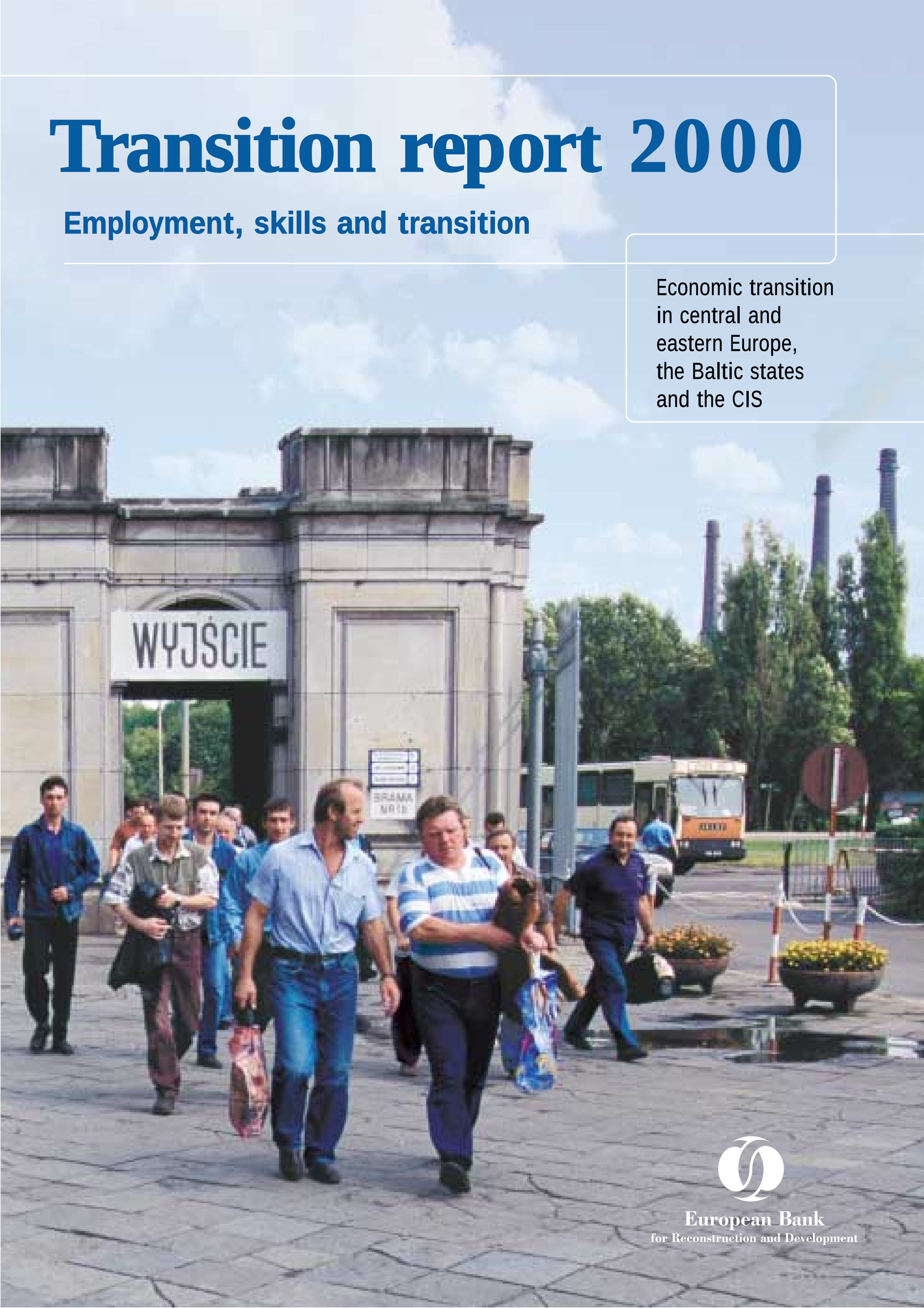
Transition report 2000

Employment, skills and transition

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



European Bank
for Reconstruction and Development

Transition report 2000

Employment, skills and transition

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Foreword

This *Transition Report,* with its special topic of employment, skills and transition, is the seventh in an annual series. Taken together, the Reports chart the progress of transition from a command to a market economy in each of the 26 countries of central and eastern Europe and the Baltic states (CEE) and the Commonwealth of Independent States (CIS) in which the EBRD operates. They also identify and analyse the challenges of the coming years.

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

The structure of the *Transition Report* follows from its purpose: to understand the dynamic process of market reforms in transition economies and the key requirements for a successful transition. Part I of the Report focuses on the impact of initial conditions, early reform choices and the political process, all of which have powerful consequences for the direction of future reforms and for aggregate economic performance and access to international capital markets. This analysis helps to identify the characteristics of countries that have pressed ahead steadily with reforms and that have realised the benefits of these measures in terms of sustained economic growth and private capital inflows, as well as the pitfalls in transition that have impeded reforms in other countries. Central to this analysis is an assessment of how economic and political freedom and competition shape progress in reform. The analysis shows that where a private market economy has taken root through comprehensive liberalisation and privatisation, a partial basis for developing the institutions necessary to support a market economy appears to have been laid. However, the impact of these reforms on institutional performance depends strongly on the extent to which states are held accountable to their citizens through democratic processes and on the degree of state "capture" – or undue influence – exercised by powerful private interests.

Each *Transition Report* has a special theme. These have provided a detailed analysis of the transition and the forces shaping its progress, together with an examination of the policies that foster the development of the institutions and behaviour that are required to support well-functioning markets and private enterprise. It is important, therefore, to consider the Reports as a series in which each edition is complete in its own right but also inter-related and cross-referenced to previous editions.

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

- 1994 – Institutional reform and economic openness;
- 1995 – Fixed investment and enterprise development;
- 1996 – Commercial infrastructure and contractual savings institutions;
- 1997 – Enterprise performance and growth;
- 1998 – Financial sector in transition; and
- 1999 – Ten years of transition (a special issue).

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

Part II of this year's *Transition Report* contains a detailed analysis of developments in the labour markets of the transition economies. It shows how people have coped with changing demands for different types of labour, including the pursuit of self-employment, multiple job holdings and participation in the informal economy. Self-employment tends to be associated with relatively high earnings, suggesting that entrepreneurship is a rewarding strategy. However, multiple job holdings and informal activities often represent subsistence strategies, especially in CIS countries where the formal economy offers few opportunities. The analysis also finds that there are significant gaps in the quality of employee skills in transition economies relative to industrialised countries. The gaps are particularly wide in CIS countries, where technological and organisational change has been slow. This finding qualifies the widely held perception that the region has abundant human capital resources owing to its history of high investment in education.

The assessments and views expressed in this *Transition Report* are not necessarily those of the EBRD. The responsibility for them is taken by myself on behalf of the Office of the Chief Economist. While we have attempted to be as up to date as possible, the "cut-off" date for most of the information in the Report is the end of September 2000.

Willem Buiter
Chief Economist

12 October 2000

Executive summary

Chapter 1: Human dimensions of transition

As the transition in central and eastern Europe and the Baltic states (CEE) and the Commonwealth of Independent States (CIS) enters its second decade, the region as a whole is set to achieve its second consecutive year of growth. Two years ago, when the crisis in Russia held the region in its grip, the current pace of recovery would have seemed an optimistic prediction. However, the sharp rise in world oil prices, the gains in competitiveness from currency depreciations and the smooth presidential transition in Russia helped to defy the pessimistic predictions for Russia and other CIS countries. At the same time, the acceleration of EU growth has helped to spur exports and investment in central eastern Europe and the Baltic states (CEB), while prospects for south-eastern Europe (SEE) have brightened with the new reform-oriented Croatian government and the heavy electoral defeat of the ruling coalition in the Federal Republic of Yugoslavia.

Despite these favourable developments, the transition has imposed very severe human costs on many people, and improving their living conditions will be of vital importance if progress in reform is to be sustained in the coming years. This *Transition Report* focuses on the processes of adjustment in the labour markets of transition economies. In particular, it investigates how individuals and enterprises are responding to the pervasive economic changes brought about by transition as well as by the rapid pace of innovation and technological change in the advanced market economies. The Report shows the resourcefulness of individuals in a difficult environment and how they have responded to the decline in formal state employment through self-enterprise and multiple job holdings. However, the focus on the active responses of individuals should not distract attention from the challenge of building viable systems of social support for those who have suffered social and economic upheaval. Chapter 1 argues that social security reforms to provide basic and targeted support to the poor are not only a moral but also an economic imperative for a successful transition.

Part I: Transition and economic performance

Chapter 2: Progress in transition and institutional performance

The past year has seen the greatest progress in reform since 1997, as measured by the EBRD's transition indicators. Progress has been achieved across most countries and dimensions of reform, as several countries at the early stages of transition have taken significant strides towards a market economy, particularly in the areas of privatisation and liberalisation. The 1998 crisis in Russia that led a number of CIS countries to backtrack in reform has also been largely overcome, with the lifting of most temporary trade and exchange restrictions imposed in response to the crisis. However, even where sustained liberalisation and comprehensive privatisation have been achieved, countries continue to face considerable challenges in developing the institutions that are necessary to support their nascent market economies. The countries of CEB have slowly but steadily strengthened the performance of their market-supporting institutions, but the countries of SEE and the CIS continue to lag well behind in terms of institutional performance.

These recent developments largely conform with patterns in transition that have become well-established over the past decade. These patterns include the introduction of liberalisation and privatisation ahead of the development of market-supporting institutions and the significant influence of economic, social and political conditions at the start of transition on future progress in reform. The countries in central Europe clearly benefited from relatively favourable initial conditions, although the initial advantages of these countries are gradually fading. Moreover, where there has been sustained liberalisation and comprehensive privatisation, openness to international trade and investment, and the establishment of democratic political systems that function freely and fairly, the foundations appear to have been laid for strengthening steadily the performance of market-supporting institutions. At the same time, it is important to recognise that such evolutionary progress is not automatic. There are many pitfalls that can trap the reform process. For example, a formal framework for democracy and civil liberties does not necessarily prevent powerful private interests from exercising undue influence over the state and from "capturing" it for their own benefit. A key challenge in transition is to ensure that newly established economic and political freedoms underpin robust economic and political competition.

Chapter 3: Macroeconomic performance and prospects

The recovery following the 1998 Russian crisis is now in full swing and average growth for the region as a whole is estimated to be in the 4-5 per cent range in 2000. The current growth is broadly based across the region, with average growth in the CIS at 5.2 per cent surpassing levels in CEE at 4.2 per cent for the second year running. Moreover, forecasts for 2001 point to a continuation of this trend. The region has clearly benefited from an unexpectedly favourable international environment with the acceleration of growth in the EU and – for Russia and the energy-rich countries of the CIS – the increase in world oil prices. However, domestic policy adjustments to the impact of the Russian crisis have also helped to sustain growth in much of CEE and to spur a quick recovery in the CIS.

Significant risks to macroeconomic stability remain, however. Given the importance of a strong external environment to the recovery, deterioration in the international economy would increase pressure on the region. Regarding domestic policies, the advanced countries of CEE will need to pay particular attention to tight fiscal management in order to sustain macroeconomic balance. Pressure on fiscal policy is likely to result from accession-related public investment requirements, while the need to maintain external competitiveness calls for continued budgetary caution. The principal risks to macroeconomic performance in the CIS continue to be the high dependence on commodity exports and rising debt service payments following sharp real currency depreciation. Improvements in revenue collection and tax administration are also a priority, as are structural reforms aimed at removing obstacles to new private businesses and restructuring large industrial enterprises. The chapter argues that the present external environment and the temporary cushion provided by the large currency depreciation have created a window of opportunity to address these critical domestic reform issues.

Chapter 4: Cross-border capital flows

Capital flows to the region have become more clearly differentiated since the Russian crisis, both in terms of recipient countries and in types of flows. Net private flows into the whole region contracted by 65 per cent between 1997 and 1999, although they are recovering slightly in 2000. Most of the decline in net private capital is accounted for by flows to the CIS and SEE. The capital flow to the relatively advanced transition countries in CEE has showed considerable resilience and continued to rise in recent years. In terms of types of flows, FDI has been the most robust, increasing by 20 per cent in the whole region in 1999. However, while direct investments in CEE doubled between 1996 and 1999, FDI declined by about 25 per cent in the CIS. Net official flows to the region fell sharply to less than US$ 0.5 billion in 1999 from almost US$ 9 billion in 1998, reflecting net repayments of Kazakhstan, Romania, Russia and Ukraine.

International capital flows into the transition economies can make a significant contribution to realising the region's growth potential. However, weighing against these benefits are the risks of exposure to a volatile international environment. As shown by the market turbulence in 1998, these risks are highest in countries that have integrated themselves into the international capital markets without first establishing the structural and institutional foundations for macroeconomic and financial stability. While emphasising the importance of appropriate macroeconomic policies, the chapter underlines that limiting the ability to access a wide range of international financing instruments can restrict the impact of volatile capital flows. In countries such as Romania, Russia and Ukraine it has been the reliance on just one or two types of capital flows, and the absence of significant FDI, that has contributed to significant swings in net capital flows and to economic volatility. Moreover, the chapter shows that progress in structural reforms in banking, corporate governance and the regulation of securities markets has had a positive impact on attracting a range of capital flows to the transition economies.

Part II: Employment, skills and transition

Chapter 5: Labour markets, unemployment and poverty during the transition

Labour market developments during the transition have varied widely across countries. In CEE countries, where progress in market-oriented reforms has been more rapid, a recovery in employment levels is now firmly entrenched after the sharp decline in the early years. In contrast, the slower pace of enterprise restructuring in the CIS initially led to a less dramatic decline in employment, but workers have typically faced large real wage reductions and, in many cases, substantial wage arrears and involuntary leave. This approach to transition has resulted in particularly severe rises in poverty for large sections of the population.

A detailed analysis of individual and household surveys for selected countries shows that individuals have responded in widely divergent ways to the changing labour market environment. Where the investment climate has been favourable, some individuals have adjusted through active strategies, such as moving to new jobs or regions and engaging in entrepreneurial activities. Self-employment in particular has been a very successful high earnings strategy, although the relatively low numbers of self-employed, even in advanced transition countries, imply that obstacles to business start-ups remain significant. Adjustments by many individuals in countries at less advanced stages of reform have involved multiple job holdings and subsistence informal activities. Labour market performance could be enhanced substantially through institutional reforms, in particular by limiting the duration of unemployment benefit and combining social support programmes with active programmes that enable the unemployed and under-employed to move into more productive jobs.

Chapter 6: Human capital, technology and skills

The dramatic structural changes in transition economies, together with the rapid and widespread technological changes in advanced market economies, have created strong pressures for enterprises to adapt the composition of their workforces. Where firms in the transition economies have begun to upgrade their production processes, including the introduction of information technology, their demand for skilled workers has increased. However, in many countries an unfavourable investment climate has limited the extent of structural change, with implications for the demand for skills. To assess the extent of changes in production technologies and to investigate the types of jobs that are being created in the transition economies and the availability of skills, the chapter draws on new surveys of foreign investors and domestic enterprises.

The surveys show that there is considerable variation in the extent to which firms have upgraded their technologies. In general, it appears that there is a strong positive relation between the overall extent of reform in a country and the extent of upgrading. Moreover, firms in transition economies lag behind advanced industrialised countries in terms of the quality of their workforce. Such quality gaps are larger in the CIS than in CEE. This finding qualifies the view that the region has abundant human capital resources, despite considerable achievements in formal education. Moreover, the lack of restructuring in the less reformed economies of the region means that many skilled workers are performing jobs that do not reflect their levels of education. Over time, there will be a continuing loss of skills, leading to an even greater gap in quality.

Therefore, governments and firms need to pay increased attention to training, including improved systems of vocational training. Governments must also improve the conditions for investment and technological upgrading in order to capitalise more on the relative abundance of well-educated workers.

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Human dimensions of transition

1

As the transition in central and eastern Europe and the Baltic states (CEE) and the Commonwealth of Independent States (CIS) enters its second decade, the region as a whole is set to achieve its second consecutive year of growth. The economic recovery that started in the middle of 1999 has strengthened and broadened in 2000, and growth is expected to continue into 2001.

Two years ago, when the Russian crisis held the region in its grip, the current pace of recovery would have seemed an optimistic prediction. Indeed, reform reversals in Russia and the potential for political instability in the region's largest economy cast doubt over the outlook except in the most advanced countries on the path of EU accession. Since 1999, however, the combination of an unexpectedly favourable international environment, temporary gains in competitiveness from large depreciations of the rouble and other CIS currencies, and the smooth presidential transition in Russia helped to defy the pessimistic predictions for Russia and other CIS countries.

Closer economic integration with western Europe and the momentum of the EU accession process have spurred an investment and export boom in central and eastern Europe as the frontrunners for accession seek to emulate the success of Ireland, Portugal, Spain and Greece. The end of the Kosovo conflict, the new reform-oriented government in Croatia and the heavy electoral defeat of the ruling coalition in the Federal Republic of Yugoslavia (see Annex 1.1) have brightened prospects for south-eastern Europe as well.

Despite this encouraging news, the harmonisation process remains vulnerable to setbacks, and the reform agenda remains challenging for all countries in the region. Moreover, the benefits of growth have not been evenly spread. Many people continue to suffer from social upheaval and poverty.

This *Transition Report* focuses, in particular, on how individuals are responding to the pervasive economic changes brought about by transition as well as by the rapid pace of innovation and technological change in the industrialised countries. The people of the region have shown tremendous resourcefulness in a difficult environment by taking on multiple jobs or by starting their own business. However, more could be done to help them adapt, including removal of obstacles to entrepreneurship and, in some countries, renewed emphasis on formal education and training. The lack of restructuring in many CIS countries is also cause for serious concern, with many people under-employed in dead-end jobs, while their job skills deteriorate. Unblocking the restructuring of large industrial enterprises, particularly in the CIS, remains an urgent priority and this requires the creation of new jobs largely through business start-ups and a more effectively targeted social safety net.

The Report begins by examining the recent progress and patterns of reform across the region and the reasons for the substantial variation in economic performance. It emphasises how economic and political freedom and competition act as the driving forces for sustained progress in transition, including institutional performance (see Chapter 2). Progress in transition, in turn, has a strong influence on macroeconomic performance (Chapter 3) and access to private international capital markets (Chapter 4). The Report then looks at some of the human dimensions of transition, assessing the trends in employment and poverty and the way that both individuals (Chapter 5) and enterprises (Chapter 6) have adapted to the introduction of markets and private enterprises.

1.1 Pathways in transition from central planning

One important lesson from the experience of the past decade has been that there is no unique process or "time-line" of transition from central planning under communism to a unique, easily identifiable, familiar form of market capitalism under democratic political institutions. Indeed, there is nothing automatic or inexorable about the emergence of either an efficient market economy or a democratic political system with free and fair elections and respect for fundamental civil liberties and human rights. To achieve either one, let alone both, requires consistent effort and dedication by both politicians and the general population of the transition economies as well as the active, patient and unstinting support of the international community.

There are wide variations in the level of reform and performance of the 26 countries in which the EBRD has operated over the past ten years. The EBRD's transition indicators – extended in this Report to cover the entire decade of the 1990s – and the evidence on macroeconomic performance and structural change do not tell a single, common story but 26 distinct stories. This variety should not come as a surprise. The transition in each country started from very different initial conditions and the speed, sequence and extent of economic and political reforms have varied widely.

Despite these differences, there are clear lessons to be learned from the experience of the first decade of transition. Countries that have achieved the more rapid and comprehensive reforms – particularly in liberalising markets and trade, in hardening budget constraints and in fostering the new private sector by removing obstacles to the entry and exit of enterprises – have laid solid foundations for sustaining progress in reform. As Chapter 2 shows, where a private market economy has taken root through these reforms, market-supporting institutions have tended to develop. While countries that started the transition with favourable initial conditions have not surprisingly made relatively rapid progress in this area, even some of the less advantaged countries have now taken significant strides in building market-supporting institutions. However, institutional performance in many other countries remains lacklustre and even the process of liberalisation and privatisation is far from complete in some of them. Politically the challenge is to overcome resistance to reform by creating new employment opportunities and social fallback options for those displaced by the sheer scope and pace of structural change, and by breaking the hold of vested interests over reform policies.

The benefits of rapid and comprehensive reform are clear not only from the perspective of the reform process itself but also in terms of macroeconomic performance and access to international capital markets. Chapter 3 highlights the underlying differences in the present recovery across the region. In much of CEE, the EU accession process is a driving force for continuing reform and for rising investment demand. At the same time, Chapter 4 shows that progress in reforms in CEE is helping to expand access of the private sector to private international capital markets for the financing of investment. Given appropriate macroeconomic policies and strengthened financial sector reforms, this should lay the foundations for sustained rapid growth. In Russia and other CIS countries making good use of the present window of opportunity created by greater political stability, higher commodity prices and lower real exchange rates will determine whether the present recovery can last. This is a particularly favourable environment in which to remove obstacles to new businesses and to advance with the much-needed restructuring of large industrial enterprises.

Looking ahead to developments over the next decade, it must be emphasised that the transition process is ongoing, and the destination is not fixed. Across the world today, market capitalism has a hundred different faces. There are key differences in institutional features, such as the role of the state, the provision and financing of public goods and services, the nature of the legal system (statute versus common law), the way in which the rule of law is enforced and upheld, and the scope, power and operation of regulatory and supervisory institutions. There are also differences in the organisation and functioning of key markets, the strength and coverage of the social safety net and the characteristics of the society in which each market economy is embedded. Market capitalism is a global stew, served up in a wide range of national and sometimes sub-national varieties and flavours. Not only does it vary across countries, it is a dynamic system that is constantly evolving both within each country and globally.

The absence of a unique, common long-term destination for all of the EBRD's countries of operations need not be a source of concern as there is no single variant of market capitalism, existing or realistically achievable, that is clearly superior to the others. All of the major current manifestations have their strengths and weaknesses, even in their "native" settings. These include the so-called Anglo-Saxon model (exemplified by the United States and by the United Kingdom since Mrs Thatcher), the Rhineland model (Germany), the Japanese model, the various South-East Asian or "Tiger" models, the Scandinavian model, and the Polder model (alleged to be operative in the Netherlands). During the past 40 years each of these models has been associated with extended periods of superior performance and of below-par performance. The situation is unlikely to be different in the future.

There are certain fundamental features shared by all successful market economies. They include secure property rights, effective enforcement of contracts by an impartial legal system, transparent governance, low barriers to market entry and exit, a reasonably level playing field for existing enterprises and aspiring entrants alike, and a predictable fiscal and regulatory environment. Other necessary features are the absence of the use of threats, intimidation, harassment and extortion by private parties or by the state, and low levels of corruption, both petty and grand, including state "capture". The detailed institutional implementation of these key features depends, however, on time, place and culture.

Transplanting an existing economic system wholesale into a national economy for which it did not develop organically can be a recipe for disaster. Even selective "institutional grafts" should be made with careful attention to differences in national institutional capabilities, political systems, society and culture. For instance, while the eventual adoption of the *acquis communautaire* of the EU is the shared target of all aspiring accession candidates and a precondition for EU membership, the dynamics of this process should not be a one-size-fits-all experience. Rather, it should recognise and reflect essential country-specific differences in economic structure and institutional capacity. It seems a safe prediction that most of the EBRD's countries of operations will develop their own distinct brand of market capitalism.

While there are many distinct varieties of a market economy that can, given time, deliver remarkable levels of material prosperity for most people, there are also forms of capitalism that combine glaring inefficiency with extreme inequality in the distribution of income and wealth and widespread poverty. Dysfunctional forms of capitalism include systems where oligarchs wield undue influence or where there is crony capitalism and repeated lapses into populist adventures. Economic progress is also stunted when the nation state fragments into a number of quasi-feudal enclaves with severely restricted movement of goods, services and people. The characteristics of institutional failure are relatively easy to identify, but much harder to change. A key role in avoiding a dead end for transition is played by the political process.

1.2 Democracy and the market economy

Unique among international financial institutions (IFIs), the EBRD's mandate has a political as well as an economic dimension. Empirical evidence from the post-World War II period has been interpreted by some to demonstrate that electoral democracy, even multi-party democracy with free and fair elections, is neither necessary nor sufficient for economic growth. Some autocratic or authoritarian societies have achieved economic modernisation and high rates of growth for periods of one or two decades, particularly where economic policies have been predictable and property rights have been protected. There have also been electoral democracies that have been mired in economic stagnation.

The experience of transition, however, stands clearly in contrast to the view that autocratic governments are better at reform and deliver superior economic performance. The evidence in Chapter 2 shows that in the EBRD's countries of operations the process of political competition associated with democracies has been a key factor in sustaining economic reforms. The fear that democratically elected governments would reverse reforms under populist pressure has not materialised. Although not sufficient for a successful transition, democracy has at least not delayed reforms.

Indeed, there is considerable doubt about the long-term viability of the co-existence of an open, competitive market economy and an autocratic and repressive political system. The institutions, procedures and culture that support an innovative, competitive and entrepreneurial market economy are bound to generate increasing pressures for both aspects of political democracy: open and free elections and respect for human rights and civil liberties. At the very least, therefore, a dynamic market economy and political democracy are likely to be the joint products of a common set of cultural and technological developments.

Today's and tomorrow's successful economies, moreover, will be high-tech industrial and post-industrial economies. Effective application and development of information and computer technologies requires high levels of skill, education, creativity and ingenuity. An open, entrepreneurial society that supports and sustains economic efficiency and growth could not exist without the second key dimension of democracy – human rights and civil liberties, including freedom of expression and of association, equal treatment under the law and due process. Respect for individuals and minority rights are increasingly necessary, therefore, if a country is to make the best use of its human resources.

A country endowed with vast natural resources may be able to subsist, at least for a while, by living off the abundance that nature has bestowed. Sustained economic growth, however, requires an active and imaginative approach to the dual challenges of globalisation and information technology. Modern service industries and modern high-tech industries in general require the ability to think the unthinkable and to challenge conventional wisdom and established practice. An autocratic, authoritarian government aims to discourage political entrepreneurship and risk-taking by its citizens, and ends up discouraging economic innovation as well.

It therefore makes practical as well as moral sense to link political and economic transition, as the EBRD's mandate does. Over the medium to long term, it is most unlikely that a country with a vibrant, flexible and dynamic economic system would at the same time systematically violate human rights and deny its citizens a free and meaningful vote. The establishment of both an efficient market economy and political democracy cannot, however, be taken for granted. Economic stagnation coupled with human rights violations and sham elections is a possible long-term outcome. Equally possible is a populist version of electoral democracy and limited protection of individual and minority rights.

It is essential to support open, transparent and accountable governments and to establish a vibrant civil society capable of sustaining the legal and regulatory institutions that support an efficient market economy. These challenges are as important for the countries of transition as the creation of the proper legal and regulatory structures themselves. The EBRD acknowledges this and takes the responsibilities of its political mandate very seriously, as is evident from the Bank's country strategies. New strategies are now made publicly available on the Bank's Web site.

1.3 Employment, skills and transition

The transition from central planning to market capitalism can be described – with apologies to Schumpeter – as a process of *destructive creation*. The destruction has necessarily come first. It has involved large losses in employment, as unproductive firms have been closed down or have withered away. It has led to substantial unemployment in many transition countries. Many firms have had to restructure while new firms have entered the market with the combination of products, skills and capital input that is required in a globally integrated market economy. As this *Transition Report* chronicles, however, the scale and speed of these changes have differed substantially across the region. These differences have had profound consequences for the citizens of these countries. Many have experienced loss of employment and income while a large number have fallen into poverty. Others have kept their jobs but lost out on the opportunities to improve their skills and ultimately their earnings. Moreover, pre-transition achievements in education have not been maintained in some countries, raising concern about the opportunities for younger generations.

This *Transition Report* takes a close look at what has happened to individuals and households in transition. The focus is primarily on the labour market but the Report also covers poverty and education, recognising that the human dimension of transition is not limited to a person's experience at work. Poverty is not confined to unemployed workers. Education is, or should be, preparation for citizenship and a joyful activity in its own right as well as an investment in the skills and knowledge required in the market place.

In the transition economies, the degree of economic competition is closely linked with the extent of structural change and this has had significant implications for developments in the labour market. In central eastern Europe and the Baltic states (CEB), entry barriers for new enterprises, including obstacles to the exit of non-viable producers from the market, have been removed far more effectively than in the CIS and in south-eastern Europe (SEE). As a consequence, unemployment rose early on in most CEB countries, but so did the entry of new firms and activities. Entrepreneurship and self-employment have become increasingly commonplace in CEB.

Moreover, while both poverty and inequality have increased, the extent has been limited by effective social assistance and the creation of labour market institutions. Informal activity has taken place but mostly for market-related reasons, including tax evasion. At the same time, there have been attempts to develop the levels of education and training. As firms have invested in new plant and equipment, there has been evidence of the upgrading of skills. In Hungary – as Chapter 6 shows – the adoption of new technology has contributed to the development of skills as the economy tries to keep pace with the innovation and technical change of the advanced market economies.

While reform in much of CEB has been brought about by a complex set of factors, a critical step has been the growing freedom for enterprises to enter the market, unencumbered by artificial barriers and restrictions, including unnecessary regulation. In the case of the exit of non-viable enterprises, the main factor has been the state's willingness to provide basic social safety nets for the unemployed and the vulnerable, such as pensioners. While the cost of providing a social safety net has been high, the benefits have been substantial.

Not only have barriers to closure and restructuring been lifted without in most cases widespread poverty, but also a well-functioning labour market and its associated institutions have emerged. Combined with the liberalisation of markets, domestic and external, this has provided incentives for individuals and firms to maintain and improve their skills. Moreover, despite fiscal pressures on educational spending, the educational achievements of the previous system have not diminished. Even so, the rapid adoption of new technology in the advanced market economies and the associated improvements in workers' skills will place the transition economies under increasing pressure to develop these skills if they are to maintain their traditional strength in this field.

Further south and east, however, the progress is generally less positive. The restructuring of firms, including exit of the non-viable producers, has proceeded slowly. Many of the CIS countries still expect a large share of the social safety net to be provided by the large enterprises that made up the bulk of the former planned economy. Many of these enterprises no longer have the means or the inclination to provide such support. The result is poverty among the unemployed and among workers who have not been paid in cash or in kind for months on end. As a result, a widespread informal economy has developed. Unlike in CEB, such informal activities have mostly been due to a lack of opportunities in the formal sector and – as shown in Chapter 5 – are undertaken as a survival strategy. This combination of factors has naturally weakened government revenues. This in turn has limited the government's ability to put in place the types of safety nets that are required for restructuring to proceed.

Even in Russia and other CIS countries, however, there are localised success stories where new businesses are showing considerable resilience and strength. Supporting these successes is the EBRD's Russia Small Business Fund, which is a remarkable success story of micro lending to the entrepreneurial and innovative self-employed. Most of the 50,000 entrepreneurs and small-scale enterprises supported by this scheme have developed their businesses and serviced their debts, even after the Russian crisis of August 1998, when many of the well-connected larger borrowers, including some privileged oligarchs, saw their businesses collapse and reneged on their debts. Building on this experience, the Bank has been expanding its micro and small business finance programmes in other CIS and SEE countries, where development of new private businesses remains a high priority, including Albania, Bosnia and Herzegovina, Kazakhstan and Ukraine.

At the human level, the costs of past reform failures have been enormous. In Russia over a third of households has fallen into poverty, while inequality and corruption have grown. Furthermore, as Chapter 6 emphasises, a lack of restructuring means little new investment either in plant and equipment or in employees. Many of the economies of the CIS have become heavily dependent on their natural resources, putting little effort into the development of job skills. As a result, skills have depreciated and the quality of the workforce has dropped. While there are pockets of innovation and adoption of new technology – principally in services – the general picture is far bleaker than in CEB.

This has important implications for government and IFI policies concerning education, training and the general development of job skills. Educational services have declined dramatically in quality in some countries, while the state has often failed to provide even elementary support for the vulnerable. Although the fiscal burden of such support will be substantial, ultimately it may be no larger than the cost of the implicit or hidden support for firms and households that has been the hallmark of policy so far. In addition, a government commitment to provide safety nets will prompt further restructuring and provide incentives for enterprises and employees to develop the job skills that are essential for transition.

The main lesson from this analysis is surprisingly simple: an effective social safety net is not only needed on moral grounds to tackle the problem of poverty, but it is essential for the political viability and economic strength of a market system. At the same time, it must be recognised that some of the social safety nets in the EBRD's countries of operations are wasteful and ineffective.[1] However, it is practically impossible to create a social safety net that combines the need to offer beneficiaries a decent standard of living, to encourage behaviour that minimises dependence on the social safety net and to be affordable in budgetary terms. Each society has to define its own trade-off among these three aims.

At the level of enterprises and individuals, an adequate social safety net and good economics go hand in hand. For example, in a one-company town where the dominant firm is no longer viable, or requires drastic downsizing to remain viable, the restructuring may be politically impossible to achieve (or may be delayed – at great cost) unless a social safety net is in place, financed either by the central government or other sources. This example – and there are many like it – points to

1 In a number of central and east European countries, early retirement was offered to workers as young as 40 in order to massage the unemployment data. Re-employing these prematurely inactive workers will not be easy even though, in view of the demographic developments faced by all CEE countries, a shortage of labour is more likely than a surplus in the medium term.

a potentially fruitful area for IFI cooperation, whether by helping in the restructuring of the firm or by financing the entry of new enterprises. The IFIs also have a wider role to play in the design, implementation and financing of an appropriate social safety net. In Russia and Ukraine, for example, these initiatives could be pursued – at least at the outset – as local or regional pilot projects.

Finally, effective policies to alleviate or prevent poverty require improvements in the capacity of the EBRD's countries of operations to create wealth and employment through improvements in the business and investment climate. The removal of the remaining barriers to a successful transition is needed to achieve sustained growth, which will create the resources for the elimination of poverty.

Annex 1.1: Yugoslavia in transition

At the time of going to press, dramatic changes are taking place in the Federal Republic of Yugoslavia.[1] The country has a new President, Vojislav Kostunica, following Federal Presidential elections on 24 September 2000 and subsequent popular protest at the initial refusal of the authorities to accept the result. While many key issues remain unresolved, it appears that new opportunities and horizons are opening up for the country. The international community has already announced the lifting of a number of sanctions and has expressed its intention to assist in the reconstruction of the country with a package of programmes.[2]

President Slobodan Milosevic lost power after a string of military defeats in Croatia, Bosnia and Herzegovina and, finally, in Kosovo in 1999. Those defeats lost him the support of the large constituency that had originally supported his expansionist programme. In addition, ten years of war and international sanctions had led to a catastrophic reduction in living standards. Vojislav Kostunica, his successor as Federal President, starts his period of office with the advantage of strong international support – including from Yugoslavia's neighbours – but faces considerable challenges at home.

This annex provides a brief overview of the current state of the Yugoslav economy and the extent to which there has been progress in structural reforms. After a decade of conflict and international isolation, it is clear that the economy is in a deep crisis. However, provided the country's international relations are normalised quickly and the transition towards democratic and accountable government proceeds smoothly, the prospects for recovery are good. Yugoslavia occupies a key strategic position in south-eastern Europe, it has a relatively large market, and foreign investors from EU countries in the region are already showing interest in investing there.

Macroeconomic performance

The Yugoslav economy is suffering a serious depression as a result of the cumulative effect of ten years of mismanagement, war and isolation, and the effects of the NATO bombing campaign in 1999. Reliable information on even the most basic macroeconomic indicators is difficult to obtain at present, but rough estimates suggest that GDP in 1999 at official exchange rates was around US$ 15-20 billion or not much more than half the 1989 level. Recorded unemployment is over 30 per cent of the labour force and the true rate may be as high as 50 per cent. Real GDP fell by about 20-25 per cent in 1999 and as a result the poverty rate, which was officially estimated at 20 per cent of the population in 1998, is undoubtedly much higher at present.

Some recovery in the economy is under way in 2000, with growth for the year likely to be in the region of 5-7 per cent, but the lack of investment and the crisis in the public finances are hindering a rapid recovery. The agricultural sector, which accounts for nearly one-quarter of GDP, has been badly hit by drought in 2000, and the wheat crop, normally a significant export earner, will be well below average. Inflation is running at around 50-60 per cent per annum, fuelled by an expansionary monetary policy, and would be even higher if widespread administrative controls were not in force.

The economy also suffers from severe fiscal and external imbalances, and has minimal foreign reserves. Large and persistent budget deficits are being financed in part by monetary emissions by the Central Bank and the build-up of wage arrears in the public sector. The current account deficit was reduced sharply in 1999 due to a severe contraction in imports, but the isolation from the international financial community means that the trade and current account deficits have to be financed largely by one-off, usually short-term credits. The country is in default of virtually all of its foreign debts, but the level of external debt is still rising steadily, mainly through the build-up of interest arrears, and currently stands at around US$ 12-14 billion. An agreement in principle on debt rescheduling was reached with the Paris Club in 1998 but its implementation is dependent on the lifting of sanctions and agreement being reached with the IMF.

Progress in market-oriented reform

Liberalisation

Very little progress has been achieved in economic liberalisation. Price controls are widespread, with government control (either direct or indirect) over an estimated 60 per cent of all goods. Prices of utilities are well below cost-recovery levels. The economy is relatively protected, with a complicated system of extensive tariffs on imports. In Serbia as of mid-October a multiple exchange rate regime is in place: the official rate (currently Yu Dinar 6 = DM 1) is used for customs tariffs on the import of raw materials and for selling foreign currency to government enterprises. Higher exchange rates apply for others (for example, importers selling dinar to the Central Bank), although banks sometimes give preferential rates to selected enterprises. The current black market rate (mid-October) is around Yu Dinar 30 = DM 1. Montenegro has had an official dual currency system since November 1999, with many enterprises and state-owned utilities only accepting payment in foreign currency (usually the Deutschmark).

Privatisation

While it is impossible to give a precise estimate of the size of the private sector, a rough estimate puts the private sector share of GDP at about 40 per cent, with most small-scale enterprises in private hands. The true size of the private sector

1 The Federal Republic of Yugoslavia consists of two republics, Serbia and Montenegro. Kosovo, a province of Serbia, has been under UN administration since the end of the NATO bombing campaign in June 1999.

2 At their summit in Biarritz on 14 October, EU governments pledged €200 million in immediate support to help Yugoslavia through the winter.

may be significantly higher once the informal or illegal economy is taken into account.

The privatisation process began in former Yugoslavia in 1989 following the enactment of the Federal Law on Privatisation. The two republics, Serbia and Montenegro, have followed somewhat different paths since then. In 1991, Serbia enacted a more restrictive law, but many companies nevertheless continued with privatisation, mostly through management-employee buy-outs and shares for pensioners. Amendments to the law in 1994 annulled many of the sales, and from 1995 onwards privatisation ground to a virtual standstill. Serbia adopted a new privatisation law in late 1997 with the aim of attracting foreign investors, but the large level of indebtedness of large state-owned enterprises has prevented much activity taking place so far. Privatisation revenues in 1998 were about US$ 100 million.

Montenegro initially launched its privatisation process in the early 1990s by transferring state-owned capital to a number of state funds. By the end of 1995 these funds had become majority shareholders in about 350 companies. A new privatisation plan in Montenegro was approved in 1998 and led to the establishment of a Privatisation Council. The plan, which has yet to be implemented, targets about 300 enterprises, most of which will be privatised either by a mass voucher scheme or by international tender.

Enterprise reform

The country's large enterprises are largely unreformed and are characterised by substantial losses, soft budget constraints, widespread inter-enterprise arrears and barter arrangements There are no effective bankruptcy procedures. While there is a competition law in place, it has not been applied. Property rights are unclear in many cases; the initial days after the election of President Kostunica saw the spontaneous ousting of some owners and the return of social ownership.

In contrast to the large enterprise sector, many small and medium-sized enterprises (SMEs) were profitable between 1994-98 despite the absence of financial support from the banking sector. Currently there are more than 200,000 registered SMEs, of which about 60,000 are active. Some SMEs have attempted to overcome the lack of finance by establishing their own shareholding banks or joint guarantee funds but their small size acts as a brake on further expansion of successful enterprises.

Infrastructure

Much of the country's infrastructure was in very poor condition even before the NATO bombing campaign in 1999. According to independent Serbian estimates, the direct damage to infrastructure, including industrial facilities, from the bombing was approximately US$ 3-4 billion. By the middle of 2000 about 35 smaller bridges had been completely rebuilt but none of the large bridges over the Danube had been repaired. Upgrading of roads, railways and bridges not yet repaired is an urgent requirement not only for Yugoslavia but also for the surrounding countries. The only major privatisation in infrastructure so far has been the sale in 1997 of 49 per cent of Telecom Srbija to STET (Italy) and OTE (Greece).

Financial institutions

About 80 per cent of the banking sector in Yugoslavia is owned by enterprises under social ownership. Confidence in the banking sector is very low, a legacy of the freezing of foreign currency deposits and several pyramid scheme scandals in 1992-93. Although Yugoslavia has a functioning payments system, the combination of war destruction, lack of financial investment and various sanctions has badly affected the quality of loan portfolios. In the Serbian banking sector an estimated 50 per cent of the loan portfolio is non-performing. Many banks (particularly state-owned banks) will also have the problem of dealing with frozen foreign currency deposits and liabilities. In Montenegro temporary regulations prevent commercial banks from extending DM loans that are not fully covered by reserves or by deposits of similar maturity. A plan to introduce its own central bank has been adopted by the Montenegro Government but not yet implemented.

Prospects for the future

Yugoslavia faces enormous challenges on many fronts. In the political sphere an urgent task of the new leaders will be to win the support for their policy from a people impatient for change but perhaps ill-prepared for the consequences, which in the short-term are bound to involve significant hardship. Perhaps an even more difficult task will be learning how to operate with the governmental, security and judicial apparatus inherited from the previous regime, which remains largely intact at lower levels. Obviously it cannot be changed overnight but its loyalty to the new regime and efficiency must remain in doubt. Developing well-functioning state institutions within the framework of the rule of law and supported by the population will be among the biggest challenges facing the new leadership.

The introduction of a widespread and comprehensive economic reform programme is urgent. A central element of this programme must be a credible stabilisation programme that controls public expenditure, especially in the areas of military expenditure and pensions, and that reduces inflation. Administrative controls on most prices, trade and access to foreign exchange should be quickly eliminated, and the exchange rate should be unified. Bureaucratic and administrative obstacles to enterprises, particularly SMEs, should be dismantled to allow the private sector to "kick start" the recovery and to attract foreign investment. The international community has a critical role to play in this process, first by approving an emergency short-term assistance programme but also by helping Yugoslavia to design a longer-term growth strategy.

Part I

Transition and economic performance

Chapter 2

Progress in transition and institutional performance

Chapter 3

Macroeconomic performance and prospects

Chapter 4

Cross-border capital flows

Progress in transition and institutional performance

2

At the beginning of a new decade of transition, progress in reform in central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) has regained momentum. The past year has seen the largest improvement since 1997 in reform across the region, as measured by the EBRD's transition indicator scores.

In 2000 progress has been achieved across most countries and dimensions of reform, as several countries at the early stages of transition have taken significant strides towards a market economy, particularly in the areas of privatisation and liberalisation. Some of the countries recently invited to enter into EU accession negotiations have redoubled their reform efforts. The 1998 crisis in Russia that led a number of CIS countries to backtrack in reform has also been largely overcome, with the lifting of most temporary trade and exchange restrictions imposed in response to the crisis. However, a small group of countries – Belarus, Turkmenistan and Uzbekistan – have yet to embark on comprehensive liberalisation and privatisation.

Even where sustained liberalisation and comprehensive privatisation have been achieved, countries continue to face considerable challenges in developing the institutions that are necessary to support their nascent market economies. The countries of CEB have slowly but steadily strengthened the performance of their market-supporting institutions. However, those in SEE and the CIS continue to lag well behind in terms of institutional performance. In these regions, legislative and regulatory changes have often been extensive, but the implementation and enforcement (effectiveness) of the new laws and regulations is weak. The institutional framework is often marred by inconsistencies within laws and regulations and their arbitrary interpretation, bureaucratic red tape and corruption. Moreover, as a result of continuing weaknesses in institutions, macroeconomic imbalances are difficult to manage and financial sectors remain vulnerable to bouts of instability. When instability strikes, governments often resort to increased administrative controls of prices, trade and access to foreign exchange as stopgap measures.

This chapter analyses recent progress in market-oriented reforms across the region, placing these changes in the context of the patterns that have emerged over the first decade of reform. These patterns include the introduction of liberalisation and privatisation ahead of the development of market-supporting institutions and the significant influence of economic, social and political conditions at the start of transition on future progress in reform.

Differences in starting points have had a strong impact on the reform process, with the countries in central Europe clearly benefiting from relatively favourable initial conditions. However, the initial advantage of these advanced reformers is now gradually fading. Moreover, the foundations appear to have been laid for strengthened institutional performance in countries where there has been sustained liberalisation and comprehensive privatisation, openness to international trade and investment, and the establishment of democratic political systems that function freely and fairly. The chapter argues that this combination of factors will over time support the emergence of a well-functioning market economy.

At the same time, it is important to recognise that such evolutionary progress is not automatic. There are many pitfalls that can trap the reform process. For example, economic liberalisation does not necessarily ensure that newly created markets are competitive. Nor does it ensure that enterprises are free to enter and exit the market, particularly where liberalisation is haphazard and where there are strong incentives for certain individuals to block further progress in reform. While international integration can be a catalyst for growth, it can also be a source of macroeconomic and financial instability, especially where it is not accompanied by strong domestic reforms. Moreover, a formal constitutional and legal framework for democracy and civil liberties does not necessarily prevent powerful private interests from exercising undue influence over the state and from "capturing" it for their own benefit. The challenge is to ensure that newly established economic and political freedoms underpin robust economic and political competition.

The first section of this chapter introduces the EBRD's transition indicators (see Table 2.1). Section 2.2 reports on recent progress across the region, as reflected in the transition indicator scores. Section 2.3 introduces a simple framework that identifies the main factors advancing reform across the region and guides the analysis in the remainder of the chapter. Sections 2.4 and 2.5 focus on progress in economic liberalisation and privatisation respectively. Section 2.6 analyses institutional reform and performance, highlighting how the lack of enforcement of new laws in the less advanced transition economies hinders the functioning of markets and private enterprise. Section 2.7 provides a statistical analysis of the main factors driving institutional change over the past ten years. For this purpose, the EBRD's transition indicators have been backdated to 1989. Annex 2.1 provides the transition indicators scores for 1989-93 and describes progress in reform in the early 1990s.

