0	71.0	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.6	3.0	2.4	2.1	1.5	1.5	na
Share of industry in total employment (in per cent)	24.0	23.5	23.4	23.8	23.1	22.0	na
Change in labour productivity in industry (in per cent)	10.3	11.6	13.5	3.1	4.6	9.3	na
Investment/GDP (in per cent)	19.8	21.7	23.5	28.0	na	na	na
<i>EBRD index of small-scale privatisation</i>	3.7	3.7	3.7	3.7	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.7	3.7	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of enterprise reform</i>	2.3	2.7	2.7	2.7	2.7	2.7	2.7
Markets and trade							
Share of administered prices in CPI (in per cent)	21.3	22.0	24.7	21.3	21.3	18.6	na
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	1.0	na
Share of trade with non-transition countries (in per cent)	76.4	77.1	78.0	73.8	79.2	68.0	na
Share of trade in GDP (in per cent)	79.3	83.8	95.5	106.8	117.6	119.3	na
Tariff revenues (in per cent of imports)	10.3	10.6	9.1	8.0	na	na	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	2.3	2.3	2.3	2.7	2.7	2.7	3.0
Financial sector							
Number of banks (foreign-owned)	34 (26)	35 (25)	35 (24)	34 (23)	32 (23)	29 (21)	na
Asset share of state-owned banks (in per cent)	14.1	2.5	2.3	1.7	1.8	2.1	na
Asset share of foreign-owned banks (in per cent)	75.2	82.7	81.6	74.5	80.1	82.3	na
Non-performing loans (in per cent of total loans)	5.6	4.4	3.7	3.8	3.2	2.5	na
Domestic credit to private sector (in per cent of GDP)	19.4	26.7	35.2	42.9	47.1	66.8	na
Domestic credit to households (in per cent of GDP)	3.7	7.1	10.0	14.4	16.6	23.0	na
Of which mortgage lending (in per cent of GDP)	na	1.2	2.7	4.8	7.2	10.4	na
Stock market capitalisation (in per cent of GDP)	4.2	7.9	10.4	19.7	31.1	51.3	na
Stock trading volume (in per cent of market capitalisation)	13.9	16.3	22.8	35.2	19.6	34.2	na
Eurobond issuance (in per cent of GDP)	6.6	0.0	1.1	1.4	2.0	na	na
<i>EBRD index of banking sector reform</i>	3.3	3.3	3.7	3.7	3.7	3.7	3.7
<i>EBRD index of reform of non-bank financial institutions</i>	2.3	2.3	2.3	2.3	2.7	2.7	3.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	36.6 (33.1)	36.1 (44.9)	35.1 (60.9)	32.2 (80.8)	31.3 (107.6)	30.1 (129.6)	na
Internet users (per 100 inhabitants)	8.0	12.0	15.9	20.6	21.7	24.9	na
Railway labour productivity (1989=100)	65.9	75.2	78.4	73.7	76.3	74.5	na
Residential electricity tariffs (USc kWh)	5.2	5.2	6.0	8.4	8.8	9.1	na
Average collection rate, electricity (in per cent)	95	92	92	93	93	93	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.9	3.1	3.5	3.6	na	na	na
<i>EBRD index of infrastructure reform</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>Electric power</i>	3.3	3.3	3.7	3.7	3.7	3.7	3.7
<i>Railways</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3
<i>Roads</i>	2.3	2.3	2.3	2.7	2.7	2.7	2.7
<i>Telecommunications</i>	3.0	3.0	3.3	3.3	3.7	3.7	3.7
<i>Water and waste water</i>	3.0	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.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	4.5	5.0	6.6	6.2	6.3	6.2	6.0
Private consumption	4.0	6.3	5.3	5.5	8.5	5.1	na
Public consumption	6.1	3.1	6.8	4.1	-2.5	3.4	na
Gross fixed capital formation	8.5	13.9	13.5	23.3	14.7	21.7	na
Exports of goods and services	8.1	10.7	12.7	8.5	8.7	5.2	na
Imports of goods and services	5.0	16.4	14.5	13.1	14.0	9.9	na
Industrial gross output	4.6	14.0	17.1	6.7	5.9	9.2	na
Agricultural gross output	4.3	-0.2	3.4	-4.4	0.9	-18.3	na
Employment							
<i>(Percentage change)</i>							
Labour force (end-year)	-0.5	1.1	1.2	-0.2	3.1	2.3	na
Employment (end-year)	2.9	4.5	3.4	2.0	4.4	4.6	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	16.8	13.7	12.0	10.1	8.9	6.9	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	5.9	2.3	6.1	5.0	7.3	8.4	12.4
Consumer prices (end-year)	3.9	5.6	4.0	6.5	6.5	12.5	9.4
Producer prices (annual average)	1.3	4.9	6.0	6.9	6.9	8.4	na
Producer prices (end-year)	6.3	4.3	5.2	9.6	5.1	11.1	na
Gross average monthly earnings in economy (annual average)	3.4	9.2	9.1	4.3	4.6	19.6	na
Government sector							
<i>(In per cent of GDP)</i>							
General government balance ¹	-0.1	0.0	1.4	1.8	3.0	3.4	3.7
General government expenditure ¹	39.3	40.6	39.1	38.9	37.0	39.1	na
General government debt	53.6	45.9	37.9	29.2	22.7	18.2	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	11.7	18.8	23.3	24.3	26.9	31.3	na
Domestic credit (end-year)	27.4	33.9	34.2	33.0	15.3	58.8	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	42.8	47.5	52.3	59.0	64.9	74.4	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Base interest rate ²	3.3	2.8	2.4	2.1	3.3	4.6	na
Interbank interest rate (up to 1 month)	1.2	1.1	2.0	2.2	3.5	4.9	na
Deposit rate (1 month)	2.8	2.9	3.0	3.0	3.2	4.0	na
Lending rate (less than 1 year)	9.4	8.8	8.8	7.9	8.1	10.3	na
<i>(Leva per US dollar)</i>							
Exchange rate (end-year)	1.9	1.5	1.4	1.7	1.5	1.3	na
Exchange rate (annual average)	2.1	1.7	1.6	1.6	1.6	1.4	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-319.0	-1,022.2	-1,671.1	-3,404.6	-5,658.7	-8,592.2	-9,978.7
Trade balance	-1,658.5	-2,575.9	-3,687.9	-5,490.8	-7,028.1	-10,141.4	-12,579.5
Merchandise exports	5,354.1	7,081.4	9,931.2	11,776.4	15,101.4	18,523.5	23,500.0
Merchandise imports	7,012.6	9,657.3	13,619.1	17,267.2	22,129.5	28,664.9	36,079.5
Foreign direct investment, net	876.3	2,070.3	2,879.2	4,002.5	7,332.5	8,153.7	8,364.4
Gross reserves, excluding gold (end-year)	4,407.0	6,291.0	8,776.3	8,040.5	10,941.3	16,487.9	na
External debt stock	11,311.7	13,439.1	17,276.3	18,862.0	26,823.1	41,344.7	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	6.0	6.2	6.2	4.6	5.0	5.9	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	17.3	14.9	25.5	42.4	19.0	8.5	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	7.8	7.8	7.8	7.7	7.7	7.6	na
GDP (in millions of leva)	32,401.6	34,627.5	38,822.6	42,797.4	49,361.0	56,519.8	67,313.3
GDP per capita (in US dollars)	1,988.4	2,561.8	3,175.8	3,522.7	4,111.2	5,176.7	na
Share of industry in GDP (in per cent)	25.6	24.9	24.4	26.1	na	na	na
Share of agriculture in GDP (in per cent)	10.7	10.0	9.2	8.0	na	na	na
Current account/GDP (in per cent)	-2.0	-5.1	-6.8	-12.5	-17.9	-21.7	-21.2
External debt - reserves (in US\$ million)	6,904.7	7,148.1	8,500.1	10,821.5	15,881.7	24,856.8	na
External debt/GDP (in per cent)	72.5	67.2	70.1	69.4	84.7	104.5	na
External debt/exports of goods and services (in per cent)	149.7	133.8	123.8	116.6	131.5	166.4	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 Effective interest rate at end-month, based on the average annual yield attained at three-month government securities primary auctions.

Croatia

Key developments and challenges

Privatisation has progressed slowly over the past year. To increase the pace the government needs to reassess its privatisation objectives and align them with the relevant EU regulations. It also needs to decide on the role of the Croatian Privatisation Fund and what to do with the majority state-owned companies.

Progress with the deregulation programme, known as the “regulatory guillotine”, has been slower than expected. Reforms should include regulatory impact assessments for county and municipal regulations to further reduce state intervention in the economy and improve the business climate.

Further progress in health care and pension reform is needed and more fiscal consolidation is necessary. In particular, all off-budget operations need to be included in the general government accounts to increase transparency. However, fiscal consolidation should not prevent financially sound local government entities from making essential infrastructure investments.

Country data

Population (in millions)	4.4
Area ('000 sq km)	87.7
GDP (in billion US\$, 2007)	51.3
Average transition score (scale: 1 to 4.33)	3.52

Progress in structural reform

Liberalisation and privatisation

Progress in privatisation has been slow over the past year, partly because of the aftermath of the corruption scandal that led to the management of the Croatian Privatisation Fund (CPF) being removed in June 2007. Several public tenders were announced for companies in the CPF's portfolio in 2007 and the sales of two steelworks and the aluminium producer TLM were concluded, although many other tenders were unsuccessful or have yet to be finalised. In November 2007 the government sold 7 per cent of oil company INA and in June 2008 it sold 4.2 per cent of Hrvatski Telekom (HT) and 12.5 per cent of the fertiliser company Petrokemija. In all three cases the sales were to current and former employees. In September 2008, the CPF approved the sale of 91.5 per cent of KIM to Dukat (both dairy producers) and 38.1 per cent of Sladorana to Viro (both sugar producers). The government also submitted to the European Commission (EC) individual restructuring plans for five shipyards, with plans to issue public tenders for all of them by the end of 2008.

Croatia committed itself, as of 1 July 2008, not to introduce into purchase and sales contracts any clauses which are not in conformity with the EU's *acquis communautaire*.¹ A new privatisation strategy is now being prepared by the CPF that will involve setting up several closed-end investment funds managing stocks of local state-owned companies.

As of September 2008 negotiations on 21 chapters of the *acquis communautaire* have been opened (of which three have been provisionally closed). Regarding pre-accession assistance, in July 2008 the EC lifted the two precautionary measures it had introduced in December 2007, namely the suspension of *ex ante* endorsement of contracts under Phare 2006 and the provisional €5 million reduction of the Instrument for Pre-Accession Assistance (IPA) 2008 envelope.

Business environment and competition

Progress with the regulatory guillotine project (known as “Hitrorez”), which eliminates a series of unnecessary laws and regulations, has been disappointing. By the end of July 2008 the government had agreed to implement only 542 of 799 recommendations. Although 321 of these have been carried out, they mainly involve the removal of formalities, leaving the bureaucratic process largely intact. Hitrorez is scheduled for completion by the end of 2008 but some 4,500 regulations at county and municipal level that make the business climate particularly difficult have yet to be tackled. An e-register of national regulations has been produced, allowing them all to be found in one place.

Meanwhile, the government continues to subsidise heavily loss-making enterprises in sectors such as railways and shipbuilding. However, following a decision by the Competition Agency in July 2008, government support to the latter is to be suspended until the privatisation process is over.

Infrastructure

Competition in the energy sector is still limited, although the electricity market has been fully open since 1 July 2008. The price of electricity is still about 40–50 per cent lower than the market price, despite increases on 1 July of up to 20 per cent for small consumers and 22–28 per cent for companies. The government has agreed to subsidise the price increase for households that consume less than 2,000 kWh a year, without any means testing.

Competition in the telecommunications sector is increasing. In May 2008 the telecommunications regulator ordered HT to lower by 56.4 per cent the bit-stream price it charges competitors to use its network for running broadband internet services.

In June 2008 the parliament adopted the Electronic Communications Act, which was criticised from all sides, including the European Union, because it effectively gives control of the underground fibre-optics cable network to HT and supports the status quo. The Act created a new regulatory body – the Croatian Agency for Postal and Electronic Communications (HAKOM) – by merging the telecommunications and postal regulators. HAKOM recently denied a request from Telcro Group to initiate a public tender for a fourth mobile operator. Telcro aspires to become the first mobile virtual network operator in Croatia.

¹ The *acquis communautaire* is the body of European law that countries must adopt to become European Union members.

Macroeconomic performance

Real GDP grew by 5.6 per cent in 2007, the highest rate since 2002, but growth is likely to be significantly lower in 2008 as a whole (it reached 3.4 per cent in the second quarter of 2008). The main drivers of growth were gross fixed capital formation, which rose by 6.5 per cent, and private consumption, which was up by 6.0 per cent. However, the latter has since decelerated due to rising inflation and slower credit growth. Average annual consumer price inflation ended 2007 at a relatively low 2.9 per cent, but has risen in recent months to 6.4 per cent year-on-year by September 2008.

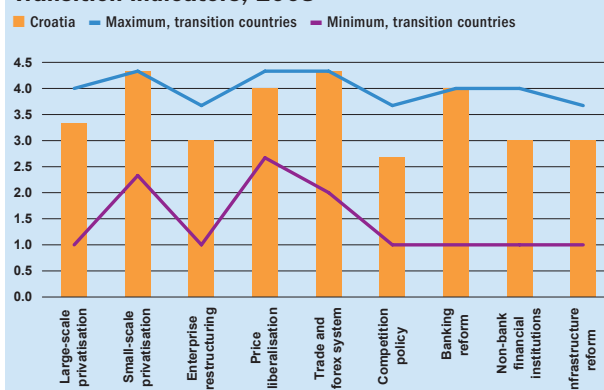
The Croatian National Bank (CNB) has continued with its restrictive monetary policy, further tightening measures introduced in 2007 to curb the rise in external indebtedness. These measures have had some success, as the growth rates of both gross external debt and domestic credit have slowed (the growth of the latter was 12.9 per cent in the year to December 2007 compared with 18.9 per cent a year earlier). Meanwhile, record levels of net foreign direct investment (FDI) were recorded in 2007, accounting for 9.1 per cent of GDP, and were more than sufficient to finance the current account deficit of 8.6 per cent of GDP. In terms of sector distribution, FDI remained concentrated in the financial sector (more than 64 per cent) while less than 6 per cent went to manufacturing.

The general government deficit continued to fall, ending 2007 at 2.3 per cent of GDP, 0.3 percentage points lower than originally projected. With a change to Eurostat methodology (ESA95), the government is aiming for a deficit of 1.3 per cent of GDP in 2008 and intends to achieve a balanced budget by 2010 and a small surplus in 2011. A new Budget Act, which aims to restrict the growth of indebtedness of municipalities, cities, counties and the companies owned by them, was adopted in July 2008.

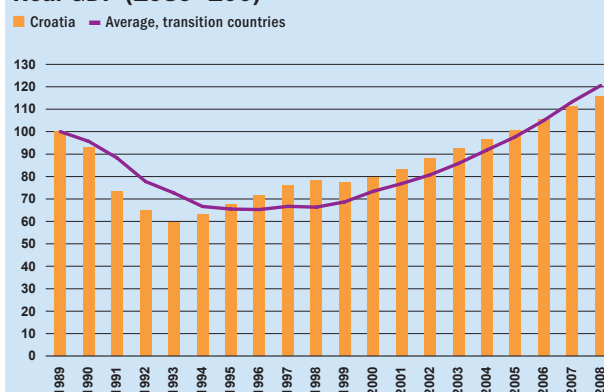
Outlook and risks

Croatia's medium-term economic prospects remain favourable due to the prospect of EU membership and the expectation that further structural reforms, especially those related to reducing state ownership and intervention, will be implemented. However, in an environment of higher inflation and growing global risk aversion a mix of slightly less restrictive monetary policy and more prudent fiscal policy is required. More needs to be done to improve the transparency of public finances, especially the inclusion of all off-budget operations in the general government accounts, and to achieve a reduction in government spending. Faster progress in implementing health care reforms is needed to avoid the government paying off debts of state-owned hospitals and health insurance providers, while pension reform also has some way to go. Currently, some individuals are effectively penalised for voluntarily participating in private pension funds (the second pillar), as their pensions are lower than the pensions of those who rely on the state pension only (the first pillar), while voluntary pension funds (the third pillar) have not yet taken off. Furthermore, external indebtedness, albeit growing at a slower pace, will need to be monitored carefully.

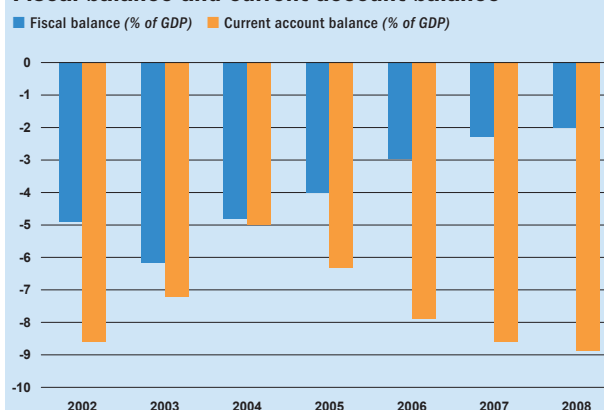
Transition indicators, 2008



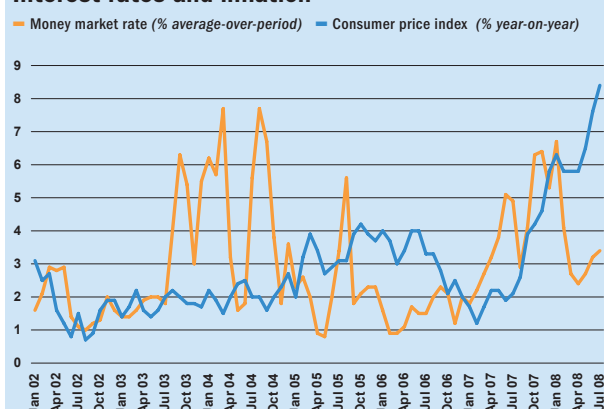
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – full	Capital adequacy ratio – 10 per cent	Share of population living in poverty – 4.0 per cent (2004)
Controls on inward direct investment – no ¹	Secured transactions law – inefficient	Independence of the electricity regulator – full	Deposit insurance system – yes	Government expenditure on health – 6.1 per cent of GDP (2005)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – full	Quality of securities market laws – high	Government expenditure on education – 4.7 per cent of GDP (2005)
Exchange rate regime – managed float		Independence of the road directorate – full	Private pension funds – yes	Household expenditure on power and water – 13.1 per cent
Wage regulation – no ²		Quality of concession laws – medium		
Tradeability of land – full ³				

Structural indicators

	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP) ⁴	14.9	16.6	16.8	17.0	18.1	19.2	na
Private sector share in GDP (in per cent)	60.0	65.0	65.0	65.0	65.0	70.0	70.0
Private sector share in employment (in per cent)	62.0	65.0	66.0	68.0	68.0	70.0	70.0
Budgetary subsidies and current transfers (in per cent of GDP)	2.3	2.5	2.6	2.6	2.6	2.7	na
Share of industry in total employment (in per cent) ⁵	22.8	21.6	21.7	20.5	21.0	21.6	na
Change in labour productivity in industry (in per cent)	4.2	9.8	2.5	8.8	-1.0	2.6	na
Investment/GDP (in per cent)	29.1	31.1	30.6	31.0	32.8	32.7	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	3.3	3.3	3.3	3.3	3.3	3.3
EBRD index of enterprise reform	2.7	2.7	3.0	3.0	3.0	3.0	3.0
Markets and trade							
Share of administered prices in CPI (in per cent)	0.0	0.0	0.0	0.0	0.0	0.0	na
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	0.0	0.0	0.0	0.0	na
Share of trade with non-transition countries (in per cent)	72.6	74.2	72.3	69.6	69.3	69.6	na
Share of trade in GDP (in per cent)	67.7	69.1	69.5	70.2	73.9	74.2	na
Tariff revenues (in per cent of imports) ⁶	2.9	2.1	1.6	1.5	1.3	1.2	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	4.3	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	2.7	2.7
Financial sector							
Number of banks (foreign-owned)	46 (23)	42 (19)	39 (15)	36 (13)	35 (15)	35 (16)	na
Asset share of state-owned banks (in per cent)	4.0	3.4	3.1	3.4	4.2	4.7	na
Asset share of foreign-owned banks (in per cent)	90.2	91.0	91.3	91.3	90.8	90.4	na
Non-performing loans (in per cent of total loans)	12.8	13.1	7.5	6.2	5.2	4.8	na
Domestic credit to private sector (in per cent of GDP)	53.8	56.3	59.2	64.5	73.2	76.6	na
Domestic credit to households (in per cent of GDP)	23.8	27.7	30.4	34.0	38.2	41.1	na
Of which mortgage lending (in per cent of GDP)	6.8	8.5	10.1	12.0	14.7	16.4	na
Stock market capitalisation (in per cent of GDP)	15.6	18.7	28.7	34.8	64.6	119.6	na
Stock trading volume (in per cent of market capitalisation)	3.8	4.8	6.0	6.7	8.7	8.6	na
Eurobond issuance (in per cent of GDP)	11.4	2.9	4.3	na	0.9	1.3	na
EBRD index of banking sector reform	3.7	3.7	4.0	4.0	4.0	4.0	4.0
EBRD index of reform of non-bank financial institutions	2.7	2.7	2.7	2.7	3.0	3.0	3.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	41.7 (53.5)	42.8 (58.0)	42.7 (64.2)	41.4 (80.2)	40.1 (96.5)	40.1 (110.5)	na
Internet users (per 100 inhabitants)	18.0	23.2	31.1	32.4	37.0	43.8	na
Railway labour productivity (1989=100)	78.1	90.4	92.7	107.0	125.3	141.7	na
Residential electricity tariffs (USc kWh)	6.5	8.2	9.1	9.4	10.0	10.5	na
Average collection rate, electricity (in per cent)	94	95	96	98	100	100	na
GDP per unit of energy use (PPP in US dollars per kgoe)	5.8	5.8	6.2	6.6	na	na	na
EBRD index of infrastructure reform	2.7	3.0	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	2.3	2.3	2.7	2.7	2.7	2.7	2.7
Roads	2.3	3.0	3.0	3.0	3.0	3.0	3.0
Telecommunications	3.3	3.3	3.3	3.3	3.7	3.7	4.0
Water and waste water	3.3	3.3	3.3	3.3	3.3	3.3	3.3

¹ Registration is required with commercial courts and National Bank of Croatia.² But there is a minimum wage regulation.³ Land is tradeable but the right to trade land applies to foreigners only on a reciprocity basis and foreigners cannot acquire certain types of land (including agricultural) from the state. The Croatian property market will be liberalised for EU citizens on 1 February 2009, as part of the harmonisation

with EU legislation on free movement of capital. An adjustment period limiting the sale of agricultural land, forests and parks was requested.

⁴ Excludes swaps with frozen currency deposits.⁵ Data based on labour force surveys.⁶ Refers to all taxes on international trade.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	5.6	5.3	4.3	4.3	4.8	5.6	3.8
Private consumption	7.7	4.6	4.8	3.4	3.5	6.2	na
Public consumption	4.9	1.3	-0.3	0.8	2.2	3.4	na
Gross fixed capital formation	13.9	24.7	5.0	4.8	10.9	6.5	na
Exports of goods and services	1.2	11.4	5.7	4.6	6.9	5.7	na
Imports of goods and services	13.4	12.1	4.6	3.5	7.3	5.8	na
Industrial gross output	5.4	4.1	3.7	5.1	4.5	5.6	na
Agricultural gross output	7.7	-15.9	11.9	-8.7	4.4	-3.9	na
Employment¹							
<i>(Percentage change)</i>							
Labour force (end-year)	1.4	0.1	-0.2	0.7	0.7	-0.9	na
Employment (end-year)	3.8	0.1	0.5	2.5	2.8	0.1	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	14.5	14.4	13.8	12.3	10.5	9.7	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	1.7	1.8	2.1	3.3	3.2	2.9	6.5
Consumer prices (end-year)	1.8	1.7	2.7	3.6	2.0	5.8	5.1
Producer prices (annual average)	-0.4	1.9	3.5	3.0	2.9	3.4	na
Producer prices (end-year)	2.3	1.1	4.8	2.7	1.9	5.8	na
Gross average monthly earnings in economy (annual average)	6.0	4.8	6.4	4.4	6.2	6.2	na
Government sector							
<i>(In per cent of GDP)</i>							
General government balance	-4.9	-6.2	-4.8	-4.0	-3.0	-2.3	-2.0
General government expenditure	50.7	51.3	49.5	48.5	47.8	48.3	na
General government debt	40.0	40.9	43.2	43.7	40.8	37.8	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M4, end-year)	9.5	11.0	8.6	10.5	18.0	18.3	na
Domestic credit (end-year)	28.4	12.3	11.8	19.2	18.9	12.9	na
<i>(In per cent of GDP)</i>							
Broad money (M4, end-year)	64.1	65.0	65.1	66.8	72.8	78.5	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Domestic rate	4.5	4.5	4.5	4.5	4.5	9.0	na
Money market interest rate (overnight credits)	1.9	7.0	6.0	4.0	3.5	6.7	na
Deposit rate ²	1.6	1.7	1.8	1.6	1.9	2.7	na
Lending rate ²	10.9	11.5	11.4	9.9	9.1	9.3	na
<i>(Kuna per US dollar)</i>							
Exchange rate (end-year)	7.1	6.1	5.6	6.2	5.6	5.0	na
Exchange rate (annual average)	7.9	6.7	6.0	5.9	5.8	5.4	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-1,925.5	-2,162.3	-1,874.7	-2,555.0	-3,287.1	-4,436.8	-4,754.0
Trade balance	-5,646.0	-7,904.6	-8,345.8	-9,341.5	-10,486.5	-12,933.4	-15,754.0
Merchandise exports	5,006.2	6,311.4	8,214.5	8,959.8	10,644.4	12,622.7	14,776.0
Merchandise imports	10,652.2	14,216.0	16,560.3	18,301.3	21,130.9	25,556.1	30,530.0
Foreign direct investment, net	552.5	1,927.3	732.3	1,551.0	3,211.9	4,644.1	4,806.0
Gross reserves, excluding gold (end-year)	5,885.8	8,191.3	8,759.0	8,801.1	11,488.6	13,675.3	na
External debt stock ³	15,771.5	24,850.7	31,209.5	30,464.7	38,544.9	48,819.7	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year) ⁴	4.9	5.2	4.8	5.1	5.3	5.2	na
<i>(In per cent of exports of goods and services)</i>							
Debt service ⁴	-23.8	-20.2	-24.2	-26.9	-36.8	-40.7	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	4.4	4.4	4.4	4.4	4.4	4.4	na
GDP (in billions of kuna)	181.2	198.4	215.0	231.3	250.6	275.1	303.4
GDP per capita (in US dollars)	6,083.6	7,402.6	8,140.6	8,926.5	10,524.1	13,120.0	na
Share of industry in GDP (in per cent)	19.4	19.5	20.2	20.7	20.5	20.5	na
Share of agriculture in GDP (in per cent) ⁵	7.3	6.0	6.5	6.3	6.2	6.0	na
Current account/GDP (in per cent) ⁴	-8.6	-7.2	-5.0	-6.3	-7.9	-8.6	-9.9
External debt - reserves (in US\$ million)	9,885.7	16,659.4	22,450.5	21,663.6	27,056.3	35,144.3	na
External debt/GDP (in per cent) ⁴	61.9	75.8	80.0	82.4	85.6	88.6	na
External debt/exports of goods and services (in per cent) ⁴	136.1	151.3	161.0	168.6	172.2	181.1	na

¹ Data based on labour force surveys.⁴ Ratio calculated in euros.² Weighted average over all maturities.⁵ Agriculture includes hunting, forestry and fishing.³ Change in reporting methodology from 2007 onwards.

Estonia

Key developments and challenges

Rapidly weakening economic growth has contributed to an increase in credit losses and declining asset values in the banking sector. To ensure financial stability, continued close monitoring and cooperation between the financial regulatory authorities is essential.

With slower domestic demand, improving competitiveness will be a key challenge in the coming years. As wage levels have become less competitive, other areas, such as the quality of labour, innovation and transport infrastructure, will be increasingly important for attracting capital and investments.

Assuring efficient and sustainable supplies of energy will be crucial in the years to come. With rising energy prices and a high dependency on imports, there should be more focus on developing renewables, increasing energy efficiency in production and improving regional energy infrastructure.

Country data

Population (in millions)	1.3
Area ('000 sq km)	87.7
GDP (in billion US\$, 2007)	20.9
Average transition score (scale: 1 to 4.33)	3.93

Progress in structural reform

Business environment and competition

The investment climate in Estonia remains highly competitive. Both petty and high-level corruption remain low and Estonia has steadily risen up the global rankings on Transparency International's Corruption Perceptions Index. Business regulation also remains highly competitive.

Estonia ranked 22nd globally in the World Bank's *Doing Business 2009* survey for the ease of doing business, and remains the highest ranked country in central eastern Europe and the Baltic states (CEB). Estonia, however, scores worse than the CEB averages in terms of employing workers, getting credit, enforcing contracts and closing a business. The costs and regulatory burden surrounding the hiring and firing, as well as rigidity of employment, continue to be significantly higher than both the CEB and OECD averages. Moreover, competitiveness has deteriorated in the past year owing to rapid growth in unit labour costs. Although labour shortages are expected to abate for cyclical reasons, they are likely to remain a challenge in the longer run owing to the projected decline in population.

Against this background, in early July 2008 the government drew up plans for developing competitiveness and expanding export capacity, with a focus on improving the business environment, education, labour markets and cooperation between enterprises and science. The government has also prepared a new draft labour law which aims to increase flexibility by reducing some of the rigidities in hiring and firing workers, while improving the unemployment safety net.

Infrastructure

Structural reforms in infrastructure are generally very advanced. The issues of energy security and the development of renewable energy have nevertheless become increasingly pressing.

In November 2007 Eesti Energia acquired the Aulepa wind park development with the aim of building the largest wind park in the Baltic states. The park will start operating in 2009 and will supply 1.3 per cent of Estonia's electricity consumption. The move is part of Eesti Energia's long-term strategy of decreasing carbon dioxide emissions by reducing its dependence on oil shale. In November 2007 renewables accounted for a mere 0.4 per cent of the electricity generation mix in Estonia.

The move is also a response to the need for more generation capacity by 2016 when the oil-shale-fired power plants of AS Narva Elektriijaamad, which have not been brought into compliance with the EU directive on large combustion plants, will be closed or reconstructed. Restructuring the existing oil-shale-based power plants remains a significant challenge, not least from an environmental perspective. In addition, Eesti Energia has initiated negotiations with Latvia, Lithuania and Poland on the construction of a new nuclear power plant in Lithuania. As these plans are still uncertain, the Estonian and Finnish authorities have also held discussions over the possibility of building a nuclear power plant in Estonia and a second underwater cable between the two countries.

Financial sector

The banking sector is facing more challenging times as cyclical conditions deteriorate. With no residual state ownership and 99 per cent of assets in foreign hands, the banking sector has remained highly profitable with a negligible ratio of non-performing loans. However, the annual growth of household credit has decelerated rapidly over the past year, from over 60 per cent in early 2007 to below 20 per cent by mid-2008.

While the credit growth has slowed down to more sustainable levels, there is a risk that it will further worsen the macro-economic situation. With the weakening domestic economy, particularly in the housing and construction sectors, asset quality is deteriorating and past due payments and credit losses have increased. Banking sector indicators for the main foreign banks are, however, still generally favourable, and foreign banks active in Estonia are well capitalised and profitable. Risks are, however, on the rise and will increase if there is a more pronounced and lasting economic slowdown in the region. In Estonia, over 80 per cent of all loans are in foreign currency.

Macroeconomic performance

After several years of very high output growth, the Estonian economy started to slow down in 2007. Real GDP grew by 6.3 per cent in 2007 but contracted by -0.5 per cent in the first half of 2008 compared with the same period the previous year. A combination of decelerating credit growth, falling house prices and declining real disposable incomes has significantly weakened both consumer spending and construction investment. Moreover, since 2006 export growth has slowed markedly, mainly in response to transit related trade, while competitiveness in the manufacturing sector has been affected by the high rate of wage growth in recent years. Unemployment was at a record low of 4 per cent in the second quarter of 2008.

Inflation rose to 6.6 per cent on average in 2007 and continued rising to 11.3 per cent in February 2008 where it has remained broadly stable until mid-2008. Around half of the increase can be explained by higher food and energy prices, but the rate is also affected by increases in indirect taxes and administered prices, while rising labour costs have also put significant upward pressure on inflation. The growth of real wages has outpaced that of productivity since 2006.

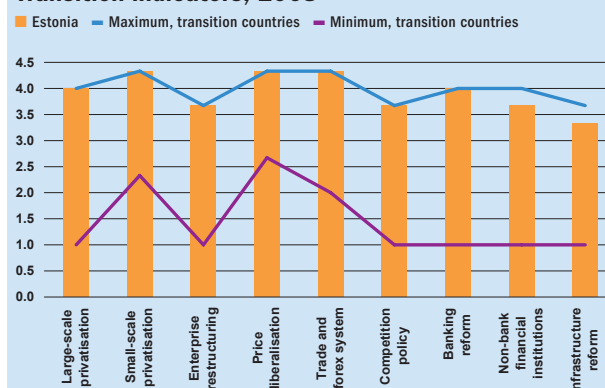
In 2007, the general government balance showed a surplus of 3.3 per cent of GDP. Although the surplus was down from 3.6 per cent the previous year, it was much higher than planned. In early 2008 the weak growth of tax revenues has led to cutbacks in spending as the government aims for a balanced budget. With strong public finances and low government debt, there is scope for allowing automatic stabilisers to work in case of a more protracted slowdown.

The slower growth of domestic demand has meant that the trade deficit has fallen rapidly since mid-2007. Consequently, the current account deficit has narrowed from 18.0 per cent of GDP in 2007 to 10.8 per cent in the second quarter of 2008. External debt rose to close to 120 per cent of GDP in 2007 as external sources continued to finance bank lending.

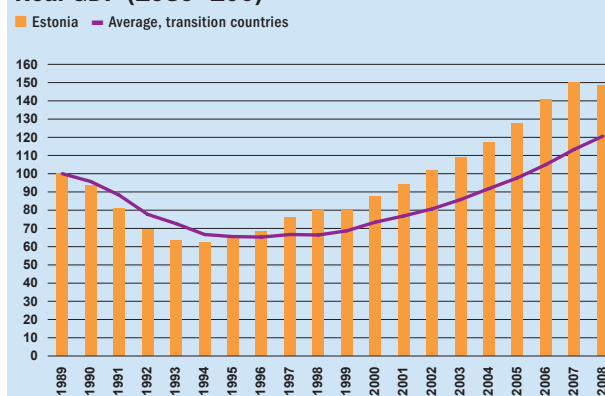
Outlook and risks

Although the slowdown in the Estonian economy implies a necessary adjustment to domestic and external imbalances, the speed of this slowdown brings important risks to macroeconomic and financial stability. While allowing automatic stabilisers to work, the authorities will need to push ahead with further measures to strengthen overall competitiveness, while relevant authorities for financial supervision will need to monitor progress in the financial sector carefully, in close cooperation with supervisors of foreign banks. To ensure competitiveness in the medium term it will be important to ensure the flexibility of the labour market and strengthen education and innovation. Reforms in the areas of governance and enterprise restructuring, competition policy and infrastructure would help to consolidate Estonia's position as an attractive destination for foreign investment while the domestic economy adjusts to a more sustainable path.

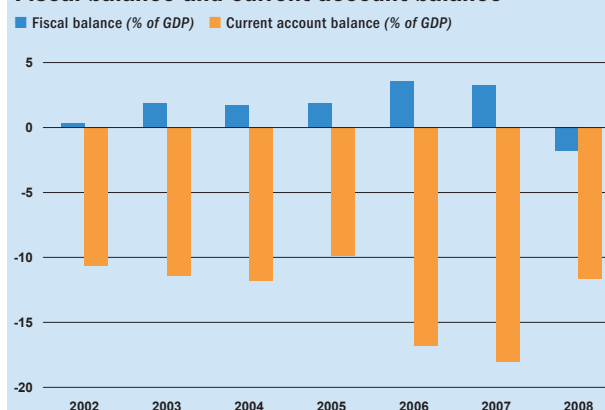
Transition indicators, 2008



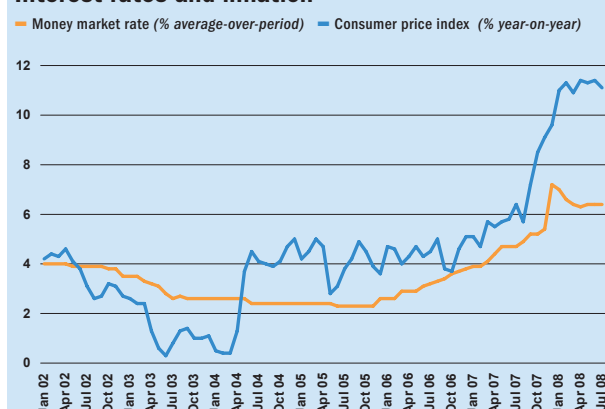
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – full	Capital adequacy ratio – 10 per cent	Share of population living in poverty – 7.5 per cent (2003)
Controls on inward direct investment – no	Secured transactions law – inefficient	Independence of the electricity regulator – full	Deposit insurance system – yes	Government expenditure on health – 4.0 per cent of GDP (2005)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – full	Quality of securities market laws – high	Government expenditure on education – 6.0 per cent of GDP (2005)
Exchange rate regime – currency board in ERM II		Independence of the road directorate – partial	Private pension funds – yes	Household expenditure on power and water – 6.1 per cent
Wage regulation – no		Quality of concession laws – low ¹		
Tradeability of land – full except foreigners				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	7.0	7.2	7.3	na	na	na	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)	73.3	73.7	74.5	75.5	74.8	75.9	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.9	1.1	1.3	0.7	0.6	0.6	na
Share of industry in total employment (in per cent)	24.7	25.2	27.0	26.0	23.8	22.9	na
Change in labour productivity in industry (in per cent)	13.2	4.6	0.2	15.8	14.9	10.7	na
Investment/GDP (in per cent)	32.4	33.2	34.7	34.5	38.6	37.9	na
<i>EBRD index of small-scale privatisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of large-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of enterprise reform</i>	3.3	3.3	3.3	3.7	3.7	3.7	3.7
Markets and trade							
Share of administered prices in CPI (in per cent) ²	28.5	24.9	26.9	26.7	24.7	23.3	na
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	3.0	2.0	2.0	2.0	na
Share of trade with non-transition countries (in per cent)	71.8	72.0	72.0	72.6	68.4	66.9	na
Share of trade in GDP (in per cent)	111.3	109.5	114.8	124.8	137.1	123.6	na
Tariff revenues (in per cent of imports)	0.0	0.1	0.2	0.3	0.3	0.3	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	3.0	3.0	3.3	3.3	3.7	3.7	3.7
Financial sector							
Number of banks (foreign-owned)	7 (4)	7 (4)	9 (6)	13 (10)	14 (12)	15 (13)	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)	97.5	97.5	98.0	99.4	99.1	98.7	na
Non-performing loans (in per cent of total loans)	0.8	0.5	0.3	0.2	0.2	0.5	na
Domestic credit to private sector (in per cent of GDP)	26.0	30.7	39.7	57.0	78.2	89.3	na
Domestic credit to households (in per cent of GDP)	10.6	14.3	19.7	28.1	38.2	43.3	na
Of which mortgage lending (in per cent of GDP)	5.5	9.5	14.6	22.6	33.0	37.7	na
Stock market capitalisation (in per cent of GDP)	29.9	38.4	47.1	25.2	34.6	26.9	na
Stock trading volume (in per cent of market capitalisation)	14.9	18.3	17.5	51.1	20.5	34.9	na
Eurobond issuance (in per cent of GDP)	8.7	5.8	8.1	2.5	na	0.2	na
<i>EBRD index of banking sector reform</i>	3.7	3.7	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of reform of non-bank financial institutions</i>	3.3	3.3	3.3	3.3	3.7	3.7	3.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	35.1 (65.0)	34.1 (77.7)	33.3 (94.1)	33.3 (108.8)	34.1 (125.2)	37.1 (148.4)	na
Internet users (per 100 inhabitants)	32.8	44.4	50.2	51.9	55.1	58.4	na
Railway labour productivity (1989=100)	223.7	256.5	294.4	359.7	348.0	285.2	na
Residential electricity tariffs (USc kWh)	5.7	6.5	8.1	9.2	10.1	10.2	na
Average collection rate, electricity (in per cent)	98	99	99	99	99	99	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.5	3.6	3.8	4.4	na	na	na
<i>EBRD index of infrastructure reform</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3
<i>Electric power</i>	3.0	3.0	3.0	3.0	3.3	3.3	3.3
<i>Railways</i>	4.3	4.3	4.3	4.3	4.3	4.0	4.0
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>Water and waste water</i>	4.0	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.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	7.8	7.1	7.5	9.2	10.4	6.3	-1.0
Private consumption	10.9	9.6	6.7	10.6	15.1	8.9	na
Public consumption	1.9	0.3	3.0	1.6	2.6	4.8	na
Gross fixed capital formation	24.1	19.2	4.4	9.9	22.4	7.8	na
Exports of goods and services	1.7	8.0	16.6	20.5	8.3	1.5	na
Imports of goods and services	6.0	10.4	15.5	16.3	17.1	2.8	na
Industrial gross output	8.1	8.7	7.5	13.6	12.0	7.7	na
Agricultural gross output	8.3	5.0	-6.9	-2.8	3.3	-1.9	na
Employment							
<i>(Percentage change)</i>							
Labour force (annual average)	-1.2	1.2	-0.2	0.1	4.1	0.1	na
Employment (annual average)	1.4	1.5	0.2	2.0	6.4	1.4	na
<i>(In per cent of labour force)</i>							
Unemployment (annual average)	10.3	10.0	9.6	7.9	5.9	4.7	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	3.6	1.3	3.0	4.1	4.4	6.6	10.7
Consumer prices (end-year)	2.7	1.1	5.0	3.6	5.1	9.6	9.0
Producer prices (annual average)	0.4	0.2	2.9	2.1	4.5	8.3	na
Producer prices (end-year)	1.4	0.3	3.9	2.2	5.9	8.7	na
Gross average monthly earnings in economy (annual average)	11.5	9.4	8.4	10.8	16.5	20.5	na
Government sector							
<i>(In per cent of GDP)</i>							
General government balance	0.4	1.8	1.7	1.9	3.6	3.3	-1.8
General government expenditure	35.6	34.6	33.9	33.9	33.4	34.3	na
General government debt	5.6	5.5	5.1	4.6	4.3	3.5	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	11.1	10.9	15.8	42.0	28.2	13.4	na
Domestic credit (end-year)	27.6	28.7	29.2	32.1	41.9	34.2	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	37.3	36.9	38.5	47.6	51.6	50.3	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Deposit rate (over 12 months)	3.7	2.4	2.1	3.0	4.1	5.6	na
Lending rate (over 12 months)	6.6	5.1	6.2	9.2	7.7	9.7	na
<i>(Kroons per US dollar)</i>							
Exchange rate (end-year)	14.9	12.4	11.5	12.5	11.9	10.6	na
Exchange rate (annual average)	16.6	13.9	12.6	12.4	12.5	11.4	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-779.0	-1,116.3	-1,413.0	-1,381.9	-2,758.6	-3,771.0	-2,880.0
Trade balance	-1,117.4	-1,556.7	-1,989.8	-1,911.8	-3,022.5	-3,677.2	-2,700.0
Merchandise exports	3,505.9	4,595.8	5,887.4	7,794.7	9,755.6	11,075.1	13,100.0
Merchandise imports	4,623.3	6,152.5	7,877.2	9,706.5	12,778.1	14,752.3	15,800.0
Foreign direct investment, net	152.6	762.7	697.8	2,248.8	672.9	1,115.3	1,050.0
Gross reserves, excluding gold (end-year)	1,000.4	1,373.4	1,792.5	1,945.1	2,855.9	3,330.0	na
External debt stock ¹	4,703.8	7,064.7	10,011.3	11,306.3	16,859.0	25,247.1	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	2.1	2.2	2.2	2.0	2.3	2.2	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	9.8	11.2	12.5	12.9	14.4	14.9	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	1.4	1.4	1.4	1.3	1.3	1.3	na
GDP (in billions of kroons)	121.4	136.0	151.0	173.5	205.0	238.9	261.8
GDP per capita (in US dollars)	5,367.7	7,236.6	8,872.7	10,410.1	12,223.7	15,567.5	na
Share of industry in gross value added (in per cent)	25.3	25.5	24.2	25.3	25.2	25.3	na
Share of agriculture in gross value added (in per cent)	3.7	3.6	3.5	3.2	2.7	2.7	na
Current account/GDP (in per cent)	-10.7	-11.4	-11.8	-9.9	-16.8	-18.0	-11.2
External debt - reserves (in US\$ million)	3,703.4	5,691.3	8,218.8	9,361.2	14,003.1	21,917.1	na
External debt/GDP (in per cent)	64.4	72.0	83.5	80.6	102.6	120.8	na
External debt/exports of goods and services (in per cent)	90.3	103.6	114.6	102.9	127.1	163.2	na

¹ Data are from the Bank of Estonia and include non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

FYR Macedonia

Key developments and challenges

While the tax system has been simplified and the business registration process improved, important challenges remain regarding dealing with construction permits and closing a business. The weak judicial system also needs strengthening, especially with respect to enforcing contracts, to improve the functioning of market mechanisms.

Further modernisation of the power sector is urgently needed. The policy of gradually increasing electricity prices to market levels must continue in order to tackle the sector's financial problems and to ensure more reliable power supplies.

While GDP growth was strong and broad based in 2007, the problems of high unemployment and relatively low foreign direct investment (FDI) remain. In addition to structural reforms aimed at creating jobs, further integration and alignment with the European Union is important for attracting more FDI.

Country data

Population (in millions)	2.0
Area ('000 sq km)	26.0
GDP (in billion US\$, 2007)	7.7
Average transition score (scale: 1 to 4.33)	3.18

Progress in structural reform

Business environment and competition

The business environment improved further over the past year as reflected in the World Bank's *Doing Business 2009* report, which ranks FYR Macedonia 71st out of 181 countries, an improvement of eight places on last year's ranking. Progress was made regarding the introduction of low and simplified taxation, the "regulatory guillotine" (the process of eliminating and simplifying regulations quickly) and customs reform. The authorities took steps to improve the legislation with a "one-stop shop" system, reducing the time required to register a business to four hours and the costs of registration to less than €50. The requirement to deposit paid-in capital before registering a limited liability company was eliminated. As a result, the numbers of business registrations increased from about 7,000 in 2005 to more than 11,000 in 2007.

Progress was also made on the new law on real estate cadastre, which will encourage the use of land as loan collateral and should ultimately help to lower borrowing costs. Legislative changes introduced in 2007 to allow foreign individuals and legal entities to own construction land are expected to encourage increased FDI. However, the time and costs associated with obtaining necessary construction permits and licences remain high. The authorities are committed to further improving the business environment, including by reducing employees' social contributions.

The amendments to the labour law adopted in July 2008 should increase flexibility in working hours and reduce dismissal costs for redundancies. Overall, the business environment remains challenging for both domestic and foreign investors as enterprises identify corruption and judicial shortcomings as major constraints on their activities.

Infrastructure

Ensuring reliable power supplies is still a concern. The liberalisation of the electricity market for large industrial users came into effect on 1 January 2008, in line with the provisions of the Energy Community Treaty. The government is in the process of reforming electricity tariffs and the tariff methodology, with the aim of gradually increasing prices in order to reduce budgetary subsidies to the sector. These subsidies are paid to the state-owned power transmission operator, MEPSO, to cover operating losses and were estimated at around €11.4 million in 2007. While the liberalisation and restructuring of the electricity sector is a government priority, the government decided to abandon earlier plans to privatise the electricity generation company, ELEM, and instead to further invest in improving the company's management and finances.

In April 2008 the government launched a tender for a 20-year concession for the management, operation and maintenance of the airport system (comprising Skopje and Ohrid airports and the construction of a new cargo airport in Stip), which was won by Turkish company TAV in September 2008. Total investment is estimated at around €200 million. The financial position of Macedonian Railways improved due to a significant increase in traffic levels in the last year after the company had been split in 2007 into a state-owned rail infrastructure company and a joint-stock company responsible for the operation of passenger and freight services. In July 2008 the government initiated a motorway network concession for the construction, financing and maintenance of 560 kilometres of motorways with an estimated cost of €2.4 billion. Preliminary interest was expressed by 48 companies.

Financial sector

The growth of credit to the private sector remains strong, rising by over 40 per cent in the first seven months of 2008. The authorities are concerned about the pace of credit growth and, as of 1 July 2008, banks and savings banks are obliged to make a deposit with the central bank if the year-on-year growth of their loans to households exceeds 40 per cent. However, the level of credit to the private sector as a share of GDP remains at less than 40 per cent. The banking sector continues to be well capitalised, with an average capital adequacy ratio of 17 per cent, more than twice the level required by law. The share of non-performing loans is declining as the old non-performing loans are slowly worked out and replaced by better quality ones. Foreign bank presence is increasing as the majority shareholdings of several small and medium-sized banks were sold to foreign strategic investors in late 2007 and the first half of 2008. The outlook for the financial sector is generally positive and the direct impact of the international liquidity difficulties should remain limited because banks rely mainly on domestic deposits rather than international credit lines to fund lending.

Macroeconomic performance

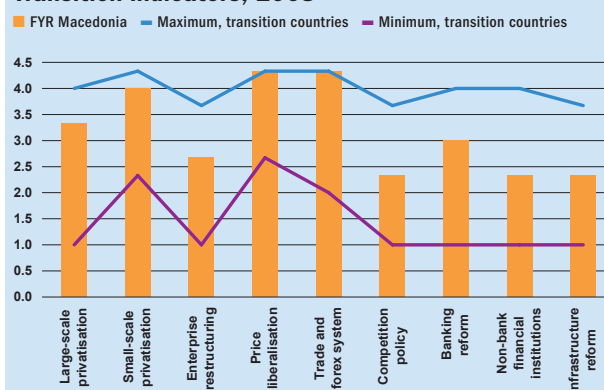
Real GDP rose by 5.1 per cent in 2007, the highest rate recorded so far in the transition period. It was also broad based, supported by a sharp increase in exports, strong industrial performance and higher household consumption. FYR Macedonia's industrial output continued to grow by 9.7 per cent in the first eight months of 2008 compared to the same period of 2007, driven by mining, machinery, metal and petroleum products. However, unemployment remains above one-third of the labour force. While inflation averaged only 2.3 per cent in 2007, reflecting the de facto exchange rate peg to the euro, it started to rise markedly at the end of 2007 and remained at a little under 10 per cent in the first half of 2008. Apart from rising food and energy prices there are increasing signs of demand-side factors contributing to inflationary pressures. In response to rising inflation, the central bank raised its key interest rate three times in February, March and May 2008 from 5.1 to 7.0 per cent.

Exports increased by 40 per cent in 2007, supported by FYR Macedonia's participation in the expanded Central European Free Trade Agreement (CEFTA), which contributed to a modest current account deficit of 3.2 per cent of GDP. However, the trade deficit widened considerably in the first half of 2008, mainly because of the higher cost of energy imports and strong domestic demand. These factors, together with a sharp decline in private transfers, contributed to an increase in the current account deficit to €408 million in the first half of 2008, compared to a surplus of €92 million in the same period of 2007. FDI fell from €345 million in 2006, mainly reflecting privatisation in the energy sector, to €240 million in 2007. With a share of FDI to GDP of 4.2 per cent, it remains relatively low compared with other countries in the region. However, the government's focus on attracting FDI resulted in receipts of €269 million of FDI in the first half of 2008 – an amount higher than the FDI received in 2007 as a whole.