2.1 Transition indicators

The EBRD's *Transition Reports* have provided assessments of progress in transition for 26 countries of CEB, SEE and the CIS since the first Report was published in 1994. These assessments are made for a number of core dimensions of reform that correspond with the main elements of a market economy – markets

Table 2.1

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

			Enterprises			Markets and trade			Financial institutions	
Countries	Population (millions, mid-2000)	Private sector share of GDP in %, mid-2000 (EBRD estimate)[1]	Large-scale privatisation	Small-scale privatisation	Governance & enterprise restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions
Albania	3.3	75	2	4	2	3	4+	2-	2+	2-
Armenia	3.8	60	3	3+	2	3	4	1	2+	2
Azerbaijan	8.1	45	2-	3+	2	3	3+	2	2	2-
Belarus	10.2	20	1	2	1	2-	2-	2	1	2
Bosnia and Herzegovina	4.1	35	2	2+	2-	3	3	1	2+	1
Bulgaria	8.1	70	4-	4-	2+	3	4+	2+	3	2
Croatia	4.5	60	3	4+	3-	3	4+	2+	3+	2+
Czech Republic	10.3	80	4	4+	3+	3	4+	3	3+	3
Estonia	1.4	75	4	4+	3	3	4+	3-	4-	3
FYR Macedonia	2.0	55	3	4	2+	3	4	2	3	2-
Georgia	5.4	60	3+	4	2	3+	4+	2	2+	2-
Hungary	10.0	80	4	4+	3+	3+	4+	3	4	4-
Kazakhstan	14.8	60	3	4	2	3	3+	2	2+	2+
Kyrgyzstan	4.7	60	3	4	2	3	4	2	2+	2
Latvia	2.4	65	3	4+	3-	3	4+	2+	3	2+
Lithuania	3.7	70	3	4+	3-	3	4	3-	3	3
Moldova	4.3	50	3	3+	2	3+	4	2	2+	2
Poland	38.7	70	3+	4+	3	3+	4+	3	3+	4-
Romania	22.3	60	3	4-	2	3	4	2+	3-	2
Russia	145.4	70	3+	4	2	3	2+	2+	2-	2-
Slovak Republic	5.4	75	4	4+	3	3	4+	3	3	2+
Slovenia	2.0	55	3	4+	3-	3+	4+	3-	3+	3-
Tajikistan	6.3	40	2+	3+	2-	3	3+	2-	1	1
Turkmenistan	5.1	25	2-	2	1	2	1	1	1	1
Ukraine	49.5	60	3-	3+	2	3	3	2+	2	2
Uzbekistan	24.9	45	3-	3	2-	2	1	2	2-	2

1 The "private sector shares" of GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available. Here the term "private companies" refers to all enterprises in which a majority of the shares are owned by private individuals or entities. The roughness of the EBRD estimates reflects data limitations, particularly with respect to the scale of informal activity. The EBRD estimates may in some cases differ markedly from available data from official sources on the contribution to GDP made by the "private sector" or by the "non-state sector". This is in most cases because the definition of the EBRD concept differs from that of the official estimates. Specifically for the CIS countries, official data in most cases refer to value added in the "non-state sector" – a broad concept which incorporates collective farms as well as companies in which only a minority stake has been privatised.

Classification system for transition indicators[1]

Large-scale privatisation

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

Small-scale privatisation

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

Governance and enterprise restructuring

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

Price liberalisation

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

Trade and foreign exchange system

1 Widespread import and/or export controls or very limited legitimate access to foreign exchange.
2 Some liberalisation of import and/or export controls; almost full current account convertibility in principle but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates).
3 Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.
4 Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full current account convertibility.
4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; WTO membership.

Competition policy

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

Banking reform and interest rate liberalisation

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

Securities markets and non-bank financial institutions

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

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

and trade, enterprises and financial institutions. Progress in each of these dimensions represents an improvement in how well markets, enterprises and financial institutions function. Progress is measured against the standards of industrialised market economies, recognising that there is neither a perfectly functioning market economy nor a unique endpoint for transition. The measurement scale for the indicators ranges from 1 to 4+, where 1 represents little or no change from a rigidly planned economy and a 4+ represents a standard that would not look out of place in an industrialised market economy.

Within the broad categorisation of reforms, the transition indicators in Table 2.1 measure specific aspects of transition. On markets and trade, the indicators capture the liberalisation of prices, trade and access to foreign exchange as well as the extent to which utility pricing reflects economic costs.[1] The indicators also assess the effectiveness of competition policy in combating abuses of market dominance and anti-competitive practices. On enterprises, the indicators measure the extent of small-scale and large-scale privatisation and of enterprise reforms, such as the elimination of production subsidies and the introduction of bankruptcy procedures and of sound corporate governance. On financial institutions, the indicators capture the extent to which interest rates have been liberalised, two-tier banking systems established and securities markets created. They also assess whether prudential regulations have been raised to international standards and if procedures exist for resolving the failure of financial institutions.

A unique feature of this *Transition Report* is the backdating of the EBRD's transition indicators to 1989, the start of political transition and comprehensive economic reform in central Europe. These indicators provide valuable insights into reform progress in the early years of transition, when many of the persistent patterns in transition were first established.[2] As with the transition indicators published in this and previous Reports, the scores reflect the assessments of EBRD country economists using the criteria described in the notes to Table 2.1. The transition indicators for 1989-93 are presented in Annex 2.1, which also analyses how conditions at the start of transition influenced the early years of reform.

Chart 2.1

Average annual EBRD transition indicator scores and variance, 1989-2000

Source: EBRD.

Note: The chart shows the average annual EBRD transition indicator scores across all 26 countries and all dimensions from 1989 to 2000 as well as the variance across countries. The chart also shows the average and variance when we exclude Belarus, Turkmenistan and Uzbekistan, that is Average (EBRD -3) and Variance (EBRD -3).

In addition to the core dimensions of transition that have been measured by each of the *Transition Reports,* this chapter has three annexes that summarise progress in additional areas of reform central to a well-functioning private market economy. Annex 2.2 presents the results of the EBRD's legal transition survey of 111 practising lawyers in 26 countries in the region. The EBRD's Office of the General Counsel implemented and analysed this survey, which measures the extent and effectiveness of commercial and financial laws, with a particular focus on those laws and regulations that are fundamental to investment and financing decisions. They include company law, bankruptcy and secured transactions laws as well as banking and securities laws and regulations. The survey examines both the content of the law and the effectiveness of judicial enforcement. It therefore provides a valuable accompaniment to the EBRD's economic transition indicators.

Annex 2.3 assesses progress in the development of commercial infrastructure. The analysis focuses on five sectors: electric power, railways, road transport, telecommunications, water and waste water. The infrastructure indicators focus on the areas of tariff reform, commercialisation (including private sector participation) and effective regulation. Annex 2.4 examines progress in environmental protection. In particular, it assesses the progress in improving air quality in transition economies using the "pressure-response-state" framework developed by the OECD.

2.2 Recent progress in transition

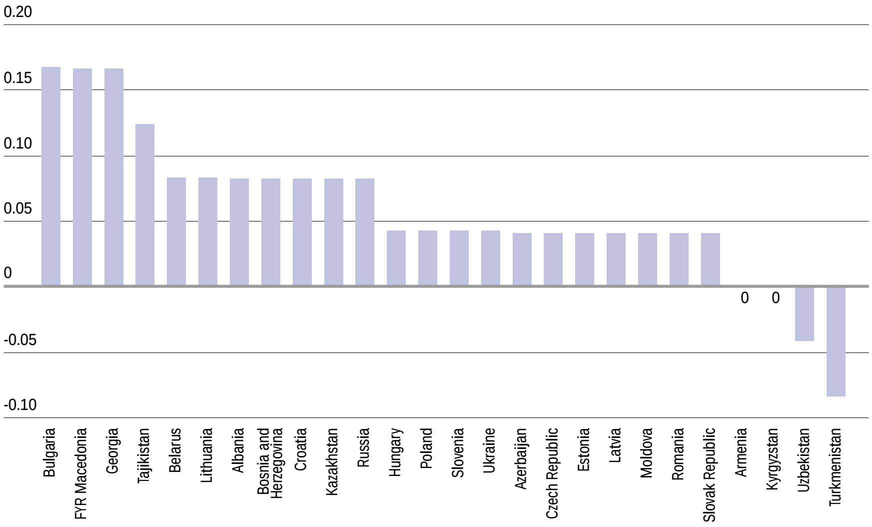
Chart 2.1 shows the overall transition indicator scores from 1989 to 2000, averaged across all countries of the region and all core dimensions of reform (markets, enterprises and financial institutions). This average provides a summary measure of region-wide progress in reform. It shows rapid progress from 1989 to 1995 and then a marked slowdown from 1996 to 1999 (see Annex 2.1 for variation across reform dimensions). In 2000 the average overall transition indicator registered its largest rise since 1997, with 22 countries achieving increases in their scores and two showing no change.

1 As reported in the notes to Table 2.1, a transition indicator score of 4 in price liberalisation would reflect full economic pricing of utility services. In the table, a 3+ is allocated to those few countries that have achieved significant progress in tariff reform in the energy sector, the sector in which initial under-pricing was probably most extreme. Annex 2.3 presents a more detailed discussion of progress in the reform of infrastructure that complements the rating on price liberalisation.

2 Chapter 2 of *Transition Report* 1999 describes these patterns and assesses their underlying determinants.

Chart 2.2

Change in average transition indicator scores, 1999-2000



Source: EBRD.

Only Turkmenistan and Uzbekistan have registered further declines in their average scores, as they continued to backtrack in reform. These reversals reflect growing economic distortions, involving the channelling of cheap bank credit and preferential access to foreign exchange to inefficient domestic producers at the expense of the rest of the economy.

Not only has the overall average score registered its largest increase in recent years but also the variation in the average scores across most countries has continued to narrow. If countries with a weak government commitment to market-oriented reforms (Belarus, Turkmenistan and Uzbekistan) are excluded from the group, there is some evidence for convergence in average reform scores across countries since 1995, albeit interrupted by the Russian crisis. Nevertheless, significant differences persist in the patterns of reform between countries at more and less advanced stages of transition. This variation is examined in subsequent sections on liberalisation, privatisation and institutional performance.

Countries that have achieved the greatest progress in reform over the past year include the Former Yugoslav Republic of (FYR) Macedonia, Georgia and Tajikistan (see Chart 2.2 and the transition assessments at the back of the Report) as they continue to make progress on long-delayed reforms, particularly in the areas of price and trade liberalisation, small-scale privatisation and competition policy. The scope for reform in these countries has increased following the end of the Kosovo war and the recovery from civil conflicts.

Noticeable progress was achieved in some of the countries recently invited to begin negotiations on EU accession, particularly Bulgaria and Lithuania but also Latvia, Romania and the Slovak Republic. These countries made progress in the areas of privatisation and the financial sector. Three CIS countries (Belarus, Kazakhstan and Russia) returned to earlier levels of liberalisation by reversing some of the administrative controls on prices and trade that were imposed in the wake of the Russian crisis in 1998. Meanwhile, Moldova continued to liberalise domestic prices by raising energy tariffs to cost-recovery levels.

In Russia there has been some improvement in the areas of governance and enterprise restructuring, as shown by a sharp decline in barter, the successful resolution of a number of high-profile corporate governance scandals and the apparently tightening grip of President Putin on the so-called oligarchs. With an improved economic outlook and rising asset values, the incentives for Russian managers have also shifted somewhat from asset stripping towards investing and ensuring better protection of their property rights. However, it is too early to judge whether these developments will last and lead to sustained improvements in enterprise performance. The authorities need to seize the opportunity to advance reforms in critical areas, such as the judiciary, public administration, payments discipline in infrastructure and bank restructuring. The proposed measures in the Government's reform programme are encouraging but the test will be in their effective implementation.

While some of the new EU accession countries made noticeable strides in reform, the front-runners in the accession continued to improve. Reflecting a sound and well-established prudential framework and increased investor confidence and activity, Poland and Hungary are the first countries to reach a transition indicator score of 4- in the functioning of their securities markets. More generally, the EU accession process is prompting the advanced reformers to make further adjustments to laws and regulations and to improve their enforcement in the areas of competition policy (Slovenia), financial regulation and corporate governance (the Czech Republic) as well as commercialisation of infrastructure and the environment (see Annexes 2.3 to 2.4).

2.3 Liberalisation, politics and progress in transition

Recent developments in reform reflect a number of key driving forces – the extent of political and economic competition, the evolutionary nature of institutional change in a market economy, and the influence of conditions at the start of transition. These initial conditions largely determined the distribution of benefits and costs of initial reforms among various groups in society as well as the resulting distribution of economic and political power.

Economic and political competition determines the extent to which broad groups emerge that would benefit from the development of market-supporting institutions and thus could provide a constituency for market-based reforms. Political competition also determines to what extent the political process is responsive to these groups as opposed to the demands of narrow vested interests. At the same time, it must be recognised that the process of creating institutions that support markets and private enterprises is an evolutionary process since the institutions need to become widely accepted in society in order to shape economic practices.

With the simultaneous transformation of both economic and political systems, there was the potential for widely differing transition patterns to emerge. The extent of the redistribution of state-owned assets and thus of economic power in the transition economies has been unprecedented, while the post-communist states overseeing this redistribution have often been weak. The rewards for individuals, firms and lobby groups that have managed to gain undue influence over the state have therefore been extremely high.

Because markets and states are being built simultaneously, moreover, there have been fewer constraints on key decision-makers in government than are typically found in market economies at a comparable level of development. In many transition countries, political parties, trade unions and lobbies do not effectively represent collective interests (see Chapter 5 on trade unions). As a result, demands for political action have not generally been filtered through civic organisations with broad mandates. Instead, individuals and firms have often lobbied and "captured" the state directly to serve their own interests.[3] Sustained progress in transition requires institutions and processes that can curb the influence of narrow vested interests. Two such processes are economic and political competition.

Economic competition requires sustained liberalisation of markets and trade. It can serve to reduce the economic power of those that have benefited heavily from haphazard liberalisation and from give-away privatisations – be they incumbent "red barons" or nouveaux riches oligarchs. Economic competition can also serve to strengthen the focus of enterprises on earning profits through productive activities in the market place. However, competition only works if uncompetitive firms receive no hand-outs from the state, such as direct subsidies, toleration of tax arrears, cheap bank loans and non-payment of infrastructure tariffs.

A strong complement to economic competition is, therefore, political competition. Political competition in the form of sustained democratic elections, supported by basic civic liberties and organisations, can encourage political decision-makers to focus on the majority of the electorate rather than narrow vested interests.[4] Periodic changes in government can make it more difficult for vested interests to exert undue influence over policy. The threat of a change in power can also deter governments from providing special privileges to narrow interest groups, which could provoke a backlash from the electorate.

While political competition can prompt economic policy-makers to serve the broader needs of society rather than the interests of a few, the strength of this competition is determined by the political process in each country and the initial political conditions following the end of communist regimes. Although the collapse of communism was usually associated with revolutions in central and eastern Europe, many subsequent governments, particularly in the CIS, were led by the same political elites that had ruled under communism. Many of these politicians from the ruling communist parties preferred the *status quo,* believing that economic and political reforms would undermine their interests. In contrast, new political leaders and the new elite that supported them often had a greater incentive to introduce reforms. In particular, new governments used economic liberalisation and democratic reforms to limit the power of government bureaucrats and enterprise managers and to prevent the re-emergence of a political monopoly.[5]

There is, in fact, a significant relationship between the extent to which economic liberalisation and democracy have been sustained in the transition and the turnover of political elites at the start of economic and political reform. Chart 2.3 shows those countries in which a non-communist political party led the first post-communist government and those in which communist party officials retained power. Countries that experienced prolonged war or civil conflict at the start of transition (Armenia, Azerbaijan, Bosnia and Herzegovina, Croatia, Georgia and Tajikistan) are excluded from the two groups.

The proportion of years since the start of transition with comprehensive liberalisation is 67 per cent on average for those countries in which a non-communist party came to power and only 31 per cent on average for those countries where communist party officials retained power. Comprehensive liberalisation of markets and trade is defined as an EBRD transition indicator score of 3- on price liberalisation (most prices free except for housing rents and infrastructure tariffs) and 4- on trade liberalisation (full current account convertibility). Comprehensive liberalisation is measured by the number of years in which both scores were reached, scaled by the number of years since the start of transition.[6]

The average proportion of years since the start of transition with an executive and parliament democratically elected in free and fair elections is 81 per cent in the first group of countries and only 38 per cent in the second. The determination of whether an election was free and fair is based on the election monitoring reports of the Council of Europe and the Organisation for Security and Cooperation in Europe, and, where elections were not monitored by these organisations, on the Freedom House assessments of political rights. The proportion of years with democratically elected executives and parliaments is defined as the number of years in which both were serving on the basis of free and fair elections, scaled by the number of years since the start of transi-

3 For evidence and analysis of state capture in transition economies, see Chapter 6 of *Transition Report* 1999, Hellman and Schankerman (2000), and Hellman, Kaufman, and Jones (2000).

4 See Chapter 5 of *Transition Report* 1999 for a more detailed assessment of the relationship between democracy and economic reform in transition economies.

5 Other factors that can influence reform decisions and their implementation include social cohesion and culture. See Chapter 5 of *Transition Report* 1999 and La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998).

6 The starting dates were given as 1989 for Hungary and Poland, 1990 for the Czech and Slovak Republics, Bulgaria, Romania and the successor states of former Yugoslavia, 1991 for Albania and the Baltic states and 1992 for the CIS.

tion. Elections that were free but not fair receive a partial score of one-half year for the period over which the election results hold.

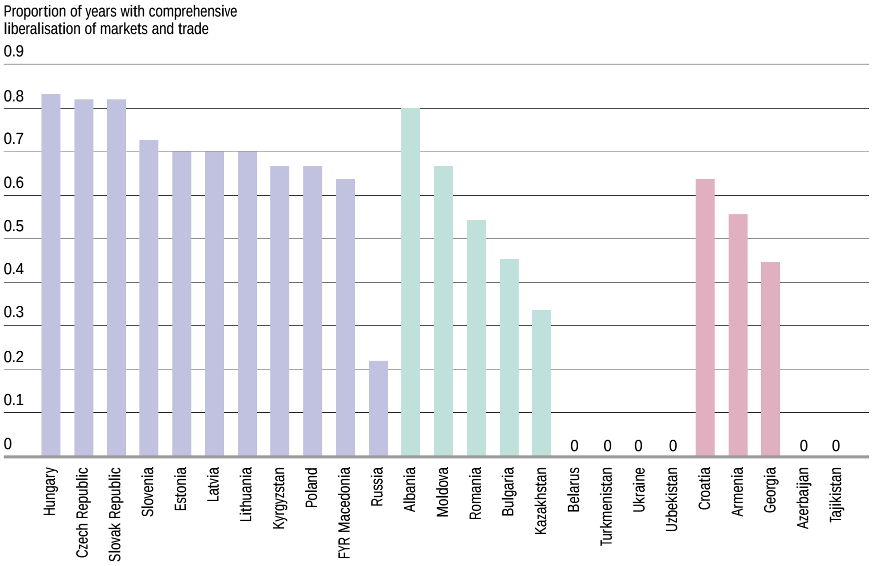
While the extension of economic and political freedoms at the start of transition served to weaken the opponents of change, these reforms also imposed significant costs on the electorate. The extent of these costs was largely related to the economic and social conditions that prevailed at the start of transition. These initial conditions include the initial level of development (GDP per capita), geographical location (proximity to the EU), distortions in the allocation of employment, extent of macroeconomic imbalances and length of time under central planning.

In general, the more challenging the initial conditions in terms of inherited economic distortions and imbalances, the larger are the costs of adapting to market forces, which can in turn increase the social costs of change for citizens and make reforms more difficult to sustain politically. These initial conditions also encompass the potential economic benefits of geographical location and the country's social norms and values. They can have considerable influence on economic behaviour and, therefore, affect how individuals respond to new economic incentives and institutions.[7]

Early and sustained commitments to economic liberalisation and democracy are also significantly associated with a more favourable set of conditions prevailing at the start of transition.[8] Chart 2.4a shows the relationship between initial conditions and the proportion of years since the start of transition with comprehensive liberalisation of markets and trade. Chart 2.4b shows the relationship between initial conditions and the proportion of years since the start of transition with executives and parliaments elected by free and fair elections. Despite difficult initial conditions, basic economic and political freedoms have been sustained by the political leaderships of many countries. Those countries that have achieved a higher degree of economic and political

Chart 2.3a

Proportion of years with comprehensive liberalisation versus initial government turnover



Countries that had a change in political leadership in the first post-communist government
Countries with no change in political leadership in the first post-communist government
Countries that experienced prolonged war or civil conflict at the start of transition

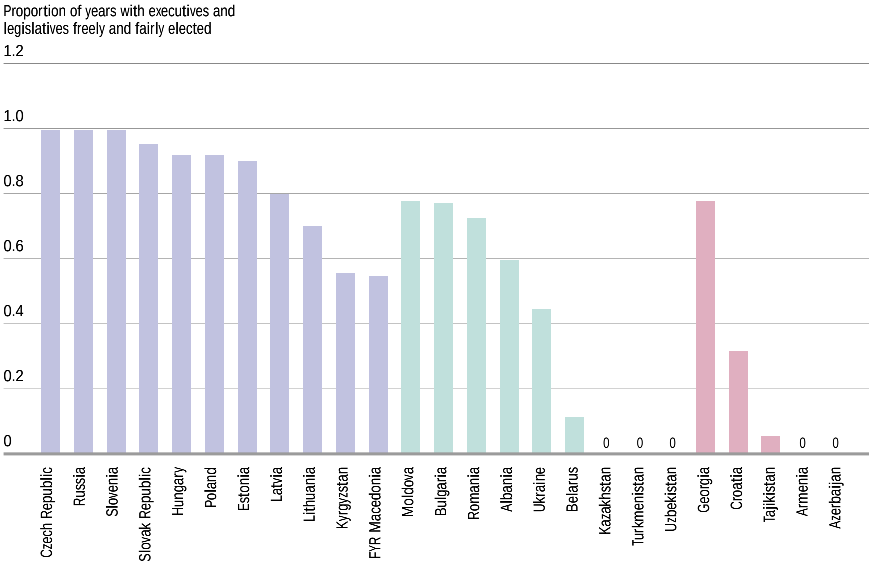
Sources: Tykov (1994) and EBRD.

Note: The proportion of years with comprehensive liberalisation is defined here to be the number of years in which a country achieved a score of at least 3- on price liberalisation and 4- on trade and foreign exchange liberalisation, divided by the length of transition in each country.

The start of transition is given as: 1989 for Hungary and Poland; 1990 for Bulgaria, the Czech and Slovak Republics, Romania and the successor states of former Yugoslavia; 1991 for Albania and the Baltic states; 1992 for the CIS.

Chart 2.3b

Proportion of years with democracy versus initial government turnover



Countries that had a change in political leadership in the first post-communist government
Countries with no change in political leadership in the first post-communist government
Countries that experienced prolonged war or civil conflict at the start of transition

Sources: OSCE, Council of Europe and EBRD.

Note: The proportion of years with executives and legislatives that are freely and fairly elected is calculated from election observations of the Organisation for Security and Cooperation in Europe (OSCE) from 1991 to 1996, the OSCE Office for Democratic Institutions and Human Rights from 1996 to 2000 and the Parliamentary Assembly of the Council of Europe from 1990 to 2000. For the start of transition, see note to Chart 2.3a.

7 See North (1990) and Elster (1989) for a general discussion and Raiser (1997, 1999) for an application to the transition economies.

8 See *Transition Report* 1999, Chapter 2, pp. 28-30.

liberalisation than predicted by their initial conditions lie below the trend lines in Charts 2.4a and 2.4b. They include the Baltic states, Georgia, Kyrgyzstan and Moldova.

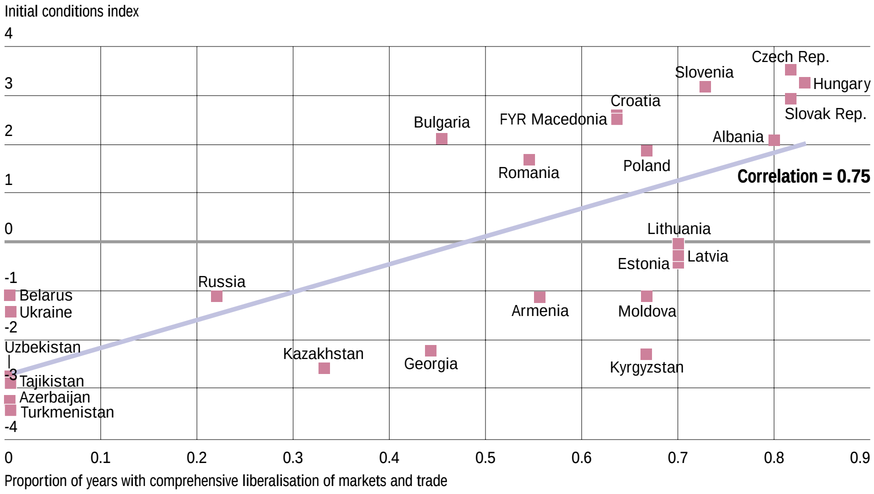
While economic and political competition and political and economic starting points are the main drivers of the transition process, other factors significantly affect progress in transition. The most important of these are international integration, changes in ownership structures through privatisation and the effect (both positive and negative) that privatisation has on the political process. Section 2.4 examines how international integration, particularly commitments made under membership or accession protocols in international organisations, such as the World Trade Organization (WTO), the International Monetary Fund (IMF) or the European Union, can strengthen reforms by binding governments' hands. The dynamic effects of various privatisation methods, in particular through their support for further reform, are discussed in Section 2.5.

Table 2.2 presents evidence on each of the main factors emphasised above, which are likely to drive progress in transition across the region in years to come. It shows for each country the quality of their initial conditions, the comprehensiveness of their liberalisation and political democratisation efforts to date, the extent of openness to competition from non-transition economies and the degree of state capture. Countries are ordered according to their average transition indicators for institutional development in 2000.

It is apparent that more advanced transition economies have benefited from better initial conditions, have been able to sustain liberalisation and democratic electoral systems longer and have lower levels of state capture. For less advanced countries there is more variation across these dimensions, but by and large the foundations for sustained progress in transition are considerably weaker – particularly in the CIS. This analysis highlights the key challenges for sustaining and accelerating progress in reform in the second decade of transition.

Chart 2.4a

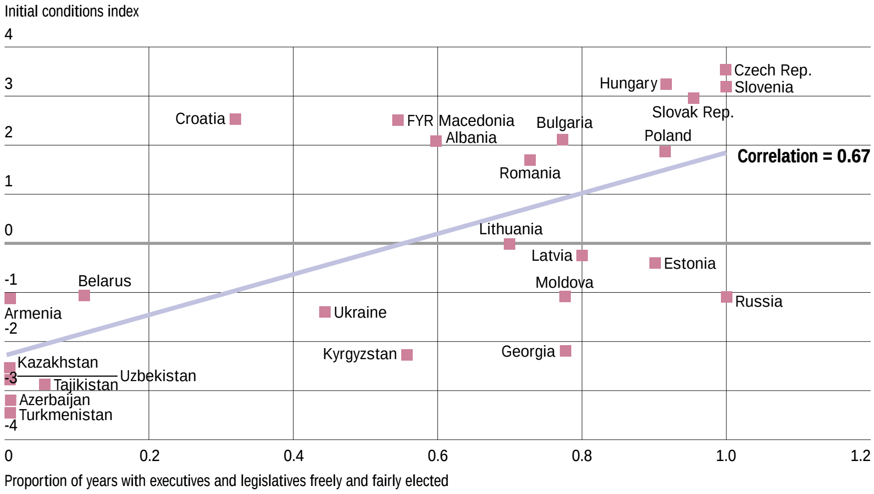
Initial conditions versus proportion of years with comprehensive liberalisation



Source: EBRD.
Note: The index of initial conditions is derived from factor analysis and represents a weighted average of measures for the level of development, trade dependence on the Council for Mutual Economic Assistance, macroeconomic disequilibria, distance to the EU, natural resource endowments, market memory and state capacity. The index has been inverted for the purpose of this chart, so that higher values relate to more favourable starting positions. See *Transition Report* 1999, Chapter 2, for further details. See Chart 2.3a for a definition of the proportion of years with comprehensive liberalisation.

Chart 2.4b

Initial conditions versus proportion of years with democracy



Sources: OSCE, Council of Europe and EBRD.
Note: The index of initial conditions is derived from factor analysis and represents a weighted average of measures for the level of development, trade dependence on the Council for Mutual Economic Assistance, macroeconomic disequilibria, distance to the EU, natural resource endowments, market memory and state capacity. The index has been inverted for the purpose of this chart, so that higher values of the index relate to more favourable starting positions. See *Transition Report* 1999, Chapter 2, for further details. See Chart 2.3b for a definition of the proportion of years with freely and fairly elected governments.

2.4 Liberalisation

There are remarkably wide differences among transition economies in the pace and extent of liberalisation. The countries in CEB as well as Albania, FYR Macedonia, Kyrgyzstan and Moldova liberalised domestic prices very early in their transition and sustained these reforms. These countries also liberalised trade and access to foreign exchange, albeit more gradually than they freed domestic markets. These relatively early and sustained "liberalisers" have maintained markets and trade free of government administration for more than two-thirds of the period since the transition began for their respective countries.

The rapid and sustained approach to liberalisation stands in contrast to the more uneven progress in much of SEE and the CIS. Among these countries, Bulgaria

Table 2.2

Transition paths and their determinants

Country	Institutional performance	Initial conditions index	Initial government turnover	Cumulative liberalisation	Cumulative democracy	State capture index
Hungary	3.5	3.3	Y	10.0	11.0	7.0
Poland	3.3	1.9	Y	8.0	11.0	12.0
Czech Republic	3.2	3.5	Y	9.0	11.0	11.0
Estonia	3.1	-0.4	Y	7.0	9.0	10.0
Lithuania	2.8	0.0	Y	7.0	4.0	11.0
Slovenia	2.8	3.2	Y	8.0	11.0	7.0
Slovak Republic	2.8	2.9	Y	9.0	10.5	24.0
Croatia	2.7	2.5	W	7.0	3.5	27.0
Latvia	2.6	-0.2	Y	7.0	8.0	30.0
Bulgaria	2.4	2.1	N	5.0	8.5	28.0
FYR Macedonia	2.3	2.5	Y	7.0	6.0	na
Romania	2.3	1.7	N	6.0	8.0	21.0
Kazakhstan	2.2	-2.5	N	3.0	0	12.0
Kyrgyzstan	2.1	-2.3	Y	6.0	5.0	29.0
Moldova	2.1	-1.1	N	6.0	7.0	37.0
Ukraine	2.1	-1.4	N	0	4.0	32.0
Georgia	2.0	-2.2	W	4.0	7.0	24.0
Albania	1.9	2.1	N	8.0	6.0	16.0
Azerbaijan	1.9	-3.2	W	0	0	41.0
Russia	1.9	-1.1	Y	2.0	9.0	32.0
Uzbekistan	1.8	-2.8	N	0	0	6.0
Armenia	1.8	-1.1	W	5.0	0	7.0
Belarus	1.5	-1.1	N	0	1.0	8.0
Tajikistan	1.4	-2.9	W	0	0.5	na
Turkmenistan	1.0	-3.4	N	0	0	na

Note: Institutional performance is the unweighted average of transition indicators in 2000 for banking sector, non-banking financial institutions, competition policy, and enterprise reform and corporate governance.

The index of initial conditions is derived from factor analysis and represents a weighted average of measures for the level of development, trade dependence on CMEA, macroeconomic disequilibria, distance to the EU, natural resource endowments, market memory and state capacity. The index was inverted for the purpose of this table so that higher values of the index relate to more favourable starting positions. See *Transition Report* 1999, Chapter 2, for further details.

Initial government turnover indicates those countries which had a change in political leadership in the first post-communist government (Y), those with no change in political leadership (N), and those which experienced prolonged war or civil conflict at the start of transition (W).

Cumulative liberalisation denotes the number of years in which a country has achieved a score of at least 3- on price liberalisation and at least 4- on trade and foreign exchange liberalisation.

Cumulative democracy denotes the number of years in which executives and legislatives have been freely and fairly elected.

The state capture index is taken from Hellman et al. (2000). It measures the extent to which businesses have been affected by the sale of government decisions and policies to private interests. A higher value indicates more “capture”. It is based on the Business Environment and Enterprise Performance Survey implemented in 1999 by the EBRD in collaboration with the World Bank.

and Russia attempted to liberalise both domestic and external markets relatively early in the transition, but temporarily backtracked on these reforms. However, towards the end of 1999 Russia had regained its 1997 level of price liberalisation, following the abolition of most of the temporary restrictions on domestic flows of goods and services introduced after the crisis in August 1998. Foreign trade and access to foreign exchange have also been freed considerably from restrictions but this progress has been partially offset by the re-introduction of oil export quotas. Among the early liberalisers in this group were Albania, FYR Macedonia, Kyrgyzstan and Moldova, none of which has so far backtracked in liberalisation.

The other countries in SEE and the CIS have seen much more gradual progress in price and trade liberalisation. However, even among these countries, there have been reversals in trade liberalisation, by Romania in 1996 and by Kazakhstan and Ukraine in 1999 following the Russian crisis. In Romania the new government that took over after the elections of 1997 quickly restored the level of price and trade liberalisation. Kazakhstan regained its level of trade liberalisation by the end of 1999, but subsequently re-introduced oil export quotas. Ukraine abolished several restrictions on access to foreign exchange in recent months, but continues to maintain a number of trade licences. Belarus, Turkmenistan and Uzbekistan have yet to embark on comprehensive liberalisation of markets and trade. Progress also remains incomplete in Azerbaijan, Bosnia and Herzegovina and Tajikistan, despite significant recent measures in the latter country in particular.

While initial conditions and political developments early in the transition appear to have lasting effects on liberalisation, the challenge is how to advance liberalisation where progress remains incomplete and to sustain comprehensive liberalisation once it has been achieved. The experience of Bulgaria following the return to power of the former Communist Party in 1994 suggests that a change of government can lead to temporary setbacks, but a reform government was again elected in December 1996 and restored the previous level of market liberalisation.

Similar swings in reform commitment in response to government turnover have occurred in Romania. In Croatia and the

Slovak Republic a recent change in government has led to an acceleration of reforms, and the same is now hoped for in Yugoslavia. In contrast, most of the countries that have yet to achieve comprehensive liberalisation have not sustained free and fair democratic elections. A democratic political system and democratic change of government, therefore, appears to be one way of “kick starting” liberalisation.

Another way of sustaining the liberalisation of trade and access to foreign exchange is through multilateral commitments, which help to anchor these measures in well-established institutions. The commitments related to WTO accession, IMF Article VIII on currency convertibility and EU agreements on regional integration and free trade tend to reduce the likelihood of policy reversals and add to the transparency and predictability of the trade and payment regimes. The commitments are also likely to contribute to the development of institutions that support markets and private enterprise. Table 2.3 shows the status of each transition country with respect to these three international institutions.

Among the most notable progress in this area in the past year is the accession of Albania, Croatia, Estonia and Georgia to the WTO. Negotiations with Armenia and Lithuania have also been successfully concluded and accession is now imminent. The EU’s decision in December 1999 to open accession negotiations with Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic will also play a key role in consolidating liberalisation and strengthening institutional performance in CEB and SEE. In the remainder of the CIS, however, international commitments provide much less impetus for reform. WTO negotiations are slow in Azerbaijan, Belarus, Central Asia (except Kyrgyzstan), Russia and Ukraine. In the absence of prospects for closer integration, EU association agreements have not exercised significant influence on the reform process in the CIS. Possibly the strongest anchor for liberalisation in this region is the commitment made to the IMF under macroeconomic adjustment loans.

Table 2.3

International commitments of transition economies as of 2000

	GATT/WTO membership	IMF Article VIII status	EU Association Agreement	EU Partnership and Cooperation Agreement Signed	EU Partnership and Cooperation Agreement Entered into force
Albania	July-00	–	–	–	–
Bulgaria	Dec-96	Sep-98	Mar-93	–	–
Croatia	July-00	May-95	–	–	–
Czech Republic	Jan-95	Oct-95	Oct-93	–	–
FYR Macedonia	–	Jun-98	–	–	–
Hungary	Jan-95	Jan-96	Dec-91	–	–
Poland	Jul-95	Jun-95	Dec-91	–	–
Romania	Jan-95	Mar-98	Feb-93	–	–
Slovak Republic	Jan-95	Oct-95	Oct-93	–	–
Slovenia	Jul-95	Sep-95	Jun-96	–	–
Estonia	Nov-99	Aug-94	Jun-95	–	–
Latvia	Feb-99	Jun-94	Jun-95	–	–
Lithuania	–	May-94	Jun-95	–	–
Armenia	–	May-97	–	Apr-96	Jul-99
Azerbaijan	–	–	–	Apr-96	Jul-99
Belarus	–	–	–	Mar-95	–
Georgia	Jun-00	Dec-96	–	Apr-96	Jul-99
Kazakhstan	–	Jul-96	–	Jan-95	Jul-99
Kyrgyzstan	Dec-98	Mar-95	–	Feb-95	Jul-99
Moldova	–	Jun-95	–	Nov-94	Jul-98
Russia	–	Jun-96	–	Jun-94	Dec-97
Tajikistan	–	–	–	–	–
Turkmenistan	–	–	–	May-98	–
Ukraine	–	Sep-96	–	Jun-94	Mar-98
Uzbekistan	–	–	–	Jun-96	Jul-99

Sources: WTO, IMF, EU, *Transition Report* 1997, Chapter 5.

2.5 Privatisation

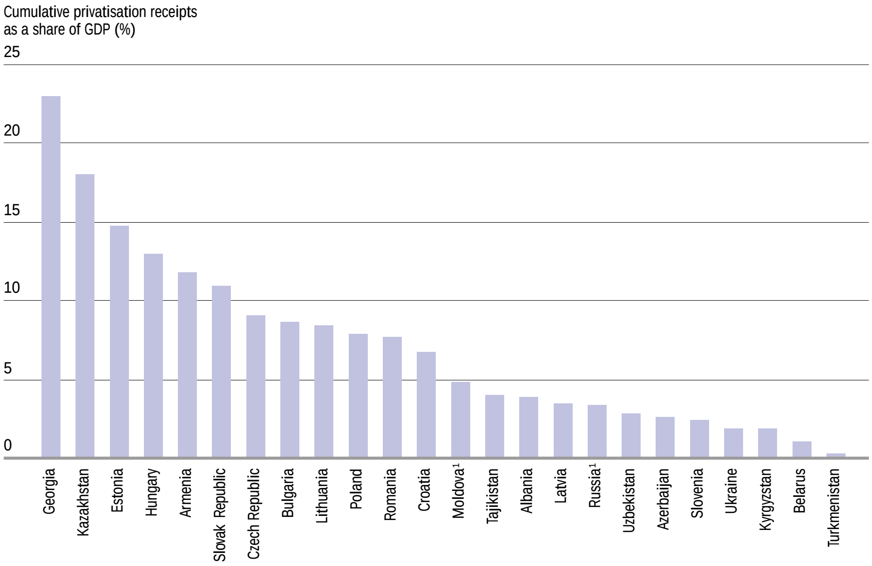
The variety of approaches to privatisation in the region reflects the many objectives (sometimes conflicting) and constraints involved in the reallocation of state assets. The key objectives were to build a critical mass of support for reforms and to remove the state from ownership of enterprises. In some cases, privatisation also aimed to improve the post-privatisation performance of enterprises, to strengthen competition and to generate revenue for the government. Privatisation helps, therefore, to complement liberalisation, sustaining political support for reforms and strengthening the response of enterprises to change. Political constraints on privatisation, however, have been equally important in determining the extent and form of privatisation. In particular, the methods of privatisation often reflected the initial balance of power between the privatisation authority, the ministries controlling the firms, local government, enterprise managers and their employees, often resulting in widespread concessions to insiders (existing managers and workers) in many large-scale privatisation programmes.

Privatisation of large-scale enterprises has achieved mixed success in meeting its objectives. Pro-reform politicians have not benefited greatly from rapid mass privatisation of large state-owned enterprises. In many countries, privatisation has been one of the most controversial areas of government policy regardless of the methods chosen and their speed of implementation. In some cases, the distribution or sale of state assets to favoured groups in return for political support (such as the infamous Russian loans-for-shares scandal) may have undermined the credibility of reformers and their policies. Moreover, the evidence on whether privatisation has improved the performance of privatised companies is equally ambiguous. The only form of privatisation that has clearly contributed to improving post-privatisation performance of enterprises is the sale of assets to strategic investors.[9]

9 For evidence on the impact of privatisation on enterprise performance, see Chapter 7 of *Transition Report* 1999, Carlin, Fries, Schaffer and Seabright (2000) and Djankov and Murrell (2000). Shleifer and Treisman (2000) assess the political impact of Russian privatisation.

Chart 2.5

Cumulative privatisation receipts, 1989-99



Source: EBRD survey of national authorities.

1 Figures for Moldova and Russia are for cumulative privatisation receipts from 1989 to 1998 only. Data for Bosnia and Herzegovina and FYR Macedonia were not available.

The outstanding challenge for privatisation, therefore, is to implement remaining sales as transparently and competitively as possible and to avoid the suspicion of political favouritism. This can be achieved by using competitive investment tenders or auctions to sell stakes in state companies to strategic investors. In fact, with the transition now in its second decade, most governments have tended to shift away from privatisation programmes towards direct sales through tenders and auctions. In addition, enterprises privatised in ways that did not place priority on post-privatisation performance, including management-employee buy-outs and voucher-based mass privatisations, need to be strengthened. One way to strengthen the ownership structures and corporate governance of such firms is through the market for corporate control and the exercise of financial discipline associated with external finance. However, these corporate governance mechanisms do not function well in many transition economies.

As Chart 2.5 shows, cumulative privatisation receipts have varied considerably across the transition economies. This variation reflects both the approaches chosen in large-scale privatisation and the attractiveness of the assets on offer. High receipts have been achieved by Estonia and Hungary, which used direct sales as their primary privatisation method. In many countries (including Georgia and Kazakhstan), however, privatisation revenue is dominated by a few prominent deals, such as the sale of the dominant telecommunications company, power generation and distribution, natural resources, such as oil fields and mines, and the main banks. The value of these assets depends on the quality of the local business environment as well as the size of the market and its economic potential.

Over the past year, Bulgaria, Poland and Romania have been the most active in large-scale privatisation. Bulgaria and Poland have placed greater emphasis on direct sales and raised over US$ 7.9 billion and US$ 250 million in privatisation receipts respectively. Over half of the amount in Poland is from the sale of a minority stake in TPSA, the telecommunications company. In addition, the Czech Republic sold stakes in two major banks for US$ 1.7 billion and Croatia and the Slovak Republic each sold minority stakes in their dominant telecommunications companies for just under US$ 1 billion. In contrast, most privatistions in Romania over the past year were in the form of management-employee buy-outs. An overview of most of the largest privatisation deals in the region over the past 18 months is given in Table 2.4.

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

2.6 Institutional performance

Since the start of transition, the development of institutions that support markets and private enterprises has lagged behind progress in liberalisation and privatisation. Chart 2.6 shows the pattern of liberalisation and privatisation versus the development of market-supporting institutions from 1989 to 2000, using the EBRD's transition indicators. Each point plotted in the chart depicts for a particular country and year the average transition indicator score for liberalisation and privatisation versus the average score for supporting institutions. The scatter plot of these points reveals that most countries have focused first on liberalisation and privatisation and that institutional performance improved only after these reforms had been implemented extensively. This pattern is depicted by the scatter of points beneath the 45-degree line that divides the diagram into two parts. These points correspond to countries and years in which progress in liberalisation and privatisation advanced ahead of institutional performance. There are very few points above the line, indicating countries where the opposite is true.

While Chart 2.6 provides a general pattern of reform, the precise sequence of reforms has differed sharply across the

Table 2.4

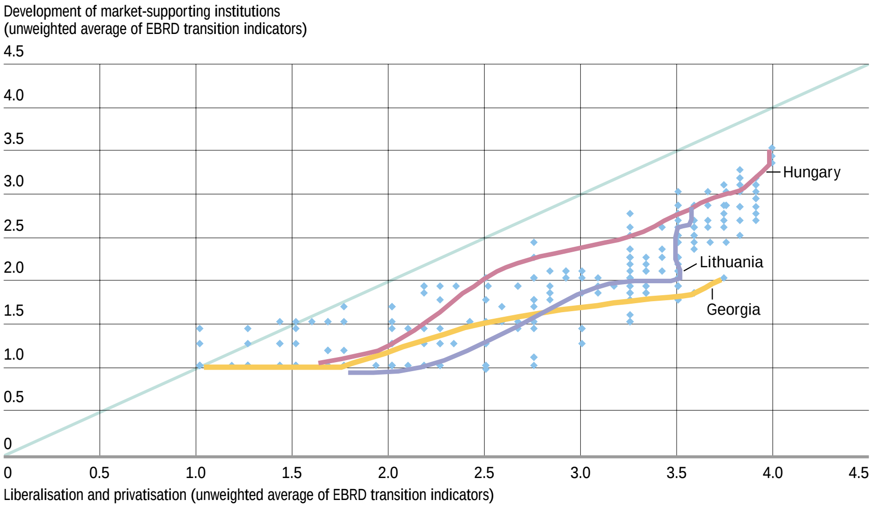
Selected large-scale privatisations in transition economies, February 1999 to August 2000

Company	Country	Sector	Date	Value (US$ million)
National Commercial Bank	Albania	Banking	Jun 2000	10
Albania Mobile Communications (AMC)	Albania	Telecommunications	Jun 2000	85.6
Hebros Bank	Bulgaria	Banking	Dec 1999	23.5
Neftochim	Bulgaria	Oil and gas	Oct 1999	101
Agropolychim Devnya	Bulgaria	Chemicals and allied products	Sep 1999	–
Alumina Shumen	Bulgaria	Metals	Sep 1999	9.0
Expressbank	Bulgaria	Banking	Sep 1999	39.5
Antibiotic	Bulgaria	Pharmaceuticals	Jun 1999	5.7
Assarel Medet	Bulgaria	Mining	Jun 1999	1.4
Balkan Bulgarian Airlines	Bulgaria	Airline	Jun 1999	0.2
Bulstrad	Bulgaria	Insurance	Jun 1999	7.6
Dunav Tours	Bulgaria	Tourism	Jun 1999	2.7
DZU-Stara Zagora	Bulgaria	Electrical and electronic equipment	Jun 1999	0.1
Kremikovtzi	Bulgaria	Metals	Jun 1999	–
LeKoKo	Bulgaria	Machinery	Jun 1999	7.5
Opticomechanichen-Streltcha	Bulgaria	Manufacturing	Jun 1999	–
Park Hotel Sofia	Bulgaria	Hotel	Jun 1999	2.6
Pharmacia	Bulgaria	Pharmaceuticals	Jun 1999	11.0
Riga Hotel	Bulgaria	Hotel	Jun 1999	1.2
Sopharma	Bulgaria	Pharmaceuticals	Jun 1999	31.8
Troyapharm	Bulgaria	Pharmaceuticals	Jun 1999	7.4
Privredna Banka Zagreb (PBZ)	Croatia	Banking	Jan 2000	300
Hravtske Telekomunikacije (HT)	Croatia	Telecommunications	Oct 1999	850
Ceska Sporitelna	Czech Republic	Banking	Feb 2000	534
Ceskoslovenska Obchodni Banka (CSOB)	Czech Republic	Banking	Jun 1999	1,175
Stredoceska plynarenska (STP)	Czech Republic	Gas transmission and distribution	Jun 1999	0.5
Optiva Pank	Estonia	Banking	Jul 2000	12.7
Narva Elektrivorgud	Estonia	Electricity	Apr 1999	4.5
Eesti Gaas	Estonia	Oil and gas	Mar 1999	3.9
Estonian Shipping Company	Estonia	Shipping	Mar 1999	21.9
Eesti Telekom	Estonia	Telecommunications	Feb 1999	222
K&H Bank	Hungary	Banking	Mar 2000	36.5
National Savings and Commercial Bank	Hungary	Banking	Nov 1999	162
Edasz	Hungary	Electricity	Oct 1999	26.3
Emasz	Hungary	Electricity	Oct 1999	66.0
Titasz/Dedasz	Hungary	Electricity	Oct 1999	19.9
Elmu	Hungary	Electricity	Sep 1999	17.6
Matav	Hungary	Telecommunications	Jun 1999	346
Lietuvos Telekomas	Lithuania	Telecommunications	Jun 2000	161
Lietuvos Draudimas	Lithuania	Insurance	Jun 1999	26.3
Klaipeda Sea Freight (Klasco)	Lithuania	Shipping	Mar 1999	50.0
Klaipedos Hidrotechnika	Lithuania	Manufacturing	Mar 1999	2.8
Stopanska Banka	FYR Macedonia	Banking	Dec 1999	57.6
Power distribution companies	Moldova	Electricity	Jan 2000	25.0
Orbis Hotels	Poland	Hotel	Aug 2000	133
Bedzin Heat and Power	Poland	Electricity	Aug 2000	7.8
Zespol Elektroceplowni Wybrzeze	Poland	Electricity	Aug 2000	60.0
Telekomunikacja Polska (TPSA)	Poland	Telecommunications	Jul 2000	4,300
Polski Concern Naftowy Orlen (PKN Orlen)	Poland	Oil and gas	Jul 2000	509
ZPG Dolina Nidy	Poland	Manufacturing	Dec 1999	60.0
Polski Koncern Naftowy (PKN)	Poland	Oil and gas	Nov 1999	513
Powszechny Zaklad Ubezpieczen (PZU)	Poland	Insurance	Nov 1999	711
Polskie Linie Lotwicze (LOT)	Poland	Airline	Nov 1999	33.7
Warta	Poland	Insurance	Oct 1999	44.2
KFA	Poland	Manufacturing	Oct 1999	8.3
Polar Home Appliances	Poland	Manufacturing	Sep 1999	35.9
VIS	Poland	Manufacturing	Sep 1999	11.6
Grajewo	Poland	Paper and board	Aug 1999	5.1
Izolacja Zdunska Wola	Poland	Miscellaneous services	Aug 1999	20.2
Polifarb Debica	Poland	Chemicals and allied products	Aug 1999	6.1
Bank Zachodni	Poland	Banking	Jun 1999	580
Pekao Bank	Poland	Banking	Jun 1999	1,090
Orbis Hotels	Poland	Hotel	May 1999	54.5
Morliny Meat Plant	Poland	Food and beverage	Apr 1999	8.0
Odlewnia Zeliwa Srem (Srem Foundry)	Poland	Machinery	Apr 1999	11.2
Patnow-Adamow-Konin	Poland	Electricity	Mar 1999	87.9
Banc Post	Romania	Banking	Apr 1999	42.8
LUKoil	Russia	Oil and gas	Oct 1999	200
Slovenske Telekomunikacie (ST)	Slovak Republic	Telecommunications	Jul 2000	939
Mykolayiv	Ukraine	Construction materials	Oct 1999	–

Source: Privatisation International database.

Chart 2.6

Patterns of transition: liberalisation and privatisation versus institutional performance



Source: EBRD.

Note: The pattern of liberalisation and privatisation versus the development of market-supporting institutions from 1989 to 2000 is shown using the EBRD transition indicators. Each point gives, for a particular country and year, the average of the indicator scores for liberalisation and privatisation versus the average score for market-supporting institutions.

Liberalisation and privatisation denotes the unweighted average of transition indicators for privatisation, price liberalisation and trade and foreign exchange liberalisation.

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

region, as shown by the three outcomes for Hungary, Lithuania and Georgia. In Hungary almost perfect balance has been achieved between progress in liberalisation/privatisation and institutional reform. Most of the central European countries follow a similar path. In contrast to this is the strongly curve-shaped pattern of Lithuania, representing rapid initial liberalisation in the first half of the 1990s followed by strong institutional reform during the second half of the decade. This path is typical for the Baltic states. In Georgia equally rapid liberalisation failed to trigger subsequent institutional reform, leading the country to diverge increasingly from a balanced reform path. This outcome is typical for the less advanced transition economies, excluding the small group of countries where there has been little progress in any aspect of reform.

Progress in institutional reform over the past year largely conforms with this well-established pattern. Slow but steady progress in building market-supporting institutions, particularly in the area of financial institutions and markets, continued to be made by many countries in CEB (Croatia, the Czech Republic, Estonia, Hungary, Lithuania, Poland and the Slovak Republic). A number of these countries have recently strengthened their policies and practices for the resolution of bank failures, privatised some remaining state-owned banks and further aligned banking regulations with international standards, such as the Basle Committee's core principles on banking regulation. Some have also seen significant improvements in the functioning of their securities markets. In addition, the Czech Republic has strengthened its bankruptcy laws and, to a lesser extent, its judicial administration, while Slovenia has further aligned its competition law with that of the EU.

Among the less advanced transition economies, recent improvements in institutional performance have been sparser than those in the more advanced countries. In 1999-2000, FYR Macedonia and Russia have made improvements to enterprise governance and restructuring by strengthening bankruptcy procedures and enforcement of shareholder and creditor rights respectively. FYR Macedonia has also introduced a new competition law. Albania and Bulgaria have upgraded their banking laws and strengthened practices for resolving bank failures respectively while Georgia has launched a new securities market.

Accelerating the slow pace of institutional change in the less advanced transition economies is perhaps the most pressing challenge in the second decade of transition. This remains a significant task despite considerable efforts by multilateral and bilateral donors to assist in the modernisation of laws and regulations in the CIS by following a standard or benchmark of an industrialised market economy. As shown by recent research on the reform of company and securities laws and competition policy, as well as by the EBRD's survey of legal practitioners (see Annex 2.2), the problem does not lie with the extensiveness of new laws and regulations but rather with weaknesses in their application and enforcement (effectiveness).[10] The EBRD has accumulated some hands-on experience in this respect through several of its projects (See Box 2.1).

Developing the capacity to apply and enforce new laws and regulations inevitably takes time. The government needs to gain command over the necessary resources, while judges, regulators and other bureaucrats must learn new skills and practices. The capacity of the state in transition economies to adapt has differed dramatically across the region, broadly in line with differences in the overall level of economic development and the flexibility of the existing state bureaucracy. In some of the CIS countries these factors have severely delayed the strengthening of institutional performance. Attempting to achieve rapid legislative changes in this context may sometimes have been counterproductive, as it reduces the opportunity for local judges and lawyers to participate in adapting new laws to local traditions and conditions.[11]

2.7 Institutional performance in transition – what has been learned?

Since many of the remaining challenges of transition involve strengthening the performance of market-supporting institutions, it is important to identify factors

10 See Pistor, Raiser and Gelfer (2000) and Dutz and Vagliasindi (2000).

11 Pistor, Raiser and Gelfer (2000) argue that the wholesale transfer of entire legal systems to the region, particularly in the CIS where no modern tradition of market compatible commercial law existed, may to some extent have exacerbated problems of weak enforcement.

Box 2.1

Legal effectiveness – the EBRD's experience as an investor

Many investors operating in transition economies can be frustrated by the ongoing changes to the legal and regulatory environment and the resulting inconsistencies in the institutional infrastructure supporting investment. Similarly frustrating is the lack of consistent interpretation of the new laws by the courts (see also Annex 2.2 for further information on legal effectiveness and the results of the 2000 Legal Indicator Survey). The Business Environment and Enterprise Performance Survey carried out by the EBRD jointly with the World Bank in 23 transition economies during the course of 1999 highlighted the lack of security of property and contract rights as a key concern for investors in many transition economies.[1]

Pistor, Raiser and Gelfer (2000) argue that the sheer pace and scope of the introduction of new laws, previously unknown to the legal tradition of a country, can lower legal effectiveness by reducing familiarity and acceptability of the new legal framework among the judicial profession. These authors as well as Dutz and Vagliasindi (2000) find that legal effectiveness is much more important for economic outcomes (in financial market development and the functioning of competition) than the extensiveness of the legal framework.[2] Dutz and Vagliasindi (2000), however, also show that over time legal effectiveness tends to improve in conjunction with advances in the level of formal protection offered under the law. Berglof and Roland (2000) stress the importance of institutional anchors, such as the EU accession process, as one means of improving legal effectiveness.

One of the most pertinent reasons for the slow improvement in legal effectiveness is arguably the lack of resources in the judicial system for salaries and training. As the chart (drawn from the EBRD Legal Indicator Survey) demonstrates, in many transition economies lower court judges earn only a fraction of the salaries of private lawyers. Low pay reduces the incentives of judges to invest the time and judgement required to interpret legislation impartially and consistently and increases the susceptibility to corruption. It also drives the best lawyers away from public duty to private law firms. The cross-country ranking in the chart matches other dimensions of institutional performance quite closely. Taking the average over 1999 and 2000, the highest salary ratio is in Estonia and the lowest in Azerbaijan.

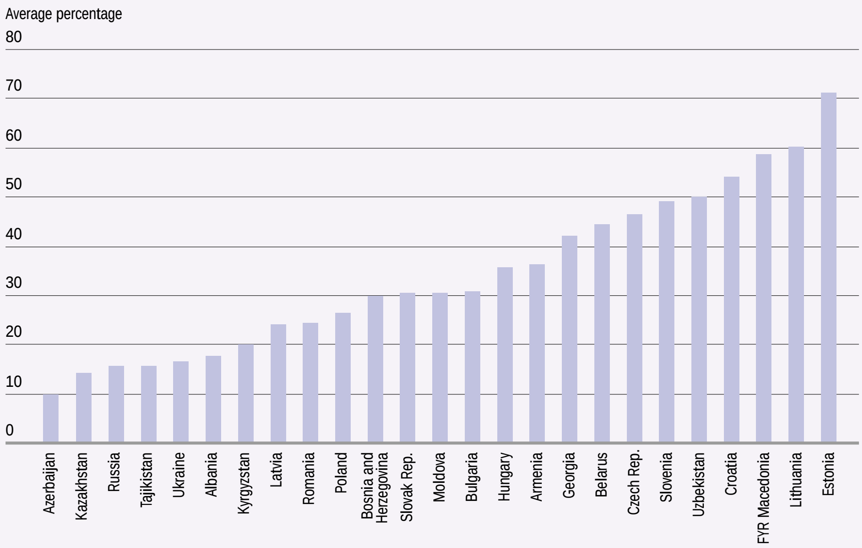
As the largest investor in the transition economies, the EBRD has accumulated significant experience regarding the enforcement of its rights through the judicial systems of the region. This box summarises a number of projects that illustrate the kinds of problems investors may face. The examples are drawn from Romania and Russia, but should be seen as examples of generic transition-related issues and not national problems in particular. For reasons of confidentiality, the names of the projects are not reported.

Case 1: Romania

The EBRD has recently encountered difficulties in utilising the bankruptcy laws in Romania. The Bank provided loans to a large chemical factory, which subsequently went into default. Following two years of non-payment, the EBRD initiated bankruptcy proceedings against the company in a Romanian bankruptcy court. The bankruptcy suit was denied by the court and subsequently went to appeal.

The experience uncovered several shortcomings in the application of existing legislation. First, a written decision by the court was issued weeks after the hearing had taken place, although under the law this

Ratio of the salary of lower court judges to private lawyers, 1999-2000



Source: EBRD Legal Indicator Survey, see Annex 2.2.

Note: The results were computed on the basis of pooled responses from the 1999 and 2000 surveys. The number of replies varies substantially across countries. Only two replies for Belarus, Georgia and Tajikistan and three replies for Bosnia and Herzegovina and Uzbekistan were received. For these countries, results are subject to particular uncertainty.

that have contributed to the progress that has been achieved so far.

Differences in the pace and quality of institutional reform across the region can be traced back to the fundamental forces that influence progress in transition, in particular economic and political competition and the extent to which they have been complemented by privatisation and international integration. Institutional reforms arise from the needs of market participants expressed through the political system and the incentives and capacity of governments to respond.[12] In the context of transition, demands for institutions that support markets and private enterprise have come from individuals who participate in a private market economy. Liberalisation and privatisation, therefore, are instrumental in strengthening the demand for institutional change. Whether market demands translate into institutional change depends on the responsiveness of the state and, therefore, on the nature of the political system. Initial conditions in the form of existing formal and informal institutions as well as external factors can also influence how the governing elite implements institutional reforms.

This analysis suggests that the concept of demand for, and supply of, institutions provides a useful framework for the analysis of institutional change and performance in transition. However, in applying this framework, demand and supply need to be seen as dynamic forces. In an evolutionary view of institutional development, it is the interaction of demand and supply factors over time that determines innovation in institutions.

[12] See Feeny (1993) for a discussion of the "supply and demand" framework for analysing institutional change.

must be issued within eight working days. This is a typical example of the kinds of delays faced by many investors in the region. Second, according to the written decision, the denial of the bankruptcy was based on the finding by the Syndic Judge that the debts of the EBRD were unliquidated because of an arbitration proceeding challenging the validity of the EBRD's debt. This was filed by the company just two days before the bankruptcy hearing in Romania. This means that any debtor could block the initiation of a procedure for judicial reorganisation and bankruptcy by simply initiating a dispute against its creditor. In other words, creditors' access to the bankruptcy courts can be severely restricted if the debtor decides to contest the debt – a result that would emasculate creditors' rights in Romania.

Case 2: Russia
The EBRD has experienced a number of difficulties in enforcing its creditor rights in Russia. In one case, the Bank was struck off the register of creditor claims in a company, which had filed for bankruptcy, following the intervention of the liquidator. This action appears to have been undertaken to prevent the EBRD from voting at a meeting of creditors to displace the liquidator for not properly discharging his duties. Following six months of considerable effort on the part of the EBRD, the Bank was finally reinstated as a creditor.

Case 3: Russia
In another case, a creditor of the EBRD reneged on a US$ 58 million loan, when it managed to persuade a Russian court that it had paid the loan. The court accepted the company's version of events despite the substantial documentary evidence that the EBRD provided in support of its case and the substantial and serious internal contradictions in the company's own case. The disrespect for documentary evidence provided by foreign investors in support of their position and repeated allegations of incompetence and corruption by regional and district court judges are common problems for many investors in the region. These problems are more severe in countries where governments have not ratified the New York Convention on the Enforcement of International Arbitration Awards, allowing no recourse to impartial jurisdiction outside the country.[3]

Case 4: Russia
A third case from the EBRD's experience in Russia demonstrates the abuse of both creditor and shareholder rights that continues to discourage serious foreign investors to engage in Russia. A Russian oil company, to which the EBRD had extended a loan and was the largest creditor, went bankrupt after it sold oil to an affiliated oil company. The affiliate failed to pay and went into bankruptcy, although it was quickly reorganised by its foreign shareholders. During the bankruptcy proceedings for the EBRD's debtor company, 98 per cent of creditors voted for the same external manager. However, following the application of a rival oil producer seeking to take control of the company, the local judge removed him and appointed a new external manager. This person immediately took action to change the voting balance of the creditors committee and to sell the company despite an offer by the affiliate company to settle all creditors' claims in full. The company was sold to the rival oil company, at a very favourable price, in an unusual but apparently legal auction process.

Subsequently an agreement was reached with the shareholders of the affiliate to return the company to it and all creditors were paid from the auction sale proceeds. The threat to the international reputation of the rival oil producer – and, by extension, to Russia itself – and its future access to international finance contributed to the pressure put on it to rectify the actions that it had previously taken and to reach agreement with the foreign investors. The case is thus an example of how improved corporate behaviour can be influenced by the requirements of international providers of capital. Whether this kind of pressure can be brought to bear more generally on the domestic Russian corporate sector remains an open question.

1 See Chapter 6 of *Transition Report* 1999 and Hellman and Schankerman (2000).

2 See also recent overviews in the *Law in Transition* journal, published by the EBRD's Office of the General Counsel.

3 Countries which have not acceded to the 1958 New York Convention are Albania, Tajikistan and Turkmenistan. Kyrgyzstan has acceded but the Constitutional Court ruled the model UNCITRAL law unconstitutional. In Kazakhstan the New York Convention has yet to be ratified by parliament to become enforceable.

Specifically, the demand for institutions that support markets and private enterprise is likely to increase in line with the length of time that a basic private market economy has functioned. As progress is made in liberalisation of markets and trade and in privatisation of enterprises, new interest groups emerge, which demand the consolidation of markets and supporting institutions.[13] However, the formation of these interest groups takes time, partly because of the need to gain experience of a private market economy and of the incentives for individuals with a shared interest to free ride on the efforts of others. While these new interest groups form and gain influence, aspects of the previous regime are likely to persist, such as soft budget constraints for favoured enterprises, barter and bureaucratic corruption. The development of institutions needed to support markets and private enterprise is therefore likely to be slow. These considerations suggest that there is a clear link across the region between the number of years a country has achieved comprehensive liberalisation and small-scale privatisation and the level of institutional performance.

Increased trade and foreign direct investment (FDI), moreover, can intensify competitive pressures on local producers and thereby strengthen their demand for efficient institutions that can help to reduce their production and transactions costs. In addition, this contact with the outside world helps to expand local knowledge of institutional arrangements and practices in other countries, such as those in the EU. This knowledge can help to shape the demands for new market-supporting institutions in transition economies. In addition, trade and FDI facilitate the introduction of new production technologies. The share of trade with non-transition economies and the number of years that a country has fulfilled the requirements of WTO membership or the IMF's Article VIII (on current account convertibility) are useful indicators of the extent and depth of external contact.

The supply of institutions is influenced by the responsiveness of the state to the demands of interest groups and by its command over resources. How a government chooses to allocate resources depends on its responsiveness to interest groups and on how the ruling elite is likely to benefit. As argued above, central to persuading the ruling elite in the transition economies to commit to reform has

13 See North (1990) and Olson (2000) on the formation of coalitions demanding institutions that support markets and private enterprise and Greif, Milgrom and Weingast (1994) on the formation of narrow interest groups that demand such institutions.

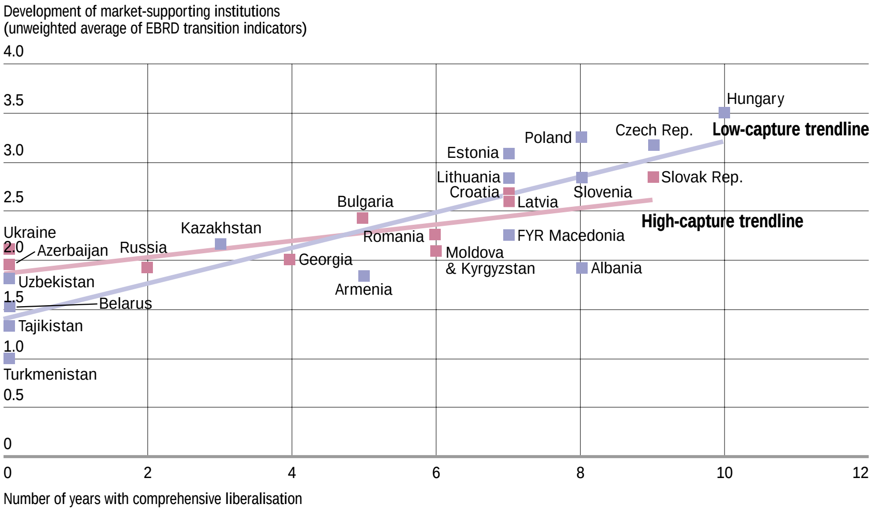
been the transition to democracy and pluralism, in which the interests of workers, investors, pensioners, environmentalists and others gain a meaningful vote and a voice. However, the simultaneous political and economic transition has also seen the emergence of powerful vested interests that have exercised undue influence over political decision-making. These considerations suggest that there should be a link between the number of years that the executive and legislature have served on the basis of free and fair elections and the level of institutional performance. However, in countries characterised by a high level of state capture this link would be expected to be considerably weaker.

Finally, the capacity of governments in transition economies to provide essential public goods, such as market-supporting institutions, has differed widely in line with variations in government revenues. The sharp falls in output as well as difficulties in shifting the burden of taxation towards indirect taxes and consumption and away from corporate turnover and profits have severely reduced governments' revenue-raising capacities, particularly in the CIS. One measure of government capacity is general government revenue as a share of GDP.

Regression analysis can be used to determine the relative weight of each of the above factors in influencing institutional performance. Such an analysis reveals that the level of institutional performance (as measured by the average EBRD transition indicator scores for competition policy, governance and restructuring, banking reforms and the development of securities markets) is closely linked with two fundamental factors: the number of years with comprehensive liberalisation of markets and trade and the number of years with executives and legislatures elected by free and fair elections.[14] These factors are significant even once an allowance is made for the fact that the level of institutional performance is partly influenced by conditions at the start of transition. The impact of comprehensive liberalisation and democratic practices on institutional perform-

Chart 2.7a

Comprehensive liberalisation, capture and institutional performance



High-capture states   Low-capture states

Source: EBRD.

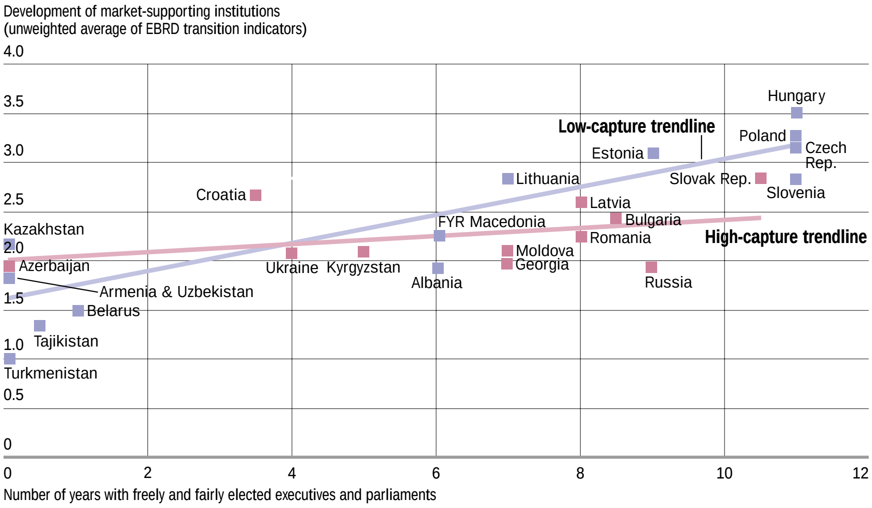
Note: The development of market-supporting institutions denotes the unweighted average of EBRD transition indicators for banking sector, non-banking financial institutions, competition policy, and enterprise reform and corporate governance.

Comprehensive liberalisation is defined as achieving a score of at least 3- on price liberalisation and 4- on trade and foreign exchange liberalisation.

Countries are divided into high-capture and low-capture states following Hellman et al. (2000). Tajikistan and Turkmenistan were classified as low-capture states by EBRD staff. See Table 2.2 for the index of state capture.

Chart 2.7b

The functioning of democracy, capture and institutional performance



High-capture states   Low-capture states

Sources: OSCE, Council of Europe and EBRD.

Note: The development of market-supporting institutions denotes the unweighted average of EBRD transition indicators for banking sector, non-banking financial institutions, competition policy, and enterprise reform and corporate governance.

The number of years with freely and fairly elected executives and parliaments is calculated from election observations of the Organisation for Security and Cooperation in Europe (OSCE) from 1991 to 1996, the OSCE Office for Democratic Institutions and Human Rights from 1996 to 2000 and the Parliamentary Assembly of the Council of Europe from 1990 to 2000.

Countries are divided into high-capture and low-capture states following Hellman et al. (2000). Tajikistan and Turkmenistan were classified as low-capture states by EBRD staff. See Table 2.2 for the index of state capture.

14 Other factors, such as the share of trade with non-transition economies, or government revenues over GDP, were not statistically significant in simple cross-section regressions, in part because of strong multi-collinearity with the measures of economic and political liberalisation. Preliminary results using the full 1989-2000 panel suggest that privatisation policies and government revenues are important factors influencing economic performance in their own right, although trade orientation remains insignificant. For a related study, using more sophisticated econometric techniques with similar results, see Raiser, Tommaso and Weeks (2000).

ance are clear, therefore, even once initial conditions and initial government turnover are taken into account.

Chart 2.7 shows the relationships between institutional performance and the number of years with comprehensive liberalisation and freely and fairly elected executives and parliaments. The values are for each country in 2000. However, the relationships between institutional performance and the establishment of democracy and a basic private market economy are significantly affected by state capture. In those countries where the actions of the state appear to have been unduly influence by vested interests, the establishment of a private market economy and democracy has a much weaker influence on institutional performance.

Although there are significant links between institutional performance and economic and political competition, this finding does not mean that policy should focus only on economic liberalisation and political rights. Rather, the association underscores the importance of creating conditions under which economic and political competition can be sustained over time. The experience of transition has shown that economic liberalisation is difficult to sustain unless there are hard budget constraints on enterprises and banks. This financial discipline can often be achieved only through comprehensive privatisation. International integration can intensify competitive pressures and help domestic producers respond to them by promoting the introduction of technology, skills and practices that are appropriate to a market economy. Fiscal reforms are needed for the government to gain command over the resources that are necessary for the effective provision of public goods, such as a well-functioning judiciary and public administration, and for basic social protection, including education, health care and assistance for the unemployed (see Chapters 5 and 6).

2.8 Conclusions

The past year has seen the largest improvement in the EBRD's transition indicator scores since 1997. This increase in the pace of reform is evident throughout the region and across all aspects of reform. A number of countries that have been lagging in reform, including Bulgaria, FYR Macedonia, Georgia and Tajikistan, have taken significant strides, particularly in the areas of liberalisation and privatisation. At the same time, countries at more advanced stages of reform have continued to make steady progress in strengthening the performance of their market-supporting institutions. This is especially evident in those countries that have been invited to enter into EU accession negotiations. However, in two countries where commitment to reform is weak – Turkmenistan and Uzbekistan – there has been further backtracking in reform.

These recent developments largely conform with patterns in market-oriented reforms that have become well-established over the first decade of transition. These patterns include the introduction of liberalisation and privatisation ahead of the development of market-supporting institutions and the significant influence of economic, social and political conditions at the start of transition on the future progress of reform. Where sustained liberalisation and comprehensive privatisation have taken root, with countries open to international trade and investment, and with democratic political systems functioning freely and fairly, the foundations appear to have been laid for sustained progress in transition and strengthened institutional performance. This combination of factors helps to accelerate the establishment of a well-functioning market economy.

At the same time, it is important to recognise that this evolutionary process is not automatic. Economic and political liberalisation must be sustained, in part through complementary reforms, such as forms of privatisation that help to build competitive markets and the protection of property rights and that strengthen the performance of enterprises following privatisation. Governments must adapt to the requirements of a market economy by providing institutions that are necessary for a well-functioning market economy. They must also provide a social safety net that helps people adapt to the market. The international community also has a vital role to play in fostering international integration through the process of accession to the EU and the WTO.

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Annex 2.1: Transition indicators 1989–93

The EBRD began rating progress in economic reforms in the countries of central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) in 1994. The *Transition Report* 1994 established the ratings system of 1 (no reform) to 4+ (performance similar to market economies) and introduced the main dimensions of the transition process, namely liberalisation of prices, foreign trade and access to foreign exchange, small-scale and large-scale privatisation, enterprise reform and corporate governance, and the functioning of financial institutions. In 1995 these were expanded to include competition policy and non-bank financial institutions and securities markets. Since 1995 the EBRD has also provided a rating on legal reform in transition, although because of changes in the coverage and content of the underlying survey of legal practitioners, the ratings are comparable only since the 1998 survey. In 1998 the EBRD rated progress in infrastructure for the first time and has continued to expand these ratings.

For many of the dimensions covered by the EBRD's ratings, the bulk of progress in reform has been made since the transition ratings were introduced. This is particularly the case for institutional reforms in the enterprise and financial sectors, which did not start in many cases before the middle of the 1990s. However, in the area of liberalisation and privatisation, there was considerable progress in the early 1990s. To obtain a better picture of the transition process over its entire first decade, this annex analyses the transition indicators for the eight core dimensions for the period 1989-93. The EBRD's ratings in each dimension for the years 1991-2000 are provided in the country assessments at the back of the Report.

The data presented in this annex support the empirical analysis in Chapter 2. The findings confirm the importance of initial conditions for progress in reform and the emergence of reform imbalance in many countries between liberalisation/privatisation and institutional performance. The data also show how some countries have caught up in their reform efforts while others have fallen behind. In particular, bearing in mind the later starting date for economic reforms in the CIS, it appears that many former Soviet republics initially made rapid progress – exceeding progress in most SEE countries. After this initial spurt, however, the majority of CIS countries did not make further progress and have fallen behind as a result. This evidence suggests that constraints on the reform process resulting, for instance, from difficult initial conditions may become more binding as reforms become more complex. It is also consistent with the view that in many CIS countries the winners of partial liberalisation and privatisation efforts have often been able to block further progress in reform and to preserve for themselves the advantages created by a partially liberalised economy.

Methodology and data sources

Before analysing the main results, it is important to recognise the limitations of this exercise. First, the transition indicators are subjective ratings, reflecting the EBRD's assessment of both the extensiveness and the effectiveness of policy measures. The definitions provided in Table 2.1 are clear and limit the room for discretion. However, the data on which staff must base their judgements are imperfect or incomplete, even with available information from national authorities and from secondary sources such as the IMF and World Bank and specialist EBRD staff.

The limitations of the underlying information apply particularly to the pre-1994 period. For liberalisation and privatisation some empirical data was often available. They are reported for each country in the country assessments at the back of this Report. In addition, the World Bank's internal and external liberalisation and private sector environment indices, while not strictly comparable, were helpful in deciding borderline cases.[1]

For the financial sector, enterprise reforms and competition policy, useful evidence was obtained from descriptive analyses in earlier *Transition Reports* and in IMF and World Bank country reports published at that time. The establishment of a key institution, such as a competition office, a securities market commission, a stock exchange or the introduction of new prudential standards in the banking sector, was often considered enough to move a country up one point. Minuses or pluses were used to take account of the effectiveness of the new institutions (see the country assessments at the back of the Report for major events in institutional reform).

Recent research has supplied more objective ratings for the extensiveness of commercial legislation in the key areas of investor rights and competition policy using international best practice as a benchmark.[2] These ratings date back a number of years and should in principle allow changes to the legal framework to be distinguished from improvements in its interpretation and enforcement. The transition indicators take account of both concepts and are therefore smoother by construction than a rating concentrating merely on formal legislation.

Before turning to an analysis of the early transition years, it should be noted that in a few instances the ratings given by the EBRD in earlier years seemed inappropriate on the basis of currently available information. Rather than forcing the backdated series to match earlier ratings, in cases where there was strong evidence for revising the rating, it was modified retrospectively. Despite the lack of hard evidence at the time, only in two cases was it necessary to revise the scores by a full point.

1 The indices are reported in the *World Development Report* 1996.

2 See Pistor et al. (2000) and Dutz and Vagliasindi (2000).

Chart A.2.1.1

Average annual EBRD transition indicators by dimension

Source: EBRD. Note: For definitions of the rating thresholds for each dimension, see Table 2.1.

Patterns in transition

Chart A.2.1.1 shows the average transition indicators for each dimension and each year since 1989. As such, it provides a visual summary of progress in transition up to 2000. The chart shows clearly that more rapid progress has been achieved in liberalisation and privatisation than in institutional reform. It also shows that the greatest progress in liberalisation and privatisation was made prior to 1994, with the steepest increase in 1992 and 1993. In contrast, institutional reforms made their greatest progress between 1994 and 1996. As noted in Chapter 2, however, this is not typical for all transition economies, with some achieving even progress across dimensions throughout the 1989-2000 period and others making little progress on the institutional side.

The pace of reform progress in the four institutional dimensions (enterprise restructuring, competition policy, banking reform and non-bank financial institutions) tends to flatten after 1996 despite the considerable distance that needs to be covered to reach performance levels associated with a well-functioning market economy. The chart confirms, therefore, the considerable barriers to building effective market-supporting institutions in the transition economies. These barriers are associated with limited state capacity and in some cases reform blockages due to state capture and remaining market distortions (see Section 2.6).

Chart A.2.1.2 looks at aggregate reform progress in each country, allowing for the variation in starting points. The chart accounts for differences in the starting date of transition by presenting the ranking in reform progress achieved after four years of transition and correlating this with the ranking on the initial conditions index introduced in Section 2.3. The correlation thus adjusts for the fact that transition started at different dates across the region – 1989 for Hungary and Poland, 1990 for the remainder of CEB and SEE, except Albania, 1991 for Albania and the Baltic states and 1992 for the CIS. For instance, Chart A.2.1.2 shows that Kyrgyzstan, Moldova and Russia achieved a higher level of reform than Hungary or Poland four years after the start of their transition (1995 and 1992 respectively), although in real time they obviously lagged behind considerably.

The rank correlation between initial conditions and average reforms in year four is 0.46, which is lower than expected given the strong impact of initial conditions on cumulative reform progress reported in Chapter 2. Indeed, the chart suggests that much more rapid reform progress was achieved in the majority of CIS countries in 1992-95 than in SEE countries in 1990-93. The Balkan wars held back progress in the successor states to former Yugoslavia, but in Bulgaria and Romania the chart shows that there was a relatively haphazard and hesitant start to the transition process.

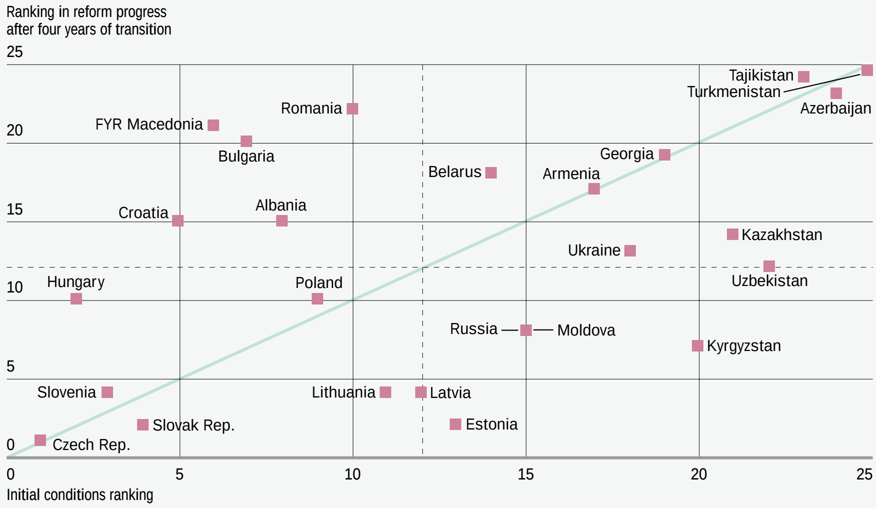
If the rank correlation between progress in reform and initial conditions were repeated for year eight of the transition (1996 for Hungary and Poland and 1999 for the CIS), a much closer association would be found with initial conditions. The rank correlation coefficient in that later year is 0.67 and statistically significant. It would appear that the CIS did not manage to capitalise on its initial reform push and fell behind over time compared with countries with more favourable initial conditions. Chart A.2.1.3 confirms this by presenting a rank correlation of reforms in year four of the transition to year eight. Countries above the line fell behind during the second four years of their reforms; countries below the line improved during this period. The most notable improvements were realised by Bulgaria, Croatia, FYR Macedonia, Hungary, Poland and Romania, but also by Georgia. The biggest laggards were Belarus, Russia, Ukraine and Uzbekistan.

The reasons why reforms did not progress further in the CIS, in line with patterns observed in CEB and SEE, reflect the constraints discussed in Chapter 2. In Belarus and Uzbekistan, reforms were reversed as the losers from initial liberalisation efforts gained control over the government. Even where this was not associated with a change of government, as in Uzbekistan, the extent of economic difficulties associated with economic reform in neighbouring countries may have convinced the ruling elite that they had little to gain by pursuing reforms further. In Russia, and to a lesser extent in Ukraine, a partial level of reform emerged, which generated significant income for those who had benefited from the initial reallocation of property rights. These "oligarchs" arguably had more to gain from preserving the benefits associated with the semi-liberalised nature of the economy than from further reductions in distortions and the creation of market-supporting institutions.

This annex supports, therefore, some of the main conclusions of Chapter 2. First, institutional reforms have been both slower to implement and apparently more difficult to push towards performance standards in advanced market economies than liberalisation and private ownership. Second, progress in transition has been significantly influenced by initial conditions. Moreover, this annex shows that the constraints on reform imposed by difficult starting points can sometimes gain in importance over time as the complexity of reforms increases. A combination of unfavourable starting positions and strong vested interests created by initial, partial reform efforts slowed progress in transition in much of the CIS during the second half of the 1990s. Despite the encouraging signs of recent convergence in reform levels across the region, this annex emphasises once more the considerable challenges facing governments in less advanced transition economies as they move into the second decade of transition.

Chart A.2.1.2

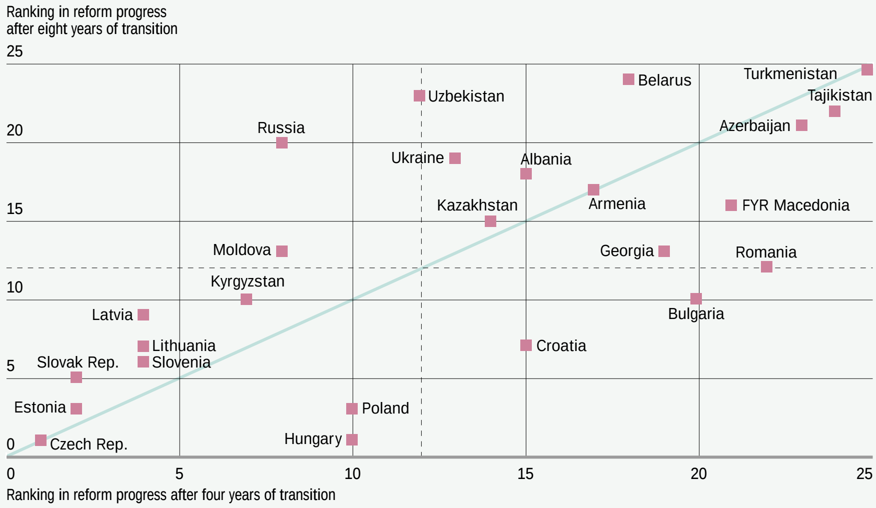
Reform progress after four years of transition versus initial conditions ranking



Source: EBRD.
Note: For details on how the initial conditions index was computed, see *Transition Report* 1999, Chapter 2, Box 2.1, p.28. The correlation coefficient is 0.46. The start of transition is given as: 1989 for Hungary and Poland; 1990 for Bulgaria, Croatia, Czech Republic, FYR Macedonia, Romania, Slovak Republic and Slovenia; 1991 for Albania, Estonia, Latvia and Lithuania; 1992 for Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

Chart A.2.1.3

Reform progress after four years of transition versus ranking after eight years of transition



Source: EBRD.
Note: The correlation coefficient is 0.67. The start of transition is given as: 1989 for Hungary and Poland; 1990 for Bulgaria, Croatia, Czech Republic, FYR Macedonia, Romania, Slovak Republic and Slovenia; 1991 for Albania, Estonia, Latvia and Lithuania; 1992 for Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

Annex 2.2:
Legal transition indicators

This is the sixth year that the EBRD has conducted a survey of the views of local lawyers and academics regarding legal reform in central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS). Through the Legal Indicator Survey (LIS), the EBRD's Office of the General Counsel has developed measures to assess both the extent to which key commercial and financial laws approximate internationally acceptable standards (extensiveness) and the degree to which these laws are implemented or enforced (effectiveness). The survey also provides a basis for analysing the role of legal reform in promoting investment and growth in the region.[1]

The results of this year's LIS reflect how lawyers and other experts familiar with the EBRD's countries of operations perceive the state of legal reform in mid-2000. These perceptions do not always correspond directly with the written legislation or regulations that exist in the various jurisdictions. The LIS indicates how lawyers subjectively view and understand legal transition in the region. Table A.2.2.1 provides an assessment of commercial laws, including pledge, bankruptcy and company law. Table A.2.2.2 provides an assessment of banking and capital market laws.

The LIS results presented in Tables A.2.2.1 and A.2.2.2 assess perceptions of legal reform based on two criteria: the extensiveness and effectiveness of legal reform. For commercial law, extensiveness was measured based on the impact of a jurisdiction's pledge, bankruptcy and company law on commercial transactions, such as secured lending, project finance, debt restructuring and the formation of joint-stock companies.[2] For financial markets, extensiveness was assessed on the basis of whether banking and capital markets' legal rules approach minimum international standards, such as the Basle Committee on Banking Supervision's Core Principles or the Objectives and Principles of Securities Regulation developed by the International Organisation of Securities Commission (IOSCO). Effectiveness of legal reform measures the extent to which commercial and financial legal rules are clear, accessible and adequately implemented, both administratively and judicially.

Extensiveness scores must be read in conjunction with effectiveness scores to reach a more complete understanding of how commercial legal reform is progressing in any jurisdiction. For example, Kyrgyzstan has consistently received strong scores for the extensiveness of its commercial laws because of the wholesale reform of its pledge, company and bankruptcy law in 1997. Nonetheless, LIS results have shown a stubborn and sizeable gap between Kyrgyzstan's extensiveness and effectiveness scores. This indicates that its relatively comprehensive laws are not being properly implemented. Other countries with a serious "implementation gap" in at least two survey segments include Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Georgia, FYR Macedonia and Ukraine. Large gaps between extensiveness and effectiveness scores (those greater than 20 points on a scale of 100) were taken into consideration in assessing the final indicators.

The legal indicators reported in both tables reflect subjective assessments of respondents to the survey as well as the views of EBRD lawyers with experience in working on commercial and financial market transactions in the region. For a few countries the LIS respondents provided significantly differing assessments. Where there were large discrepancies, the EBRD's in-house knowledge of that country's conditions was utilised to arbitrate among the differing views. Accordingly, while the purpose of the LIS and the resulting analysis is to provide an impression of how local lawyers perceive the quality of laws and how well these laws work in practice, some caution must be exercised in interpreting the results.

Overview of Legal Indicator Survey 2000 results

The extensiveness scores for most countries continue to climb each year. The majority of countries have now achieved a rating of 4 for the extensiveness of their commercial laws. In categories such as pledge law and capital markets scores achieved by the majority of countries are quite high. By contrast, effectiveness scores are much lower for all countries, and appear quite low when contrasted with extensiveness scores in the six LIS categories. Because extensiveness scores are rising, the relationship between extensiveness and effectiveness scores has become increasingly important as a measure of how successfully countries are implementing legal reforms.

The LIS also includes questions about general legal effectiveness in each country. These questions focus on the effectiveness of the courts and the legislative system (that is, whether laws are made available to the public and how transparent the legislative process is). They also focus on the overall perception of how far the rule of law is entrenched and respected. Most countries scored within a narrow range of between 40 and 60 (on a scale of 100) on this dimension. While this indicates that general legal effectiveness is not as poor as the implementation of specific laws, significant room for improvement remains.

1 The survey sample covers private law firms, academics and other experts familiar with commercial laws in the transition economies. The majority of private sector lawyers are selected based on their experience in advising the EBRD on local laws in the context of the Bank's investments.

2 The LIS secured transactions questions focus on the ability of parties to contract for non-possessory pledges in movable property, to protect their pledges through registration in a centralised collateral registry and to enforce their pledges effectively. The LIS company law questions focus on the ability of parties to form a joint-stock company and for shareholders to effectively enforce their rights with respect to management and majority owners, and the accountability of directors and company management. The LIS bankruptcy questions focus on the ability of creditors to pursue insolvency proceedings and to utilise reorganisation and liquidation procedures in the event of an enterprise's insolvency.

Table A.2.2.1

Legal transition indicators: commercial law

Country	2000			1999		
	Overall	Extensiveness	Effectiveness	Overall	Extensiveness	Effectiveness
Albania	2+	3+	2-	2	2	2-
Armenia	3	4-	2	3-	4-	2
Azerbaijan	3-	3	2	3-	3+	2
Belarus	1+	1	2+	2	2	2
Bosnia and Herzegovina	2+	3	1	2-	2	1
Bulgaria	4-	4	4-	4-	4	4-
Croatia	4-	4	3+	3+	4	3-
Czech Republic	3+	3	3+	3	3+	3-
Estonia	4-	4-	3+	4-	3+	4-
FYR Macedonia	3	3+	2+	4-	4-	4-
Georgia	2	3	2	2	2	2
Hungary	4-	4	4-	4-	4	4-
Kazakhstan	4-	4	4-	3+	3+	3+
Kyrgyzstan	3	3+	3	3	3+	3
Latvia	4-	4	4-	3	4-	3
Lithuania	4-	4	3+	3+	4	3
Moldova	3	3	2	3+	4-	3
Poland	4-	4-	4	3+	4	3
Romania	4-	3+	4-	3+	3+	4-
Russia	3+	4-	3	3	4-	2+
Slovak Republic	3	3	3	3	3+	3
Slovenia	4-	4	4-	4	4	4
Tajikistan	2-	2	2-	na	na	na
Turkmenistan	na	na	na	na	na	na
Ukraine	3	3+	2	2	2	2
Uzbekistan	3-	3	2+	3-	3-	2+

Source: EBRD.

Hungary and Slovenia are noteworthy as jurisdictions where perceptions of commercial and financial markets legal reform remain consistently high. In contrast, other countries have experienced declines in their effectiveness scores despite having relatively robust legal frameworks. For example, Poland and the Czech Republic – EU accession countries that have previously received strong scores in commercial law – experienced significant declines in effectiveness in 1999, which lowered their overall scores. In 2000, however, both of these countries have made somewhat of a comeback with an increase in their effectiveness indicators.