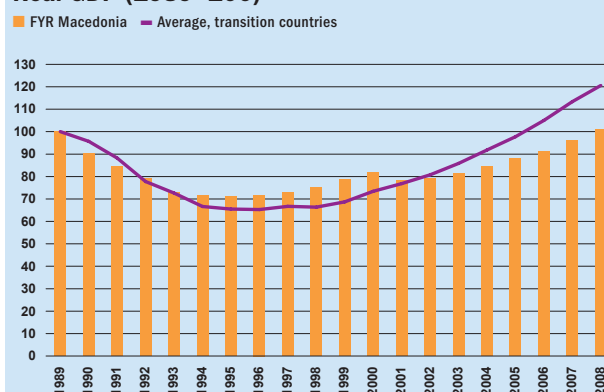
Outlook and risks

Despite the prospect of a more difficult external environment, real GDP growth is expected to remain slightly above 5 per cent in 2008. It seems likely, however, that inflation will exceed earlier government projections of 4 to 5 per cent, with high output growth and rising energy costs contributing to inflationary pressures. The wider current account deficit together with a possible negative impact of the international financial turmoil on capital inflows highlight the need for a continuation of the government's prudent fiscal stance. With limited budget flexibility, improved planning of public expenditure is important, especially in light of the substantial requirements for public infrastructure investment. In the medium term, economic growth of some 4-5 per cent a year should be sustainable, but it is dependent not just on the country's reform efforts, but also on the progress of negotiations for EU accession and the maintenance of domestic and regional political stability.

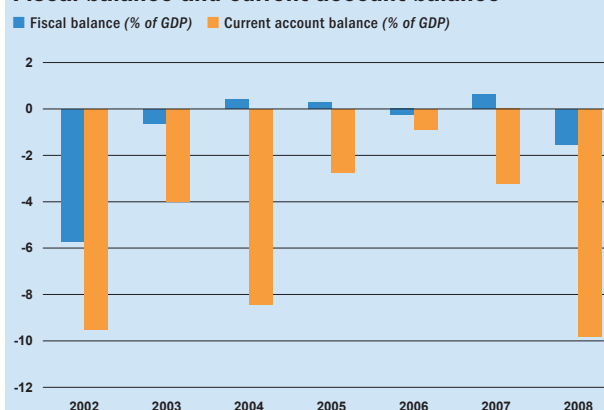
Transition indicators, 2008



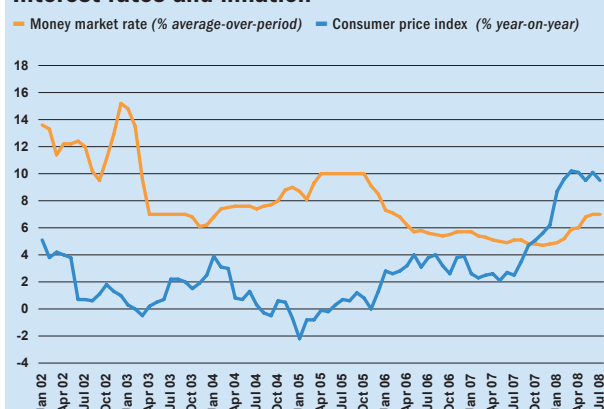
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – high	Capital adequacy ratio – 8 per cent	Share of population living in poverty – <2.0 per cent (2003)
Controls on inward direct investment – yes ¹	Secured transactions law – modern/some defects	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 4.7 per cent of GDP (2007)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – yes	Quality of securities market laws – medium	Government expenditure on education – 5.0 per cent of GDP (2007)
Exchange rate regime – de facto fixed to euro		Independence of the road directorate – partial	Private pension funds – yes	Household expenditure on power and water – 12.6 per cent
Wage regulation – no		Quality of concession laws – medium		
Tradeability of land – limited de jure				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	13.3	13.6	13.8	14.3	20.0	20.2	na
Private sector share in GDP (in per cent)	60.0	60.0	65.0	65.0	65.0	65.0	70.0
Private sector share in employment (in per cent)	50.0	50.0	55.0	55.0	60.0	60.0	60.0
Budgetary subsidies and current transfers (in per cent of GDP)	1.4	1.1	1.1	1.3	2.3	3.4	na
Share of industry in total employment (in per cent)	24.8	23.8	25.8	25.8	25.0	24.9	na
Change in labour productivity in industry (in per cent)	13.5	11.9	-5.8	2.7	1.9	0.9	na
Investment/GDP (in per cent)	20.7	20.0	21.4	20.7	21.6	23.9	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.0	3.0	3.3	3.3	3.3	3.3	3.3
<i>EBRD index of enterprise reform</i>	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)	10.9	13.4	1.5	1.2	1.2	1.2	na
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	0.0	0.0	0.0	0.0	na
Share of trade with non-transition countries (in per cent) ²	56.6	68.7	54.1	57.2	54.5	55.3	na
Share of trade in GDP (in per cent)	80.4	77.2	83.6	88.5	95.4	108.5	na
Tariff revenues (in per cent of imports)	5.1	5.1	4.2	3.4	2.7	2.8	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.0	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	2.0	2.0	2.0	2.0	2.0	2.3	2.3
Financial sector							
Number of banks (foreign-owned)	20 (7)	21 (8)	21 (8)	20 (8)	19 (8)	18 (11)	na
Asset share of state-owned banks (in per cent)	2.0	1.8	1.9	1.6	1.6	1.4	na
Asset share of foreign-owned banks (in per cent)	44.0	47.0	47.3	51.3	53.2	85.9	na
Non-performing loans (in per cent of total loans)	35.7	34.9	27.5	22.2	15.1	10.9	na
Domestic credit to private sector (in per cent of GDP)	17.7	18.2	21.5	24.0	28.9	36.4	na
Domestic credit to households (in per cent of GDP)	2.4	3.7	5.6	7.5	9.6	13.5	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)	4.3	7.7	7.7	11.0	16.5	32.8	na
Stock trading volume (in per cent of market capitalisation)	4.3	8.1	8.6	18.3	22.4	26.5	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	3.0	na	na	na
<i>EBRD index of banking sector reform</i>	2.7	2.7	2.7	2.7	2.7	2.7	3.0
<i>EBRD index of reform of non-bank financial institutions</i>	1.7	1.7	2.0	2.0	2.3	2.3	2.3
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	27.7 (18.1)	25.9 (38.3)	26.5 (48.5)	26.2 (62.0)	24.1 (69.6)	22.7 (74.5)	na
Internet users (per 100 inhabitants)	5.0	6.2	7.8	7.9	13.2	33.6	na
Railway labour productivity (1989=100)	59.2	67.2	76.2	112.9	132.0	161.0	na
Residential electricity tariffs (USc kWh)	4.1	4.7	5.1	4.4	5.1	5.7	na
Average collection rate, electricity (in per cent)	75	77	81	83	87	88	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.8	4.9	5.2	5.5	na	na	na
<i>EBRD index of infrastructure reform</i>	2.0	2.0	2.3	2.3	2.3	2.3	2.3
<i>Electric power</i>	2.3	2.3	2.3	2.7	3.0	3.0	3.0
<i>Railways</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	2.3	2.7	3.0	3.0	3.0	3.3	3.3
<i>Water and waste water</i>	2.0	2.0	2.0	2.0	2.3	2.3	2.3

¹ There are controls on arms production, trade in narcotics, historical and cultural heritage.

² For some years data were unavailable for some important trading partners, such as Bosnia and Herzegovina, Croatia, Montenegro and Serbia. As a result, the share of trade with non-transition countries for these years has been over-estimated.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
	<i>(Percentage change in real terms)</i>						
GDP	0.9	2.8	4.1	4.1	3.7	5.1	5.3
Industrial gross output	-0.8	4.7	-2.2	7.0	3.6	3.7	na
Agricultural gross output	-2.0	4.8	6.2	0.2	4.6	-2.0	na
Employment							
	<i>(Percentage change)</i>						
Labour force (end-year)	-4.4	4.4	-3.3	4.4	2.6	1.7	na
Employment (end-year)	-6.3	-2.8	-4.1	4.3	4.6	3.5	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	31.9	36.7	37.2	37.3	36.0	34.9	na
Prices and wages							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	1.8	1.2	-0.4	0.5	3.2	2.3	8.4
Consumer prices (end-year)	1.1	2.6	-1.9	1.2	2.9	6.1	5.9
Producer prices (annual average)	-0.9	-0.3	0.9	3.2	7.3	2.6	na
Producer prices (end-year)	1.1	-0.2	1.3	4.0	6.5	6.9	na
Gross average monthly earnings in economy (annual average)	6.4	4.9	4.1	2.7	8.0	4.8	na
Government sector							
	<i>(In per cent of GDP)</i>						
General government balance	-5.7	-0.6	0.4	0.3	-0.3	0.6	-1.5
General government expenditure	40.5	34.5	33.2	34.9	33.7	34.2	na
General government debt	42.9	39.0	36.6	39.5	32.9	25.5	na
Monetary sector							
	<i>(Percentage change)</i>						
Broad money (M2, end-year)	-10.1	18.5	16.0	15.9	24.4	27.8	na
Domestic credit (end-year)	24.5	25.0	21.2	1.7	23.7	59.6	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	26.8	30.8	33.9	36.4	41.7	48.3	na
Interest and exchange rates							
	<i>(In per cent per annum, end-year)</i>						
Basic rate of the National Bank	10.7	7.0	6.5	6.5	6.5	6.5	na
Interbank interest rate	15.2	6.2	10.0	8.5	5.7	4.8	na
Deposit rate	9.2	6.7	6.5	5.6	4.4	5.3	na
Lending rate	17.7	14.5	12.0	12.1	10.7	9.9	na
	<i>(Denars per US dollar)</i>						
Exchange rate (end-year)	58.6	49.1	45.1	51.7	46.5	41.7	na
Exchange rate (annual average)	64.8	54.3	49.4	49.3	48.8	44.7	na
External sector							
	<i>(In millions of US dollars)</i>						
Current account	-357.8	-184.1	-452.8	-157.9	-56.4	-248.1	-886.4
Trade balance	-804.3	-851.0	-1,139.0	-1,063.0	-1,285.0	-1,627.0	-2,633.0
Merchandise exports	1,112.2	1,362.7	1,674.9	2,040.6	2,396.3	3,349.5	4,267.0
Merchandise imports	1,916.5	2,213.7	2,813.8	3,103.6	3,681.2	4,976.5	6,900.0
Foreign direct investment, net	105.5	117.5	321.9	94.2	424.0	320.7	434.4
Gross reserves, excluding gold (end-year)	666.7	866.3	899.2	1,323.0	1,865.4	2,239.1	na
External debt stock	1,640.6	1,840.5	2,079.4	2,274.8	2,410.8	2,783.7	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	3.7	4.0	3.2	4.3	5.3	4.8	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	22.2	19.7	12.4	10.2	18.8	15.5	na
Memorandum items							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in billions of denars)	244.0	251.5	265.3	286.6	310.9	343.0	364.1
GDP per capita (in US dollars)	1,882.7	2,315.8	2,685.6	2,906.2	3,186.0	3,836.1	na
Share of industry in GDP (in per cent)	19.7	20.8	19.5	19.6	20.2	22.6	na
Share of agriculture in GDP (in per cent)	10.1	11.4	11.3	10.8	10.8	8.7	na
Current account/GDP (in per cent)	-9.5	-4.0	-8.4	-2.7	-0.9	-3.2	-9.7
External debt - reserves (in US\$ million)	973.9	974.2	1,180.2	951.7	545.4	544.6	na
External debt/GDP (in per cent)	43.6	39.7	38.7	39.1	37.8	36.3	na
External debt/exports of goods and services (in per cent)	120.0	105.6	97.7	89.0	80.4	70.1	na

Georgia

Key developments and challenges

The banking sector faces significant liquidity and currency risks after the conflict in August 2008, and ensuring banking sector sustainability is a major challenge. To reduce financial sector vulnerabilities, liquidity support, stronger banking supervision and careful portfolio and liquidity management by banks are required.

The authorities have made good progress with economic reforms in recent years, especially regarding the business environment. The major challenge now is to restore investor confidence, which will require continued reforms in the business environment.

As foreign private investment and financing decrease after the conflict, significant financing from official agencies is critical to maintain confidence in the currency, while large reconstruction needs will put pressure on the government's fiscal position. The monetary authorities face the challenge of supporting the currency and maintaining financial sector stability while keeping inflation under control.

Country data

Population (in millions)	4.5
Area ('000 sq km)	70.0
GDP (in billion US\$, 2007)	10.2
Average transition score (scale: 1 to 4.33)	3.07

Progress in structural reform

Liberalisation and privatisation

In April 2008 the government approved a package of new laws under a programme entitled the "Global Competitiveness of the Financial Sector", which aims to improve the country's competitiveness in the global financial markets through a number of tax reforms. The tax code was amended to allow for a gradual reduction in the rate of income tax, starting in 2009, from its current rate of 25 per cent to 15 per cent in 2012. The tax rate on dividends and interest will also be gradually eliminated and a number of tax exemptions for international financial companies will be brought in. To stimulate entrepreneurship and reduce the grey economy, the government introduced a tax deferral for the first 10 years of operations for newly registered enterprises.

Business environment and competition

Thanks to a number of measures introduced over the last year it is now easier to do business in Georgia, and the country continues to rank highly in the World Bank's *Doing Business* 2009 scores. In addition to the tax amendments (described above), electronic declaration of taxes became possible at the beginning of 2008, and recently a pilot project of risk-based customs inspections started, whereby only 15-20 per cent of all imports will be checked. Property

registration procedures have been further simplified as well. The improved business environment had attracted significant foreign direct investment (FDI) of more than US\$ 1.5 billion in 2007 and about US\$ 800 million in the first seven months of 2008.

Financial sector

The banking sector has strengthened significantly in the past two years. Progress has also been made with strengthening the regulatory framework for the financial sector. In April 2008 the newly established Financial Supervisory Agency (FSA), which will regulate all segments of the financial sector (banking, insurance and securities market), started operating. The establishment of a consolidated supervisory agency is important given the close links between banks, insurance and leasing companies. Bank lending to the private sector continued to grow by more than 70 per cent in nominal terms during 2007. The global liquidity crunch and the associated reduction in the availability of low-cost foreign funding, as well as a tightening of domestic monetary policy, have led to a slowdown in bank lending as of April 2008. Lending growth was about 40 per cent in nominal terms in the first half of 2008.

Although the banking sector has weathered the August conflict reasonably well so far, risks have increased significantly. During the conflict, banks suffered from withdrawals of dollar deposits equating to about 12 per cent of total deposits, although some small net inflows were seen subsequently. Bank lending stopped during the conflict and it remains limited. Given the still high level of dollarisation in the banking sector (more than 60 per cent of lending is in foreign currency), a possible depreciation of the currency would affect the quality of banks' portfolios as the repayment capacity of unhedged corporates and retail clients weakens. Non-performing loans may also increase because of the slowdown in economic growth due to the conflict. The National Bank of Georgia (NBG) has provided additional liquidity to the banking sector in the form of uncollateralised lending and waivers for the reserve requirement, and it has reduced its refinancing rate to ease liquidity constraints.

Despite recent high growth rates, the non-bank financial sector remains underdeveloped. The leasing sector is still very small due to a lack of funding and an inadequate legal framework. For some years only two leasing companies, owned by the two largest banks, have serviced the Georgian market. However, recently Latvian Parex Leasing started operations as well. The insurance subsector is also small, with aggregate insurance premiums amounting to only 0.7 per cent of GDP in 2007. Thirteen insurance companies operate in the market and most of them are owned by banks, which generate most of the insurance business through cross-selling insurance products on the back of their growing retail lending. The government programme of providing medical insurance for the poor and civil servants has helped to develop medical insurance, particularly in the regions. The legal and regulatory environment for the insurance sector remains weak, an area where the FSA has indicated it will concentrate its efforts during 2009.

Macroeconomic performance

After real economic growth of 12.4 per cent in 2007, growth remained strong at 8.5 per cent in the first half of 2008, supported by high inflows of FDI. On the supply side the main drivers of growth are mining, services and construction. The combination of high international food and energy prices, continuing substantial FDI flows and a high rate of fiscal spending have fuelled inflation, which reached 11 per cent at the end of 2007 and 9.8 per cent in July 2008. While the NBG will formally introduce inflation targeting only in 2009, it announced an end-year inflation target for 2008 of 8 per cent. To attain this goal, the NBG raised its main policy interest rate from 10 to 12 per cent in April 2008 while allowing the lari to appreciate in nominal terms against the US dollar by about 9.5 per cent in 2007 and 12 per cent during the first half of 2008.

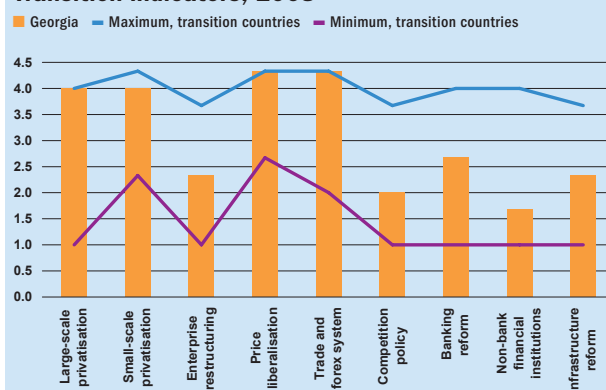
Reduced foreign inflows and foreign currency withdrawal from the banking sector put considerable pressure on the currency during the August conflict. The NBG has defended the currency, keeping the exchange rate stable at GEL 1.41 against the dollar by intervening in the interbank market. As a result, international reserves fell from US\$ 1.5 billion to US\$ 1.04 billion at end-September 2008. As external pressures on inflation started to ease in both the energy and food sectors the NBG reduced its main policy interest rate twice to 10 per cent in September. This rate reduction was designed to help the NBG to maintain financial sector stability amid the increased risk of reduced liquidity in light of the conflict. On the fiscal side, revenues have been buoyant but the government now faces significant post-conflict reconstruction needs and the prospect of lower revenue if economic growth decelerates sharply.

The current account deficit widened to a very substantial 27 per cent of GDP in the first quarter of 2008, from around 20 per cent of GDP in 2007. Despite higher exports, imports increased by 43 per cent in the first half of 2008 owing to stronger domestic demand and the higher cost of energy and food imports. Large FDI inflows and remittances from workers living abroad have largely financed the external deficit so far. The substantial international financial support of US\$ 4.5 billion pledged in October 2008 will replace the reduction in FDI after the conflict.

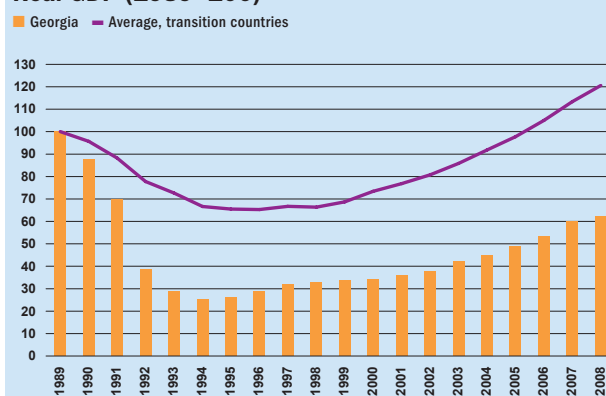
Outlook and risks

Georgia faces a period of considerable uncertainty after the August conflict. Economic growth is predicted to slow due to an expected reduction in private foreign-financed investments, a decrease in bank lending and a slowdown in post-conflict private consumption, particularly beyond 2008. Significant international financial support and remittances from workers living abroad will cover the current account deficit, which is expected to remain large due to high imports for reconstruction and donor-financed development projects. Financing from the International Monetary Fund (under a US\$ 750 million 18-month stand-by agreement signed in September 2008) and other official agencies is expected to support foreign reserves and maintain the confidence in the currency. Amidst a global financial crisis, the substantial support pledged by the international community should help to restore investor confidence and boost growth in the medium term.

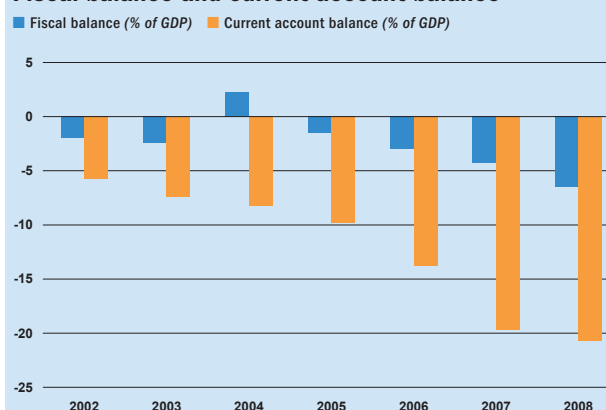
Transition indicators, 2008



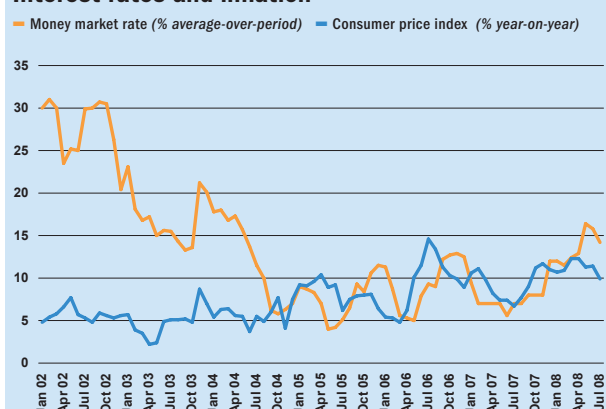
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – high	Capital adequacy ratio – 12 per cent	Share of population living in poverty – 25.3 per cent (2003)
Controls on inward direct investment – no	Secured transactions law – some defects	Independence of the electricity regulator – partial	Deposit insurance system – no	Government expenditure on health – 1.5 per cent of GDP (2007)
Interest rate liberalisation – full	Quality of corporate governance law – very low	Separation of railway infrastructure from operations – no	Quality of securities market laws – low	Government expenditure on education – 2.7 per cent of GDP (2007)
Exchange rate regime – managed float		Independence of the road directorate – partial	Private pension funds – yes	Household expenditure on power and water – 11.0 per cent
Wage regulation – no		Quality of concession laws – low		
Tradeability of land – unlimited				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	23.3	23.6	24.5	28.1	32.9	38.1	na
Private sector share in GDP (in per cent)	65.0	65.0	65.0	65.0	70.0	75.0	75.0
Private sector share in employment (in per cent)	76.8	77.3	77.9	77.7	79.0	79.0	80.0
Budgetary subsidies and current transfers (in per cent of GDP)	1.8	1.6	2.4	7.5	9.3	6.6	na
Share of industry in total employment (in per cent)	6.3	5.9	6.5	6.8	6.0	na	na
Change in labour productivity in industry (in per cent)	17.5	11.1	9.0	8.3	31.9	na	na
Investment/GDP (in per cent)	22.0	24.4	26.6	26.3	25.6	na	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.3	3.3	3.3	3.7	3.7	4.0	4.0
<i>EBRD index of enterprise reform</i>	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)	5.4	5.5	5.4	5.4	5.4	na	na
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	na	na
Share of trade with non-transition countries (in per cent)	64.5	64.0	55.4	50.3	61.5	na	na
Share of trade in GDP (in per cent)	45.5	51.6	62.7	64.9	68.8	69.5	na
Tariff revenues (in per cent of imports)	7.1	6.8	8.0	8.4	7.2	5.4	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	27 (5)	24 (6)	21 (7)	19 (10)	17 (10)	19 (14)	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) ¹	12.2	34.9	58.1	75.9	86.9	90.6	na
Non-performing loans (in per cent of total loans)	7.9	7.5	6.2	3.8	2.5	2.6	na
Domestic credit to private sector (in per cent of GDP)	8.1	8.7	9.7	14.8	19.7	27.1	na
Domestic credit to households (in per cent of GDP)	3.0	3.0	2.8	4.1	5.6	8.8	na
Of which mortgage lending (in per cent of GDP)	0.5	0.5	1.0	1.1	1.4	2.6	na
Stock market capitalisation (in per cent of GDP)	2.9	5.3	3.8	5.5	8.3	13.0	na
Stock trading volume (in per cent of market capitalisation)	4.1	0.5	11.6	13.6	18.6	4.4	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	na	na	2.0	na
<i>EBRD index of banking sector reform</i>	2.3	2.3	2.7	2.7	2.7	2.7	2.7
<i>EBRD index of reform of non-bank financial institutions</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	13.9 (10.9)	14.6 (15.6)	15.1 (18.6)	12.7 (26.3)	12.5 (38.4)	12.5 (38.4)	na
Internet users (per 100 inhabitants)	1.6	2.6	3.9	6.1	7.5	8.2	na
Railway labour productivity (1989=100)	71.9	72.6	68.6	93.4	118.4	110.9	na
Residential electricity tariffs (USc kWh)	4.1	4.1	4.2	4.9	7.5	9.8	na
Average collection rate, electricity (in per cent)	36	33	37	58	81	95	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.4	4.7	4.9	4.9	na	na	na
<i>EBRD index of infrastructure reform</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Electric power</i>	3.3	3.0	3.0	3.0	3.0	3.3	3.3
<i>Railways</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>Roads</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Telecommunications</i>	2.3	2.3	2.3	2.3	2.7	2.7	2.7
<i>Water and waste water</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0

¹ Data on bank ownership are based on the legal registration of ownership and not the beneficial ownership.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	5.5	11.1	5.9	9.6	9.4	12.4	2.0
Private consumption	3.4	3.2	7.6	0.1	29.1	9.8	na
Public consumption	5.7	4.1	64.2	27.2	-3.6	7.8	na
Gross fixed capital formation	-5.2	20.9	9.0	12.0	-0.4	14.8	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	7.8	14.0	12.2	13.0	16.2	15.0	na
Agricultural gross output	-1.4	10.3	-7.9	12.0	-9.6	6.0	na
Employment¹							
<i>(Percentage change)</i>							
Labour force (end-year)	-5.0	8.1	-4.4	0.7	-0.1	-2.8	na
Employment (end-year)	-6.8	9.6	-6.3	-0.8	0.2	-2.5	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	11.9	10.7	12.5	13.8	13.6	13.3	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	5.7	4.9	5.7	8.4	9.2	9.3	9.0
Consumer prices (end-year)	5.6	7.0	7.5	6.4	8.8	11.0	10.0
Producer prices (annual average)	6.0	2.3	3.8	7.2	9.6	10.2	na
Producer prices (end-year)	1.5	5.4	0.7	8.2	10.9	16.9	na
Gross average monthly earnings in economy (annual average)	20.5	10.4	24.5	30.2	36.1	29.5	na
Government sector²							
<i>(In per cent of GDP)</i>							
General government balance	-2.0	-2.5	2.3	-1.5	-3.0	-4.2	-6.5
General government expenditure	17.8	18.7	19.4	24.9	29.2	33.5	na
General government debt	67.4	61.5	47.0	36.6	28.9	23.4	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M3, end-year)	17.1	22.7	42.6	26.4	39.3	50.3	na
Domestic credit (end-year)	9.5	14.7	7.4	39.8	34.5	28.8	na
<i>(In per cent of GDP)</i>							
Broad money (M3, end-year)	11.6	12.4	15.2	16.4	19.3	23.5	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Money market rate	27.7	16.9	11.9	7.7	9.5	7.8	na
Treasury bill rate (3-month maturity) ³	43.4	44.3	19.2	na	na	na	na
Deposit rate (3-month) ⁴	9.8	9.3	7.2	7.6	11.4	9.5	na
Lending rate (3-month)	31.8	32.3	31.2	21.6	18.8	20.4	na
<i>(Laris per US dollar)</i>							
Exchange rate (end-year)	2.1	2.1	1.8	1.8	1.7	1.6	na
Exchange rate (annual average)	2.2	2.1	1.9	1.8	1.8	1.7	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-196.0	-294.0	-430.0	-628.0	-1,069.0	-2,005.8	-2,575.4
Trade balance	-439.0	-598.0	-719.0	-1,214.0	-2,019.0	-2,895.7	-3,325.4
Merchandise exports	553.0	730.0	1,272.0	1,472.0	1,667.0	2,088.3	2,506.0
Merchandise imports	992.0	1,328.0	1,991.0	2,686.0	3,686.0	4,984.0	5,831.3
Foreign direct investment, net	122.0	335.0	420.0	529.0	1,115.0	1,535.5	1,227.0
Gross reserves, excluding gold (end-year)	197.7	190.9	383.0	473.9	881.0	1,617.0	na
External debt stock	1,858.0	1,954.0	2,039.0	2,137.0	2,000.0	2,080.0	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	1.6	1.3	1.8	1.8	2.5	3.5	na
<i>(In per cent of current account revenues, excluding transfers)</i>							
Debt service	7.4	10.0	10.2	5.6	5.6	4.6	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	4.6	4.6	4.5	4.5	4.5	4.5	na
GDP (in millions of laris)	7,456.0	8,565.0	9,969.8	11,621.0	13,789.9	16,998.6	18,826.2
GDP per capita (in US dollars)	741.0	877.0	1,155.9	1,419.5	1,722.2	2,251.3	na
Share of industry in GDP (in per cent)	17.6	17.7	16.1	15.7	14.9	13.8	na
Share of agriculture in GDP (in per cent)	19.3	19.3	16.4	14.8	11.3	10.9	na
Current account/GDP (in per cent)	-5.8	-7.4	-8.3	-9.8	-13.7	-19.7	-20.6
External debt - reserves (in US\$ million)	1,660.3	1,763.1	1,656.0	1,663.1	1,119.0	463.0	na
External debt/GDP (in per cent)	54.7	49.0	39.2	33.3	25.7	20.4	na
External debt/exports of goods and services (in per cent)	167.2	151.7	111.4	106.9	77.8	70.3	na

¹ Figures consistent with ILO methodology.³ Data relate to the average auction rates during the year.² General government includes the state, municipalities and extra-budgetary funds.⁴ Data refer to average rates for local currency from the IMF's statistics.

Hungary

Key developments and challenges

For the country to achieve long-term growth it is essential to stimulate private sector growth and investment, strengthen incentives for labour market participation and improve the effectiveness of government spending on education and innovation.

The electricity market has been liberalised and the competition issues surrounding the incumbent power company are being addressed. To ensure efficient energy markets, further measures will be necessary to improve competition in the field of transmission.

To maintain investor confidence it is crucial to complete fiscal consolidation according to plan, focusing on reducing public expenditure in order to lower the tax burden, thus contributing to an improved business environment.

Country data

Population (in millions)	10.1
Area ('000 sq km)	93.0
GDP (in billion US\$, 2007)	138.4
Average transition score (scale: 1 to 4.33)	3.96

Progress in structural reform

Business environment and competition

Progress in structural reform over the past year has been dominated by fiscal reform and a successful reduction of the excessive budget deficit. Despite the recent focus on tax increases in an environment of already high taxes, the investment climate in Hungary remains competitive. Administrative corruption is still a common problem but both petty and high-level corruption remain low by transition country standards, and Hungary has steadily risen up the rankings on Transparency International's Corruption Perceptions Index. In the World Bank's *Doing Business 2009* survey, Hungary ranked 41st globally for the ease of doing business and scored highly for the ease of starting a business, obtaining credit and enforcing contracts.

In June 2008 Daimler announced that it had chosen the Hungarian city of Kecskemét as the location for its first car manufacturing plant in central and eastern Europe. The investment amounts to €800 million, the largest single amount of foreign direct investment (FDI) in Hungary to date. The plant is expected to begin production in 2011, manufacturing around 100,000 cars a year and providing employment for about 2,500 people. The quality of Hungary's transport infrastructure, distance to consumers and the availability of labour were among the deciding factors in Daimler's choice of location.

Infrastructure

As of the start of 2008 the electricity market was fully liberalised. The new Electricity Act sets out to raise the competitiveness of the economy by establishing full competition while guaranteeing long-term security of supply. However, nothing was done to reduce the dominant position of the incumbent state-owned power company MVM, including its long-term power purchase agreements – which allow it exclusive rights to buy over 70 per cent of electricity output – and its ownership of the power grid. The European Commission in June 2008 requested that Hungary eliminate these agreements as they constitute incompatible state aid to the power generators. In addition, aid granted to generators since Hungary's accession to the European Union should be recovered. The government has announced that it will terminate the long-term power purchase agreements by the end of 2008, thereby hoping also to moderate energy price pressures. In September 2008, the government proposed the privatisation of the system operator Mavir, splitting it off from MVM.

As of February 2008 households have also been able to choose their gas supplier. However, the benefits for small consumers will be felt only gradually as there are few alternative supplies to Russian gas, while EON retains a dominant position in the wholesale market. Moreover, prices are likely to rise in the future due to cuts in state subsidies.

Financial sector

The privatisation of the banking sector is almost complete and the ratio of domestic credit to the private sector to the country's GDP is high by regional standards. However, the banking sector has yet to develop more innovative financial instruments. In the first quarter of 2008 outstanding balances of residential mortgage-backed securities amounted to only €0.1 billion and there was no issuance of structured finance products in 2007. Securitisation has been slow to take off, partly because the banking sector is dominated by foreign banks that have traditionally focused on providing cheap funding to their subsidiaries. Foreign-currency lending has become increasingly common in recent years owing to high forint interest rates and has been used mainly for house purchases, as well as consumption.

In the non-banking sector, the insurance and pension sectors have continued to grow. At the end of 2007 the total portfolios of private and voluntary pension funds had a combined market value of HUF 2,763 billion (around €11 billion). The total capitalisation of the Budapest Stock Exchange (BSE) was €32.5 billion at the end of 2007 (32.4 per cent of GDP), but few companies use it to raise capital. At the end of July 2008 there were only 41 domestic and three foreign companies with listed shares. Finally, Hungary has one of the most developed private equity fund sectors among the transition countries. According to the Hungarian Venture Capital Association, 26 venture capital and private equity investments were made in enterprises in Hungary in 2007 for a value of €491 million, down from €734 million in 2006. The importance of private domestic investors is increasing, even though government agencies and banks (mainly the Hungarian Development Bank) remain the dominant players.

Macroeconomic performance

Real GDP grew by only 1.1 per cent in 2007, but gained momentum in the first half of the year supported by recovering domestic demand. Weak economic activity in 2007 mainly reflected the substantial dampening impact of the fiscal consolidation introduced in mid-2006. Real disposable incomes were negatively affected by higher direct and indirect taxes as well as rising inflation, but household consumption was supported by consumers drawing on savings and loans. However, export growth remained robust and supported overall GDP growth. Despite weak economic activity the labour market remained tight, with strong demand for highly skilled labour.

Over the past year inflation has been affected by higher food and energy prices as well as rising unit labour costs – the result of a slowdown in productivity and a gradual increase in wages. CPI inflation rose by 6.7 per cent in the year to July 2008. In response, the National Bank of Hungary (NBH) increased interest rates by 100 basis points since April 2008, to 8.5 per cent. Moreover, in March 2008 the NBH abandoned the flexible peg of the forint to the euro, thereby allowing monetary policy to focus solely on inflation. In the months to July, and in common with other currencies in the region, the forint appreciated strongly, raising some concerns over competitiveness. Since then, the currency has depreciated again as turbulence hit financial markets.

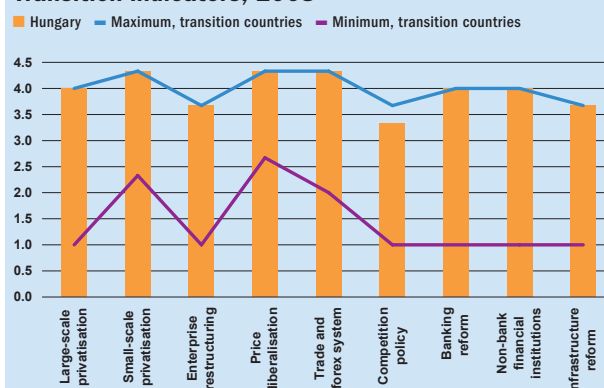
The general government deficit declined to 5.5 per cent of GDP in 2007, below the initial target. Substantial efforts with tax reform have yielded results in terms of improving revenues while spending controls have improved. For 2008 the deficit is currently on track to stay within the budget target of 3.4 per cent of GDP. These developments have stabilised the government debt-to-GDP ratio with the prospect of some decrease in the ratio over the medium term.

The current account deficit fell to 6.4 per cent of GDP in 2007, as the trade balance recorded a surplus for the first time since the start of transition. Net FDI inflows slowed in 2007 to US\$ 2.2 billion, reflecting transitory factors linked to the change of ownership of Budapest Airport, but also continued strong investment abroad by Hungarian companies.

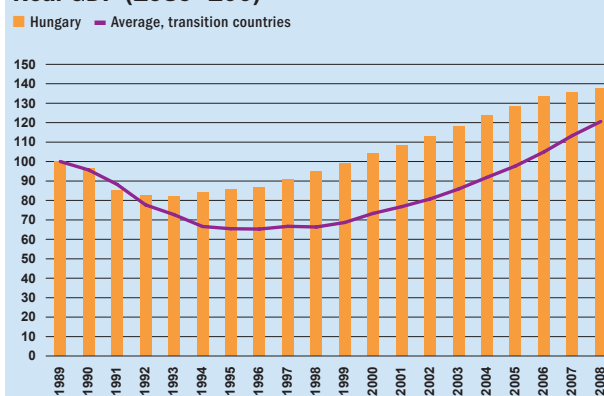
Outlook and risks

The economic situation in Hungary has worsened as the effects of the external financial turmoil have begun to be felt. The authorities have taken measures to ensure financial stability and a joint IMF, EU and World Bank financing package of US\$ 25.1 billion is being put in place, focusing on fiscal sustainability and the financial sector. In addition, inflation remains a key challenge and its reduction to the medium-term target level of 3 per cent will be crucial. With the weakening external environment, these policy measures are expected to dampen growth in 2009. In the longer term, the government will also need to address challenges to growth, for example by strengthening incentives for labour market participation and increasing the efficiency of the public sector. Reducing the relatively high levels of both external and government debt will be of key importance in order to reduce vulnerability and increase the confidence of foreign investors.

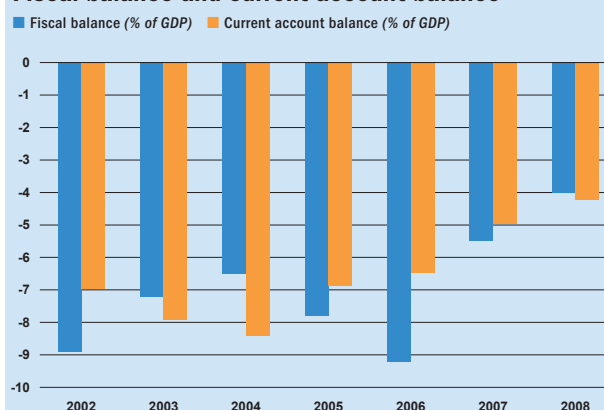
Transition indicators, 2008



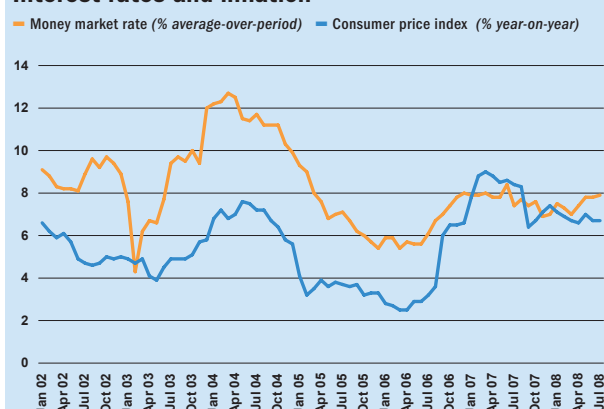
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – full	Capital adequacy ratio – 8 per cent	Share of population living in poverty – <2.0 per cent (2005)
Controls on inward direct investment – no	Secured transactions law – advanced	Independence of the electricity regulator – full	Deposit insurance system – yes	Government expenditure on health – 5.5 per cent of GDP (2005)
Interest rate liberalisation – full	Quality of corporate governance law – high	Separation of railway infrastructure from operations – full	Quality of securities market laws – high	Government expenditure on education – 5.8 per cent of GDP (2005)
Exchange rate regime – floating		Independence of the road directorate – full	Private pension funds – yes	Household expenditure on power and water – 10.9 per cent
Wage regulation – no		Quality of concession laws – medium		
Tradeability of land – full except foreigners				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	30.7	31.5	33.5	34.2	35.3	na	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)	79.3	79.1	79.1	79.3	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	2.5	2.4	3.7	2.3	na	na	na
Share of industry in total employment (in per cent)	34.1	33.3	32.8	32.4	32.3	32.6	na
Change in labour productivity in industry (in per cent)	4.1	5.2	5.8	4.9	4.5	2.5	na
Investment/GDP (in per cent)	22.9	21.9	22.4	22.7	21.9	na	na
<i>EBRD index of small-scale privatisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of large-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of enterprise reform</i>	3.3	3.3	3.3	3.7	3.7	3.7	3.7
Markets and trade							
Share of administered prices in CPI (in per cent)	16.4	15.9	16.0	15.4	14.8	15.1	na
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	1.0	1.0	na
Share of trade with non-transition countries (in per cent)	84.5	84.0	83.1	78.2	74.8	73.5	na
Share of trade in GDP (in per cent)	107.2	105.2	111.8	116.5	132.0	134.7	na
Tariff revenues (in per cent of imports)	1.4	1.3	0.3	0.1	na	na	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	3.0	3.0	3.3	3.3	3.3	3.3	3.3
Financial sector							
Number of banks (foreign-owned)	38 (28)	38 (29)	38 (27)	38 (27)	40 (28)	40 (27)	na
Asset share of state-owned banks (in per cent)	10.7	7.4	6.6	7.0	7.4	3.7	na
Asset share of foreign-owned banks (in per cent)	85.0	83.5	63.0	82.6	82.9	64.2	na
Non-performing loans (in per cent of total loans)	4.9	3.8	3.7	3.1	3.0	2.8	na
Domestic credit to private sector (in per cent of GDP)	33.6	41.0	44.7	49.8	54.0	59.2	na
Domestic credit to households (in per cent of GDP)	7.4	10.9	12.8	15.6	18.5	21.7	na
Of which mortgage lending (in per cent of GDP)	4.1	8.0	9.5	11.5	13.9	16.4	na
Stock market capitalisation (in per cent of GDP)	17.2	18.3	25.0	31.6	33.8	32.4	na
Stock trading volume (in per cent of market capitalisation)	44.4	46.5	57.6	78.0	83.7	106.0	na
Eurobond issuance (in per cent of GDP)	0.0	0.5	4.2	6.1	6.0	2.7	na
<i>EBRD index of banking sector reform</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of reform of non-bank financial institutions</i>	3.7	3.7	3.7	4.0	4.0	4.0	4.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	36.2 (67.9)	35.6 (78.5)	35.3 (86.4)	33.8 (92.3)	33.4 (99.0)	32.4 (110.0)	na
Internet users (per 100 inhabitants)	15.8	23.7	26.7	29.7	34.8	41.9	na
Railway labour productivity (1989=100)	130.3	133.9	145.1	160.8	177.5	173.2	na
Residential electricity tariffs (USc kWh)	8.7	11.4	13.5	14.8	14.4	18.8	na
Average collection rate, electricity (in per cent)	90	99	99	99	99	99	na
GDP per unit of energy use (PPP in US dollars per kgoe)	5.4	5.6	6.1	6.2	na	na	na
<i>EBRD index of infrastructure reform</i>	3.7	3.7	3.7	3.7	3.7	3.7	3.7
<i>Electric power</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>Railways</i>	3.3	3.3	3.3	3.3	3.3	3.7	3.7
<i>Roads</i>	3.3	3.3	3.3	3.7	3.7	3.7	3.7
<i>Telecommunications</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>Water and waste water</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0

Macroeconomic indicators	2002	2003	2004	2005	2006	2007 <i>Estimate</i>	2008 <i>Projection</i>
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	4.1	4.2	4.8	4.0	4.1	1.1	1.7
Private consumption	10.6	8.3	2.5	3.4	1.9	0.7	na
Public consumption	5.8	5.3	1.8	2.4	4.3	-7.4	na
Gross fixed capital formation	9.8	2.2	7.9	8.5	-6.2	1.5	na
Exports of goods and services	3.9	6.2	15.0	11.3	18.6	15.9	na
Imports of goods and services	6.8	9.3	13.7	7.0	14.8	13.1	na
Industrial gross output	3.6	4.1	3.7	3.6	4.9	3.4	na
Agricultural gross output	-9.8	0.0	53.4	-1.4	-7.0	-13.3	na
Employment	<i>(Percentage change)</i>						
Labour force (annual average)	0.2	1.4	0.1	0.8	1.0	-0.2	na
Employment (annual average) ¹	0.1	1.3	-0.6	0.0	0.7	-0.1	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	5.8	5.9	6.1	7.2	7.5	7.4	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)	5.3	4.7	6.8	3.6	3.9	8.0	6.3
Consumer prices (end-year)	4.8	5.7	5.5	3.3	6.6	7.4	4.9
Producer prices (annual average)	-1.8	2.4	3.5	4.3	6.5	0.2	na
Producer prices (end-year)	-1.3	6.2	1.6	4.5	4.5	1.6	na
Gross average monthly earnings in economy (annual average)	18.3	12.0	6.1	8.8	8.2	8.0	na
Government sector	<i>(In per cent of GDP)</i>						
General government balance ²	-8.9	-7.2	-6.5	-7.8	-9.2	-5.5	-3.4
General government expenditure	51.3	49.1	48.9	50.0	51.8	50.1	na
General government debt	55.7	58.0	59.4	61.6	65.5	65.9	na
Monetary sector	<i>(Percentage change)</i>						
Broad money (M2, end-year)	13.8	13.6	9.9	13.0	11.8	8.6	na
Domestic credit (end-year)	15.3	19.8	11.9	23.4	15.9	10.9	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	43.9	45.3	45.5	48.3	50.1	50.9	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>						
Refinance rate	8.5	12.5	9.5	6.0	8.0	7.5	na
Interbank interest rate (up to 30-day maturity)	8.9	12.2	9.7	6.1	8.1	na	na
Deposit rate weighted average (fixed for less than 1 year)	7.4	8.7	9.1	5.2	7.4	6.8	na
Lending rate weighted average (maturing within 1 year)	9.7	11.2	11.0	7.4	9.2	8.8	na
	<i>(Forints per US dollar)</i>						
Exchange rate (end-year)	225.2	207.9	180.3	213.6	191.6	172.6	na
Exchange rate (annual average)	257.9	224.3	202.7	199.6	210.4	183.6	na
External sector	<i>(In millions of US dollars)</i>						
Current account	-4,643.2	-6,697.8	-8,791.0	-8,417.8	-8,533.5	-8,895.3	-9,600.0
Trade balance	-2,075.6	-3,271.0	-3,555.0	-2,796.0	-2,576.0	435.0	1,600.0
Merchandise exports	34,684.1	42,794.0	55,280.0	62,827.0	73,321.0	93,434.0	109,800.0
Merchandise imports	36,759.7	46,065.0	58,835.0	65,623.0	75,897.0	92,999.0	108,200.0
Foreign direct investment, net	2,721.8	478.8	3,404.8	5,586.3	3,639.7	2,197.2	2,200.0
Gross reserves, excluding gold (end-year)	10,359.0	12,748.7	15,920.0	18,552.3	21,526.0	23,968.0	na
External debt stock	36,883.2	53,767.5	70,871.9	86,013.8	104,572.8	136,872.3	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	2.9	2.8	2.8	2.9	2.9	2.6	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service ³	13.7	14.2	15.5	16.1	13.1	12.9	na
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million)	10.2	10.1	10.1	10.1	10.1	10.1	na
GDP (in billions of forints)	17,180.6	18,940.7	20,718.1	22,042.5	23,795.3	25,405.8	27,411.5
GDP per capita (in US dollars)	6,547.6	8,325.6	10,100.9	10,937.6	11,224.1	13,759.0	na
Share of industry in GDP (in per cent)	26.1	26.7	26.5	26.6	23.0	21.7	na
Share of agriculture in GDP (in per cent)	4.4	4.2	6.1	5.8	5.4	3.6	na
Current account/GDP (in per cent)	-7.0	-7.9	-8.6	-7.6	-7.5	-6.4	-5.7
External debt - reserves (in US\$ million)	26,524.1	41,018.7	54,951.8	67,461.5	83,046.8	112,904.3	na
External debt/GDP (in per cent)	55.4	63.7	69.4	77.9	92.5	98.9	na
External debt/exports of goods and services (in per cent)	87.7	103.5	107.3	113.3	120.7	123.9	na

¹ Data from labour force surveys.³ Excluding inter-company loans.² Data are based on Eurostat methodology (ESA95), excluding part of the cost of pension reform.

Kazakhstan

Key developments and challenges

The government is preparing a simplified tax code with lower rates, a broader tax base and a shift in the burden towards the mineral resources sector. If implemented effectively, the code could enhance private sector development and economic diversification.

The further development of the railway network is crucial to economic diversification. It is important that railway and other infrastructure projects are based on sound financial principles and that only profitable lines or businesses are developed under a public-private partnership (PPP) scheme. Cargo transportation would benefit most – in terms of wider availability of cars at a lower cost – if the railway market were opened to private operators.

Given banks' reduced access to foreign borrowing, the monetary authorities should continue to give priority to maintaining financial stability. This involves keeping the exchange rate stable and providing banks with enough liquidity, while gradually reducing inflation.

Country data

Population (in millions)	15.0
Area ('000 sq km)	2,728.0
GDP (in billion US\$, 2007)	103.8
Average transition score (scale: 1 to 4.33)	3.00

Progress in structural reform

Business environment and competition

The government is intervening more in the mineral resources sector. A new Memorandum of Understanding on the Kashagan oilfield was prepared that stipulates that the state-owned oil company, KazMunayGas, will raise its stake to 16.8 per cent from its current 8.3 per cent. The operating company Eni will be replaced by another operating company or consortium after the start of commercial production, which is now expected around 2013.

In July 2008 KazMunayGas purchased 51 per cent of MangistauMunaiGas (MMG) from Indonesian Central Asia Petroleum. This gives the government influence over domestic gas prices as MMG not only owns the Pavlodar petrochemical plant – Kazakhstan's largest oil refinery – but also the network of "Helios" petrol stations. In June 2008 the Kazakh government also bought a stake in a mining and metals company, Kazakhmys, by transferring a 7.7 per cent stake in natural resources group Eurasian Natural Resources Corporation (ENRC) to Kazakhmys in return for 15 per cent of the latter's shares. In August, Kazakhmys increased its share in ENRC to 25.02 per cent. The government is now a shareholder in two of the country's most important mining companies.

A new tax code will be adopted in January 2009, which will include a reduced corporate income tax, a flat rate for social taxes and a mineral resources extraction tax (from which oil companies operating under production sharing agreements

will be exempt). In anticipation of the new mineral resources tax, the government introduced a crude oil export duty of US\$ 15 per barrel in May 2008. Initially it was announced that major oil companies with existing contracts that include a "stable tax regime" clause would be exempt. However, in July 2008 it became clear that some of the large consortia, including the one operating the Karachaganak field, would have to pay the oil export duty as well.

Infrastructure

The government recently revealed a US\$ 7.5 billion railway modernisation plan that consists of 12 large-scale projects, including the construction of new railway lines and the electrification of existing ones. Nine projects will be on a concession basis. The plan also focuses on improving corporate governance within Kazakhstan Temir Zholy (KTZ, the state-owned railway carrier), which is important for fighting corruption within the KTZ group. In early 2008, KTZ raised its tariffs by around 10 per cent. KTZ enjoys a monopoly, which is reflected particularly in the cargo sector where there is insufficient supply of railway services at relatively high prices. There is a substantial difference between tariffs for cargo and passenger transport, with the relatively low passenger transportation tariffs being cross-subsidised by the more profitable cargo transportation. Nevertheless, the tariff increase is a first step in allowing KTZ to start investing more in its freight transportation capacity and the quality of its assets.

In the summer of 2007, parliament approved amendments to the concession law, which removed some important imperfections of the 2006 legislation. The new law introduced a more transparent process for selecting concessionaries and set clearer responsibilities for the state bodies involved. The challenges are to implement the new procedures, to develop know-how and institutional capacity to handle the complexities of concessions, and to ensure that concessions are structured in a sustainable manner.