Russia continues to make a strong showing with respect to the extensiveness of its commercial laws but is plagued by problems with the effective application of these laws. Low effectiveness may reflect negative perceptions held by practitioners about the ability of government agencies and the courts to grapple with complex commercial and financial markets legislation.

In a few countries, the LIS has resulted in unexpectedly high effectiveness scores – particularly in light of enforcement and implementation problems in these countries. One explanation for these unexpected results could be the underutilisation of newly enacted laws. If new commercial laws (such as bankruptcy laws) or financial markets laws (such as securities laws) are not used actively in practice, lawyers may assume that these new laws are more effective than they really are. Once attempts are made to implement these new laws, enforcement problems may become apparent and decreasing LIS effectiveness scores would be likely to capture this trend. For example, in 1999, Albania and Moldova received high financial markets effectiveness scores despite a lack of robust banking and capital market sectors. In 2000 these scores dropped significantly for both countries.

Classification system for legal transition indicators: commercial law

Extensiveness

1 Legal rules concerning pledge, bankruptcy and company law are perceived as very limited in scope. Laws appear to impose substantial constraints on the creation, registration and enforcement of security over movable assets, and may impose significant notarisation fees on pledges. Company laws do not ensure adequate corporate governance or protect shareholders' rights. Bankruptcy laws are perceived as unable to provide for certainty or clarity with respect to the definition of an insolvent debtor, the scope of reorganisation proceedings or the priority of distribution to creditors following liquidation. Laws in these substantive areas often have not been amended to approximate those of more developed countries and the laws that have been amended are perceived to contain ambiguities or inconsistencies.

2 Legal rules concerning pledge, bankruptcy and company law are limited in scope and are subject to conflicting interpretations. Legislation may have been amended but new laws do not appear to approximate those of more developed countries. Specifically, the registration and enforcement of security over movable assets has not been adequately addressed, leading to uncertainty with respect to the registration and enforcement of pledges. Pledge laws may impose significant notarisation fees on pledges. Company laws may not ensure adequate corporate governance or protect shareholders' rights. Laws appear to contain inconsistencies or ambiguities concerning, among other things, the scope of reorganisation proceedings and/or the priority of secured creditors in bankruptcy.

3 New or amended legislation has recently been enacted (i.e., within the past five years) in at least two of the three areas that were the focus of the LIS – pledge, bankruptcy or company law – but could benefit from further refinement and clarification. Legal rules appear to permit a non-possessory pledge over most types of movable assets. However, the mechanisms for registration of the security interest are still rudimentary and appear not to provide parties with adequate protection. There is scope for enforcement of pledges without court assistance. Company laws appear to contain limited provisions for corporate governance and the protection of shareholders' rights. Bankruptcy legislation contains provisions for both reorganisation and liquidation but may place claims of other creditors above those of secured creditors in liquidation.

4 Comprehensive legislation exists in at least two of the three areas of commercial law that were the focus of this survey – pledge, bankruptcy and company law. Pledge law allows parties to take non-possessory pledges in a wide variety of movable property and contains mechanisms for enforcement of pledges without court assistance. The legal infrastructure, however, is not fully developed to include a centralised or comprehensive mechanism for registering pledges. Company laws contain provisions for corporate governance and the protection of shareholders' rights. Director and officer duties appear to be clearly defined. Bankruptcy law appears to include detailed provisions for reorganisation and liquidation. Liquidators possess a wide variety of powers to deal with the property and affairs of a bankrupt.

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

Effectiveness

1 Commercial legal rules are usually very unclear and sometimes contradictory. The administration and judicial support for the law is perceived as rudimentary. The cost of transactions, such as creating a pledge over a movable asset, is prohibitive so as to render a potentially extensive law ineffective. There appear to be no meaningful procedures in place in order to make commercial laws operational and enforceable. There also appear to be significant disincentives for creditors to seek the commencement of bankruptcy proceedings in respect of insolvent debtors.

2 Commercial legal rules are generally unclear and sometimes contradictory. There are few, if any, meaningful procedures in place in order to make commercial laws operational and enforceable.

3 While commercial legal rules are reasonably clear, administration or judicial support of the law appears to be often inadequate or inconsistent, creating a degree of uncertainty (for example, substantial discretion in the administration of laws and few up-to-date registries for pledges).

4 Commercial laws are reasonably clear and administrative and judicial support of the law is reasonably adequate. Specialised courts, administrative bodies or independent agencies may exist for the liquidation of insolvent companies, the registration of publicly traded shares or the registration of pledges.

4+ Commercial laws are perceived as clear and readily ascertainable. Commercial law appears to be well-supported administratively and judicially, particularly regarding the efficient functioning of courts, liquidation proceedings, the registration of shares and the orderly and timely registration of security interests.

Overall score

The overall score in the third column of the table is the average of the scores given for the two indicators rounded down. A "+" after a number is used to indicate countries that have just made it to the highest tier of one category and are within a few points of reaching the next category in the scale. A "-" indicates countries that are at the bottom of a category where a significant improvement is required for that jurisdiction to fall more comfortably within the middle range for that category.

Table A.2.2.2

Legal transition indicators: financial regulations

Country	2000			1999		
	Overall	Extensiveness	Effectiveness	Overall	Extensiveness	Effectiveness
Albania	2-	2	1	2+	3	2+
Armenia	2+	2	3	3	3	3+
Azerbaijan	2	2	2-	2-	2	1
Belarus	2+	2+	2	1+	2	1
Bosnia and Herzegovina	1	1	1	1	1	1
Bulgaria	3-	3	2+	3-	3	2+
Croatia	3	3+	3-	3-	3	3-
Czech Republic	3+	4	3-	3	3+	2+
Estonia	3+	4	3-	4-	4	3+
FYR Macedonia	2+	3	2-	2+	3	2
Georgia	3-	3+	2	1	1	1
Hungary	4	4	4	4	4	4
Kazakhstan	3	3	3-	3-	3	3-
Kyrgyzstan	3	3+	3-	2+	3-	2
Latvia	3	3	3	3-	3	2
Lithuania	4-	4	4-	3-	3-	2
Moldova	2	3-	2-	3	4	2+
Poland	4	4	4	4	4	4
Romania	3+	4	3	3-	3	3-
Russia	3	3	3-	3-	3	2
Slovak Republic	3	3	3-	3+	4	3+
Slovenia	4	4	4	3+	3+	3+
Tajikistan	2	2	1	na	na	na
Turkmenistan	na	na	na	na	na	na
Ukraine	3-	3	2+	2	2	2
Uzbekistan	2	2	2-	2-	2	1

Source: EBRD.

LIS commercial law results

Extensiveness scores for commercial law continue to increase for the majority of the countries surveyed. The LIS produced the strongest overall scores in pledge law, with company law a close second. Many jurisdictions have amended their collateral laws, for example, to allow parties to take non-possessory pledges in movable property.

Commercial law effectiveness scores remain relatively low compared with extensiveness scores, particularly for bankruptcy and pledge laws. By contrast, effectiveness scores for company law appear more robust. In many cases, company law reform occurred at a much earlier phase in a country's transition process so courts and other institutions have had time to implement the law more effectively.

Shifting scores and an aggregate decline in legal indicators may reflect the greater degree of familiarity that lawyers now have in these jurisdictions with commercial laws. With greater use, the blemishes and shortcomings inherent in any legislation become apparent and respondents may become more critical. In addition, as legal and economic transition progress, respondents may have raised their standards with respect to the implementation of legal reform.

FYR Macedonia and Moldova both experienced sharp drops in their commercial law scores. In part, this may reflect the fact that lawyers in these countries have become more familiar with their commercial laws and understand better their shortcomings. Moreover, utilisation seems to have created more balanced perceptions of the effectiveness of various laws. For example, Moldova received quite low scores for the effectiveness of its pledge law. This may reflect the apparent stagnation in legal reform and the failure to actively imple-

Classification system for legal transition indicators: financial regulations

Extensiveness

1 Legal rules concerning banking and securities regulation are perceived as very limited in scope. For example, capital adequacy standards and restrictions on affiliated lending in banking appear to be non-existent. There may be no functioning stock exchange in this jurisdiction, or the capital markets' legal infrastructure may be in its earliest stage of development.

2 Legal rules governing financial markets are perceived as somewhat limited in scope. Although regulations in banking may have been amended to accord with core principles, at least one important area of regulation is deficient – for example, capital adequacy, use of international accounting standards or use of consolidated comprehensive supervision. Oversight of securities markets appears limited and regulation of securities intermediaries and investment funds, for example, are either non-existent or rudimentary.

3 Legislation for financial markets is perceived as reasonably comprehensive but could benefit from further refinement in some areas. Banking regulations appear generally to conform with the Basle Committee's Core Principles, although regulations concerning bank insolvency and deposit protection may not have been adopted. Further refinement to the regulation of securities intermediaries and/or investment funds and the creation of shareholder depositories and registers seem to be needed to achieve conformity with minimum international standards.

4 Comprehensive financial market legislation is perceived as conforming generally with minimum international standards. However, refinement appears to be needed in at least one important area of either banking or securities regulation. For example, many jurisdictions in this category may need to enact rules concerning money laundering or bank insolvency. Legislation concerning shareholder depositories and registries seems to be in its early stages of implementation.

4+ Banking and capital markets legislation and regulation are perceived as comprehensive and in conformity with minimum international standards.

Effectiveness

1 Legal rules governing financial markets are perceived as usually very unclear and often contradictory. The regulatory support of the laws is rudimentary. Supervisory mechanisms seem to be either non-existent or poor. There appear to be no meaningful procedures to make financial laws fully operational.

2 Legal rules are perceived as somewhat unclear and sometimes contradictory. Supervision of financial institutions appears to exist only on an ad hoc basis. There appear to be few, if any, meaningful procedures in place to enforce the law. There may be a lack of adequately trained staff in either banking or capital markets regulatory authorities.

3 Although legal rules governing financial markets are perceived as reasonably clear, regulatory and supervisory support of the law may be inconsistent, creating a degree of uncertainty. Although the regulator may have engaged in corrective actions against failing banks and securities market practices, enforcement problems appear to exist.

4 Legal rules governing financial markets are perceived as readily ascertainable. Banking and securities laws appear to be well-supported administratively and judicially, particularly regarding the efficient functioning of enforcement measures against failing institutions and illegal market practices. For example, the regulator has taken corrective action to liquidate failing banks. Enforcement actions against individuals and securities intermediaries are evident, but might still benefit from more systematic and rigorous enforcement. Courts seem to have adequate authority to review enforcement decisions or other corrective actions for banks and/or securities firms.

4+ Regulators appear to possess comprehensive enforcement powers and exercise authority to take corrective action on a regular basis. Examination of securities intermediaries and licensing of intermediaries seem to be frequent, as is the use of corrective action, such as prosecution for insider dealing, revocation of bank licences, and liquidation of insolvent banks.

Overall score

The overall score in the third column of the table is the average of the scores given for the two indicators rounded down. A "+" after a number is used to indicate countries that have just made it to the highest tier of one category and are within a few points of reaching the next category in the scale. A "-" indicates countries that are at the bottom of a category where a significant improvement is required for that jurisdiction to fall more comfortably within the middle range for that category.

ment centralised pledge registry systems. In FYR Macedonia a similar decrease in scores may reflect the small number of cases that have been brought under the relatively new bankruptcy law. FYR Macedonia has recently amended its bankruptcy law in response to the perceived inefficiency of existing legislation.

Bankruptcy

In contrast to 1999, there was a marked increase in bankruptcy-related legal reform in 2000. Countries are amending their legislation, often enacted in the early to mid-1990s, in an effort to improve the implementation of the law and to encourage greater use of bankruptcy procedures. Amendments often refine and clarify issues such as the nature of a bankruptcy trustee's powers and the authority and role of the judiciary in bankruptcy proceedings.

Ukraine adopted a new bankruptcy law that came into force in January 2000. The new Ukrainian law widens the category of persons that may initiate bankruptcy proceedings and establishes the minimum debt that may serve as the basis for a bankruptcy. It also provides for the appointment of a trustee (referred to as an arbitration manager) who must have specialised training in law, economics or another related profession.

Romania modified its bankruptcy law in the second half of 1999. Under the amendments, many of the duties previously held by judges have been shifted to the bankruptcy administrator, thus clarifying the division of labour. Despite these recent amendments, Romania received only an average score for the extensiveness and effectiveness of its bankruptcy law. Possibly, practitioners have yet to become well-acquainted with the new law and have not had significant experience in utilising the legislation.

In the first half of 2000 the Czech Republic amended its bankruptcy law partly in response to pressure from the EU. Since 1991, there have been more than ten amendments to the law. The frequent amendments have created a perception that the bankruptcy law is ineffective. Delays in bankruptcy proceedings are a persistent problem in the Czech Republic. Some commentators have also noted that under the current law company management is able to strip a debtor of its assets during the lengthy period between the filing of a petition for bankruptcy and the time when the court declares a company officially bankrupt. The Czech amendments reduce that period to ten days.

The Slovak bankruptcy law has similarly needed revision. Revisions adopted in 2000 provide for the replacement of management and prevent the transfer of capital out of an insolvent enterprise without the bankruptcy administrators' approval. The amendments also provide a reorganisation procedure as an alternative to liquidation.

Pledge law

Pledge law is the area where there has been significant legislative reform in the majority of transition countries. This corresponds to the stronger extensiveness score received by the majority of LIS countries surveyed. Bulgaria, Kazakhstan, Latvia, Poland, Romania and Ukraine received high effectiveness scores for their pledge laws. Except for Romania, each of these jurisdictions has a centralised registration system for non-possessory pledges in movable property.

Despite the enactment of extensive legal frameworks for pledges in movable property in the past few years, the implementation phase is still very much in progress, with a number of countries, such as Albania, Moldova (with EBRD assistance) and Romania, establishing centralised and computerised registration systems. Kyrgyzstan has been in the process of establishing a registry since 1997, without success. Interestingly, Hungary and FYR Macedonia, both of which have established centralised pledge registries, have received relatively low scores for pledge effectiveness. For these countries, lower effectiveness may reflect raised expectations by registry users and problems in the use of the newly established registries.

Albania has joined the group of countries with modern pledge laws permitting non-possessory pledges. The new Albanian Law on Securing Charges was passed in October 1999 and was originally supposed to enter into force in January 2000. This date has been postponed, however, until a computerised pledge registry becomes operational. Belarus adopted a new Civil Code in July 1999 that augments the 1993 Law on Pledges. Creation of a pledge, however, does not give a secured creditor priority in bankruptcy proceedings. Additionally, in Belarus there is no centralised pledge registry.

In the Czech Republic new legislation came into effect in 2000 governing the sale of property through public auctions. The legislation transfers the ability to initiate auctions from the courts to private persons. This will allow pledge-burdened banks to auction off property rather than file a lawsuit or secure the permission of the debtor. However, even with this reform, it remains virtually impossible for creditors to take non-possessory pledges in movable property.

Company law

While LIS indicators for company law continued to improve in 2000, a large implementation gap remains. The area where respondents seem to perceive the largest effectiveness problem is in the implementation of shareholder rights with respect to the ability to introduce resolutions at an annual meeting, to solicit votes by proxy and to successfully challenge the actions of management through shareholder litigation in the courts. The effectiveness problems generally correlate with the areas in which governments are revising their existing company legislation. A number of jurisdictions have enacted amendments aimed at improving minority shareholder rights and more clearly defining the way in which a company may increase or decrease its basic share capital.

Bosnia and Herzegovina adopted a Law on Business Companies in June 1999, which is reflected in the country's increased extensiveness score in 2000. Latvia's extensiveness score for commercial law also increased in 2000. This probably reflects amendments to Latvia's Law on Joint Stock Companies, which provides greater protection for minority shareholders, including new limits on increases in equity capital, changes in the rights of the general meeting of shareholders, and a change in the minimum number of supervisory board members. Lithuania's company law scores also increased significantly in 2000 in response to amendments made to its company law that tighten rules on related party transactions.

LIS financial markets results

Overall, indicators for the financial markets were much higher than those in the commercial law portion of the LIS. To some extent, this may reflect actions on the part of government and financial regulators to move their legislation into conformity with international standards. Additionally, the benchmarks for legislative and other harmonisation with international standards may be clearer in financial markets as compared with commercial law. For both banking and capital markets, principles have been established by international organisations and agreed to by a wide group of nations. Both the Basle Core Principles and the IOSCO Principles of Effective Securities Regulation are examples of measurement tools to which countries can adapt their legislation. Because there is greater consensus about what constitutes effective regulation in financial markets, the perception of LIS respondents tends to vary less as well.

EU accession countries have continued to harmonise their financial service legislation with relevant EU directives in order to provide for greater disclosure and transparency in capital markets and to provide for bank depositor protection in the area of banking. These countries topped the charts for extensiveness in the financial markets survey. Of the accession countries, Hungary, Lithuania, Poland and Slovenia also had high effectiveness scores.

There has also been a greater emphasis on consolidated supervision across the financial sector through the formation of “super regulators”, which supervise banking, capital markets and insurance sectors. In 2000, Latvia and the Slovak Republic enacted legislation that will create these consolidated super regulators.

Capital markets

Capital markets indicators for extensiveness continued to improve in 2000 with a large number of countries receiving high scores, including Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, Russia and Slovenia. The majority of these are EU accession countries or are involved in the World Trade Organization (WTO) accession process, both of which impose requirements on states with respect to trade in financial services. However, despite these high extensiveness scores, these countries still show a marked implementation gap. Effective implementation and enforcement of capital markets laws remains a problem throughout the region, possibly due to the need to create independent capital market regulators.

Both Armenia and Azerbaijan adopted new capital market legislation in the second half of 1999. The new Armenian Law on the Regulation of the Securities Market covers the issue, purchase and sale of securities and establishes the Armenian Securities Commission. The new Azerbaijan Law on the Protection of Rights and Interests in the Securities Markets includes penalties for those who violate stock market laws, and establishes a fund to compensate shareholders whose interests may be harmed by such violations. Azerbaijan also created a new State Commission for Securities in late 1999.

Lithuania’s scores increased dramatically in 2000 corresponding to a wave of reform in the capital markets sector. The Lithuanian Securities Commission approved the Rules of Secondary Trading Outside of the Stock Exchange, which regulate securities transactions conducted outside the stock exchange and establish procedures for dissemination of information on these transactions. Lithuania also enacted a new Law on Investment Companies, which will make it easier for such companies to be established.

Georgia’s capital markets score increased significantly in 2000, reflecting the creation of a stock exchange in autumn 1999 with more than 25 members. This follows the enactment of legislation in 1998 that created an independent securities regulator. However, Georgia’s low effectiveness indicator reveals that much remains to be done before these new regulatory institutions are perceived as operating effectively.

The Czech Republic’s indicators improved in 2000 in response to efforts to address shortcomings in its capital market regulations. In an effort to improve disclosure on the stock market, the Prague Stock Exchange tightened its listing rules in the second half of 1999 to require companies to make public information on their subsidiaries, the volume of outstanding loans, the names of creditors and significant changes to management and boards of directors. Listed companies also must report any change in their financial situation that might affect the price of their securities.

Ukraine’s capital markets indicators also increased significantly in 2000. Ukraine’s State Commission on Securities and Stock Markets adopted new regulations, which specify the type of information that must be disclosed by public joint-stock companies and bond issuers.

Russia’s capital market indicators remained relatively stable reflecting the uncertainty over the passage of proposed changes in securities market regulations. During spring 2000, amendments to the Joint Stock Company Law and a new Law on Collective Investments were introduced into the Duma. These laws would tighten minority shareholder protection and rationalise the regulation of investment funds respectively. To date, these reforms remain under consideration by the Federal Assembly.

Banking

Although banking indicators are not as high as those for capital markets, there is less of an implementation gap in the banking scores. According to LIS respondents, banking supervision has been moderately effective throughout the region. This perception may reflect the fact that in many jurisdictions (for example in the Baltic states and south-eastern Europe) bank failures have forced regulators to take a more active role in banking supervision and oversight.

In Kyrgyzstan the Government has taken various supervisory actions against failing banks, including revoking the licences of four banks and suspending the licence of another. One of these banks has been restructured and handed over to a newly created bank, which is fully controlled by the Kyrgyz National Bank. A second bank is now under the National Bank’s special administration as well.

In July 1999, Russia enacted the Law on Restructuring of Credit Organisations establishing a new government entity, the Association for the Restructuring of Credit Organisations (ARCO). The law provides for the reorganisation of troubled banks provided that the Russian Central Bank recommends that they be restructured. ARCO has been criticised for its slow start and lack of aggressive action to clean up the Russian banking sector. Russia’s low banking indicators in the LIS reflect these unfulfilled expectations.

Ukraine has also received lower scores for the extensiveness and effectiveness of its banking system. Early in 2000 the National Bank of Ukraine gained authority to impose fines on directors of banks and other credit institutions for failing to meet National Bank requirements. However, Ukraine’s present banking law was adopted in 1991 and requires revision to match developments in commercial banking. Ukraine is currently considering a new law on banks and banking activity, which will introduce procedures for liquidating commercial banks and for insuring individual deposits. Under the proposed law, the National Bank will have the authority to establish minimum capital requirements for various types of banks.

The Czech Republic has received lower effectiveness scores in the banking sector than many of its EU accession counterparts. Czech banks have been criticised for poor corporate governance, and the EU has criticised the Czech Government for problems in implementing prudential regulation.

Belarus's increased financial market indicators in 2000 are likely to be a response to legislative activity in the banking sector. The Government approved the Rules on the Creation and Activity Regulation of Banks in February 2000, and the National Bank introduced beneficial terms for the formation and operation of banks in free economic zones.

Annex 2.3: Infrastructure transition indicators

The transformation of infrastructure services to meet the requirements of a market economy is central to the transition in central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS). In recognition of the importance of infrastructure, previous *Transition Reports* have included assessments of progress in infrastructure transition, focusing in particular on electric power, water and waste water, telecommunications, road and rail. This annex updates the analysis provided in Annex 2.3 of the *Transition Report* 1999.

The indicators focus on three broad areas of reform: tariff reform, commercialisation of infrastructure enterprises, and regulatory and institutional development. Indicators are defined on a scale of 1 to 4+, with specific criteria for scoring in each sector. The rating scales for each sector are based on sector-specific transition challenges and corresponding paths of reform. Each path is broadly defined to encompass alternative reform models that might be appropriate in different contexts, although the criteria do include judgements about the order of reforms.

For example, power sector reform indicators give equal value to competition based on a pool or third-party network access. In either case, market liberalisation will be difficult to implement if electricity tariffs are not first re-balanced to eliminate cross subsidies. In the municipal sector, asset divestiture and franchising are given equal value. However, privatisation is regarded as more likely to succeed if it occurs after tariffs have been raised towards the level of long-term costs.

Table A.2.3.1 presents the infrastructure indicators for 2000. Progress in infrastructure reform has continued to advance in the past year, resulting in ten countries being upgraded in the power sector, six in rail, six in telecommunications, two in roads, and two in water and waste water. There was one downgrade – the power sector in Kazakhstan. Most of the progress was concentrated in the advanced countries of CEB, where the prospect of EU accession, the need for securing private finance and the raising of receipts through asset sales (particularly in the power and telecommunications sectors) continued to propel reforms.

In the railways sector new laws were approved in Ukraine and Uzbekistan for corporatisation and the introduction of medium-term business planning respectively. Business plans represent an initial step in the commercialisation of the railways, helping to identify investment priorities and financial needs. Initial business plans have also been developed, or improved, over the past year in the railways sector of Azerbaijan, Kazakhstan and the Slovak Republic. In Poland a new railway law envisages labour restructuring, the unbundling of the railway into separate freight, passenger and infrastructure companies, and privatisation.

Participation of the private sector is beginning to expand in activities beyond the provision of direct railway services. Private sector initiatives for the production of concrete sleepers and for the supply of locomotives under contract are developing in Azerbaijan and Kazakhstan respectively.

The principle of public service obligation (PSO), moreover, is slowly gaining acceptance throughout the region. Under this principle, the state agrees to provide financing for those non-commercial services that the railways are asked to provide for social or other reasons (for example, rural passenger services). PSO introduces transparency into the financial accounts of the railways and increases awareness in government of the cost imposed by loss-making services.

In the electric power sector, private sector participation continued to expand with further asset sales in Estonia, Georgia and Moldova. In Albania, private management was introduced into power companies. Building on new legislation, Armenia, Bulgaria and Romania have established independent regulators and have begun to draft secondary legislation (tariff rules, grid codes, etc.). However, the independence of the regulators in setting tariffs for privatised companies remains to be tested. Industry restructuring is moving ahead in these three countries, and privatisation of power distribution is expected later in 2000 or in 2001. New legislation has also been passed in Lithuania, and a privatisation adviser has been appointed.

Power industry privatisation is high on the reform agenda in both Kyrgyzstan and the Slovak Republic. Both countries have hired privatisation advisers, but the enabling legislation and implementation plans remain undeveloped. Power sector restructuring is also being actively debated in Russia, but the precise form of industry restructuring has not been clarified. In Ukraine, where privatisation is moving forwards, there have been substantial increases recently in cash collection following implementation of an action plan agreed between the Government and the international financial institutions (IFIs).

One country moving backwards in the past year is Kazakhstan, which had progressed rapidly in the early stages of transition, unbundling power generation, transmission and distribution. At the same time, some assets were privatised to strategic investors and the market was liberalised. However, one strategic investor recently sold its stake back to the Government following a long dispute with the regulator over tariff levels, and another investor is currently involved in discussions with the regulator over tariffs.

The road sector has seen some developments over the past year in the area of road financing. In some transition economies it is not unusual to find road user charges based on taxes unrelated to road use, such as a company turnover tax. Such arrangements are inefficient in that

Table A.2.3.1

Infrastructure transition indicators, 2000

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

Source: EBRD.

the payments required from road users do not relate to the cost they impose on the road. However, a number of countries, including Ukraine and Armenia, have recently abolished this type of tax and replaced it with a new, or modified, fuel tax. In general, road user charges should be based on vehicle and fuel taxes. Some EU accession countries still need to introduce vehicle taxation (for example, Estonia). Most still have to review their existing vehicle taxation to harmonise it with EU legislation, which is based on a combination of gross vehicle weight, axle loads and suspension systems.

Road funds continue to show mixed success. They can be found across the region – in Azerbaijan, Bulgaria, Belarus, Bosnia and Herzegovina, the Czech Republic, FYR Macedonia, Latvia, Lithuania, Poland, Romania and the Slovak Republic. Most road funds serve primarily as a vehicle for collecting revenue from road user charges. However, many have suffered recent setbacks. Hungary recently abolished its Road Fund, and Russia might soon follow suit due, paradoxically, to its success in collecting revenues (in both cases, road revenues far exceed spending, and there is political pressure to divert funds elsewhere). A number of road funds (one centrally based and one for each oblast) were established in Ukraine in 2000, but revenues were soon diverted to the central budget by presidential decree.

In the water and waste-water sectors, there have not been major changes in rules and enforcement practice in most countries. In Bulgaria, however, the municipality of Sofia has chosen a comprehensive private sector solution by awarding in December 1999 a concession agreement to an international operator for the operation of the Sofia water and waste-water system. In Lithuania a new

Classification system for infrastructure transition indicators, 2000

Telecommunications

1 Little progress has been achieved in commercialisation and regulation. There is a minimal degree of private sector involvement. Strong political interference takes place in management decisions. There is a lack of cost-effective tariff-setting principles, with extensive cross-subsidisation. Few other institutional reforms to encourage liberalisation are envisaged, even for mobile phones and value-added services.

2 Modest progress has been achieved in commercialisation. Corporatisation of the dominant operator has taken place and there is some separation of operation from public sector governance, but tariffs are still politically set.

3 Substantial progress has been achieved in commercialisation and regulation. There is full separation of telecommunications from postal services, with a reduction in the extent of cross-subsidisation. Some liberalisation has taken place in the mobile segment and in value-added services.

4 Complete commercialisation (including privatisation of the dominant operator) and comprehensive regulatory and institutional reforms have been achieved. There is extensive liberalisation of entry.

4+ Implementation of an effective regulation (including the operation of an independent regulator) has been achieved, with a coherent regulatory and institutional framework to deal with tariffs, interconnection rules, licensing, concession fees and spectrum allocation. There is a consumer ombudsman function.

Electric power

1 The power sector operates as a government department. There is political interference in running the industry, with few commercial freedoms or pressures. Average prices are below costs, with external and implicit subsidy and cross-subsidy. Very little institutional reform has been achieved. There is a monolithic structure, with no separation of different parts of the business.

2 The power company is distanced from government. For example, it operates as a joint-stock company, but there is still political interference. There has been some attempt to harden budget constraints, but management incentives for efficient performance are weak. Some degree of subsidy and cross-subsidy exists. Little institutional reform has been achieved. There is a monolithic structure, with no separation of different parts of the business. Minimal, if any, private sector involvement has occurred.

3 A law has been passed providing for full-scale restructuring of the industry, including vertical unbundling through account separation and setting-up of a regulator. Some tariff reform and improvements in revenue collection have been achieved, and there is some private sector involvement.

4 A law for industry restructuring has been passed and implemented, with separation of the industry into generation, transmission and distribution. A regulator has been set up. Rules for cost-reflective tariff-setting have been formulated and implemented. Arrangements for network access (negotiated access, single buyer model) have been developed. There is substantial private sector involvement in distribution and/or generation.

4+ Business has been separated vertically into generation, transmission and distribution. An independent regulator has been set up, with full power to set cost-reflective effective tariffs. There is large-scale private sector involvement. Institutional development has taken place, covering arrangements for network access and full competition in generation.

Railways

1 Monolithic organisational structures still exist. State railways are still effectively operated as government departments. Few commercial freedoms exist to determine prices or investments. There is no private sector involvement. Cross-subsidisation of passenger service obligations with freight service revenues is undertaken.

2 New laws distance rail operations from the state, but there are weak commercial objectives. There is no budgetary funding of public service obligations in place. Organisational structures are still overly based on geographic or functional areas. Ancillary businesses have been separated but there is little divestment. There has been minimal encouragement of private sector involvement. Initial business planning has been undertaken, but the targets are general and tentative.

3 New laws have been passed that restructure the railways and introduce commercial orientation. Freight and passenger services have been separated, and marketing groups have been grafted onto traditional structures. Some divestment of ancillary businesses has taken place. Some budgetary compensation is available for passenger services. Business plans have been designed with clear investment and rehabilitation targets, but funding is unsecured. There is some private sector involvement in rehabilitation and/or maintenance.

4 New laws have been passed to fully commercialise the railways. Separate internal profit centres have been created for passenger and freight (actual or imminent). Extensive market freedoms exist to set tariffs and investments. Medium-term business plans are under implementation. Ancillary industries have been divested. Policy has been developed to promote private rail transport operations.

4+ Railway law has been passed allowing for separation of infrastructure from operations, and/or freight from passenger operations, and/or private train operations. There is private sector participation in ancillary services and track maintenance. A rail regulator has been established. Access pricing has been implemented. Plans have been drawn up for a full divestment and transfer of asset ownership, including infrastructure and rolling stock.

Roads

1 There is a minimal degree of decentralisation, and no commercialisation has taken place. All regulatory, road management and resource allocation functions are centralised at ministerial level. New investments and road maintenance financing are dependent on central budget allocations. Road user charges are based on criteria other than relative costs imposed on the network and road use. Road construction and maintenance are undertaken by public construction units. There is no private sector participation. No public consultation or accountability take place in the preparation of road projects.

2 There is a moderate degree of decentralisation, and initial steps have been taken in commercialisation. A road/highways agency has been created. Initial steps have been undertaken in resource allocation and public procurement methods. Road user charges are based on vehicle and fuel taxes but are only indirectly related to road use. A road fund has been established but it is dependent on central budget allocations. Road construction and maintenance is undertaken primarily by corporatised public entities, with some private sector participation. There is minimal public consultation/participation and accountability in the preparation of road projects.

3 There is a fairly large degree of decentralisation and commercialisation. Regulation, resource allocation, and administrative functions have been clearly separated from maintenance and operations of the public road network. Road user charges are based on vehicle and

Classification system for infrastructure transition indicators, 2000 (continued)

fuel taxes and fairly directly related to road use. A law has been passed allowing for the provision and operation of public roads by private companies under negotiated commercial contracts. There is private sector participation either in road maintenance works allocated via competitive tendering or through a concession to finance, operate and maintain at least a section of the highway network. There is limited public consultation and/or participation and accountability in the preparation of road projects.

4 There is a large degree of decentralisation of road administration, decision-making, resource allocation and management according to government responsibility and functional road classification. A transparent methodology is used to allocate road expenditures. A track record has been established in implementing competitive procurement rules for road design, construction, maintenance and operations. There is large-scale private sector participation in construction, operations and maintenance directly and through public-private partnership arrangements. There is substantial public consultation and/or participation and accountability in the preparation of road projects.

4+ A fully decentralised road administration has been established, with decision-making, resource allocation and management across road networks and different levels of government. Commercialised road maintenance operations are undertaken through open and competitive tendering by private construction companies. Legislation has been passed allowing for road user charges to fully reflect costs of road use and associated factors, such as congestion, accidents and pollution. There is widespread private sector participation in all aspects of road provision directly and through public-private partnership arrangements. Full public consultation is undertaken in the approval process for new road projects.

Water and waste water

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

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

3 A fairly large degree of decentralisation and commercialisation has taken place. Water and waste-water utilities operate with managerial and accounting independence from municipalities, using international accounting standards and management information systems. A municipal finance law has been approved. Cost recovery is fully operated through tariffs and there is a minimum level of cross-subsidies. A semi-autonomous regulatory agency has been established to advise on tariffs and service quality but without the power to set either. More detailed rules have been drawn up in contract documents, specifying tariff review formulae and performance standards. There is private sector participation through the full concession of a major service in at least one city.

4 A large degree of decentralisation and commercialisation has taken place. Water and waste-water utilities are managerially independent, with cash flows – net of municipal budget transfers – that ensure financial viability. A municipal finance law has been implemented, providing municipalities with the opportunity to raise finance. Full cost recovery exists and there are no cross-subsidies. A semi-autonomous regulatory agency has the power to advise and enforce tariffs and service quality. There is substantial private sector participation through build-operate-transfer concessions, management contracts or asset sales to service parts of the network or entire networks. A concession of major services has taken place in a city other than the country's capital.

4+ Water and waste-water utilities are fully decentralised and commercialised. Large municipalities enjoy financial autonomy and demonstrate the capability to raise finance. Full cost recovery has been achieved and there are no cross-subsidies. A fully autonomous regulator exists with complete authority to review and enforce tariff levels and performance quality standards. There is widespread private sector participation via service management/lease contracts, with high-powered performance incentives and/or full concessions and/or divestiture of water and waste-water services in major urban areas.

independent regulatory commission responsible for tariff calculation and increases was also established in December 1999.

Across all transition economies the telecommunications sector has been characterised by extensive reform and ongoing investment to upgrade and expand networks and to introduce new services (particularly in the segment of enhanced services, such as the Internet and data transmission services). In Poland a new telecommunications law was introduced in 2000, and TPSA (the dominant fixed-line operator) was partially privatised through an initial public offering. Similarly in Albania and Croatia new laws were passed, and the dominant fixed line operator in Croatia was privatised. In Kyrgyzstan an independent regulator was established, although it is expected to take some time before sufficient institutional capacity is developed for the efficient implementation of regulation. In Bosnia and Herzegovina all three operators now have international licences, and separation of post and telecommunications is currently taking place.

Annex 2.4: Environmental transition indicators

The transition countries of central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) cover a vast and diverse region with different geographical, environmental and socio-economic conditions. Environmental transition indicators have to take into account that these countries are moving towards market-based economies as well as trying to achieve sustainable development. They take into consideration, therefore, both economic efficiency and environmental sustainability, which are fully realised only when market, institutional and environmental reforms come together.

The assessment in this annex uses a "pressure-response-state" framework and draws on a survey among environment ministries in the region. Following a similar analysis in 1997, the survey aimed to obtain information about the development of environmental policies, environmental liabilities, environmental regulations, institutional capacities and participation by civil society.

Pressure on the environment

The slump in economic activity in the early phases of transition led to a reduction in most environmental pressures. One of the few exceptions is municipal waste generation, where waste volumes remained constant, probably due to the early adoption of Western consumer behaviour in urban areas and industrial reform (see Chart A.2.4.1). As household incomes increase, municipal waste management will become increasingly important. For other sectors, the question is whether transition will result in sufficient efficiency gains to prevent economic growth leading to an adverse impact on the environment.

A definite answer is not yet possible. Nevertheless, initial data for advanced transition countries show that economic growth has intensified pressure on the environment in some respects, but not in others. Chart A.2.4.2 provides evidence on air pollution. The burning of fossil fuels for power generation in industries and in the domestic sector is the most significant cause of air pollution.

Transition economies still have exceptionally low levels of energy efficiency. In CEB and SEE countries energy efficiency is still only half of the level in western Europe, although it is improving. In CIS countries energy efficiency is over four times lower than the standard of western Europe (see Annex 2.4 of *Transition Report* 1999). However, in countries such as Poland and the Slovak Republic energy use has started to decrease owing to efficiency-enhancing restructuring, the shift from an industrial to a service-based economy, increased energy tariffs and more rigorous collection.

At the same time, the installation of modern pollution abatement technology, the switch to cleaner fuels and the replacement of old boilers have reduced emissions. The preparation for EU accession and the adoption of EU environmental standards are also leading to additional investments in the environment. The overall result has been a noticeable reduction in air pollutants, such as SO_2. In other transition countries lower air emissions are mostly due to reduced economic activity.

Of course, the emission reductions already achieved may not be sufficient to ensure sustainable development, and they could be reversed. Growing wealth associated with the steady progress in transition will result in more consumption-related environmental pressures. The increase in private car ownership in advanced countries is already putting renewed pressure on urban air quality, in particular NO_x, and is aggravating traffic congestion. Car ownership (in terms of passenger cars per 1,000 people) in some transition countries, such as Slovenia (403), the Czech Republic (358) and Estonia (312), is now equal to that in west European countries, such as Belgium (435), France (392) and Portugal (309).

Response to environmental problems

Transition countries are implementing various policy, economic, legal, institutional and social responses to address environmental problems. The challenge of transition is to develop a system of environmental control that is compatible with a market economy (for example, by providing price incentives) and to create an effective institutional framework that can enforce compliance and ensure the non-discriminatory application of rules. The quality of this framework depends on the factors listed below.

Environmental policy

Measuring progress in environmental policy is difficult. National Environmental Action Plans (NEAPs) and the participation in, and implementation of, international environmental treaties have been used as indicators of environmental policy reform (see Annex 2.4 of *Transition Report* 1999). According to this measure, transition economies have made further progress over the last year. Of the 26 countries covered by this report, 22 have prepared a NEAP. In the remaining four countries NEAPs are under preparation (see Table A.2.4.1).

Environmental liability

Past contamination is a pressing issue across the region, especially soil contamination related to large industrial plants and military bases. The issue of liability for this contamination raises complex legal, financial and commercial questions and is considered problematic even in Western countries. In the context of privatisation, there are broadly two ways of dealing with environmental liabilities. The first is to assign sole responsibility to the former owner (the state), who then indemnifies the new owner. The second way is to share the cost of mitigation between buyer and seller, based on an environmental audit and assessment of the likely risks. Under this system, the mitigation costs are deducted from the purchase price, and the new owner takes over environmental liability for the contaminated property. Both approaches are common in the region (see Table A.2.4.1).

Environmental expenditure

The amount of money spent on environmental protection is an indicator of commitment and institutional capacity. In transition economies environmental issues are relatively low on the list of government priorities, and state budgetary allocations are correspondingly low. A number of countries have, however, established environmental funds, which are fed from environmental charges (for example, on pollution or resource use) and fines. If these funds are included, environmental expenditure in Hungary (0.6 per cent in 1996), Poland (1.0 per cent in 1996) and Slovenia (0.7 per cent in 1997) as a percentage of GDP is comparable to the level in high-income OECD countries. In other transition countries, environmental expenditure still lags behind. In Russia, for example, environmental expenditure in 1998 accounted for 0.03 per cent of total federal expenditure.

Financial incentives

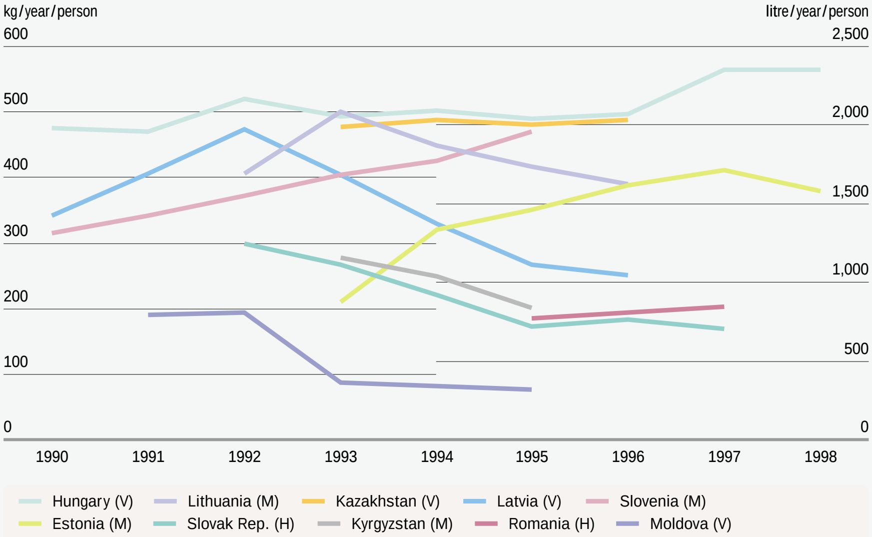
Many transition countries have comprehensive systems of permits, pollution charges and non-compliance fees (see Table A.2.4.1). In most cases, their main objective is to raise revenue for environmental funds, which in CIS countries tend to be an important source of finance for environmental agencies. The effect of emission and effluent charges is undermined by the low level of energy and water tariffs and poor collection rates in many transition economies. This reduces the incentive for consumers to make efficient use of resources. One exception is Poland, which has among the highest pollution charges in the world for certain pollutants (for example, SO_2).

Civil society

The right of organisations and individual citizens to voice their views on development proposals, plans and policies is an indispensable element of a democratic society. All transition countries have in place basic environmental laws and rules for environmental impact assessment (EIA). However, clear and transparent EIA procedures, including public participation, are limited to a handful of transition countries (for example, Bulgaria, Croatia, FYR Macedonia, Hungary and Poland). Public

Chart A.2.4.1

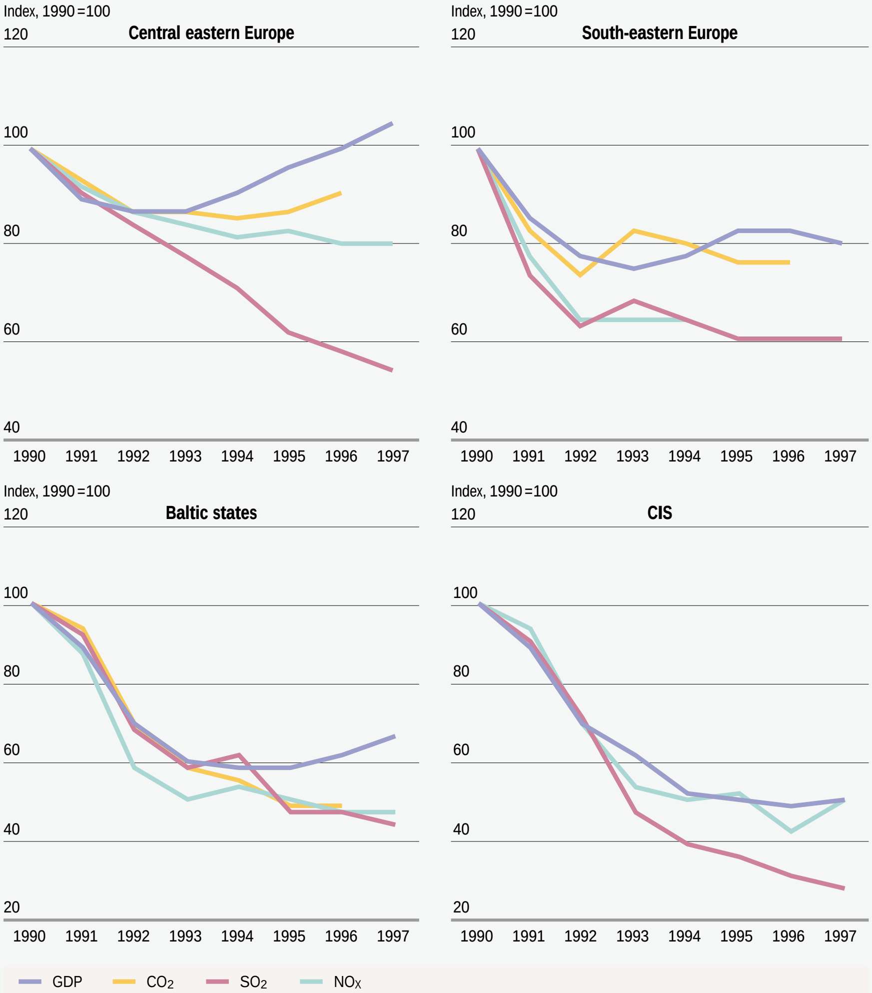
Change in waste production in selected countries



Source: UNEP-GRID State of Environment reports.
V: municipal waste in volume (litre/year/person) - refer to scale on the right
M: municipal waste in weight (kg/year/person) - refer to scale on the left
H: household waste in weight (kg/year/person) - refer to scale on the left

Chart A.2.4.2

Emission of major pollutants



Sources: Co-operative Programme for Monitoring and Evaluation of the Long-range Transmission of Air Pollutants in Europe (EMEP) and Carbon Dioxide Information Analysis Center (CDIAC).
Note: CIS data exclude Central Asia, Azerbaijan and Georgia.
SEE excludes Albania, Bosnia and Herzegovina and FYR Macedonia.