Financial sector

The international liquidity crunch reduced Kazakh banks' access to foreign borrowing. Aggregate bank lending decreased by 0.2 per cent during the first five months of 2008 and this negatively affected the real economy, in particular small and medium-sized manufacturing firms and the property sector. Construction of residential property virtually stopped as construction companies experienced liquidity shortages and potential buyers could no longer access mortgage financing. Residential property prices in some of the larger cities have fallen by around 30–40 per cent since they peaked in May 2007. The proportion of bank loans that are classified as non-performing increased over the last year and the banking sector remains characterised by substantial currency mismatches.

Kazakh banks have become more attractive takeover targets for foreign strategic investors. After the takeover of ATF Bank by Italian UniCredit in 2007, Korean Kookmin Bank decided to gradually acquire majority control in Kazakhstan's sixth largest bank, Bank CenterCredit, in 2008. Abu Dhabi-based private equity firm Alnair Capital raised its stake in KazKommertsBank (KKB), while Austrian Raiffeisen Bank announced that it would open a greenfield subsidiary. Over the past year there has been only very slow progress in introducing the long overdue anti-money-laundering law, which has still not been passed by parliament.

Macroeconomic performance

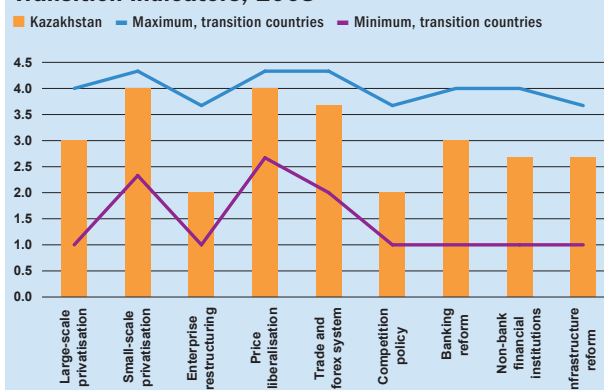
After five years of strong economic growth, averaging 9.7 per cent a year, growth is expected to slow sharply to 4.3 per cent in 2008. The reduced availability of bank credit constrained growth in the non-oil sector, in particular that of small and medium-sized enterprises (SMEs). During the first seven months of 2008 industrial production grew by only 3.3 per cent compared with 5.6 per cent in the same period of 2007, and manufacturing output fell by 0.9 per cent. Large-scale government support for the construction sector, SMEs and agribusiness has somewhat softened the impact of the credit crunch. High commodity prices and increasing mining and oil production have also prevented a sharper downturn. The reduced availability of consumer credit has curtailed import growth as well. Together with the relatively high oil prices that prevailed until recently, this has led to a rapid increase in the trade surplus and the first current account surplus in four years (projected at 3.8 per cent of GDP for 2008 as a whole).

On 1 December 2007 the National Bank of Kazakhstan (NBK) raised its refinancing rate to 11 per cent from 9 per cent in order to slow inflation. Prices nevertheless continued to increase sharply and inflation reached 20 per cent in the year to August 2008. Price increases have been driven by: higher prices for sunflower oil, wheat and bread; tariff increases for electricity, water and gas; and the delayed effect of high money growth in the first half of 2007. Inflation is expected to decline gradually to just above 11 per cent by December 2008, mainly reflecting a sharp reduction in liquidity and credit growth. Given this outlook, the NBK even lowered its refinancing rate as of July 2008 to 10.5 per cent and reduced banks' reserve requirements by one percentage point, both in an effort to revitalise the ailing banking system and to stimulate a recovery in the non-oil economy.

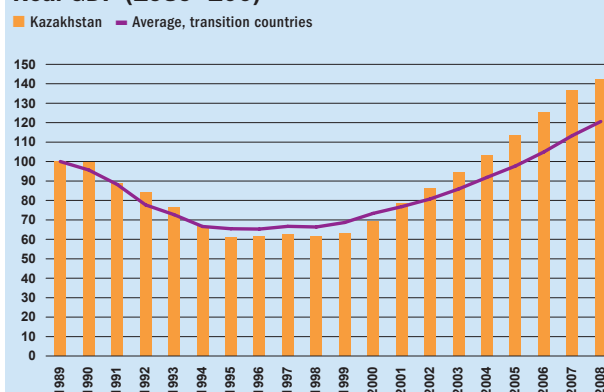
Outlook and risks

In the short term, a relatively sharp downward growth adjustment is inevitable in 2008 and 2009 as the paralysis in parts of the construction sector and related difficulties in the banking system need to be resolved. The stability of the banking sector also depends on the ability of the central bank to maintain stability of the exchange rate, which has effectively been pegged to the US dollar since October 2007. To date, outflows of foreign exchange due to lower than expected debt repayments by commercial banks and profit repatriation by oil companies have so far been compensated by higher than expected oil-related earnings. However, this also shows that the economic fate of Kazakhstan remains dependent on oil price developments in the short-to-medium term. Longer-term prospects for Kazakhstan remain good. The large Kashagan oilfield is expected to start production in 2013 and there is potential for expanding uranium, copper and grain production.

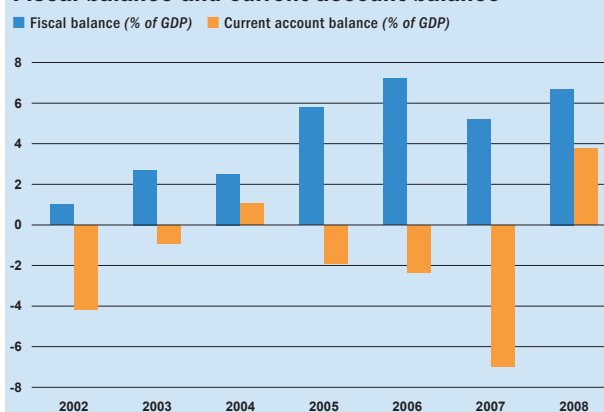
Transition indicators, 2008



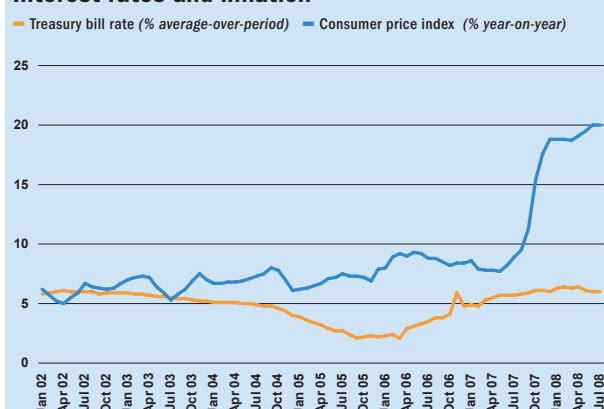
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – low	Capital adequacy ratio – 12 per cent	Share of population living in poverty – 16.0 per cent (2003)
Controls on inward direct investment – yes	Secured transactions law – some defects	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 2.2 per cent of GDP (2006)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – full	Quality of securities market laws – medium	Government expenditure on education – 3.2 per cent of GDP (2006)
Exchange rate regime – de facto pegged to US dollar		Independence of the road directorate – no	Private pension funds – yes	Household expenditure on power and water – 3.7 per cent
Wage regulation – no		Quality of concession laws – medium		
Tradeability of land – full except foreigners ¹				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	27.6	28.9	29.0	29.2	29.7	30.1	na
Private sector share in GDP (in per cent)	65.0	65.0	65.0	65.0	65.0	70.0	70.0
Private sector share in employment (in per cent)	75.0	75.4	75.3	75.5	77.0	78.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.1	0.1	0.1	na	na	na	na
Share of industry in total employment (in per cent)	12.3	12.2	12.1	12.3	12.9	12.8	na
Change in labour productivity in industry (in per cent)	11.4	5.1	8.6	7.6	3.8	0.6	na
Investment/GDP (in per cent)	27.3	25.7	26.3	31.0	32.8	32.1	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>EBRD index of enterprise reform</i>	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	na	na
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	na
Share of trade with non-transition countries (in per cent)	61.8	65.5	65.3	64.7	65.0	66.5	na
Share of trade in GDP (in per cent)	73.3	73.9	79.8	81.0	77.6	78.5	na
Tariff revenues (in per cent of imports) ²	3.1	3.0	2.7	2.6	3.6	3.7	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	3.3	3.3	3.7	3.7	3.7	3.7	3.7
<i>EBRD index of competition policy</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	38 (17)	36 (16)	35 (15)	34 (14)	33 (14)	35 (18)	na
Asset share of state-owned banks (in per cent)	5.2	5.1	3.7	0.2	0.2	0.2	na
Asset share of foreign-owned banks (in per cent)	34.3	56.9	5.5	7.3	5.4	38.5	na
Non-performing loans (in per cent of total loans) ³	4.1	3.9	4.2	3.3	2.4	2.7	na
Domestic credit to private sector (in per cent of GDP)	18.6	21.9	26.5	35.7	47.8	59.4	na
Domestic credit to households (in per cent of GDP) ⁴	1.6	2.6	5.2	9.0	15.8	20.3	na
Of which mortgage lending (in per cent of GDP) ⁵	0.2	0.6	1.7	3.0	4.1	na	na
Stock market capitalisation (in per cent of GDP)	5.5	7.7	8.7	18.6	54.3	39.2	na
Stock trading volume (in per cent of market capitalisation)	26.5	22.0	30.3	14.9	14.7	20.9	na
Eurobond issuance (in per cent of GDP)	1.3	1.7	8.1	4.9	9.7	7.9	na
<i>EBRD index of banking sector reform</i>	2.7	3.0	3.0	3.0	3.0	3.0	3.0
<i>EBRD index of reform of non-bank financial institutions</i>	2.3	2.3	2.3	2.3	2.7	2.7	2.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	14.0 (6.9)	15.0 (9.0)	17.2 (16.5)	18.3 (36.4)	19.8 (52.9)	21.0 (81.6)	na
Internet users (per 100 inhabitants)	1.7	2.0	2.7	4.1	8.7	12.3	na
Railway labour productivity (1989=100)	51.0	58.5	62.6	101.7	119.2	83.6	na
Residential electricity tariffs (USc kWh) ⁶	2.5	2.8	3.1	3.1	3.7	4.9	na
Average collection rate, electricity (in per cent)	92	na	na	na	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.2	2.3	2.4	2.5	na	na	na
<i>EBRD index of infrastructure reform</i>	2.3	2.3	2.3	2.3	2.7	2.7	2.7
<i>Electric power</i>	3.0	3.0	3.3	3.3	3.3	3.3	3.3
<i>Railways</i>	2.7	2.7	2.7	3.0	3.0	3.0	3.0
<i>Roads</i>	2.0	2.0	2.0	2.0	2.0	2.3	2.3
<i>Telecommunications</i>	2.3	2.3	2.7	2.7	3.0	3.0	3.0
<i>Water and waste water</i>	1.7	1.7	2.0	2.0	2.0	2.0	2.0

¹ Ownership of agricultural land is limited to residents of Kazakhstan and legal entities established under Kazakh law, including those that are fully or partially owned by foreign persons.

² Refers to taxes on international trade.

³ The series has been revised.

⁴ National Bank of Kazakhstan, Statistical Bulletin.

⁵ Data sources are Agency of the Republic of Kazakhstan for Regulation and Supervision of Financial Market and Financial Organisation and Kazakhstan Mortgage Company, and includes loans from non-bank financial institutions.

⁶ Tariffs are given end-of-year.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	9.8	9.3	9.6	9.7	10.7	8.9	4.3
Private consumption	2.7	11.8	13.9	11.4	14.3	14.0	na
Public consumption	-7.5	8.9	10.6	11.8	18.0	18.5	na
Gross fixed capital formation	10.0	8.0	22.5	11.9	24.0	18.6	na
Exports of goods and services	16.6	7.5	10.9	1.4	7.1	5.4	na
Imports of goods and services	3.1	-7.6	14.8	13.3	13.7	14.5	na
Industrial gross output	10.5	9.1	10.4	10.3	11.1	3.0	na
Agricultural gross output	3.4	2.1	-0.3	7.3	6.0	8.8	na
Employment¹							
<i>(Percentage change)</i>							
Labour force (end-year)	-1.1	3.5	2.4	0.8	1.6	2.5	na
Employment (end-year)	0.2	4.1	2.8	1.1	2.0	3.1	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	9.3	8.8	8.4	8.1	7.8	7.3	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	5.9	6.4	6.9	7.6	8.6	10.8	17.5
Consumer prices (end-year)	6.6	6.8	6.7	7.5	8.4	18.8	11.3
Producer prices (annual average)	0.3	9.3	16.9	23.7	18.4	12.4	na
Producer prices (end-year)	11.9	5.9	23.8	20.3	14.6	31.9	na
Gross average monthly earnings in economy (annual average)	17.5	13.8	22.5	20.3	20.4	28.9	na
Government sector²							
<i>(In per cent of GDP)</i>							
General government balance ³	1.0	2.7	2.5	5.8	7.2	5.2	6.7
General government expenditure ⁴	21.0	22.3	22.7	22.3	20.2	24.4	na
General government debt	15.6	15.0	11.4	8.1	6.7	5.9	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	30.1	34.2	68.2	26.3	78.1	25.9	na
Domestic credit (end-year)	30.2	38.1	81.1	52.3	76.5	58.8	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	19.2	21.1	27.8	27.2	36.0	36.4	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Refinancing rate	7.5	7.0	7.0	8.0	9.0	11.0	na
Treasury bill rate (3-month maturity) ⁵	5.2	5.9	3.3	3.3	3.3	7.0	na
Deposit rate ⁶	11.0	10.9	9.3	9.1	9.8	11.1	na
Lending rate ⁷	14.1	14.9	13.7	13.0	12.2	14.8	na
<i>(Tenges per US dollar)</i>							
Exchange rate (end-year)	155.6	144.2	130.0	134.0	127.0	120.7	na
Exchange rate (annual average)	153.3	149.6	136.0	132.9	126.1	122.6	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-1,024.3	-272.6	454.9	-1,086.2	-1,875.2	-7,249.0	5,400.0
Trade balance ⁸	1,987.1	3,679.0	6,785.4	10,321.8	14,642.0	15,141.0	32,700.0
Merchandise exports	10,026.9	13,232.6	20,603.1	28,300.6	38,762.0	48,349.0	68,500.0
Merchandise imports	8,039.8	9,553.6	13,817.7	17,978.8	24,120.0	33,208.0	35,800.0
Foreign direct investment, net	2,163.8	2,213.4	5,436.0	2,123.0	6,630.0	7,100.0	3,400.0
Gross reserves, excluding gold (end-year)	2,555.3	4,962.0	9,277.0	7,070.0	19,100.0	17,600.0	na
External debt stock ⁹	18,251.0	22,920.6	32,946.0	43,430.0	74,000.0	96,400.0	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year) ¹⁰	2.6	4.5	5.9	3.3	7.0	4.7	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	35.4	35.2	36.2	37.1	32.3	33.2	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	14.9	15.0	15.1	15.1	15.1	15.1	na
GDP (in billions of tenges)	3,776.3	4,612.0	5,870.1	7,591.0	10,214.0	12,726.0	17,439.0
GDP per capita (in US dollars)	1,657.2	2,062.3	2,862.5	3,783.2	5,362.9	6,867.3	na
Share of industry in GDP (in per cent)	25.3	25.3	25.4	24.2	23.4	22.4	na
Share of agriculture in GDP (in per cent)	9.5	8.8	8.1	7.9	7.6	7.6	na
Current account/GDP (in per cent)	-4.2	-0.9	1.1	-1.9	-2.3	-7.0	3.8
External debt - reserves (in US\$ million)	15,695.7	17,958.6	23,669.0	36,360.0	54,900.0	78,800.0	na
External debt/GDP (in per cent)	74.1	74.3	76.3	76.0	91.4	92.8	na
External debt/exports of goods and services (in per cent)	157.8	153.4	145.8	142.3	178.0	185.7	na

¹ 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 Oil Fund. Balance excludes privatisation revenues.⁴ Expenditures include extra-budgetary funds.⁵ Average effective yield of short-term National Bank of Kazakhstan notes.⁶ Deposit rate refers to the weighted average of interest rates on time deposits of individuals, in tenge by maturity.⁷ Lending rate refers to weighted average of interest rates on credits extended to legal entities, excluding banks, in tenge by maturity.⁸ Exports at declared customs prices. They are not corrected for under-invoicing of oil and gas exports.⁹ Includes inter-company debt by branches of non-resident foreign enterprises and short-term debt.¹⁰ Excludes National Oil Fund.

Kyrgyz Republic

Key developments and challenges

The business environment has improved due to administrative changes such as the establishment of a “one-stop shop” for registering new enterprises and a streamlined building permit procedure. However, much more effort is needed to tackle high-level corruption and to strengthen the judiciary.

Increased utility tariffs have contributed to an environment that is more conducive to private sector investment in the electricity and heat sectors. Nevertheless, to ensure that large-scale hydropower projects materialise and to secure reliable gas supplies during the winter, better regional cooperation remains important.

The rate of inflation has surged this year to one of the highest levels in the region. An appropriate fiscal and monetary policy mix is needed to bring down inflation, while providing sufficient income support for the poor.

Country data

Population (in millions)	5.1
Area ('000 sq km)	200.0
GDP (in billion US\$, 2007)	3.7
Average transition score (scale: 1 to 4.33)	2.93

Progress in structural reform

Liberalisation and privatisation

In July 2008 a new law was adopted that allows the government to bypass the parliament when privatising assets included in the government privatisation programme. Previously, privatisation required parliamentary approval, which in some cases significantly slowed down the process. The new law should ease the privatisation of remaining large state-owned enterprises, mainly in infrastructure, including the regional electricity distribution companies, Kyrgyz Air, Kyrgyzaltyn (a gold mining and refining company) and KyrgyzGaz (the gas distribution company).

Business environment and competition

The Kyrgyz authorities recently adopted a number of measures to improve the business environment. These include introducing a “one-stop shop” for business registration in May 2008 and streamlining licensing procedures for the construction sector. A moratorium on tax inspections by the tax inspectorate has been introduced between April and December 2008, while other regulatory bodies are obliged to reduce their number of inspections by two-thirds. The moratorium will be extended beyond 2008 to those companies that increase their tax payments. These measures are expected to significantly reduce the amount of time that businesses spend on dealing with bureaucracy. Minority

shareholders' rights have also been strengthened by amending the law on joint-stock companies to restrict and discourage related-party transactions.

Infrastructure

In May 2008 the government passed a regulation that outlined tariff increases for electricity and heat from June 2008 until 2012. Electricity tariffs were increased for all classes of consumers from 1 June; for example, residential consumers will see an increase of between 32 and 53 per cent to 82-94.9 tyiyn (2.3-2.6 US cents) per kilowatt hour (kWh), close to the short-term cost-recovery level of 2.8 US cents per kWh. District heating tariffs were increased by 120 per cent to Som 860 (US\$ 24) per gigacalorie. These tariff increases reflect the need to attract investment into the electricity sector, which remains characterised by high losses, as well as to meet the 45 per cent increase in the price of gas imported from Uzbekistan, which is primarily used to generate electricity and heat during the peak winter period.

The declining water level in the Naryn River has created a serious challenge for the upstream Kyrgyz Republic and downstream Uzbekistan and Kazakhstan. The dry winter in 2007-08 has lowered the level of the Naryn, which has in turn led to low water levels in the Toktogul reservoir, which feeds the largest electricity generator in the Kyrgyz Republic. Therefore the Kyrgyz Republic could face serious electricity shortages in the winter, while neighbouring countries may have insufficient water for irrigation. Under the Soviet-era regional energy and water trading arrangement, the Kyrgyz Republic would release water in the spring and summer to be used for irrigation in the downstream countries, in exchange for fuel supplies during the winter months. However, since this arrangement broke down after independence, the Kyrgyz Republic has been limiting the release of water during the spring and summer so that it can generate more electricity from the hydropower plants during the winter to save on fuel costs. In October 2008, five Central Asian republics (including the Kyrgyz Republic) signed an agreement on measures to manage regional water and energy resources in the 2008-09 winter period.

Financial sector

After a sharp growth of 64 per cent in real terms in 2007, domestic credit to the private sector ground to a halt in real terms during the first half of 2008. This mainly reflected the reduced credit supply from Kazakh bank subsidiaries, some of which were negatively affected by the global liquidity crunch. Kazakh banks accounted for around 38 per cent of total banking assets in the Kyrgyz Republic at the end of 2007. The introduction of deposit insurance, effective from 2010 and covering deposits up to Som 20,000 (US\$ 555) could increase trust in the banking system and strengthen the domestic funding of banks. Currently only 5 per cent of the population has a bank account. It will be mandatory for all banks to participate in the new deposit insurance scheme, and banks should comply with regulatory standards. The functioning of the Credit Information Bureau (CIB) has improved following amendments to the Civil Code. These changes allow the CIB to collect more credit information, while ensuring that borrowers have the right to check their data in the CIB register.

Macroeconomic performance

Real GDP growth accelerated to 8.2 per cent in 2007, underpinned by increased investment in construction and higher consumption, both supported by a growth in remittances from workers living abroad and a sharp increase in bank lending. In 2008 domestic demand weakened owing to the abrupt slowdown in credit growth. However, total output was maintained as production from the Kumtor gold mine recovered after an accident in 2006. Overall GDP growth remained at 7.1 per cent year-on-year during the first half of 2008.

Consumer price inflation picked up in mid-2007 due to higher commodity prices and remained high in 2008, increasing by 32.5 per cent in the year to July, as domestic food prices continued to surge, reflecting continuing price rises of imported food (such as wheat). In addition, prices of services, such as transport, were also rising sharply owing to higher fuel prices. Inflation slowed to 29.5 per cent in August as domestic food prices eased somewhat. Against this background, monetary policy was tightened. The central bank resisted downward pressure on the currency at the beginning of 2008 and when the currency experienced strong upward pressure in mid-2008, it allowed it to appreciate while actively sterilising foreign exchange purchases by sales of short-term notes to reduce domestic liquidity.

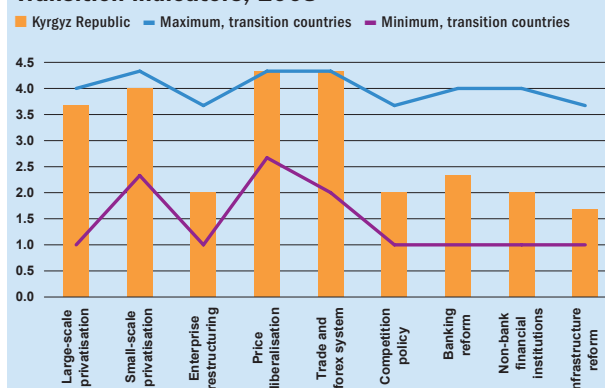
Strong revenue flows contributed to a narrowing of the fiscal deficit from 2.5 per cent of GDP in 2006 to 0.7 per cent in 2007. For 2008 the authorities were initially encouraged to adopt a relatively expansionary budget, increasing spending on wages and pensions to compensate for price increases. However, in response to mounting inflationary pressures, current spending on non-priority items was reduced and steps were taken to improve tax collection. Under the revised plan, the fiscal deficit target is 1.3 per cent of GDP.

The current account deficit is likely to widen from 0.2 per cent of GDP in 2007 to 4.3 per cent of GDP in 2008. Higher prices of fuel and food alone are estimated to increase the import bill by around 7 per cent of GDP. Furthermore, the growth in remittances could stagnate, given the slowdown in the Kazakh economy, where an estimated 15–20 per cent of remittances originate. Higher volumes and prices of gold exports should partially offset these negative developments. The ratio of external debt to GDP, at 61 per cent in 2007, remains high but is gradually declining.

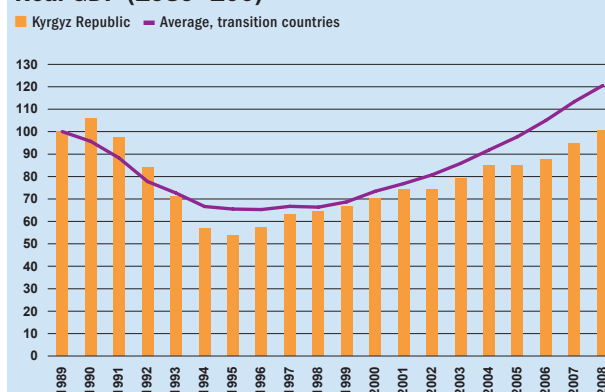
Outlook and risks

The main short-term macro problem is inflation, which is likely to remain around 20 per cent in 2008. The authorities need to maintain a tight fiscal policy, while supporting those most vulnerable to price increases. They may also have to tighten monetary policy further. GDP growth is likely to slow to 6.5 per cent in 2008 and is at risk from the introduction of electricity rationing due to lower water levels in the Toktogul reservoir. In the medium term, steps are necessary to ensure that the country's energy supply needs are met through a more permanent regional agreement on water and energy management.

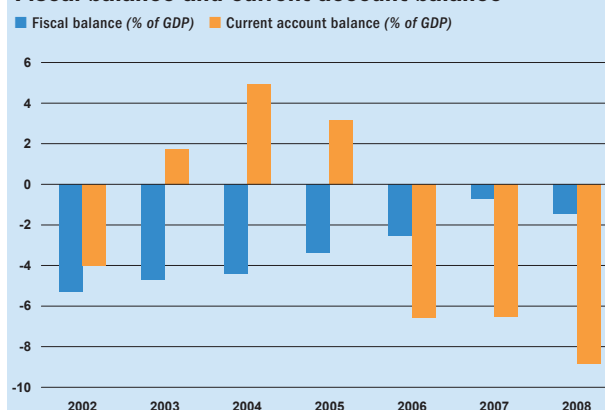
Transition indicators, 2008



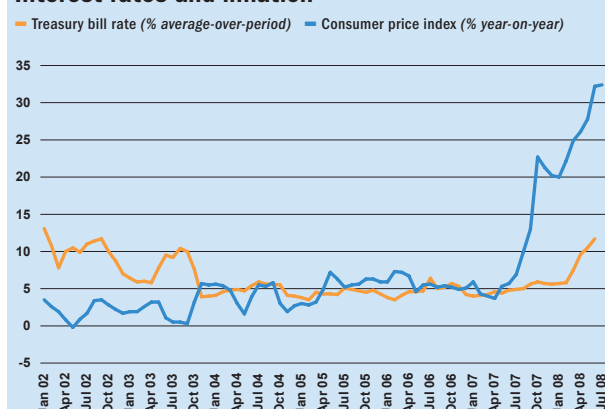
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – medium	Capital adequacy ratio – 12 per cent	Share of population living in poverty – 21.4 per cent (2003) ²
Controls on inward direct investment – no ¹	Secured transactions law – modern/some defects	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 2.8 per cent of GDP (2007)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – no	Quality of securities market laws – medium	Government expenditure on education – 5.1 per cent of GDP (2007)
Exchange rate regime – managed float		Independence of the road directorate – no	Private pension funds – yes	Household expenditure on power and water – 4.4 per cent
Wage regulation – no		Quality of concession laws – low		
Tradeability of land – full except foreigners				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.9	3.2	7.2	7.4	7.4	7.6	na
Private sector share in GDP (in per cent)	65.0	65.0	75.0	75.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	79.7	80.2	80.9	81.2	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	3.4	3.2	3.1	3.4	3.7	3.6	na
Share of industry in total employment (in per cent)	8.7	9.7	10.4	10.2	10.8	10.8	na
Change in labour productivity in industry (in per cent)	-21.8	0.6	-6.2	-14.1	-16.0	4.5	na
Investment/GDP (in per cent)	20.3	20.5	20.8	21.8	22.9	22.0	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	3.7	3.7	3.7	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	12.0	12.9	12.5	17.7	na
Number of goods with administered prices in EBRD-15 basket	1.0	1.0	1.0	2.0	2.0	3.0	na
Share of trade with non-transition countries (in per cent)	53.8	50.3	53.9	41.5	43.5	70.3	na
Share of trade in GDP (in per cent)	68.8	72.3	77.6	77.2	102.4	112.0	na
Tariff revenues (in per cent of imports)	1.5	1.3	1.2	3.7	3.9	3.9	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	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	20 (6)	21 (7)	19 (9)	19 (10)	20 (10)	22 (10)	na
Asset share of state-owned banks (in per cent)	9.7	7.2	4.1	4.8	3.4	8.7	na
Asset share of foreign-owned banks (in per cent)	50.4	61.2	70.1	73.6	71.5	58.7	na
Non-performing loans (in per cent of total loans)	17.6	11.2	6.1	7.7	6.2	3.5	na
Domestic credit to private sector (in per cent of GDP)	4.2	4.8	7.1	7.9	10.4	15.9	na
Domestic credit to households (in per cent of GDP)	0.3	0.5	0.9	1.2	2.2	3.3	na
Of which mortgage lending (in per cent of GDP)	0.0	0.1	0.3	0.5	1.4	2.4	na
Stock market capitalisation (in per cent of GDP)	0.5	1.6	1.5	1.7	3.1	3.1	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	na	na	na	na
EBRD index of banking sector reform	2.0	2.3	2.3	2.3	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)	7.9 (1.1)	7.9 (2.8)	8.2 (5.2)	8.4 (10.3)	8.6 (23.7)	9.1 (40.5)	na
Internet users (per 100 inhabitants)	3.0	4.0	5.2	10.5	12.2	14.1	na
Railway labour productivity (1989=100)	16.2	22.0	27.4	25.4	28.7	29.7	na
Residential electricity tariffs (USc kWh)	1.0	1.1	1.1	1.2	1.3	1.7	na
Average collection rate, electricity (in per cent)	48	48	76	86	74	79	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.8	2.9	3.1	3.2	na	na	na
EBRD index of infrastructure reform	1.7	1.7	1.7	1.7	1.7	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	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Telecommunications	2.3	2.7	3.0	3.0	3.0	3.0	3.0
Water and waste water	1.7	1.7	1.7	1.7	1.7	1.7	1.7

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 the population living in poverty was 44 per cent in 2005.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	0.0	7.0	7.0	-0.2	3.1	8.2	6.5
Private consumption	6.6	6.0	11.2	13.3	28.0	11.3	na
Public consumption	-0.7	4.7	0.1	-1.1	4.0	21.6	na
Gross fixed capital formation	1.7	10.8	11.4	6.0	10.0	12.0	na
Exports of goods and services	7.3	21.2	20.0	-5.0	11.9	26.1	na
Imports of goods and services	19.2	13.1	23.9	11.2	42.6	29.4	na
Industrial gross output	-10.9	17.0	3.7	-12.1	-10.2	7.3	na
Agricultural gross output	3.1	3.2	4.1	-4.2	1.7	1.6	na
Employment							
<i>(Percentage change)</i>							
Labour force (annual average)	-6.8	4.2	3.3	-1.6	0.9	2.7	na
Employment (annual average)	3.5	4.3	3.1	4.3	0.9	2.7	na
<i>(In per cent of labour force)</i>							
Unemployment (annual average)	13.5	10.4	8.8	8.8	9.0	8.9	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	2.0	3.1	4.1	4.3	5.6	10.2	24.4
Consumer prices (end-year)	2.3	5.6	2.8	4.9	5.1	20.1	18.9
Producer prices (annual average)	7.1	13.5	9.0	2.8	15.3	11.9	na
Producer prices (end-year)	7.5	13.5	4.3	6.3	10.4	20.6	na
Gross average monthly earnings in economy (annual average)	15.8	13.7	16.9	16.6	25.2	21.4	na
Government sector¹							
<i>(In per cent of GDP)</i>							
General government balance	-5.3	-4.7	-4.4	-3.4	-2.5	-0.7	-1.3
General government expenditure	28.1	27.2	27.7	28.1	28.9	31.5	na
General government debt	106.9	106.9	92.9	85.9	72.5	57.7	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	33.9	33.4	32.1	10.2	51.0	34.9	na
Domestic credit (end-year)	21.6	11.3	-18.8	19.0	37.9	61.1	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	14.6	17.5	20.6	21.2	28.4	31.2	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Official rate	5.3	4.8	4.8	6.2	4.7	13.2	na
Money market rate ²	7.8	5.8	4.0	1.0	2.1	4.3	na
Deposit rate ³	5.9	5.0	6.7	5.8	5.6	5.4	na
Lending rate ³	24.8	19.1	29.3	26.6	23.2	25.3	na
<i>(Soms per US dollar)</i>							
Exchange rate (end-year)	46.1	44.2	41.6	41.3	38.1	35.5	na
Exchange rate (annual average)	46.9	43.7	42.6	41.0	40.2	37.3	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-64.2	33.4	109.6	60.8	-87.2	-5.8	-210.5
Trade balance	-108.3	-56.9	-90.0	-311.5	-686.5	-1,076.0	-1,604.2
Merchandise exports	498.1	666.2	813.8	794.1	1,106.0	1,995.5	2,117.7
Merchandise imports	606.4	723.1	903.8	1,105.5	4.0	2,635.5	3,721.9
Foreign direct investment, net	4.7	45.5	131.5	42.6	182.0	208.1	224.2
Gross reserves, excluding gold (end-year)	288.8	364.6	548.7	609.0	817.0	1,194.0	na
External debt stock	1,845.4	1,985.6	2,107.6	2,103.9	2,205.1	2,291.1	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	4.6	5.0	5.8	5.2	4.4	4.5	na
<i>(In per cent of exports of goods and services)</i>							
Debt service ⁴	14.0	14.3	8.7	7.1	5.7	4.4	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	5.0	5.0	5.1	5.1	5.2	5.3	na
GDP (in millions of soms)	75,366.7	83,871.6	94,350.7	100,899.2	113,800.1	139,749.4	173,910.3
GDP per capita (in US dollars)	321.6	381.3	434.8	478.7	545.0	712.9	na
Share of industry in GDP (in per cent)	21.3	20.2	21.7	20.0	17.6	16.4	na
Share of agriculture in GDP (in per cent)	34.4	33.6	29.9	28.5	28.7	29.0	na
Current account/GDP (in per cent)	-4.0	1.7	5.0	2.8	-3.1	-0.2	-4.3
External debt - reserves (in US\$ million)	1,556.6	1,621.0	1,558.9	1,494.9	1,388.1	1,097.1	na
External debt/GDP (in per cent)	114.9	103.3	95.2	85.5	77.9	61.2	na
External debt/exports of goods and services (in per cent)	288.3	240.9	205.9	199.7	148.5	102.1	na

¹ General government includes the state, municipalities and extra-budgetary funds. It also includes expenditure under the foreign-financed public investment programme and net lending.

² Weighted average rate on interbank loans in soms with 1-90 day maturities, from International Financial Statistics.

³ Weighted average over all maturities from the IMF's statistics.

⁴ Debt service scheduled and excludes US\$ 111 million debt rescheduling granted by the Paris Club of official creditors for 2002-04.

Latvia

Key developments and challenges

To ensure long-term sustainable growth there should be more focus on the tradeable sector and higher-value products. This will require a redistribution of productivity-enhancing investment favouring the export sector. In the shorter term, macroeconomic stability will depend on the rapid adjustment of high wage and import growth.

With high employment and record low levels of unemployment, measures to increase labour supply and productivity and improve skill levels remain important challenges in the medium term.

Although liberalisation of the power sector is largely complete, rising energy costs and emerging supply constraints underline the need to diversify energy sources and increase energy efficiency.

Country data

Population (in millions)	2.3
Area ('000 sq km)	64.5
GDP (in billion US\$, 2007)	27.2
Average transition score (scale: 1 to 4.33)	3.63

Progress in structural reform

Business environment and competition

High inflation and excessive wage growth have continued to erode Latvia's overall competitiveness. Exports have performed well so far, but the structure of the export sector is currently tilted towards lower-value goods. While Latvia's business environment is among the best in the region, with low wage levels and corporate income taxes, several obstacles remain.

According to the World Bank's *Doing Business 2009* survey, Latvia ranked 29th globally (out of 181 countries) for the ease of doing business, down three places compared with 2008, with major weaknesses related to the ease of employing workers and registering property. Political corruption remains a major concern, while the poor availability of information on government procedures and the quality of public services add to the existing bureaucratic obstacles.

Infrastructure

Liberalisation of the power sector is largely complete and efforts are now focused on ensuring the security and diversification of energy supplies as well as increasing energy efficiency. The government aims to increase the share of electricity produced from renewable energy sources from 45 to 49 per cent by 2010. Latvia has ratified the Kyoto Protocol and has become a participant in the European carbon credit market. An immediate challenge will be the significantly higher electricity prices that are expected once Lithuania's Ignalina nuclear power plant closes at the end of 2009.

Privatisation in the telecommunications sector remains disappointing after several attempts to privatise the incumbent fixed-line operator, Lattelecom. In April 2008 the Latvian government finally agreed to offer the Nordic telecommunications group TeliaSonera full ownership of the mobile operator Latvian Mobile Telephone (LMT), in exchange for TeliaSonera's 49 per cent share in Lattelecom – a deal estimated at US\$ 1.6 billion. Although this made Lattelecom fully state owned once again, the government was motivated by the need to prevent TeliaSonera from buying both companies (Lattelecom and LMT) and thereby dominating the market. The government intends to resell its 49 per cent share in Lattelecom by the end of 2008.

At the same time, competition has intensified with the rapid expansion of mobile telephony services, leading to lower prices. Moreover, measures have been taken to underpin the regulator's independence, complete number portability and strengthen the regulations on administrative charges and fees, among other things.

Financial sector

Rapid credit growth in recent years has led to a level of domestic credit that is among the highest in central eastern Europe and the Baltic states – 78 per cent of GDP in 2007. Over the past year, however, growth of credit to households slowed from an annual rate of over 60 per cent to just 16.9 per cent by June 2008.

As economic conditions and asset values deteriorate, the share of past overdue loans has increased rapidly and is expected to lead to further credit losses. At the end of June 2008, the banking sector in Latvia comprised 20 banks (half of which were subsidiaries of foreign banks, accounting for 73 per cent of total bank capital) and five branches of foreign banks. Foreign-owned banks are generally better able to withstand a cyclical increase in credit losses as they tend to be part of larger and profitable foreign bank groups. Nevertheless, risks are on the rise and warrant close monitoring by financial stability authorities.

With regard to equity markets, the availability of external equity capital is still scarce and Latvia's private equity fund sector is smaller than its neighbours', despite increasing interest from Nordic investors.

Macroeconomic performance

After several years of strong growth and widening current account deficits, growth slowed sharply from late 2007. Although real GDP rose by 10.3 per cent in 2007 as a whole, annual growth fell to just 0.1 per cent in the second quarter of 2008. The slowdown has been led by reduced household spending and investment, a reflection of high inflation and the deceleration in credit growth. The latter resulted from banks tightening credit growth and measures taken by the government in the spring of 2007. With average house prices down by between 20 and 30 per cent in the year to May 2008, construction activity has also declined. Export growth has held up fairly well, although it has been affected by the slowdown in the neighbouring Baltic states. In response to fears of recession, the government cancelled, as of 19 June 2008, the requirement for a 10 per cent down-payment on house purchases introduced a year earlier. Unemployment has risen slightly since the record low of 5.5 per cent recorded at the end of 2007.

A combination of high wage growth, rising energy and food prices and increased excise duties on tobacco has led to a rapid rise in inflation, which reached 16.7 per cent in July 2008, the highest in the European Union. With monetary policy constrained by the fixed exchange rate target, the monetary authorities have few means to address inflation.

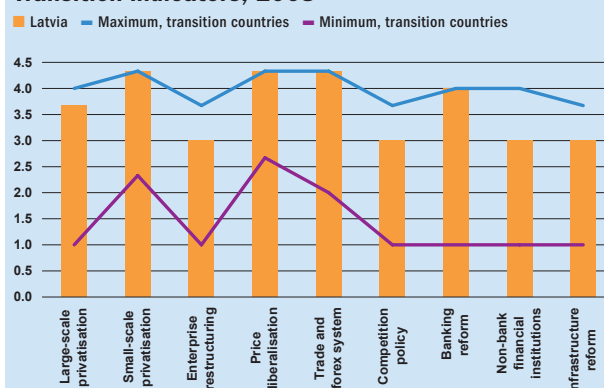
In response to signs of overheating, the government saved the windfall budget revenues it received in 2007, resulting in a balanced budget, the best outcome in a decade. For 2008 the government is aiming to achieve another balanced budget, and has announced plans to cut expenditure, although these are not expected to include pensions and wages for health care workers and teachers. In the first half of 2008, tax revenues held up well but they are expected to decelerate as the economy slows.

The current account deficit was 22.9 per cent of GDP in 2007, the highest deficit in the European Union, and mainly reflected the continuous deterioration in the trade balance. However, as domestic demand has weakened, import growth has slowed significantly, contributing to a narrowing of the deficit to 14.6 per cent of GDP in the second quarter of 2008.

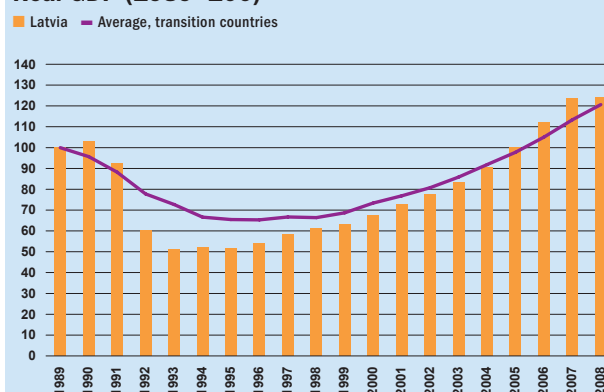
Outlook and risks

In view of the size of both the domestic and external imbalances in the economy, GDP growth is likely to remain subdued for some time while these imbalances adjust. The rapid slowdown, with declining quarterly growth in the first half of 2008, has led to rising risks to macroeconomic and financial stability. Lowering inflation and wage increases to levels that are consistent with productivity growth is an immediate challenge. The labour market is generally viewed as flexible but further measures to increase geographical mobility and improve skill levels are needed for a flexible response to demand, also in view of an already high employment rate. The economy also needs production to be refocused towards the tradeable goods sector. Productivity enhancing investment and increased use of EU funds will be crucial to improve competitiveness over the longer term. These adjustments will be crucial in determining a credible path for membership of the eurozone in the coming years.

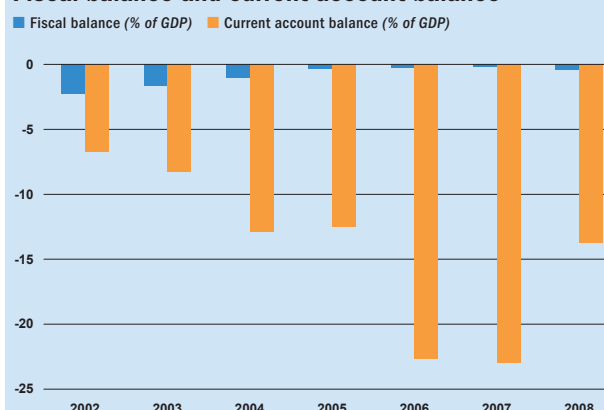
Transition indicators, 2008



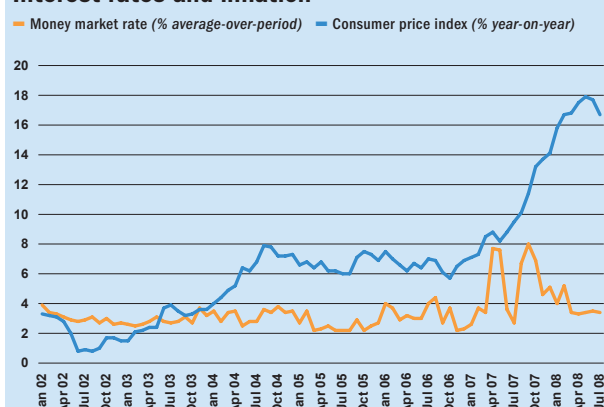
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – full	Capital adequacy ratio – 8 per cent	Share of population living in poverty – 4.7 per cent (2003)
Controls on inward direct investment – no ¹	Secured transactions law – advanced	Independence of the electricity regulator – full	Deposit insurance system – yes	Government expenditure on health – 3.8 per cent of GDP (2005)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – full	Quality of securities market laws – high	Government expenditure on education – 6.1 per cent of GDP (2005)
Exchange rate regime – fixed peg in ERM II		Independence of the road directorate – partial	Private pension funds – yes	Household expenditure on power and water – 3.8 per cent ²
Wage regulation – no		Quality of concession laws – medium		
Tradeability of land – full except foreigners				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	4.9	5.1	5.2	5.3	na	na	na
Private sector share in GDP (in per cent)	70.0	70.0	70.0	70.0	70.0	70.0	70.0
Private sector share in employment (in per cent)	75.0	76.0	76.0	76.0	76.0	76.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	5.4	5.3	5.0	4.5	na	na	na
Share of industry in total employment (in per cent)	19.5	19.6	18.8	17.3	18.0	17.2	na
Change in labour productivity in industry (in per cent)	-0.8	5.5	12.0	15.6	1.2	7.3	na
Investment/GDP (in per cent)	26.7	28.8	33.0	34.4	39.7	37.2	na
<i>EBRD index of small-scale privatisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of large-scale privatisation</i>	3.3	3.7	3.7	3.7	3.7	3.7	3.7
<i>EBRD index of enterprise reform</i>	2.7	3.0	3.0	3.0	3.0	3.0	3.0
Markets and trade							
Share of administered prices in CPI (in per cent)	20.7	16.3	16.2	14.4	14.0	12.9	na
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)	67.7	65.5	59.6	54.5	53.6	51.6	na
Share of trade in GDP (in per cent)	70.5	74.6	81.5	85.6	87.3	84.5	na
Tariff revenues (in per cent of imports)	0.6	0.6	0.3	0.3	na	na	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	2.3	2.7	2.7	3.0	3.0	3.0	3.0
Financial sector							
Number of banks (foreign-owned)	23 (10)	23 (10)	23 (9)	23 (9)	24 (12)	25 (14)	na
Asset share of state-owned banks (in per cent)	4.0	4.1	4.0	4.3	4.4	4.2	na
Asset share of foreign-owned banks (in per cent)	42.8	53.0	48.6	57.9	63.3	63.8	na
Non-performing loans (in per cent of total loans)	2.0	1.4	1.1	0.7	0.5	0.4	na
Domestic credit to private sector (in per cent of GDP)	26.2	34.2	44.2	59.0	78.5	na	na
Domestic credit to households (in per cent of GDP)	7.3	11.6	17.6	26.8	38.0	42.7	na
Of which mortgage lending (in per cent of GDP)	4.1	7.6	12.4	19.5	28.9	33.7	na
Stock market capitalisation (in per cent of GDP)	7.3	9.5	11.5	16.5	12.9	10.8	na
Stock trading volume (in per cent of market capitalisation)	24.0	15.7	8.1	4.6	4.3	4.8	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.8	1.3	na	na
<i>EBRD index of banking sector reform</i>	3.7	3.7	3.7	3.7	3.7	4.0	4.0
<i>EBRD index of reform of non-bank financial institutions</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	30.1 (39.4)	28.2 (52.6)	28.5 (67.2)	31.7 (81.1)	28.6 (95.1)	28.3 (97.4)	na
Internet users (per 100 inhabitants)	13.3	24.2	35.4	44.7	46.7	51.7	na
Railway labour productivity (1989=100)	99.0	118.2	109.4	118.6	106.7	116.9	na
Residential electricity tariffs (USc kWh)	6.5	7.1	8.2	8.1	8.4	9.9	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)	5.2	5.4	5.8	6.5	na	na	na
<i>EBRD index of infrastructure reform</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>Electric power</i>	3.0	3.0	3.3	3.3	3.3	3.3	3.3
<i>Railways</i>	3.3	3.3	3.3	3.3	3.7	3.7	3.7
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.3
<i>Water and waste water</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3

¹ There are controls on raffles and gambling for certain nationals.² Estimate based on the poorest 20 per cent of households (lowest income quintile).

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	6.5	7.2	8.7	10.6	12.2	10.3	0.4
Private consumption	7.4	8.2	9.1	11.3	21.4	14.0	na
Public consumption	2.2	1.9	2.1	2.7	4.9	4.8	na
Gross fixed capital formation	13.0	12.3	23.8	23.6	16.3	8.4	na
Exports of goods and services	5.4	5.2	9.4	20.3	6.6	11.1	na
Imports of goods and services	4.7	13.1	16.6	14.8	19.3	15.0	na
Industrial gross output	8.8	8.0	8.3	8.4	10.5	5.4	na
Agricultural gross output	4.4	-2.4	3.3	9.4	-5.2	8.2	na
Employment							
<i>(Percentage change)</i>							
Labour force (end-year)	1.7	0.2	0.9	-0.1	2.9	2.0	na
Employment (end-year)	3.0	1.8	1.1	1.8	5.0	2.9	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	12.0	10.6	10.4	8.7	6.8	6.1	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	1.9	2.9	6.2	6.7	6.5	10.1	15.8
Consumer prices (end-year)	1.5	3.6	7.3	6.9	6.9	14.1	12.9
Producer prices (annual average)	1.0	3.2	8.6	7.8	10.3	16.1	na
Producer prices (end-year)	0.8	4.1	11.4	7.0	13.2	13.1	na
Gross average monthly earnings in economy (annual average)	8.5	11.3	9.7	16.5	22.9	31.6	na
Government sector							
<i>(In per cent of GDP)</i>							
General government balance	-2.3	-1.6	-1.0	-0.4	-0.2	0.0	-2.0
General government expenditure ¹	35.6	34.8	35.8	35.6	37.9	38.0	na
General government debt	13.5	14.6	14.9	12.4	10.7	9.7	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	21.0	19.1	26.9	38.7	39.7	14.4	na
Domestic credit (end-year)	39.8	47.3	40.4	57.6	58.1	28.8	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	31.7	34.7	37.9	43.1	48.8	44.7	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Refinancing rate	3.0	3.0	4.0	4.0	5.0	6.0	na
Interbank market rate ²	2.1	1.6	2.3	3.5	4.6	4.3	na
Deposit rate (short-term, under 1 year)	3.1	3.4	3.6	3.0	3.6	7.8	na
Lending rate (short-term, under 1 year)	5.4	5.8	7.6	5.7	7.3	12.6	na
<i>(Lats per US dollar)</i>							
Exchange rate (end-year)	0.6	0.5	0.5	0.6	0.5	0.5	na
Exchange rate (annual average)	0.6	0.6	0.5	0.6	0.6	0.5	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-624.7	-920.7	-1,761.7	-1,992.6	-4,522.0	-6,484.2	-6,444.5
Trade balance	-1,478.9	-2,003.2	-2,780.4	-3,018.3	-5,130.7	-6,898.1	-7,034.5
Merchandise exports	2,544.8	3,170.3	4,221.0	5,360.9	6,140.3	8,227.1	9,714.6
Merchandise imports	4,023.7	5,173.5	7,001.4	8,379.2	11,271.0	15,125.2	16,749.1
Foreign direct investment, net	250.2	253.6	527.5	585.2	1,491.3	1,912.7	2,000.0
Gross reserves, excluding gold (end-year)	1,241.4	1,432.4	1,912.0	2,232.1	4,353.4	5,553.4	na
External debt stock ³	7,043.1	9,400.0	13,448.5	15,179.2	23,769.0	38,954.2	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	3.2	2.8	2.8	2.7	3.9	3.8	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	15.9	19.9	21.4	36.4	39.8	27.4	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	2.3	2.3	2.3	2.3	2.3	2.3	na
GDP (in millions of lats)	5,758.3	6,392.8	7,434.5	9,059.1	11,171.7	13,957.4	16,227.3
GDP per capita (in US dollars)	3,971.1	4,799.0	5,935.1	6,953.0	8,688.1	11,913.2	na
Share of industry in GDP (in per cent)	20.5	20.0	19.9	19.1	19.3	19.4	na
Share of agriculture in GDP (in per cent)	4.1	3.7	4.0	3.5	3.1	2.9	na
Current account/GDP (in per cent)	-6.7	-8.2	-12.8	-12.8	-22.7	-23.9	-12.1
External debt - reserves (in US\$ million)	5,715.8	7,864.9	11,426.3	12,818.6	19,259.5	33,196.0	na
External debt/GDP (in per cent)	75.6	84.0	97.7	94.7	119.2	142.4	na
External debt/exports of goods and services (in per cent)	186.2	201.0	224.1	201.7	270.6	327.4	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 developments and challenges

Although the business environment remains among the best in the transition region, the economy's competitiveness is challenged by rapid wage growth and inflation, while vulnerability to external shocks has increased. Therefore, further measures are necessary to stabilise the economy and improve the business environment.