Table A.2.4.1

Privatisation and environmental liability

		Economic instruments				Liability for past contamination	
		Air emissions		Water pollution			
	NEAP completion	Emissions charge	Non-compliance fee	Effluent charge	Non-compliance fee	Audit requirements	Indemnification
Albania	✔	na	na	na	na	na	na
Armenia	✔	na	✔	na	na	na	na
Azerbaijan	✔	✔	✔	✔	✔	under preparation	no
Belarus	✔	✔	✔	✔	✔	no	no
Bosnia and Herzegovina	under preparation	no	no	no	no	no	no
Bulgaria	✔	no	✔	no	✔	✔	✔
Croatia	to be completed 2000	no	✔	✔	✔	no	no
Czech Republic	✔	✔	✔	✔	✔	✔	na
Estonia	✔	✔	✔	✔	✔	na	na
FYR Macedonia	✔	na	✔	✔	✔	na	na
Georgia	✔	✔	✔	✔	✔	✔	no
Hungary	✔	no	na	no	✔	✔	✔
Kazakhstan	✔	✔	✔	na	na	no	✔
Kyrgyzstan	✔	✔	✔	na	na	no	no
Latvia	✔	✔	✔	✔	✔	✔	no
Lithuania	✔	✔	✔	✔	✔	na	na
Moldova	✔	✔	✔	✔	✔	✔	no
Poland	✔	✔	✔	✔	✔	no	no
Romania	✔	no	✔	✔	✔	✔	no
Russia	✔	✔	✔	✔	✔	✔	no
Slovak Republic	✔	✔	✔	✔	✔	na	no
Slovenia	✔	no	no	no	no	✔	no
Tajikistan	under preparation	✔	✔	✔	✔	no	no
Turkmenistan	under preparation	✔	✔	✔	✔	no	no
Ukraine	✔	✔	✔	✔	✔	no	no
Uzbekistan	✔	✔	✔	✔	✔	no	no

Sources: EBRD questionnaire survey and interviews with environmental ministries and *Investors' Guidebooks for Environment, Health and Safety*, The Stationery Office, London.

Note: ✔ = yes

access to environmental information has not yet become the norm in any transition country. The ratification of the Aarhus Convention on Access to Information, Public Participation in Decision-making and Access to Justice in Environmental Matters is expected to improve the situation in the medium term. By August 2000, 20 countries in the region had signed the convention.

Non-governmental organisations (NGOs) make an important contribution to civil society, and their role in influencing environmental policy is increasing across the region. NGOs played a prominent role, for instance, in the preparation of NEAPs. According to one survey, there are now over 3,000 environmental NGOs in CEB and SEE – almost a third of them in the Czech Republic, Hungary and Poland. Approximately 270 environmental NGOs are reportedly operating in Central Asia. However, most NGOs are small and do not have paid staff. Contributions to NGOs are rarely encouraged through tax incentives.

State of the environment

Transition entails changes in economic structure and output, consumption patterns and social and policy responses. These changes have repercussions on the environment, although reliable data to document the relationship between transition and the state of the environment are scarce. Improvements in environmental quality have been reported, for example, in the Czech Republic, Hungary, Slovenia and Poland in spite of overall economic recovery and growth. The Baltic states, Croatia and the Slovak Republic appear to follow this trend. In most other transition countries the reduction of total emission and effluent tends to be linked to the reduction of total output.

Table A.2.4.2 reports data on urban air quality in some of the major cities of the region. It shows that the air quality in most cities is more or less on a par with that of Paris, New York or Tokyo. Many exceed air quality guidelines of the World Health Organization (WHO) for at least some periods during the year. Moreover, it should be noted that air pollution in many industrial towns is much higher than in the capital cities.

This annex has illustrated the complexity of the relationship between economic transition and environmentally sustainable development. Although some advanced countries have experienced improvements in environmental quality, the region still faces major challenges to improve its environment and to attain sustainable development.

Table A.2.4.2

Air quality in major cities

Country	City	SO_2 ug/m^3	SO_2 Year	NO_2 ug/m^3	NO_2 Year	Particulates ug/m^3	Particulates Year
Albania	Tirana	9	1995	na	–	56	1995
Armenia	Yerevan	110	1998	180	1998	600	1998
Belarus	Minsk	1	1996	40	1996	200	1996
Bosnia and Herzegovina	Sarajevo	12	1995	36	1995	38	1995
Bulgaria	Sofia	17	1999	21	1999	132	1999
Croatia	Zagreb	20	1996	43	1996	36	1997
Czech Republic	Prague	35	1997	75	1997	59	1996
Estonia	Tallinn	1	1999	32	1999	93	1999
FYR Macedonia	Skopje	25	1998	40	1998	53	1998
Georgia	Tbilisi	190	1998	40	1998	300	1998
Hungary	Budapest	39	1997	46	1997	55	1997
Kazakhstan	Almaty	na	–	60	1996	150	1996
Kyrgyzstan	Bishkek	5	1997	52	1997	480	1997
Latvia	Riga	43	1997	75	1997	100	1996
Lithuania	Vilnius	9	1997	42	1997	95	1997
Moldova	Chisinau	3	1996	40	1999	140	1999
Poland	Warsaw	12	1997	25	1997	81	1995
Romania	Bucharest	11	1997	96	1997	103	1997
Russia	Moscow	2	1997	26	1997	100	1997
Russia	St Petersburg	7	1997	98	1997	156	1997
Slovak Republic	Bratislava	18	1998	63	1998	46	1997
Slovenia	Ljubljana	29	1996	39	1996	57	1996
Turkmenistan	Ashghabat	50	1997	36	1997	375	1997
Ukraine	Kiev	30	1998	100	1998	135	1998
Uzbekistan	Tashkent	10	2000	72	2000	150	2000
Comparison							
France	Paris	14	1995	57	1995	14	1995
USA	New York	26	1995	79	1995	62	1994
Japan	Tokyo	18	1995	68	1995	49	1995
China	Beijing	90	1995	122	1995	377	1995
Standards							
EU	–	60	–	–	–	150	–
WHO	Annual average	50	–	40	–	60-90	–

Sources: UNEP-GRID State of the Environment Reports (national or city); *World Development Indicators 2000;* WHO; the European Environment Agency; EBRD survey. Note that methodologies and results are not necessarily consistent across studies.

Note: ug = microgram

Macroeconomic performance and prospects

3

Strong growth has returned to most transition countries. The recovery that began in Russia and many other countries around the middle of 1999 is now in full swing and average growth for the region as a whole is estimated to be close to 5 per cent in 2000. Moreover, almost all countries now have relatively stable exchange rates and low inflation rates. Perhaps the most striking aspect of the current recovery is that for the first time since the start of transition it is broadly based across the region. Indeed, growth rates in a majority of countries in the Commonwealth of Independent States (CIS) in 2000 will exceed those achieved in central and eastern Europe and the Baltic states (CEE).[1] In 2000, for the first time, the region's largest economy, Russia, is expected to grow faster than the region's second-largest economy, Poland.

While these are encouraging trends, differences in overall performance between the advanced transition countries in CEE and the less advanced reformers further east remain significant. For instance, while CEE as a whole has almost reached its pre-transition output level, it would take the CIS at least a decade of comparably high growth rates to recover the output lost during the first decade of transition. Moreover, growth rates will have to exceed those in CEE for several generations if the CIS is to catch up with the income levels in the more advanced transition economies. Fiscal and external imbalances also vary substantially across the region, as do their underlying causes. Such differences reflect not only different progress in reforms but also deeper variation in economic structure and levels of development, many of which were already present under central planning.

This chapter assesses recent developments in the region and considers some of the risks that might derail the current positive trends. The main findings of the chapter are:

- Recovery across the region has benefited from a favourable global environment. Surging manufacturing exports to western Europe are driving growth in most of CEE. Similarly, the economies of the CIS countries have benefited from higher demand and prices for their commodity exports. Nevertheless, the CIS is mainly reaping the benefits of large currency devaluations, sheltering their producers from import competition.

- The countries of the region have overcome the direct effects of the financial crises in Asia and Russia. Modest corrections to macro policy have allowed most countries in CEE to survive the turbulence of the past years without much damage. The impact on the CIS was much larger, and some of the effects will be less transitory. All countries excluding Armenia have experienced a drastic real depreciation of their currencies. While this has created opportunities for import-substituting industries, it has also caused external debt burdens to increase dramatically, raising questions about their sustainability.

- In most transition countries the size of governments is still large when compared with OECD economies. For the EU accession countries this poses a risk of widening fiscal imbalances caused by the high public expenditure required for accession. Financing this from increased taxes will be difficult, given already high tax burdens. The challenge will therefore be to streamline expenditure, enhance the efficiency of public administration and improve the effectiveness of social assistance. In the CIS public finances are increasingly dependent on a few commodity sectors and are exposed therefore to the volatility of commodity prices. Rising debt service payments will increase the urgency to shift to a broad and more reliable tax base.

- The advanced countries of CEE will have to continue to attract large capital inflows, reflecting their relatively low domestic savings rates and the need for high investment rates to fuel growth. For the CIS the main risks to the external balance arise from the dependence on commodity exports, from high external debt service and from continued capital flight.

The analysis in this chapter is based on a set of macroeconomic indicators collected for all transition countries over the past ten years and reported in Annex 3.1. Further macroeconomic data for each country can also be found in the country assessments at the back of the Report. It is important to recognise the limitations of official statistics in many transition economies. While significant improvements have been made, inadequate price deflators, large shadow economies and inconsistencies in the underlying data concepts create serious distortions in the official data and complicate cross-country comparisons.

As in previous years, the EBRD has surveyed a number of institutions with expertise in the region to find out their assessment of growth and inflation in 2000 and 2001. These forecasts are in Tables A.3.10 to A.3.13 in Annex 3.1.

Section 3.1 examines recent economic developments and prospects across the region. Sections 3.2 and 3.3 examine key risks to the macroeconomic outlook for the region, focusing on fiscal deficits and external imbalances respectively. Section 3.4 provides some conclusions.

3.1 Recent economic developments

For the first time since the start of the transition, the whole region is likely to grow for a second consecutive year (see Chart 3.1). Indeed, the average weighted growth for the region is forecast to be 4.8 per cent, a significant accelera-

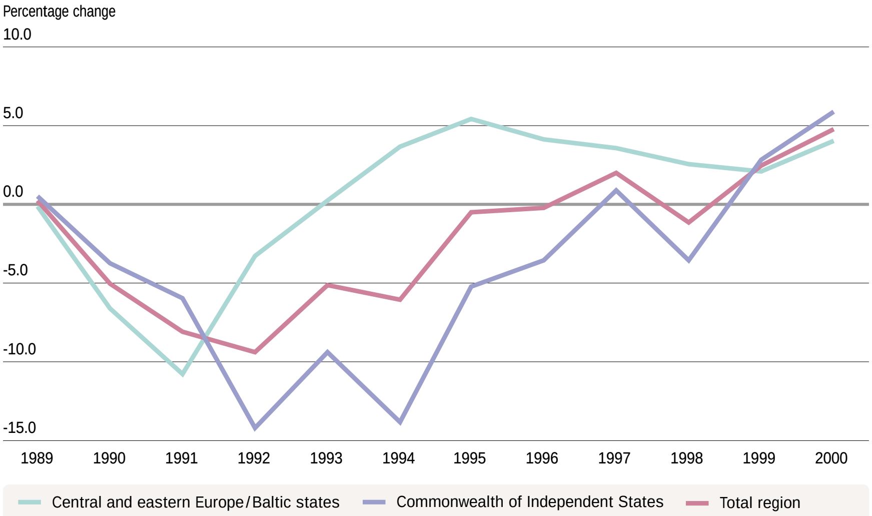
[1] In much of this chapter, the analysis focuses on two broad regions: central and eastern Europe and the Baltic states (CEE) and the CIS. Where appropriate, the former region is divided further into central eastern Europe and the Baltic states (CEB) and south-eastern Europe (SEE) following the analytical division provided inside the front cover of the Report. In the CIS occasionally separate reference is made to Russia and Ukraine as structurally distinct from the so-called CIS periphery.

tion from the 2.5 per cent recorded in 1999. Average growth in CEE is likely to accelerate to 4.1 per cent in 2000 from 2.1 per cent in 1999, while average growth in the CIS is expected to reach 5.9 per cent, up from 2.8 per cent in 1999.

However, differences between the regions remain large, both with regard to their overall macroeconomic performance since the start of reforms and with regard to the causes for their present high growth rates. Over the past year, the countries of central eastern Europe and the Baltic states (CEB) have benefited from the strong recovery under way in western Europe. South-eastern Europe (SEE) is also benefiting from growth in the EU, but remains more fragile due to political instability in Yugoslavia and less robust macroeconomic and structural reforms. In contrast, the return to growth in the CIS has been driven primarily by the large depreciations of the exchange rates.

Chart 3.1

Growth in real GDP for central and eastern Europe and the Baltic states and the Commonwealth of Independent States



Source: Table A.3.1.
Note: Regional weights are computed on the basis of GDP in US dollars for the previous year.

Central and eastern Europe and the Baltic states

Growth is accelerating thanks to EU demand

Over recent years, strong growth in CEB has been associated with robust export performance (see Table A.3.2 in Annex 3.1). However, in 1999 this general pattern was temporarily broken for some countries as important export markets collapsed following the Russian crisis and the Kosovo conflict. As a result, sharp differences in economic performance across the region emerged. Only three countries continued to have strong growth in exports in 1999: Hungary, the Czech Republic and the Slovak Republic. In the latter two, strong export performance was, however, insufficient to offset depressed domestic demand as a result of macroeconomic austerity measures and weak financial systems.

Other countries of the region suffered severely from the collapse of export markets. In Poland a slowdown of the economy was only avoided in 1999 as a result of the significant relaxation of monetary and fiscal policy that contributed to high growth of private consumption and gross fixed investment and almost a doubling of the current account deficit. The collapse of the Russian market meant that all three Baltic states entered into recession in 1999 despite expansionary fiscal policies. In part this was due to the loss of confidence in their fixed exchange rate regimes, necessitating a sharp rise in real interest rates that stifled private consumption and investment.

Furthermore, most countries in SEE witnessed a sharp downturn either because of the collapse of the Russian market or through the effect of the conflict in Kosovo on trade and external financing conditions. In Romania these adverse external developments were compounded by domestic imbalances caused by delays in stabilisation and fiscal consolidation and a significant backlog in crucial structural reforms. As a result, GDP has been in continuous decline since 1997.

In 2000, however, growth in almost all CEE countries is accelerating and exports are once again the main driving force (see Chart 3.2). All countries of the region are benefiting significantly from the recovery under way in the EU.[2] This continues to be especially true for Hungary, with growth likely to reach 6 per cent for 2000 as a whole. The return to growth in the Czech Republic of at least 2 per cent in 2000 is also mainly driven by exports to the EU, although domestic demand has strengthened as well. Even in Poland export growth has started to show signs of recovery and should help Poland sustain growth of around 5 per cent in 2000.

Growth in the Baltic states is also now resuming strongly as a result of exports, with particularly strong export-led growth under way once again in Estonia. Similarly, fuelled by EU demand, export-led growth is taking root in SEE. For example, exports in Bulgaria increased 20 per cent year on year in the second quarter of 2000 after a subdued performance in 1999. In Romania, positive growth of around 1.5 per cent is expected in 2000, with exports set to rise at double digit rates on the back of a large real exchange rate adjustment.

Inflation is picking up

Inflation has started to rise in most countries. Supply-side factors (such as the high prices for energy and for food, following recent droughts) and sharp increases in administered prices have played an important role in Croatia, the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia. For

2 The EU decision at the Helsinki Summit in December 1999 to extend formal accession negotiations to Bulgaria, Latvia, Lithuania, the Slovak Republic and Romania (in addition to the negotiations already under way with the Czech Republic, Estonia, Hungary, Poland and Slovenia) has also given a boost to growth within the region. Accession prospects have spurred reforms in many countries and stabilised expectations, thus supporting rapid investment growth (as in Bulgaria for instance). The negotiations under way within the framework of Stabilisation and Association Agreements launched in May 1999 for SEE are hoped to have similar positive effects on the economic outlook of the region.

example, in Hungary the Central Bank increased key interest rates by 100 basis points in October 2000 because of inflationary pressure (this increase was the first since the Russian crisis).

The recent surge in Polish headline inflation also resulted in part from the poor harvest and the Government's policy of protecting domestic food producers by restricting imports, as well as high world oil prices. However, the loosening of monetary policy during late 1998 and early 1999 to sustain domestic demand was an important additional factor contributing to recent price increases. In response, the Polish Central Bank has raised interest rates by 600 basis points since August 1999 to constrain domestic demand, but in doing so it faces a difficult trade-off between trying to meet its inflation target and undermining the recovery of exports by putting upward pressure on the zloty. Romania is likely to be the only country in CEE to continue to have high inflation, although inflation has been on a downward trend since the end of 1999.

External balances are improving but they remain high

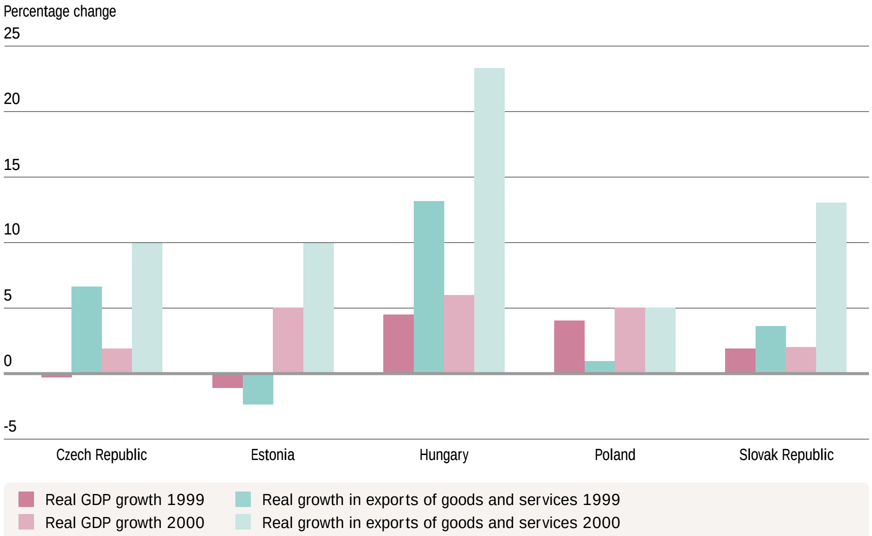
Strong export performance has led to some improvements in the current accounts of a majority of countries in CEE in early 2000. This is particularly striking given the high dependence of the region on energy imports and, thus, their vulnerability to the trebling of crude oil prices since early 1999.

According to IMF estimates, an increase in the price of oil of US$ 5 a barrel above its baseline assumption of US$ 26.53 a barrel in 2000 would lead to an increase in the current account deficit in the order of 0.5 to 1 per cent of GDP in Bulgaria, Croatia, the Czech Republic, Hungary and Slovenia, and greater than 1 per cent of GDP in Lithuania and the Slovak Republic.[3] It is therefore fortuitous that the positive impact from the EU's strong recovery has coincided with the potentially serious negative impact of high oil prices. Yet, this also highlights the particular vulnerability of the region to any slowdown in EU growth as a result of currently high energy prices.

[3] IMF, *World Economic Outlook*, September 2000.

Chart 3.2

Real GDP growth and real export growth 1999 and 2000, selected countries in central and eastern Europe and the Baltic states



Source: EBRD.

Note: Data for 1999 are EBRD staff estimates based on the latest available official statistics and data from the IMF. Data for 2000 are EBRD staff forecasts.

Notwithstanding the recent improvements, current account deficits in CEE remain high, at close to 5 per cent of GDP or more in eight of the 13 countries. In the short term these countries should not face any problems in financing such large external deficits. In most cases current account deficits are covered by sizeable surpluses on the capital account resulting from high mainly privatisation-related inflows of foreign direct investment (see Chart 3.3). Indeed FDI inflows have increased significantly in 2000 (see Chapter 4). This should mitigate concerns about the size of the deficit although sharp reductions in FDI inflows or large offsetting outflows of portfolio investment could still undermine external stability. Among the CEB countries, only in Latvia, Lithuania and Slovenia is FDI likely to account for less than half of the current account deficit in 2000.

Outlook for 2001 is positive, but will depend on achieving the right balance for macro policy

GDP growth in CEE is expected to continue strongly in 2001, with growth largely remaining at the high levels of 2000 in Hungary, Poland and Slovenia while rising in all other countries (see Tables A.3.10 to A.3.11 in Annex 3.1). In more than half of the countries the growth rate is expected to be 4 per cent or higher in 2001.

There are a number of risks to this positive outlook, however. Rapid growth may increasingly exert inflationary pressure and put renewed strain on external balances. Average inflation in the region is expected to fall only slightly from the level anticipated for 2000. In Hungary, Poland and the Slovak Republic average inflation is estimated to remain at 6.5 to 7 per cent in 2001, and the authorities in Hungary and Poland have already announced adjustments to earlier, more ambitious targets. In SEE additional risks relate to political instability in Yugoslavia although recent developments have considerably heightened the prospects for reconstruction in the Balkans.

In the present high growth environment, careful attention needs to be paid to getting the right balance for macroeconomic policy. In particular, the openness of the region's capital and goods markets reduces the ability of central banks to combat inflation while maintaining a competitive exchange rate (see Box 3.1). Therefore, the main burden of adjustment will be carried by fiscal policy. Nevertheless, fiscal adjustment may be difficult for two reasons.

First, with strong growth, fiscal revenues and thus fiscal balances have been improving across the region, reducing the sense of urgency that prevailed during

Box 3.1

Options for monetary policy in EU accession countries

Since the beginning of transition, there has been a lively debate about the appropriate monetary policy target for the countries in the region. There is little agreement among economists about the optimal arrangement. It is, therefore, not surprising that monetary arrangements in the EU accession countries vary widely. While Estonia is operating a currency board and Hungary a crawling peg, Slovenia targets the growth of monetary aggregates and the Czech Republic and Poland target inflation. Some of these differences might be explained by different characteristics of the economies in question. For example, because small open economies are more vulnerable to exchange rate volatility, it may be appropriate for Estonia to operate a currency board, whereas a large economy such as Poland can better afford to consider other arrangements.

Nevertheless, the structural differences should not be overstated. This box examines the pros and cons of exchange rate targeting, currency board arrangements and inflation targeting (see table below). The aim is not to make specific recommendations, but to summarise the debate in an analytical and easily accessible way. A particular problem for the credibility of monetary policy across the region arises from the criteria of membership in the European Monetary Union (EMU). Current conditions include both exchange rate stability and inflation rates similar to Euroland. These two goals are unlikely to be compatible for the countries of the region for the foreseeable future, since their real exchange rates are likely to continue to appreciate as their productivity levels catch up with west European levels. The degree of flexibility available to the accession countries as they prepare for EMU membership should therefore be clarified as early as possible.

Pros and cons of options for monetary policy

Exchange rate peg / corridor

For

- The EU accession countries will sooner or later be expected to move to some form of exchange rate targeting ahead of joining EMU.
- An exchange rate target is easily understood and probably more directly influenced by monetary policy than inflation in the countries of the region.
- Under an exchange rate target, the real exchange rate tends to be less influenced by volatile capital flows.

Currency board

For

- Higher credibility than other exchange rate targeting regimes. In fact many economists have recently argued that it is the only viable form of exchange rate targeting (Frankel et al., 2000).
- Clear rules of behaviour limit the amount of discretion and increase transparency.
- As with exchange rate targets, the real exchange rate tends to be less affected by volatile capital flows.

Inflation targets

For

- EMU membership may not be credible *ex ante,* unless a country enters at the “correct” exchange rate. It has sometimes been argued that a period of free floating is needed to establish this rate (Corker et al., 2000).
- High and volatile inflation rates lower growth and can cause significant real output costs. Inflation targeting limits these costs.

Exchange rate peg / corridor

Against

- An appropriate parity is difficult to establish and much more easily subject to lobbying by interest groups (for example, exporters) than an inflation target
- With fixed exchange rates, financial markets tend to underestimate exchange rate risks in their portfolio decision and as a result might over-invest. Sudden changes in the risk perception of markets may then lead to large outflows and ensuing currency crises.
- Exchange rate targets are sustainable only with a consistent fiscal policy stance. However, fiscal policy in most of the countries in the region may be restricted by accession-related expenditure.
- The expected real appreciation will partially come through higher inflation rates than those in Euroland.

Currency board

Against

- A currency board deprives the central bank of its role as a lender of last resort. It thus increases the vulnerability to a banking crisis.
- A currency board requires a high degree of flexibility in goods and labour markets.
- It requires a very high degree of fiscal policy flexibility to stabilise demand.
- There is vulnerability to asymmetric shocks, such as a crisis in a major trading partner (see Baltic states after the Russian crisis or Argentina after the Brazilian crisis).
- The expected real appreciation will entirely come through higher inflation rates than those in Euroland.

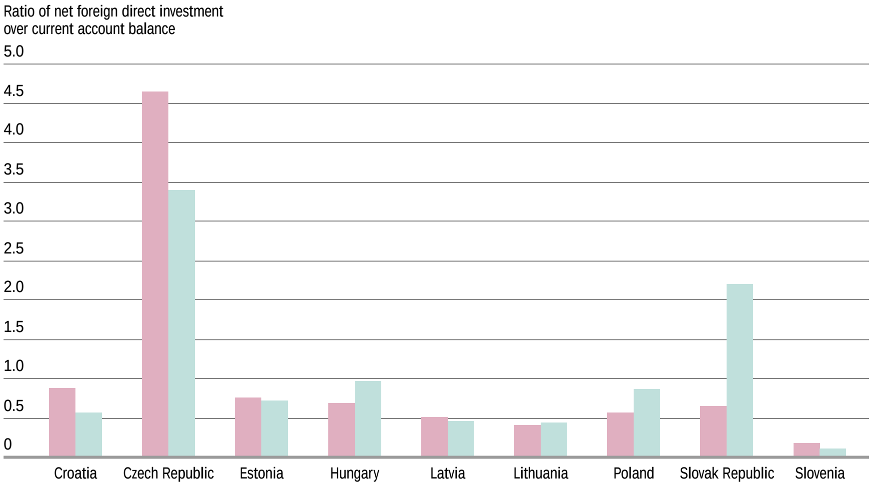
Inflation targets

Against

- Inflation targeting may be less transparent and less credible than exchange rate targeting because the transmission mechanism from monetary policy to the price level is still not well-established in most transition economies. However, the central European countries have made some progress on this front (Christophersen et al., 1999).
- The real exchange rate tends to be much more volatile, particularly in small open economies.

Chart 3.3

Share of current account deficits financed by foreign direct investment, 1999-2000, selected countries in central and eastern Europe and the Baltic states



Sources: Tables A.3.7 and A.3.9

Note: A current account deficit was given a positive number so that the ratio is positive in all cases.

1999. Second, the region still struggles with large public sectors, over-extended social security systems and substantial off-budget expenditure for bank and industrial restructuring. In this environment, expenditure cuts may often involve structural reforms to social security and public administration, all of which are politically sensitive. Recent budget debates – in Poland, the Czech Republic or Hungary, for example – should be viewed against this background. The structural roots of present fiscal policy challenges in CEE are discussed in more detail in Section 3.2.

Commonwealth of Independent States

Broad-based recovery at last – and not just because of high oil prices

The most encouraging development in the region has certainly been the recovery of Russia and many other CIS countries. Growth in 2000 is expected to equal or exceed 5 per cent in half of the CIS countries. Price levels and exchange rates have become more stable, although the majority of countries still remain vulnerable to bouts of significant volatility. Only Belarus and Uzbekistan, which are paying an increasing price for their lack of structural reform, and Moldova, hit by another bad harvest, are bucking the general positive trend.

Contrary to widespread belief, the recovery is not only driven by the high oil price but to a much greater degree by a recovery of industrial production on the back of sharp real exchange rate depreciations, which has given domestic producers large cost advantages over imports. This view is supported by the fact that it is not only the resource-based economies, such as Russia and Kazakhstan, that are growing strongly but also other countries in the region, such as – for the first time since the start of transition – Ukraine. According to preliminary estimates, increases in industrial production in the first half of 2000 range from 3 per cent in Armenia to 16 per cent in Kazakhstan, with both Ukraine and Russia reporting rises of about 10 per cent. It is consistent with this interpretation that light consumer goods industries in particular, such as food products, textiles and the producers of household appliances, are growing strongly for the first time since the start of transition.

If the present gains are to be sustained over the longer term, however, domestic producers will need to undertake deeper adjustment to remain competitive once the present real exchange rate cushion has been eroded. It remains to be seen whether the positive business opportunities provided by the current macroeconomic environment will provide sufficient incentives for managers to change their business strategies from the corrupt and asset-depleting practices characteristic of previous years.

Some recent reports from Russia suggest a decline in the number of high-profile corporate governance scandals. With some of their wealth wiped out by the crisis of 1998, Russia's oligarchs may have come to realise that asset-grabbing is no longer the best strategy for becoming rich and that wealth increasingly depends on making the acquired assets work. Moreover, there is some evidence that capital flight is indeed declining. Ultimately, however, growth in Russia will not be sustained unless the ambitious reform agenda contained in the recent economic programme is consistently implemented.

Although real exchange rate realignments are probably the most important factor behind the turnaround of economic fortunes in the CIS in 2000, high oil prices have clearly helped. High oil prices have improved the external and fiscal accounts of the oil and gas exporting countries (see Chart 3.4) and contributed to the rapid return to relative macroeconomic stability. Exchange rate stability and lower inflation as well as the high growth in Russia have supported the rebuilding of intra-CIS trade links. The return to an active regional foreign policy under President Putin has facilitated this process of reintegration. Indeed, without increased pipeline capacities through Russia, and the revival of previous supplier relationships, growth in Kazakhstan, Tajikistan and Turkmenistan in particular would be much lower.

The long-term costs of the depreciation

Despite all the recent good news, the long-term costs of the Russian crisis for many of the countries of the CIS are large. The depreciation of the real exchange rate, while good for competitiveness, has caused the external debt burden of many of the countries of the CIS to increase dramatically. For some of the smaller economies, such as Georgia, Kyrgyzstan, Moldova and Tajikistan, the ability to service the debt is very much in question, while Russia and Ukraine are still awaiting the completion of external debt restructuring. Furthermore, many of the countries have experienced banking

Table 3.1

Share of commodities in total exports of CIS countries in 1999

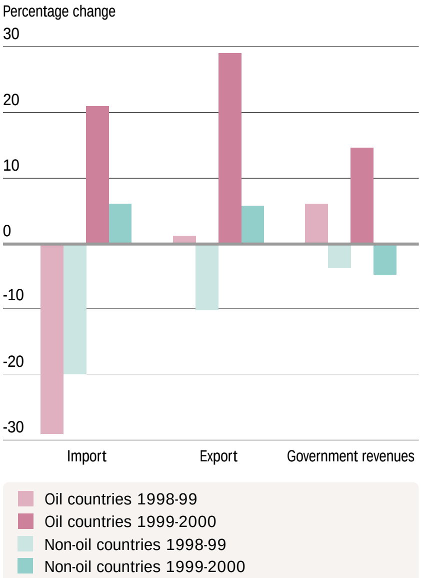
Country	Main commodities exported	Percentage of total exports
Armenia	Precious stones, minerals and metals	70.3
Azerbaijan	Oil, metal and cotton	79.2
Belarus	Metal and wood	12.3
Georgia	Metals, fuels and tea	58.6
Kazakhstan	Grain, metals and fuel	77.2
Kyrgyzstan	Gold, metals and cotton	40.5
Moldova	Metals, minerals and wood	4.2
Russia	Metal and fuels	64.1
Tajikistan	Cotton and aluminium	59.0
Turkmenistan	Minerals, fuels and cotton	85.0
Ukraine	Fuel, wood, food, raw materials and metals	57.5
Uzbekistan	Cotton, gold and gas	63.0

Sources: EBRD and IMF, *Recent Economic Developments Report*.

Note: For Azerbaijan, Georgia, Kyrgyzstan, Russia, Tajikistan and Ukraine, data refer to 1998.

Chart 3.4

Impact of higher oil prices on government revenues, imports and exports of CIS countries



Source: EBRD.

Note: Oil countries include Azerbaijan, Kazakhstan, Russia and Turkmenistan. Imports and exports are of merchandise only. Government revenues are general government revenues.

crises, which all but swept away their banking systems. The immediate real cost of these crises has been limited because of the weak links between the banking sector and the real economy across the region. However, longer-term development cannot proceed without a functioning financial system and in many CIS countries, most notably Russia, the measures taken to stabilise financial institutions and to promote deeper financial intermediation remain seriously inadequate.

The outlook is positive but risks of future volatility remain high

The current high growth is generally expected to continue into 2001. Forecasters surveyed by the EBRD predict, on average, a continuation of growth at 4.3 per cent in 2001 (see Tables A.3.10 to A.3.11 in Annex 3.1). There is considerable variation across the forecasts of different institutions. JP Morgan, for example, predicts growth in Russia of 6 per cent for 2001 while many other institutions foresee growth of only 3 per cent. A similar variation can be found for many other countries.

Inflation forecasts largely mirror the pattern for growth. While the general trend is encouraging all over the region, with average inflation expected to fall to 25.4 per cent in 2001 from 31.6 per cent (see Tables A.3.12 to A.3.13 in Annex 3.1) in 2000, the differences between the forecasts of different institutions are again significant. The relatively large variation across forecasts partly reflects poor availability of data in many countries of the CIS. However, the variation also highlights the considerable volatility facing many countries of the region, with forecasters apparently attaching different probabilities to a wide range of possible outcomes.

Among the principle risks to macroeconomic performance in the CIS are political instability, the high dependence on commodity exports and the management of the exchange rate. Political risks stem, for instance, from the absence of a final settlement between Armenia and Azerbaijan, the heightened security concerns in Central Asia and ongoing power struggles among the old and new ruling elites in Russia. As international evidence suggests, societies with wide disparities in income tend to experience more political instability, and many CIS countries since the start of transition have joined the ranks of some of the more unequal developing countries around the world.

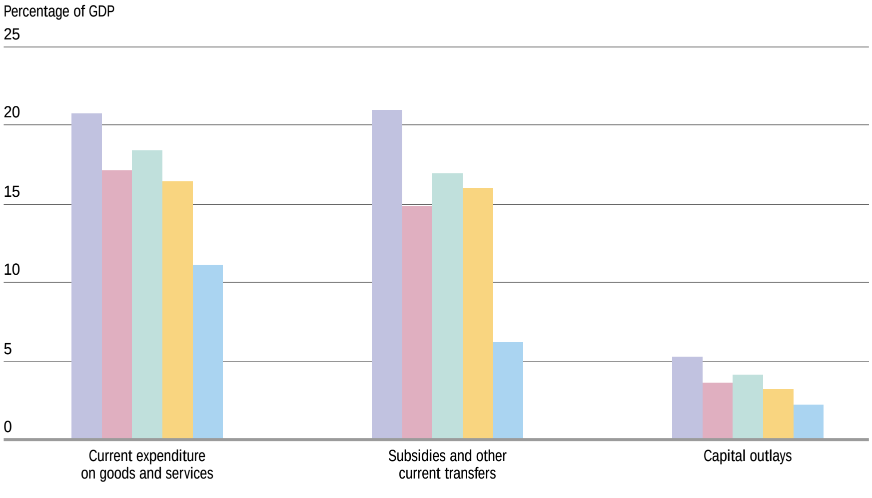
Commodity dependence is very high across most of the CIS, with the exception of Belarus and Moldova (see Table 3.1). If commodity prices decline again – as a result of slower global growth – the impact on the region's external and fiscal balances would be considerable. In view of the weaknesses in budgetary systems in particular (which will be discussed in more detail in the next section), most CIS countries are presently ill-equipped to deal with the impact of an adverse external commodity price shock.

In the wake of the crisis, central banks across the CIS have had to abandon exchange rate pegs, which had provided the most important anchor for price stability in the region. A majority of central banks have now adopted a policy of implicitly targeting the nominal exchange rate. In Armenia, Georgia, Kazakhstan, Kyrgyzstan, Russia, Tajikistan and Ukraine, relatively stable exchange rates during the first half of 2000 have brought year-on-year inflation rates down, as the exchange rate resumed its role as a stabiliser for inflationary expectations.

However, the realignment of real exchange rates over the past two years is creating very different policy challenges across the CIS. In the cases of Russia and Kazakhstan, concerns about external competitiveness in the context of large balance of payments surpluses have motivated implicit exchange rate targeting and large central bank interventions to prevent currency appreciation. The resulting expansion of domestic money supply raises concerns over inflation. In the remainder of the CIS, risks to macroeconomic stability instead stem from continuously high external deficits, which in the context of already high debt burdens may necessitate further real exchange rate depreciation.

Chart 3.5

Structure of government expenditure in 1998



Source: UN Economic Commission for Europe, *Economic Survey of Europe*, No.1, 2000, p.192, Table 3.2.8.

Note: Central eastern Europe includes Czech Republic, Hungary, Poland, Slovak Republic and Slovenia. For the purposes of this chart, Croatia is also included in this group, given structural similarities with central eastern Europe. South-eastern Europe includes Albania, Bulgaria, FYR Macedonia and Romania. Data for current expenditure on goods and services and subsidies in the Baltic states exclude Lithuania. CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova and Tajikistan. Data for current expenditure on goods and services exclude Azerbaijan, Kyrgyzstan and Tajikistan. Data for subsidies and other current transfers exclude Azerbaijan and Tajikistan.

3.2 Challenges for fiscal policy

The persistence of fiscal imbalances apparent in many transition economies poses risks for the sustainability of long-term economic growth. Fiscal deficits are often seen as a sign of macroeconomic vulnerability causing higher borrowing costs in international markets and potential swings in capital flows. Moreover, public borrowing can “crowd out” private investment and thus reduce growth. Fiscal deficits are often at the root of economy-wide gaps between savings and investment and thus higher external imbalances (see Section 3.3).

In the initial years of transition, fiscal deficits in the region were largely due to high expenditure associated with the inherited oversized public sector and the collapse in revenues. Although the size of governments has decreased substantially since the start of the transition, public sectors in CEE are still on average the same size as their counterparts in the EU and much larger than in the United States and Japan (see Tables A.3.5 and A.3.6 in Annex 3.1). In the CIS, public sectors are on average smaller than in advanced industrialised countries. However, there are large differences across countries. There are also large differences in the spending structures (see Chart 3.5). For instance, in the CIS (excluding Russia) government transfers account for a much smaller share of total expenditures than in any of the other regions. The sharp fall in transfers in the CIS has exacerbated the social situation, already severely affected by large declines in average real incomes.

Recent research confirms that the public sectors in the region are large relative to those of the OECD countries.[4] After controlling for factors such as GDP per capita, dependence ratios and political variables, which explain the largest part of the variation in the size of public sectors in OECD countries, all transition economies with the exception of Bulgaria had larger than predicted public sectors. The difference is especially large for Albania, Croatia, Poland and the Slovak Republic. In general, large current expenditure, including social assistance and government consumption, are the main cause of large public sectors. While social assistance in particular does not necessarily hamper rapid growth, its financing nonetheless creates a problem in the context of high tax burdens in much of CEE.

Government revenues have fallen dramatically during the transition and in many CIS countries are now too low to sustain basic public services. For instance, in 1999 general government revenues were 15.6 per cent of GDP in Georgia, 13 per cent in Tajikistan, and 24 per cent on average for the CIS excluding Russia. By contrast, in CEE average general government revenues in 1999 were 40 per cent of GDP.

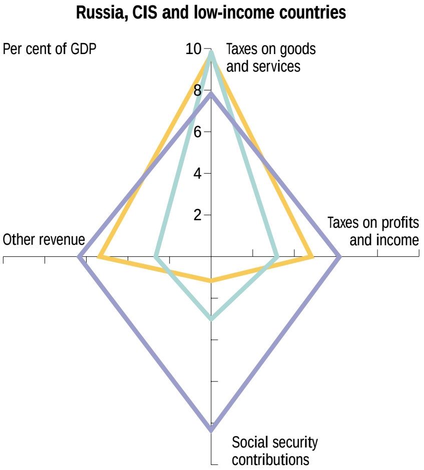
Differences in the structure of revenues, related to deeper differences in levels of economic development across the region, explain part of these variations. The extent to which the state’s autonomy has been undermined by powerful interest groups that are able to extract favours from the government has also played an important role. While revenues from indirect taxation do not differ that much across the region, there are huge differences in the direct taxation of profits and personal income. The taxation of profits, personal income and social contributions together account on average for 22 per cent of GDP in CEE; in the CIS excluding Russia and Ukraine this figure is only 6 per cent. Indeed, as Chart 3.6 shows, the structure of revenues in CEE is relatively similar to the system in most EU countries while the revenue structures of the smaller CIS countries are more similar to those of low-income countries in other regions of the world.

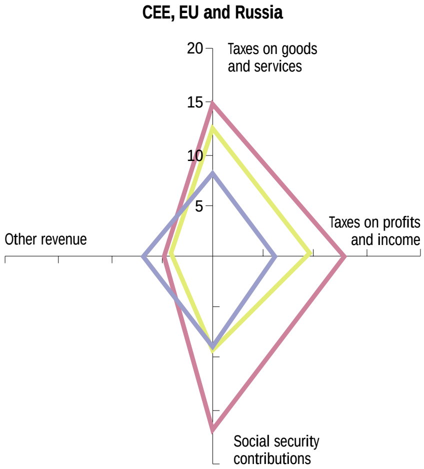
In short, the challenges for fiscal policy in the coming years differ widely across the region. For the accession countries, tensions will arise in balancing the high expenditure needed for EU and NATO accession with the constraints imposed by already large public sectors and high tax burdens, as well as the overall fiscal discipline needed for macroeconomic convergence with EU requirements. In the CIS, by contrast, the challenge is mainly to find a revenue base adequate for meeting rising interest expenditure on foreign debt without the need to reduce further spending on basic public services. Indeed, there is in many cases an urgent need for increasing public expenditure, such as in the social sphere, albeit with better targeting of such expenditure. This challenge is compounded by the high potential volatility of many CIS countries’ tax bases due to heavy reliance on commodity exports.

4 See Begg and Wyplosz (1999).

Chart 3.6

Structure of general government revenues





Russia — CIS excluding Russia and Ukraine — Low-income countries — EU — CEE

Sources: *UN Economic Survey of Europe*, No.1, 2000; *IMF Government Finance Statistics Yearbook, 1999*; *Monthly Bulletin Statistics* of European Central Bank, July 2000.

Note: Figures refer to 1998 or latest year available.

CEE includes Albania, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Poland, Romania and Slovak Republic; other revenue also includes Lithuania. CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan and Moldova; other revenue also includes Tajikistan.

The data for low-income countries are the average of all countries with available data within the GDP per capita bracket provided by the richest CIS country outside Russia (Ukraine at US$ 1/PPP 3,200) and the poorest (Tajikistan at US$ 1/PPP 950), as of 1998. EU is the average across all member states of Euroland.

The fiscal costs of accession to the EU

Accession to the EU will require additional expenditure on compliance with environmental standards, transport infrastructure, and legal reforms and institution-building, among other things. According to two recent studies, for the environment and transport sectors alone the investment needs spread over 10 to 20 years are estimated to amount to around €200 billion (see Table 3.2).[5] In the environment sector, water and air pollution account for four-fifths of the estimated costs, while in the transport sector around four-fifths is for roads and railways. Assuming these costs are spread over a period of 20 years for environment investments and over a period of ten years in the transport sector, the accession countries will face annual investment costs equivalent to over 4 per cent of current GDP for the next decade. Adding to these costs, expenditure related to meeting accession requirements in the steel industry, nuclear safety, the energy sector, agriculture, telecommunications, social policy and enhanced consumer protection, annual costs could, according to some estimates, rise to 11 per cent of annual regional GDP over a ten-year period.[6] These costs are lower and will be easier to bear for the more advanced countries.[7]

How will this expenditure be financed? According to the EU budget provisions that were adopted at the Berlin European Council in March 1999, there will be pre-accession financing available for all membership candidates in the areas of technical assistance and training (through the Phare instrument), agriculture (through the SAPARD instrument) and infrastructure and environment (through the ISPA instrument). Financial support of about 1 per cent of current GDP from these instruments will be available from 2000 until 2006, or until a country becomes an EU member.[8] The EU has also agreed to a medium-term financial framework for an enlarged EU comprising 21 countries, which starting in 2002 sets aside substantial financial support of about 1.2 per cent of current GDP per annum (€4.1 billion) exclusively for new members. However, while EU assistance may go some way towards financing the costs related to accession, a significant gap is likely to remain to be financed either by governments or private sector contributions.

Against the background of already large public sectors and high statutory tax rates, the governments of accession countries will find it difficult to increase revenues in order to accommodate higher expenditure. This is particularly true in countries where privatisation-related financing is likely to decline soon. If a widening of the deficit is to be avoided, governments will need to improve the efficiency of public services by cutting discretionary expenditure (such as public sector wages, social security, and welfare services excluding pensions and expenditure on goods and services) and by enhancing the effectiveness of social assistance. It is in this light that recent structural reforms in the pension systems of Hungary, Latvia and Poland, and similar planned initiatives in Bulgaria and Croatia, are particularly welcome.[9]

Without reducing the budgetary liabilities implicit in generous pay-as-you-go systems, the budgets of the accession countries will face mounting pressure from an ageing population at the very time that accession-related investment needs are most urgent. Notwithstanding initial teething problems in the administration of the new three-pillar system, for instance in Poland, pension reforms have progressed relatively smoothly.

5 There are a number of methodological problems in quantifying the investment needs for accession (including defining the scope of what costs are purely accession-related and the assumptions made on the time horizon of investments). For a detailed analysis, see Wallden (1998).

6 See Wallden (1998). The costs expressed in terms of the accession country's aggregate GDP are of course sensitive to the underlying growth projections used. Despite the uncertainty surrounding this and other assumptions, it is a fair guess that accession will necessitate enormous investment efforts in the accession countries, underlining the need to analyse how these would be financed.

7 The most recent IMF Selected Issues and Statistical Appendix for Hungary (22 February 2000), based on Hungary's National Programme for the Adoption of the Acquis, estimated that in 2000-01 total EU expenditure will amount to 2.6% of GDP annually. EU transfers are estimated to amount to 0.9% and 0.7% of GDP respectively, while the central government has allocated 1.1% and 1.2%.

8 Total pre-accession instruments allocated amount to €3.1 billion per year between 2000 and 2006, of which €1.6 billion is for Phare, €0.5 billion is for SAPARD and €1 billion is for ISPA.

9 While the move towards fully funded pension systems will alleviate contingent budgetary liabilities in the medium future, in the short term the required reforms reduce the resources available in existing public pay-as-you-go systems, and may lead to higher transitory deficits in public funds, which have to be taken into account in formulating fiscal policy.