Adequate supplies of energy and more efficient energy use are growing concerns, especially in light of the planned closure of the Ignalina nuclear power plant at the end of 2009. Economic efficiency, competition and market principles should guide reforms in the energy sector.

In view of the need to lower inflation and reduce pressures in the labour market, the government should pursue reforms to mobilise labour resources and improve education and vocational training to increase labour market flexibility.

Country data

Population (in millions)	3.4
Area ('000 sq km)	65.3
GDP (in billion US\$, 2007)	38.3
Average transition score (scale: 1 to 4.33)	3.70

Progress in structural reform

Business environment and competition

While Lithuania's business environment remains relatively attractive, the country continues to suffer from petty and high-level corruption. Lithuania is among the top three transition countries in the World Bank's *Doing Business 2009* report and the regulatory burden for firms is in many respects comparable to, or better than, that in established market economies. However, employment legislation, investor protection and tax administration are seen to be particularly burdensome. Moreover, the perception of corruption in Lithuania has worsened slightly, with the country sliding to 7th place among transition countries on Transparency International's Corruption Perceptions Index between 2007 and 2008.

Infrastructure

The need to diversify energy supplies and improve energy efficiency is crucial with rising energy prices and the planned closure of the Ignalina nuclear power plant in 2009. In line with the agreements in the EU accession treaty, Lithuania closed one reactor in 2004 and is committed to closing the second by the end of 2009, leaving the country highly dependent on external energy sources. The power produced at Ignalina meets approximately 70 per cent of Lithuania's electricity

demand (with some exported to neighbouring countries). However, as other viable solutions, such as a new nuclear plant and power links to Poland and Sweden, will not be ready by 2010, costs are expected to rise dramatically as electricity would need to be either imported or produced by increased use of fossil fuels. Calculations by the Lithuanian Energy Institute suggest that electricity prices could double, which in turn could raise inflation by some 3–3.5 percentage points. In July 2008 the parliament decided to hold a consultative referendum in conjunction with the parliamentary elections in October, on whether or not to delay the shutdown of Ignalina until a technically safe deadline, although no longer than it would take to build a new plant (around 10 years).

In early 2008 further steps were taken to establish a "national champion" in the energy sector. This involved the merger of the state's holdings in Lietuvos Energija (handling transmission, trade and regulation of electricity supplies) and Rytu Skirstomieji Tinklai (a power generator) with the private equity company NDX Energija. This created the Lithuanian Electricity Organisation (LEO LT), in which the state will hold 61.7 per cent of the shares. LEO LT will be an investment vehicle for the country's energy projects, such as the new nuclear power plant and power links to Poland and Sweden. While the details are not fully clear, LEO LT will be of strategic importance and therefore ineligible for privatisation. In view of the European Commission's push for energy sector unbundling, it will be crucial to develop competition and enforce market principles to ensure economic efficiency. Cross-border integration with other energy markets would also provide third party access to monopoly networks.

Financial sector

Credit to households continued to expand quickly, rising by 40 per cent in the year to June 2008, and has yet to show the same signs of rapid deceleration as in the other Baltic states. More than half of all loans are in foreign currency and are mainly financed by foreign (Nordic) parent banks. Competition in the banking sector has led to aggressive lending practices (such as low margins between deposit and lending rates and increasing loan-to-collateral ratios for new loans), but asset quality and capital adequacy indicators remain satisfactory.

Over the past few years, the Bank of Lithuania (BoL) has taken measures to strengthen banks' capital bases. The most important measure introduced last year was the implementation of the New Basel Capital Accord System (Basel II) which implies a significant measure for ensuring financial stability. Moreover, it imposed a 60 per cent limit on the part of the current year's profit that may count towards regulatory capital. It also tightened the assessment of risk of residential and commercial property-secured loans. Furthermore, the required reserves of commercial banks remain subject to a 6 per cent ratio, well above the 2 per cent ratio required by the European Central Bank. The BoL has also encouraged better risk management by urging banks to pay due attention to loan-to-value ratios and debt service ratios, broadening the collection of information in the credit registry and making public statements on risks related to the housing market.

Macroeconomic performance

Following strong real GDP growth in 2007 at 8.8 per cent, economic growth in Lithuania decelerated to 5.2 per cent in the year to the second quarter of 2008. Domestic demand has slowed, reflecting tightening credit, falling house prices and higher inflation. Export growth was also weak in 2007, because of interrupted activity at the Mazeikiu Nafta oil refinery that hampered exports of oil products, but they increased again in early 2008. The unemployment rate began to stabilise at the end of 2007 at record low levels before rising to around 5 per cent by mid-2008.

Inflation, however, has continued to rise and was 12.2 per cent in July 2008, compared with 5.7 per cent on average in 2007. Inflation has risen not only in response to energy and food price developments, but also to rising wage costs. In the first quarter of 2008, wages rose by more than 20 per cent, leaving the growth of real wages well above that of labour productivity. In the absence of effective counter-cyclical policy measures, inflation has kept rising, thereby negatively affecting competitiveness.

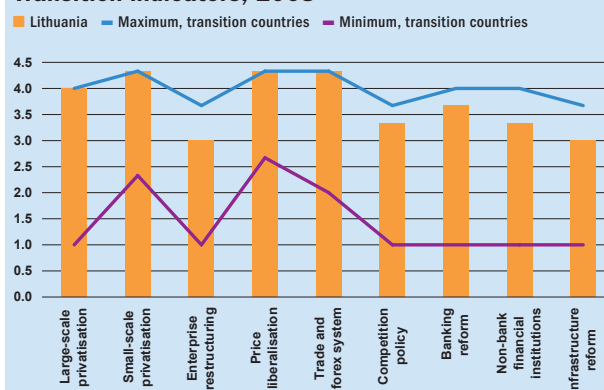
Despite strong economic growth and high revenues, the general government deficit rose to 1.2 per cent of GDP in 2007, implying a fiscal loosening compared with 2006. This further aggravated the rise in domestic and external imbalances. Public debt fell slightly in 2007 and remained low at 17.3 per cent of GDP. In 2008 the government's target for the fiscal deficit is 0.5 per cent of GDP. The growth of revenues is expected to moderate while expenditure is not expected to be cut ahead of the general election in October 2008.

Lithuania's current account deficit has widened rapidly as the growth of imports has outstripped that of exports. The current account deficit rose to 13.7 per cent of GDP in 2007, and has remained high in the first half of 2008. FDI inflows remained high in 2007, reaching more than US\$ 1.4 billion (3.5 per cent of GDP). However, in early 2008 FDI inflows covered just a quarter of the current account deficit.

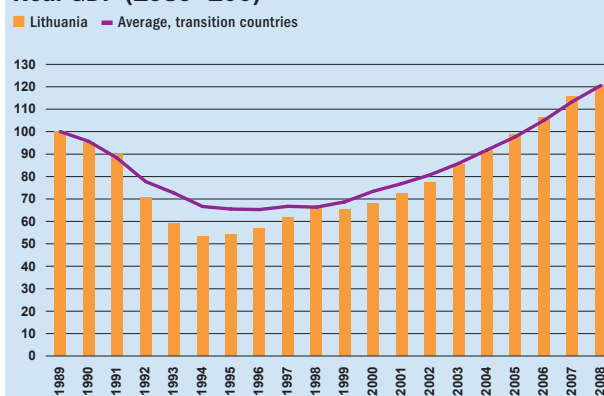
Outlook and risks

GDP growth is expected to slow significantly in 2009 with a sizeable downside risk to domestic demand. Export growth should be strengthened by the return to full capacity at the Mazeikiu Nafta oil refinery, while weakening domestic demand should lead to a slowdown in import growth. Inflationary pressures are, however, expected to remain owing to forthcoming increases of regulated energy prices as well as the effects of the planned closure of the Ignalina nuclear power plant at the end of 2009. Therefore, to reduce inflationary pressures and protect competitiveness, wage growth needs to moderate. In the medium term this should be supported by measures to improve labour market supply, address skills mismatches and labour mobility. Progress in this area is crucial as lowering inflation is one of the main challenges to Lithuania's aspirations to join the eurozone.

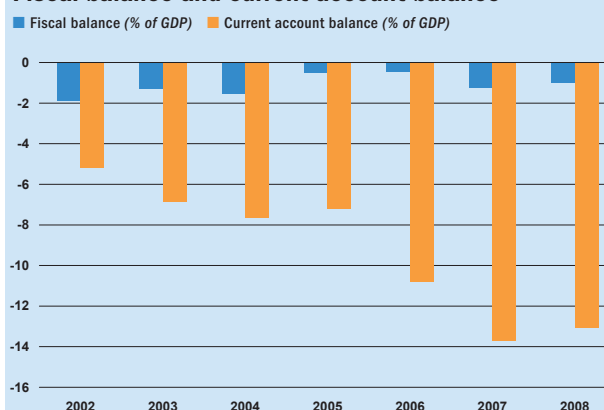
Transition indicators, 2008



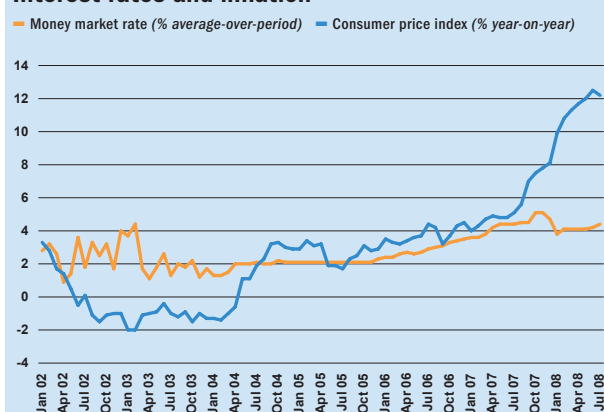
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – full	Capital adequacy ratio – 8 per cent	Share of population living in poverty – 7.8 per cent (2003)
Controls on inward direct investment – no ¹	Secured transactions law – advanced	Independence of the electricity regulator – full	Deposit insurance system – yes	Government expenditure on health – 4.3 per cent of GDP (2005)
Interest rate liberalisation – full	Quality of corporate governance law – high	Separation of railway infrastructure from operations – partial	Quality of securities market laws – high	Government expenditure on education – 5.5 per cent of GDP (2006)
Exchange rate regime – currency board in ERM II		Independence of the road directorate – partial	Private pension funds – yes	Household expenditure on power and water – 3.8 per cent
Wage regulation – no		Quality of concession laws – high		
Tradeability of land – full except foreigners ²				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	11.1	12.7	13.3	13.7	16.5	na	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)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.2	0.3	0.7	0.8	0.8	0.7	na
Share of industry in total employment (in per cent)	20.9	20.7	20.1	20.1	19.7	19.5	na
Change in labour productivity in industry (in per cent)	1.7	15.7	13.2	4.9	11.0	6.1	na
Investment/GDP (in per cent)	22.1	23.2	23.9	25.1	27.0	29.4	na
<i>EBRD index of small-scale privatisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of large-scale privatisation</i>	3.7	3.7	3.7	4.0	4.0	4.0	4.0
<i>EBRD index of enterprise reform</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Markets and trade							
Share of administered prices in CPI (in per cent)	23.4	19.6	17.1	15.4	14.1	13.5	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)	61.5	63.6	58.2	54.2	52.2	52.1	na
Share of trade in GDP (in per cent)	94.7	91.6	93.3	103.0	109.2	104.3	na
Tariff revenues (in per cent of imports) ³	0.5	0.5	0.4	0.1	0.1	na	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	3.0	3.0	3.0	3.3	3.3	3.3	3.3
Financial sector							
Number of banks (foreign-owned)	14 (7)	13 (7)	12 (6)	12 (6)	11 (6)	14 (6)	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)	96.1	95.6	90.8	91.7	91.8	91.7	na
Non-performing loans (in per cent of total loans)	5.8	2.6	2.4	0.7	1.0	1.1	na
Domestic credit to private sector (in per cent of GDP)	16.2	22.9	28.8	41.3	50.6	61.2	na
Domestic credit to households (in per cent of GDP)	2.4	4.2	7.1	12.0	17.9	24.4	na
Of which mortgage lending (in per cent of GDP)	1.9	3.4	5.5	9.0	12.6	17.2	na
Stock market capitalisation (in per cent of GDP)	9.3	16.9	26.1	31.7	32.6	24.7	na
Stock trading volume (in per cent of market capitalisation)	15.1	17.5	8.2	10.1	22.8	10.1	na
Eurobond issuance (in per cent of GDP)	0.7	0.1	5.0	3.0	4.2	3.9	na
<i>EBRD index of banking sector reform</i>	3.0	3.3	3.3	3.7	3.7	3.7	3.7
<i>EBRD index of reform of non-bank financial institutions</i>	3.0	3.0	3.0	3.0	3.0	3.3	3.3
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	26.9 (47.4)	23.9 (62.8)	23.8 (88.5)	23.4 (127.1)	23.2 (138.1)	23.6 (144.9)	na
Internet users (per 100 inhabitants)	14.4	20.1	22.3	25.8	31.7	39.3	na
Railway labour productivity (1989=100)	54.4	67.8	71.0	77.1	83.0	91.1	na
Residential electricity tariffs (USc kWh)	7.9	9.4	9.7	10.2	9.1	10.9	na
Average collection rate, electricity (in per cent)	90	91	97	99	99	99	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.0	4.3	4.7	5.6	na	na	na
<i>EBRD index of infrastructure reform</i>	2.7	2.7	2.7	2.7	3.0	3.0	3.0
<i>Electric power</i>	3.0	3.0	3.3	3.3	3.3	3.3	3.3
<i>Railways</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.7
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	3.3	3.3	3.3	3.3	3.7	3.7	3.7
<i>Water and waste water</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3

¹ There are controls for national security, defence and lotteries.² There is full tradeability of non-agricultural land. Ownership of agricultural land, however, is constitutionally prohibited for foreigners and partially restricted for Lithuanian legal persons.³ Refers to all taxes on imports excluding VAT and import duties.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	6.9	10.3	7.3	7.9	7.7	8.8	3.9
Private consumption	5.8	10.3	12.2	12.1	11.8	11.5	na
Public consumption	1.6	3.8	7.7	3.6	5.5	3.8	na
Gross fixed capital formation	10.9	14.1	15.5	10.9	17.4	15.8	na
Exports of goods and services	19.4	6.9	4.4	17.7	12.2	4.7	na
Imports of goods and services	17.7	10.4	14.9	17.2	13.8	9.1	na
Industrial gross output	6.1	17.3	9.8	7.7	10.8	7.3	na
Agricultural gross output	8.2	7.7	-0.4	2.7	-10.5	13.2	na
Employment¹							
<i>(Percentage change)</i>							
Labour force (end-year)	-0.3	0.7	-1.3	-0.9	-1.2	0.9	na
Employment (end-year)	4.0	2.3	-0.1	2.6	1.7	2.3	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	13.8	12.4	11.4	8.3	5.6	4.3	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	0.3	-1.1	1.2	2.7	3.8	5.7	11.1
Consumer prices (end-year)	-1.0	-1.3	2.9	3.0	4.5	8.1	9.7
Producer prices (annual average)	-2.8	-0.4	6.1	11.4	7.6	7.0	na
Producer prices (end-year)	1.9	-0.2	6.8	13.5	2.8	19.4	na
Gross average monthly earnings in economy (annual average)	-4.9	5.8	7.2	11.0	17.2	21.2	na
Government sector							
<i>(In per cent of GDP)</i>							
General government balance	-1.9	-1.3	-1.5	-0.5	-0.5	-1.2	-1.0
General government expenditure ²	34.8	33.2	33.4	33.6	33.9	35.6	na
General government debt	22.4	21.2	19.4	18.6	18.2	17.3	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	16.9	18.2	24.1	35.5	21.5	21.4	na
Domestic credit (end-year)	22.7	37.8	32.0	56.1	34.9	40.6	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	28.5	30.9	34.8	41.3	43.7	44.9	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Interbank interest rate	10.0	4.3	3.0	3.3	4.5	5.0	na
Treasury bill rate (3-month maturity)	3.7	2.5	2.1	2.4	3.0	4.2	na
Deposit rate	1.7	1.3	1.2	2.4	3.0	5.4	na
Lending rate	6.8	5.8	5.7	5.3	5.1	6.9	na
<i>(Litai per US dollar)</i>							
Exchange rate (end-year)	3.3	2.7	2.5	2.8	2.6	2.4	na
Exchange rate (annual average)	3.7	3.1	2.8	2.7	2.8	2.5	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-733.9	-1,278.5	-1,725.2	-1,886.6	-3,216.4	-5,261.9	6,150.0
Trade balance	-1,336.8	-1,704.3	-2,383.1	-2,971.5	-4,207.6	-5,624.7	-6,600.0
Merchandise exports	6,030.7	7,658.2	9,310.1	11,987.0	14,147.7	17,184.3	24,100.0
Merchandise imports	7,367.6	9,362.5	11,693.2	14,958.4	18,355.3	22,808.9	30,700.0
Foreign direct investment, net	714.5	142.0	510.4	689.0	1,550.7	1,408.6	1,100.0
Gross reserves, excluding gold (end-year)	2,430.6	3,485.4	3,519.0	3,919.5	5,672.3	7,565.8	na
External debt stock ³	6,198.8	8,337.8	10,471.6	12,560.3	18,957.1	30,082.9	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	3.5	3.9	3.2	2.8	3.3	3.5	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	14.8	16.6	14.9	16.6	16.9	17.5	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	3.5	3.5	3.4	3.4	3.4	3.4	na
GDP (in millions of litai)	51,971.2	56,803.9	62,586.7	71,380.4	81,905.3	96,739.7	111,884.4
GDP per capita (in US dollars)	4,077.8	5,376.7	6,553.1	7,658.4	8,766.5	11,352.8	na
Share of industry in GDP (in per cent)	26.4	28.3	29.9	29.9	30.4	29.8	na
Share of agriculture in GDP (in per cent)	6.2	5.7	5.3	5.1	4.6	4.7	na
Current account/GDP (in per cent)	-5.2	-6.9	-7.7	-7.2	-10.8	-13.7	-13.9
External debt - reserves (in US\$ million)	3,768.1	4,852.4	6,952.6	8,640.7	13,284.9	22,517.1	na
External debt/GDP (in per cent)	43.8	44.9	46.5	48.0	63.7	78.5	na
External debt/exports of goods and services (in per cent)	82.5	87.4	89.1	83.2	106.7	141.6	na

¹ Data based on the population census.² General government expenditure includes net lending.³ Includes non-resident currency and deposits and loans to foreign subsidiaries.

Moldova

Key developments and challenges

Better product quality and quality control systems, together with full liberalisation of agricultural land ownership to stimulate investment, would allow Moldova to benefit fully from the Autonomous Trade Preferences regime with the European Union and to further diversify export markets.

The establishment of the Competition Commission and the implementation of regulatory reform have been important first steps in improving the business environment. Further measures are needed to streamline business regulations for SMEs, perform proper regulatory impact assessments and update competition law to improve the operation of the competition authority.

The challenges of high inflation, large external imbalances and exchange rate volatility call for continued prudent fiscal and exchange rate policies to complement the tightening of monetary policy.

Country data

Population (in millions)	3.4
Area ('000 sq km)	33.8
GDP (in billion US\$, 2007)	4.4
Average transition score (scale: 1 to 4.33)	3.00

Progress in structural reform

Liberalisation and privatisation

Moldova's trade regime with the European Union has been further liberalised with the introduction of the Autonomous Trade Preferences (ATP) system in March 2008. Under the ATP, Moldovan goods are granted duty-free access to the EU market (except for a small number of agricultural products, including wine, that remain subject to quotas). This will offer Moldovan enterprises better export opportunities and in the medium term could attract export-oriented foreign direct investment (FDI). However, liberalised market access is subject to stringent quality controls, which are the main hurdle for Moldovan exporters to EU markets, particularly in agriculture. Meanwhile, wine exports to Russia resumed in November 2007 after an 18-month ban imposed by the Russian authorities but they are subject to stringent phytosanitary controls by the Russian authorities. Although 21 winemakers (out of more than 100) are now entitled to ship wine and alcohol products to Russia, only a few are doing so.

The privatisation process has been revived following the adoption of the Law on Public Property Management and Divestiture in May 2007. Under the new law parliament approves only the list of enterprises that will remain in state ownership – currently 172 assets. The new approach avoids the long delays required for parliamentary approval of each individual privatisation. Consequently since the autumn of 2007, the Public Property Agency has held several rounds of sales of

state-owned enterprises through the stock exchange and opened a number of privatisation tenders. Some 84 state assets have been sold since November 2007 (including land and unfinished buildings), generating revenues of MDL 440 million (€27 million), substantially more than the 2008 budget target of MDL 206 million (€12.6 million) for the year as a whole. Furthermore, the privatisation of Banca de Economii (Moldova's second largest bank) and that of the incumbent fixed-line operator, Moldtelecom, are under way. According to official sources there are about 500 enterprises and assets left in state ownership that could eventually be privatised.

Business environment and competition

The Law on Licensing Entrepreneurial Activity, originally aimed at curbing tax evasion, has been amended. Small and medium-sized enterprises (SMEs) can now continue to provide a limited number of services and trade most goods and some food products on the basis of a simplified licensing regime (*patenta*) without having to pay standard sales and profit taxes.

The National Agency for the Protection of Competition (NAPC) has been operating for more than a year and has already issued several decisions. However, it still displays some weaknesses; for example, there was a lack of transparency and accountability during the consultation and decision-making processes in a number of cases against foreign-owned companies. Also, the financial autonomy of the NAPC is fragile. The NAPC's record highlights the need to amend the Competition Law to bring it into line with international best practice, in particular by defining and addressing state aid issues and providing clear and transparent procedures for the NAPC's operations.

Infrastructure

Gas import prices for 2008 were set by Gazprom at US\$ 213 per thousand cubic metres (tcm) and increased to US\$ 253 per tcm from July 2008 as part of the gradual convergence with European levels. The price of imported electricity from Ukraine rose to US\$ 44 per MWh in June 2008. To date, end-user electricity, gas and heat tariffs have been raised – most recently in July 2008 – according to a revised tariff methodology that is in line with increases in import prices. However, a proportion of the tariff increases is covered by central or local government subsidies. While this eases the burden on socially vulnerable households it also distorts price signals and acts as a disincentive to other users to increase energy efficiency.

There has been only modest progress in reforming the municipal utilities sector. Water tariffs in Chisinau were increased twice in 2007, strengthening the financial position of the water operator, Apa-Canal. The municipal district heating operator, Termocom, remains bankrupt owing to the high level of accumulated debt to the two state-owned companies providing heat. These companies have in turn accumulated substantial debt to MoldovaGaz. The Chisinau municipal council reversed an earlier decision to increase district heating tariffs, which meant the municipality had to substantially increase operating subsidies to Termocom to cover the entire residential tariff increase. The council's decision has led to Termocom taking the municipality to court, which has further strained relations between the parties.

Macroeconomic performance

Economic growth declined to 3 per cent in 2007, the lowest annual rate of GDP growth since 2000. This was caused mainly by a severe drought that depressed agricultural output by more than 23 per cent. Construction and services remained the main drivers of growth in 2007, while industrial output declined by 2.7 per cent. GDP growth accelerated to 5.4 per cent in the first half of 2008, on the back of a recovery in industrial production, particularly food processing and wine, and strong output from the services sector.

Inflation accelerated in 2007 and the first half of 2008. Large remittances, official aid and other capital inflows, a booming credit market, as well as higher prices for imports and food (the latter due to the poor harvest in 2007) were mainly responsible for the increase in inflation, which peaked at 17 per cent year-on-year at end-May 2008. Inflationary pressures have eased after the National Bank of Moldova (NBM) tightened monetary policy, namely by increasing the refinancing rate by 5 percentage points since September 2007 (to 18.5 per cent by April 2008) and raising banks' reserve requirements from 10 to 22 per cent. A good harvest in 2008 is also helping. As a result, inflation decreased to 11.7 per cent year-on-year at the end of August 2008. Fiscal policy remained largely prudent and the consolidated budget deficit is expected to remain below 1.5 per cent of GDP in 2008. Indirect taxes on consumption continue to generate the largest share of government revenues, reflecting a strong dependence on remittance-driven consumption.

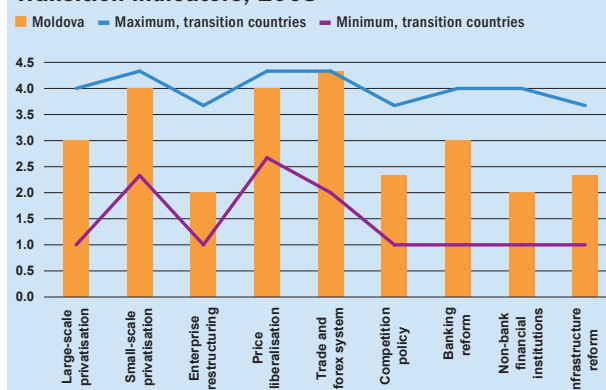
External imbalances widened in 2007 with the current account deficit exceeding 15 per cent of GDP by the end of the year, mainly because of the relatively strong growth in imports. Nevertheless, the current account deficit was financed by capital inflows, as net FDI inflows amounted to 10 per cent of GDP in 2007, while official foreign financial assistance also played an important role. These trends continued in the first quarter of 2008.

The Moldovan leu appreciated in nominal terms by 20 per cent against the US dollar and 11 per cent against the euro in the 12 months to August 2008, reflecting the strength of current and capital inflows, but depreciated sharply in September 2008. The availability of US dollars in the foreign exchange market enabled the NBM to substantially increase its foreign exchange reserves. These amounted to US\$ 1.77 billion by August 2008, equivalent to three-and-a-half months of imports. External debt increased by about US\$ 800 million in 2007 to reach 75 per cent of GDP at the end of the year.

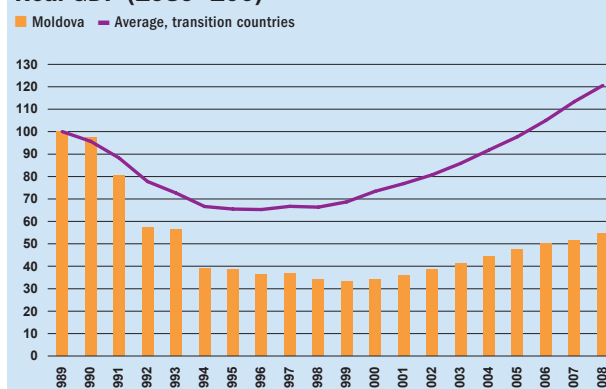
Outlook and risks

The partial resumption of wine exports to Russia, coupled with the introduction of the ATP regime with the European Union, have improved the country's export prospects. However, converting this potential into an actual expansion of trade will very much depend on further improvements in competitiveness. Commitments to increase social expenditure, a tax break for reinvested profits, as well as the need to partially absorb the energy price shock through subsidies, will pose further macroeconomic challenges. Economic growth has risen in 2008 and is expected to continue in 2009, but firm economic policies designed to maintain macroeconomic stability and foster structural reforms will be required to secure medium-term economic prospects.

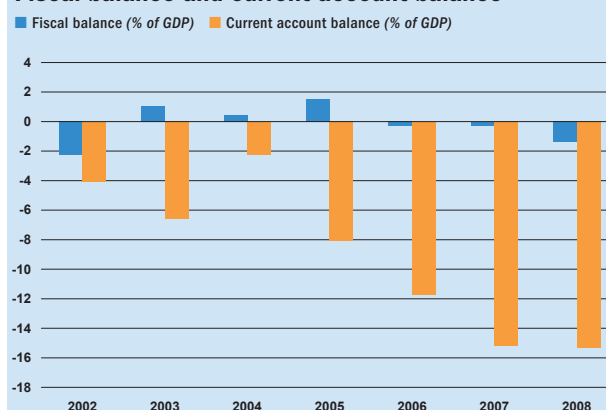
Transition indicators, 2008



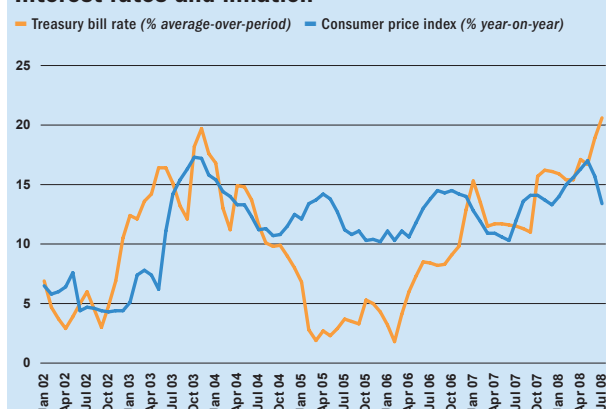
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – medium	Capital adequacy ratio – 12 per cent	Share of population living in poverty – 29.1 per cent (2005)
Controls on inward direct investment – no	Secured transactions law – modern/some defects	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 4.9 per cent of GDP (2007)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – no	Quality of securities market laws – high	Government expenditure on education – 8.0 per cent of GDP (2007)
Exchange rate regime – managed float		Independence of the road directorate – no	Private pension funds – yes	Household expenditure on power and water – 9.6 per cent
Wage regulation – yes		Quality of concession laws – medium		
Tradeability of land – full except foreigners				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	13.5	13.9	14.2	14.7	15.6	16.3	na
Private sector share in GDP (in per cent)	55.0	55.0	55.0	60.0	65.0	65.0	65.0
Private sector share in employment (in per cent)	na	60.0	60.0	60.0	60.0	65.0	70.0
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)	11.4	12.1	12.4	12.0	12.8	na	na
Change in labour productivity in industry (in per cent)	6.8	20.4	9.9	10.7	-7.6	-0.7	na
Investment/GDP (in per cent)	21.7	23.2	25.3	30.8	32.7	38.2	na
<i>EBRD index of small-scale privatisation</i>	3.7	3.7	3.7	3.7	3.7	3.7	4.0
<i>EBRD index of large-scale privatisation</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>EBRD index of enterprise reform</i>	2.0	1.7	1.7	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	7.0	7.0	7.0	4.0	5.0	5.0	na
Share of trade with non-transition countries (in per cent)	43.4	37.0	37.3	37.7	34.9	34.5	na
Share of trade in GDP (in per cent)	102.1	112.8	105.6	113.8	108.5	113.6	na
Tariff revenues (in per cent of imports)	2.4	2.4	2.3	2.4	2.4	2.0	na
<i>EBRD index of price liberalisation</i>	3.7	3.7	3.7	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	2.0	2.0	2.0	2.0	2.0	2.3	2.3
Financial sector							
Number of banks (foreign-owned)	16 (10)	16 (9)	16 (9)	16 (7)	15 (6)	16 (7)	na
Asset share of state-owned banks (in per cent)	13.4	15.5	17.6	19.3	15.3	9.5	na
Asset share of foreign-owned banks (in per cent)	36.7	35.2	33.6	19.6	22.9	24.8	na
Non-performing loans (in per cent of total loans)	7.6	6.4	6.9	5.3	4.4	3.7	na
Domestic credit to private sector (in per cent of GDP)	17.2	20.3	21.2	23.6	27.5	36.9	na
Domestic credit to households (in per cent of GDP)	0.5	0.6	0.9	2.1	2.9	5.5	na
Of which mortgage lending (in per cent of GDP)	0.9	1.0	1.1	1.5	2.6	4.0	na
Stock market capitalisation (in per cent of GDP)	24.3	24.4	22.3	na	na	na	na
Stock trading volume (in per cent of market capitalisation)	5.2	7.7	9.7	5.9	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	na	na	na	na
<i>EBRD index of banking sector reform</i>	2.3	2.3	2.7	2.7	2.7	3.0	3.0
<i>EBRD index of reform of non-bank financial institutions</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	16.9 (8.0)	18.7 (11.3)	20.3 (18.5)	22.1 (25.9)	24.3 (32.4)	28.5 (49.6)	na
Internet users (per 100 inhabitants)	3.5	6.8	9.5	13.1	17.4	18.5	na
Railway labour productivity (1989=100)	28.2	29.5	31.0	31.4	40.0	34.7	na
Residential electricity tariffs (USc kWh)	6.0	5.6	6.0	5.9	5.7	6.9	na
Average collection rate, electricity (in per cent)	99	100	95	97	96	96	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.1	2.1	2.3	2.4	na	na	na
<i>EBRD index of infrastructure reform</i>	2.3	2.0	2.0	2.3	2.3	2.3	2.3
<i>Electric power</i>	3.3	3.0	3.0	3.0	3.0	3.0	3.0
<i>Railways</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Roads</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Telecommunications</i>	2.3	2.3	2.3	2.7	3.0	3.0	3.0
<i>Water and waste water</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0

Macroeconomic indicators	2002	2003	2004	2005	2006	2007 Estimate	2008 Projection
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	7.8	6.6	7.4	7.5	4.8	3.0	6.0
Private consumption	5.9	18.5	6.2	10.1	7.0	3.5	na
Public consumption	31.4	3.2	-16.2	6.3	5.3	17.4	na
Gross fixed capital formation	1.1	13.5	10.5	11.0	15.1	16.7	na
Exports of goods and services	18.9	19.2	11.0	17.7	2.8	7.7	na
Imports of goods and services	15.8	28.7	3.6	18.1	10.3	12.1	na
Industrial gross output	10.8	15.6	8.2	7.0	-4.8	-2.7	na
Agricultural gross output	3.4	-13.6	20.8	0.8	-1.1	-23.1	na
Employment	<i>(Percentage change)</i>						
Labour force (end-year)	-0.1	-8.8	-3.3	-2.2	-2.5	-3.2	na
Employment (end-year)	0.4	-9.9	-3.4	-0.6	-3.5	-0.8	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year) ¹	6.8	7.9	8.0	6.4	7.4	5.1	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)	5.2	11.6	12.5	12.0	12.8	12.3	13.5
Consumer prices (end-year)	4.4	15.7	12.5	10.2	14.0	13.3	11.4
Producer prices (annual average)	4.7	7.8	5.6	5.3	12.2	26.5	na
Producer prices (end-year)	6.7	9.2	4.9	7.0	13.1	28.4	na
Gross average monthly earnings in economy (annual average)	27.2	28.8	23.8	19.5	28.7	21.6	na
Government sector	<i>(In per cent of GDP)</i>						
General government balance ²	-2.2	1.0	0.4	1.5	-0.3	-0.3	-1.4
General government expenditure ²	31.5	33.1	35.1	37.0	40.1	41.9	na
General government debt ³	73.1	58.9	46.0	34.7	33.9	28.4	na
Monetary sector	<i>(Percentage change)</i>						
Broad money (M2, end-year)	30.4	24.4	44.7	36.7	12.2	47.3	na
Domestic credit (end-year)	25.2	24.3	25.8	15.8	30.1	39.0	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	20.0	20.4	25.4	29.5	27.9	34.5	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>						
Refinancing rate	9.5	14.0	14.5	12.5	14.5	16.0	na
Interbank interest rate (up to 30-days maturity)	5.2	13.0	13.3	6.3	9.5	12.3	na
Deposit rate (1 year)	14.4	12.7	15.2	13.0	11.9	15.1	na
Lending rate (1 year)	23.1	19.2	21.0	18.9	18.2	18.9	na
	<i>(Lei per US dollar)</i>						
Exchange rate (end-year)	13.8	13.2	12.5	12.8	12.9	11.3	na
Exchange rate (annual average)	13.6	13.9	12.3	12.6	13.1	12.1	na
External sector	<i>(In millions of US dollars)</i>						
Current account	-67.2	-130.4	-57.6	-241.4	-399.0	-667.9	-952.0
Trade balance	-378.2	-623.4	-754.2	-1,191.5	-1,590.9	-2,243.5	-2,962.0
Merchandise exports	659.8	805.2	994.1	1,104.6	1,053.5	1,374.6	1,718.0
Merchandise imports	1,038.0	1,428.5	1,748.2	2,296.1	2,644.4	3,618.2	4,680.0
Foreign direct investment, net	132.0	71.0	145.7	198.9	223.0	443.1	600.0
Gross reserves, excluding gold (end-year)	268.9	302.3	470.3	597.4	775.3	1,333.7	na
External debt stock	1,814.9	1,924.5	1,897.8	2,079.3	2,523.8	3,300.3	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	2.5	2.1	2.7	2.6	3.0	3.8	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	13.8	12.2	10.2	11.8	21.8	25.9	20.7
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million) ⁴	3.6	3.6	3.4	3.4	3.4	3.4	na
GDP (in millions of lei)	22,556.0	27,618.9	32,032.0	37,651.9	44,754.0	53,353.7	64,395.0
GDP per capita (in US dollars)	458.2	547.5	767.3	882.6	1,003.7	1,280.3	na
Share of industry in GDP (in per cent)	20.2	20.5	20.5	19.1	18.0	na	na
Share of agriculture in GDP (in per cent)	21.0	18.3	17.5	16.4	14.8	na	na
Current account/GDP (in per cent)	-4.0	-6.6	-2.2	-8.1	-11.7	-15.2	-15.3
External debt - reserves (in US\$ million)	1,546.0	1,622.3	1,427.5	1,481.9	1,748.5	1,966.6	na
External debt/GDP (in per cent)	109.2	97.2	73.0	69.6	74.0	75.1	na
External debt/exports of goods and services (in per cent)	207.1	181.7	142.6	138.0	164.3	164.5	na

¹ According to ILO methodology.³ Includes public and publicly guaranteed debt.² General government includes the state, local government, social security and healthcare.⁴ Excluding Transnistria.

Mongolia

Key developments and challenges

The windfall profit tax and the government's likely participation in mining projects have affected the attractiveness of Mongolia's mining sector for foreign investors. It is important that the government benefits fully from the country's resources but the investment climate needs to remain internationally competitive.

The financial sector has continued to improve but trust in the banking sector could be further strengthened by establishing a deposit insurance scheme and through effective operation of the Credit Information Bureau.

Lowering inflation remains a key objective. Introducing price controls and subsidies may have some impact in the short term but it risks creating distortions over the longer term. The government should therefore focus on improving fiscal discipline and increasing market competition.

Country data

Population (in millions)	2.7
Area ('000 sq km)	1,567.0
GDP (in billion US\$, 2007)	3.9
Average transition score (scale: 1 to 4.33)	3.07

Progress in structural reform

Liberalisation and privatisation

In response to increasing inflationary pressures in early 2008, a council was set up to create a price stabilisation programme. However, policy responses have mainly consisted of short-term measures, such as price controls, subsidies and tax exemptions. During the first quarter of 2008 the government subsidised oil distributors in order to contain retail fuel prices. The government has also taken steps to lower bread prices, such as offering bread manufacturers concessions on flour imports and then negotiating directly with them to lower prices. However, competition among bread producers is limited as two dominant producers account for 69 per cent of the domestic market.

Business environment and competition

The mining sector is crucial for Mongolia as it constituted 27 per cent of GDP, 36 per cent of government revenue and 64 per cent of total exports in 2007. While investors appeared to be content with the changes in the minerals law in 2006, the introduction of the windfall profit tax later that year was more controversial. These changes, according to the International Monetary Fund (IMF), substantially increased the marginal tax rate for the copper sector to as much as 81 per cent once royalties, the windfall profit tax, corporate tax and withholding tax are all taken into account.

The ranking of Mongolia's attractiveness for minerals exploration, as published by the Fraser Institute, accordingly dropped from 3rd place (out of 64 countries) in 2005-06 to 56th (out of 68 countries) in 2007-08. Nevertheless, the proposed amendments to the windfall profit tax regime, which would increase the gold price threshold from the current US\$ 500 to US\$ 650 per ounce, were rejected by the parliament in August 2007.

In the meantime the investment agreement between the government and the Canadian and UK-based mining companies Ivanhoe Mines and Rio Tinto, relating to the large Oyu Tolgoi copper and gold mining project, has not yet been approved. The project is expected to bring sizeable investments, almost equal to the current value of GDP, and it should pave the way for other large-scale mining projects in the country. An agreement appeared to have been reached in April 2007 but the government was unable to obtain parliamentary approval and withdrew the draft later in the year. One of the first tasks for the new government, established in September 2008, will be to secure agreement to reasonable terms and conditions among all the stakeholders.

Infrastructure

In recent years competition in the mobile phone market has increased significantly. The largest private operator, MobiCom, had enjoyed significant market dominance for some time but the award of a number of licences to new operators and the subsequent growth in their operations in recent years resulted in a fall in MobiCom's market share to around 60 per cent by 2008. The resulting increase in competition has led to a significant fall in tariffs and they are now among the lowest in the region. In the fixed-line telephone business, the government approved sector restructuring in 2005, allowing non-discriminatory access for any parties and the adoption of a vertically separated model. Accordingly, the fixed-line company was separated into a network company and an operating company (of which 40 per cent is owned by Korea Telecom) in 2007.

Financial sector

Mongolia's financial sector has improved over the last year. Bank lending increased further in recent years and the government authorised the establishment of the Credit Information Bureau to collect and provide consumer credit information on individual consumers. The non-bank financial sector is relatively underdeveloped, partly due to weak regulation. However, following the establishment of the independent regulator in 2006 – the Financial Regulatory Commission (FRC) – minimum capital requirements were tightened. The result has been a significant reduction in the number of non-bank financial intermediaries while the sector's assets have more than doubled over the same period. In addition, stock market capitalisation increased significantly from US\$ 112 million in 2006 to US\$ 723 million in 2008 (about 16 per cent of GDP) while market liquidity also increased. There have been seven initial public offerings during 2007-08 after several years of no issuances. A proposal for the long-awaited deposit insurance scheme has been submitted to parliament, but it has not yet been approved.

Macroeconomic performance

The economy continues to expand rapidly. Real GDP grew by 9.9 per cent during 2007, up from an 8.6 per cent growth rate in 2006, and growth remained buoyant in the first quarter of 2008 at 10.2 per cent. The economy benefited from higher copper and gold prices and strong foreign direct investment (FDI). Per capita income has more than doubled in the last three years, partly because of higher wages (both private and public) and a sharp rise in social benefits.

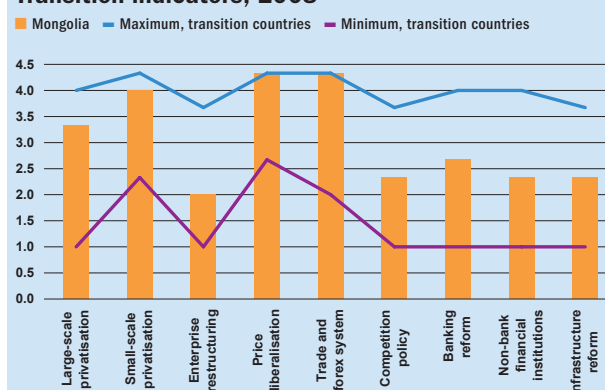
These developments contributed to a boom in the construction and service sectors. However, in the first half of 2008 there were signs of overheating. Year-on-year consumer price inflation rose from 6.2 per cent in June 2007 to 32.4 per cent in June 2008, the highest level since 1997. The central bank has tightened monetary policy by increasing reserve requirements and raising the policy rate several times since October 2007. This has slowed the growth in lending. However, higher food prices and a looser fiscal policy in the run-up to the 2008 elections have continued to fuel inflation. Fiscal spending rose significantly in 2007–08 with increases in social spending, public investment and public sector wages. The net result of these trends has been significant deterioration from the fiscal surplus of 8.1 per cent of GDP recorded in 2006, to 2.2 per cent in 2007 and almost break-even during the first half of 2008.

The trade deficit has increased substantially owing to the higher cost of food and energy imports. Imports rose by 43 per cent in 2007 but exports by only 26 per cent. This trend continued during the first half of 2008, resulting in a US\$ 418 million trade deficit (10.1 per cent of GDP). The current account remained in surplus owing to strong transfers in 2007 but during the first half of 2008 it slipped into deficit. Nevertheless, thanks to robust FDI inflows, official international reserves continued to increase to an estimated US\$ 1.3 billion in March 2008 (covering 4.6 months of imports), a significant increase from US\$ 300 million just three years ago. External public debt has fallen from 51 per cent of GDP at the end of 2004 to 24 per cent at the end of 2007, mainly because of strong GDP growth.

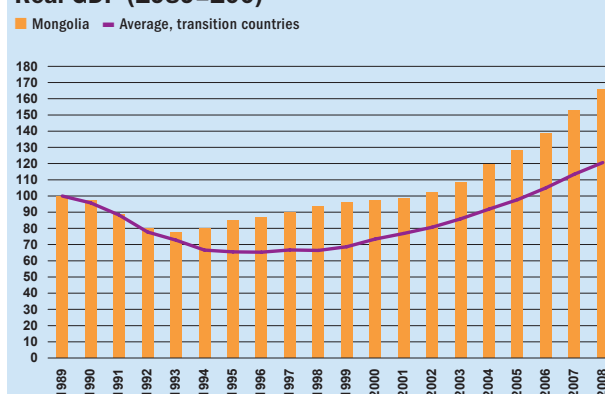
Outlook and risks

Despite solid economic growth in recent years, poverty remains widespread and disparities between the rich and poor have increased. Partly for this reason lowering inflation is important. Robust economic growth is expected in the medium term, mainly on the back of mining sector development, although this underlines the importance of early parliamentary approval of a new investment agreement. In the long term, however, sustainable growth depends on structural reforms, including increased competition in the non-mining sector and Mongolia's better integration into the global economy. In addition, the recent authorisation by parliament to issue commercial foreign debt of up to US\$ 1.2 billion (25 per cent of GDP) may endanger debt sustainability.

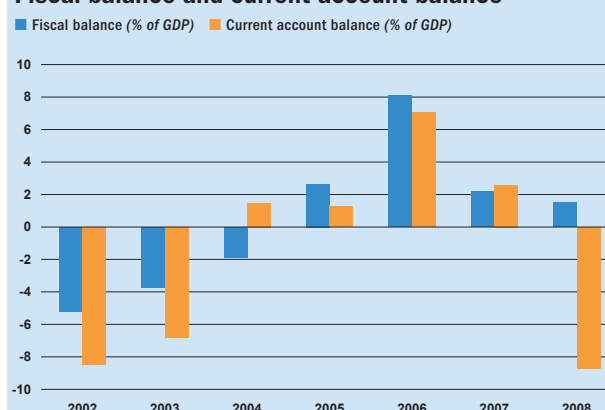
Transition indicators, 2008



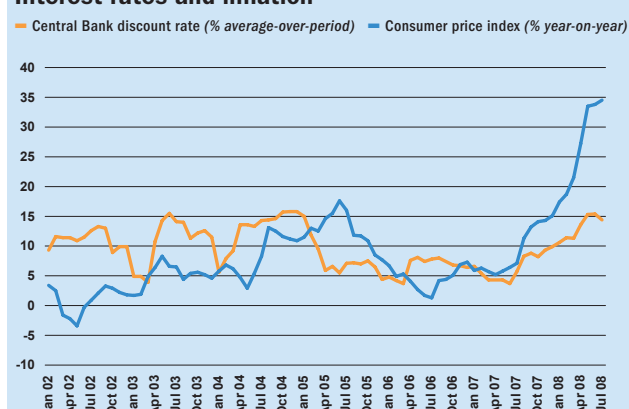
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – medium	Capital adequacy ratio – 10 per cent	Share of population living in poverty – 32.2 per cent (2006)
Controls on inward direct investment – no	Secured transactions law – malfunctioning	Independence of the electricity regulator – partial	Deposit insurance system – no	Government expenditure on health – 3.1 per cent of GDP (2007)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – no	Quality of securities market laws – medium	Government expenditure on education – 5.5 per cent of GDP (2007)
Exchange rate regime – managed float		Independence of the road directorate – no	Private pension funds – no	Household expenditure on power and water – 9.4 per cent ¹
Wage regulation – no		Quality of concession laws – not available		
Tradeability of land – limited de facto				

Structural indicators

	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	7.5	8.2	9.0	9.2	10.1	10.5	na
Private sector share in GDP (in per cent)	65.0	70.0	70.0	70.0	70.0	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)	7.8	7.6	7.5	7.0	7.2	11.1	na
Share of industry in total employment (in per cent)	14.3	15.6	16.1	16.7	17.3	17.9	na
Change in labour productivity in industry (in per cent)	-7.5	-11.2	8.4	3.8	1.4	5.3	na
Investment/GDP (in per cent)	26.7	35.5	36.5	35.5	35.9	41.1	na
<i>EBRD index of small-scale privatisation</i>	3.7	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	2.3	2.7	3.0	3.0	3.0	3.3	3.3
<i>EBRD index of enterprise reform</i>	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	na	na
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	na	na
Share of trade with non-transition countries (in per cent)	73.7	75.1	76.4	75.8	78.6	78.0	na
Share of trade in GDP (in per cent)	100.3	100.1	104.2	99.4	97.2	105.8	na
Tariff revenues (in per cent of imports)	2.9	3.5	3.7	3.9	4.0	4.0	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	1.7	1.7	1.7	2.0	2.0	2.3	2.3
Financial sector							
Number of banks (foreign-owned)	16 (0)	17 (4)	17 (4)	17 (4)	16 (5)	16 (6)	na
Asset share of state-owned banks (in per cent)	20.6	6.2	5.3	3.8	0.0	0.0	na
Asset share of foreign-owned banks (in per cent)	0.0	na	38.9	39.1	45.8	46.4	na
Non-performing loans (in per cent of total loans)	6.1	4.8	6.0	5.6	4.7	3.2	na
Domestic credit to private sector (in per cent of GDP)	16.6	26.6	28.4	30.6	33.6	32.7	na
Domestic credit to households (in per cent of GDP)	4.3	7.6	9.8	11.4	13.5	18.1	na
Of which mortgage lending (in per cent of GDP)	na	na	na	1.3	1.9	3.2	na
Stock market capitalisation (in per cent of GDP)	2.5	3.0	1.4	2.0	3.5	15.7	na
Stock trading volume (in per cent of market capitalisation)	3.5	2.2	2.3	6.0	13.5	14.7	na
Eurobond issuance (in per cent of GDP)	na	na	na	na	na	na	na
<i>EBRD index of banking sector reform</i>	2.0	2.3	2.3	2.3	2.3	2.7	2.7
<i>EBRD index of reform of non-bank financial institutions</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.3
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	5.3 (8.9)	5.6 (13.0)	5.6 (16.3)	5.9 (21.1)	5.9 (28.9)	5.9 (29.9)	na
Internet users (per 100 inhabitants)	2.1	5.8	7.6	10.1	11.6	na	na
Railway labour productivity (1989=100)	148.1	159.8	189.2	202.6	198.3	184.8	na
Residential electricity tariffs (USc kWh)	4.2	4.6	4.6	5.0	5.0	4.9	na
Average collection rate, electricity (in per cent)	na	na	na	na	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	na	na	na	na	na	na	na
<i>EBRD index of infrastructure reform</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.3
<i>Electric power</i>	2.3	2.3	2.3	2.7	2.7	2.7	2.7
<i>Railways</i>	2.0	2.0	2.3	2.3	2.3	2.3	2.3
<i>Roads</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
<i>Telecommunications</i>	2.7	2.7	2.7	2.7	2.7	2.7	3.0
<i>Water and waste water</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0

¹ Estimate is for the poor households in Ulaanbaatar, based on UNDP's survey "Impact of Utility Charges on Poor Households" in Ulaanbaatar.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	4.0	5.9	10.1	7.3	8.6	9.9	8.6
Industrial gross output	1.5	3.0	15.0	9.6	9.7	10.0	na
Agricultural gross output	5.0	3.7	17.7	7.7	9.1	9.5	na
Employment							
<i>(Percentage change)</i>							
Labour force (end-year) ¹	3.3	6.4	2.7	1.5	4.2	1.1	na
Employment (end-year)	4.6	6.4	2.6	1.9	4.3	1.4	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year) ²	3.4	3.5	3.6	3.3	3.2	2.8	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	0.3	5.1	8.3	12.7	5.1	9.0	29.4
Consumer prices (end-year)	1.7	4.7	11.0	9.5	6.0	15.1	31.5
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)	9.4	22.0	30.4	5.4	26.2	35.5	na
Government sector							
<i>(In per cent of GDP)</i>							
General government balance ³	-5.2	-3.7	-1.9	2.6	8.1	2.2	1.5
General government expenditure ³	39.0	37.1	35.0	27.5	28.5	38.4	na
General government debt ⁴	88.2	106.7	89.0	68.6	52.8	45.5	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	42.0	49.6	20.5	37.2	30.8	57.3	na
Domestic credit (end-year)	25.2	160.8	19.9	35.9	-7.4	72.5	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	33.3	42.4	39.3	41.8	40.9	52.5	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Central bank bills rate	9.9	11.5	15.8	4.4	6.4	9.9	na
Deposit rate ⁵	13.2	14.0	14.2	13.0	13.0	13.4	na
Lending rate ⁵	28.4	26.3	25.4	23.6	21.4	17.1	na
<i>(Togrog per US dollar)</i>							
Exchange rate (end-year)	1,122.2	1,168.3	1,211.8	1,221.0	1,165.0	1,170.0	na
Exchange rate (annual average)	1,108.5	1,142.7	1,185.2	1,205.2	1,179.7	1,169.8	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-108.0	-98.6	26.6	29.2	222.0	101.0	-404.0
Trade balance	-228.8	-199.3	-149.1	-155.0	29.0	-218.0	-839.0
Merchandise exports	524.0	627.3	872.0	1,069.0	1,545.0	1,952.0	2,163.0
Merchandise imports	752.8	826.6	1,021.1	1,224.0	1,516.0	2,170.0	3,002.0
Foreign direct investment, net	77.8	131.5	129.0	258.0	290.0	328.0	688.0
Gross reserves, excluding gold (end-year)	271.0	178.0	208.0	333.0	718.0	1,001.0	na
External debt stock	978.1	1,287.0	1,429.0	1,433.0	1,529.0	1,703.0	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	3.4	2.0	1.8	2.5	4.6	4.7	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	4.5	34.0	7.4	2.9	2.2	2.1	2.2
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	2.6	2.6	2.6	2.6	2.7	2.8	na
GDP (in billions of togrog)	1,411.4	1,660.4	2,154.2	2,779.0	3,715.0	4,558.0	5,456.0
GDP per capita (in US dollars)	499.0	562.7	695.2	871.2	1,166.3	1,416.9	na
Share of industry in GDP (in per cent)	22.5	25.3	29.9	30.2	36.0	33.9	na
Share of agriculture in GDP (in per cent)	20.7	20.1	20.9	21.7	19.5	20.6	na
Current account/GDP (in per cent)	-8.5	-6.8	1.5	1.3	7.0	2.6	-8.7
External debt - reserves (in US\$ million)	707.1	1,109.0	1,221.0	1,100.0	811.0	702.0	na
External debt/GDP (in per cent)	76.8	88.6	78.6	62.2	48.6	43.7	na
External debt/exports of goods and services (in per cent)	138.0	154.1	118.2	96.6	75.3	67.4	na

¹ Economically active population registered at the employment registration office.