Table 3.2

Total investment needs in the environment and transport sectors

Environment[1]

	Water	Air	Waste[2]	Total environment	Annual investment[3]
	(€ billion)				(in per cent of GDP 1999)
Bulgaria	4.9	5.1	5.1	15.1	6.4
Czech Republic	3.3	6.4	3.8	13.4	1.3
Hungary	6.6	2.7	4.4	13.7	1.5
Poland	18.1	13.9	3.3	35.2	1.2
Romania	10.1	9.1	2.7	21.9	3.4
Slovak Republic	1.9	1.9	1.6	5.4	1.5
Slovenia	na	0.7	1.2	1.8	0.5
Estonia	1.5	na	na	na	na
Latvia	1.7	na	na	na	na
Lithuania	2.4	na	na	na	na
Baltic states total	*na*	*8.5*	*0.9*	*9.3*	*2.2*
Total	**50.5**	**48.2**	**22.9**	**121.6**	**1.8**

Transport[4]

	Rail	Road	Inland water	Airports	River ports	Sea ports	Terminals	Total transport	Annual investment[5]
	(€ billion)								(in per cent of GDP 1999)
Bulgaria	2.1	2.2	0	0.2	0.1	0.5	0.1	5.3	4.6
Czech Republic	3.7	5.8	0.4	0.2	0.02	na	0.008	10.2	2.0
Hungary	4.0	4.6	0.4	0.3	0.1	na	0.7	10.2	2.2
Poland	14.6	17.6	0.4	2.9	0.0004	0.7	0.2	36.4	1.3
Romania	5.2	5.1	0.3	0.1	0.1	0.4	0	11.2	3.5
Slovak Republic	1.9	4.6	0	0.03	0	na	0	6.5	3.5
Slovenia	3.0	2.6	na	0.1	na	0.1	0	5.7	3.1
Estonia	0.3	0.3	na	0.036	na	0.043	0	0.6	1.1
Latvia	0.9	0.4	na	0.1	na	0.6	0.03	2.0	3.4
Lithuania	1.3	0.5	0	0.1	0	0.4	0	2.3	2.3
Total	**37.0**	**43.7**	**1.5**	**4.1**	**0.3**	**2.7**	**1.0**	**90.4**	**2.6**

1 Source: EDC Ltd., *Compliance Costing for Approximation of EU Environmental Legislation in the CEEC*, Dublin, April 1997. The study was prepared for the Commission and is a best guestimate of the total costs in the environment sector. It covers water, air pollution and waste management, leaving out areas such as chemicals, noise and forest preservation.

2 Investments for waste are maximum investments.

3 GDP data for 1999 taken from EBRD own staff estimates. The figures are calculated as total investment in euro divided by 20 years as per cent of 1999 GDP.

4 Source: TINA Final Report, *Identification of the Network Components for a Future Trans-European Network in Bulgaria, Romania, Hungary, Slovenia, Slovak Republic, Czech Republic, Poland, Lithuania, Latvia, Estonia, and Cyprus*, Tina Secretariat, October 1999. This study was also conducted for the Commission. It covers the costs of completing a transport network in the ten accession countries, which would comprise 18,000 km of roads, 20,000 km of railway lines, 38 airports, 13 seaports and 49 river ports.

5 GDP data for 1999 taken from EBRD own staff estimates. The figures are calculated as total investment in euro divided by 10 years as per cent of 1999 GDP.

Fiscal sustainability and foreign debt management in the CIS

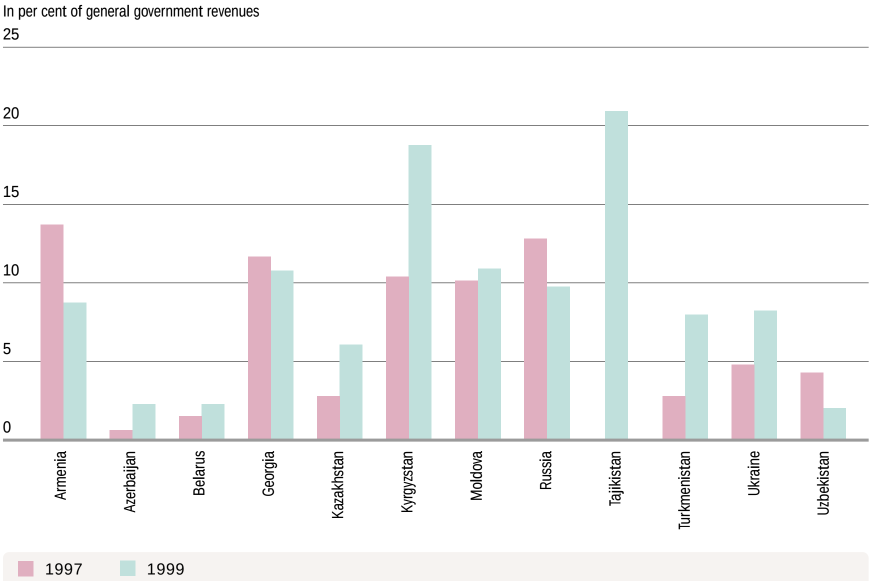
Large fiscal deficits arising from high inherited standards of public services but low revenue-raising capacity remain a key challenge in many CIS countries. In the absence of developed domestic securities markets, the financing of these deficits has led to a rapid build-up of external public debt. This has created serious debt management problems in the wake of currency devaluations across the region.

Before the Russian crisis in 1998, most countries in the CIS did not have particularly high debt levels. The unweighted average ratios of foreign debt – most of which was public – to GDP and foreign debt service to exports were 43 per cent and 12 per cent respectively in 1997 (see Chart 3.7). Following currency depreciations and a dramatic decline in foreign trade turnover, these ratios increased to 71 per cent and 20 per cent respectively by 1999. Kyrgyzstan currently spends 40 per cent of its government revenues on debt service payments, even though a large part of this debt is low-interest lending from international financial institutions and bilateral lending.

The average interest burden on the budgets of CIS countries is only 7.5 per cent of total revenues but this is likely to rise. According to the fiscal sustainability criteria under the World Bank/IMF initiative for debt forgiveness for highly indebted countries, Georgia, Kyrgyzstan, Moldova and Tajikistan have sufficient levels of foreign debt relative to government revenues to qualify for debt forgiveness (although they do not qualify on some other criteria, such as per capita income). This fact is even more striking considering that all these countries started with debt close to zero less than ten years ago.

Chart 3.7a

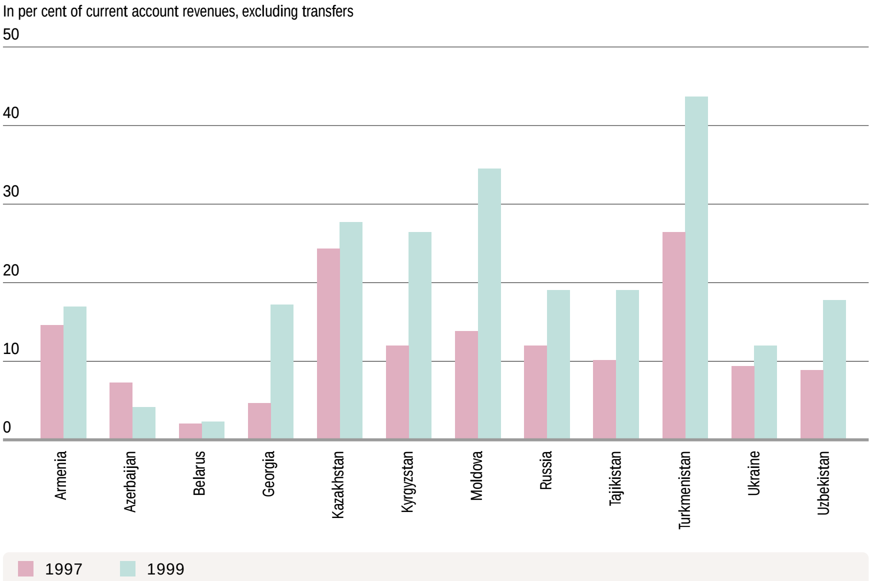
Public sector interest expenditure, CIS countries



Sources: World Economic Outlook database and *IMF Recent Economic Developments Report*.
Note: Data for Tajikistan are for 1998.

Chart 3.7b

External debt service, CIS countries



Source: EBRD staff estimates. Note: Data for Russia include public debt service only.

Russia and Ukraine defaulted on their external debt during 1998 and are awaiting restructuring. Although public finances in both countries have improved substantially since the default, both are nonetheless likely to face high foreign debt payments for the foreseeable future even when the restructuring is completed.

High levels of foreign debt and continuing fiscal imbalances are a particular cause of concern because of the volatility of budget revenues and their dependence on unpredictable commodity prices. The IMF has estimated that a 10 per cent fall in the oil price alone decreases government revenues in Russia by about 0.1 per cent of GDP and in Kazakhstan by 0.2 per cent.[10] Therefore, the recent trebling of the oil price since early 1999 has increased revenues in Russia by 1.5 per cent of GDP and in Kazakhstan by 3 per cent of GDP. Azerbaijan and Turkmenistan are similarly dependent on oil- and gas-related tax and royalty income. Georgia places its hopes for future revenues on transit fees from a major export pipeline for Caspian oil, which is planned to cross its territory. Kyrgyzstan and Uzbekistan rely heavily on gold, Armenia on diamonds, and Tajikistan on aluminium. State-controlled cotton exports are also an important source of government revenues in Turkmenistan and Uzbekistan.

In all these countries a decline in commodity prices would severely affect revenues and trigger renewed pressure for expenditure cuts on vital public services, possible debt servicing problems and further deterioration of public sector capacity. Present buoyant revenues in several CIS countries should not distract governments therefore from the fundamental structural challenges in the reform of their fiscal systems.

3.3 Sustainable growth and the balance of savings and investment

Numerous studies have shown the close correlation between domestic savings, investment rates and growth.[11] This section looks at the factors determining investment demand and the degree of saving in the transition economies. Currently only countries in CEE face the risk of increasing structural imbalances since savings rates in these countries are low and investment demand is rising rapidly. In the CIS investment levels remain low while savings in those countries not ravaged by wars earlier in the transition are as high as in comparable market economies. Moreover, high capital output ratios in the CIS suggest that for the foreseeable future sustainable growth can be achieved by putting existing capital to better use. This is not to say that there are no risks to the balance of payments in CIS countries. Nevertheless, these risks are associated with high fiscal deficits, high external debt service payment, the concentration of exports on a few commodities and ongoing capital flight.

10 See *World Economic Outlook,* October 1999.

11 See Levine and Renelt (1992) for a review of this evidence.

Chart 3.8a

National savings and gross fixed capital formation by region

National savings — Gross fixed capital formation

Source: IMF, *World Economic Outlook*.

Note: CEE includes Albania, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia. CIS (rest) includes Armenia, Belarus, Georgia, Kazakhstan, Moldova and Uzbekistan.

Chart 3.8b

Gap between private saving and private investment

CEE — Russia and Ukraine — CIS (rest)

Source: EBRD.

Note: The gap between private savings and private investment is calculated as the difference between the current account deficit and the fiscal deficit. Regional sub-groups include all countries in the sub-region.

Savings rates

As Chart 3.8 demonstrates, private savings rates have either declined or remained roughly constant since the early transition years. Extending the series back to the late 1980s would reveal that since the start of transition, private savings rates have fallen precipitously throughout the region. Several factors contributed to an initial fall in savings rates. First, given the wide-ranging price and quantity controls in place under communist regimes, consumers were unable to choose their optimal level of consumption, and this resulted in artificially high savings. Second, the return on investment was low under the communist regime. In fact capital productivity throughout the eastern block fell from the 1970s to the 1980s on average by 50 per cent.[12] Given low returns, savings needed to be kept high to maintain economic growth under central planning. With the move to free markets, incentives to save were reduced on both counts.

After the initial adjustment and the sharp fall in savings rates at the start of the transition, savings rates started to stabilise in the mid-1990s. Since this period, it has become possible to investigate whether savings rates in transition economies have started to be determined by the same factors as in market economies and to make some predictions as to their likely long-term development. A detailed investigation of savings rates across the world shows that the major determinants are the degree of urbanisation, dependency ratios, the level of real income, GDP growth, and fiscal and external balances.[13] Assuming that savings rates in transition countries follow the same pattern, and comparing the implied savings rates with the actual ones, reveals interesting results (see Chart 3.9). Actual savings rates in CEE are found to be below the level of comparable market economies (with the exception of the Czech Republic and the Slovak Republic), while savings rates in the CIS are as high or higher than in comparable economies.

It is important to note that predicted national savings rates in Chart 3.9 take into account the large current capital inflows into CEE, which lower the need to save domestically. On this evidence, it would therefore appear that national savings rates are particularly low in CEE, causing potential financing problems if investment demand rises. What happens to savings in the future is likely to be determined by several trends.

On the one hand, expectations of high and sustained future growth rates may continue to depress savings rates particularly among the young. Counteracting this trend is the likelihood that the present generous social assistance and public pension systems will not remain sustainable as the population ages, thus increasing the need for private savings. Moreover, as prosperity trickles down to those who so far have suffered most during the transition, their need to spend savings in order to make ends meet may

12 See De Broek and Koen (2000).

13 See Denizer and Wolf (1998); Loayza et al. (1998); and Rodrik (1998).

be reduced. In addition, underdeveloped financial systems significantly diminish opportunities for financial intermediation and may restrict the level of recorded private savings. Unofficial savings (for example, money kept under the mattress) may be considerably higher, particularly in the less advanced countries. As financial reforms progress, some of these unofficial savings may become available for domestic investment.

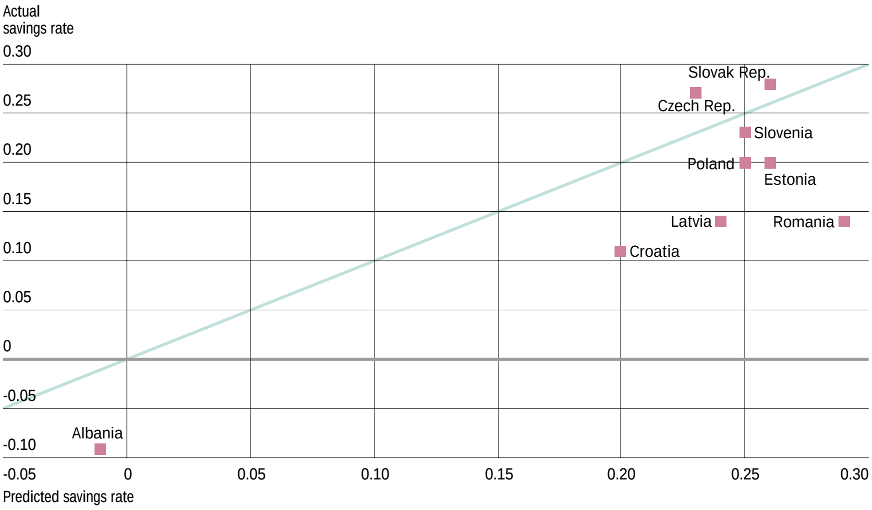
Investment needs

Investment rates fell sharply at the beginning of the transition. Reduced resources available for investment and the abolition of the central investment plan were key factors in this decline. In recent years investment rates have risen in CEE. In contrast, investment rates have fallen even further in the CIS after the Russian crisis as investment has been slower to recover than output. As a consequence, the capital stock in the CIS continues to decline but is now increasing in other regions.

Although investment figures are notoriously weak in the transition economies and caution in interpreting the data is therefore strongly warranted, there are nonetheless some interesting observations that can be made on the cross-country patterns of investment demand. In the initial phase of transition, growth is hardly ever driven by capital investment since the available capital stock is already large.[14] The ratio of the book value of the capital stock to output in most countries at the trough of the transition recession was extremely high, partly because of the over-investment under the old system but also because of the dramatic contractions of output (see Chart 3.10). This is the case even once a generous allowance is made for obsolescence of plant and equipment.[15]

Chart 3.9a

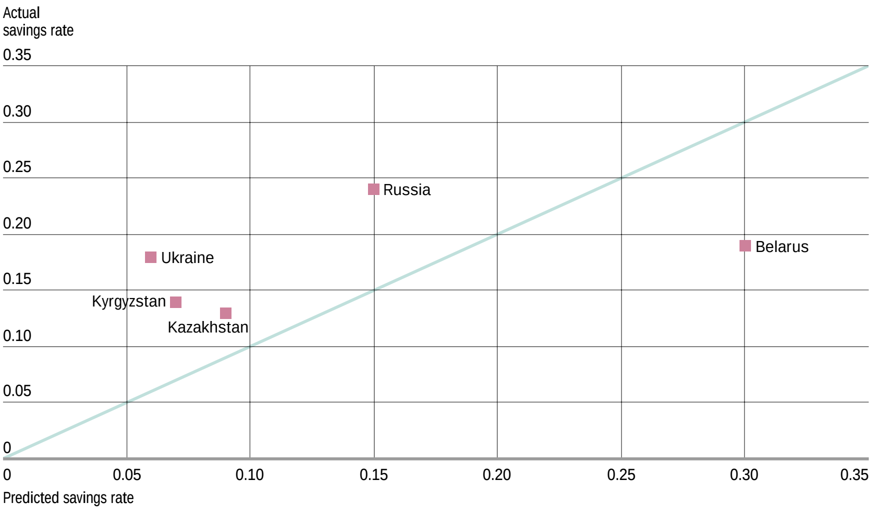
Actual versus predicted savings rate, selected countries of central and eastern Europe and the Baltic states in 1997



Sources: World Bank, *World Development Indicators* and IMF, *World Economic Outlook*.
Note: Predicted savings are computed on the basis of a regression for 70 mid-income countries over the period 1992-98. Gross domestic savings were regressed on the dependency ratio, the urbanisation ratio, M2 over GDP, GDP at PPP exchange rates per capita (non-linear dependency), the external balance, the fiscal balance, GDP growth, inflation and a constant. Transition economies were excluded from the sample to predict the savings rate.

Chart 3.9b

Actual versus predicted savings rate, selected countries of CIS in 1997



Sources: World Bank, *World Development Indicators* and IMF, *World Economic Outlook*.
Note: Predicted savings are computed on the basis of a regression for 70 mid-income countries over the period 1992-98. Gross domestic savings were regressed on the dependency ratio, the urbanisation ratio, M2 over GDP, GDP at PPP exchange rates per capita (non-linear dependency), the external balance, the fiscal balance, GDP growth, inflation and a constant. Transition economies were excluded from the sample to predict the savings rate.

With large existing capital stocks and correspondingly large depreciation requirements, investment would need to reach extremely high levels relative to GDP to make a notable contribution to growth.[16] Only when the transition countries have reached the production frontier, i.e. have put the existing resources to their most effective use, does the capital output ratio stabilise at a level similar to that of other market economies. When an economy reaches this stage, future growth is increasingly driven by new investments.

Looking across the region, the capital output ratio has stabilised only in the most advanced transition countries,

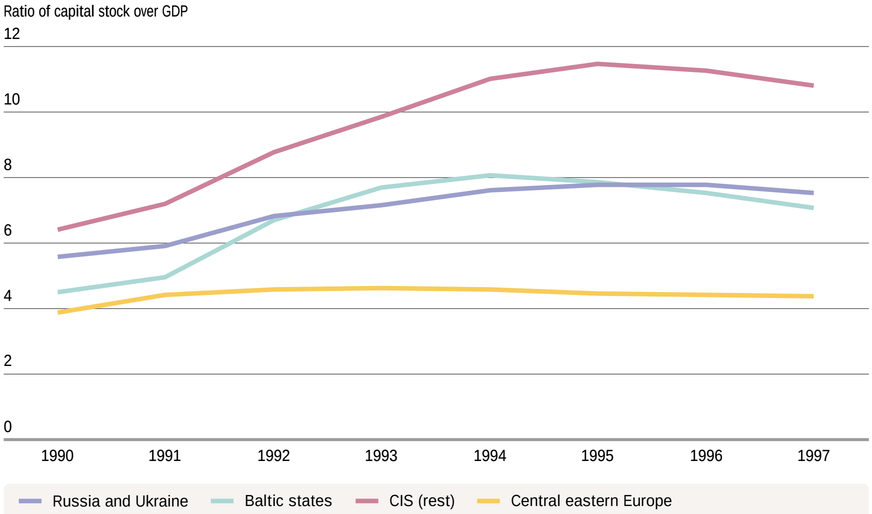
14 Hungary is probably one important exception, as very early large inflows of FDI allowed the country to grow mainly as a result of exports to the EU.

15 In a developed market economy the typical capital output ratio does not exceed 3-4. Even if half the capital stock in Russia and the CIS was obsolete, they would still have capital output ratios of around 5, which is much too high, given their low levels of income.

16 Using a growth accounting framework, it is easy to see that given the high capital stock compared with output, excessively high investment rates as a percentage of GDP would be needed for investment to have a sizeable impact on growth.

Chart 3.10

Capital productivity in selected regions, 1990-97



Source: IMF.
Note: Data are not available for south-eastern Europe.

such as the Czech Republic, the Slovak Republic, Poland and Hungary. In these countries, accession-related investment needs are likely to lead to further increases in investment rates or at least a stabilisation at current high levels, resulting in further increases in the capital output ratio. In all other countries capital output ratios continue to fall as output grows more rapidly than investment. Indeed, given the scope for efficiency improvements in much of the corporate sectors of the CIS, growth is unlikely to be severely constrained by the lack of funds for investment for several years to come. This is of course dependent on the governments in these countries adopting policies that encourage restructuring and the entry of new enterprises, which has characterised the earlier recovery further west.[17]

External financing requirements

Savings rates and private sector investment needs show different trends in CEE and the CIS. In most CEE countries high growth rates associated with rising investment but stagnant private savings rates have led to growing current account deficits. Given increasing capacity constraints and the need to keep up with technological developments world-wide, investment rates will probably have to rise further if growth is to be sustained.

Given the gap between current savings rates and potential investment needs, it is essential for the transition economies to increase savings rates, particularly as temporary financing sources, such as privatisation receipts, dry up. The most effective way for governments to increase national savings and thus to control their external balances will be to decrease their fiscal deficits (see previous section). In addition, better targeting of assistance programmes and reforms to pension systems can help to increase private domestic savings.

At the same time it is essential that CEE countries maintain their competitive edge in order to continue to attract the foreign capital inflows that match their investment needs. In this respect the analysis in Box 3.2 clearly shows that several of these countries need to monitor their real exchange rates very closely.

For the CIS, net external financing constraints are unlikely to limit growth in the near future.[18] Unlike in CEE, there does not appear to be at present a large gap between savings and private investment needs in the CIS. Yet, investment demand will need to recover at some point, if only to maintain those assets that still have economic value. Raising national savings from presently low levels will be a future priority, therefore, in the CIS.

In the short term, however, dependence on commodities and the extent of capital flight present more urgent challenges on the external front than raising domestic savings. With the exception of Belarus and Ukraine, the share of commodities in total exports exceeds 50 per cent and is as high as 80 per cent for many countries (see Table 3.1 above). For some, such as Azerbaijan, Kazakhstan and Russia, which have an abundance of natural resources, the structure of exports is unlikely to change much for the foreseeable future. Some of the countries are starting to address these structural issues. Kazakhstan, for instance, is establishing a stabilisation fund similar to that used in Norway. Azerbaijan has started to explore the same option. The quality and independence of the management of these funds will determine to a considerable extent how future terms of trade shocks will be weathered by these two economies.

The continuous capital flight from countries with high growth potential is a sad testimony to the weaknesses in the investment climate that still plague the region. In particular, the insecurity of property and investor rights has driven private savings abroad and deprived domestic enterprises of funds for investment. Yet, developments in the aftermath of the Russian crisis may to some extent offer a chance for a change in this respect. As companies earn record profits and are able to finance basic investments out of retained earnings, the expected increase in future income makes them more attractive to outside investors and makes existing owners more interested in raising the value of their assets. From this perspective, the apparent undervaluation of most CIS countries compared with their market competitors (see Box 3.2) may offer a chance to start the process of restructuring that will allow this part of the region to fulfil its potential.

3.4 Conclusions

The economic outlook for the region has significantly improved over the past year. With the recovery in CEE gaining speed and with Russia's strong output performance pulling up the remainder of the CIS,

17 On the scope for improvements in this respect, see *Transition Report* 1999, Chapters 7-9.

18 A recent report by McKinsey (1999) based on case studies of Russian companies comes to the same conclusion.

Box 3.2

Competitiveness

There are several ways to establish measures of relative competitiveness across countries. One approach is to track the development of unit labour costs over time to indicate trends in the competitive position of a country. Unit labour cost indices are presented in Table A.3.8 in Annex 3.1. An alternative approach, which allows one directly to compare levels of competitiveness across countries is based on the comparison of actual and predicted US dollar wage rates (see table). This approach was presented in the *Transition Report* 1998, which found that by the end of 1997 none of the countries of the region appeared to have dollar wages that were high compared with countries with similar levels of productivity, workforce skills and comparable economic structures.[1]

These calculations were undertaken before the large devaluations in East Asia, Latin America and other emerging markets, such as Turkey, which are the main competitors for the transition economies on global markets. An update of the analysis up to the end of 1999 reveals that the Asian crisis and the fall in commodity prices had a significant effect on the relative competitiveness of the region. As a result of devaluations in competitor countries, many of the countries of the CIS approached the danger zone of overvaluation in 1998. There is some evidence, therefore, that an adjustment to real exchange rates was needed at that time. Nevertheless, the analysis also shows that by 1999 in Russia the real exchange rate clearly overshot the equilibrium value in the aftermath of the crisis. Other CIS countries devalued later but by mid-2000 had restored the real parity with the Russian rouble. A substantial real appreciation is therefore likely for most CIS countries over the medium term.

The situation for other parts of the region appears rather different. Most of CEE and specifically the Baltic states have dollar wage rates very close to the predicted values and cannot afford, therefore, any further substantial exchange rate appreciation without major productivity gains. This is even more evident in view of the need to attract substantial capital inflows into the region, which is discussed in Section 3.4.

1 See *Transition Report* 1998 for a detailed description of the analysis.

Actual to equilibrium wage ratio

	1995	1996	1997	1998	1999
Armenia	0.1	0.2	0.3	0.3	0.4
Azerbaijan	0.2	0.3	0.6	0.7	0.6
Belarus	0.2	0.3	0.4	0.4	na
Bulgaria	0.4	0.4	0.5	0.6	na
Croatia	2.0	2.1	2.6	2.7	2.5
Czech Republic	0.4	0.4	0.6	0.6	0.6
Estonia	0.6	0.7	0.8	0.9	na
Hungary	0.8	0.8	1.0	0.9	0.9
Kazakhstan	0.5	0.6	0.8	0.8	0.7
Kyrgyzstan	0.4	0.4	0.4	0.4	na
Latvia	0.7	0.6	0.8	0.8	0.8
Lithuania	0.4	0.5	0.8	0.8	0.8
Moldova	0.4	0.6	0.9	0.9	na
Poland	0.7	0.7	0.9	1.0	0.9
Romania	0.3	0.4	0.5	0.8	0.5
Russia	0.3	0.4	0.6	0.4	0.2
Slovak Republic	0.5	0.5	0.6	0.6	0.6
Slovenia	1.1	1.0	1.3	1.3	1.3
Tajikistan	0.2	0.4	0.5	0.5	0.4
Turkmenistan	0.1	0.1	0.4	0.4	0.3
Ukraine	0.3	0.4	0.6	0.5	0.4
Uzbekistan	0.3	0.4	0.4	0.5	0.4

Sources: Monthly wage: International Labour Organization database; PPP GNP per capita: World Bank and EBRD staff estimation; Share of agriculture in GDP: World Bank, *World Development Indicators;* Human capital indicator: Barro-lee indicator for secondary school education, World Bank estimates.

Note: Equilibrium wages were calculated from a regression of US dollar wages on GDP per capita, the share of agriculture in GDP and an indicator of human capital for 87 countries, including 15 transition economies over the period 1990-98. To allow for deviations from equilibrium specific to transition economies, dummies for CEE and the CIS were included in the regression, but not taken into account when calculating equilibrium wages.

Estimates for Armenia, Azerbaijan, Croatia, Slovenia, Tajikistan and Turkmenistan are extrapolated from the regression results using EBRD data. For details on the regression methodology, see Kraijnak and Zettelmeyer (1997).

2000 will see the highest average growth rate yet achieved in the region since the start of transition.

Behind the current recovery lies a favourable worldwide economic environment. CEE is benefiting from strong growth in the EU and the boost to investor confidence as a result of accession prospects. The CIS is reaping the benefits of large currency devaluations, sheltering their producers from import competition, and of high commodity prices, swelling government tax revenues and reducing the high external imbalances that were characteristic of the region in previous years.

Broadly sound macroeconomic policies have supported the recovery in most countries. It is clear that without stable macroeconomic conditions and improvements in the business environment, the present recovery in the less advanced transition countries will be short-lived.

The chapter has analysed a number of macroeconomic policy challenges in detail. In the advanced countries of CEE particular attention will need to be given to getting the right balance for macroeconomic policy, with more of an emphasis on tight fiscal management. This point is further underlined by the apparent imbalance between domestic savings and investment requirements, particularly in the accession countries, and the need to maintain external competitiveness. The chapter identifies a significant financing gap between assistance pledged by the EU to facilitate the accession process and expected investment needs to meet environmental, social and infrastructure standards required for EU accession. It is unlikely that CEE will be able to finance this gap entirely from abroad. To avoid having to raise already high taxes even further, CEE needs to rationalise the public sector. Against the background of healthy economic growth, now would seem a good time to start.

In the CIS, macroeconomic challenges are different. The most urgent relates to foreign debt management in the aftermath of the currency devaluations across the region. Debt service burdens are high and increasing. Tax reforms, tighter tax administration to encourage better compliance and – in some cases – further efforts jointly with multilateral and bilateral creditors to restructure foreign obligations will be the key to fiscal sustainability over the medium term. In the resource-rich economies of the region, structural reforms to public finances are needed to reduce the reliance on highly volatile taxes on exporters of producers of commodities and to cushion the public sector against future trade setbacks. Further cutbacks in expenditure through reduced public spending on key services would undermine the credibility and capacity of the state with serious long-term consequences.

Over the medium term, further progress in structural reforms will be needed if current growth in Russia and the CIS is to be sustained. The current constellation of low asset values and high corporate cash flows provides a good opportunity to start the process of restructuring and to make better use of the region’s existing capacity. As the experience of Poland in particular demonstrates, a process of restructuring in existing firms coupled with the entry of private businesses can generate high growth without recourse to high levels of investment. However, unlocking this growth potential will require progress in two key areas.

First, entrepreneurs need to have confidence in the broad direction of economic policy – measures to regain credibility and commit to a stable environment are central to this. Second, efficiency improvements will be sustained only if enterprises are subject to competition – new entrants need a level playing field to push incumbent firms along, and to facilitate the redeployment of existing assets to their best use.

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Annex 3.1: Macroeconomic performance tables

Table A.3.1

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

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Estimated level of real GDP in 1999
						(in per cent)							(1989=100)
Albania	9.8	-10.0	-28.0	-7.2	9.6	8.3	13.3	9.1	-7.0	8.0	7.3	7.0	95
Bulgaria	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-6.9	3.5	2.4	4.0	67
Croatia	-1.6	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	-0.3	3.5	78
Czech Republic	1.4	-1.2	-11.6	-0.5	0.1	2.2	5.9	4.8	-1.0	-2.2	-0.2	2.0	95
Estonia	8.1	-6.5	-13.6	-14.2	-9.0	-2.0	4.3	3.9	10.6	4.7	-1.1	5.0	77
FYR Macedonia	0.9	-9.9	-7.0	-8.0	-9.1	-1.8	-1.2	1.2	1.4	2.9	2.7	5.0	74
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.5	6.0	99
Latvia	6.8	2.9	-10.4	-34.9	-14.9	0.6	-0.8	3.3	8.6	3.9	0.1	4.5	60
Lithuania	1.5	-5.0	-5.7	-21.3	-16.2	-9.8	3.3	4.7	7.3	5.1	-4.2	2.2	62
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.8	4.1	5.0	122
Romania	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.9	-6.1	-5.4	-3.2	1.5	76
Slovak Republic	1.4	-2.5	-14.6	-6.5	-3.7	4.9	6.7	6.2	6.2	4.1	1.9	2.0	100
Slovenia	-1.8	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.5	4.6	3.8	4.9	5.1	109
Central and eastern Europe and the Baltic states [1]	*-0.1*	*-6.6*	*-10.7*	*-3.2*	*0.3*	*3.7*	*5.4*	*4.1*	*3.6*	*2.6*	*2.1*	*4.1*	*97*
Armenia	14.2	-7.4	-11.7	-41.8	-8.8	5.4	6.9	5.9	3.3	7.2	3.3	3.5	42
Azerbaijan	-4.4	-11.7	-0.7	-22.6	-23.1	-19.7	-11.8	1.3	5.8	10.0	7.4	7.5	47
Belarus	8.0	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.8	11.4	8.3	3.4	2.0	80
Georgia	-4.8	-12.4	-20.6	-44.8	-25.4	-11.4	2.4	10.5	10.8	2.9	3.0	3.0	34
Kazakhstan	-0.4	-0.4	-13.0	-2.9	-9.2	-12.6	-8.2	0.5	1.7	-1.9	1.7	8.2	63
Kyrgyzstan	8.0	3.0	-5.0	-19.0	-16.0	-20.1	-5.4	7.1	9.9	2.1	3.6	5.0	63
Moldova	8.5	-2.4	-17.5	-29.1	-1.2	-31.2	-1.4	-7.8	1.3	-8.6	-4.4	-3.0	31
Russia	0.0	-4.0	-5.0	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-4.6	3.2	6.5	57
Tajikistan	-2.9	-1.6	-7.1	-29.0	-11.0	-18.9	-12.5	-4.4	1.7	5.3	3.7	5.0	44
Turkmenistan	-6.9	2.0	-4.7	-5.3	-10.0	-17.3	-7.2	-6.7	-11.3	5.0	16.0	20.0	64
Ukraine	4.0	-3.4	-11.6	-13.7	-14.2	-23.0	-12.2	-10.0	-3.0	-1.9	-0.4	3.0	36
Uzbekistan	3.7	1.6	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	2.5	4.4	4.1	1.0	94
Commonwealth of Independent States [2]	*0.6*	*-3.7*	*-6.0*	*-14.1*	*-9.3*	*-13.8*	*-5.2*	*-3.5*	*0.9*	*-3.5*	*2.8*	*5.9*	*55*
Central and eastern Europe, the Baltic states and the CIS	**0.3**	**-5.0**	**-8.1**	**-9.3**	**-5.1**	**-6.0**	**-0.5**	**-0.2**	**2.0**	**-1.1**	**2.5**	**4.8**	**68**

Note: Data for 1989-98 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 1999 are preliminary actuals, mostly official government estimates. Data for 2000 represent EBRD projections.

Estimates of growth for Bosnia and Herzegovina are only available since 1995 and therefore are not included in this summary table. Data for Bosnia and Herzegovina are provided in the selected economic indicators at the back of this Report.

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

[2] Estimates for real GDP represent weighted averages for CIS countries. The weights used for the growth rates were EBRD estimates of nominal dollar-GDP lagged by one year; those used for the index in the last column were EBRD estimates of GDP converted at PPP US$ exchange rates in 1989.

Table A.3.2

GDP growth by components

(real change in per cent)

	1997	1998	1999
Bulgaria			
Real GDP growth	-6.9	3.5	2.4
Private consumption	-15.7	8.1	5.2
Public consumption	-11.5	4.1	-0.4
Gross fixed investment	-23.9	16.4	25.3
Exports of goods and services	3.1	-15.6	-5.2
Imports of goods and services	-2.7	-2.8	5.1
Croatia			
Real GDP growth	6.5	2.5	-0.3
Private consumption	12.8	0.3	-3.0
Public consumption	3.0	3.2	-0.1
Gross fixed investment	23.3	3.0	-5.9
Exports of goods and services	7.6	6.9	-0.2
Imports of goods and services	25.1	-4.6	-3.9
Czech Republic			
Real GDP growth	-1.0	-2.2	-0.2
Private consumption	1.8	-2.9	1.4
Public consumption	0.8	-0.9	-0.1
Gross fixed investment	-2.9	-3.9	-5.5
Exports of goods and services	8.1	10.7	6.6
Imports of goods and services	7.2	7.9	5.8
Estonia			
Real GDP growth	10.6	4.7	-1.1
Private consumption	8.9	6.2	-2.2
Public consumption	1.3	3.9	7.9
Gross fixed investment	17.5	11.3	-15.2
Exports of goods and services	30.4	12.5	-2.4
Imports of goods and services	29.8	12.5	-6.4
Hungary			
Real GDP growth	4.6	4.9	4.5
Private consumption	1.7	4.9	4.4
Public consumption	5.7	-0.3	2.2
Gross fixed investment	9.2	13.3	6.6
Exports of goods and services	26.4	16.7	13.2
Imports of goods and services	24.6	22.8	12.3

	1997	1998	1999
Latvia			
Real GDP growth	8.6	3.9	0.1
Private consumption	5.0	6.2	0.8
Public consumption	0.3	6.1	-6.7
Gross fixed investment	20.7	44.0	-10.4
Exports of goods and services	13.1	4.9	-5.8
Imports of goods and services	6.8	19.0	-6.2
Poland			
Real GDP growth	6.9	4.8	4.1
Private consumption	7.0	4.9	7.0
Public consumption	3.4	3.0	3.5
Gross fixed investment	21.9	14.5	5.0
Exports of goods and services	9.9	11.0	1.0
Imports of goods and services	16.7	14.0	6.0
Romania			
Real GDP growth	-6.1	-5.4	-3.2
Private consumption	-3.1	-4.6	-4.9
Public consumption	-11.6	14.1	-2.5
Gross fixed investment	-3.0	-18.1	-5.1
Exports of goods and services	na	na	9.7
Imports of goods and services	na	na	-5.1
Slovak Republic			
Real GDP growth	6.2	4.1	1.9
Private consumption	5.6	5.3	0.1
Public consumption	4.0	4.0	-6.9
Gross fixed investment	12.0	11.1	-18.8
Exports of goods and services	17.6	12.2	3.6
Imports of goods and services	13.1	19.9	-6.1
Slovenia			
Real GDP growth	4.6	3.8	4.9
Private consumption	3.3	2.9	5.3
Public consumption	4.3	5.9	5.7
Gross fixed investment	11.3	11.1	16.1
Exports of goods and services	11.3	7.2	1.8
Imports of goods and services	12.2	10.4	7.3

Source: EBRD.

Note: Data for 1997-98 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 1999 are preliminary actuals, mostly official government estimates.

Table A.3.3

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

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

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 projection
Central and eastern Europe and the Baltic states												
Albania	0.0	0.0	35.5	226	85.0	22.6	7.8	12.7	33.2	20.6	0.4	0.4
Bulgaria	6.4	26.3	334	82.0	73.0	96.3	62.0	123	1,082	22.2	0.7	7.0
Croatia	na	610	123	666	1,518	97.6	2.0	3.5	3.6	5.7	4.2	6.5
Czech Republic	1.4	9.7	52.0	11.1	20.8	10.0	9.1	8.8	8.5	10.7	2.1	3.9
Estonia	6.1	23.1	211	1,076	89.8	47.7	29.0	23.1	11.2	8.2	3.3	3.8
FYR Macedonia	1,246	608	115	1,664	338	127	16.4	2.5	1.5	0.6	-1.3	8.5
Hungary	17.0	28.9	35.0	23.0	22.5	18.8	28.2	23.6	18.3	14.3	10.1	9.5
Latvia	4.7	10.5	172	951	109	35.9	25.0	17.6	8.4	4.7	2.4	2.9
Lithuania	2.1	8.4	225	1,021	410	72.1	39.6	24.6	8.9	5.1	0.8	1.0
Poland	251	586	70.3	43.0	35.3	32.2	27.8	19.9	14.9	11.8	7.3	9.9
Romania	1.1	5.1	170	210	256	137	32.3	38.8	154	59.1	45.8	45.0
Slovak Republic	2.3	10.8	61.2	10.0	23.2	13.4	9.9	5.8	6.1	6.7	10.6	11.9
Slovenia	1,306	550	118	207	32.9	21.0	13.5	9.9	8.4	8.0	6.1	8.6
Median [1]	*5.4*	*23.1*	*117.7*	*210*	*85.0*	*35.9*	*25.0*	*17.6*	*8.9*	*8.2*	*3.3*	*7.0*
Mean [1]	*237*	*190*	*132*	*476*	*232*	*56.2*	*23.3*	*24.1*	*105*	*13.7*	*7.1*	*9.1*
Commonwealth of Independent States												
Armenia	4.8	10.3	274	1,346	3,732	5,273	177	18.8	13.8	8.7	0.6	-0.5
Azerbaijan	na	7.8	107	912	1,129	1,664	412	19.7	3.5	-0.8	-8.5	1.5
Belarus	1.7	4.7	94.1	971	1,190	2,221	709	52.7	63.8	73.2	294	168
Georgia	na	3.3	79.0	887	3,125	15,607	163	39.4	7.1	3.6	19.3	4.4
Kazakhstan	na	na	78.8	1,381	1,662	1,892	176	39.1	17.4	7.3	8.4	13.2
Kyrgyzstan	na	na	85.0	855	772	229	40.7	31.3	25.5	12.0	36.8	18.6
Moldova	na	4.2	98.0	1,276	789	330	30.2	23.5	11.8	7.7	39.3	32.0
Russia	2.0	5.6	92.7	1,526	875	311	198	47.8	14.7	27.6	86.1	20.7
Tajikistan	na	4.0	112	1,157	2,195	350	609	418	87.8	43.6	27.5	24.2
Turkmenistan	2.1	4.6	103	493	3,102	1,748	1,005	992	83.7	16.8	24.2	10.0
Ukraine	2.2	4.2	91.0	1,210	4,735	891	377	80.0	15.9	10.6	22.7	28.0
Uzbekistan	0.7	3.1	82.2	645	534	1,568	305	54.0	58.9	17.8	29.1	30.0
Median [1]	*na*	*na*	*93.4*	*1,064*	*1,426*	*1,616*	*251*	*43.6*	*16.6*	*11.3*	*25.8*	*19.6*
Mean [1]	*na*	*na*	*108*	*1,055*	*1,987*	*2,674*	*350*	*151*	*33.7*	*19.0*	*48.3*	*29.2*

Note: Data for 1989-98 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 1999 are preliminary actuals, mostly official government estimates. Data for 2000 represent EBRD projections.

Estimates of inflation for Bosnia and Herzegovina (for the Federation and Republika Srpska separately) are provided in the selected economic indicators at the back of this Report.

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

Table A.3.4

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

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 projection	Change 1998-99	Change 1999-2000
						(in per cent of GDP)							(in percentage points)	
Albania	na	-6.1	-20.7	-23.1	-15.5	-12.6	-10.1	-12.1	-12.6	-10.4	-11.3	-9.5	-0.9	1.9
Bulgaria	-1.0	-8.1	-4.5	-2.9	-8.7	-3.9	-5.7	-10.4	-2.1	0.9	-0.9	-1.5	-1.9	-0.6
Croatia	na	na	na	-3.9	-0.8	-1.2	-1.4	-1.0	-1.4	-0.4	-6.2	-6.7	-5.8	-0.5
Czech Republic	na	-0.2	-1.9	-3.1	0.5	-1.1	-1.4	-0.9	-1.7	-2.0	-3.3	-4.2	-1.3	-0.9
Estonia	na	na	na	na	-0.7	1.3	-1.3	-1.9	2.2	-0.3	-4.6	-1.2	-4.3	3.4
FYR Macedonia	na	na	-4.5	-9.8	-13.4	-2.7	-1.0	-1.4	-0.4	-1.8	0.0	1.0	1.7	1.0
Hungary	na	0.0	-3.0	-7.2	-6.6	-8.4	-6.7	-5.0	-6.6	-5.6	-5.6	-3.6	0.0	2.0
Latvia	na	na	na	na	na	-4.4	-3.9	-1.8	0.3	-0.8	-4.2	-2.7	-3.4	1.5
Lithuania	na	na	na	na	-5.3	-4.8	-4.5	-4.5	-1.8	-5.8	-8.6	-3.3	-2.8	5.3
Poland	-7.4	3.1	-2.1	-4.9	-2.4	-2.2	-3.1	-3.3	-3.1	-3.2	-3.3	-3.0	-0.1	0.3
Romania	na	na	na	-4.6	-0.4	-2.2	-2.5	-3.9	-4.6	-5.0	-3.5	-4.0	1.5	-0.5
Slovak Republic	na	na	na	-11.9	-6.0	-1.5	0.4	-1.3	-5.2	-5.0	-3.6	-3.3	1.4	0.3
Slovenia	na	na	2.6	0.3	0.6	-0.2	-0.3	-0.2	-1.7	-1.4	-0.9	-1.0	0.5	-0.1
Central and eastern Europe and the Baltic states [1]	*-4.2*	*-2.3*	*-4.9*	*-7.1*	*-4.9*	*-3.2*	*-3.2*	*-3.7*	*-3.0*	*-3.1*	*-4.3*	*-3.3*	*-1.2*	*1.0*
Armenia	na	na	-1.9	-13.9	-54.7	-16.5	-9.0	-8.6	-5.8	-3.7	-5.9	-6.3	-2.2	-0.4
Azerbaijan	na	na	na	2.7	-15.3	-12.1	-4.9	-2.8	-1.6	-4.2	-5.4	-7.7	-1.2	-2.3
Belarus	na	na	na	-3.3	-5.2	-1.3	-6.9	-1.9	-1.2	-0.6	-5.6	-4.5	-5.0	1.1
Georgia	na	na	-3.0	-25.4	-26.2	-7.4	-5.3	-4.9	-7.0	-6.5	-6.7	-6.3	-0.3	0.4
Kazakhstan	na	1.4	-7.9	-7.3	-4.1	-7.7	-3.4	-5.3	-7.0	-7.7	-5.3	-0.2	2.3	5.1
Kyrgyzstan	na	na	na	na	-14.4	-5.7	-8.4	-8.8	-8.8	-11.2	-12.8	-7.2	-1.6	5.6
Moldova	na	na	0.0	-26.6	-7.5	-5.9	-5.8	-9.7	-7.5	-3.3	-3.2	-2.9	0.1	0.3
Russia	na	na	na	-18.9	-7.3	-10.4	-6.0	-8.9	-7.6	-8.0	-1.0	2.0	7.0	3.0
Tajikistan	1.3	-3.0	-20.2	-30.5	-20.9	-5.2	-5.3	-5.8	-3.3	-3.8	-3.1	-1.4	0.7	1.8
Turkmenistan	na	1.7	3.0	-9.4	-4.1	-2.3	-2.6	0.3	0.0	-2.7	0.9	0.2	3.6	-0.7
Ukraine	na	na	na	-25.4	-16.2	-7.7	-6.1	-6.1	-5.0	-3.0	-2.5	-1.5	0.5	1.0
Uzbekistan	-0.9	-1.1	-3.6	-18.3	-10.4	-6.1	-4.1	-7.3	-2.4	-3.0	-1.8	-3.0	1.2	-1.2
Commonwealth of Independent States [1]	*0.2*	*-0.2*	*-4.8*	*-16.0*	*-15.5*	*-7.4*	*-5.6*	*-5.8*	*-4.8*	*-4.8*	*-4.1*	*-3.2*	*0.4*	*1.1*

Note: Data for 1989-98 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 1999 are preliminary actuals, mostly official government estimates. Data for 2000 represent EBRD projections. Estimates of government balances for Bosnia and Herzegovina (for the Federation and Republika Srpska separately) are provided in the selected economic indicators at the back of this Report.

[1] Unweighted average for the region.

Table A.3.5

General government revenue

(in per cent of GDP)

	1994	1995	1996	1997	1998	1999
Croatia	41.8	43.5	44.3	43.0	46.0	42.8
Czech Republic	42.6	41.9	40.3	39.7	39.3	41.4
Estonia	42.1	40.5	38.8	40.4	38.4	36.9
Hungary	50.3	45.9	45.3	44.3	43.8	41.7
Latvia	na	37.2	37.4	41.3	42.6	42.6
Lithuania	32.6	32.3	29.6	32.6	32.4	31.9
Poland	48.3	47.4	47.0	46.4	42.6	42.7
Slovak Republic	44.0	47.0	45.6	41.1	38.3	39.7
Slovenia	43.4	43.1	42.7	42.1	43.0	43.7
Central eastern Europe and the Baltic states [1]	*43.1*	*42.1*	*41.2*	*41.2*	*40.7*	*40.4*
Albania	23.8	23.4	18.3	16.9	20.3	21.3
Bosnia and Herzegovina	na	39.0	0.5	40.4	45.9	44.7
Bulgaria	41.8	35.7	31.9	31.4	36.8	39.8
FYR Macedonia	43.1	37.9	35.7	34.9	34.0	38.0
Romania	31.7	31.4	28.9	27.3	28.3	32.1
South-eastern Europe [1]	*35.1*	*33.5*	*23.1*	*30.2*	*33.1*	*35.2*
Russia	*34.6*	*32.5*	*33.0*	*35.3*	*31.7*	*34.1*
Armenia	27.7	19.9	17.6	19.7	20.8	22.4
Azerbaijan	33.8	17.6	17.6	19.1	17.0	19.5
Belarus	46.0	36.1	40.8	44.9	45.9	42.3
Georgia	na	7.1	9.3	14.8	16.4	15.6
Kazakhstan	18.5	16.9	13.2	13.5	18.2	19.1
Kyrgyzstan	26.8	24.8	23.9	23.9	24.4	24.0
Moldova	30.4	30.9	26.6	33.0	29.8	25.4
Tajikistan	42.8	11.5	13.2	13.7	12.0	13.1
Turkmenistan	16.9	20.5	16.6	25.4	21.8	20.5
Ukraine	43.7	39.1	36.7	38.0	36.0	34.7
Uzbekistan	29.2	34.6	34.3	30.1	32.4	32.1
Commonwealth of Independent States [1]	*31.6*	*23.5*	*22.7*	*25.1*	*25.0*	*24.4*
Other selected countries						
Germany	43.5	43.1	43.9	43.7	43.8	44.6
Greece	35.5	36.4	36.9	38.9	40.1	41.9
Japan	32.1	32.0	31.7	31.6	31.6	31.1
Portugal	37.8	38.8	40.1	41.0	41.3	42.8
United States	29.4	29.8	30.2	30.5	30.9	31.1

Sources: EBRD for transition economies and OECD *Economic Outlook* for OECD countries.

Note: Data for 1994-98 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 1999 are preliminary actuals, mostly official government estimates.

[1] Unweighted average for the region. Croatia is included in central eastern Europe for the purposes of this table, given the structural similarities with this region.

Table A.3.6

General government expenditure

(in per cent of GDP)

	1994	1995	1996	1997	1998	1999
Croatia	40.6	44.9	45.3	44.4	46.4	49.0
Czech Republic	41.8	41.5	40.6	40.9	40.8	42.0
Estonia	40.8	41.7	40.7	38.2	38.7	41.6
Hungary	58.7	52.2	48.2	50.9	49.4	44.8
Latvia	40.5	41.2	39.2	41.0	43.4	46.8
Lithuania	37.4	36.8	34.2	33.7	37.9	40.6
Poland	50.5	49.2	49.3	48.0	44.0	44.7
Slovak Republic	45.5	45.2	47.0	45.5	42.9	43.3
Slovenia	43.6	43.4	42.9	43.8	44.4	44.7
Central eastern Europe and the Baltic states [1]	*44.4*	*44.0*	*43.0*	*42.9*	*43.1*	*44.2*
Albania	36.4	33.4	30.3	29.4	30.7	32.6
Bosnia and Herzegovina	na	39.3	52.7	40.9	53.3	50.5
Bulgaria	45.7	41.3	42.3	33.5	35.8	40.7
FYR Macedonia	45.8	39.0	37.1	35.3	35.8	38.0
Romania	33.9	34.7	33.8	34.3	35.2	36.8
South-eastern Europe [1]	*40.5*	*37.6*	*39.3*	*34.7*	*38.2*	*39.7*
Russia	*45.1*	*38.5*	*41.9*	*42.9*	*39.7*	*36.0*
Armenia	44.1	28.9	26.2	25.5	24.5	28.3
Azerbaijan	45.9	22.5	20.3	20.8	21.2	24.9
Belarus	47.3	43.0	42.7	46.1	46.5	47.9
Georgia	23.5	12.3	14.1	21.8	22.9	22.3
Kazakhstan	18.4	20.8	18.6	20.4	25.8	24.4
Kyrgyzstan	32.4	33.2	32.7	32.7	35.6	36.8
Moldova	36.3	36.7	36.3	40.5	33.2	28.6
Tajikistan	59.0	27.0	19.0	17.0	15.8	16.3
Turkmenistan	19.2	23.1	16.3	25.3	24.5	19.6
Ukraine	51.4	33.0	42.8	43.0	39.0	37.1
Uzbekistan	35.3	38.7	41.6	32.5	34.5	34.0
Commonwealth of Independent States [1]	*37.5*	*29.0*	*28.2*	*29.6*	*29.4*	*29.1*
Other selected countries						
Germany	46.0	46.3	47.3	46.3	45.6	45.6
Greece	45.5	46.6	44.4	42.8	42.6	43.5
Japan	34.4	35.6	35.9	34.9	36.6	38.1
Portugal	43.8	44.5	43.4	43.5	43.5	44.7
United States	33.1	32.9	32.4	31.4	30.5	30.1

Sources: EBRD for transition economies and OECD *Economic Outlook* for OECD countries.

Note: Data for 1994-98 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 1999 are preliminary actuals, mostly official government estimates. General government expenditure includes net lending.

1 Unweighted average for the region. Croatia is included in central eastern Europe for the purposes of this table, given the structural similarities with this region.

Table A.3.7

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

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Change 1998-99	Change 1999-2000
						(in per cent of GDP)							(in percentage points)	
Albania	na	na	na	-68.5	-30.1	-14.4	-7.2	-9.1	-12.1	-6.1	-8.0	-8.5	-1.9	-0.5
Bulgaria	-1.6	-8.2	-1.0	-4.2	-10.1	-0.3	-0.2	0.2	4.2	-0.5	-5.5	-5.5	-5.0	0.0
Croatia	na	na	-3.4	3.2	5.6	5.7	-7.7	-5.8	-11.6	-7.1	-7.6	-4.1	-0.5	3.5
Czech Republic	na	na	na	na	1.3	-1.9	-2.6	-7.4	-6.1	-2.4	-2.0	-3.5	0.4	-1.5
Estonia	na	na	na	na	1.3	-7.3	-4.4	-9.1	-12.2	-9.2	-5.7	-6.9	3.4	-1.2
FYR Macedonia	na	-9.1	-5.5	-0.8	0.6	-5.3	-5.0	-6.5	-7.5	-8.8	-4.0	-9.3	4.9	-5.3
Hungary	-4.6	0.4	0.8	0.9	-9.0	-9.4	-5.6	-3.7	-2.1	-4.9	-4.2	-3.4	0.6	0.8
Latvia	na	na	na	na	19.1	5.5	-0.4	-5.4	-6.1	-10.7	-10.3	-9.9	0.4	0.4
Lithuania	na	na	na	na	-3.2	-2.2	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	0.8	5.2
Poland	-2.2	1.0	-2.6	1.1	-0.7	0.7	4.5	-1.0	-3.2	-4.4	-7.6	-7.1	-3.2	0.5
Romania	na	-9.6	-3.5	-8.0	-4.5	-1.4	-6.3	-8.9	-6.8	-7.0	-3.8	-4.9	3.2	-1.0
Slovak Republic	na	na	na	na	-4.7	4.6	2.1	-10.6	-9.6	-9.7	-5.5	-3.3	4.2	2.2
Slovenia	9.0	3.0	1.0	7.4	1.5	4.0	-0.5	0.2	0.1	-0.8	-3.9	-2.6	-3.2	1.3
Central and eastern Europe and the Baltic states [1]	*0.2*	*-3.8*	*-2.0*	*-8.6*	*-2.5*	*-1.7*	*-3.3*	*-5.9*	*-6.4*	*-6.4*	*-6.1*	*-5.8*	*0.3*	*0.3*
Armenia	na	na	na	na	-14.3	-16.0	-17.0	-18.2	-18.7	-20.6	-15.0	-14.5	5.6	0.5
Azerbaijan	na	na	na	-12.2	-12.2	-9.4	-13.2	-25.8	-23.1	-32.6	-15.0	-6.3	17.6	8.7
Belarus	na	na	na	na	-11.9	-9.1	-4.4	-3.7	-5.8	-6.9	-3.3	-6.3	3.7	-3.0
Georgia	na	na	na	-33.5	-40.2	-22.3	-7.5	-6.1	-11.0	-11.2	-7.9	-6.9	3.3	1.0
Kazakhstan	na	na	na	-31.5	-7.2	-7.8	-1.3	-3.6	-3.6	-5.6	-1.1	4.2	4.5	5.3
Kyrgyzstan	na	na	na	na	na	-7.6	-15.7	-23.3	-7.9	-22.4	-14.9	-12.8	7.5	2.2
Moldova	na	na	na	-3.0	-11.9	-7.0	-6.8	-11.9	-14.8	-19.0	-2.8	-8.0	16.2	-5.1
Russia	na	na	na	na	na	2.1	1.4	1.7	0.1	0.8	13.6	17.2	12.8	3.6
Tajikistan	na	na	na	na	-28.9	-20.2	-12.8	-7.4	-6.1	-9.2	-3.3	-4.6	6.0	-1.4
Turkmenistan	na	na	na	68.5	14.1	4.0	0.9	0.1	-24.2	-38.8	-28.2	-0.5	10.7	27.7
Ukraine	na	na	na	na	na	-3.1	-3.1	-2.7	-2.7	-3.1	2.7	1.7	5.8	-1.0
Uzbekistan	na	na	na	-12.0	-8.4	2.1	-0.2	-8.1	-5.1	-0.4	-2.7	-2.4	-2.3	0.3
Commonwealth of Independent States [1]	*na*	*na*	*na*	*-3.9*	*-13.4*	*-7.9*	*-6.6*	*-9.1*	*-10.2*	*-14.1*	*-6.5*	*-3.3*	*7.6*	*3.2*
Central and eastern Europe, the Baltic states and the CIS [1]	**na**	**na**	**na**	**-6.6**	**-7.0**	**-4.6**	**-4.9**	**-7.4**	**-8.2**	**-10.1**	**-6.3**	**-4.6**	**3.8**	**1.7**

Note: Data for 1989-98 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank and the OECD. Data for 1999 are preliminary actuals, mostly official government estimates. Data for 2000 represent EBRD projections.

[1] Unweighted average for the region.

Table A.3.8

Indicators of competitiveness

(change as a percentage, unless indicated)

	1995	1996	1997	1998	1999	1995-99
Bulgaria [1]						
Industrial gross output	-5.4	-11.8	-11.3	4.3	-12.5	-32.5
Productivity in industry	-3.3	-10.1	-4.3	12.3	-2.8	-9.2
Real wage in manufacturing (PPI-based)	na	na	16.2	14.1	na	na
D-Mark unit labour costs	na	na	24.4	14.6	na	na
Real D-Mark exchange rate index (1994=100)	113.4	98.8	140.4	164.0	164.2	–
Wage share	na	0.39	0.42	0.41	na	–
Croatia [2]						
Industrial gross output	-0.3	1.3	3.8	3.2	-2.9	5.1
Productivity in industry	5.2	9.4	12.0	9.3	0.9	42.1
Real wage in industry (PPI-based)	30.8	11.0	8.2	11.4	2.8	79.7
D-Mark unit labour costs	26.8	2.2	0.5	-1.5	-2.8	24.7
Real D-Mark exchange rate index (1994=100)	101.5	104.7	108.3	111.3	107.6	–
Wage share	na	0.57	0.50	0.52	0.51	–
Czech Republic						
Manufacturing gross output	8.2	5.5	6.4	2.5	-2.7	21.1
Productivity in manufacturing	11.1	9.6	11.1	5.6	2.2	45.9
Real wage in manufacturing (PPI-based)	8.7	11.9	8.4	5.6	6.3	48.1
D-Mark unit labour costs	1.5	10.1	0.9	4.3	2.1	20.0
Real D-Mark exchange rate index (1994=100)	102.7	113.2	118.9	130.0	129.4	–
Wage share	0.25	0.27	0.25	0.25	0.25	–
Estonia						
Manufacturing gross output	2.9	2.2	18.5	5.7	-7.9	21.3
Productivity in manufacturing	3.8	7.8	2.3	11.4	-10.6	14.1
Real wage in manufacturing (PPI-based)	14.1	7.7	11.5	10.7	3.5	57.0
D-Mark unit labour costs	30.6	14.7	16.7	2.6	12.6	102.0
Real D-Mark exchange rate index (1994=100)	126.7	153.9	167.8	180.1	184.6	–
Wage share	0.52	0.50	0.50	0.48	0.52	–
Hungary						
Manufacturing gross output	5.0	3.4	14.8	16.2	12.5	62.9
Productivity in manufacturing	9.8	3.3	13.0	10.1	0.2	41.4
Real wage in manufacturing (PPI-based)	-3.8	-0.6	3.6	7.4	8.5	15.5
D-Mark unit labour costs	-18.4	1.8	1.7	-8.2	9.0	-15.4
Real D-Mark exchange rate index (1994=100)	93.1	98.2	107.3	107.3	110.7	–
Wage share	0.30	0.29	0.27	0.27	0.29	–
Latvia						
Manufacturing gross output	-4.5	7.3	17.1	3.7	-9.8	-1.2
Productivity in manufacturing	14.2	15.6	12.7	13.4	-3.6	66.1
Real wage in manufacturing (PPI-based)	9.3	0.8	17.8	4.8	7.7	94.7
D-Mark unit labour costs	2.2	-1.2	18.4	-7.2	11.4	129.0
Real D-Mark exchange rate index (1994=100)	115.1	134.3	156.2	161.8	173.4	–
Wage share	0.41	0.38	0.39	0.43	0.48	
Lithuania [3]						
Manufacturing gross output	0.9	3.5	8.0	9.3	-7.9	13.5
Productivity in manufacturing	12.0	8.5	7.6	10.2	-6.7	34.5
Real wage in manufacturing (PPI-based)	14.0	14.9	18.1	28.6	-10.4	78.3
D-Mark unit labour costs	14.7	30.3	31.8	10.5	3.3	124.7
Real D-Mark exchange rate index (1994=100)	120.6	155.5	191.6	202.3	211.5	–
Wage share	0.32	0.32	0.32	0.35	0.33	–

Table A.3.8 (continued)

Indicators of competitiveness

(change as a percentage, unless indicated)

	1995	1996	1997	1998	1999	1995-99
Poland						
Manufacturing gross output	11.6	9.8	12.8	5.1	5.3	53.0
Productivity in manufacturing	7.0	10.0	12.1	4.7	9.5	51.2
Real wage in manufacturing (PPI-based)	5.4	14.5	12.1	8.4	5.8	55.2
D-Mark unit labour costs	2.7	8.9	3.0	5.0	-7.1	12.3
Real D-Mark exchange rate index (1994=100)	104.1	116.2	124.1	130.8	128.3	–
Wage share	0.32	0.33	0.34	0.34	0.34	–
Romania						
Manufacturing gross output	12.1	12.5	-6.8	-18.1	-6.1	-9.6
Productivity in manufacturing	24.0	14.8	-1.4	-15.9	9.8	29.6
Real wage in manufacturing (PPI-based)	14.2	4.4	-17.1	11.9	-7.6	2.2
D-Mark unit labour costs	-27.1	-1.0	5.0	63.3	-19.2	0
Real D-Mark exchange rate index (1994=100)	74.3	73.2	98.9	141.9	124.2	–
Wage share	0.35	0.33	0.29	0.33	0.28	–
Russia [4]						
Manufacturing gross output	-3.9	-6.8	1.9	-5.2	8.1	-6.5
Productivity in manufacturing	4.8	0.2	12.0	19.1	7.3	50.4
Real wage in manufacturing (PPI-based)	-31.3	9.6	-13.7	7.7	-9.2	-36.5
D-Mark unit labour costs	-5.9	76.2	-5.9	-43.0	-43.2	-49.4
Real D-Mark exchange rate index (1994=100)	125.0	170.2	195.4	145.5	113.8	–
Wage share	na	na	na	na	na	–
Slovak Republic						
Manufacturing gross output	10.2	2.4	1.6	6.5	-3.0	18.4
Productivity in manufacturing	5.3	2.5	4.1	11.5	2.0	27.7
Real wage in manufacturing (PPI-based)	6.0	9.8	7.5	6.1	-3.9	27.6
D-Mark unit labour costs	4.2	15.3	12.2	-5.8	-6.5	18.8
Real D-Mark exchange rate index (1994=100)	102.8	109.3	119.6	122.3	119.5	–
Wage share	0.26	0.30	0.30	0.29	0.29	–
Slovenia						
Manufacturing gross output	2.8	0.9	0.2	3.9	0	8.0
Productivity in manufacturing	8.3	6.7	4.5	5.4	1.8	29.6
Real wage in manufacturing (PPI-based)	4.6	7.3	6.2	5.0	6.3	33.0
D-Mark unit labour costs	3.7	-1.6	4.8	2.7	2.2	12.4
Real D-Mark exchange rate index (1994=100)	107.1	106.7	110.9	115.7	116.4	–
Wage share	0.40	0.39	0.37	0.36	0.35	–

Sources: Production, employment and wage figures are taken from various issues of monthly, quarterly and annual publications from national authorities, the IMF, the OECD and the ILO. Data on the exchange rate to the D-Mark, on CPI and PPI are based on national authorities, the IMF and EBRD estimates.

Note: Data for 1995-98 represent the percentage change of annual averages based on actual data. Figures for 1999 represent preliminary official estimates.

Productivity is calculated as the ratio of manufacturing/industry production over manufacturing/industry employment.

The real D-Mark exchange rate is calculated as the domestic CPI divided by the product of the German CPI and the exchange rate. An increase in the index represents a real appreciation.

D-Mark unit labour costs are calculated as wages in D-Mark divided by productivity.

The wage share is the ratio of wages and value added in manufacturing. A level of 1 would mean that 100% of value added in manufacturing is paid out as wages.

Real wages are calculated as average monthly wages deflated by PPI. Average monthly wages in manufacturing are deflated by PPI in manufacturing, while average monthly earnings in industry are deflated by PPI in industry.

1 Wage data is taken from the ILO database.

2 Figures for 1995-97 refer to industry and thereafter to manufacturing. PPI refers to industry for 1995-97 and to manufacturing for 1998-99.

3 Output and PPI refer to mining, quarrying and manufacturing. Production data for 1999 refer to sales.

4 From 1997, figures refer to industry.

Table A.3.9

Foreign direct investment (net inflows recorded in the balance of payments)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 projection	Cumulative FDI-inflows 1989-99[1]	Cumulative FDI-inflows per capita 1989-99	FDI-inflows per capita 1998	FDI-inflows per capita 1999	FDI-inflows 1998	FDI-inflows 1999
	(in US$ million)												(US$ million)	(US$)	(US$)		(in per cent of GDP)	
Albania	na	na	na	20	45	65	89	97	42	45	51	92	454	137	13	15	1.5	1.4
Bulgaria	na	4	56	42	40	105	98	138	507	537	806	500	2,332	284	65	98	4.4	6.5
Bosnia and Herzegovina	na	na	na	na	na	0	0	0	0	100	60	100	160	37	24	14	2.6	1.4
Croatia	na	na	na	13	78	106	96	509	302	781	1,350	450	3,234	716	173	299	3.6	6.7
Czech Republic	na	na	na	983	563	749	2,526	1,276	1,275	2,641	4,912	6,000	14,924	1,447	256	476	4.7	9.2
Estonia	na	na	na	na	156	212	199	111	130	574	222	250	1,604	1,115	397	154	11.0	4.3
FYR Macedonia	na	0	0	0	0	24	12	12	18	175	27	100	268	134	88	14	5.0	0.8
Hungary	187	311	1,459	1,471	2,328	1,097	4,410	1,987	1,653	1,453	1,414	1,650	17,770	1,764	144	140	3.1	2.9
Latvia	na	na	na	na	50	279	245	379	515	303	331	300	2,100	866	124	136	5.0	5.3
Lithuania	na	na	na	na	30	31	72	152	328	921	478	295	2,012	545	249	129	8.6	4.5
Poland	na	0	117	284	580	542	1,134	2,741	3,041	4,966	6,642	10,000	20,047	518	128	172	3.2	4.3
Romania	na	-18	37	73	87	341	417	415	1,267	2,079	949	500	5,647	252	92	42	5.0	2.8
Slovak Republic	10	24	82	100	107	236	194	199	84	374	701	1,500	2,111	391	70	130	1.8	3.6
Slovenia	-14	-2	-41	113	111	131	183	188	340	250	144	50	1,400	701	125	72	1.3	0.7
Central and eastern Europe and the Baltic states	*183*	*319*	*1,710*	*3,098*	*4,175*	*3,919*	*9,673*	*8,202*	*9,500*	*15,198*	*18,086*	*22,787*	*74,064*	*636*	*139*	*135*	*4.3*	*3.9*
Armenia	na	na	na	0	1	8	25	18	52	221	131	150	455	120	58	34	11.7	7.1
Azerbaijan	na	na	na	na	0	22	282	661	1,093	1,024	510	274	3,592	448	129	64	24.5	12.8
Belarus	na	na	na	na	18	11	15	73	198	142	225	100	681	67	14	22	1.0	2.9
Georgia	na	na	na	na	0	8	6	54	236	221	96	109	622	116	41	18	6.4	3.5
Kazakhstan	na	na	na	100	473	635	964	1,137	1,320	1,143	1,584	1,500	7,356	494	74	106	5.2	10.0
Kyrgyzstan	na	na	na	na	na	38	96	47	83	109	35	42	408	87	23	8	6.6	2.9
Moldova	na	na	na	17	14	18	73	23	75	86	33	100	339	79	20	8	5.1	2.8
Russia	na	na	na	na	na	500	1,663	1,665	4,036	1,734	746	2,000	10,344	71	12	5	0.6	0.4
Tajikistan	na	na	na	9	9	12	20	25	30	24	21	30	150	25	4	3	1.8	1.9
Turkmenistan	na	na	na	na	79	103	233	108	108	62	89	100	782	159	13	18	2.6	4.8
Ukraine	na	na	na	na	na	151	257	526	581	747	489	750	2,751	55	15	10	1.8	1.6
Uzbekistan	na	na	na	9	48	73	-24	90	167	226	201	231	790	32	9	8	2.2	2.7
Commonwealth of Independent States	*0*	*0*	*0*	*135*	*642*	*1,579*	*3,610*	*4,426*	*7,979*	*5,739*	*4,160*	*5,386*	*28,270*	*146*	*34*	*25*	*5.8*	*4.4*
Total	**183**	**319**	**1,710**	**3,234**	**4,817**	**5,498**	**13,283**	**12,629**	**17,479**	**20,937**	**22,247**	**27,173**	**102,334**	**410**	**91**	**85**	**5.0**	**4.1**

Sources: IMF, central banks and EBRD estimates.

Note: For most countries, figures cover only investment in equity capital and in some cases contributions-in-kind.

Gross inflows of FDI are in some cases considerably higher than net inflows on account of increasing intra-regional investment flows (see Annex 4.1).

[1] Column refers to FDI flows accumulated for the years for which data are available.

Table A.3.10

GDP growth forecasts for 2000 (in per cent)

	Average[1]	Range[2]	EBRD (Aug 2000)	European Union (March 2000)	OECD (June 2000)	IMF (Sept 2000)	United Nations DESA[4] (Aug 2000)	Economist Intelligence Unit (Aug 2000)	PlanEcon (Aug 2000)	IWH[5] (July 2000)	Kopint-Datorg[6] (Sept 2000)	Vienna Institute (June 2000)	CSFB[7] (Sept 2000)	JP Morgan (Sept 2000)	Dun & Bradstreet (July 2000)
Central and eastern Europe and the Baltic states															
Albania	7.2	1.3	7.0	na	na	7.0	7.0	6.7	8.0	na	na	na	na	na	7.3
Bosnia and Herzegovina	12.6	6.0	15.0	na	na	13.7	na	9.0	na	na	na	na	na	na	na
Bulgaria	4.1	1.3	4.0	4.5	na	4.5	3.5	3.7	4.1	3.5	4.0	4.0	4.0	4.8	4.5
Croatia	2.7	2.0	3.5	na	na	2.5	3.0	3.5	2.6	na	2.5	1.5	3.0	na	2.5
Czech Republic	2.3	2.1	2.0	1.8	1.4	2.3	2.3	2.7	2.8	2.2	2.5	1.5	3.5	2.6	2.2
Estonia	4.6	3.2	5.0	4.0	na	4.0	5.0	4.5	5.3	4.5	6.2	4.0	na	na	3.0
FYR Macedonia	4.2	3.7	5.0	na	na	5.0	4.0	4.0	5.7	na	na	4.0	na	na	2.0
Hungary	5.5	1.7	6.0	4.7	5.2	5.5	5.0	5.5	5.7	5.5	5.5	5.5	5.5	6.4	5.0
Latvia	3.9	2.7	4.5	2.5	na	4.0	3.5	3.5	4.3	4.5	5.2	3.0	na	na	4.2
Lithuania	2.7	2.3	2.2	2.2	na	2.5	2.8	3.0	4.3	2.5	2.8	2.0	na	na	2.5
Poland	5.0	1.4	5.0	5.1	5.0	5.0	5.2	5.5	5.2	5.0	5.0	4.5	5.0	4.1	5.0
Romania	1.0	2.8	1.5	-0.6	na	1.3	1.2	1.5	2.2	1.0	1.0	0.0	na	na	1.0
Slovak Republic	2.1	1.4	2.0	2.2	2.0	2.4	2.0	1.6	3.0	2.0	2.0	2.0	2.1	2.0	2.3
Slovenia	4.5	1.1	5.1	4.1	na	4.5	4.2	4.5	4.6	4.5	4.8	4.0	na	na	4.5
Average	*4.4*	*1.8*	*4.8*	*3.1*	*3.4*	*4.6*	*3.7*	*4.2*	*4.4*	*3.5*	*3.8*	*3.0*	*3.9*	*4.0*	*3.5*
Weighted average [3]	*4.0*	*na*	*4.2*	*na*	*na*	*3.9*	*na*	*4.3*	*na*	*na*	*na*	*na*	*na*	*na*	*na*
Commonwealth of Independent States															
Armenia	3.4	1.8	3.5	na	na	4.5	3.5	3.0	2.7	na	na	na	na	na	na
Azerbaijan	7.0	3.2	7.5	na	na	5.0	7.5	7.0	8.2	na	na	na	na	na	7.0
Belarus	0.7	9.3	2.0	na	na	-6.3	2.0	2.5	1.2	na	na	na	na	na	3.0
Georgia	3.8	4.6	3.0	na	na	4.0	6.0	6.0	1.4	na	na	na	na	na	2.5
Kazakhstan	6.9	3.5	8.2	na	na	5.0	5.0	6.5	8.5	na	na	na	na	na	8.5
Kyrgyzstan	4.2	1.8	5.0	na	na	4.0	4.0	3.2	4.7	na	na	na	na	na	4.5
Moldova	-1.5	4.0	-2.0	na	na	na	1.0	-3.0	-2.0	na	na	na	na	na	na
Russia	5.1	3.5	6.5	na	4.0	7.0	4.0	5.0	5.8	4.0	5.0	4.0	6.0	6.5	3.5
Tajikistan	4.5	1.0	5.0	na	na	5.0	4.0	4.0	5.0	na	na	na	na	na	4.0
Turkmenistan	13.3	15.7	20.0	na	na	15.9	15.0	18.0	4.3	na	na	na	na	na	6.5
Ukraine	2.3	2.5	3.0	na	na	2.5	2.0	2.0	3.5	2.0	3.0	1.0	3.0	na	1.2
Uzbekistan	1.7	3.0	1.0	na	na	3.0	2.5	1.5	2.4	na	na	na	na	na	0.0
Average	*4.3*	*2.7*	*5.2*	*na*	*na*	*4.5*	*4.7*	*4.6*	*3.8*	*3.0*	*4.0*	*2.5*	*4.5*	*na*	*4.1*
Weighted average [3]	*4.7*	*na*	*5.9*	*na*	*na*	*na*	*3.9*	*4.6*	*5.4*	*na*	*na*	*na*	*na*	*na*	*na*

Note: All forecasts quoted here were published or reported to the EBRD between March and September 2000. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

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

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

3 Weighted average based on EBRD estimates of nominal dollar GDP in each country in 1999. Several institutions calculate their own weighted average. The IMF estimates growth in central and eastern Europe including Belarus and Ukraine at 3.1% in 2000, and for Transcaucasus and Central Asia at 5.3% in 2000. The EU estimates the weighted average growth rate for ten countries in central and eastern Europe and the Baltic states (this group excluding Albania, Croatia and FYR Macedonia) at 3.7% in 2000.

4 United Nations, Department of Economic and Social Affairs, N.Y.

5 Institute for Economic Research, Halle, Germany.

6 Institute for Economic and Market Research Information, Hungary.

7 Credit Suisse First Boston.

Table A.3.11

GDP growth forecasts for 2001 (in per cent)

	Average[1]	Range[2]	EBRD (Oct 2000)	European Union (March 2000)	OECD (June 2000)	IMF (Sept 2000)	United Nations DESA[4] (Aug 2000)	Economist Intelligence Unit (Aug 2000)	PlanEcon (Aug 2000)	IWH[5] (Aug 2000)	Kopint–Datorg[6] (Sept 2000)	Vienna Institute (Aug 2000)	CSFB[7] (Aug 2000)	JP Morgan (June 2000)	Dun & Bradstreet (Sept 2000)
Central and eastern Europe and the Baltic states															
Albania	6.7	3.0	5.0	na	na	8.0	7.0	7.7	6.5	na	na	na	na	na	6.2
Bosnia and Herzegovina	10.2	4.5	10.0	na	na	12.5	na	8.0	na	na	na	na	na	na	na
Bulgaria	4.3	1.7	4.0	4.9	na	5.0	3.5	3.3	5.0	4.0	3.8	4.0	5.0	4.9	4.0
Croatia	3.5	1.5	3.0	na	na	4.0	4.0	4.0	3.8	na	3.5	2.5	4.0	na	3.0
Czech Republic	3.3	3.0	4.0	3.1	2.3	3.2	3.0	3.0	4.3	3.0	3.5	2.0	5.0	3.5	3.0
Estonia	5.4	2.8	5.5	5.5	na	6.0	6.0	6.0	5.8	5.0	5.8	na	na	na	3.2
FYR Macedonia	4.4	3.0	3.0	na	na	6.0	4.0	4.5	5.6	na	na	5.0	na	na	3.0
Hungary	5.1	1.5	6.0	5.1	5.0	5.0	4.5	4.5	4.8	5.5	5.5	5.5	5.0	5.6	4.5
Latvia	4.7	2.2	4.5	3.9	na	6.0	4.5	5.0	5.3	5.0	4.5	na	na	na	3.8
Lithuania	3.8	2.0	3.5	3.4	na	4.0	3.5	4.0	5.0	3.0	4.7	na	na	na	3.0
Poland	4.9	2.3	4.0	5.5	4.8	5.5	5.0	5.3	5.5	5.0	4.7	5.0	5.0	3.2	4.6
Romania	2.7	4.3	3.0	2.8	na	3.0	3.0	3.0	5.3	2.0	2.5	1.0	na	na	1.5
Slovak Republic	3.2	1.9	4.0	3.3	3.0	3.5	3.0	2.6	4.5	3.0	3.0	3.0	3.0	3.0	2.6
Slovenia	4.2	0.8	4.5	4.1	na	4.6	3.8	4.0	4.5	4.0	4.5	4.0	na	na	4.0
Average	*4.7*	*1.9*	*4.6*	*4.2*	*3.8*	*5.5*	*4.2*	*4.6*	*5.1*	*4.0*	*4.2*	*3.6*	*4.5*	*4.0*	*3.6*
Weighted average[3]	*4.3*	*na*	*4.2*	*na*	*na*	*4.6*	*na*	*4.4*	*na*	*na*	*na*	*na*	*na*	*na*	*na*
Commonwealth of Independent States															
Armenia	5.7	1.0	5.5	na	na	6.0	6.0	6.0	5.0	na	na	na	na	na	na
Azerbaijan	8.0	1.8	8.0	na	na	7.9	8.0	8.5	8.8	na	na	na	na	na	7.0
Belarus	0.5	8.8	2.0	na	na	-0.6	3.0	2.0	-5.8	na	na	na	na	na	2.5
Georgia	5.9	2.0	6.0	na	na	5.0	7.0	7.0	5.2	na	na	na	na	na	5.0
Kazakhstan	6.0	3.5	6.6	na	na	4.0	6.0	7.0	7.5	na	na	na	na	na	5.0
Kyrgyzstan	4.4	1.5	4.0	na	na	4.2	5.0	3.5	4.8	na	na	na	na	na	5.0
Moldova	2.9	2.0	2.0	na	na	4.0	3.0	2.0	3.7	na	na	na	na	na	na
Russia	3.6	3.0	4.0	na	3.0	4.0	3.0	3.0	3.8	3.0	3.0	3.0	4.5	6.0	3.3
Tajikistan	4.9	1.4	5.0	na	na	5.0	5.0	5.0	5.4	na	na	na	na	na	4.0
Turkmenistan	5.8	6.0	3.0	na	na	6.4	5.0	9.0	4.6	na	na	na	na	na	7.0
Ukraine	2.5	3.0	2.5	na	na	3.5	2.0	1.5	4.0	2.5	1.0	3.0	3.5	na	1.5
Uzbekistan	0.9	4.0	-1.0	na	na	3.0	2.0	1.0	-0.9	na	na	na	na	na	1.0
Average	*4.3*	*2.6*	*4.0*	*na*	*na*	*4.4*	*4.6*	*4.6*	*3.8*	*2.8*	*2.0*	*3.0*	*4.0*	*na*	*4.1*
Weighted average[3]	*3.6*	*na*	*3.9*	*na*	*na*	*3.9*	*3.2*	*3.2*	*3.7*	*na*	*na*	*na*	*na*	*na*	*na*

Note: All forecasts quoted here were published or reported to the EBRD between March and September 2000. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

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

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

3 Weighted average based on EBRD estimates of nominal dollar GDP in each country in 1999. Several institutions calculate their own weighted average. The IMF estimates growth in central and eastern Europe including Belarus and Ukraine at 4.2% in 2001, and for Transcaucasus and Central Asia at 4.5% in 2000. The EU estimates the weighted average growth rate for ten countries in central and eastern Europe and the Baltic states (this group excluding Albania, Croatia and FYR Macedonia) at 4.6% in 2001.

4 United Nations, Department of Economic and Social Affairs, N.Y.

5 Institute for Economic Research, Halle, Germany.

6 Institute for Economic and Market Research Information, Hungary.

7 Credit Suisse First Boston.

Table A.3.12

Inflation forecasts for 2000 (change in the average consumer price level, in per cent)

	Average[1]	Range[2]	EBRD (Aug 2000)	European Union (March 2000)	OECD[3] (June 2000)	IMF (Sept 2000)	United Nations ECE[3] (Aug 2000)	Economist Intelligence Unit (Aug 2000)	PlanEcon (Aug 2000)	IWH[4] (Aug 2000)	Kopint–Datorg[5] (Sept 2000)	Vienna Institute (Aug 2000)	CSFB[6] (Aug 2000)	JP Morgan (June 2000)	Dun & Bradstreet (Sept 2000)
Central and eastern Europe and the Baltic states															
Albania	1.6	3.6	0.4	na	na	2.0	1.0	0.5	4.0	na	na	na	na	na	na
Bosnia and Herzegovina	4.0	2.0	3.0	na	na	na	na	5.0	na	na	na	na	na	na	na
Bulgaria	6.6	7.7	7.0	7.9	na	8.0	8.0	0.3	8.0	6.0	8.0	5.0	7.7	6.5	na
Croatia	5.9	1.2	6.5	na	na	6.0	6.0	6.0	5.3	na	5.5	5.5	6.1	na	na
Czech Republic	3.8	1.4	3.9	3.0	3.8	3.9	4.0	4.4	4.0	3.5	4.0	3.7	3.5	3.6	na
Estonia	3.7	1.6	3.8	3.5	na	3.0	4.6	3.8	3.4	3.5	4.2	na	na	na	na
FYR Macedonia	5.6	8.9	8.5	na	na	1.0	8.0	9.9	6.0	na	na	3.0	na	na	3.0
Hungary	8.8	1.5	9.5	8.0	8.0	8.0	9.0	9.5	8.8	8.5	9.5	8.3	9.4	8.9	na
Latvia	3.4	1.1	2.9	3.5	na	4.0	3.5	3.0	3.5	3.0	3.5	na	na	na	na
Lithuania	2.0	2.0	1.0	1.8	na	2.0	3.0	1.9	1.6	3.0	1.7	na	na	na	na
Poland	9.4	2.2	9.9	9.2	9.6	9.0	9.0	9.5	9.8	9.5	10.2	8.0	10.2	9.1	na
Romania	41.3	7.0	45.0	39.0	na	40.0	40.0	46.0	41.5	40.0	40	40.0	na	na	na
Slovak Republic	12.2	5.5	11.9	13.2	10.0	12.0	12.5	12.8	13.1	12.0	9.5	15.0	11.7	12.5	na
Slovenia	7.8	4.5	8.6	5.0	na	7.0	8.0	8.2	8.0	8.0	9.5	7.5	na	na	na
Average	*8.3*	*2.8*	*8.7*	*9.4*	*7.9*	*8.1*	*9.0*	*8.6*	*9.0*	*9.7*	*9.6*	*10.7*	*8.1*	*8.1*	*na*
Commonwealth of Independent States															
Armenia	1.0	3.0	-0.5	na	na	1.0	2.5	1.2	0.8	na	na	na	na	na	na
Azerbaijan	2.3	1.5	1.5	na	na	2.0	3.0	2.5	2.5	na	na	na	na	na	na
Belarus	182.3	44.0	168.4	na	na	156.0	200.0	195.0	192.0	na	na	na	na	na	na
Georgia	5.1	2.0	4.4	na	na	5.0	6.0	4.0	5.9	na	na	na	na	na	na
Kazakhstan	13.5	2.0	13.2	na	na	13.0	15.0	13.3	13.1	na	na	na	na	na	na
Kyrgyzstan	21.4	5.9	18.6	na	na	23.0	20.0	21.0	24.5	na	na	na	na	na	na
Moldova	34.8	17.0	32.0	na	na	28.0	35.0	34.0	45.0	na	na	na	na	na	na
Russia	20.6	8.0	20.7	na	20.0	19.0	25.0	21.5	20.9	17.0	23.0	20.0	20.5	19.5	na
Tajikistan	23.9	25.0	24.2	na	na	17.0	25.0	15.0	22.2	na	na	na	na	na	40.0
Turkmenistan	19.4	29.4	10.0	na	na	14.0	25.0	7.0	36.4	na	na	na	na	na	24.0
Ukraine	26.4	10.0	28.0	na	na	26.0	20.0	29.0	29.0	28.0	30.0	20.0	27.9	na	na
Uzbekistan	28.5	11.0	30.0	na	na	26.0	25.0	36.0	28.9	na	na	na	na	na	25.0
Average	*31.6*	*15.1*	*29.2*	*na*	*na*	*27.5*	*33.5*	*31.6*	*35.1*	*22.5*	*26.5*	*20.0*	*24.2*	*na*	*29.7*

Note: All forecasts quoted here were published or reported to the EBRD between March and September 2000. 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. The IMF provides average regional inflation forecasts for 2000 for central and eastern Europe excluding Belarus and Ukraine at 12%, including Belarus and Ukraine at 19% and for Transcaucasus and Central Asia at 16%. The EU estimates the weighted average inflation rate for ten countries in central and eastern Europe and the Baltic states (this group excluding Albania, Croatia and FYR Macedonia) at 10.4% in 2000.

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

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

3 Inflation is based on the private consumption deflator.

4 Institute for Economic Research, Halle, Germany.

5 Institute for Economic and Market Research Information, Hungary.

6 Credit Suisse First Boston.

Table A.3.13

Inflation forecasts for 2001 (change in the average consumer price level, in per cent)

	Average[1]	Range[2]	EBRD (Oct 2000)	European Union (March 2000)	OECD[3] (June 2000)	IMF (Sept 2000)	United Nations ECE[3] (Aug 2000)	Economist Intelligence Unit (Aug 2000)	PlanEcon (Aug 2000)	IWH[4] (Aug 2000)	Kopint–Datorg[5] (Sept 2000)	Vienna Institute (Aug 2000)	CSFB[6] (Aug 2000)	JP Morgan (June 2000)	Dun & Bradstreet (Sept 2000)
Central and eastern Europe and the Baltic states															
Albania	3.8	2.0	5.0	na	na	3.0	3.0	3.7	4.1	na	na	na	na	na	na
Bosnia and Herzegovina	3.3	3.0	3.0	na	na	2.0	na	5.0	na	na	na	na	na	na	na
Bulgaria	4.3	6.8	4.5	4.8	na	5.0	4.8	0.3	7.1	4.0	3.8	3.0	5.8	3.9	na
Croatia	5.2	3.2	6.7	na	na	5.0	5.5	5.5	4.9	na	3.5	6.0	4.8	na	na
Czech Republic	4.2	2.5	5.7	3.3	4.7	4.1	4.0	5.2	5.0	3.5	3.5	4.0	4.7	3.2	na
Estonia	4.0	3.4	4.1	2.4	na	3.0	5.0	4.8	3.6	3.5	5.8	na	na	na	na
FYR Macedonia	4.8	5.0	4.0	na	na	7.0	5.5	5.3	4.5	na	na	5.0	na	na	2.0
Hungary	6.6	2.8	7.1	5.8	6.0	6.0	7.0	8.0	6.3	7.0	5.5	6.5	8.3	6.2	na
Latvia	3.5	1.5	3.4	3.5	na	3.0	4.0	3.5	3.3	3.0	4.5	na	na	na	na
Lithuania	3.2	2.7	2.0	2.5	na	2.0	4.0	4.3	2.9	3.0	4.7	na	na	na	na
Poland	6.5	3.7	6.6	5.3	6.5	7.0	7.0	6.5	7.2	7.5	4.7	7.0	8.2	4.5	na
Romania	25.1	32.5	30.0	25.0	na	19.0	30.0	30.0	24.8	30.0	2.5	35.0	na	na	na
Slovak Republic	7.1	8.2	8.0	7.5	8.0	6.0	8.3	8.7	7.3	8.0	3.0	11.0	2.8	6.8	na
Slovenia	5.5	1.9	6.4	4.5	na	5.0	6.0	6.0	6.0	6.0	4.5	5.5	na	na	na
Average	*6.2*	*5.0*	*6.9*	*6.5*	*6.3*	*5.5*	*7.2*	*6.9*	*6.7*	*7.6*	*4.2*	*9.2*	*5.8*	*4.9*	*na*
Commonwealth of Independent States															
Armenia	4.3	2.2	5.2	na	na	3.0	5.0	4.5	3.6	na	na	na	na	na	na
Azerbaijan	3.6	1.7	3.4	na	na	3.0	4.5	4.2	2.8	na	na	na	na	na	na
Belarus	123.5	73.6	80.5	na	na	83.0	150.0	150.0	154.1	na	na	na	na	na	na
Georgia	6.8	5.0	10.0	na	na	8.0	5.0	5.6	5.6	na	na	na	na	na	na
Kazakhstan	8.0	4.9	7.9	na	na	8.0	6.0	7.0	10.9	na	na	na	na	na	na
Kyrgyzstan	13.4	6.6	10.2	na	na	15.0	10.0	15.0	16.6	na	na	na	na	na	na
Moldova	23.8	21.0	24.0	na	na	13.0	20.0	28.0	34.0	na	na	na	na	na	na
Russia	15.9	9.0	15.1	na	20.0	14.0	11.0	18.0	18.6	11.0	20.0	15.0	18.1	13.8	na
Tajikistan	20.5	38.0	19.6	na	na	7.0	20.0	17.0	14.1	na	na	na	na	na	45.0
Turkmenistan	25.0	21.0	30.7	na	na	35.0	20.0	14.0	28.1	na	na	na	na	na	22.0
Ukraine	19.0	10.0	17.0	na	na	15.0	15.0	19.0	20.0	20.0	25.0	20.0	20.2	na	na
Uzbekistan	41.4	64.0	50.5	na	na	22.0	30.0	35.0	86.0	na	na	na	na	na	25.0
Average	*25.4*	*17.4*	*22.9*	*na*	*na*	*18.8*	*24.7*	*26.4*	*32.9*	*15.5*	*22.5*	*17.5*	*19.2*	*na*	*30.7*

Note: All forecasts quoted here were published or reported to the EBRD between March and September 2000. 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. The IMF provides average regional inflation forecasts for 2001 for central and eastern Europe excluding Belarus and Ukraine at 7%, including Belarus and Ukraine at 11% and for Transcaucasus and Central Asia at 16%. The EU estimates the weighted average inflation rate for ten countries in central and eastern Europe and the Baltic states (this group excluding Albania, Croatia and FYR Macedonia) at 6.6% in 2001.

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

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

3 Inflation is based on the private consumption deflator.

4 Institute for Economic Research, Halle, Germany.

5 Institute for Economic and Market Research Information, Hungary.

6 Credit Suisse First Boston.

Cross-border capital flows

4

The past year has seen a moderate recovery in capital flows to the transition economies in tandem with the resurgence of the regional and global economies. However, capital flows have become clearly more differentiated since the crisis in Russia in 1998, both in terms of recipient countries and of types of flows. Between 1998 and 1999 capital flows into the region fell by roughly two-thirds. Nearly all of this was due to a decline in flows to Russia. Meanwhile, capital flows to the more advanced countries of the region remained relatively stable in 1999, and there are signs of an increase in 2000. In terms of types of capital flows, foreign direct investment (FDI) has been more robust and less affected by market volatility than other types, such as bonds, equity flows and syndicated lending.