² Officially registered.

³ General government revenue and expenditure include grants and net lending.

⁴ Direct and assumed debt of the central government and loans guaranteed by the government.

⁵ Weighted average over all maturities.

Montenegro

Key developments and challenges

Despite strong economic growth, a number of serious impediments to doing business remain, including barriers to market entry, difficulties with obtaining licences and widespread corruption. A determined effort should be made to address these problems to create the right conditions for strong, long-term growth.

Energy shortages still occur, reflecting the large infrastructure needs of the country. Private sector involvement in this area, in the context of open competition and transparent regulation, would help to alleviate these problems.

The sharp rise in inflation over the past year and strong credit growth signal an overheating economy. In the absence of monetary policy tools the authorities should redouble their efforts to keep spending under control and to monitor closely the quality of credit allocation.

Country data

Population (in millions)	0.7
Area ('000 sq km)	13.8
GDP (in billion US\$, 2007)	3.5
Average transition score (scale: 1 to 4.33)	2.82

Progress in structural reform

Liberalisation and privatisation

Over the past year Montenegro has made significant progress in integrating into regional and global trading structures. In October 2007 the government and the European Union (EU) signed a Stabilisation and Association Agreement. This was followed in April 2008 by the government's adoption of a national programme for integration with the European Union, which contains a multi-year plan for harmonising the legal framework with that of the EU's body of law, the *acquis communautaire*. In addition, negotiations on membership of the World Trade Organization (WTO) are advanced and membership is likely in 2009.

As of mid-2008, approximately 85 per cent of state assets had been privatised. The government's latest plan for privatisation was adopted in March 2008. It included a number of strategic companies, such as Montenegro Airlines and the Port of Bar. The government has also launched the tender for the publisher Pobjeda and the shipyard Jadran Bijela (both unsuccessful so far). However, privatisation receipts have been modest in 2008, amounting to less than €25 million in the first half of the year.

Business environment and competition

Several business-friendly measures have been in place for a number of years, including a corporate tax rate of 9 per cent, the lowest in the region. The number of registered businesses has risen steadily and reached almost 39,000 in June 2008, up from 32,000 in February 2007, although many are inactive. However, surveys continue to suggest that significant barriers to business remain and that corruption and bureaucracy impede business creation, especially in the area of licences. The government signalled its concern earlier this year by setting up a Council for the Elimination of Business Barriers, chaired by the prime minister and involving government ministries and the private sector. However, its effectiveness remains to be tested.

Infrastructure

Energy supply remains a key issue for Montenegro. The country depends on imports of electricity to meet demand and blackouts are frequent. Non-residential electricity prices are approximately twice as high as those for residential consumers, implying an inefficient subsidy from small and medium-sized businesses to households. However, the two biggest industrial companies, the aluminium conglomerate KAP and the steel mill in Nikšić, continue to enjoy heavily subsidised electricity prices. The privatisation process in the energy sector stalled last year when the sale of the Pljevlja plant and coal mine was cancelled for political reasons. The government did, however, adopt a Strategy for Energy Development in December 2007. The plan is to build an additional capacity of 700 megawatts (MW), bringing total capacity to 1,600 MW by 2025. In March 2008 the government launched the restructuring of the national power utility EPCG, with the aim of splitting the company into five separate business units. The government plans to issue 22 per cent of shares of EPCG and sell them to a strategic partner.

In the roads sector there are major investment needs, especially given the lack of investment to date, the difficult terrain and the ambitious plans to expand tourism over the medium term. The government has a number of priority projects, including the Bar-Boljare highway. The pre-qualification tender for construction of this highway was launched in June 2008 and attracted 11 bidders. The government is considering several financing options, including public-private partnerships (PPPs).

Financial sector

The banking sector continues to grow rapidly, bringing much-needed credit to the private sector but also raising concerns about possible overheating. Total domestic credit rose by 176 per cent in 2007 but slowed somewhat in 2008, reaching 81 per cent year-on-year by mid-2008. This slowdown partly reflects the introduction of new regulations by the central bank, effective from January 2008, that are designed to restrict the growth of credit. According to the new measures, the largest commercial banks, with net credits in their balance sheet of over €200 million, are obliged to limit their annual credit expansion to 30 per cent. The smallest lenders, with credit portfolios of less than €100 million, will be allowed to increase their extended credits by no more than 60 per cent annually. A ceiling of 40 per cent on credit growth is applied to lenders that have outstanding loans in the range of €100 million to €200 million.

Macroeconomic performance

The economy continues to grow strongly, with real GDP growth of more than 10 per cent in 2007 and a growth rate in the first half of 2008 tentatively estimated at 8 per cent. Services, including financial services and tourism, are driving the strong growth but this year has also seen a recovery in mining and utilities and a continued solid performance in the construction and industrial sectors.

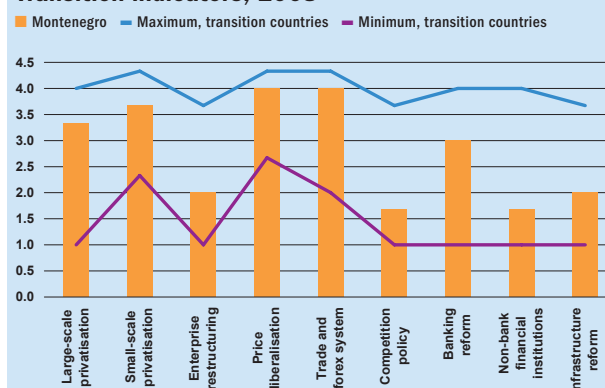
However, there are obvious concerns about overheating. Inflation is a particular worry, since it has risen steadily to 11.4 per cent in the year to June. Montenegro's unilateral adoption of the euro some years ago rules out any exchange rate adjustment. This puts the burden on fiscal policy. So far, the government has managed the boom in activity fairly well and has run fiscal surpluses in the past two years. Following a fiscal surplus of more than 6 per cent of GDP in 2007, figures for the first half of 2008 suggest another surplus is likely to be recorded this year. However, the level of government spending, at around 45 per cent of GDP, is high by regional standards and may need to be reduced over time to ensure overall sustainability.

On the external side, there has been no let-up in the huge surge of foreign direct investment (FDI) into the country in recent years. Gross FDI inflows in 2007 were close to €900 million and amounted to €215 million in the first quarter of 2008. Property continues to account for a substantial share (nearly 40 per cent) of the total. Due to the large import needs of the construction and tourism sectors, the current account deficit is by far the highest among transition countries at 33 per cent of GDP in 2007, but it is likely to abate once the extraordinary inflows of FDI decline.

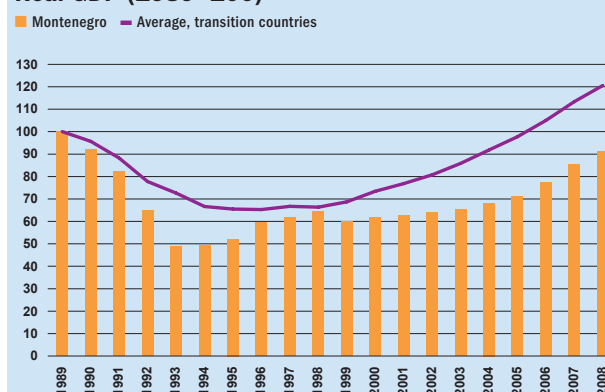
Outlook and risks

The medium-term outlook for Montenegro is bright but the risks to this favourable outcome are substantial. The country is going through a post-independence boom, mostly associated with the development of property, tourism and other services, but it will be difficult to maintain this level of growth without a more diversified economy. The current double-digit rate of inflation is likely to create serious competitiveness problems for exporters unless it is reduced significantly in the coming months. In the context of rising energy prices, the future of the main export earner, KAP, is uncertain as the company relies on low electricity prices to remain viable, although the current high subsidies are due to end in 2010. The tourism sector continues to have great potential but the huge influx of property investment runs the risk of overburdening the country's still weak infrastructure and putting off future tourists. Meanwhile the country's further integration into Euro-Atlantic structures looks set to continue but the slow pace of institutional reform and administrative weaknesses may delay progress towards eventual EU accession.

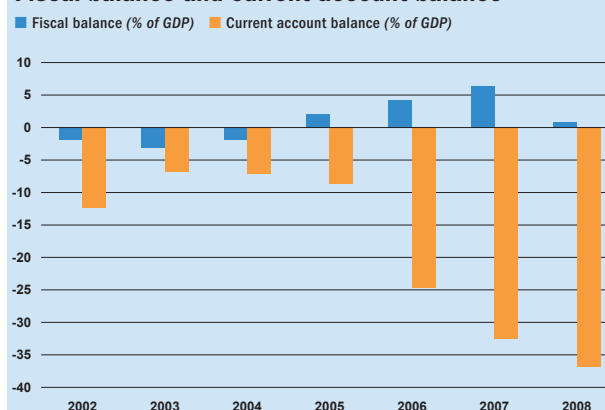
Transition indicators, 2008



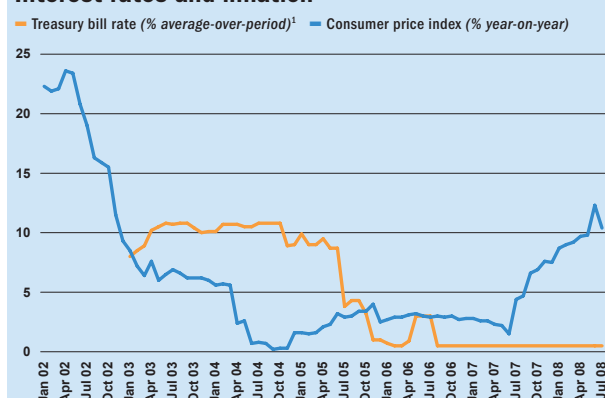
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



¹ Data were unavailable between January 2002 and January 2003.

Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – full	Competition office – yes	Telecoms regulatory assessment compliance – medium	Capital adequacy ratio – 8 per cent	Share of population living in poverty – na
Controls on inward direct investment – no	Secured transactions law – some defects	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 6.2 per cent of GDP (2005)
Interest rate liberalisation – full	Quality of corporate governance law – very low	Separation of railway infrastructure from operations – full	Quality of securities market laws – medium	Government expenditure on education – 5.4 per cent of GDP (2004)
Exchange rate regime – unilateral euroisation		Independence of the road directorate – partial	Private pension funds – no	Household expenditure on power and water – na
Wage regulation – no		Quality of concession laws – medium		
Tradeability of land – limited de jure				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	na	na	na	na	na	na	na
Private sector share in GDP (in per cent)	na	na	na	na	na	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)	na	0.7	0.8	0.6	0.3	0.6	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)	na	na	na	na	na	na	na
<i>EBRD index of small-scale privatisation</i>	3.0	3.3	3.3	3.7	3.7	3.7	3.7
<i>EBRD index of large-scale privatisation</i>	2.7	2.7	2.7	3.3	3.3	3.3	3.3
<i>EBRD index of enterprise reform</i>	1.7	1.7	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	9.2	9.2	na
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	2.0	2.0	na
Share of trade with non-transition countries (in per cent)	na	na	na	na	na	na	na
Share of trade in GDP (in per cent)	79.0	59.7	79.1	79.0	100.0	104.8	na
Tariff revenues (in per cent of imports)	na	na	na	na	na	na	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	3.0	3.0	3.0	3.7	3.7	4.0	4.0
<i>EBRD index of competition policy</i>	1.0	1.0	1.0	1.0	1.0	1.7	1.7
Financial sector							
Number of banks (foreign-owned)	10 (3)	10 (3)	10 (3)	10 (7)	10 (8)	11 (8)	na
Asset share of state-owned banks (in per cent)	23.8	19.2	16.4	5.1	0.0	0.0	na
Asset share of foreign-owned banks (in per cent)	16.9	23.5	31.0	87.7	91.9	78.7	na
Non-performing loans (in per cent of total loans)	na	4.7	5.7	5.2	2.8	3.2	na
Domestic credit to private sector (in per cent of GDP)	8.0	13.3	16.8	20.7	39.4	88.4	na
Domestic credit to households (in per cent of GDP)	1.7	3.6	4.8	6.4	17.3	32.8	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	62.0	99.1	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	20.6	13.8	na
Eurobond issuance (in per cent of GDP)	na	na	na	na	na	na	na
<i>EBRD index of banking sector reform</i>	2.0	2.0	2.3	2.3	2.7	2.7	3.0
<i>EBRD index of reform of non-bank financial institutions</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	na	na	46.8 (78.0)	57.2 (89.1)	58.9 (107.3)	58.9 (107.3)	na
Internet users (per 100 inhabitants)	na	na	na	39.8	44.3	46.8	na
Railway labour productivity (1989=100)	103.7	100.9	111.2	127.6	144.7	149.8	na
Residential electricity tariffs (USc kWh)	na	na	6.0	5.9	7.5	10.1	na
Average collection rate, electricity (in per cent)	na	na	na	na	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	na	na	na	na	na	na	na
<i>EBRD index of infrastructure reform</i>	1.3	1.7	1.7	2.0	2.0	2.0	2.0
Electric power	1.0	1.7	2.0	2.3	2.3	2.3	2.3
Railways	1.0	1.0	1.0	1.0	1.7	1.7	1.7
Roads	1.7	1.7	2.0	2.0	2.0	2.0	2.0
Telecommunications	2.3	2.3	2.7	3.0	3.0	3.3	3.3
Water and waste water	2.0	2.0	2.0	2.0	2.0	2.0	2.0

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	1.9	2.5	4.4	4.2	8.6	10.3	7.0
Industrial gross output	0.6	2.4	13.8	-1.9	1.0	0.4	na
Agricultural gross output	na	na	na	na	na	na	na
Employment	<i>(Percentage change)</i>						
Labour force (end-year)	-2.6	-6.1	13.0	-3.6	-2.3	0.7	na
Employment (end-year)	-0.3	-3.3	29.9	2.0	3.7	5.5	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	40.2	38.5	29.3	25.2	20.6	16.8	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)	16.0	6.7	2.4	2.3	3.0	4.2	8.0
Consumer prices (end-year)	9.2	6.2	1.5	2.4	2.8	7.7	7.0
Producer prices (annual average)	4.5	4.5	5.8	2.1	3.0	8.5	na
Gross average monthly earnings in economy (annual average)	30.5	17.8	12.2	7.6	15.3	14.1	na
Government sector	<i>(In per cent of GDP)</i>						
General government balance	-1.9	-3.1	-1.9	2.1	4.2	6.3	0.9
General government expenditure	45.5	46.6	40.5	39.1	42.5	45.2	na
Monetary sector	<i>(Percentage change)</i>						
Broad money (M2, end-year)	na	na	16.3	49.6	87.9	72.9	na
Domestic credit (end-year)	na	na	42.4	10.6	142.3	175.5	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	na	30.5	32.1	44.2	70.1	102.6	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>						
Discount rate	na	na	na	na	na	na	na
Money market rate	na	na	na	na	na	na	na
Deposit rate	5.2	4.9	4.8	5.0	5.4	4.8	na
Lending rate (long-term)	na	na	na	12.1	9.9	9.2	na
	<i>(Euros per US dollar)</i>						
Exchange rate (official, end-year)	1.0	0.8	0.7	0.8	0.8	0.7	na
Exchange rate (official, annual average)	1.1	0.9	0.8	0.8	0.8	0.7	na
External sector	<i>(In millions of US dollars)</i>						
Current account	-158.0	-116.3	-149.0	-197.3	-667.0	-1,129.6	-1,650.0
Trade balance	-402.0	-405.3	-517.9	-650.1	-1,066.4	-1,836.0	-2,785.5
Merchandise exports	305.0	305.9	561.4	581.8	813.9	903.0	999.6
Merchandise imports	707.0	711.2	1,079.3	1,231.9	1,880.3	2,739.0	3,785.1
Foreign direct investment, net	84.0	44.0	63.3	481.9	585.3	717.4	826.5
Gross reserves, excluding gold (end-year)	58.3	63.7	82.0	216.1	408.6	687.8	na
External debt stock ¹	841.7	521.0	624.0	649.4	632.2	632.5	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	0.9	1.0	0.8	1.9	2.3	2.7	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	4.2	4.8	3.4	2.8	2.4	2.6	na
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million)	0.7	0.7	0.7	0.7	0.7	0.7	na
GDP (in millions of euros)	1,360.4	1,510.0	1,670.0	1,815.0	2,149.0	2,540.0	2,900.0
GDP per capita (in US dollars)	1,941.6	2,582.8	3,142.8	3,478.3	4,084.2	5,267.3	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)	-12.3	-6.8	-7.2	-8.6	-24.7	-32.5	-36.8
External debt - reserves (in US\$ million)	783.4	457.3	542.0	433.3	223.6	-55.3	na
External debt/GDP (in per cent)	65.7	30.6	30.1	28.3	23.5	18.2	na
External debt/exports of goods and services (in per cent)	178.7	99.9	71.6	65.1	47.2	34.7	na

¹ Public debt only. Private external debt was approximately 30 per cent GDP in 2007.

Poland

Key developments and challenges

The government has announced ambitious plans for privatising some 740 companies. These plans should be implemented as soon as possible, given the potential efficiency gains that stem from private involvement in the restructuring of these companies.

With a still relatively underdeveloped motorway network and growing constraints in the energy sector, the authorities should speed up investment to improve the transport and energy infrastructure, and involve the private sector wherever possible to maximise delivery efficiency.

The government should focus more on research and development to improve labour productivity and competitiveness. It should also raise the low rate of labour participation by reducing labour tax wedges, reforming early retirement pensions and reducing the administrative burdens faced by enterprises.

Country data

Population (in millions)	38.3
Area ('000 sq km)	313.9
GDP (in billion US\$, 2007)	420.1
Average transition score (scale: 1 to 4.33)	3.78

Progress in structural reform

Liberalisation and privatisation

Gross privatisation revenues amounted to Zł 1.95 billion (€543 million) in 2007, most of which came from the sale of minority government stakes in privately controlled companies. Difficult market conditions contributed to a slowdown in the sale of state enterprises in the first half of 2008. During this period gross privatisation revenues amounted to Zł 250 million (€80 million), equivalent to only 11 per cent of the annual target. One of the major transactions was the capital increase of the chemical firm ZA Tarnów, conducted on the Warsaw Stock Exchange in June 2008. The government announced in April 2008 an ambitious list of 740 companies to be privatised by 2011, generating expected revenues of up to Zł 27 billion (€8.4 billion).

Business environment and competition

Despite pre-election promises, implementation of key reforms has been slower than expected in the past year. One of the more prominent reforms was the creation in January 2008 of the "Friendly State" Committee in the parliament, which has the main task of reducing red tape and abolishing unnecessary regulations. The Committee subsequently proposed a number of measures that would simplify tax reporting procedures, and submitted draft amendments to a number of bills that are expected to be considered by the parliament by the end of 2008. The reduction of bureaucracy has been long seen as vital to the development of entrepreneurship in the country. However, according to the World Bank's *Doing Business 2009*

report, Poland's ranking on ease of doing business fell four places to 76th (out of 181 countries) compared with its 2008 placing – the lowest among the new EU member states. Among the measures that the government plans to implement are a reduction in the minimum capital requirement for new enterprises, an acceleration in the approval of building permits and an expansion of online tax payments. These concerns over the business environment are shared by the Polish Business Confederation, which has compiled lengthy lists of bureaucratic obstacles to the development of private enterprises.

Infrastructure

Despite significant pressure to improve its infrastructure ahead of the UEFA Euro 2012 football championship, and the ready availability of EU funds, only around 30 kilometres of new motorways had been completed in 2007. Initial delays to infrastructure investments owing to the price hikes of construction materials and services have been aggravated by problems with the public procurement law and by the not fully adequate procedures for assessing environmental impacts. The latter has still to be brought into compliance with the relevant EU directive. Further improvements in administrative capacity to increase the absorption of EU funds are also needed. New public private partnership (PPP) legislation, adopted in 2005, is also yet to have any significant results. Only two motorway stretches (the A1 and A2) are being constructed under PPP arrangements. The private sector's role in railways is also limited: at the end of 2007 only one regional passenger line was being operated by a private consortium and private operators had only about a 20 per cent market share in the cargo segment.

In the energy sector, steps to sell the first of the country's four state-owned electricity producers have been taken, with a partial privatisation through an initial public offering expected later in 2008. Entry of private capital into this sector is much needed, as electricity demand is now expected to outstrip available supplies as early as 2011 or 2012.

Social sector

In April 2008 the government announced a reform programme "Solidarity between Generations 50+" aimed at increasing labour participation among people over the age of 50. This package includes changes to the early retirement scheme, tax relief for enterprises employing workers over 50 and substantial training funds for older employees. There has been a significant drop in unemployment – to 6.7 per cent by August 2008 (according to Eurostat figures). However, the total employment rate was 57 per cent in 2007, the second lowest in the European Union (after Malta) and significantly below the EU average of 65.4 per cent. The problem is particularly severe for workers aged 55 to 64, only 29.7 per cent of whom are in employment (for women in this age group the employment rate is below 20 per cent). In particular, the farmers' social security system is in need of reform in order to counteract hidden unemployment in the agricultural sector.

Lengthy public consultations on the reform of higher education have not, so far, led to any significant changes. Poland's expenditure on research and development has for many years been low, averaging only 0.6 per cent of GDP between 1996 and 2006 (according to Eurostat), which is around a third of the EU average over the same period.

Macroeconomic performance

Real GDP growth accelerated to 6.6 per cent in 2007, the highest growth rate in a decade. In 2008, output rose by 6.1 per cent in the first half of the year, driven by strong domestic demand. Investment rose by 17.3 per cent in 2007 and grew by a further 15.3 per cent year-on-year in the first half of 2008, financed by a combination of strong corporate profits, inflows of EU funds and foreign direct investment (FDI), the latter reaching a record of €18 billion in 2007. Household consumption also remained strong, reflecting rising employment and wages, as well as high inflows of remittances from Polish workers abroad. While export growth weakened somewhat in mid-2007, it accelerated in late 2007 and early 2008, benefiting from strong demand in the region and the eurozone.

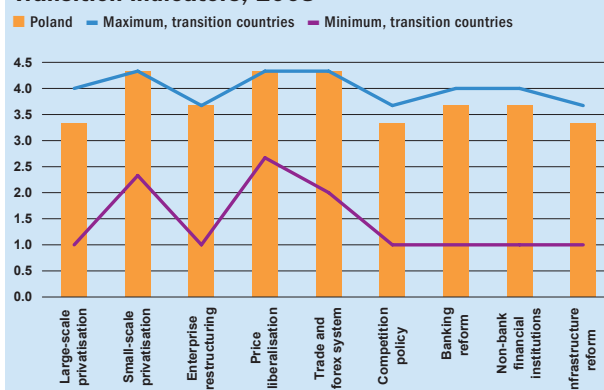
Inflation has been on an upward trend over the past two years, rising to 4.8 per cent in the year to July 2008. There has been a rapid price increase of core items, in particular services, reflecting rising wage increases, which in the enterprise sector rose by an annual rate of 11.6 per cent in July 2008. In response to these pressures, the Monetary Policy Council of the central bank has increased the policy rate five times since last summer, reaching 6 per cent in July 2008.

The general government deficit fell to an estimated 2 per cent of GDP in 2007, the lowest since 1999 and well below the targeted deficit of 3.4 per cent. This mainly reflected strong GDP growth and expenditure restraint. In 2008 the deficit is expected to rise somewhat because of further cuts in social contribution rates, the introduction of a tax allowance for families with children and higher salaries for teachers and doctors. Income tax rates will be simplified in 2009 with just two brackets at 18 and 32 per cent. Public debt declined to just over 45 per cent of GDP in 2007. The current account deficit rose to 4.1 per cent of GDP in 2007 compared with 2.7 per cent in 2006, as imports grew rapidly and profits of foreign-owned companies increased.

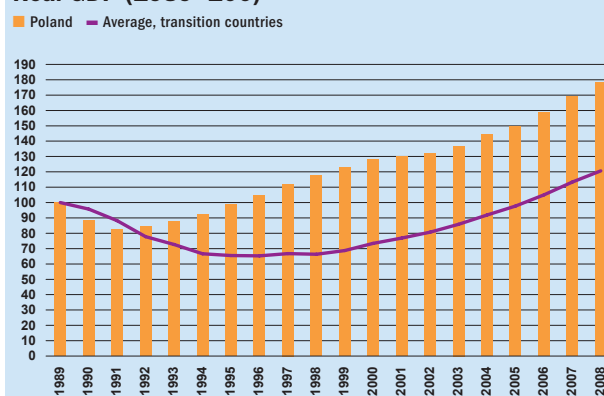
Outlook and risks

The growth momentum has weakened in recent months but remains favourable in the short term. In the past year, capacity constraints had become evident and labour market shortages were putting upward pressure on wages and inflation, which in turn affected cost competitiveness. The main effects of the global credit crunch have been tighter liquidity and higher interest rates. While the political situation is clearer, the timing of the implementation of already-announced reform measures remains uncertain. The lack of fiscal expenditure reform represents a risk in the medium term, as the recent improvement in public finances is largely explained by the cyclical upturn in revenues. In addition, the approved cuts in personal income tax rates need to be complemented with further measures to increase work incentives and tighten eligibility criteria for early retirement and social benefits. Euro adoption has come back onto the agenda with the government's announcement in September 2008 that it will aim for euro adoption in 2012.

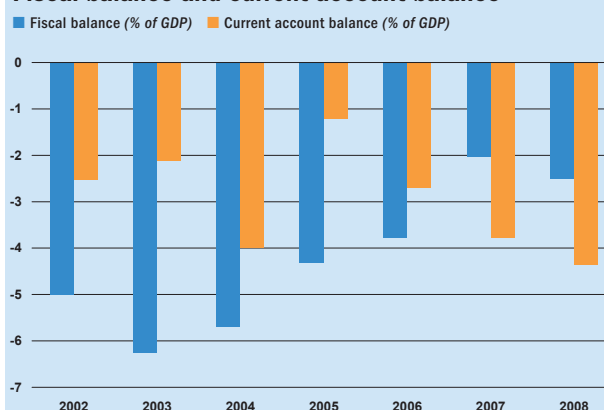
Transition indicators, 2008



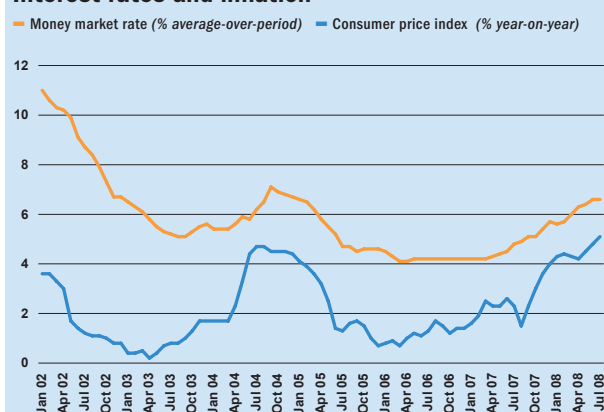
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – full	Capital adequacy ratio – 8 per cent	Share of population living in poverty – <2.0 per cent (2002) ²
Controls on inward direct investment – no	Secured transactions law – inefficient	Independence of the electricity regulator – full	Deposit insurance system – yes	Government expenditure on health – 4.2 per cent of GDP (2004)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – full	Quality of securities market laws – high	Government expenditure on education – 5.6 per cent of GDP (2005)
Exchange rate regime – floating		Independence of the road directorate – partial	Private pension funds – yes	Household expenditure on power and water – 6.8 per cent
Wage regulation – no		Quality of concession laws – medium ¹		
Tradeability of land – full except foreigners				

Structural indicators

	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	11.9	12.4	13.5	13.9	14.0	14.2	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)	67.2	68.5	70.3	70.5	71.0	72.2	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.4	0.3	0.6	0.6	0.6	0.6	na
Share of industry in total employment (in per cent)	28.7	28.4	28.3	28.7	29.3	30.1	na
Change in labour productivity in industry (in per cent)	8.5	7.1	7.0	0.6	5.4	na	na
Investment/GDP (in per cent)	18.6	18.7	20.1	19.3	20.5	0.0	0.0
<i>EBRD index of small-scale privatisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of large-scale privatisation</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3
<i>EBRD index of enterprise reform</i>	3.3	3.3	3.3	3.7	3.7	3.7	3.7
Markets and trade							
Share of administered prices in CPI (in per cent)	1.0	1.0	1.0	1.2	1.0	1.0	na
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)	81.3	81.7	79.9	78.0	76.3	76.3	na
Share of trade in GDP (in per cent)	50.8	58.9	66.9	64.3	70.8	72.5	na
Tariff revenues (in per cent of imports)	1.7	1.7	0.9	0.4	na	na	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	3.0	3.0	3.0	3.3	3.3	3.3	3.3
Financial sector							
Number of banks (foreign-owned)	59 (45)	58 (46)	57 (44)	61 (50)	63 (52)	64 (54)	na
Asset share of state-owned banks (in per cent)	26.6	25.8	21.7	21.5	21.1	19.5	na
Asset share of foreign-owned banks (in per cent)	70.7	71.5	71.3	74.3	74.2	75.5	na
Non-performing loans (in per cent of total loans)	24.7	25.1	17.4	11.6	7.7	5.4	na
Domestic credit to private sector (in per cent of GDP)	28.2	29.2	27.5	29.2	33.4	na	na
Domestic credit to households (in per cent of GDP)	9.4	10.3	10.6	12.4	15.6	20.0	na
Of which mortgage lending (in per cent of GDP)	2.4	3.4	3.8	5.0	7.2	9.9	na
Stock market capitalisation (in per cent of GDP)	13.6	16.5	23.0	31.1	40.9	44.1	na
Stock trading volume (in per cent of market capitalisation)	28.7	26.6	33.1	36.3	45.3	47.5	na
Eurobond issuance (in per cent of GDP)	11.2	0.7	1.7	4.0	1.4	1.0	na
<i>EBRD index of banking sector reform</i>	3.3	3.3	3.3	3.7	3.7	3.7	3.7
<i>EBRD index of reform of non-bank financial institutions</i>	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	30.7 (36.0)	31.9 (45.1)	32.6 (59.9)	30.7 (75.7)	29.8 (95.5)	27.1 (108.7)	na
Internet users (per 100 inhabitants)	23.0	23.2	27.6	32.6	36.6	42.0	na
Railway labour productivity (1989=100)	99.9	101.3	103.3	98.8	102.4	102.6	na
Residential electricity tariffs (USc kWh)	7.0	7.7	8.5	9.9	10.8	12.3	na
Average collection rate, electricity (in per cent)	90	na	na	na	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.7	4.9	5.3	5.6	na	na	na
<i>EBRD index of infrastructure reform</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3
<i>Electric power</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3
<i>Railways</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>Roads</i>	3.3	3.0	3.0	3.0	3.0	3.0	3.0
<i>Telecommunications</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>Water and waste water</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3

¹ Poland has no specific concession law but partly conforms with internationally accepted principles on concession law.

² Estimate based on the poorest 20 per cent of households (lowest income quintile).

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure <i>(Percentage change in real terms)</i>							
GDP	1.4	3.9	5.3	3.6	6.2	6.6	5.3
Private consumption	3.4	2.1	4.7	2.1	5.0	5.0	na
Public consumption	1.4	4.9	3.1	5.2	6.1	5.8	na
Gross fixed capital formation	-6.3	-0.1	6.4	6.5	14.9	17.6	na
Exports of goods and services	4.8	14.2	14.0	8.0	14.6	8.4	na
Imports of goods and services	2.8	9.6	15.8	4.7	17.3	12.2	na
Industrial gross output	-2.3	5.9	9.1	4.4	11.7	na	na
Agricultural gross output	1.0	2.9	6.7	-1.1	-3.3	na	na
Employment <i>(Percentage change)</i>							
Labour force (end-year)	-0.8	-0.6	0.9	0.8	-1.7	0.0	na
Employment (end-year)	-2.3	0.0	2.5	2.4	3.6	4.2	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year) ¹	19.7	19.3	18.0	16.7	12.2	8.5	na
Prices and wages <i>(Percentage change)</i>							
Consumer prices (annual average)	1.9	0.8	3.5	2.2	1.2	2.5	4.3
Consumer prices (end-year)	0.8	1.7	4.4	0.7	1.4	4.0	4.0
Producer prices (annual average)	1.2	2.7	7.1	0.7	2.2	2.2	na
Producer prices (end-year)	2.3	3.7	5.4	0.2	2.4	2.3	na
Gross average monthly earnings in economy (annual average)	3.5	3.2	4.0	9.8	5.0	9.1	na
Government sector <i>(In per cent of GDP)</i>							
General government balance	-5.0	-6.3	-5.7	-4.3	-3.8	-2.0	-2.5
General government expenditure	44.2	44.6	42.6	43.3	43.8	42.6	na
General government debt	42.2	47.1	45.7	47.1	47.6	45.4	na
Monetary sector <i>(Percentage change)</i>							
Broad money (M2, end-year)	-1.6	5.7	7.5	12.6	15.9	14.2	na
Domestic credit (end-year) ²	0.8	5.2	4.2	13.8	23.0	26.7	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	40.1	40.7	39.9	42.2	45.4	47.2	na
Interest and exchange rates <i>(In per cent per annum, end-year)</i>							
Rate on 28-day open market operations ³	6.8	5.3	6.5	4.5	4.0	5.0	na
3-months WIBOR	6.7	5.6	6.7	4.6	4.2	5.7	na
Deposit rate ⁴	4.2	2.9	2.9	3.4	3.1	3.8	na
Lending rate ⁴	11.6	9.6	10.3	7.6	7.2	8.3	na
<i>(Zlotys per US dollar)</i>							
Exchange rate (end-year)	3.9	3.8	3.0	3.3	2.9	2.4	na
Exchange rate (annual average)	4.1	3.9	3.7	3.2	3.1	2.8	na
External sector <i>(In millions of US dollars)</i>							
Current account	-5,009.0	-4,599.0	-10,115.0	-3,716.0	-9,394.0	-17,100.0	-30,200.0
Trade balance	-7,249.0	-5,725.0	-5,622.0	-2,766.0	-7,006.0	-17,057.0	-23,700.0
Merchandise exports	46,742.0	61,007.0	81,862.0	96,395.0	117,468.0	145,337.0	184,400.0
Merchandise imports	53,991.0	66,732.0	87,484.0	99,161.0	124,474.0	162,394.0	208,100.0
Foreign direct investment, net	3,901.0	4,284.0	11,761.0	6,951.0	10,727.0	17,976.0	13,700.0
Gross reserves, excluding gold (end-year)	29,794.0	34,168.0	36,783.0	42,571.0	48,484.0	65,745.0	na
External debt stock	84,875.0	107,274.0	129,807.0	132,830.0	169,568.0	231,713.0	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	5.7	5.3	4.4	4.5	4.0	4.2	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	23.0	24.0	27.0	22.0	26.0	19.9	na
Memorandum items <i>(Denominations as indicated)</i>							
Population (end-year, million)	38.2	38.2	38.2	38.2	38.1	38.1	na
GDP (in billions of zlotys)	808.6	843.2	924.5	983.3	1,060.2	1,162.9	1,277.2
GDP per capita (in US dollars)	5,185.4	5,674.7	6,624.9	7,967.1	8,957.5	11,037.2	na
Share of industry in GDP (in per cent)	28.7	29.6	30.8	31.0	32.6	na	na
Share of agriculture in GDP (in per cent)	2.7	2.6	2.5	2.5	2.3	na	na
Current account/GDP (in per cent)	-2.5	-2.1	-4.0	-1.2	-2.7	-4.1	-5.2
External debt - reserves (in US\$ million)	55,081.0	73,106.0	93,024.0	90,259.0	121,084.0	165,968.0	na
External debt/GDP (in per cent)	42.8	49.5	51.3	43.7	49.6	55.2	na
External debt/exports of goods and services (in per cent)	149.5	148.6	136.2	117.9	122.8	133.1	na

¹ According to Eurostat.² Includes domestic credit to non-financial sector and general government.³ In 2003 and 2004 the rate refers to 14-day open market operations, from January 2005 it refers to 7-day open market operations.⁴ Weighted average, as reported by the National Bank of Poland. Calculation of the new rates has been conceptually adjusted to harmonised ECB requirements. The data since 2004 are adjusted to the new methodology.

Romania

Key developments and challenges

Competitive pressures from the EU single market have intensified, especially for small and medium-sized enterprises. The main challenge is to attract fresh capital, both debt and equity, and associated skills and technology, and combine this with a more flexible labour market to ease wage pressures, and a stepping-up of the fight against corruption.

The quality of infrastructure – roads, railways and municipal services – remains well below the EU average and is causing bottlenecks. Private sector involvement in the provision of infrastructure services can increase efficiency and the quality of delivery.

The economy is growing rapidly but is showing some signs of overheating, with inflation still above target and a large current account deficit. Tighter control of public spending is necessary to increase the effectiveness of the macroeconomic policy mix and to deliver sustainable low inflation.

Country data

Population (in millions)	21.7
Area ('000 sq km)	238.4
GDP (in billion US\$, 2007)	165.7
Average transition score (scale: 1 to 4.33)	3.44

Progress in structural reform

Business environment and competition

Although the business environment continues to improve, there is still a need to strengthen state institutions and law enforcement. These points were brought out in the most recent European Commission (EC) progress report on Romania, issued on 23 July 2008, in which it welcomed the first results of efforts to reform the judicial system and fight corruption. However, it noted the lack of a broad political consensus, which is hindering the eradication of high-level corruption. It also urged the authorities to strengthen judicial reform and make a clear commitment to tackling this problem.

Romania's labour market has become progressively tighter in recent years, reflecting strong labour demand as well as significant outward migration, with the unemployment rate below 4 per cent by mid-2008. According to a recent OECD report, rigid labour market regulations and bureaucracy are among the factors responsible for the relatively high proportion of informal employment in the economy. These include high payroll taxes, overly strict contractual conditions, high social security contributions and the costly process of hiring and firing workers. The OECD also noted that high taxes,

complicated and strict regulations and lengthy and costly registration procedures are the main obstacles to business registration. In the World Bank's *Doing Business 2009* survey, Romania scores well among transition countries in terms of ease of starting a business, access to credit and enforcing contracts, but poorly in the employment of workers and paying taxes.

Infrastructure

The National Energy Sector Strategy 2007-20, adopted in September 2007, advocates the creation of an integrated power sector "national champion", able to compete at the regional level. In October 2008, the government adopted an emergency ordinance to establish the new company, which will include Electrica's three electricity distribution companies, the assets of hydropower generator Hidroelectrica and the integrated mining-generation energy holdings of Turceni and Rovinari. The government also announced that, in the future, shares in the new company would be listed on the Bucharest stock exchange.

The strategy also advocates the creation of public-private partnerships (PPPs) in the energy sector, including nuclear power. Several European utility companies took part in a tender to participate in a PPP with the state nuclear company, Nuclearelectrica, to build two additional units at the Cernavodă nuclear power plant and were awarded shareholdings in the new units. However, the state's share in the project was recently increased from an initially agreed 20 per cent to a majority stake of 51 per cent. Nuclearelectrica now needs the endorsement of the Competition Council to take a majority participation in the project and to renegotiate the utility companies' shareholdings, and the delay has led to an increase in the costs of the project.

Investment needs in the transport sector remain substantial, and significant EU funding (around €4.6 billion) is expected to be available in the coming years. PPPs for roads and railways have not yet been developed. However, a concession contract is currently under tender for the 58 kilometre Comarnic-Brasov highway. There are plans to attract private investors for other key roads such as the Bucharest North Ring Road and a new motorway to Moldova.

Social sector

Romania has made progress over the past year with the implementation of its pension reforms. Under new legislation, contribution to a private pension fund is obligatory for all employees under the age of 35 and a gradually increasing part of their contributions to the state system will be re-directed to the private pillar. As of mid-2008, there are eight voluntary and 14 compulsory private pension funds operating in the country, but assets under management are still limited (around €64 million as of end-June 2008). The development of the private pension system is expected to foster capital market investments, although currently the bulk of their portfolios is made up of cash contributions, bank deposits and government securities.

Macroeconomic performance

Economic growth has been very strong in the past year, with GDP rising by a robust 6 per cent in 2007, increasing to 8.2 per cent (on an annual basis) in the first quarter of 2008 and 9.3 per cent in the second quarter. Figures released for July 2008 showed export growth of 18.5 per cent year-on-year in euro terms, higher than import growth (15.2 per cent). Industrial output is also growing strongly at nearly 6 per cent in the first seven months of the year, but by July 2008 retail sales were showing signs of a mild slowdown.

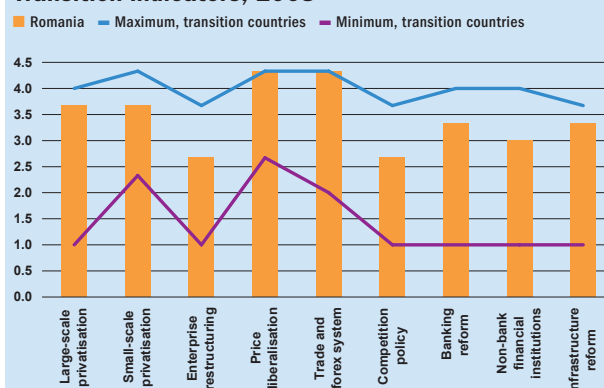
There are various indications that the economy is overheating: the rapid rise of domestic demand on the back of a credit boom, which has started to moderate somewhat, has led to a large current account deficit, inflation is declining but remains high and the labour market is tight. Annual inflation was 8.0 per cent in August and is likely to fall further in the second half of the year, especially if reports of a good harvest are confirmed, which would help to lower agricultural prices. The National Bank of Romania has raised the monetary policy rate repeatedly in 2008, including a 25 basis point rise in July to 10.25 per cent.

The government has also signalled its concerns about fiscal discipline by committing to a proposed deficit this year of 2.3 per cent of GDP, slightly below the level in 2007. However, to attain this target the government will have to resist some of the pre-election pressures to increase spending. The current account deficit seems to have stabilised at around 14 per cent of GDP by mid-2008. The resulting considerable external financing requirement was to a large extent met through borrowing; foreign direct investment (FDI) coverage of the deficit was around 40 per cent last year but has risen to more than 60 per cent for the first seven months of 2008, reflecting strong non-privatisation related investment flows this year. The foreign exchange market responded to these risks with an 18 per cent depreciation of the leu in the second half of last year (from non-sustainable highs in the first half of the year), but it was stable for most of 2008 up to early October, when it began to depreciate again.

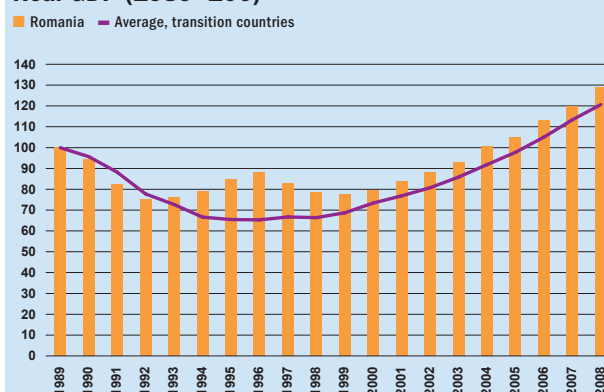
Outlook and risks

In the current global environment, the short-term prospects for the economy are highly uncertain, but the long-term prospects look encouraging. There is still much catching up to do, but the country is well placed to act as an important regional centre and to take advantage of the substantial EU funds that will be made available in the coming years. In the short term, the key macroeconomic challenge is to manage the inevitable slowdown carefully. Fiscal discipline will be vital, particularly as the government tries to establish its credibility and a strong fiscal track record in the run-up to membership of the eurozone. A more fundamental challenge is to build up the capacity of human capital, both through increased training and education of those in the country and by attracting back those who have left in recent years to work abroad.

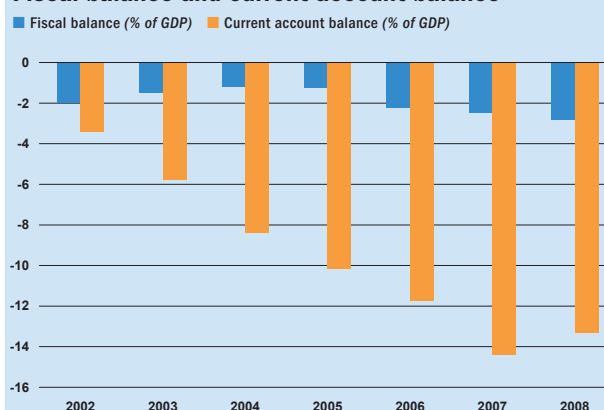
Transition indicators, 2008



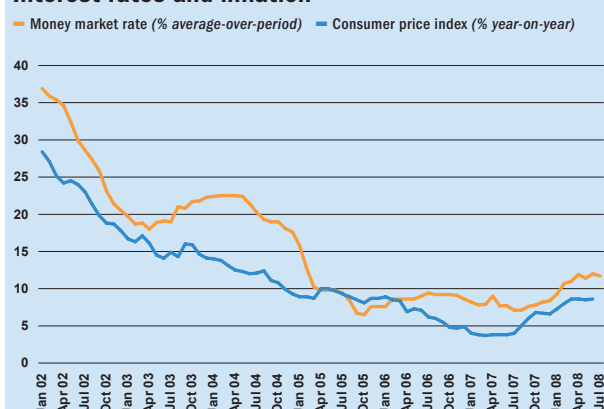
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – full	Capital adequacy ratio – 12 per cent	Share of population living in poverty – 12.9 per cent (2003)
Controls on inward direct investment – no	Secured transactions law – advanced	Independence of the electricity regulator – full	Deposit insurance system – yes	Government expenditure on health – 3.9 per cent of GDP (2005)
Interest rate liberalisation – full	Quality of corporate governance law – high	Separation of railway infrastructure from operations – full	Quality of securities market laws – high	Government expenditure on education – 3.6 per cent of GDP (2005)
Exchange rate regime – managed float		Independence of the road directorate – full	Private pension funds – yes	Household expenditure on power and water – 3.7 per cent
Wage regulation – yes		Quality of concession laws – medium		
Tradeability of land – full except foreigners				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	8.7	8.9	9.2	9.5	9.7	na	na
Private sector share in GDP (in per cent)	65.0	65.0	70.0	70.0	70.0	70.0	70.0
Private sector share in employment (in per cent)	52.5	56.5	58.0	64.9	66.3	68.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	14.0	13.5	14.6	14.2	14.7	16.3	na
Share of industry in total employment (in per cent)	31.7	30.2	31.8	30.6	31.4	32.0	na
Change in labour productivity in industry (in per cent)	0.8	9.2	-0.3	6.1	4.3	2.4	na
Investment/GDP (in per cent)	21.7	21.8	23.8	22.6	26.5	31.6	na
<i>EBRD index of small-scale privatisation</i>	3.7	3.7	3.7	3.7	3.7	3.7	3.7
<i>EBRD index of large-scale privatisation</i>	3.3	3.3	3.7	3.7	3.7	3.7	3.7
<i>EBRD index of enterprise reform</i>	2.0	2.0	2.0	2.3	2.7	2.7	2.7
Markets and trade							
Share of administered prices in CPI (in per cent)	20.3	21.5	22.4	21.9	20.6	21.4	na
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	0.0	na
Share of trade with non-transition countries (in per cent)	84.0	83.9	80.5	78.6	77.8	74.7	na
Share of trade in GDP (in per cent)	66.2	66.7	71.0	66.9	64.9	63.1	64.5
Tariff revenues (in per cent of imports)	1.7	1.8	1.5	na	na	na	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	2.3	2.3	2.3	2.3	2.7	2.7	2.7
Financial sector							
Number of banks (foreign-owned)	31 (24)	30 (21)	32 (23)	33 (24)	31 (26)	31 (26)	na
Asset share of state-owned banks (in per cent)	43.6	40.6	7.5	6.5	5.9	5.7	na
Asset share of foreign-owned banks (in per cent)	52.9	54.8	58.5	59.2	87.9	87.3	na
Non-performing loans (in per cent of total loans)	2.3	1.5	1.7	1.7	1.8	3.0	na
Domestic credit to private sector (in per cent of GDP)	10.1	13.7	15.7	20.0	26.1	32.9	na
Domestic credit to households (in per cent of GDP)	na	3.8	4.8	7.2	11.2	17.7	na
Of which mortgage lending (in per cent of GDP)	na	0.3	0.5	0.6	0.9	1.4	na
Stock market capitalisation (in per cent of GDP)	10.1	9.2	13.9	22.2	24.4	27.3	na
Stock trading volume (in per cent of market capitalisation)	23.0	8.8	11.6	21.0	16.0	20.8	na
Eurobond issuance (in per cent of GDP)	3.3	0.9	0.0	1.2	na	na	na
<i>EBRD index of banking sector reform</i>	2.7	2.7	3.0	3.0	3.0	3.3	3.3
<i>EBRD index of reform of non-bank financial institutions</i>	2.0	2.3	2.3	2.3	2.3	2.7	3.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	19.3 (23.5)	20.0 (32.5)	20.3 (47.1)	20.3 (61.8)	19.4 (80.5)	20.1 (106.7)	na
Internet users (per 100 inhabitants)	10.1	11.5	20.8	31.5	52.2	56.0	na
Railway labour productivity (1989=100)	51.0	53.7	60.0	55.1	63.2	60.3	na
Residential electricity tariffs (USc kWh)	7.0	8.1	8.6	11.3	12.9	15.9	na
Average collection rate, electricity (in per cent)	96	98	100	99	100	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.2	4.4	4.9	5.3	na	na	na
<i>EBRD index of infrastructure reform</i>	3.0	3.0	3.3	3.3	3.3	3.3	3.3
<i>Electric power</i>	3.0	3.0	3.3	3.3	3.3	3.7	3.7
<i>Railways</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>Roads</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>Telecommunications</i>	3.0	3.0	3.0	3.0	3.3	3.3	3.3
<i>Water and waste water</i>	3.0	3.0	3.3	3.3	3.3	3.3	3.3

Macroeconomic indicators	2002	2003	2004	2005	2006	2007 Estimate	2008 Projection
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	5.1	5.2	8.5	4.2	7.9	6.0	7.5
Private consumption	5.2	8.4	14.6	9.9	12.4	11.0	na
Public consumption	3.2	7.7	-4.9	8.5	-3.1	5.6	na
Gross fixed capital formation	8.2	8.6	11.1	12.7	19.3	28.9	na
Exports of goods and services	17.5	8.4	13.9	7.7	10.6	8.8	na
Imports of goods and services	12.0	16.0	22.1	16.0	22.4	26.1	na
Industrial gross output, unadjusted series	4.3	3.1	5.3	2.1	7.2	5.4	na
Agricultural gross output	-3.0	7.6	16.8	-13.9	3.3	-17.0	na
Employment	<i>(Percentage change)</i>						
Labour force (end-year)	-13.5	-2.2	1.9	-1.4	0.6	-0.3	na
Employment (end-year)	-14.8	-0.8	0.4	0.0	0.2	0.9	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year) ¹	8.0	6.7	8.1	6.8	7.2	6.1	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)	22.5	15.4	12.0	9.5	6.9	4.8	7.2
Consumer prices (end-year)	17.8	14.1	9.3	8.6	4.9	6.6	6.0
Producer prices (annual average)	23.6	19.5	18.5	12.3	11.9	8.6	na
Producer prices (end-year)	24.5	19.6	18.5	12.5	12.0	8.7	na
Gross average monthly earnings in economy (annual average)	27.3	23.6	22.5	17.0	18.9	22.6	na
Government sector	<i>(In per cent of GDP)</i>						
General government balance ²	-2.0	-1.5	-1.2	-1.2	-2.2	-2.5	-2.8
General government expenditure	39.6	33.6	33.6	33.5	35.3	36.9	na
General government debt ²	25.0	21.5	18.8	15.8	12.4	13.0	na
Monetary sector	<i>(Percentage change)</i>						
Broad money (M2, end-year)	38.1	23.3	37.1	36.5	28.1	34.0	na
Domestic credit (end-year)	38.7	49.0	40.2	43.7	52.0	64.5	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	24.7	23.3	25.6	29.9	32.1	36.6	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>						
Discount rate	29.0	20.4	18.0	7.5	8.8	7.5	na
1-week BUBOR	20.5	22.3	17.6	7.6	8.6	8.4	na
Deposit rate (average)	19.2	11.0	11.5	6.4	4.8	6.7	na
Lending rate (average)	35.4	25.4	25.6	19.6	14.0	13.4	na
	<i>(Lei per US dollar)</i>						
Exchange rate (end-year) ³	3.4	3.3	2.9	3.1	2.6	2.5	na
Exchange rate (annual average) ³	3.3	3.3	3.3	2.9	2.8	2.4	na
External sector	<i>(In millions of US dollars)</i>						
Current account	-1,573.0	-3,454.5	-6,333.3	-10,054.2	-14,446.0	-23,842.7	-25,416.8
Trade balance	-2,613.0	-4,464.9	-6,611.5	-9,873.3	-14,770.1	-24,137.9	-27,727.4
Merchandise exports	13,869.0	17,627.0	23,518.4	28,148.9	32,469.4	40,175.6	47,752.7
Merchandise imports	16,482.0	22,091.9	30,129.8	38,022.2	47,239.5	64,313.4	75,480.1
Foreign direct investment, net	1,080.0	2,156.2	6,368.0	6,587.3	10,956.7	9,817.7	11,553.1
Gross reserves, excluding gold (end-year)	6,144.5	8,049.9	14,805.6	20,994.5	28,061.1	37,204.3	na
External debt stock	16,971.3	22,398.0	29,700.8	38,866.3	54,174.5	69,860.6	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	3.9	3.9	5.2	5.8	6.2	6.0	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service ⁴	19.9	16.7	15.5	13.4	14.0	12.4	na
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million)	21.8	21.7	21.7	21.7	21.7	21.7	na
GDP (in billions of lei) ³	151.5	197.6	246.5	288.2	344.5	404.7	430.0
GDP per capita (in US dollars)	2,102.5	2,738.0	3,484.5	4,550.7	5,651.5	7,636.0	na
Share of industry in GDP (in per cent)	28.1	25.0	24.7	24.6	na	na	na
Share of agriculture in GDP (in per cent)	11.4	11.6	12.6	8.4	7.8	na	na
Current account/GDP (in per cent)	-3.4	-5.8	-8.4	-10.2	-11.8	-14.4	-13.3
External debt - reserves (in US\$ million)	10,826.8	14,348.2	14,895.2	17,871.8	26,113.3	32,656.4	na
External debt/GDP (in per cent)	37.0	37.6	39.3	39.3	44.1	42.2	na
External debt/exports of goods and services (in per cent)	104.8	108.5	109.5	117.3	137.2	138.1	na

¹ Officially registered unemployed. According to the ILO methodology, the rate of unemployment in Romania is lower than the official one.

² Calculated according to Eurostat methodology (ESA95).

³ The Romanian lei was redenominated in July 2005. All data have been converted to new lei (RON).

⁴ Debt service payments on private and public external debt.

Russia

Key developments and challenges

Higher domestic demand is putting more strain on Russia's ageing infrastructure. Tariff reforms to achieve full cost-recovery and further legal and regulatory improvements are needed to attract sustained private investment in infrastructure and to allow public-private partnerships (PPPs) to progress.

Following a further deterioration in the international credit crunch, access by Russian private and state-owned companies to international capital markets is becoming increasingly constrained. To ensure that domestic credit is allocated efficiently to a broad range of industries the authorities will need to allow a balanced expansion of private and state-owned banks and enterprises.

The authorities have employed a range of measures to stem rising inflation, while providing ample liquidity to domestic banks. As costs and wages continue to rise, the authorities will need to reduce administrative control and allow the real cost of capital to go up.

Country data

Population (in millions)	142.2
Area ('000 sq km)	17,075.0
GDP (in billion US\$, 2007)	1,288.6
Average transition score (scale: 1 to 4.33)	3.04

Progress in structural reform

Liberalisation and privatisation

Since the change in political leadership in the spring of 2008 there have been few initiatives to open state companies to private investment, despite some declarations in support of reform. In fact, in May 2008 state shareholdings in over 400 companies were consolidated in Russian Technologies, a mainly defence-oriented state holding company.

In October 2007 the government sought a voluntary agreement among retailers to limit price rises in a number of essential food items, as part of its effort to combat inflation. This agreement was complemented by various trade measures, such as export duties on grain and reduced import tariffs on milk and dairy products. In July 2008 the authorities created a state grain trading company that would consolidate control over the country's grain exports, which has until now been largely in private hands. Given the particularly rapid escalation in producer costs, the competition authorities are closely monitoring the prices set by suppliers to domestic infrastructure projects. The government has suspended the application of certain commitments made as part of the World Trade Organization (WTO) accession process and indicated that the process is unlikely to be concluded over the next year.

Business environment and competition

In July 2008 the president signed an anti-corruption plan that, through a series of new laws to be passed before the end of 2008, defines new criminal penalties for corrupt behaviour, provides for better scrutiny of the conduct of public officials and improves governance in the delivery of public services. The government also plans to reduce the administrative burden on businesses, in particular small and medium-sized enterprises (SMEs), and to carry out comprehensive reform of the judiciary to strengthen the rule of law.

The Law on Foreign Investment in Strategic Industries came into effect in May 2008 and clarifies the legal framework in key sectors. Foreign investors must now obtain official permission before acquiring controlling stakes in 42 strategic industries (lower ownership thresholds apply for investments in mineral extraction or if the investor is state-owned). Foreign investors have expressed concerns about the required security clearance and potential constraints in sectors where they already operate, such as energy and telecommunications. Firms in strategic industries also face restrictions on listing their shares on foreign stock exchanges, which could affect investment in these industries.

Infrastructure

The government recently announced a large investment programme to improve transport infrastructure, with two-thirds of the targeted 13,500 billion roubles (€380 billion) coming from private investors between 2010 and 2015. The potential benefits of attracting more private investment in infrastructure are shown by the expansion of sea port capacity, following the adoption of a clearer legal framework in 2007. By contrast, only limited progress has been made with the government-sponsored public-private partnerships (PPPs), which are essential for leveraging private capital. Amendments to the competition law now stipulate competitive tendering for PPP contracts. At the same time, long delays in implementation reflect the complexity of structuring agreements with private investors and the need to approve various legislative amendments, in particular those relating to the terms of the government's participation and risk-sharing arrangements.

Russia's power sector entered a new phase in July 2008 when RAO UES ceased to exist. This was the culmination of a process of "unbundling", when separate generation and distribution companies were spun off and sold to various investors. A number of foreign and domestic investors have acquired controlling stakes in the 14 regional generation companies (TGKs) and in the seven wholesale generation companies (OGKs). Only two companies (RusHydro and the Federal Grid Company) will remain state-owned. Moreover, the share of electricity that can be sold on the liberalised market will gradually increase, which should stimulate investment in new generating capacity.

The government also approved a series of increases in household gas and electricity tariffs (each by about 25 per cent). These increases reflect the higher price benchmarks that are now used for energy and would accelerate the convergence with prices charged to industrial consumers.

Macroeconomic performance

Strong growth in domestic investment and consumption continued to drive the Russian economy forward, with GDP growing by 8 per cent in the first half of 2008 (year-on-year). By mid-2008, there were still signs that the economy was overheating: the substantially higher inflation, very strong import growth and real wage growth in excess of productivity increases. Consumer and producer prices had risen by 15 and 28 per cent respectively over the previous 12 months. Despite these growing cost pressures, the small Russian manufacturing sector nevertheless benefited from strong domestic demand and grew at 9.5 per cent in 2007. This compares to growth in the hydrocarbons sector of less than two per cent.

Continued strong fiscal surpluses have raised the possibility of further tax reductions, although so far only a minor reduction in the extractive industries tax has been adopted. At the end of 2007, 640 billion roubles (about €19 billion) was transferred to various public investment projects in areas such as infrastructure, nanotechnology and residential housing repair, as well as the state development bank.

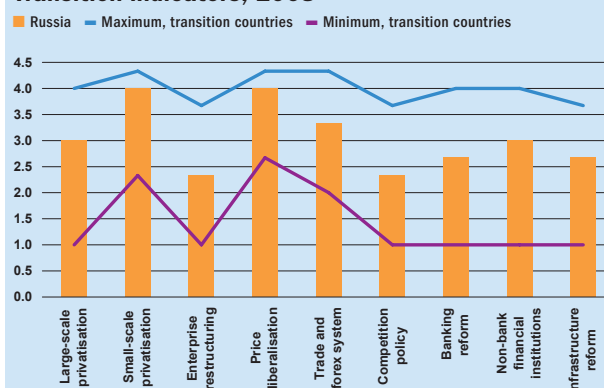
In 2007 the surge in international oil prices temporarily raised the external trade surplus, even though total exports showed only modest real growth. As the current account surplus declined once again, overall liquidity conditions in Russia depend increasingly on more volatile capital inflows, which reversed in the third quarter of 2007 and in early 2008. The third quarter of 2008 again saw an increase in foreign investors' perceptions of political risk. Substantial capital outflows resulted, following the conflict with Georgia and due to an increase in international risk aversion.

Up to September 2008 the banking sector had remained reasonably stable and benchmark interest rates showed only marginal increases. This resilience was supported by selective deposits in commercial banks by budgetary institutions, and by substantial liquidity injections by the central bank. Following the large capital outflows in September 2008 these instruments were further widened, notably through deposits by the Central Bank of Russia with the state development bank designed to meet the external refinancing needs of banks and companies.

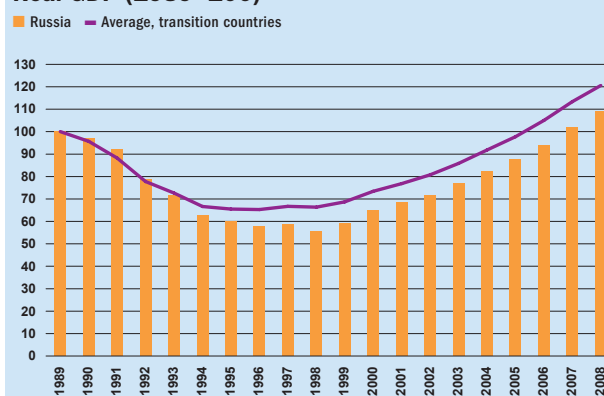
Outlook and risks

Rapidly tightening liquidity in the domestic financial system coupled with lack of access to international credit are now the main risks to Russia's growth. Growth in private investment is likely to slow rapidly as access to external credit will remain constrained. Liquidity will tighten further, financing costs will increase and foreign investors may be deterred by rising costs within Russia. Ultimately, measures to lower inflation will require growth more in line with potential output. In mid-2008 the Russian authorities began to tighten monetary policy and allowed greater flexibility in the rouble rate. Over the medium term this is likely to lead to an increase in the costs of bank funding and a withdrawal of the very generous liquidity support mechanisms granted to the banking system by the central bank last year. The adjustment of the banking sector to tighter liquidity conditions will require an even-handed approach by the supervisor, as liquidity constraints in international and domestic credit markets have benefited those banks and other borrowers that are ostensibly state-backed. This risks poor lending decisions and an expansion of state-owned firms at the expense of smaller private enterprises and banks.

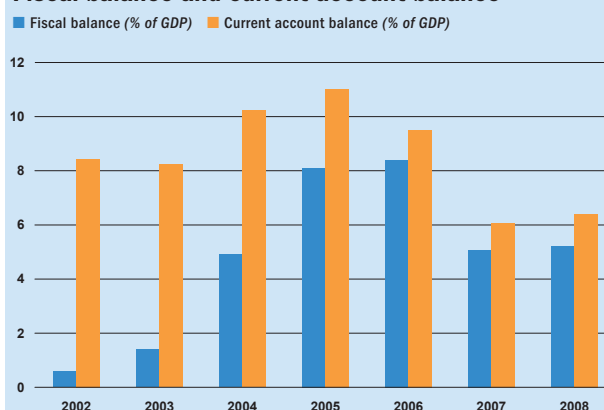
Transition indicators, 2008



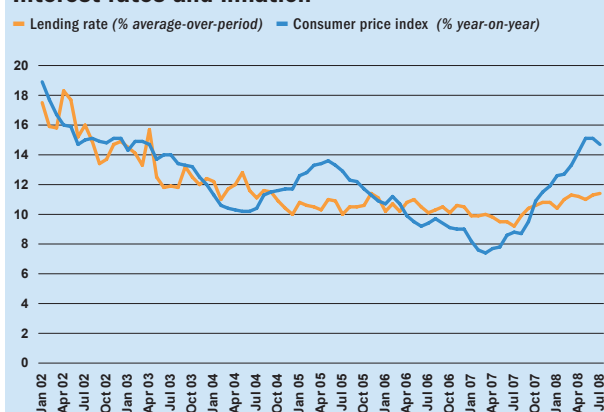
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – medium	Capital adequacy ratio – 10-11 per cent	Share of population living in poverty – 15.8 per cent (2005)
Controls on inward direct investment – yes ¹	Secured transactions law – malfunctioning	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 3.2 per cent of GDP (2005)
Interest rate liberalisation – full	Quality of corporate governance law – high	Separation of railway infrastructure from operations – partial	Quality of securities market laws – medium	Government expenditure on education – 3.7 per cent of GDP (2005)
Exchange rate regime – managed float		Independence of the road directorate – partial	Private pension funds – yes	Household expenditure on power and water – 6.6 per cent
Wage regulation – no		Quality of concession laws – low		
Tradeability of land – limited de facto				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	4.7	5.6	6.2	6.3	6.5	6.5	na
Private sector share in GDP (in per cent)	70.0	70.0	70.0	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) ²	na	na	na	3.5	na	na	na
Share of industry in total employment (in per cent)	23.1	22.6	22.2	21.7	21.3	21.2	na
Change in labour productivity in industry (in per cent)	4.8	8.4	8.9	6.2	5.8	6.3	na
Investment/GDP (in per cent)	20.0	20.8	20.9	20.1	21.3	24.5	na
<i>EBRD index of small-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	3.3	3.3	3.3	3.0	3.0	3.0	3.0
<i>EBRD index of enterprise reform</i>	2.3	2.3	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	6.7	6.7	na
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	1.0	1.0	na
Share of trade with non-transition countries (in per cent)	70.3	69.5	67.5	73.2	75.2	74.6	na
Share of trade in GDP (in per cent)	48.8	49.1	48.2	48.2	47.2	44.9	na
Tariff revenues (in per cent of imports) ³	16.9	19.4	25.1	28.7	na	na	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	3.0	3.3	3.3	3.3	3.3	3.3	3.3
<i>EBRD index of competition policy</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Financial sector							
Number of banks (foreign-owned)	1329 (37)	1329 (41)	1299 (42)	1253 (52)	1189 (65)	1136 (86)	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)	8.1	7.4	7.6	8.3	12.1	17.2	na
Non-performing loans (in per cent of total loans)	6.4	5.6	3.6	2.8	2.4	2.0	na
Domestic credit to private sector (in per cent of GDP)	17.7	21.0	24.9	26.1	31.5	38.5	na
Domestic credit to households (in per cent of GDP)	1.0	1.9	3.2	4.9	7.1	9.0	na
Of which mortgage lending (in per cent of GDP)	na	na	0.1	0.2	0.9	1.9	na
Stock market capitalisation (in per cent of GDP)	36.7	51.1	44.6	72.9	103.4	111.8	na
Stock trading volume (in per cent of market capitalisation)	30.1	46.0	53.0	39.0	64.1	58.9	na
Eurobond issuance (in per cent of GDP)	1.0	1.2	2.8	2.3	2.1	2.5	na
<i>EBRD index of banking sector reform</i>	2.0	2.0	2.0	2.3	2.7	2.7	2.7
<i>EBRD index of reform of non-bank financial institutions</i>	2.3	2.7	2.7	2.7	3.0	3.0	3.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	24.4 (12.1)	25.0 (25.0)	26.8 (51.2)	27.9 (83.6)	30.8 (105.7)	30.8 (119.3)	na
Internet users (per 100 inhabitants)	4.1	8.3	12.9	15.2	18.0	21.1	na
Railway labour productivity (1989=100)	90.1	101.6	108.1	115.7	117.1	132.9	na
Residential electricity tariffs (USc kWh) ⁴	na	2.7	3.2	3.9	4.8	5.7	na
Average collection rate, electricity (in per cent)	91	92	95	97	95	96	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.1	2.2	2.4	2.6	na	na	na
<i>EBRD index of infrastructure reform</i>	2.3	2.3	2.7	2.7	2.7	2.7	2.7
<i>Electric power</i>	2.3	3.0	3.0	3.0	3.0	3.0	3.3
<i>Railways</i>	2.3	2.3	2.7	2.7	2.7	3.0	3.0
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.3
<i>Water and waste water</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.7

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 Tariffs for 2003-07 are for flats without electric ovens.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	4.7	7.3	7.1	6.4	7.4	8.1	7.3
Private consumption	8.5	7.5	12.1	11.8	11.2	12.8	na
Public consumption	2.6	2.2	2.1	1.3	2.5	5.0	na
Gross fixed capital formation	2.8	12.8	12.6	10.6	17.7	20.8	na
Exports of goods and services	10.3	12.5	11.8	6.5	7.3	6.4	na
Imports of goods and services	14.6	17.7	23.3	16.6	21.9	27.3	na
Industrial gross output	3.7	7.0	7.3	4.0	6.3	6.3	na
Agricultural gross output	1.5	5.5	3.0	1.1	3.6	3.1	na
Employment							
<i>(Percentage change)</i>							
Labour force (end-year)	-0.1	1.4	0.2	-0.1	0.1	0.7	na
Employment (end-year)	0.9	0.6	0.6	0.6	0.6	0.8	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	8.5	7.8	7.9	7.1	6.7	5.6	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	15.7	13.7	10.9	12.7	9.7	9.0	13.0
Consumer prices (end-year)	15.0	12.0	11.7	10.9	9.0	9.0	13.5
Producer prices (annual average)	14.0	16.6	22.0	18.2	11.2	12.7	na
Producer prices (end-year)	17.1	12.5	28.8	13.4	10.4	25.1	na
Gross average monthly earnings in economy (annual average)	36.7	24.4	24.0	25.3	25.4	25.0	na
Government sector¹							
<i>(In per cent of GDP)</i>							
General government balance	0.6	1.4	4.9	8.1	8.4	5.1	5.2
General government expenditure	37.1	35.7	33.6	31.5	31.2	33.0	na
General government debt	41.4	32.4	25.9	16.5	10.6	9.5	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	32.4	50.5	35.8	38.5	48.8	47.5	na
Domestic credit (end-year)	26.5	26.5	18.7	2.7	28.4	na	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	19.7	24.3	26.0	27.9	33.5	40.2	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Central Bank refinance rate (uncompounded)	21.0	16.0	13.0	12.8	11.7	10.3	na
Money market rate	na	na	na	4.8	5.1	5.8	na
Deposit rate	4.3	4.4	3.8	3.6	4.1	5.1	na
Lending rate	15.0	13.0	11.4	10.7	10.5	10.0	na
<i>(Roubles per US dollar)</i>							
Exchange rate (end-year)	31.8	29.5	27.9	28.8	26.3	24.5	na
Exchange rate (annual average)	31.4	30.7	28.8	28.3	27.1	25.6	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	29,116.0	35,410.0	59,514.0	84,443.0	94,300.0	78,309.0	112,800.0
Trade balance	46,335.0	60,493.0	85,825.0	118,497.0	139,208.0	132,044.0	165,810.1
Merchandise exports	107,301.0	135,929.0	183,207.0	243,800.0	303,900.0	355,465.0	448,810.1
Merchandise imports	60,966.0	75,436.0	97,382.0	125,303.0	164,692.0	223,421.0	283,000.0
Foreign direct investment, net	-72.0	-1,769.0	1,662.0	119.0	10,753.0	6,800.0	5,000.0
International reserves, excluding gold (end-year)	44,053.6	73,175.0	120,809.0	175,891.0	295,568.0	465,878.0	na
External debt stock	169,900.0	199,400.0	225,000.0	257,200.0	310,600.0	464,000.0	na
<i>(In months of imports of goods and services)</i>							
International reserves, excluding gold (end-year)	6.3	8.6	11.1	12.9	16.9	19.7	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	16.8	20.1	22.2	26.0	25.1	na	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	145.0	144.2	143.5	142.8	142.2	142.2	na
GDP (in billions of roubles)	10,817.5	13,201.1	16,778.8	21,665.0	26,882.9	32,988.6	41,256.1
GDP per capita (in US dollars)	2,379.6	2,983.0	4,059.0	5,361.4	6,977.6	9,062.0	na
Share of industry in GDP (in per cent)	24.9	24.1	27.5	28.8	27.9	28.0	na
Share of agriculture in GDP (in per cent)	6.0	6.0	5.4	4.8	4.3	4.1	na
Current account/GDP (in per cent)	8.4	8.2	10.2	11.0	9.5	6.1	6.4
External debt - reserves (in US\$ million)	125,846.4	126,225.0	104,191.0	81,309.0	15,032.0	-1,878.0	na
External debt/GDP (in per cent)	49.2	46.4	38.6	33.6	31.3	36.0	na
External debt/exports of goods and services (in per cent)	140.5	131.2	110.6	95.7	92.8	118.5	na

¹ General consolidated government includes the federal, regional and local budgets and extra-budgetary funds, and excludes transfers.

Serbia

Key developments and challenges

Large-scale privatisation is proceeding slowly and many large socially or state-owned assets remain to be sold. It is important that all tenders and sales are open and transparent in order to attract much-needed high-quality investment.

Serbia has significant infrastructure needs and faces major reform challenges in energy, transport and telecommunications. The newly established National Council for Infrastructure should try to prioritise long-term reforms such as effective and independent regulation and the involvement of the private sector.

Although the economy is growing strongly, both inflation and the current account deficit are at high levels. Given the tight monetary policy, the key challenge is for fiscal policy to ensure that public spending is kept under control.

Country data

Population (in millions)	(including Kosovo) 9.9
Area ('000 sq km)	(including Kosovo) 102.0
GDP (in billion US\$, 2007)	41.0
Average transition score (scale: 1 to 4.33)	2.85

Progress in structural reform

Liberalisation and privatisation

Serbia has made significant progress in the past year both in regional integration and towards EU accession and World Trade Organization membership. The ban that was imposed on the export of wheat, corn, soy and sunflower oil by the government last year (initially for three months but then extended) was removed in June 2008. Negotiations on joining the WTO are progressing, with membership likely in 2009. Most importantly, the government signed a Stabilisation and Association Agreement with the European Union in April 2008. However, an interim trade agreement with the European Union is on hold (as of early October 2008).

Progress on large-scale privatisation has been mixed. The sale of the RTB Bor mining complex has been cancelled twice, on both occasions because the buyers failed to respect their commitments. A public invitation for expressions of interest in a strategic partnership with the state was published in July 2008, with 11 potential bidders expressing interest by the deadline of 30 September 2008. The sales of several other large enterprises have been held back or delayed, but some

development occurred in the airline industry, with tenders being issued for JAT Tehnika (in June 2008) and JAT Airways (in August 2008), although the latter subsequently failed. In February 2008 a majority stake in the oil conglomerate NIS was sold for €400 million to Russia's Gazprom, which also committed a further €500 million. The deal was ratified by parliament in September 2008, but the price may be subject to further negotiation. In October 2008 Fiat of Italy and the government signed a long-term programme of investment in the car maker Zastava. Fiat will hold a 67 per cent stake in the company and the state will retain 33 per cent.

Infrastructure

The National Council for Infrastructure was formed in July 2008 with the mandate to coordinate and manage infrastructure projects and strategies, particularly in energy, telecommunications, roads and railways. The Council is chaired by the president of Serbia and includes key ministers. One of the Council's first decisions was to cancel the concession contract awarded in March 2007 to a consortium led by the Austrian construction companies Alpine and Porr for the Horgos-Pozega highway. The reason was that the concessionaire had insisted on significant changes to the concession agreement that were unacceptable to the government.

Competition is increasing in telecommunications, particularly in the mobile segment where there are now three operators, including VIP mobile, which has expanded rapidly since it began operating in June 2007. Penetration rates in this sector are now above 100 per cent. Plans for privatisation of the fixed-line operator Telekom Srbija have advanced, with a tender scheduled for 2009. However, the state, which currently owns 80 per cent, intends to retain a majority 51 per cent stake.

Financial sector

The banking sector has continued to strengthen over the past year. The level of financial intermediation has grown rapidly and the ratio of domestic credit to GDP reached more than 30 per cent by the end of 2007. Supervisory standards have been consolidated and improved and International Financial Reporting Standards (IFRS) and other measures in line with EU standards are being implemented. Competition for market share is quite intense and greenfield bank subsidiaries are once again able to enter the market, following the central bank's decision to award licences to banks that meet all the necessary conditions (in May 2008 the Bank of Moscow was given approval to establish a new bank in Serbia). As of mid-2008 there are still eight majority state-owned banks and the government is considering plans for their privatisation.

The main development in the non-bank financial sector over the past year was the sale in November 2007 of 83.3 per cent of the state share in the country's second largest insurance company, DDOR Novi Sad. The stake was sold to Italy's third largest insurer, Fondiaria-Sai, for €220 million. However, capital markets remain generally underdeveloped in Serbia.

Macroeconomic performance

The Serbian economy has continued to grow strongly. Real GDP grew by 7.5 per cent in 2007 and by more than 8 per cent in the first quarter of 2008. The rapid expansion in recent years of domestic credit, particularly to households, has fuelled a consumer boom that is reflected in a high demand for imports and an associated large current account deficit of around 17 per cent of GDP (as of mid-2008). Exports have grown strongly at more than 40 per cent (in dollar terms) annually in the first half of this year, and they do not appear to be adversely affected by the significant real appreciation of the currency over the past twelve months. While services continue to be the main driving force, a recovery in agricultural output (after last year's drought) has boosted the economy this year. Growth in the sector is expected to exceed 10 per cent in 2008.

Monetary and fiscal policies have increasingly diverged over the past year. The National Bank of Serbia has operated a tight monetary policy, implementing a series of increases in the key policy rate in the first half of 2008, raising it by 575 basis points to 15.75 per cent. Nevertheless, inflationary pressures, both domestic and global, have kept the inflation rate in double digits (as of mid-2008) and, although it returned to single-digit levels by September, core inflation remains well above the target of between 3 and 6 per cent. Part of the problem lies in the high level of government spending, which was influenced by both the presidential and parliamentary elections held earlier in 2008. This has led to a likely general budget deficit in 2008 of 2.5 per cent of GDP. A budget rebalance for 2008 was expected in October.

Outlook and risks

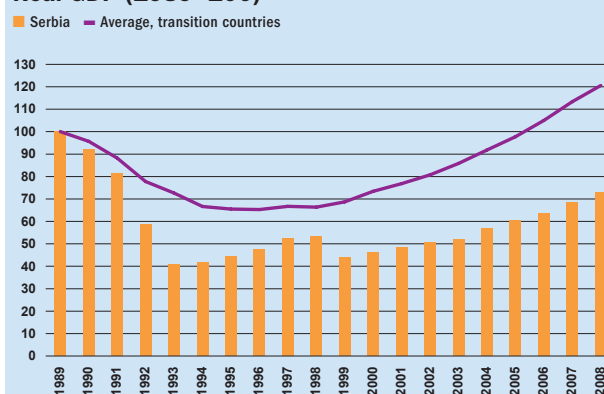
Serbia's high growth rate is likely to slow down in the short term in the context of the global financial crisis. However, provided political stability is maintained, Serbia is likely to be of great interest to foreign investors in the coming years, not only because of the major privatisations and infrastructure projects slated for the next few years, but also for the country's geographical advantages, particularly of the capital, Belgrade, with its connections to other parts of the region. The key risk to stability remains the issue of Kosovo but there are hopes that the present government will not let this block further progress on economic and structural reforms.

The main short-term macroeconomic challenge is on the fiscal side. Promises made during the parliamentary election campaign by parties that are now in government, especially those concerning pensions and other social payments, will be difficult to keep without increasing the budget deficit even further. The other key risk lies on the external side; trade and current account deficits are increasingly financed by borrowing from abroad, and careful management and supervision of lending standards will be necessary to avoid a painful contraction of the economy.

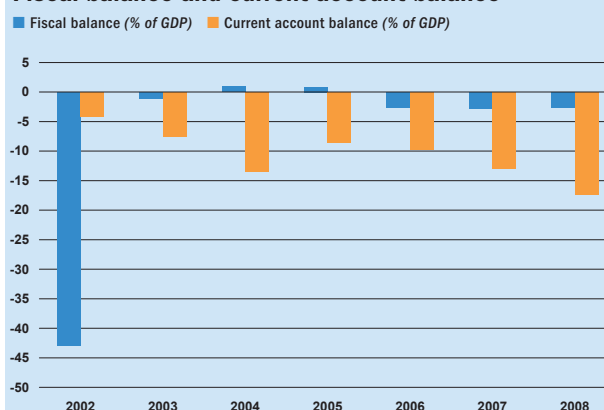
Transition indicators, 2008



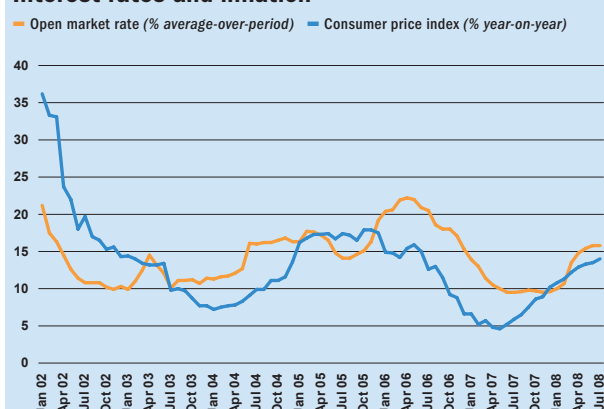
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – low	Capital adequacy ratio – 12 per cent	Share of population living in poverty – 6.6 per cent
Controls on inward direct investment – no	Secured transactions law – modern/some defects	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 6.0 per cent of GDP (2007)
Interest rate liberalisation – full	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – no	Quality of securities market laws – high	Government expenditure on education – 3.7 per cent of GDP (2007)
Exchange rate regime – managed float		Independence of the road directorate – yes	Private pension funds – yes	Household expenditure on power and water – 9.3 per cent
Wage regulation – no		Quality of concession laws – medium		
Tradeability of land – limited de jure				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	1.9	6.6	7.4	9.2	10.5	12.3	na
Private sector share in GDP (in per cent)	40.0	45.0	50.0	55.0	55.0	55.0	60.0
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)	4.3	3.6	3.1	3.1	2.7	2.7	na
Share of industry in total employment (in per cent)	37.8	36.2	36.5	36.6	38.0	39.3	na
Change in labour productivity in industry (in per cent)	10.5	10.9	12.5	9.0	14.2	14.3	na
Investment/GDP (in per cent)	17.3	22.7	37.8	26.5	27.1	27.0	na
<i>EBRD index of small-scale privatisation</i>	3.0	3.0	3.3	3.3	3.7	3.7	3.7
<i>EBRD index of large-scale privatisation</i>	2.0	2.3	2.3	2.7	2.7	2.7	2.7
<i>EBRD index of enterprise reform</i>	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)	11.0	11.2	11.2	9.2	9.9	na	na
Number of goods with administered prices in EBRD-15 basket	2.0	3.0	3.0	2.0	3.0	3.0	na
Share of trade with non-transition countries (in per cent)	82.9	79.3	na	na	na	na	na
Share of trade in GDP (in per cent)	48.1	52.3	60.0	58.6	62.7	64.8	na
Tariff revenues (in per cent of imports)	7.7	7.4	6.0	5.7	5.4	5.6	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	3.0	3.0	3.0	3.3	3.3	3.3	3.7
<i>EBRD index of competition policy</i>	1.0	1.0	1.0	1.0	1.7	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	50 (12)	47 (16)	43 (11)	40 (17)	37 (22)	35 (21)	na
Asset share of state-owned banks (in per cent)	35.6	34.1	23.4	23.9	14.9	15.8	na
Asset share of foreign-owned banks (in per cent)	27.0	38.4	37.7	66.0	78.7	75.5	na
Non-performing loans (in per cent of total loans)	na	na	na	na	na	na	na
Domestic credit to private sector (in per cent of GDP)	17.8	20.3	23.9	29.7	29.8	34.9	na
Domestic credit to households (in per cent of GDP)	na	2.6	4.9	7.6	10.1	12.6	na
Of which mortgage lending (in per cent of GDP)	na	0.4	0.7	1.4	2.5	3.7	na
Stock market capitalisation (in per cent of GDP)	4.2	6.6	13.3	22.4	32.3	53.7	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	16.3	14.6	na
Eurobond issuance (in per cent of GDP)	na	na	na	na	na	0.4	na
<i>EBRD index of banking sector reform</i>	2.3	2.3	2.3	2.7	2.7	2.7	3.0
<i>EBRD index of reform of non-bank financial institutions</i>	1.7	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	30.7 (na)	32.1 (na)	32.9 (na)	32.9 (na)	25.9 (63.3)	30.4 (85.7)	na
Internet users (per 100 inhabitants)	na	na	na	na	13.3	15.2	na
Railway labour productivity (1989=100)	113.2	127.7	161.6	199.6	251.9	282.4	na
Residential electricity tariffs (USc kWh)	3.5	4.7	5.3	5.1	5.8	7.4	na
Average collection rate, electricity (in per cent)	88	90	94	94	95	93	na
GDP per unit of energy use (PPP in US dollars per kgoe)	na	na	na	na	na	na	na
<i>EBRD index of infrastructure reform</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.3
<i>Electric power</i>	2.0	2.3	2.3	2.3	2.3	2.3	2.3
<i>Railways</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Roads</i>	2.3	2.3	2.3	2.3	2.7	2.7	2.7
<i>Telecommunications</i>	2.0	2.0	2.0	2.0	2.3	2.3	2.7
<i>Water and waste water</i>	2.0	2.0	2.0	2.0	1.7	1.7	2.0

Macroeconomic indicators	2002	2003	2004	2005	2006	2007 Estimate	2008 Projection
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	4.5	2.4	9.3	6.3	5.5	7.5	7.0
Industrial gross output	1.8	-3.0	7.1	0.8	4.7	4.6	na
Agricultural gross output	-3.2	-7.0	19.5	-5.0	-0.3	-8.0	na
Employment	<i>(Percentage change)</i>						
Labour force (end-year)	1.4	2.6	0.3	2.2	-1.1	-6.1	na
Employment (end-year)	-1.7	-1.3	0.5	0.9	-2.3	-1.5	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	29.0	31.7	31.6	32.4	33.2	29.9	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)	19.5	11.7	10.1	16.5	12.7	6.7	10.5
Consumer prices (end-year)	14.8	7.8	13.7	17.7	6.6	10.2	9.0
Producer prices (annual average)	na	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	51.7	25.3	23.7	24.1	24.4	22.0	na
Government sector	<i>(In per cent of GDP)</i>						
General government balance	-43.0	-1.1	0.9	0.9	-2.6	-2.7	-2.5
General government expenditure	43.0	41.4	40.3	40.4	44.0	44.0	na
Monetary sector	<i>(Percentage change)</i>						
Broad money (M2, end-year)	62.9	12.6	17.1	31.4	45.2	39.9	na
Domestic credit (end-year)	-32.7	23.4	52.6	40.7	3.0	44.6	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	10.9	10.7	10.2	11.0	13.7	16.3	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>						
Discount rate	9.5	9.0	8.5	8.5	8.5	8.5	na
Money market rate	32.2	27.1	16.3	20.5	16.5	14.0	na
Deposit rate	3.8	2.1	3.6	3.7	5.1	4.1	na
Lending rate (long-term)	19.7	15.5	14.6	14.4	15.9	11.1	na
	<i>(Dinars per US dollar)</i>						
Exchange rate (official, end-year)	59.0	54.6	57.9	72.2	60.0	53.7	na
Exchange rate (official, annual average)	64.2	57.5	58.7	67.2	66.8	58.4	na
External sector	<i>(In millions of US dollars)</i>						
Current account	-650.0	-1,532.0	-3,281.0	-2,194.0	-2,986.3	-5,285.2	-9,200.0
Trade balance	-3,228.0	-4,021.0	-6,469.0	-5,290.0	-6,271.0	-8,831.0	-11,000.0
Merchandise exports	2,212.0	3,319.0	4,082.0	4,970.0	6,442.0	8,858.0	11,000.0
Merchandise imports	5,440.0	7,340.0	10,551.0	10,260.0	12,713.0	17,689.0	22,000.0
Foreign direct investment, net	475.0	1,365.0	966.0	1,550.0	4,264.0	2,195.0	3,100.0
Gross reserves, excluding gold (end-year)	2,166.0	3,411.0	4,096.0	5,628.0	11,648.0	13,892.0	na
External debt stock	11,230.0	13,575.0	14,099.0	15,467.0	19,606.0	26,236.0	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	4.3	5.0	4.1	5.7	9.3	8.1	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	6.2	10.3	17.5	26.0	20.2	16.6	na
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million)	7.5	7.5	7.5	7.5	7.5	7.5	na
GDP (in billions of dinars)	1,020.1	1,171.6	1,431.3	1,747.5	2,042.0	2,393.0	2,798.0
GDP per capita (in US dollars)	2,119.4	2,719.1	3,252.0	3,466.9	4,076.4	5,461.9	na
Share of industry in GDP (in per cent)	23.1	22.1	21.7	20.6	20.6	20.0	na
Share of agriculture in GDP (in per cent)	12.7	11.5	12.7	11.3	10.7	9.2	na
Current account/GDP (in per cent)	-4.1	-7.5	-13.5	-8.4	-9.8	-12.9	-17.3
External debt - reserves (in US\$ million)	9,064.0	10,164.0	10,003.0	9,839.0	7,958.0	12,344.0	na
External debt/GDP (in per cent)	70.6	66.6	57.8	59.5	64.1	64.0	na
External debt/exports of goods and services (in per cent)	379.3	311.5	253.7	234.2	223.7	222.4	na

Slovak Republic

Key developments and challenges

A more flexible labour market will be key to addressing growing labour shortages, regional disparities and structural unemployment. Further emphasis on education and innovation are needed to improve the standards of the workforce and to maintain competitiveness over the long term.

To encourage much-needed investment and efficiency improvements, the government should resist pressure to increase its involvement in important areas of the economy (such as retail, health care and energy) and should encourage more private sector participation in the transport and municipal sectors. This will require better government administrative capacity for planning, appraisal and management.

Entry into the eurozone in January 2009 will be a commendable achievement. However, further structural reforms and continued fiscal restraint will be needed to sustain high growth rates and enable convergence with average EU incomes over the medium term.

Country data

Population (in millions)	5.4
Area ('000 sq km)	49.0
GDP (in billion US\$, 2007)	75.0
Average transition score (scale: 1 to 4.33)	3.74

Progress in structural reform

Business environment and competition

The Slovak Republic is ranked 36th (out of 181 countries) in the World Bank's *Doing Business 2009* survey, ahead of many of its regional peers, with particular improvements in the procedures and duration of starting a business. In addition, unemployment fell to a record low of 10 per cent in 2007 (although it is still the highest in the European Union) and companies are increasingly complaining about the shortage of skilled labour. Real wage growth exceeded productivity growth in the first quarter of 2008 for the first time since late 2005.

In July 2007 the government approved a new labour code that tightens labour protection laws and increases workers' rights. The new code introduces strict limits on short-term contracts and overtime, increases severance pay and makes collective bargaining agreements binding for all enterprises operating in a given sector. In April 2008 the government revised the Retail Law, which includes clauses such as prohibiting the sale of goods below cost, putting a cap on fees paid by suppliers to retailers and allowing the possibility of intervening in price setting.

Infrastructure

Over the past year the government has increased its involvement in key sectors of the economy, such as the energy sector. To curb rising inflation the government persuaded electricity company Slovenské elektrárne (SE) to limit the increase in electricity prices to an average of 2.9 per cent at the beginning of 2008. Moreover, in July 2008 the cabinet approved a proposal for imposing new regulations on the setting of energy tariffs from 2009. The proposal gives the Regulatory Office for Network Industries (URSO) direct control over final gas and electricity prices for households and small and medium-sized enterprises. In August 2008 URSO turned down an application by gas utility Slovenský plynárenský priemysel (SPP) for a 15.9 per cent increase in the retail gas price from October 2008. In April 2008 the government also announced its intention to increase its role in strategic energy projects, such as through involvement in the planned construction of new nuclear capacity, by buying back its minority 49 per cent stake in the oil transit company Transpetrol that was sold to Yukos in 2002, and by initiating an investigation into the legality of SE's privatisation.

During 2008 the Ministry of Transport finalised the prequalification process for the tender to design, build, finance, operate and maintain selected stretches of the D1 and R1 motorways. These projects are large and are considered to be key priority investments. In another public-private partnership (PPP) project, for a national toll collection system, the tender is nearing completion although only one bidder submitted a compliant bid. Complaints from other bidders about the process have been dismissed by the Public Procurement Office (UVO).

In June 2008 the Slovak and Czech transport ministers announced the planned merger of the respective state-owned national railway freight operators ZSSK Cargo and CD Cargo. The merged company would then rank second with Polish PKP and behind Deutsche Bahn in terms of European market share. The Czech government would like the merger to lead to the eventual privatisation of the entity but the Slovak government opposes any move in that direction.

Social sector

Health care reforms are still needed to cut excess facilities, reduce pharmaceutical costs, dampen demand pressures and ensure sustainable financing. The latter includes the need to address the growth in payment arrears of public health care facilities. Total arrears rose by 18 per cent year-on-year to Sk 8.1 billion (around €240 million) at the end of 2007, with public health care facilities accumulating most of them. This contrasts with the health care facilities that had been transformed into private companies under the previous government, and registered a significant fall in arrears (the transformation of hospitals into private companies was halted by the new government after the 2006 elections). In addition, in 2007 the government passed a new Health Insurance Law that prohibits private health insurers from paying out dividends and forces them to reinvest their profits in health care services. The insurers intend to seek international arbitration to protect their investments or obtain compensation. In June 2008 the smallest of the four private health insurers operating in the country – Európska ZP – announced its intention to leave the market.

Macroeconomic performance

Real GDP grew by 10.4 per cent in 2007, helped by buoyant performances in the automotive and electronics sectors. The country almost doubled its car production in 2007 and is now the world's largest car manufacturer in per capita terms. Output continued to grow rapidly at the beginning of 2008 and rose by 8.1 per cent year-on-year in the first half of 2008.

The fiscal deficit amounted to 2.2 per cent of GDP in 2007 (down from a peak of 12.2 per cent in 2000), thanks to a significant reduction in expenditure and despite the introduction of the second-pillar pensions (mandatory private pension schemes) that added just over 1 per cent of GDP a year to outlays. Government debt decreased to 29 per cent of GDP in 2007. The improved fiscal position in the Slovak Republic led the Council of the European Union to abrogate the excessive deficit procedure in June 2008. Moreover, the Slovak government approved a plan in April 2008 to lower the 2008 fiscal deficit to 2.0 per cent of GDP (from its original target of 2.3 per cent) and to balance the budget by 2011.

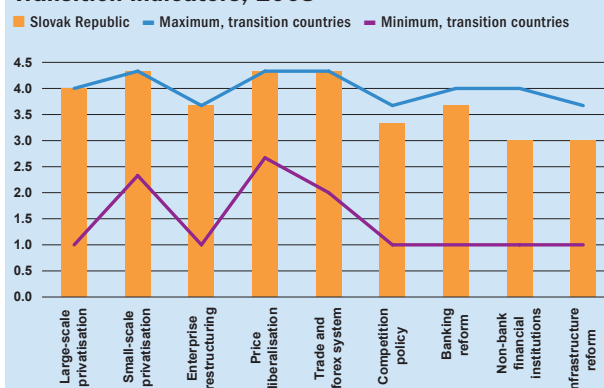
CPI inflation was 4.6 per cent year-on-year in June 2008, although it has crept up steadily since March 2008 when the EU assessment on the country's readiness to adopt the euro was made. The current account deficit narrowed to 5.3 per cent of GDP in 2007 from around 7 per cent in 2006. The deficit was once again financed by large net inflows of foreign direct investment (FDI) amounting to US\$ 2.9 billion in 2007.

Following the Slovak Republic's fulfilment of the Maastricht criteria, the country was given formal approval in July 2008 to join the eurozone by the Economic and Financial Affairs Council. The Slovak koruna had been appreciating rapidly over the previous year and in a surprise move the central parity of the koruna was revalued by 17.6 per cent in late May 2008 to Sk 30.126:€1 (following an earlier revaluation by 8.5 per cent in March 2007). The new central parity was then confirmed as the conversion rate at a meeting of the EU finance ministers in July 2008. Long-term interest rates were aligned with those in the eurozone when the European Central Bank raised its interest rates by 25 basis points to 4.25 per cent in July 2008.

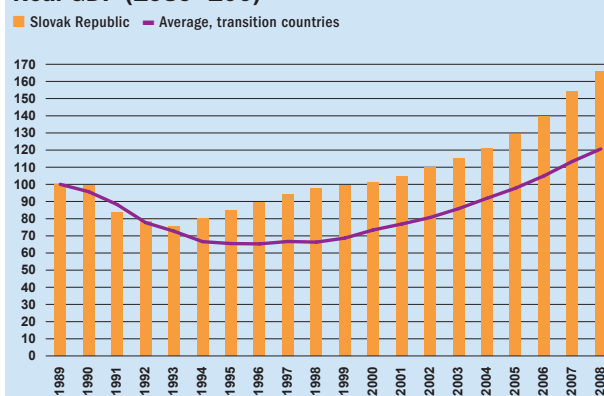
Outlook and risks

In light of the worsening external environment and given the economy's dependence on car and electronics exports, growth is likely to decelerate to around 7.3 per cent in 2008, with a further significant reduction in 2009. However, there is a significant unfinished reform agenda necessary for the country's competitiveness over the medium term. This includes reducing regional imbalances, improving the efficiency of health care, promoting education, research and innovation, greater energy efficiency and more private sector involvement in transport and municipal services. Further structural reforms and continued fiscal restraint will be needed to curb rising inflation, sustain high growth rates and enable income convergence over the medium term.

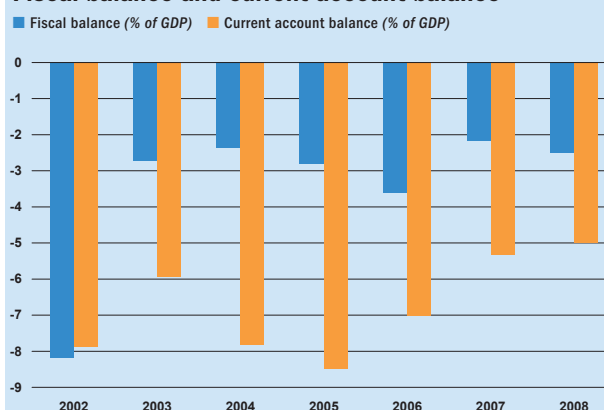
Transition indicators, 2008



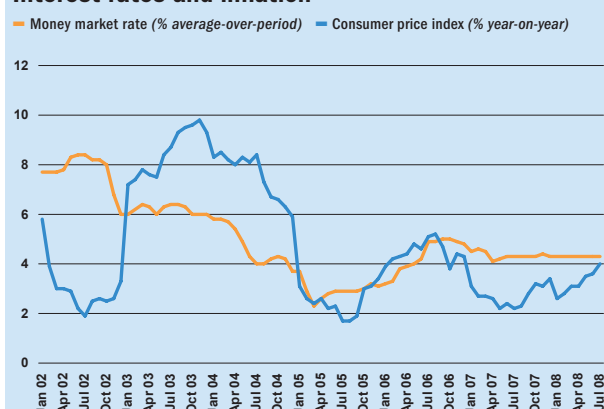
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – full	Capital adequacy ratio – 8 per cent	Share of population living in poverty – 2.9 per cent (1996)
Controls on inward direct investment – no	Secured transactions law – advanced	Independence of the electricity regulator – full	Deposit insurance system – yes	Government expenditure on health – 5.3 per cent of GDP (2007)
Interest rate liberalisation – full	Quality of corporate governance law – high	Separation of railway infrastructure from operations – full	Quality of securities market laws – high	Government expenditure on education – 4.4 per cent of GDP (2007)
Exchange rate regime – managed float in ERM II		Independence of the road directorate – full	Private pension funds – yes	Household expenditure on power and water – 9.5 per cent ¹
Wage regulation – no		Quality of concession laws – medium		
Tradeability of land – full except foreigners				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	33.7	34.7	35.1	35.2	35.2	35.2	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)	75.0	75.0	75.0	75.0	75.0	75.0	75.0
Budgetary subsidies and current transfers (in per cent of GDP)	1.6	1.7	1.9	1.3	1.3	1.3	na
Share of industry in total employment (in per cent)	30.1	29.3	29.5	29.3	29.0	28.4	na
Change in labour productivity in industry (in per cent)	4.4	6.1	2.9	2.1	7.2	12.4	na
Investment/GDP (in per cent)	29.1	24.6	26.3	28.9	28.0	27.2	na
<i>EBRD index of small-scale privatisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of large-scale privatisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of enterprise reform</i> ²	3.3	3.3	3.3	3.7	3.7	3.7	3.7
Markets and trade							
Share of administered prices in CPI (in per cent)	21.1	20.7	19.9	21.9	23.4	24.1	na
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	2.0	2.0	2.0	2.0	na
Share of trade with non-transition countries (in per cent)	63.5	66.1	62.6	61.1	61.2	62.7	na
Share of trade in GDP (in per cent)	126.3	133.3	134.5	138.3	153.1	154.5	na
Tariff revenues (in per cent of imports) ³	0.5	0.5	0.2	0.1	0.0	0.0	na
<i>EBRD index of price liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of forex and trade liberalisation</i>	4.3	4.3	4.3	4.3	4.3	4.3	4.3
<i>EBRD index of competition policy</i>	3.0	3.0	3.3	3.3	3.3	3.3	3.3
Financial sector							
Number of banks (foreign-owned)	20 (15)	21 (16)	21 (16)	23 (16)	24 (16)	26 (15)	na
Asset share of state-owned banks (in per cent)	1.9	1.5	1.3	1.1	1.1	1.0	na
Asset share of foreign-owned banks (in per cent)	84.1	96.3	96.7	97.3	97.0	99.0	na
Non-performing loans (in per cent of total loans) ⁴	11.2	9.1	7.2	5.5	7.1	2.6	na
Domestic credit to private sector (in per cent of GDP)	30.8	31.6	30.1	34.7	38.6	42.3	na
Domestic credit to households (in per cent of GDP)	5.5	7.0	8.6	11.2	13.1	16.3	na
Of which mortgage lending (in per cent of GDP)	1.0	2.2	2.9	3.6	4.1	4.5	na
Stock market capitalisation (in per cent of GDP)	6.8	7.4	9.4	9.4	8.8	8.6	na
Stock trading volume (in per cent of market capitalisation)	179.5	29.4	19.8	1.6	1.8	0.5	na
Eurobond issuance (in per cent of GDP)	0.0	0.5	2.9	na	na	na	na
<i>EBRD index of banking sector reform</i>	3.3	3.3	3.7	3.7	3.7	3.7	3.7
<i>EBRD index of reform of non-bank financial institutions</i>	2.3	2.7	2.7	2.7	3.0	3.0	3.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	26.1 (54.4)	24.1 (68.4)	23.2 (79.4)	22.2 (84.1)	21.6 (90.6)	21.4 (112.6)	na
Internet users (per 100 inhabitants)	16.0	25.6	30.7	35.3	41.8	43.6	na
Railway labour productivity (1989=100)	60.6	60.5	61.7	64.8	71.0	70.1	na
Residential electricity tariffs (USc kWh)	7.1	10.9	13.7	14.9	12.8	15.4	na
Average collection rate, electricity (in per cent)	95	na	na	na	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	3.6	3.9	4.3	4.5	na	na	na
<i>EBRD index of infrastructure reform</i>	2.7	3.0	3.0	3.0	3.0	3.0	3.0
<i>Electric power</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>Railways</i>	2.7	2.7	2.7	3.0	3.0	3.0	3.0
<i>Roads</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Telecommunications</i>	3.3	3.3	3.3	3.7	3.7	3.7	3.7
<i>Water and waste water</i>	2.3	2.7	3.0	3.0	3.3	3.3	3.3

¹ Estimate based on the poorest 25 per cent of households (lowest income quartile).

² Series has been revised.

³ Refers to import tariffs, customs duties and import surcharge.

⁴ There is a break in the series. The methodology for defining non-performing loans was changed in 2006.

Macroeconomic indicators	2002	2003	2004	2005	2006	2007 Estimate	2008 Projection
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	4.8	4.8	5.2	6.6	8.5	10.4	7.3
Private consumption	5.5	1.7	4.6	6.5	5.6	7.1	na
Public consumption	4.0	4.2	-2.0	3.5	10.1	0.7	na
Gross fixed capital formation	0.2	-2.7	4.8	17.6	8.4	7.9	na
Exports of goods and services	5.4	15.9	7.4	13.9	21.0	16.0	na
Imports of goods and services	4.4	7.4	8.3	16.1	17.7	10.4	na
Industrial gross output	6.4	5.0	4.1	3.3	10.1	12.7	na
Agricultural gross output	-2.5	-9.1	1.4	-10.7	-2.2	-0.2	na
Employment	<i>(Percentage change)</i>						
Labour force (end-year)	-0.9	0.2	0.9	-0.5	0.3	-0.2	na
Employment (end-year)	0.2	1.8	0.3	2.1	3.8	2.4	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	18.5	17.4	18.1	16.2	13.3	11.0	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)	3.3	8.5	7.5	2.5	4.5	2.8	4.3
Consumer prices (end-year)	3.4	9.2	6.0	3.7	4.2	3.4	4.3
Producer prices (annual average)	2.3	8.8	3.4	3.9	8.0	2.1	na
Producer prices (end-year)	2.2	9.5	3.5	6.1	5.6	2.8	na
Gross average monthly earnings in economy (annual average)	9.3	6.3	10.2	9.2	8.6	7.4	na
Government sector¹	<i>(In per cent of GDP)</i>						
General government balance ²	-8.2	-2.7	-2.4	-2.8	-3.6	-2.2	-2.5
General government expenditure	44.9	40.2	37.8	38.1	37.2	36.9	na
General government debt	43.4	42.4	41.4	34.2	30.4	29.4	na
Monetary sector³	<i>(Percentage change)</i>						
Broad money (M2, end-year)	5.0	7.1	0.2	7.4	14.5	11.8	na
Domestic credit (end-year)	-12.7	9.3	6.9	12.0	13.4	16.6	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	61.5	59.7	53.7	52.9	54.7	54.8	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>						
Refinancing rate	6.5	6.0	4.0	3.0	4.8	4.3	na
3-month BRIBOR	6.0	6.0	3.7	3.1	4.8	4.3	na
Deposit rate ⁴	6.7	5.3	4.1	2.4	3.6	3.8	na
Lending rate ⁴	10.3	8.5	9.1	6.7	7.7	8.0	na
	<i>(Korunas per US dollar)</i>						
Exchange rate (end-year)	40.0	32.9	29.1	31.9	26.2	22.9	na
Exchange rate (annual average)	45.3	36.8	32.3	31.0	29.7	24.7	na
External sector	<i>(In millions of US dollars)</i>						
Current account	-1,924.2	-1,971.6	-3,297.4	-4,065.0	-3,919.1	-3,994.5	-5,155.2
Trade balance	-2,116.6	-637.3	-1,536.2	-2,385.2	-2,531.8	-865.3	-1,300.0
Merchandise exports	14,382.2	21,843.2	27,621.2	31,914.8	41,477.8	57,489.5	79,900.0
Merchandise imports	16,498.8	22,480.4	29,157.4	34,299.9	44,009.7	58,354.8	81,200.0
Foreign direct investment, net	4,130.1	1,913.4	3,051.8	2,278.8	3,797.1	2,881.0	3,000.0
Gross reserves, excluding gold (end-year)	8,702.7	11,678.1	14,418.8	14,900.6	12,646.4	18,031.9	na
External debt stock	13,188.2	18,090.2	23,763.6	27,052.5	32,206.0	44,308.7	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	5.5	5.3	5.3	4.6	3.1	3.3	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service due	11.7	11.6	12.1	8.0	5.0	3.8	na
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million)	5.4	5.4	5.4	5.4	5.4	5.4	na
GDP (in billions of korunas)	1,108.1	1,222.5	1,361.7	1,485.3	1,659.6	1,851.8	2,072.4
GDP per capita (in US dollars)	4,544.8	6,179.1	7,839.4	8,885.3	10,351.6	13,886.7	na
Share of industry in GDP (in per cent)	24.2	25.9	27.1	26.2	26.0	27.2	na
Share of agriculture in GDP (in per cent)	4.6	4.1	3.6	3.5	3.5	2.6	na
Current account/GDP (in per cent)	-7.9	-5.9	-7.8	-8.5	-7.0	-5.3	-5.0
External debt - reserves (in US\$ million)	4,485.5	6,412.1	9,344.8	12,151.9	19,559.6	26,276.8	na
External debt/GDP (in per cent)	53.9	54.4	56.3	56.5	57.7	59.1	na
External debt/exports of goods and services (in per cent)	76.8	72.0	75.8	74.5	68.7	68.7	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). In line with the Eurostat derogation the second pillar pension funds are included from 2005.

³ Until 2002 monetary data are compiled in national methodology. From 2003 they are compiled in the harmonised ECB methodology.

⁴ Weighted average over all maturities.

Slovenia

Key developments and challenges

Economic growth remains steady and living standards are high by regional standards, but there is still scope, and need, to continue improving the quality of the business environment. This should include encouraging greater labour market participation.

Productivity growth could be enhanced with more rapid privatisation and restructuring of large enterprises and financial institutions. However, interest from foreign investors is likely to be limited so long as there is uncertainty over government policy on large-scale privatisation.

While Slovenia's entry into the eurozone and recent macroeconomic management are a testimony to its commitment to sound policies, substantial reforms of the health care, social security and pension systems are needed to ensure the long-term sustainability of government finances.

Country data

Population (in millions)	2.0
Area ('000 sq km)	20.5
GDP (in billion US\$, 2007)	47.1
Average transition score (scale: 1 to 4.33)	3.41

Progress in structural reform

Business environment and competition

Slovenia ranks relatively low among its regional peers in terms of the business environment. However, according to the World Bank's *Doing Business 2009* survey, it has made some important improvements over the past year. Specifically, the government has significantly reduced the time and procedures required for starting a business, improved the protection of minority investors and eased the difficulties of hiring and firing workers. However, the latter is still more onerous when compared to other countries in the region and the OECD average. In 2007 the government tried to increase labour market participation by phasing out payroll taxes, changing unemployment benefits and unifying the indexation of all social transfers to inflation rather than wages. Negotiations between the government, employers and unions produced a general agreement on wage policy in late 2007, and in June 2008 the government and most public sector unions finally concluded a wage deal that will see public sector wages increase by an average of 13 per cent over the next two years.

Infrastructure

In early March 2008 the Slovenian privatisation committee cancelled the sale of a 49 per cent stake in Telekom Slovenije (TS) – the country's leading fixed-line, mobile and internet

provider – owing to unsatisfactory bids submitted in the final round. The government and its investment funds together hold 74 per cent in the company and the government was planning to keep a 25 per cent stake to retain a say in key business decisions. It is now unclear when the privatisation will take place. However, despite the lack of progress with privatisation, TS is facing competition from privately owned participants in all segments of the sector, especially in the mobile and internet service provider markets, but increasingly also from alternative providers in the fixed market. In autumn 2007 a third mobile network operator entered the market, increasing competition for the provision of bundled services. Over the past year the independent National Regulatory Authority has dealt with a number of regulatory challenges resulting from market and technological developments.

The government is considering what to do with the loss-making railways company, as well as the profitable port of Koper and the logistics company Intereuropa. The government has indicated it would prefer a strategic partnership for the railways company rather than full privatisation, but has yet to clarify what this means. In June 2008 the European Commission criticised Slovenia's implementation of the first stage of the European Union's railway reforms, known as the First Railway Package, particularly the lack of an independent infrastructure manager and insufficient implementation of the rules on track access charging.

Financial sector

The state still retains control over a significant part of the financial sector. Although the government sold a 49 per cent stake in the country's second largest bank – NKBM – in December 2007, plans to reduce its majority stake to 25 per cent (plus one share) are still on hold. Moreover, there are still no plans to privatise further the government's financial holding in the country's largest bank, NLB. In fact, Belgium's KBC Group has been repeatedly denied permission to increase its 34 per cent stake in NLB to a majority share, despite having reportedly been given assurances to this effect when it originally invested in the bank in 2002. As a result, KBC finally decided in May 2008 not to participate in the most recent capital increase of the bank, and instead put its stake up for sale. In July 2008 the financial sector regulator gave the go-ahead for the listing of the country's largest insurer, Zavarovalnica Triglav, on the Ljubljana Stock Exchange (LJSE) in September 2008.

In June 2008 the Vienna Stock Exchange won the tender for control of the LJSE, which was until then owned by local banks and brokerages. The Vienna exchange reportedly paid €38 million for an 81 per cent stake in LJSE, which translates to €1,401 per share. The announcement followed a bidding process that began earlier this year. The purchase of LJSE follows the Vienna exchange's earlier acquisition of a 12.5 per cent stake in the Budapest Stock Exchange from Italian banking group UniCredit. The takeover should assist the development of the capital markets in Slovenia, which lag behind regional standards.

Macroeconomic performance

Real GDP grew by 6.8 per cent in 2007, the fastest rate since independence and up from 5.9 per cent a year earlier. Growth last year was driven primarily by investment (particularly in housing and infrastructure construction) and exports. Given the worsening external environment and an expected slowdown in the rate of investment, it is likely that growth will slow down in 2008. These trends are already visible in the first half of 2008, which recorded a deceleration of growth to 5.4 per cent.

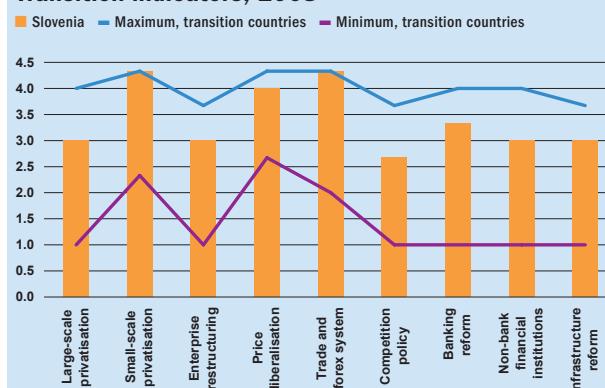
Inflation has risen sharply since the country joined the eurozone in January 2007. The harmonised index of consumer prices (HICP) inflation averaged 3.8 per cent in 2007 and continued its upward trend in 2008, driven by higher global prices for energy and food, strong domestic demand and the lack of competition in some product markets. The trend towards higher wage settlements following the deal that was struck in mid-2008, and higher inflationary expectations, are likely to boost inflation even further in 2008 to an expected average of 6 per cent for the year as a whole.

The favourable economic environment and conservative fiscal planning resulted in a general government surplus in 2007 of 0.5 per cent, according to Eurostat methodology (ESA95), compared to a 1.2 per cent deficit a year earlier. On the external side the current account deficit rose sharply in 2007 to 4.2 per cent of GDP, up from 2.6 per cent a year earlier, due to a rapid rise in imports. Slovenia continued to record net foreign direct investment (FDI) outflows for the third year in a row in 2007. FDI inflows remain very low as a result of the continuing delay in the privatisation of key companies. Gross external debt has risen sharply in recent years and amounted to more than 100 per cent of GDP in 2007 from just over 80 per cent a year earlier. Nevertheless, this is low compared to its peers in the euro area.

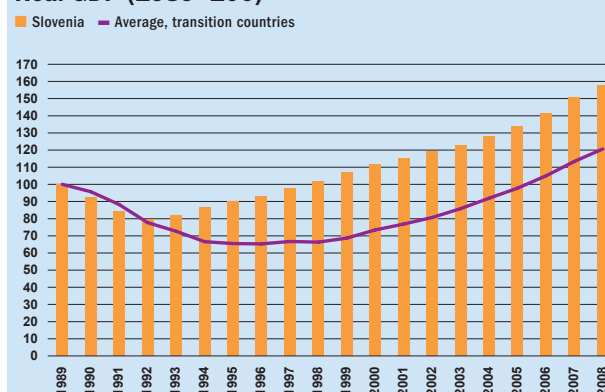
Outlook and risks

Given the worsening external environment, slower real GDP growth is forecast for this year. More decisive reforms are needed to underpin future growth without jeopardising fiscal restraint. This should include steps to increase labour market participation rates and privatise large-scale enterprises and financial institutions. In addition, further reforms to the pension, social welfare and health care systems are still necessary. Slovenia has a relatively unfavourable demographic profile (the country is forecast to have one of the highest dependency ratios in the European Union by 2050), health care expenditure is relatively high and inefficient, while social benefits are neither adequately targeted nor means-tested. In the current global environment, these reforms are even more important to sustain growth and achieve income convergence.

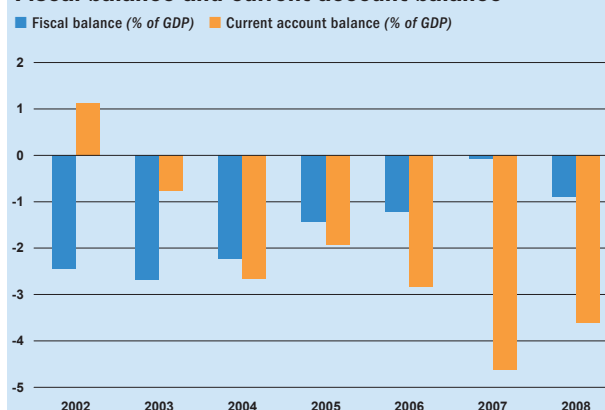
Transition indicators, 2008



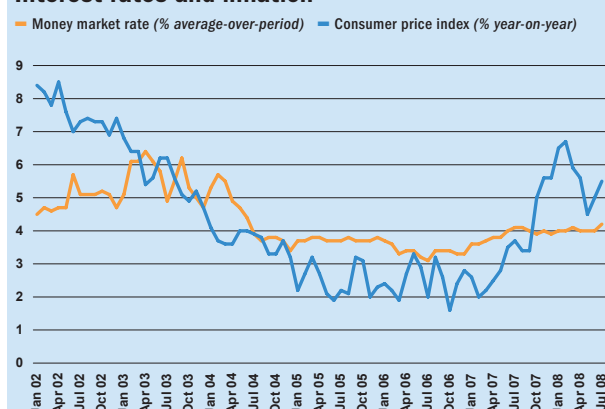
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – full	Capital adequacy ratio – 8 per cent	Share of population living in poverty – <2.0 per cent (1998)
Controls on inward direct investment – no ¹	Secured transactions law – inefficient	Independence of the electricity regulator – full	Deposit insurance system – yes	Government expenditure on health – 6.0 per cent of GDP (2006)
Interest rate liberalisation – full	Quality of corporate governance law – high	Separation of railway infrastructure from operations – full	Quality of securities market laws – high	Government expenditure on education – 6.3 per cent of GDP (2006)
Exchange rate regime – euro-floating		Independence of the road directorate – partial	Private pension funds – yes	Household expenditure on power and water – 9.1 per cent
Wage regulation – yes		Quality of concession laws – high ²		
Tradeability of land – full				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	4.6	4.7	4.7	4.8	4.9	6.4	na
Private sector share in GDP (in per cent)	65.0	65.0	65.0	65.0	65.0	70.0	70.0
Private sector share in employment (in per cent)	70.0	69.0	69.0	69.0	70.0	71.0	na
Budgetary subsidies and current transfers (in per cent of GDP)	3.2	3.3	3.5	3.7	3.6	3.3	na
Share of industry in total employment (in per cent)	40.0	37.0	37.1	36.4	35.2	35.5	na
Change in labour productivity in industry (in per cent)	0.3	7.0	1.4	4.0	10.0	4.4	na
Investment/GDP (in per cent)	23.8	25.2	27.4	27.1	28.7	31.4	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	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Markets and trade							
Share of administered prices in CPI (in per cent)	14.0	15.4	16.1	16.7	17.4	15.0	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)	77.6	77.7	77.1	73.7	72.8	71.2	na
Share of trade in GDP (in per cent)	97.3	93.3	99.3	103.4	113.3	119.9	na
Tariff revenues (in per cent of imports)	1.1	1.1	0.5	0.2	0.2	0.2	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	4.3	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) ³	22 (6)	22 (6)	22 (7)	25 (9)	25 (10)	27 (11)	na
Asset share of state-owned banks (in per cent)	13.3	12.8	12.6	12.0	12.5	14.4	na
Asset share of foreign-owned banks (in per cent)	16.9	18.9	20.1	22.6	29.3	28.8	na
Non-performing loans (in per cent of total loans)	10.0	9.4	7.5	6.4	5.5	3.9	na
Domestic credit to private sector (in per cent of GDP) ⁴	38.6	41.3	48.1	56.4	65.9	79.0	na
Domestic credit to households (in per cent of GDP)	10.5	10.8	12.2	14.8	17.0	19.2	na
Of which mortgage lending (in per cent of GDP)	2.0	2.3	2.8	4.2	4.5	6.2	na
Stock market capitalisation (in per cent of GDP)	24.1	22.5	26.2	22.0	37.2	57.2	na
Stock trading volume (in per cent of market capitalisation)	27.9	11.8	14.8	9.3	8.8	12.3	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.7	na	na	6.5	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	3.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	40.5 (83.5)	40.7 (87.1)	40.9 (93.3)	41.5 (89.4)	42.6 (92.6)	42.8 (96.4)	na
Internet users (per 100 inhabitants)	37.6	40.1	48.0	55.4	63.6	65.0	na
Railway labour productivity (1989=100)	135.7	150.3	163.2	155.4	175.8	186.5	na
Residential electricity tariffs (USc kWh)	9.3	11.5	12.9	13.1	13.3	14.0	na
Average collection rate, electricity (in per cent)	97	93	na	90	96	99	na
GDP per unit of energy use (PPP in US dollars per kgoe)	5.4	5.6	5.9	6.2	na	na	na
EBRD index of infrastructure reform	3.0	3.0	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	3.0	3.0	3.0	3.0	3.0	3.0	3.3
Water and waste water	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 A new concession law came into force in March 2007. It has not been evaluated within the EBRD Concession Assessment Project but is considered as conforming with the internationally accepted standards.

³ Two foreign branches are included in the figure.

⁴ Source: Bank of Slovenia.

Macroeconomic indicators	2002	2003	2004	2005	2006	2007 <i>Estimate</i>	2008 <i>Projection</i>
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	4.0	2.8	4.3	4.3	5.9	6.8	4.3
Private consumption	2.5	3.3	2.7	2.6	2.9	5.0	na
Public consumption	3.3	2.2	3.4	3.3	4.1	2.5	na
Gross fixed capital formation	0.7	8.1	5.6	3.8	10.4	11.9	na
Exports of goods and services	6.8	3.1	12.4	10.6	12.5	13.8	na
Imports of goods and services	4.9	6.7	13.3	6.7	12.2	15.7	na
Industrial gross output	5.4	5.2	5.0	3.8	7.3	6.3	na
Agricultural gross output ¹	15.1	-20.0	11.0	-1.2	-4.0	-11.1	na
Employment²	<i>(Percentage change)</i>						
Labour force (end-year)	-3.2	3.2	2.6	2.4	-1.5	2.0	na
Employment (end-year)	-2.5	2.9	2.9	1.6	0.3	2.9	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	6.5	6.7	6.4	7.2	5.6	4.7	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)	7.5	5.6	3.6	2.5	2.5	3.6	6.1
Consumer prices (end-year)	7.2	4.6	3.2	2.3	2.8	5.6	4.0
Producer prices (annual average)	5.1	2.5	4.3	2.7	2.3	5.4	na
Producer prices (end-year)	3.7	2.1	4.9	1.8	2.8	6.3	na
Gross average monthly earnings in economy (annual average) ³	9.8	7.5	4.4	4.9	4.8	5.9	na
Government sector	<i>(In per cent of GDP)</i>						
General government balance	-2.5	-2.7	-2.2	-1.4	-1.2	0.5	-0.5
General government expenditure	46.3	46.4	45.8	45.2	44.5	42.1	na
General government debt	28.0	27.5	27.2	27.0	26.7	23.4	na
Monetary sector	<i>(Percentage change)</i>						
Broad money (M2, end-year)	11.0	6.2	6.6	7.8	8.2	10.6	na
Domestic credit (end-year)	14.1	14.4	24.1	20.2	21.6	24.9	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	51.6	50.5	49.9	50.8	50.8	50.6	na
Interest and exchange rates	<i>(In per cent per annum, end-year)</i>						
Discount rate	7.3	5.0	3.3	3.8	3.8	4.0	na
Interbank market rate (average)	4.9	5.6	4.7	4.0	3.6	4.1	na
Deposit rate (average 31-90 days)	8.2	6.0	3.8	3.2	2.8	3.6	na
Lending rate (average short-term working capital)	13.2	10.8	8.7	7.8	7.4	5.9	na
	<i>(Euros per US dollar)</i>						
Exchange rate (end-year)	1.0	0.8	0.7	0.8	0.8	0.7	na
Exchange rate (annual average)	1.1	0.9	0.8	0.8	0.8	0.7	na
External sector	<i>(In millions of US dollars)</i>						
Current account	243.8	-215.1	-892.4	-619.8	-997.4	-1,982.2	-1,309.8
Trade balance	-247.8	-622.2	-1,257.5	-1,258.1	-1,487.2	-2,330.4	-1,932.9
Merchandise exports	10,471.1	12,916.3	16,064.6	18,145.8	21,327.0	27,093.3	32,037.0
Merchandise imports	10,718.9	13,538.5	17,322.1	19,403.9	22,814.2	29,423.7	33,969.8
Foreign direct investment, net	1,508.0	-174.1	281.1	-67.0	-215.2	-352.9	632.4
Gross reserves, excluding gold (end-year)	6,846.0	8,567.3	8,743.3	8,076.3	7,033.9	979.8	na
External debt stock	12,104.8	16,703.2	20,940.1	24,257.5	31,701.6	51,157.9	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year) ⁴	5.9	5.9	4.8	5.4	4.1	0.5	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	16.5	14.6	12.7	14.4	17.4	17.2	na
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in billions of euros)	23.1	25.1	27.1	28.7	31.0	34.5	36.4
GDP per capita (in US dollars)	10,920.1	14,201.2	16,833.4	18,122.5	19,373.6	23,551.0	na
Share of industry in GDP (in per cent)	25.1	25.2	24.7	23.9	23.7	23.2	na
Share of agriculture in GDP (in per cent)	2.9	2.2	2.4	2.4	2.1	2.1	na
Current account/GDP (in per cent) ⁴	1.1	-0.8	-2.7	-1.7	-2.6	-4.2	-3.6
External debt - reserves (in US\$ million)	5,258.8	8,135.8	12,196.8	16,181.2	24,667.7	50,178.1	na
External debt/GDP (in per cent) ⁴	55.6	58.9	62.3	66.8	81.4	108.6	na
External debt/exports of goods and services (in per cent) ⁴	85.2	95.3	97.6	115.6	117.4	143.8	na

¹ Agricultural value-added.² Data based on labour force surveys.³ Data for enterprises employing three or more persons until 2004. From 2005 onwards, data for legal persons with 1 or 2 employees in the private sector also taken into account.⁴ Ratio calculated in euros.

Tajikistan

Key developments and challenges

An acceleration of agricultural reforms, including allowing farmers the freedom to choose which crops to plant, is necessary for Tajikistan to diversify away from cotton production, to raise rural incomes and to become less vulnerable to food price inflation.

To avoid a recurrence of the extreme electricity shortages at the beginning of 2008, further reforms in the power sector are crucial. Priorities include improving the financial transparency of the state-owned electricity company, tariff reforms and enhanced regional cooperation to secure sufficient energy supplies during the winter.

In light of the IMF misreporting issue (see “Macroeconomic performance”), the authorities need to increase the independence, transparency and accountability of the central bank so as to restore the credibility of macroeconomic policy.

Country data

Population (in millions)	6.8
Area ('000 sq km)	143.1
GDP (in billion US\$, 2007)	3.7
Average transition score (scale: 1 to 4.33)	2.33

Progress in structural reform

Liberalisation and privatisation

A presidential decree was signed in 2007 that envisaged full transferability of land-user rights and the implementation of the “freedom to farm” concept. The aim was to resolve the problem of accumulated debt in cotton farms by allowing farmers to plant crops that are more profitable than cotton and to give them better access to financing. However, implementation had been slow until January 2008, when a legal framework for full transferability of land-user rights was established under a newly amended land code (although secondary legislation is still required to establish clear procedures).

For the 2008 planting season, the authorities have banned non-cash, pre-harvest funding to farmers by cotton financiers and provided US\$ 40 million of budgetary financing to banks for on-lending to farmers. The provision of non-cash funding has been criticised as one of the main reasons why farmers have become highly indebted. However, without resolving the problem of accumulated debt, farmers’ access to other forms of financing will remain limited. The continuation of budgetary financing to the sector through commercial banks risks placing a burden on these banks in the event of farmers’ default and on the budget if the government assumes the full risk.

Business environment and competition

To stimulate development of small and medium-sized enterprises (SMEs), several measures were adopted in 2008. On 1 July an amended tax code became effective, introducing a new single tax system for individual entrepreneurs as well as small enterprises primarily engaged in services. The system combines income, social and sales taxes, and entrepreneurs will no longer have to make separate payments for each category. As a result the number of tax inspections and payments is expected to fall, cutting the bureaucratic burden on businesses and lowering the scope for corruption. In addition, a two-year moratorium on inspections of SMEs by all regulatory bodies took effect from 1 August 2008, with the aim of streamlining the regulatory framework for inspections during the moratorium period.

Infrastructure

The harsh winter in 2008 and the resulting frozen reservoirs exposed the vulnerabilities of the Tajik economy to the country’s high dependence on electricity from hydropower plants (HPPs). The subsequent prolonged rationing of electricity led to reduced economic output. The problems were aggravated by a rapid decline of water levels at the reservoir that supplies HPPs at the Nurek dam. In addition, Turkmenistan and Uzbekistan, which have usually supplied Tajikistan with power to enable it to meet seasonal deficits, reduced their electricity exports in the light of rising domestic demand.

The authorities’ strategy is to expand hydropower generation capacity further. The first unit of the Sangtuda I HPP, a joint venture with Russia’s Inter RAO UES, began operating in January 2008 and is expected to be fully completed by early 2009, with a capacity of 675 megawatts. The authorities would also like to complete the Rogun HPP, the construction of which was halted following the break-up of the Soviet Union. The Rogun plant could generate more than enough electricity to meet peak winter demand. This approach does not, however, address the risk of climatic cycles when dry winters lower the water level in the reservoirs and undermine the generation capacity of the HPPs. The problem could be addressed by further diversifying the sources of energy supply through building more combined heat and power plants powered by gas from Uzbekistan. However, the authorities are reluctant to pursue this because of concerns over the price and reliability of this gas supply. Moreover, there is an underlying tension between Tajikistan and Uzbekistan over the use of trans-boundary water that is preventing both countries from finding a way to manage water more effectively and to cooperate on energy use.

Electricity tariff increases have improved incentives for energy savings in recent years. However, limited progress was made in increasing the financial transparency of the state-owned integrated power company, Barki Tojik (BT), or in unbundling its generation, distribution and transmission functions. Separation of the Ministry of Energy’s policy-making and regulatory functions has not been achieved. Finally, transactions between BT and Talco (the state-owned aluminium smelter and the largest consumer of electricity in the country) remain non-transparent.

Macroeconomic performance

The macroeconomic environment remains fragile, despite real GDP growth of 7.8 per cent in 2007. Real GDP growth was 5.8 per cent in the first half of 2008, but power shortages may dent growth by one percentage point for the year as a whole. There are also indications that the adverse weather conditions have continued to negatively affect the economy as water levels at Nurek remain low and, according to reports, more general water shortages occurred in the spring planting season. The cold weather has also disrupted food supplies and, together with sharp price increases of imported foodstuffs, it has contributed to significant food price inflation. Overall consumer price inflation reached 25 per cent in mid-2008.

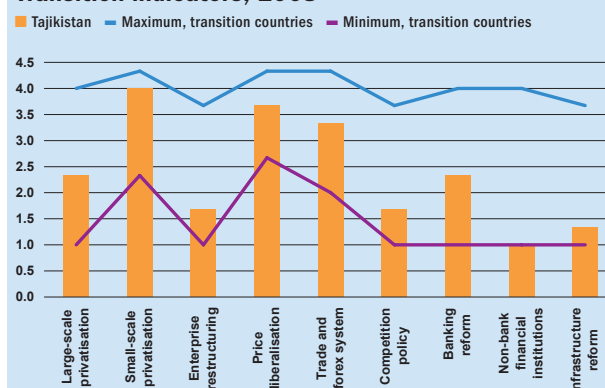
Confidence in the conduct of macroeconomic policy was severely undermined when the authorities admitted in late 2007 to the existence of hitherto undisclosed short-term public external debt, associated with pre-financing for the cotton sector, and that the reserves of the central bank were pledged against this debt. The authorities acknowledged they had misreported several benchmarks pertaining to central bank operations and benefited from debt relief from the International Monetary Fund (IMF). In accordance with the IMF's rules, the country was forced to repay around US\$ 47 million in six monthly instalments. In an attempt to rebuild credibility the authorities entered a new non-funded programme with the IMF in June 2008 for a six-month period. Under the programme, the authorities must implement a special audit of the central bank; amend central bank law to increase its independence and to prevent future conflict of interests between the central bank and the financial sector; carry out a financial audit of Talco and BT; and reach several quantitative macroeconomic benchmarks that will facilitate the build-up of international reserves.

The current account deficit widened sharply to 11.2 per cent of GDP in 2007, from 2.8 per cent in 2006. This primarily reflected the increased imports of goods and services associated with public investment programmes funded by the Chinese Export-Import Bank. Strong remittance inflows (39 per cent of GDP in 2007) continued to offset the large trade deficit of 45.1 per cent of GDP in 2007. However, the reserves of the central bank – US\$ 348 million at the end of 2007 – were almost exhausted by pledges and guarantees (US\$ 241 million and US\$ 77 million, respectively) made against loans provided by foreign commercial banks for cotton pre-financing.

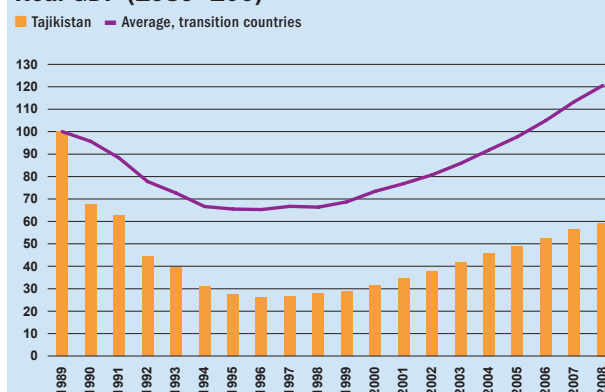
Outlooks and risks

The greatest macroeconomic risks in the short to medium-term are the precarious external liquidity position and energy security. The country remains vulnerable to a sudden increased demand for foreign currency caused by macroeconomic shocks. The country has so far been able to counterbalance the large trade deficit with surging remittance inflows, but these inflows may decline if the Russian construction sector, where many Tajik migrants work, slows down sharply. Growth in the medium to long-term hinges on implementing structural reforms promised under the IMF programme as well as accelerating agricultural and infrastructure reforms.

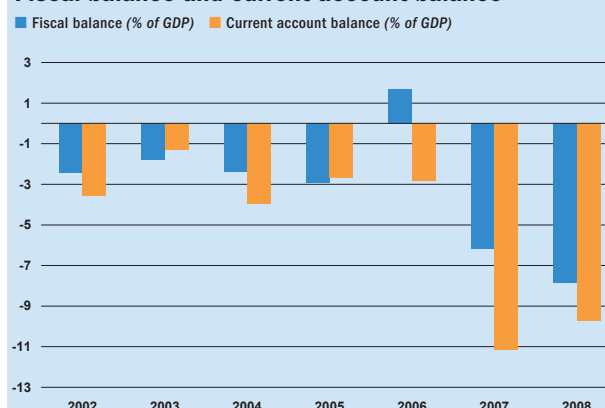
Transition indicators, 2008



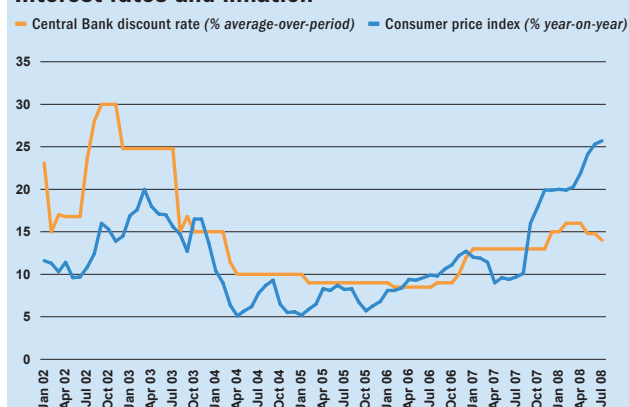
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – low	Capital adequacy ratio – 12 per cent	Share of population living in poverty – 42.8 per cent (2003)
Controls on inward direct investment – no ¹	Secured transactions law – inefficient	Independence of the electricity regulator – no	Deposit insurance system – yes	Government expenditure on health – 1.4 per cent of GDP (2007)
Interest rate liberalisation – full	Quality of corporate governance law – very low	Separation of railway infrastructure from operations – no	Quality of securities market laws – very low	Government expenditure on education – 4.0 per cent of GDP (2007)
Exchange rate regime – conventional peg		Independence of the road directorate – no	Private pension funds – no	Household expenditure on power and water – 6.0 per cent
Wage regulation – no		Quality of concession laws – very low		
Tradeability of land – limited de facto				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	5.8	6.3	6.7	7.2	7.8	7.9	na
Private sector share in GDP (in per cent)	50.0	50.0	50.0	55.0	55.0	55.0	55.0
Private sector share in employment (in per cent)	44.7	45.8	51.2	52.4	51.9	52.1	na
Budgetary subsidies and current transfers (in per cent of GDP)	0.5	0.4	0.4	0.4	0.4	0.3	na
Share of industry in total employment (in per cent)	6.6	6.1	5.7	5.7	5.5	5.3	na
Change in labour productivity in industry (in per cent)	7.2	16.6	10.9	5.8	9.4	14.4	na
Investment/GDP (in per cent)	13.5	13.2	13.7	14.9	13.4	21.6	na
<i>EBRD index of small-scale privatisation</i>	3.7	3.7	3.7	4.0	4.0	4.0	4.0
<i>EBRD index of large-scale privatisation</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>EBRD index of enterprise reform</i>	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	na	na
Number of goods with administered prices in EBRD-15 basket	0.0	0.0	0.0	0.0	0.0	na	na
Share of trade with non-transition countries (in per cent)	32.7	46.3	45.4	45.9	54.0	50.6	na
Share of trade in GDP (in per cent)	129.3	122.5	112.3	56.8	60.0	65.8	na
Tariff revenues (in per cent of imports)	2.6	2.3	2.7	5.0	3.9	3.2	na
<i>EBRD index of price liberalisation</i>	3.7	3.7	3.7	3.7	3.7	3.7	3.7
<i>EBRD index of forex and trade liberalisation</i>	3.3	3.3	3.3	3.3	3.3	3.3	3.3
<i>EBRD index of competition policy</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Financial sector							
Number of banks (foreign-owned)	14 (3)	15 (4)	12 (3)	12 (3)	10 (2)	11 (4)	na
Asset share of state-owned banks (in per cent) ²	4.5	6.1	12.2	9.7	7.6	7.2	na
Asset share of foreign-owned banks (in per cent) ²	1.8	3.6	6.2	8.9	6.5	6.6	na
Non-performing loans (in per cent of total loans)	84.2	73.6	18.7	13.8	11.4	4.9	na
Domestic credit to private sector (in per cent of GDP)	16.2	14.0	17.4	17.2	16.0	na	na
Domestic credit to households (in per cent of GDP)	na	0.5	1.1	1.3	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	na	na	na	na	na	na
<i>EBRD index of banking sector reform</i>	1.7	1.7	2.0	2.0	2.3	2.3	2.3
<i>EBRD index of reform of non-bank financial institutions</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	3.7 (0.2)	3.8 (0.7)	4.3 (2.1)	4.3 (4.1)	4.3 (4.1)	4.3 (4.1)	na
Internet users (per 100 inhabitants)	0.1	0.1	0.1	0.3	0.3	0.3	na
Railway labour productivity (1994=100)	50.3	47.3	38.0	38.4	42.3	44.5	na
Residential electricity tariffs (USc kWh)	0.5	0.5	0.6	0.6	0.6	0.6	na
Average collection rate, electricity (in per cent)	65	73	85	74	97	99	na
GDP per unit of energy use (PPP in US dollars per kgoe)	2.3	2.5	2.7	2.8	na	na	na
<i>EBRD index of infrastructure reform</i>	1.0	1.0	1.3	1.3	1.3	1.3	1.3
<i>Electric power</i>	1.0	1.0	1.7	1.7	2.0	2.0	2.0
<i>Railways</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Roads</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Telecommunications</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
<i>Water and waste water</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.7

¹ Approval from the National Bank of Tajikistan is required.² Including credit unions.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	9.1	10.2	10.6	6.7	7.0	7.8	5.0
Industrial gross output	6.3	9.9	13.8	8.5	6.7	9.9	na
Agricultural gross output	14.0	9.1	11.3	3.1	4.8	6.5	na
Employment							
<i>(Percentage change)</i>							
Labour force (annual average)	1.7	1.5	10.4	1.0	1.4	-0.1	na
Employment (annual average)	1.5	1.5	10.8	1.1	1.2	0.0	na
<i>(In per cent of labour force)</i>							
Unemployment (annual average) ¹	2.5	2.4	2.0	1.9	2.2	2.2	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	12.2	16.4	7.2	7.3	10.0	13.2	21.9
Consumer prices (end-year)	14.5	13.7	5.7	7.1	12.5	19.8	19.9
Producer prices (annual average)	10.1	15.0	17.1	10.7	42.7	21.8	na
Producer prices (end-year)	19.0	14.1	15.1	5.6	54.3	17.6	na
Gross average monthly earnings in economy (annual average)	38.0	37.6	36.3	41.1	36.7	36.4	na
Government sector²							
<i>(In per cent of GDP)</i>							
General government balance	-2.4	-1.8	-2.4	-2.9	1.7	-6.2	-7.2
General government expenditure	19.2	19.1	20.3	23.0	21.9	27.8	na
General government debt	89.4	64.8	43.1	42.3	35.5	34.8	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	55.3	42.0	51.6	30.2	63.4	78.8	na
Domestic credit (end-year)	14.0	-6.5	52.7	38.1	23.1	69.9	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	10.0	10.0	11.7	13.0	16.5	21.4	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Monetary policy rate	24.8	15.0	10.0	9.0	12.0	15.0	na
Deposit rate (up to 3 months)	11.6	14.6	8.6	8.6	8.2	5.5	na
Lending rate (up to 3 months)	13.4	15.6	21.3	25.6	26.7	22.5	na
<i>(Tajik somoni per US dollar)</i>							
Exchange rate (end-year)	3.0	2.9	3.0	3.2	3.4	3.5	na
Exchange rate (annual average)	2.8	3.1	3.0	3.1	3.3	3.4	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	-42.9	-19.9	-81.6	-61.9	-78.7	-414.7	-429.0
Trade balance	-93.9	-103.1	-151.2	-622.0	-986.4	-1,673.0	-2,187.0
Merchandise exports	730.4	900.0	1,087.8	345.7	349.5	385.0	402.0
Merchandise imports	824.3	1,003.2	1,239.0	967.7	1,335.9	2,058.0	2,589.0
Foreign direct investment, net	36.1	31.6	272.0	54.6	65.9	160.0	180.0
Gross reserves (end-year)	96.0	135.0	64.0	91.0	111.0	107.0	na
External debt stock	1,272.0	1,302.6	1,156.0	1,175.7	1,186.2	1,505.6	na
<i>(In months of imports of goods and services)</i>							
Gross reserves (end-year)	1.2	1.4	0.5	0.9	0.8	0.5	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	13.3	11.2	28.1	15.8	31.0	14.4	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	6.2	6.3	6.3	6.3	6.4	6.4	na
GDP (in millions of somoni)	3,344.6	4,758.0	6,158.0	7,201.0	9,272.0	12,779.7	16,363.5
GDP per capita (in US dollars)	193.1	248.1	328.5	364.3	440.5	578.3	na
Share of industry in GDP (in per cent)	22.1	20.9	19.6	21.3	28.0	30.7	na
Share of agriculture in GDP (in per cent)	26.3	25.2	21.6	17.2	22.0	23.2	na
Current account/GDP (in per cent)	-3.6	-1.3	-3.9	-2.7	-2.8	-11.2	-9.7
External debt - reserves (in US\$ million)	1,176.0	1,167.6	1,092.0	1,084.7	1,075.2	1,398.6	na
External debt/GDP (in per cent)	105.8	83.8	55.8	50.9	42.2	40.6	na
External debt/exports of goods and services (in per cent)	159.1	132.3	95.5	195.5	182.1	214.4	na

¹ Officially registered unemployed.² Includes externally financed public investment programmes.

Turkmenistan

Key developments and challenges

The business environment needs to improve further if private sector activity is to increase outside the hydrocarbons sector. This includes strengthening administrative capacity to implement new business laws, thereby encouraging more firms to enter the small business sector, and improving access to finance, which until now has constrained the growth of existing enterprises.

Substantial investment is needed in education and health care to stimulate the development of human capital. More generally, substantial resources must be committed to the regions to reverse the under-investment in physical infrastructure outside of the capital.

The unification of the dual exchange rate was an important policy development and should encourage foreign direct investment (FDI) into the non-hydrocarbon sector, thus helping Turkmenistan to begin diversifying its economy.

Country data

Population (in millions)	6.7
Area ('000 sq km)	488.0
GDP (in billion US\$, 2007)	12.9
Average transition score (scale: 1 to 4.33)	1.44

Progress in structural reform

Liberalisation and privatisation

Privatisation is not high on the government's agenda despite the president announcing in February 2008 an ambitious plan to increase the private sector's share in the non-hydrocarbon sector to 70 per cent by 2020. The focus is rather on increasing the small and medium-sized enterprise (SME) sector and expanding existing – albeit small – private enterprises. The government has created a number of new entities. These include the Institute for Strategic Planning and Development, which is responsible for developing a strategy for the private sector, and the State Audit Chamber, which regulates state finances and the property assets of public and private entities.

On the legislative front the government has approved a new constitution that explicitly mentions the protection of private property rights, as well as new laws and legal reforms on foreign investment, licensing, special economic zones and amending the tax code. Among other things these new laws stipulate that it should take no more than 20 days to register a new business, although in practice a lack of administrative capacity to implement these new laws has led to long registration delays.

Business environment and competition

The overall business environment remains difficult. This is despite some of the latest legislative changes, which have made it easier for businesses to enter the market, in particular

foreign investors (both inside and outside the hydrocarbon sector), by allowing property and land ownership and the repatriation of profits. A positive development has been the break-up of the state's monopoly over internet provision, with the launch of Russia's mobile internet service company (MTS) in April this year and, in parallel, the expansion of its mobile telephone services to all regions of the country. The unification of the dual exchange rate in May 2008, the opening of over 100 exchange offices across the country and the subsequent abolition of limits on foreign exchange transactions will all have a positive effect on private sector development. The latter measure applies especially to export/import firms, which have so far had difficulty in securing enough foreign exchange for trade transactions.

Financial sector

The financial sector remains small and largely state controlled with only one majority privately owned bank. Before exchange rate unification, the distorted foreign exchange market and direct monetary controls led to a low level of monetisation and constrained the role of banks in the economy. As part of the reforms, the government also issued new foreign exchange regulations in June 2008, allowing the central bank to provide banks with ready access to foreign exchange. The new regulations also allow commercial banks to open correspondent accounts, allowing them to handle financial transactions for a foreign financial institution, therefore enabling them to engage in trade finance. While a large portion of commercial bank lending is still directed to state-owned enterprises at below market interest rates, banks are starting to expand their private sector lending. Also, as of 2009, banks will be required to use International Financial Reporting Standards (IFRS) and many banks have started to improve their accounting practices.

Social sector

After the new social welfare code was adopted in July 2007 the government reviewed pension and public sector wages and linked them to average earnings. After initial wage increases, in particular for teachers, in July 2008 the government announced a further increase of 10 per cent in 2009. Nevertheless, these measures do not fully compensate for the scale of recent price increases for key items. A combination of food price inflation, the liberalisation of petrol prices that led to an eight-fold increase in petrol prices and the subsequent twenty-fold increase in transport prices (from extremely low levels), have all put pressure on household budgets, leaving those on low incomes particularly vulnerable. This is especially true for those living outside the capital.

After years of under-investment in the regions the government has started a new regional development initiative, although its scale and focus are still unclear. The quality and quantity of services provided by the health and education sectors in the regions seriously lag behind those available in the capital. In 2007 the president introduced a number of positive educational reforms to increase the number of years of compulsory secondary education and ensure that tertiary education is in accordance with standards of the Commonwealth of Independent States.

Macroeconomic performance

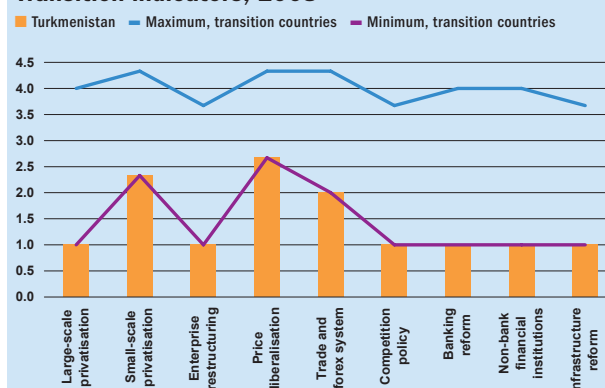
GDP growth has remained strong on the back of rising hydrocarbon export prices. Real GDP rose by 11.6 per cent in 2007 and official statistics report a 7.5 per cent increase (year-on-year) in the first half of 2008, driven by higher output from the hydrocarbon, construction, transport and retail sectors. As a result, the current account surplus remained above 30 per cent of GDP in 2007, even though imports increased by over 50 per cent during the same period. FDI inflows, particularly in the first half of 2008, continue mainly to reflect investments in offshore oil production in the Caspian Sea. Turkmenistan successfully negotiated further significant increases in off-take prices and volumes for 2009 onwards and has for the first time linked these agreements to interest-free loans from off-takers to finance hydrocarbon infrastructure.

The exchange rate unification was completed on 1 May 2008 at the rate of 14,250 manat per US dollar, a level broadly consistent with the country's strong external position. The central bank is committed to supporting the fixed rate and is ensuring the banking sector has ready access to foreign exchange. Overall credit grew strongly in the second half of 2007, mainly reflecting increased directed lending to the cotton sector. However, in the first half of 2008 the growth of both reserve and broad money slowed because of higher agricultural loan repayments by state enterprises and rising dollar sales by the central bank. The state budget for 2007 showed a surplus of 4 per cent of GDP, reflecting increasing hydrocarbon revenues and lower-than-budgeted expenditures. The latter reflects a lack of administrative capacity to implement the government investment programme. There is still a significant amount of off-budget activity, and an ongoing budgetary reform process, supported by the European Union, is intended to increase budgetary coverage and transparency.

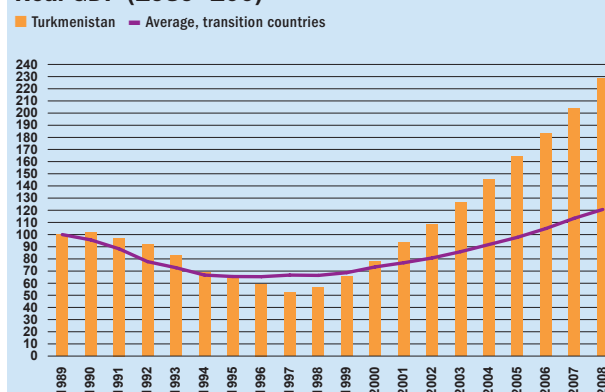
Outlook and risks

Economic growth remains strong and large trade surpluses, on the back of high hydrocarbon export prices, are expected to continue in the medium term. Containing inflation within single digits is likely to remain difficult for the central bank as adjustments of regulated prices to market levels and rising international food prices continue to push up general prices. With increasing inflationary pressures, a prudent fiscal policy is crucial for macroeconomic stability. At the same time, targeted expenditures remain necessary to dampen the impact of exchange rate unification and price rises on the real incomes of the poor. Increasing the activities of the private sector outside the oil and gas sector and diversifying the economy remain major challenges but will be the key factor in reducing Turkmenistan's vulnerability to external economic shocks.

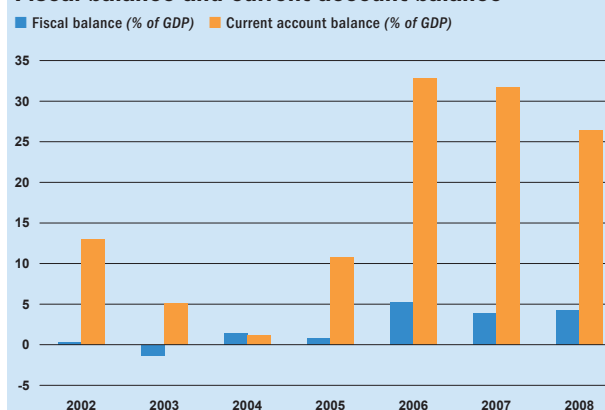
Transition indicators, 2008



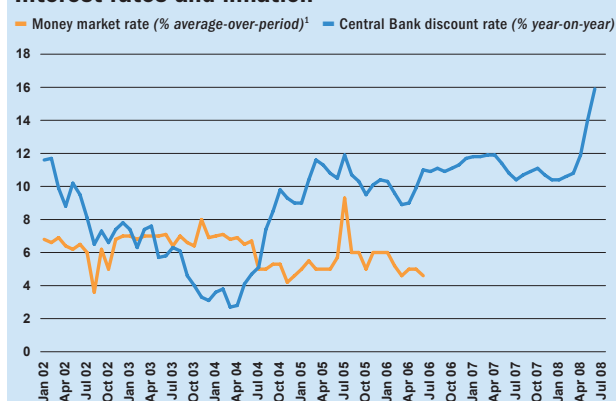
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



¹ Data were not available between May 2006 and July 2008.

Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – limited	Competition office – no	Telecoms regulatory assessment compliance – low	Capital adequacy ratio – 10 per cent ²	Share of population living in poverty – 44.0 per cent (1998)
Controls on inward direct investment – no ¹	Secured transactions law – malfunctioning	Independence of the electricity regulator – no	Deposit insurance system – no	Government expenditure on health – 4.8 per cent of GDP (2005)
Interest rate liberalisation – limited de jure	Quality of corporate governance law – low	Separation of railway infrastructure from operations – no	Quality of securities market laws – very low	Government expenditure on education – 5.4 per cent of GDP (2005)
Exchange rate regime – fixed		Independence of the road directorate – no	Private pension funds – no	Household expenditure on power and water – 0.3 per cent
Wage regulation – yes		Quality of concession laws – low		
Tradeability of land – limited de jure				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	0.6	0.6	0.6	0.6	na	na	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)	13.8	13.8	14.0	na	na	na	na
Change in labour productivity in industry (in per cent)	7.5	10.7	12.0	na	na	na	na
Investment/GDP (in per cent)	27.6	25.3	23.4	na	na	na	na
<i>EBRD index of small-scale privatisation</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.3
<i>EBRD index of large-scale privatisation</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>EBRD index of enterprise reform</i>	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)	6.8	6.7	6.7	6.7	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)	54.7	54.4	51.2	43.2	46.6	48.8	na
Share of trade in GDP (in per cent)	104.8	102.1	98.4	97.3	95.0	101.2	na
Tariff revenues (in per cent of imports) ³	na	na	na	na	na	na	na
<i>EBRD index of price liberalisation</i>	2.7	2.7	2.7	2.7	2.7	2.7	2.7
<i>EBRD index of forex and trade liberalisation</i>	1.0	1.0	1.0	1.0	1.0	1.0	2.0
<i>EBRD index of competition policy</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Financial sector							
Number of banks (foreign-owned)	13 (4)	12 (4)	11 (4)	11 (4)	11 (4)	11 (4)	na
Asset share of state-owned banks (in per cent)	95.7	96.1	96.6	96.3	94.8	97.3	na
Asset share of foreign-owned banks (in per cent)	1.7	1.6	1.0	1.0	1.0	1.1	na
Non-performing loans (in per cent of total loans)	0.3	0.5	0.4	0.3	0.2	0.2	na
Domestic credit to private sector (in per cent of GDP)	1.9	1.9	1.6	1.4	na	na	na
Domestic credit to households (in per cent of GDP)	na	0.5	0.5	0.7	0.6	0.8	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	na	na	na	na	na	na
<i>EBRD index of banking sector reform</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>EBRD index of reform of non-bank financial institutions</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	7.7 (0.2)	7.7 (0.2)	7.9 (1.0)	8.2 (2.2)	8.2 (4.4)	8.2 (4.4)	na
Internet users (per 100 inhabitants)	0.3	0.4	0.7	1.0	1.3	1.4	na
Railway labour productivity (1989=100)	33.9	38.1	37.7	41.9	44.8	44.6	na
Residential electricity tariffs (USc kWh)	0.5	0.5	0.5	0.4	na	na	na
Average collection rate, electricity (in per cent)	63	na	na	na	na	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.5	1.3	na	1.3	na	na	na
<i>EBRD index of infrastructure reform</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Electric power</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Railways</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Roads</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Telecommunications</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.7
<i>Water and waste water</i>	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.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP ¹	15.8	17.1	14.7	13.0	11.4	11.6	12.0
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	13.0	4.0	na	na	na	na	na
Imports of goods and services	-3.7	4.3	na	na	na	na	na
Industrial gross output	12.8	13.5	16.4	8.5	na	na	na
Agricultural gross output	9.5	9.5	13.0	4.0	na	na	na
Employment							
<i>(Percentage change)</i>							
Labour force (end-year)	3.2	3.0	3.0	0.0	na	na	na
Employment (end-year)	2.5	2.2	na	na	na	na	na
<i>(In per cent of labour force)</i>							
Unemployment ²	29.3	29.8	30.2	na	na	na	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	8.8	5.6	5.9	10.7	8.2	6.3	13.0
Consumer prices (end-year)	7.8	3.1	9.0	10.4	7.1	8.6	12.0
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)	8.2	84.2	5.7	21.6	na	na	na
Government sector³							
<i>(In per cent of GDP)</i>							
General government balance	0.2	-1.3	1.4	0.8	5.3	3.9	4.3
General government expenditure	18.1	19.4	18.9	19.7	14.9	13.3	na
General government debt	na	na	na	na	na	na	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M3, end-year)	1.5	33.4	13.6	5.6	10.7	96.8	na
Domestic credit (end-year)	-2.9	-0.6	3.6	-3.5	-6.7	31.0	na
<i>(In per cent of GDP)</i>							
Broad money (M3, end-year)	13.0	13.2	12.1	10.5	9.4	15.0	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Refinance rate	12.0	10.0	5.0	5.0	na	na	na
Interbank market rate	7.0	6.9	4.6	6.0	na	na	na
Deposit rate (6-12 months) ⁴	17.8	15.4	11.3	8.6	na	na	na
Lending rate (6-12 months) ⁴	21.9	20.4	17.3	17.3	na	na	na
<i>(Manats per US dollar)</i>							
Exchange rate (end-year) ⁵	10,150.0	10,390.0	10,540.0	10,870.0	10,690.0	10,690.0	na
Exchange rate (annual average)	10,097.5	10,033.5	10,375.0	11,015.2	10,881.9	10,690.0	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	583.0	305.0	82.1	874.6	3,351.0	4,036.6	5,007.1
Trade balance	1,030.0	886.0	705.5	1,997.1	4,597.8	5,333.6	6,425.7
Merchandise exports	2,862.0	3,465.0	3,853.9	4,944.1	7,155.5	9,113.7	12,163.1
Merchandise imports	1,832.0	2,579.0	3,148.4	2,947.0	2,557.7	3,780.1	5,737.4
Foreign direct investment, net	276.0	226.0	353.7	418.2	730.9	856.4	1,199.7
Gross reserves, excluding gold (end-year) ⁶	2,346.0	2,673.0	2,729.4	4,457.7	8,059.2	13,221.5	na
External debt stock	1,660.0	1,519.0	1,273.0	923.8	713.3	627.1	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	11.8	9.5	8.0	13.8	26.9	32.4	na
<i>(In per cent of exports of goods and services)</i>							
Debt service ⁷	14.3	11.6	9.6	6.3	4.1	3.2	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	5.8	6.2	6.5	6.5	6.5	6.5	na
GDP (in billions of manats)	45,240.0	59,404.8	73,820.0	89,308.0	111,254.0	136,244.0	247,152.2
GDP per capita (in US dollars)	774.5	954.9	1,094.6	1,247.3	1,572.9	1,960.8	na
Share of industry in GDP (in per cent)	40.9	39.7	38.6	na	na	na	na
Share of agriculture in GDP (in per cent)	21.8	19.6	18.4	na	na	na	na
Current account/GDP (in per cent)	13.0	5.2	1.2	10.8	32.8	31.7	26.4
External debt - reserves (in US\$ million)	-686.0	-1,154.0	-1,456.4	-3,533.9	-7,345.9	-12,594.4	na
External debt/GDP (in per cent)	37.1	25.7	17.9	11.4	7.0	4.9	na
External debt/exports of goods and services (in per cent)	53.9	40.8	30.2	17.5	9.5	6.6	na

¹ Official statistics until 2004, but EBRD estimates thereafter.

² Officially registered unemployed.

³ Significant off-budget expenditures occur through extra-budgetary funds and lending.

⁴ Unweighted average deposit and lending rates for individuals (in local currency) of state commercial banks.

⁵ Before May 2008 Turkmenistan operated 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.

⁶ Includes foreign exchange reserves of the central bank plus the foreign exchange reserve fund.

⁷ Excludes rescheduled amounts.

Ukraine

Key developments and challenges

WTO membership firmly anchors the country in a rules-based global trading system. Further land ownership reform and compliance with international standards of quality, especially for agricultural products, would allow the country to diversify exports away from metal products and benefit fully from greater trade integration with the world economy.

Ukraine requires substantial investment to upgrade its transport and municipal infrastructure. This can be achieved through better budget planning, procurement procedures and project implementation, as well as a clearer legal framework for public-private partnerships (PPPs).

The global credit tightening and fall in commodity prices are threatening macroeconomic and financial stability. A swift and well-coordinated policy response that would address financial sector liquidity and solvency problems is needed.

Country data

Population (in millions)	45.8
Area ('000 sq km)	603.7
GDP (in billion US\$, 2007)	141.2
Average transition score (scale: 1 to 4.33)	3.07

Progress in structural reform

Liberalisation and privatisation

Ukraine became a member of the World Trade Organization (WTO) in May 2008, paving the way for negotiations on a Free Trade Area with the European Union and the abolition of the EU import quota for Ukrainian steel products. The export sectors most likely to benefit from greater trade integration with the world economy are steel, chemicals and food processing, which have frequently faced restrictions from other countries. Some domestic industries that are currently protected from import competition, including car manufacturing and some agricultural products (especially sugar), will face more competition as VAT exemptions and import duties will have to be gradually abolished. The ability to comply with international quality standards and attract further private investment in the agriculture sector has been constrained so far by a combination of the moratorium on land sales, the impossibility of using land as collateral and ad hoc state interference in the sector. In anticipation of a good harvest in 2008 the government lifted in May the various quota restrictions on grain and oil seed exports that it had introduced last year in response to the global rise in food prices.

The privatisation process has stalled owing to political infighting within the governing coalition over the appointment of the head of the privatisation agency. In 2007 privatisation

revenues amounted to only US\$ 485 million, against a target of US\$ 2.1 billion. The list of companies to be privatised this year was approved in January 2008 and includes a 68 per cent stake in the telecommunications company Ukrtelecom, majority stakes in four power generating companies, minority stakes in six power distribution companies, the Odessa portside plant and a 75 per cent stake in the turbine manufacturer Turboatom. The government expected to raise US\$ 1.7 billion in privatisation revenues this year, but so far there has been little progress with sales.

Business environment and competition

Some progress has been made in improving the business environment: customs administration has been modernised, the tax system for small and medium-sized enterprises (SMEs) simplified and VAT declarations digitalised. However, Ukraine's burdensome tax regime and complicated regulatory environment remain major impediments to further private sector growth. Weaknesses in the property rights regime also remain an issue, and have surfaced with the recent dispute over Vanco Energy's right to develop oil and gas deposits in the Black Sea, as the government cancelled its production sharing agreement (PSA) in May 2008. A long-awaited joint-stock company law, designed to strengthen property and minority shareholders' rights, was approved by parliament in September 2008.

Infrastructure

Rapidly increasing gas import prices have spurred higher private sector investment to modernise production facilities and improve energy efficiency. Since January 2008 Ukraine has been paying US\$ 179.5 per thousand cubic metres of gas delivered at the Russia-Ukraine border. This price is almost certain to increase in the near future as Central Asian producers – Ukraine's main suppliers through Russia – have in turn increased their gas export prices. While domestic tariffs for industrial consumers have been rising, household tariffs in Ukraine remain below cost recovery levels and are subsidised through the budget. Little progress has been made in tackling some of the key reform issues in the energy sector, such as unbundling and corporatising the oil and gas monopoly Naftogaz Ukraine (NAK), attracting more private sector participation in power generation and distribution, strengthening the role of the regulator and increasing overall transparency in the sector.

The government has endorsed an ambitious investment programme to upgrade transport infrastructure in the six regions (Kiev, Dnipropetrovsk, Donetsk, Kharkiv, Lviv and Odessa) that will co-host (with Poland) the UEFA 2012 European football championship. Total investment needs have been estimated at Hryvnia 126.4 billion (US\$ 26 billion), 27 per cent of which is expected to be financed by state and local administrations and most of the rest (nearly US\$ 19 billion) by private sources. A new law on public procurement is awaiting approval (as of early October 2008). This law, along with the harmonisation of the concession law and regulations governing public-private partnerships (PPPs) with international best practice, would help to attract a mix of public and private investment to modernise transport and municipal infrastructure.

Macroeconomic performance

The economy grew at 7.6 per cent in 2007 and 6.9 per cent in the first nine months of 2008, supported by high steel and metal export prices, record capital inflows and a good harvest. However, industrial production declined by 4.5 per cent in September, a sign that the economy is not immune to the global financial crisis. Annual consumer price inflation peaked at 31 per cent in May 2008, the highest rate among the transition countries, but has since fallen to below 25 per cent. Much of the increase reflected higher food prices, although strong credit growth and increases in wages and other budgetary transfers, have also fuelled domestic demand and added to pressures on non-food prices.

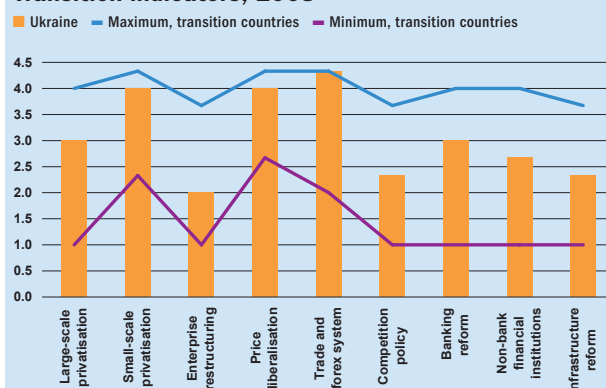
In response to these pressures, the National Bank of Ukraine (NBU) tightened monetary policy by raising the discount rate by 200 basis points in January and April 2008 to 10 and 12 per cent respectively. However, fiscal policy remained relatively expansionary due to the increased share of social spending in the 2008 budget. The hryvnia has been under devaluation pressure since mid-September. The NBU took steps to relax the de facto peg to the US dollar and allow greater exchange rate flexibility by abandoning the practice of pre-announcing the band of fluctuation of the exchange rate from mid-October. It also adopted emergency measures to stabilise the banking system following a run on deposits of the country's sixth largest bank, Prominvestbank.

Strong capital inflows have more than covered Ukraine's external financing needs so far but the trade deficit reached almost 9 per cent of GDP in the first half of 2008, short-term external borrowing has grown rapidly and the cost of refinancing on the international markets has increased sharply since the outbreak of the Georgia-Russia crisis. The country faces a peak in refinancing needs in 2009. In October, the authorities announced a tentative agreement with the IMF on a 24-month stand-by loan of the US\$ 16.5 billion which would provide balance of payments support.

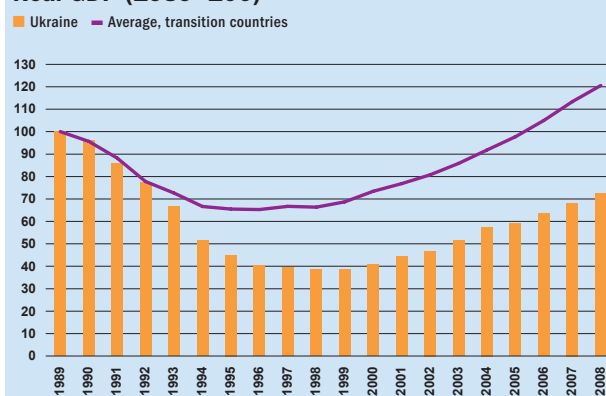
Outlook and risks

The short-term outlook for the economy has become more gloomy. GDP growth is expected to slow to 6 per cent in 2008, and fall sharply next year on the back of a less favourable external environment and a deceleration in domestic demand. Greater exchange rate flexibility could help to mitigate the effect of a large external terms-of-trade shock next year, caused by higher gas import prices and/or lower metal prices. Vulnerabilities remain in the banking system, whose rapid expansion may be coming to a sudden halt due to tighter external refinancing conditions and a likely deterioration in asset quality. Access to external capital markets for the Ukrainian private sector has largely been cut off since late August, particularly for companies or banks with lower credit quality.

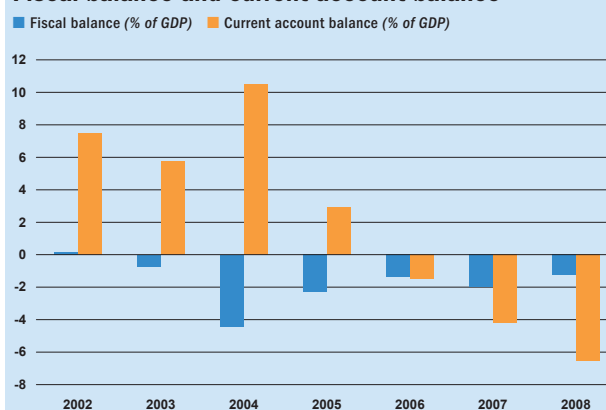
Transition indicators, 2008



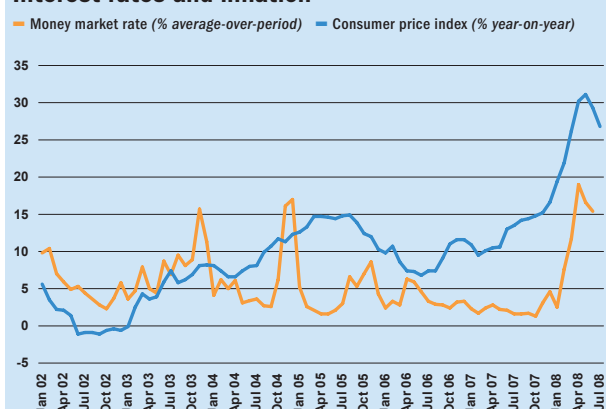
Real GDP (1989=100)



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	Telecoms regulatory assessment compliance – medium	Capital adequacy ratio – 10 per cent	Share of population living in poverty – 4.9 per cent (2003) ²
Controls on inward direct investment – no ¹	Secured transactions law – modern/some defects	Independence of the electricity regulator – partial	Deposit insurance system – yes	Government expenditure on health – 3.6 per cent of GDP (2006)
Interest rate liberalisation – full	Quality of corporate governance law – very low	Separation of railway infrastructure from operations – no	Quality of securities market laws – high	Government expenditure on education – 6.2 per cent of GDP (2006)
Exchange rate regime – managed float		Independence of the road directorate – partial	Private pension funds – yes	Household expenditure on power and water – 3.2 per cent
Wage regulation – no		Quality of concession laws – medium		
Tradeability of land – limited de facto				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	6.0	7.1	10.1	15.1	15.2	15.5	na
Private sector share in GDP (in per cent)	65.0	65.0	65.0	65.0	65.0	65.0	65.0
Private sector share in employment (in per cent)	35.6	37.7	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	1.2	2.2	2.2	2.2	3.1	2.8	na
Share of industry in total employment (in per cent)	21.0	20.4	20.1	19.7	19.5	19.3	na
Change in labour productivity in industry (in per cent)	11.3	18.5	13.8	3.2	7.1	10.2	na
Investment/GDP (in per cent)	20.2	20.3	21.2	22.6	24.8	26.9	na
EBRD index of small-scale privatisation	3.7	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)	na	na	na	na	na	8.0	na
Number of goods with administered prices in EBRD-15 basket	3.0	6.0	6.0	6.0	5.0	5.0	na
Share of trade with non-transition countries (in per cent)	47.5	52.9	48.3	48.6	50.4	51.1	na
Share of trade in GDP (in per cent)	86.4	95.2	97.4	82.6	77.2	78.1	na
Tariff revenues (in per cent of imports) ³	3.0	3.0	3.2	3.6	3.3	3.3	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	4.3
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)	157 (15)	158 (19)	160 (19)	165 (23)	170 (27)	175 (40)	na
Asset share of state-owned banks (in per cent)	12.0	9.8	8.0	9.4	8.9	8.0	na
Asset share of foreign-owned banks (in per cent)	12.3	12.1	12.1	21.3	35.0	39.4	na
Non-performing loans (in per cent of total loans)	4.5	3.4	3.2	2.2	1.7	1.3	na
Domestic credit to private sector (in per cent of GDP) ⁴	17.6	24.3	25.2	32.2	44.4	58.8	na
Domestic credit to households (in per cent of GDP)	1.6	3.7	6.6	8.1	15.3	22.5	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	3.7	6.5	na
Stock market capitalisation (in per cent of GDP)	7.4	8.6	18.1	28.6	39.8	79.2	na
Stock trading volume (in per cent of market capitalisation)	14.9	2.9	2.5	3.6	3.5	2.6	na
Eurobond issuance (in per cent of GDP)	8.8	6.3	3.6	2.5	2.8	2.8	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.7	3.0	3.0	3.0
EBRD index of reform of non-bank financial institutions	2.0	2.0	2.3	2.3	2.3	2.7	2.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	22.6 (7.7)	23.4 (13.7)	25.8 (29.2)	25.1 (64.6)	26.8 (106.5)	27.8 (119.6)	na
Internet users (per 100 inhabitants)	1.9	5.3	10.6	17.2	19.6	21.6	na
Railway labour productivity (1989=100)	49.9	56.5	60.1	56.9	57.5	64.9	na
Residential electricity tariffs (USc kWh)	2.7	2.7	2.7	2.5	3.3	4.0	na
Average collection rate, electricity (in per cent)	83	94	92	99	100	95	na
GDP per unit of energy use (PPP in US dollars per kgoe)	1.4	1.5	1.7	1.8	na	na	na
EBRD index of infrastructure reform	2.0	2.0	2.0	2.0	2.0	2.3	2.3
Electric power	3.0	3.0	3.0	3.0	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	2.7	2.7	2.7
Water and waste water	1.7	1.7	1.7	1.7	1.7	2.0	2.0

¹ Registration of foreign investment is required.² Based on the international poverty line. The poverty rate based on the national poverty line in 2002 was 28.1 per cent.³ Refers to taxes on international trade and transactions.⁴ Data from the International Monetary Fund.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	5.2	9.6	12.1	2.7	7.3	7.6	6.0
Private consumption	9.5	11.5	13.1	16.6	15.9	17.1	na
Public consumption	-6.7	6.9	1.8	2.7	2.7	2.8	na
Gross fixed capital formation	3.4	22.5	20.5	3.9	21.2	24.8	na
Exports of goods and services	7.4	10.3	21.3	-12.2	-5.6	3.2	na
Imports of goods and services	3.3	16.4	15.5	6.4	6.8	19.9	na
Industrial gross output	7.0	15.8	12.5	3.1	6.2	10.2	na
Agricultural gross output	1.2	-9.9	19.1	0.4	2.5	-5.6	na
Employment							
<i>(Percentage change)</i>							
Labour force (end-year)	-0.9	-0.3	0.1	0.4	-0.2	0.3	na
Employment (end-year)	0.6	0.4	0.7	1.9	0.2	0.8	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year) ¹	9.6	9.1	8.6	7.2	6.8	6.4	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average)	0.8	5.2	9.0	13.5	9.1	12.8	24.8
Consumer prices (end-year)	-0.6	8.2	12.3	10.3	11.6	16.6	20.2
Producer prices (annual average)	3.0	7.6	20.4	16.7	9.6	19.5	na
Producer prices (end-year)	5.7	11.1	24.1	9.5	14.1	23.3	na
Gross average monthly earnings in economy (annual average)	20.9	22.9	27.9	36.4	29.7	29.3	na
Government sector²							
<i>(In per cent of GDP)</i>							
General government balance	0.1	-0.7	-4.4	-2.3	-1.4	-2.0	-1.2
General government expenditure	35.6	37.2	41.5	44.1	44.6	44.3	na
General government debt	33.5	29.3	25.9	19.7	16.3	13.4	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	42.3	46.9	32.8	53.9	34.3	50.8	na
Domestic credit (end-year)	28.0	38.4	24.8	34.3	69.4	77.0	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	28.5	35.3	36.4	43.8	47.7	54.9	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Discount rate	7.0	7.0	9.0	9.5	8.5	8.0	na
Deposit rate ³	7.9	7.0	7.8	8.6	7.6	8.1	na
Lending rate ³	25.4	17.9	17.4	16.2	15.2	13.9	na
<i>(Hryvnias per US dollar)</i>							
Exchange rate (end-year)	5.3	5.3	5.3	5.1	5.1	5.1	na
Exchange rate (annual average)	5.3	5.3	5.3	5.1	5.1	5.1	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	3,173.0	2,891.0	6,804.0	2,531.0	-1,617.0	-5,918.0	-12,503.0
Trade balance	710.0	-269.0	3,741.0	-1,135.0	-5,194.0	-10,572.0	-17,803.0
Merchandise exports	18,669.0	23,739.0	33,432.0	35,024.0	38,949.0	49,840.0	71,628.0
Merchandise imports	17,959.0	24,008.0	29,691.0	36,159.0	44,143.0	60,412.0	89,431.0
Foreign direct investment, net	698.0	1,411.0	1,711.0	7,533.0	5,737.0	9,218.0	9,500.0
Gross reserves, excluding gold (end-year)	4,241.0	6,731.0	9,302.0	19,413.0	22,300.0	31,972.0	na
External debt stock ⁴	12,771.0	23,811.0	30,647.0	39,619.0	54,512.0	84,520.0	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	2.4	2.9	3.2	5.3	5.0	5.3	na
<i>(In per cent of exports of goods and services)</i>							
Debt service ⁵	5.7	6.2	4.6	4.9	5.1	3.9	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	47.8	47.4	47.1	46.7	46.5	46.1	na
GDP (in billions of hryvnias)	225.8	267.3	345.1	441.5	544.2	712.9	943.2
GDP per capita (in US dollars)	886.4	1,057.3	1,376.4	1,843.7	2,317.1	3,061.2	na
Share of industry in GDP (in per cent)	27.4	27.2	25.8	27.2	27.6	28.2	na
Share of agriculture in GDP (in per cent)	13.0	10.9	10.8	9.2	7.5	6.6	na
Current account/GDP (in per cent)	7.5	5.8	10.5	2.9	-1.5	-4.2	-6.5
External debt - reserves (in US\$ million) ⁴	8,530.0	17,080.0	21,345.0	20,206.0	32,212.0	52,548.0	na
External debt/GDP (in per cent) ⁴	30.1	47.5	47.3	46.0	50.6	59.9	na
External debt/exports of goods and services (in per cent) ⁴	54.7	82.2	77.2	89.3	108.5	132.1	na

¹ According to ILO methodology.² General government includes the state, municipalities and extra-budgetary funds.³ Weighted average over all maturities.⁴ Until end-2002, medium and long-term external debt only. From 2003 onwards, the series also includes short-term external debt.⁵ Refers to payments on total external debt.

Uzbekistan

Key developments and challenges

Some steps have been taken to improve the business environment, including a new tax code, but some key impediments to private sector development remain, such as de facto limited current account convertibility and the high tax burden.

Access to finance has improved but further growth of the banking sector is constrained by banks carrying out non-core functions, such as tax withholding, and by the dominance of state-owned banks. It is important to remove these burdens and accelerate the restructuring and privatisation of the state banks.

Rising prices of imports and a possible bad harvest this year owing to water shortages could negatively affect price stability and growth. More exchange rate flexibility could help absorb external shocks, while faster reforms in agriculture would mitigate the impact of domestic supply shocks.

Country data

Population (in millions)	26.0
Area ('000 sq km)	448.9
GDP (in billion US\$, 2007)	22.3
Average transition score (scale: 1 to 4.33)	2.15

Progress in structural reform

Liberalisation and privatisation

The government formally adopted its first Welfare Improvement Strategy (WIS) in September 2007. The strategy, covering the period 2008-10, accords a greater role to market principles and the private sector but falls short of outlining a plan for further liberalisation of agriculture and trade – two areas that remain heavily distorted.

In agriculture, reform in recent years has focused on transforming large-scale cooperative farms into private leasehold farms. In 2008 the process was completed and more than 215,000 private farms were established. However, the sector remains distorted by state procurement quotas that force farmers to plant cotton (and wheat) on certain land. Distortions are reinforced by insecure leaseholder rights in cases of non-compliance; by the dominance of the state in the cotton export market; and by the low prices paid for cotton by domestic processors. The authorities are considering moving towards cost-recovery for the use of water in agriculture. This would be an important step towards more efficient use of water that would not only increase overall productivity, but would also have environmental benefits in preventing further shrinkage of the Aral Sea.

Trade policy in Uzbekistan is characterised by non-transparency, restrictiveness and complexity. While average import tariffs on a trade-weighted basis are mostly in line with other countries in the region, when import-only excise taxes

are added, tariff barriers are very high. Non-tariff barriers, such as delays in customs clearance and currency conversion, also remain significant obstacles to regional integration. However, some steps have been taken to encourage trade, including amendments in 2006 and 2008 to the complicated customs code.

Business environment and competition

A new tax code that aims to simplify and clarify existing tax law became effective in January 2008. The new code replaces the 1997 tax code that had many weaknesses and required around 1,300 subsequent normative acts for the code to be implemented. The overall tax burden on enterprises will be reduced through further cuts in the tax rates and through eliminating or unifying inefficient taxes. The new code is expected to give businesses easier recourse against arbitrary enforcement actions, create a more level playing field as unjustified tax exemptions will be eliminated, while penalties for delayed tax payments will be less punitive. Nevertheless, the tax burden on businesses will remain one of the highest in the region.

Financial sector

Uzbek banks rely on customer deposits for around 40-50 per cent of their funding. In recent years the banks that have been able to grow the most – primarily small and medium-sized private banks – are the ones that have been the most successful in attracting deposits, as the government has stopped providing sovereign guarantees to foreign loans to commercial banks. Uzbek commercial banks have had very limited access to international markets to date. When Moody's rated the sector for the first time in April 2008, it was given one of the lowest ratings in the region. Factors influencing this included: the dominance of state-owned banks; close government control over banking activities that limit competition; obligations for banks to undertake non-core functions, such as tax withholding and financial supervision of the account holders; and weak corporate governance.

To strengthen the domestic funding base of commercial banks, a one-year tax amnesty took effect on 1 April 2008. During this period, bank accounts can be opened freely (and even anonymously) and law enforcement bodies as well as tax authorities will be prohibited from inquiring into the sources of funds. This measure, combined with the suspension of anti-money-laundering legislation, led the Financial Action Task Force to warn in February 2008 of higher risks of money laundering and terrorist funding. The government raised minimum capital requirements for new commercial banks from US\$ 5 million to €5 million and replenished the capital of state-owned banks. Reserve requirements on foreign and local currency deposits have been unified in order to remove disincentives and attract local currency deposits.

Social sector

In April 2008 Uzbekistan ratified the Worst Forms of Child Labour Convention, one of the fundamental conventions on international labour standards, thereby committing the country to immediate measures to prohibit and eliminate the worst forms of child labour, especially in cotton production. This follows the adoption of legislation that guarantees children's rights and an international boycott of Uzbekistan's cotton exports (which account for about 20 per cent of total exports) because of concerns about the use of child labour.

Macroeconomic performance

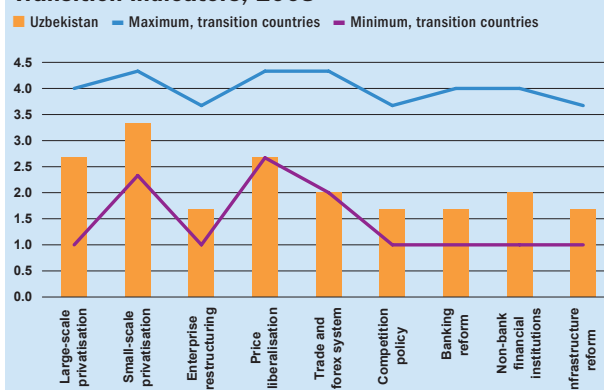
The economy remained buoyant with real GDP growing by 9.3 per cent in the first half of 2008 (year-on-year), following 9.5 per cent growth in 2007. In 2007 growth reflected the favourable international prices for Uzbekistan's main export commodities of gold, gas and cotton, strong growth in non-commodity exports and increased remittances from workers living abroad that reached 8.7 per cent of GDP. The favourable external environment has also resulted in a current account surplus of 19 per cent of GDP and a further increase in official reserves that amounted to 13 months of imports by the end of 2007. Total external debt has fallen below 20 per cent of GDP. The authorities have also accumulated around US\$ 860 million (4 per cent of GDP) into the Fund for Reconstruction and Development (FRD), a fund established for fiscal stabilisation and investment.

Fiscal policy remained tight in 2007 with a fiscal surplus of 5.1 per cent of GDP. Monetary policy has been more accommodating with broad money growing by 46 per cent in nominal terms. The central bank maintained its policy of ensuring a nominal depreciation of the local currency against the US dollar. However, in an environment of strong foreign currency inflows, the central bank had to intervene heavily in the foreign exchange market to purchase foreign currency, and these purchases were not fully sterilised. Inflation picked up in the second half of 2007, driven by increases in food, services and fuel prices. Nevertheless, compared to other countries in the region the impact of higher international food and fuel prices has been more moderate. This is partly because Uzbekistan is a net exporter of food and energy, and partly because prices of basic food items and energy products are controlled and the exports of several food items are restricted. According to official national figures, inflation stood at 6.9 per cent year-on-year at the end of 2007, only slightly up from 6.8 per cent in 2006. According to IMF estimates, however, inflation was much higher at 11.9 per cent in 2007 compared to 11.4 per cent in 2006.

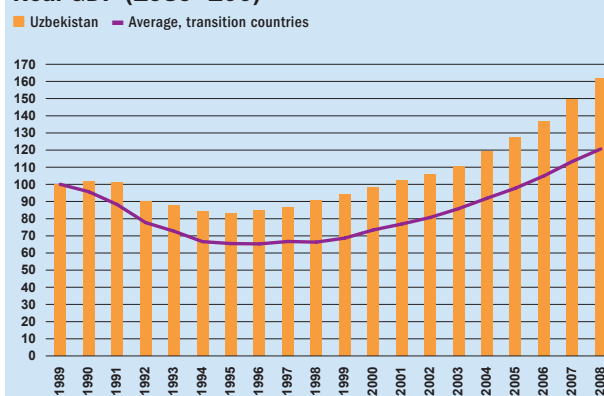
Outlook and risks

The outlook for 2008 is favourable with real GDP expected to grow by 8 per cent. The main macroeconomic policy challenge in the short term is to stem externally induced inflationary pressures. Although the authorities are prepared to increase government savings and the central bank is willing to take more liquidity out of the monetary system through sales of securities, these measures may not be sufficient to fully stem inflation. There is also a risk that water shortages in the region will affect agricultural production and add to inflationary pressures. Additional measures such as the appreciation of the nominal exchange rate and cuts in expenditure on wages may be needed. In the medium to long term, growth is likely to be constrained by various distortions in the economy and the weak banking sector. These constraints will become more apparent in a deteriorating external environment.

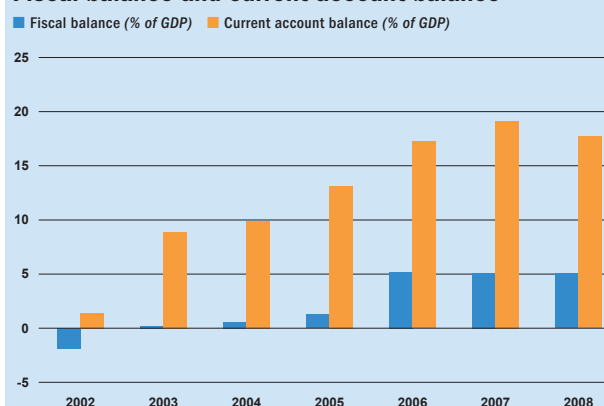
Transition indicators, 2008



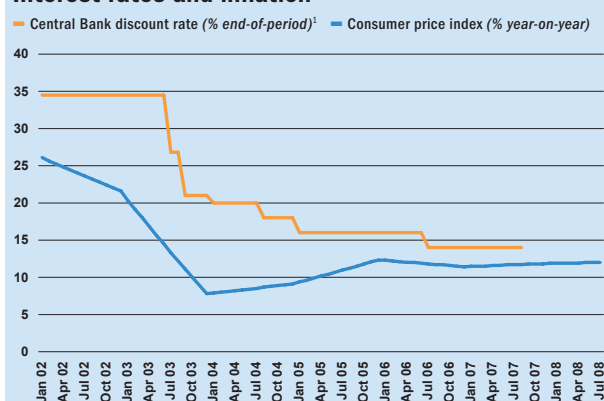
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



¹ Data were not available from July 2007 to July 2008.

Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – limited de facto	Competition office – yes	Telecoms regulatory assessment compliance – low	Capital adequacy ratio – 10 per cent	Share of population living in poverty – 26.0 per cent (2003)
Controls on inward direct investment – yes	Secured transactions law – malfunctioning	Independence of the electricity regulator – no	Deposit insurance system – yes	Government expenditure on health – 2.4 per cent of GDP (2006)
Interest rate liberalisation – limited de jure	Quality of corporate governance law – medium	Separation of railway infrastructure from operations – partial	Quality of securities market laws – low	Government expenditure on education – 6.2 per cent of GDP (2006)
Exchange rate regime – crawling peg		Independence of the road directorate – no	Private pension funds – no	Household expenditure on power and water – 5.2 per cent
Wage regulation – yes		Quality of concession laws – low		
Tradeability of land – limited de jure				

Structural indicators	2002	2003	2004	2005	2006	2007	2008
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	3.5	4.0	4.7	5.2	5.5	5.9	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) ¹	1.9	1.9	1.8	1.8	1.8	1.4	na
Share of industry in total employment (in per cent)	12.7	12.4	13.0	13.2	13.6	13.9	na
Change in labour productivity in industry (in per cent)	5.5	5.6	1.4	2.1	6.4	8.7	na
Investment/GDP (in per cent)	22.1	20.7	24.5	28.0	27.7	27.4	na
<i>EBRD index of small-scale privatisation</i>	3.0	3.0	3.0	3.0	3.3	3.3	3.3
<i>EBRD index of large-scale privatisation</i>	2.7	2.7	2.7	2.7	2.7	2.7	2.7
<i>EBRD index of enterprise reform</i>	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)	53.0	53.0	53.0	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	8.0	8.0	8.0	4.0	na	na	na
Share of trade with non-transition countries (in per cent)	48.6	57.2	54.1	49.6	44.7	45.8	na
Share of trade in GDP (in per cent)	55.8	57.1	59.7	54.3	55.6	61.7	na
Tariff revenues (in per cent of imports) ²	2.8	3.6	3.1	3.1	3.7	4.0	na
<i>EBRD index of price liberalisation</i>	2.7	2.7	2.7	2.7	2.7	2.7	2.7
<i>EBRD index of forex and trade liberalisation</i>	1.7	1.7	1.7	2.0	2.0	2.0	2.0
<i>EBRD index of competition policy</i>	2.0	1.7	1.7	1.7	1.7	1.7	1.7
Financial sector							
Number of banks (foreign-owned)	35 (6)	33 (5)	31 (5)	29 (5)	29 (5)	29 (5)	na
Asset share of state-owned banks (in per cent)	73.7	70.0	67.6	na	na	na	na
Asset share of foreign-owned banks (in per cent)	3.2	4.3	4.4	na	na	na	na
Non-performing loans (in per cent of total loans)	na	1.6	2.1	8.9	3.0	2.8	na
Domestic credit to private sector (in per cent of GDP)	34.0	27.5	24.5	21.8	17.4	15.0	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)	0.4	0.1	0.0	0.3	4.3	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	na	na	na	na
<i>EBRD index of banking sector reform</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
<i>EBRD index of reform of non-bank financial institutions</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	6.7 (0.7)	6.7 (1.3)	6.6 (2.1)	6.7 (2.7)	6.7 (9.3)	6.7 (9.3)	na
Internet users (per 100 inhabitants)	1.1	1.9	2.6	3.3	4.1	4.4	na
Railway labour productivity (1989=100)	51.1	51.8	47.9	45.6	49.1	54.7	na
Residential electricity tariffs (USc kWh)	1.2	1.7	na	2.6	2.9	3.4	na
Average collection rate, electricity (in per cent)	72	95	na	60	54	na	na
GDP per unit of energy use (PPP in US dollars per kgoe)	0.8	0.9	1.0	1.1	na	na	na
<i>EBRD index of infrastructure reform</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
<i>Electric power</i>	2.0	2.0	2.0	2.3	2.3	2.3	2.3
<i>Railways</i>	2.7	2.7	2.7	2.7	2.7	2.7	2.7
<i>Roads</i>	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Telecommunications</i>	2.0	2.0	2.0	2.0	2.0	2.0	2.0
<i>Water and waste water</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7

¹ Refers to low income support in the budget.² Refers to custom duties and export taxes.

Macroeconomic indicators						2007	2008
	2002	2003	2004	2005	2006	Estimate	Projection
Output and expenditure							
<i>(Percentage change in real terms)</i>							
GDP	4.0	4.2	7.7	7.0	7.3	9.5	8.0
Industrial gross output	8.3	6.0	9.4	7.2	10.8	12.1	na
Agricultural gross output	6.0	7.3	8.9	5.4	6.2	6.1	na
Employment							
<i>(Percentage change)</i>							
Labour force (end-year)	2.2	2.6	3.5	2.9	0.9	1.2	na
Employment (end-year)	2.2	2.7	3.4	2.9	0.9	1.2	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year) ¹	0.4	0.3	0.4	0.4	0.4	0.4	na
Prices and wages							
<i>(Percentage change)</i>							
Consumer prices (annual average) ²	27.3	11.6	6.6	10.0	14.2	12.3	11.8
Consumer prices (end-year)	21.6	7.8	9.1	12.3	11.4	11.9	12.1
Producer prices (annual average)	na	na	na	na	na	na	na
Producer prices (end-year)	46.1	27.4	26.5	28.2	24.0	10.9	na
Gross average monthly earnings in economy (annual average)	111.8	14.0	32.4	54.9	38.2	56.3	na
Government sector³							
<i>(In per cent of GDP)</i>							
General government balance	-1.9	0.1	0.6	1.2	5.2	5.1	5.0
General government expenditure	37.6	33.4	31.6	29.5	29.2	32.7	na
General government debt	54.6	41.6	35.1	28.2	20.8	15.7	na
Monetary sector							
<i>(Percentage change)</i>							
Broad money (M3, end-year)	29.7	27.1	47.8	54.3	36.8	46.1	40.0
Domestic credit (end-year)	40.9	-0.6	2.1	3.1	-40.3	-64.2	na
<i>(In per cent of GDP)</i>							
Broad money (M3, end-year)	10.6	10.3	12.2	14.4	15.2	16.3	na
Interest and exchange rates							
<i>(In per cent per annum, end-year)</i>							
Refinancing rate	34.5	20.0	20.0	16.0	14.0	14.0	na
Treasury bill rate (3-month maturity)	17.1	na	na	na	na	na	na
Deposit rate (1 year)	26.0	20.3	16.1	15.5	15.0	19.4	na
Lending rate (1 year)	33.4	23.9	21.2	19.9	21.0	24.3	na
<i>(Sums per US dollar)</i>							
Exchange rate (end-year) ⁴	1,068.3	979.0	1,056.6	1,180.0	1,240.0	1,290.0	na
Exchange rate (annual average) ⁴	885.0	995.5	999.2	1,072.3	1,219.8	1,263.7	na
External sector							
<i>(In millions of US dollars)</i>							
Current account	117.2	881.1	1,214.5	1,949.8	2,932.6	4,267.0	4,472.0
Trade balance	323.8	835.1	1,202.0	1,447.0	1,773.8	2,296.0	2,205.0
Merchandise exports	2,510.2	3,240.0	4,263.0	4,757.0	5,614.8	8,026.0	9,817.0
Merchandise imports	2,186.4	2,404.9	3,061.0	3,310.0	3,841.0	5,730.0	7,612.0
Foreign direct investment, net	65.3	70.4	187.4	87.7	194.5	739.0	918.0
Gross reserves, excluding gold (end-year)	1,302.0	1,659.0	2,146.0	2,895.0	4,459.0	7,413.0	na
External debt stock	4,260.3	4,248.7	4,322.3	4,132.5	3,853.0	3,913.0	na
<i>(In months of imports of goods and services)</i>							
Gross reserves (end-year)	5.5	6.4	6.6	8.5	11.5	13.2	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	23.2	20.5	17.1	14.1	12.7	8.6	na
Memorandum items							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	25.3	25.6	25.9	26.2	27.0	27.4	na
GDP (in billions of sums)	7,450.0	9,837.8	12,261.0	15,923.0	20,759.3	28,186.2	34,494.6
GDP per capita (in US dollars) ⁵	333.1	386.5	474.4	567.5	630.8	814.8	na
Share of industry in GDP (in per cent)	14.5	15.8	17.5	20.7	22.1	25.0	na
Share of agriculture in GDP (in per cent)	30.1	28.6	26.4	25.0	24.1	21.7	na
Current account/GDP (in per cent)	1.4	8.9	9.9	13.1	17.2	19.1	17.7
External debt - reserves (in US\$ million)	2,958.3	2,589.7	2,176.3	1,237.5	-606.0	-3,500.0	na
External debt/GDP (in per cent)	44.1	43.7	37.3	31.3	22.6	17.5	na
External debt/exports of goods and services (in per cent)	142.7	112.6	89.4	76.3	60.3	43.5	na

¹ Officially registered unemployed.² Unofficial estimates; official figures are lower.³ Includes consolidated government and the fund for Reconstruction and Development.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 for periods in which dual exchange rates were in effect.

Methodological notes

Sources of the summary data

Per capita GDP (at PPP exchange rate)

Source: IMF World Economic Outlook.

Population

Source: IMF World Economic Outlook.

The transition indicator scores in Chapter 1 reflect the judgment of the EBRD's Office of the Chief Economist about country-specific progress in transition.

The scores range from 1 to 4+ and are based on a classification system that was originally developed in the 1994 Transition Report, but has been refined and amended in subsequent Reports. In calculating averages, "+" and "-" ratings are treated by adding 0.33 and subtracting 0.33 from the full value. The infrastructure indicator reported in Table 1.1 on page 4 is a simple average of the five components (see Table 1.3 on page 6) and is 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-. The overall average transition score (reported in the country pages) is a simple average of the nine transition indicators in Table 1.1. The score "1+" is not used and so an average of 1.3 for the infrastructure scores is rounded down to 1 in Tables 1.1 and 1.3.

Overall transition indicators

(see Table 1.1 on page 4)

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 almost completed.
- 4 Complete privatisation of small companies with tradeable ownership rights.
- 4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradeability of land.

Governance and enterprise restructuring

- 1 Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
- 2 Moderately tight credit and subsidy policy, but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
- 3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (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

The ratings are calculated as the average of five infrastructure reform indicators covering electric power, railways, roads, telecoms, water and waste water. The classification system used for these five indicators is detailed below.

Infrastructure transition indicators

(see Table 1.3 on page 6)

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.

Telecoms

- 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 wastewater

- 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-operate-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 wastewater services in major urban areas.

A. Structural indicators box

B. Structural indicators table

C. Macroeconomic indicators table

Liberalisation and privatisation

Options: full (full compliance with Article VIII of IMF Agreement);
limited (restrictions on payments or transfers for current
account transactions).

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).

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).

Options: currency board pegged to euro; currency board in ERM II; de facto pegged to US dollar; de facto fixed to euro; fixed peg in ERM II; crawling peg; managed float; floating; unilateral euroisation; euro-floating.

Restrictions or substantial taxes on the ability of some enterprises to adjust the average wage or wage bill upward.

Source: EBRD staff assessments.

Options: full (no substantial restrictions on tradeability 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 tradeability 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 tradeability of land rights); no (land trade prohibited).

Source: EBRD staff assessments.

Competition or anti-monopoly office exists separately from any ministry, though it may not be fully independent.

Source: EBRD staff assessments.

Level of reform assessed in relation to the EBRD Model Law on secured transactions and the EBRD 10 core principles of secured transactions laws.

Options: advanced; some defects; inefficient; malfunctioning.

Source: EBRD Regional Survey of Secured Transactions 2005.

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 Corporate Governance Assessment 2007.

Infrastructure

Telecom regulatory assessment compliance

Level of regulatory progress in the telecommunication sector compared to established world regulatory benchmarks.

Options: full; high; medium; low.

Source: EBRD Telecommunications Regulatory Assessment 2008 (see Annex 1.2 of this Report on page 24).

Independence of 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); partial (accounting only); no.

Source: EBRD staff assessments.

Independence of the road directorate

A road management agency that is separate from the government.

Options: fully (institutional, managerial and decision-making independence and an independent account); partially (some elements of independence, but not all four dimensions); no (part of a government body).

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 infrastructure projects.

Options: very high; high; medium; low; very low.

Source: EBRD Concession Laws Assessment 2007-08.

Financial sector

Capital adequacy ratio

Ratio of bank regulatory capital to risk-weighted assets (minimum regulatory requirement); 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 Securities Markets Legislation Assessment 2007.

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 (in 1993 US\$ at purchasing power parity) a day per person.

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 authorities.

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 a percentage of GDP. Latest available year.

Source: National authorities.

Household expenditure on power and water

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.

B: Structural indicators table – definitions and data sources

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 represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies, as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available.

Source: EBRD staff estimates.

Private sector share in employment (in per cent)

“Private sector share” in employment represent rough EBRD estimates, based on available statistics from both official (government) sources 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 authorities 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 authorities 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, and so on); plant, machinery and equipment purchases; and the construction of roads, railways, schools, offices, hospitals, private residential dwellings, commercial and industrial buildings, and so on. 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 include: directly regulated prices (price set up directly by the state); partly regulated prices (state has co-determination right in setting the price); quasi-regulated prices (in the case of goods which are subject to specific customer taxes); and indirectly regulated prices (goods for which the state guarantees a purchase quote).

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 domestic credit to private sector at end-of-year, to GDP. Domestic credit to private sector comprises the claims on non-financial, majority private-owned, enterprises and households by: banking institutions; other banking institutions, which include institutions that do not accept deposits but perform financial intermediation (for example, mortgage banks, microfinance institutions); and the monetary authorities.

Sources: IMF, International Financial Statistics (IFS) and country reports.

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 the end of the 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) and which have a dedicated port on a telephone exchange. Mobile refers to users of portable telephones subscribing to an automatic public mobile service using cellular technology that provides access to the PSTN.

Source: International Telecommunications Union.

Internet users (per 100 inhabitants)

Number of internet users per 100 inhabitants, based on nationally reported data.

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 tariff, 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.

C: Macroeconomic indicators table – definitions and data sources

Data represent official estimates of out-turns 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 incorporate the informal sector into their estimates of GDP.

Employment

For some 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, 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. 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, IMF country reports 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, IMF country reports 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 national authorities and in IMF country reports.

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