International capital flows into the region are of fundamental importance to the economic transition, and can make a significant contribution to realising the region's growth potential. Domestic financial systems are still unable to offer sufficient support to investors. In addition, savings are limited, especially during the recovery from the transition recession when the expectations of future earnings stimulate consumption. Capital flows have contributed significantly to lowering the costs of financing investment and have been a key source for the financing of rising investment demand, particularly in the advanced countries (see Chapter 3).

The potential productivity (and profitability) of new capital, moreover, is likely to be higher than in advanced industrialised economies. Plant and equipment in transition economies is significant by any standards but inefficiently employed and partly obsolete. This also applies to job skills. Restructuring investment, combined with improved management and advanced technology, offers opportunities for improving the productivity of existing resources at relatively low cost. The impact of capital inflows on the transition goes, therefore, far beyond the simple flow of capital.

In contrast to these benefits are the risks to the transition countries of exposure to a volatile international environment. As shown by the market turbulence in 1998, these risks are highest in countries that have integrated themselves into the international capital markets without establishing the foundations for macroeconomic and financial stability. This chapter investigates the conditions under which countries in the region have been exposed to such volatility.

While emphasising the importance of appropriate macroeconomic policies, the chapter argues that to limit the impact of volatile capital flows, it is necessary to access a wide range of international financing instruments. In countries such as Russia, Romania or Ukraine, reliance on just one or two types of flows, and the absence of significant FDI in particular, has contributed to economic volatility as a result of swings in net capital flows. Moreover, the chapter shows that progress in structural reforms in banking, corporate governance and the regulation of securities markets has had a positive impact on attracting a range of capital flows to the transition economies. Capital inflows and progress in the transition are therefore closely linked.

The chapter starts by providing an overview of trends in international capital flows, with a particular emphasis on developments over the past year (see Section 4.2). This is followed by a discussion of the various types of flows: FDI (Section 4.3), portfolio inflows and international security issues (Section 4.4), and international bank lending (Section 4.5). Each section highlights the reasons for particular trends and fluctuations in each type of flow. Section 4.6 discusses the characteristics of the countries that have been most successful – and least successful – in attracting private international capital. There is evidence that declines in capital flows can be minimised by attracting a range of different flows. This has been achieved in countries that have given adequate support to structural reforms.

4.1 The global economy and international investor sentiment

Macroeconomic conditions in transition economies have improved significantly since the middle of 1999, when Russia began to recover from the August 1998 crisis and south-eastern Europe (SEE) overcame many of the economic disruptions of the Kosovo conflict. As discussed in Chapter 3, this has been due in large part to a more favourable global environment. While the improved economic prospects have been important in luring investors back to the region, particularly to Russia, the growth in net inflows has been moderate in volume. The upturn in US and European interest rates and continuously high growth in these two regions have tended to attract capital flows away from emerging markets, including the transition economies. Moreover, with solid export growth almost everywhere in the region, current account imbalances and therefore foreign financing needs have fallen in many countries despite rising growth.

The strengthening of investor confidence in the region is most evident in the substantial improvement in borrowing terms. Chart 4.1 shows trends in yield spreads in international markets. Yield spreads for most emerging markets, including the transition economies, have been falling following unexpectedly strong recoveries in East Asia and Russia and sustained growth in industrial market economies. This improvement in market access for transition economies reflects in part Russia's normalisation of its arrangements with international creditors – as well as political developments in Russia. The agreement reached with London Club creditors in February 2000 involves an

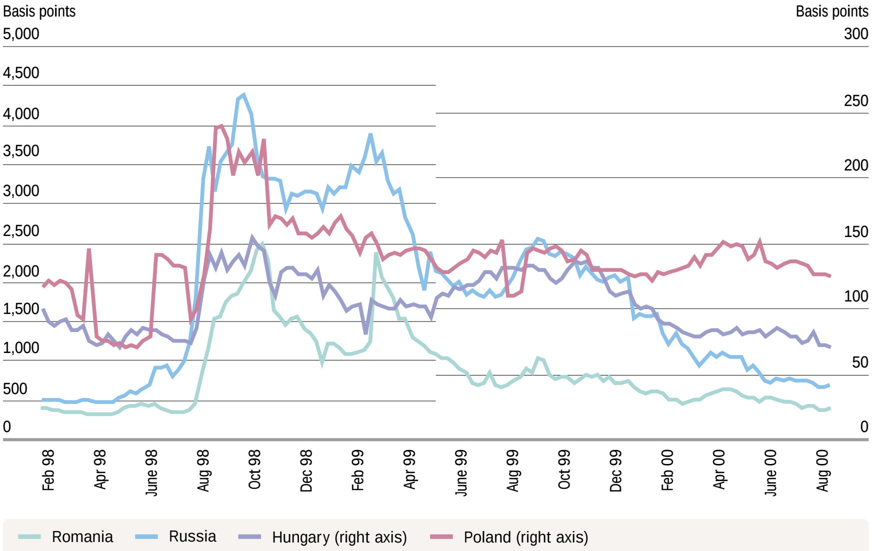
Chart 4.1a

Emerging markets bond index yield spread

Source: JP Morgan.

Chart 4.1b

Yield spreads on selected international bonds



Source: Bloomberg.

exchange of outstanding debt for Eurobonds.[1] This reduced significantly the net present value of the debt and lengthened its maturity profile. Also in early 2000 Ukraine offered to exchange its outstanding external debt for new seven-year euro and US dollar-denominated Eurobonds in order to relieve its heavy debt burden in 2000 and 2001. The offer was accepted by bondholders owning more than 95 per cent of the outstanding debt.

Rising investor confidence was also reflected in the sharp rally in equity prices in late 1999 and early 2000.[2] The Czech Republic, Poland and Russia each saw rises of about 20 per cent or more in dollar terms during the first quarter of 2000. This signals that some foreign investors, discouraged following the 1998 crisis in Russia, are now returning to the markets of central Europe. Nevertheless, global economic trends in the second quarter of 2000, including higher interest rates, an increase in the volatility of returns on equity markets and deteriorations in credit quality, have encouraged international fund managers to rebalance their portfolios in favour of cash. This has curbed somewhat the upward trend strongly evident earlier in the year. Although portfolio equity flows to the region remain modest, foreign flows have a significant impact on prices because of shallow domestic markets. Relatively small inflows and outflows can therefore have a disproportionate effect on prices.

While the general trends are broadly favourable, the extent and form of access to international capital markets among transition economies continue to differ across countries. This variation reflects differences in fiscal and external balances and in the extent of progress in transition countries (see Chapter 2). It is also influenced by the differing effect of external developments, such as the regional impact of the crisis in Russia, the recent rise in global commodity prices and the prospect of EU accession for some countries.

4.2 Net capital flows to transition economies

Net capital inflows to transition economies, according to balance of payments data, are poised to recover in 2000 following sharp declines in 1998-99. As Chart 4.2 and Table 4.1 show, net flows into the region are expected to reach US$ 16.3 billion in 2000, up from US$ 12.0 billion in 1999. However, the expected inflow in 2000 is only about half the level achieved in 1997, the last full year before the crisis in Russia. This recovery in net capital inflows is due to a return of portfolio investors to the region, a steady increase in net FDI and, to a lesser extent, an upturn in official lending.

This recovery in capital flows to transition economies also reflects a widespread rebound by most emerging markets. Net private capital flows to all emerging markets stabilised in 1999 at US$ 80.5 billion following sharp falls in 1997 and 1998.[3] Regions that have not experienced crises over the past few years, such as

1 Following an agreement on a Stand-by Arrangement with the IMF in July 1999, Russia successfully renegotiated its 1999-2000 debt schedule with the Paris Club. As a result, Russia's debt service obligations due to the Club members in 1999-2000 were rescheduled over 20 years. In a subsequent agreement with the London Club of commercial creditors, 36.5% of the total outstanding debt of US$ 32 billion was being written off, with the balance being converted into Eurobonds.

2 See Chapter 3 of this Report and Chapter 2 of *Transition Report Update* 2000.

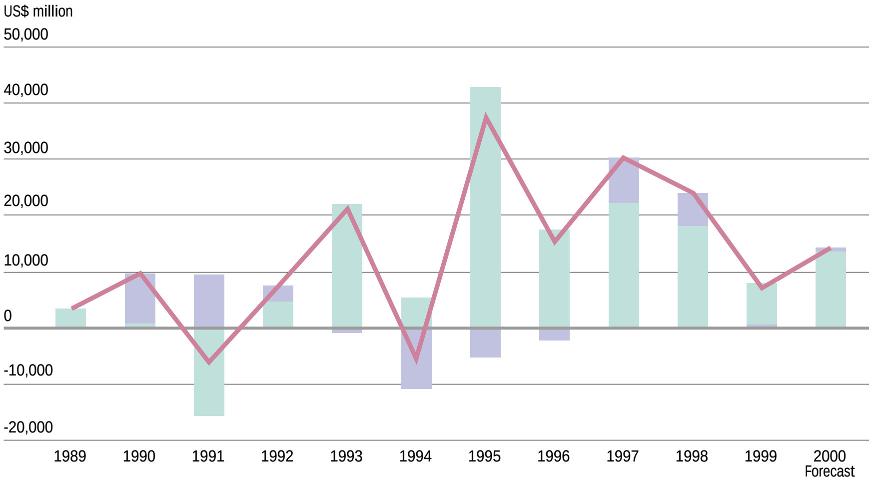
3 See IMF (2000).

Africa, central Europe and the Middle East, saw slightly increased net inflows in 1999, while outflows from the Asian countries were much lower than in 1998. The stabilisation of net private capital flows across emerging markets reflects continuing growth in FDI and a recovery in portfolio investment, which more than offset a continuing cutback in bank lending.

Official lending to transition economies in 2000 is expected to reach US$ 1.5 billion, up from US$ 0.5 billion in 1999. However, net official lending remains well below the levels achieved in 1997-98, when US$ 7.5 billion and US$ 8.8 billion was provided respectively. The main recipients of official lending in 1997-98 were Russia (US$ 9.5 billion), Ukraine (US$ 2.5 billion), Turkmenistan (US$ 1.0 billion), Romania (US$ 0.6 billion), Croatia

Chart 4.2

Total net private and official flows to transition economies



Source: IMF, World Economic Outlook database.

Table 4.1

Total capital flows by region

(US$ million)

	1992	1993	1994	1995	1996	1997	1998	1999	2000 Forecast
All transition economies[1]									
Total capital flows, net	5,809	20,551	-5,907	34,919	14,828	30,258	23,015	11,983	16,320
FDI	4,201	5,953	5,410	13,639	13,669	19,659	20,968	23,448	24,769
Portfolio investment	56	8,715	20,014	13,288	19,174	21,542	7,169	3,666	8,890
Other investment including bank loans	1,552	5,883	-31,330	7,992	-18,014	-10,942	-5,123	-15,131	-17,340
Total private flows, net	2,256	20,995	4,428	44,024	17,041	22,773	14,180	11,515	15,028
Total official flows, net	3,553	-444	-10,335	-9,105	-2,213	7,485	8,834	468	1,292
Central eastern Europe and the Baltic states									
Total capital flows, net	-1,305	10,084	-2,315	21,007	11,703	11,434	20,964	19,798	21,012
FDI	3,042	3,945	3,114	8,941	7,325	7,507	10,815	13,784	14,392
Portfolio investment	41	5,015	2,728	4,964	1,161	3,049	3,925	4,338	5,047
Other investment including bank loans	-4,388	1,125	-8,158	7,102	3,216	878	6,224	1,676	1,573
Total private flows, net	-1,821	9,821	-2,050	21,953	11,481	11,378	21,089	19,728	20,928
Total official flows, net	516	263	-265	-946	222	56	-125	70	84
South-eastern Europe									
Total capital flows, net	2,124	2,432	2,509	2,867	3,586	6,058	3,958	4,779	4,362
FDI	138	258	635	933	1,143	2,176	3,371	3,550	2,884
Portfolio investment	15	-73	-1	-58	-73	798	-194	342	95
Other investment including bank loans	1,971	2,247	1,875	1,993	2,516	3,084	781	887	1,383
Total private flows, net	1,400	2,067	1,445	2,052	2,721	4,820	3,165	3,766	3,535
Total official flows, net	724	365	1,064	815	865	1,238	793	1,013	827
Commonwealth of Independent States									
Total capital flows, net	4,990	8,035	-6,101	11,044	-460	12,766	-1,908	-12,594	-9,054
FDI	1,022	1,750	1,660	3,765	5,201	9,975	6,782	6,115	7,494
Portfolio investment	0	3,774	17,287	8,383	18,085	17,695	3,438	-1,014	3,748
Other investment including bank loans	3,968	2,511	-25,048	-1,103	-23,747	-14,904	-12,128	-17,694	-20,296
Total private flows, net	2,678	9,107	5,033	20,018	2,839	6,575	-10,073	-11,979	-9,434
Total official flows, net	2,313	-1,072	-11,134	-8,974	-3,299	6,191	8,166	-614	380

Source: IMF, World Economic Outlook database.

[1] Data exclude Bosnia and Herzegovina.

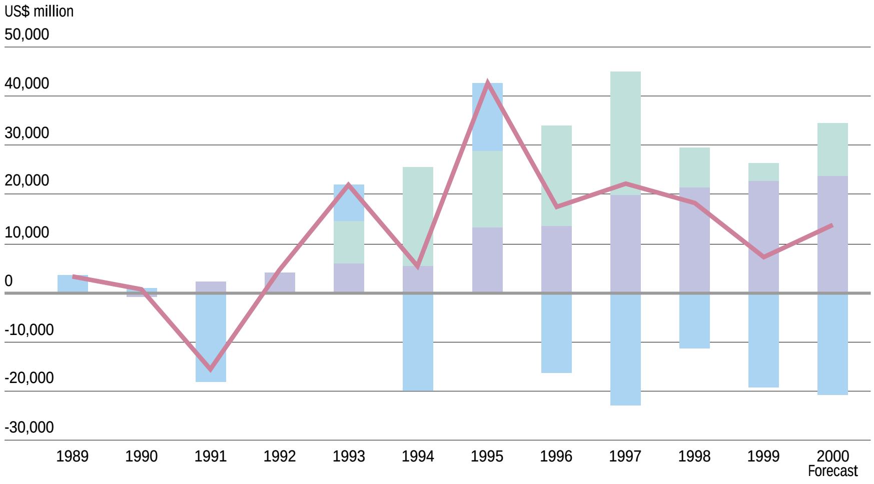
(US$ 0.5 billion) and Bulgaria (US$ 0.4 billion). In 1999, Bulgaria, Romania, Turkmenistan and Ukraine continued to attract significant net inflows of capital from official sources, receiving US$ 1.4 billion in total. However, the net borrowing position of Russia reversed sharply in the wake of the 1998 crisis, from a net inflow of US$ 5.4 billion in 1997-98 to a net outflow of US$ 1.8 billion in 1999. Bulgaria, Kyrgyzstan, Romania, Turkmenistan, Ukraine and Uzbekistan are likely to attract the bulk of official inflows to the region in 2000, while Russia is likely to make further net repayments to official creditors.

On a per-capita basis, SEE has received the largest official net flows from 1997 to 1999, reflecting in part rebuilding efforts in former Yugoslavia. Moreover, since the start of transition, cumulative net official inflows to SEE have totalled about US$ 100 per capita, compared with just over US$ 20 per capita in the CIS. Net official financing flows to central eastern Europe and the Baltic states (CEB) are US$ 81 per capita. If it were not for war-related reconstruction in former Yugoslavia, the differences in official financing would reflect the variation in GDP per capita across the region.

Net private capital flows to transition economies are expected to recover in 2000 to about US$ 15 billion, up from US$ 11.5 billion in 1999. As Chart 4.3 shows, net private capital flows to the region reached US$ 22.8 billion in 1997, and declined sharply to US$ 14.2 billion in 1998, and even further in 1999. A major reason for the fall in 1998-99 was the reticence of portfolio investors. Net portfolio investments in the region peaked in 1997 at US$ 21.5 billion, much of which flowed into Russia (US$ 18.4 billion). However, net portfolio investment amounted to just US$ 7.2 billion in 1998 and US$ 3.7 billion in 1999. The bulk of this in 1999 was allocated to the Czech Republic, Hungary and Poland. Net portfolio investment in Russia was -US$ 1.1 billion, which represents a net decline in financing of US$ 19.5 billion from 1997. The expected pick-up in 2000 is likely to be concentrated in Poland and Russia, with each country likely to attract some US$ 200-250 million in net inflows.

Chart 4.3

Private net capital flows to transition economies



Source: IMF, World Economic Outlook database.

Table 4.2

Regional distribution of FDI inflows in developing countries, 1998

	Total inflows, in US$ million	Inflows per $1,000 GDP, in US$	Inflows per capita, in US$
Africa	7,657	15.6	10.8
Latin America and the Caribbean	68,255	33.7	140.1
West Asia	4,638	7.4	20.7
Central Asia	3,032	49.9	42.1
South, East and South-East Asia	87,835	27.8	28.3
Pacific	146	12.5	22.7
Central and eastern Europe	18,532	22.3	55.1

Source: United Nations Conference on Trade and Development, *World Investment Report*, 1999, p. 20.

FDI is the one element of net private investment into transition economies that has been consistently positive. Despite the pressures on emerging markets with the onset of turmoil in East Asia in July 1997 and the crisis in Russia in August 1998, FDI into transition economies has been remarkably resilient, reaching an estimated US$ 24.8 billion in 2000, up from US$ 19.7 billion in 1997. Almost 60 per cent of FDI into the region in 2000 is likely to be destined for countries in CEB, primarily the Czech Republic, Hungary and Poland. In SEE, Bulgaria, Croatia and Romania are the primary destinations for FDI. Among the CIS countries, Kazakhstan and Russia attract the bulk of FDI, largely due to their natural resources sectors.

Cross-country differences in FDI per capita are very large. Whereas average cumulative FDI inflows per capita between 1989 and 1999 were US$ 668 in CEE, they only amounted to US$ 140 in the CIS. Furthermore, even neighbouring countries often register large variations. For instance, whereas in Hungary cumulative FDI per capita over the past decade was US$ 1,764, in Romania it only amounted to US$ 235. In the CIS, Kazakhstan received US$ 487 in FDI inflows per capita between 1989 and 1999, whereas neighbouring Uzbekistan only received US$ 32.

Such large cross-country discrepancies are also characteristic of other emerging markets. Globally, only five countries received 55 per cent of FDI inflows into emerging markets in 1998.[4] Comparing FDI inflows across the world, a recent UN study shows that economies in CEE are on average receiving roughly the same amount of FDI per dollar of GDP as South, East and South-East Asia (see Table 4.2). At the same time, they

[4] See UNCTAD (1999), *World Investment Report*. The five countries are China, Brazil, Mexico, Singapore and Indonesia.

are receiving less than Latin America and the Caribbean and more than Africa. In terms of inflows per capita, CEE receives more than any other region apart from Latin America and the Caribbean.

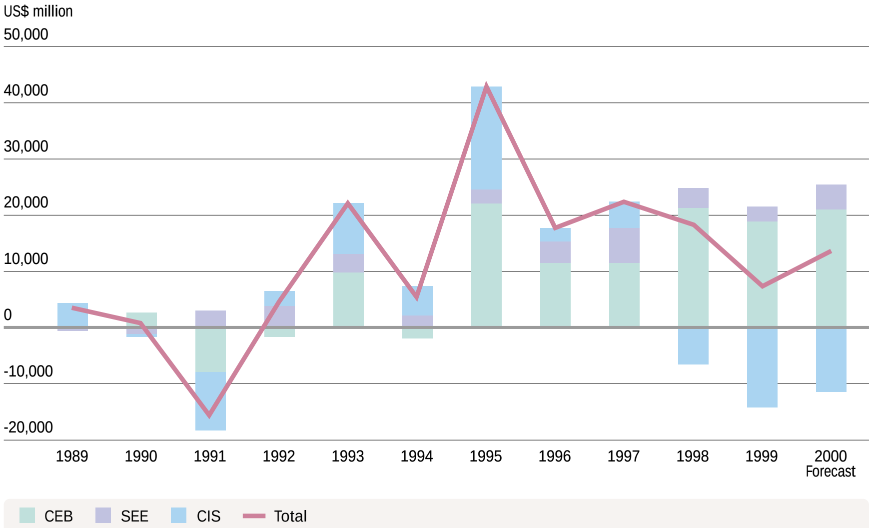
While FDI and portfolio investment are relatively easy to identify in standard balance of payments data, the available data for other types of flows, most importantly bank lending, is not easy to measure.[5] The financing item "net other capital" in the balance of payments includes net bank lending but also trade financing and some other smaller items. This category, reflecting in part capital flight, has accounted for a significant net outflow of capital from transition economies, averaging US$ 16.0 billion from 1996 to 1999. This withdrawal of net financing, which is heavily concentrated in Russia, is expected to continue in 2000. Further details on bank lending are provided in Section 4.4.

Most of the volatility in net private capital inflows – and in macroeconomic performance – in recent years has been associated with inflows destined for the CIS, in particular portfolio flows to Russia and Ukraine. In contrast, the countries of CEB have grown steadily in recent years and have continued to attract increasing amounts of FDI as well as other forms of private international investment (see Chart 4.4). Net private capital inflows to CEB have increased to an expected US$ 20.9 billion in 2000 from US$ 11.4 billion in 1997. In the CIS, however, net private capital flows have fallen sharply to an outflow of US$ 9.4 billion in 2000 compared with an inflow of US$ 12.8 billion in 1997. At the same time, net capital flows to SEE have declined slightly to US$ 3.5 billion from US$ 6.1 billion over the same period.

The relative resilience of the countries in CEB reflects in part the fact that FDI occupies a higher proportion of net capital inflows than in other countries of the region. This highlights once more the importance of creating the conditions for long-term investment in the transition process. However, as argued in Section 4.6 below, the resilience of net capital flows to CEB also reflects the fact that this region has retained much better

Chart 4.4

Private net capital flows by region



Source: IMF, World Economic Outlook database.

Note: CEB includes Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia. SEE includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia and Romania. CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

access to a range of international financing instruments, including bond issues and some portfolio equity flows. Creating the conditions for attracting a diversified portfolio of inflows significantly reduces the vulnerability to fluctuations in one particular type of investment.

4.3 Foreign direct investment

Bulgaria, Croatia, the Czech Republic, Poland and the Slovak Republic registered their largest FDI inflows ever in 1999, as shown in Table 3.1.8 in Annex 3.1. Much of this increase has been attracted by progress in cash privatisation, in particular in the banking and telecommunications sectors, by relatively favourable investment climates and by prospects of accession to the EU. For example, in Croatia the sale of 35 per cent of the national telecommunications operator to Deutsche Telekom and of 63 per cent of Privredna Banka Zagreb (PBZ) to Banca Commerciale Italiana generated US$ 1.2 billion in revenues – accounting for most FDI into Croatia in 1999. In the Czech Republic the privatisation of two large banks, Ceska Sporitelna to Erste Bank of Austria and Ceskoslovenska Obchodni Banka to KBC of Belgium, accounted for a significant share of FDI inflows into the country. In Poland the sale of the insurance company PZU to the pan-European financial group Eureko and of the state savings bank PEKAO to Unicredito Italiano and Allianz raised a further US$ 1.8 billion. Lastly, the Slovak Republic sold 51 per cent of the telecommunications operator Slovak Telecoms to Deutsche Telekom for almost US$ 1 billion, accounting for most of FDI inflows in 1999.

In 2000 a further increase in FDI is forecast for the region. This trend continues to be driven by major privatisations in the financial and telecommunications sectors in CEB. For example, direct equity investment in Poland is likely to increase to over US$ 8 billion with the sale of a 35 per cent stake in the telecommunications operator TPSA to France Telecom for US$ 4.3 billion. This transaction, which is the largest single FDI investment in the region since the start of transition, would account for over half of the net FDI inflow into Poland in 2000. In the largest intraregional foreign direct investment to date, MOL of Hungary acquired one-third of the Slovnaft oil refinery (Slovak Republic) in March 2000 for US$ 262 million. Annex 4.1 provides a closer look at this emerging trend in FDI in the region.

Across the region, privatisation policies have been a significant factor determining trends – and fluctuations – in FDI inflows. Where strategic sales have been an important component of privatisation relative to the use of vouchers, FDI inflows

5 To calculate net private flows, official flows have been subtracted from the category "net other investments", including net bank lending.

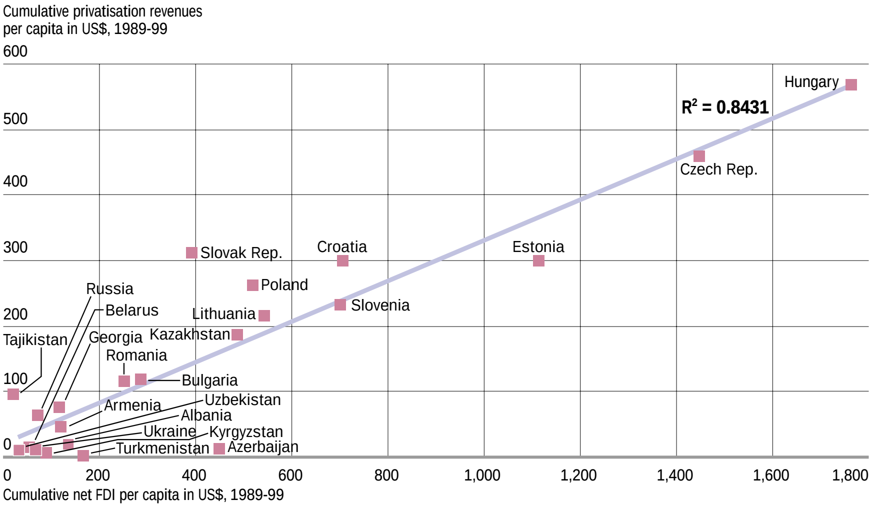
have generally been the largest. As Chart 4.5 shows, there has been a strong link between cumulative FDI per capita and privatisation revenue as a percentage of GDP since the start of the transition. Countries that have realised the largest privatisation receipts as a percentage of GDP, such as the Czech Republic, Estonia, Hungary, Lithuania, Kazakhstan, Poland and the Slovak Republic, have also attracted the most FDI per capita. Few countries have been able to attract sizeable FDI inflows without the cash privatisation of large-scale enterprises. The notable exception is Azerbaijan, which has attracted significant foreign investment into its oil and gas sector.

Many countries in the region have experienced some fluctuations in their FDI inflows due to the uneven pace of large-scale privatisations to strategic investors, particularly in the Czech Republic, Estonia and Hungary – all strong performers in attracting FDI. Moreover, many of the advanced reform countries in CEB that have attracted much of the FDI into the region are now nearing the completion of their privatisation programmes.[6]

The key issue of the post-privatisation era will be how to attract FDI into greenfield ventures and into privately owned assets. While the attractiveness of existing industrial and commercial assets will depend on their valuation in secondary markets, foreign investors who consider greenfield investments need to take into account the cost of new plant and equipment, the business environment and market potential. Of particular importance is the security provided to investors by the existence of enforceable contracts, standardised product classification and business practices, and customs and other regulations designed to regulate commercial transactions. Moreover, the experience of the transition economies and other emerging markets shows that FDI tends to be closely linked to rising bilateral trade flows.[7] In this respect, the prospect of stability resulting from the removal of barriers to market entry and integration into the European Union also helps to attract FDI.

Chart 4.5

FDI and privatisation revenues per capita



Source: EBRD.

4.4 Portfolio inflows

The bulk of portfolio investment, which is the main source of private market financing for transition economies after FDI, has entered the region via international bond issues and portfolio equity investment in the region's stock markets. In particular, the transition economies have increasingly gained access to international capital markets through Eurobond issues. However, in some countries the domestic bond market has also been opened to foreign portfolio inflows, and substantial amounts have been attracted into domestic sovereign debt instruments – the primary examples being the Treasury bills market in Poland and the GKO markets in Russia and Ukraine.

Following significant increases in Eurobond issues in the mid-1990s, there was a sharp fall immediately after the Russian crisis in August 1998, with no issues at all in September and October of that year. However, as Chart 4.6 shows, issues by more advanced transition countries recovered quickly, with Hungary placing a ten-year Eurobond in January 1999. Overall, Eurobond issues by CEB borrowers increased to €5.8 billion in 1999 from €5.2 billion in 1998.[8] Moreover, these have picked up further in 2000, often at relatively low spreads and longer maturities as investors look to eventual EU accession. Issues over the first half of 2000 amounted to €3.5 billion. Public sector issuers, mainly sovereigns, accounted for two-thirds of the borrowing in the first half of 2000. Poland priced a €600 million ten-year issue in March 2000 at only 82 basis points over German treasuries. The Slovak Republic raised €500 million at a spread of about 220 basis points compared with over 400 basis points for a similar issue a year earlier. The main issuing countries have been the Czech Republic, Hungary, Poland and the Slovak Republic.

In contrast, Eurobond issues by CIS borrowers decreased from US$ 12.5 billion in 1998 (all prior to the August crisis) to US$ 1 billion in 1999, consisting of Kazakhstan and Ukraine government Eurobond issues and an issue by a private Russian borrower (PTC International Finance). In the first half of 2000, CIS Eurobond issues amounted to just US$ 0.4 million, consisting of an issue by the Government of Kazakhstan and an issue by a private Russian borrower (VimpelCom).

Chart 4.6 shows the extent to which public sector issues continue to dominate Eurobond issues, accounting for 79 per cent of total issues in 1999 and 74 per cent in the first half of 2000. A few "blue

6 In some cases significant assets in the infrastructure sector still remain and will be sold as reforms proceed further and private ownership in infrastructure is becoming more commonplace.

7 See Brenton, di Mauro and Lücke (1998).

8 Data from Bondware.

chip" companies in the Czech Republic, Estonia, Hungary, Poland, Russia (until August 1998) and the Slovak Republic account for the bulk of private Eurobond issues from the transition economies. For example, TPSA in Poland made a €475 million issue at a spread of 125 basis points in March 2000, with a maturity of seven years.

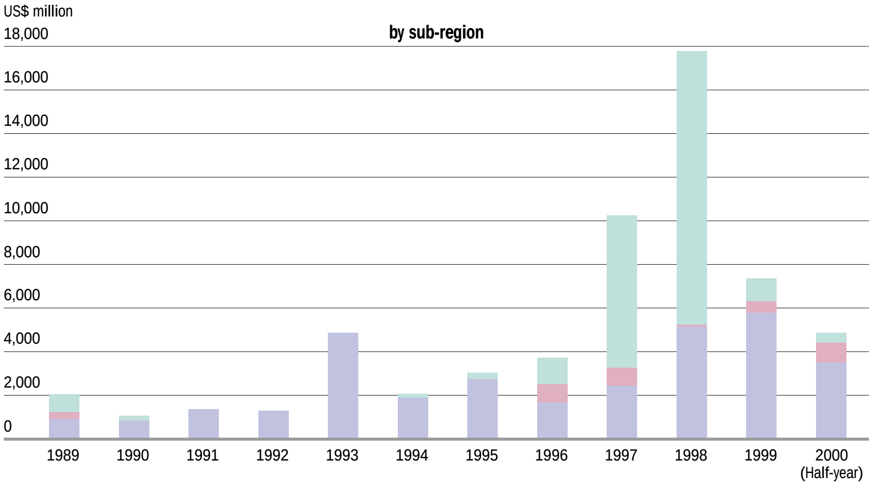
The rising volume of Eurobond issues by transition economy borrowers stands in sharp contrast to the declining amount of international equity issues from companies in the region. These amounted to just US$ 1.5 billion in 1999, down from US$ 5.5 billion in 1997 – despite the recent increases in the region's stock markets. Although equity issues are beginning to recover, they remain concentrated among a few blue chip companies in the advanced countries. There were no international equity issues in 1999 by CIS companies. This lack of market access reflects a difficult economic environment but also the difficulty faced by corporations from the region in meeting international standards for financial disclosure and corporate governance. The cost of equity is high when confidence in shareholders' rights is low.

While the volume of international equities has remained low, the region's stock markets saw a return of international portfolio investors in 1999 and the first half of 2000. Equity markets in Russia show signs of recovery, albeit from a very low base in market capitalisation, reflecting an improved political outlook. Stock exchanges across the region experienced strong rebounds in 1999, with sharp year-end rallies. Improving economic prospects lifted Russian equity prices by 65 per cent in December. The Czech, Hungarian and Polish markets, which lagged behind other markets in late 1999, registered strong gains in the first quarter of 2000.

Portfolio equity inflows are largest in the Czech Republic, Hungary and Poland. Although there are only a few stock markets with sufficient capitalisation and liquidity to attract a large-scale involvement of foreign investors, some of these markets have already overtaken the smaller EU stock markets in terms of market capitalisation and trading volumes. Nevertheless, most capital

Chart 4.6

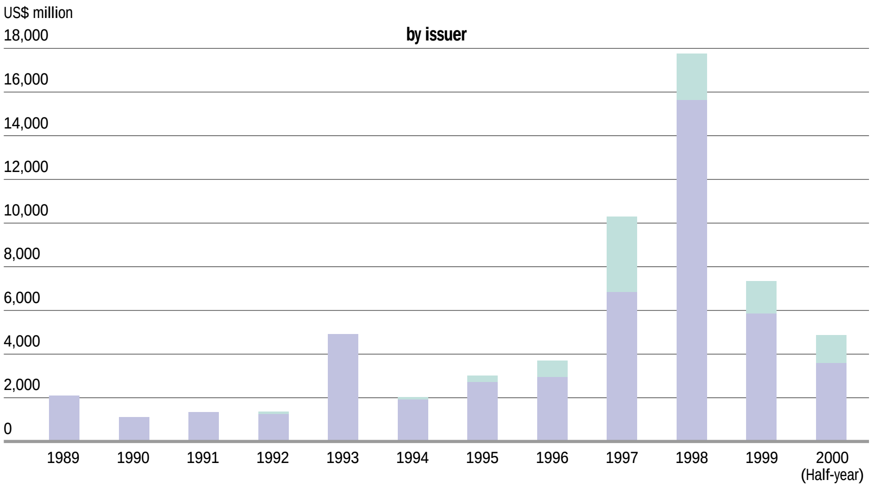
International bond issues, 1989-2000



CIS SEE CEB

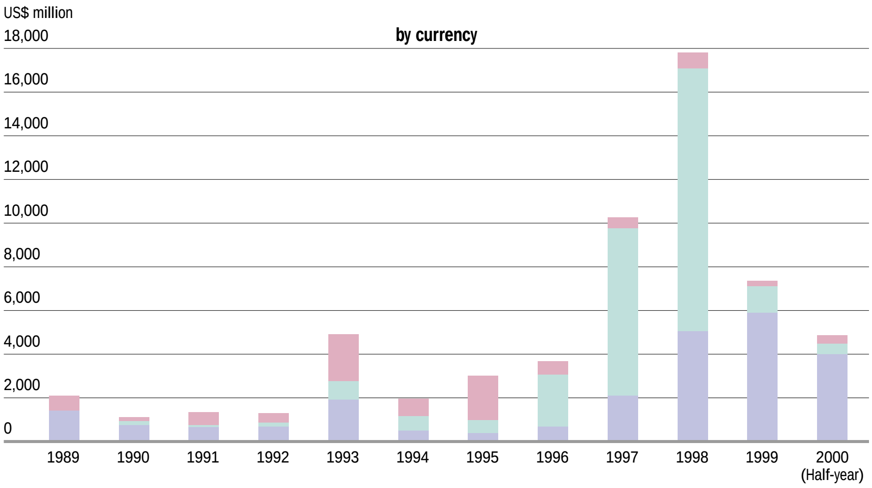
Source: Bloomberg.

Note: CEB includes Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.
SEE includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia and Romania.
CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.



Private issues Public issues

Source: Bloomberg.



Dollar issues € issues Other currencies

Source: Bloomberg.

markets in transition economies are still very small, and there has been an increasing emphasis on regional cooperation and integration, especially in CEB.

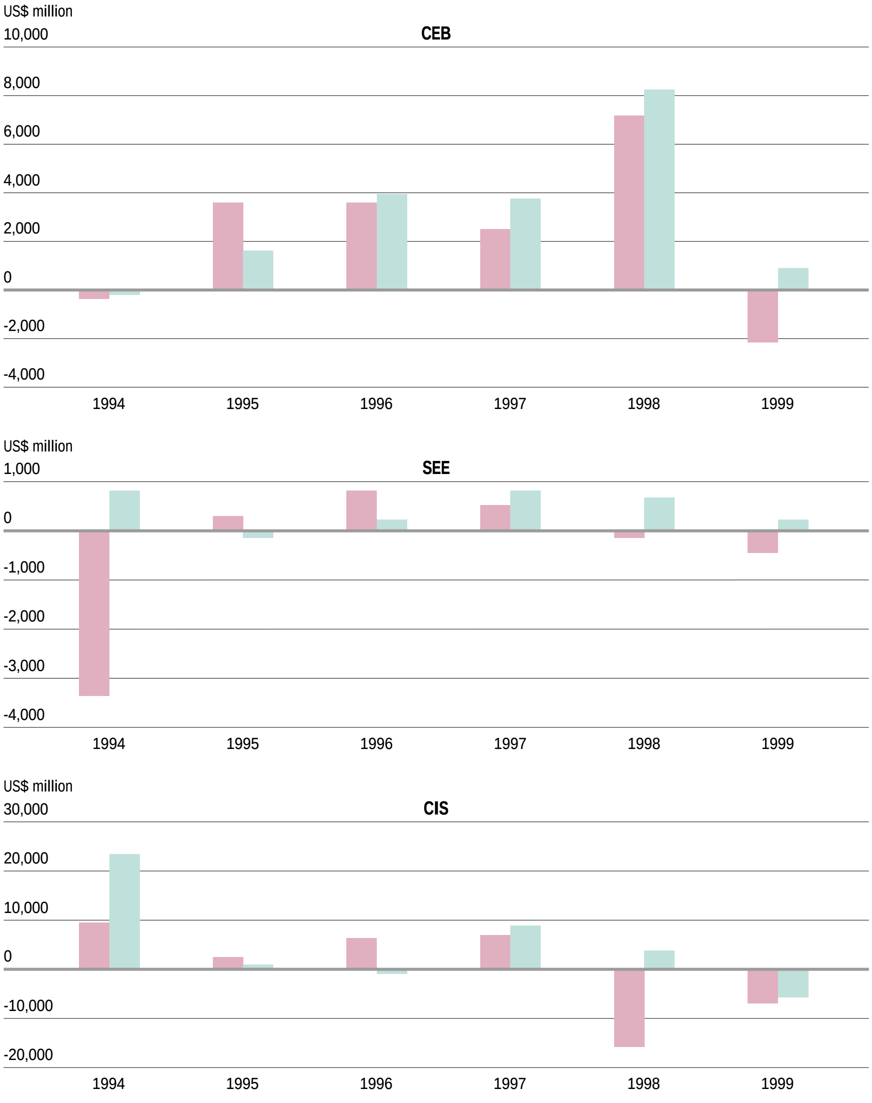
4.5 International bank lending

Data from the Bank for International Settlements (BIS) on international bank lending provide some details on the maturity structure and the recipients of international bank lending. Although their volume is still comparatively small, the maturity structure of international bank lending into transition economies tends to be relatively long-term compared with that to other emerging markets, such as Asia, where shorter-term lending tends to be of greater importance.[9] Chart 4.7 shows that throughout the region short-term lending (less than one year) is even less prevalent than lending of longer maturities. Chart 4.7 also shows that the crisis in Russia in 1998 has had a much greater impact on loans with shorter maturities than on loans with longer maturities.

BIS lending data illustrate the prevalence of the banking sector as a recipient of loans into the CIS. In CEB and SEE, on the other hand, the private sector has taken over as the primary recipient of international bank lending. Chart 4.8 shows bank lending flows since 1994 by recipient. Interestingly, capital outflows in reaction to the collapse of the Russian market for government bonds were concentrated in bank-to-bank lending in transition economies. International bank lending to the private sector has been more robust, particularly in CEB. Two factors in particular may account for this pattern. First, foreign creditors seem to have greater confidence in direct private sector borrowers as a result of prior due diligence efforts, in particular in CEB, where creditor rights are relatively well-protected.[10] Second, imprudent lending behaviour and weak regulatory oversight contributed to an erosion of confidence in banks during 1998-99. This evidence points to the importance of strengthening domestic financial intermediaries not only to mobilise better domestic savings but also to provide counterparts for a revival of international bank lending into the region.

Chart 4.7

International commercial bank lending by maturity



Source: Bank for International Settlements.

Note: CEB includes Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.
SEE includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia and Romania.
CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

4.6 Accessing capital markets: the experience so far

Early in the transition, cross-border capital flows were primarily from official sources and to public borrowers. Progress in transition has seen a shift in the composition in capital flows, moving steadily away from official to private sources. While public borrowers maintain a sizeable claim of capital inflows to finance fiscal deficits, private entities are increasingly accessing private international capital markets. The bulk of this inflow consists of FDI, but increasingly private enterprises are accessing other forms of capital as well, such as international security issues and cross-border bank loans. The heavy dominance of FDI reflects in part the benefits of concentrated equity holdings in countries where corporate governance and protection of minority investor rights are weak.

9 This partially reflects the build-up of short-term debt in emerging markets outside the region during the mid-1990s. Longer-term lending characterised inflows into Asia during earlier years.

10 See Pistor, Raiser and Gelfer (2000) for an analysis of creditor and shareholder rights in transition economies.

Expanding access to a broad range of financing instruments and sources can help to unlock investment opportunities and growth in transition economies. It is shown below that advanced transition economies generally have a larger selection of international financing instruments available to them. In response to a crisis, they have more flexibility than some of the slower reformers, therefore, in switching between various sources of funds. The remainder of this section first examines the general link between progress in reform and access to various types of capital flows. It then illustrates how access to a range of capital flows has enabled the more advanced reformers to withstand external volatilities.

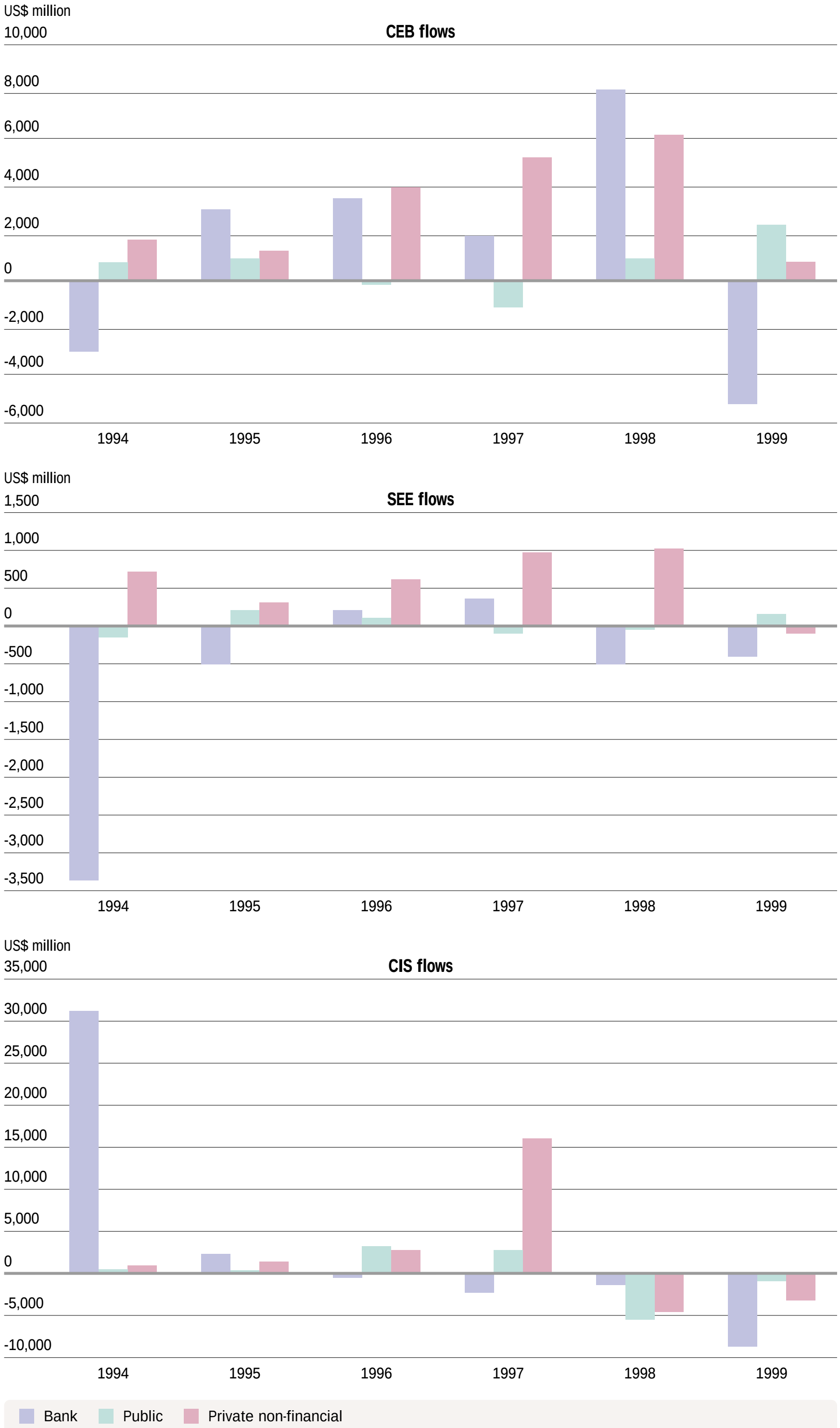
Structural and institutional reforms and private capital inflows

Although the economic potential of the region is considerable, countries have differed in their willingness and ability to tap this potential through market-oriented reforms. As shown in Charts 4.9 to 4.12, there seems to be a close association between progress in corporate governance, financial sector reform and access to a more diversified range of international financial flows.

As argued in previous *Transition Reports,* there is a close link between FDI per capita and progress in transition. Chart 4.9 suggests that the reform process opens up opportunities for profitable investment and, by also mitigating risk, motivates investors to take advantage of these opportunities. Continued reforms can therefore be expected to lead to growth in investment. These reforms have a long way to go, particularly in the CIS. Practical experience of the EBRD and survey evidence suggest that shortcomings in the implementation of reforms, and in particular in the weakness of governance, remain a significant impediment to private investment and its financing.[11] In particular, tax laws are seen as vague with little rationality across firms and there is haphazard and sometimes corrupt implementation. Laws and regulations are considered to be burdensome and ever-changing, there is continuing uncertainty about the institutional and regulatory regime, and there is little confidence in the ability of the administration to enforce property rights and contracts, or to control crime and corruption.

Chart 4.8

International commercial bank lending, by sector of recipient



Source: Bank for International Settlements.

Note: CEB includes Czech Republic, Hungary, Poland, Slovak Republic, Slovenia, Estonia, Latvia and Lithuania. SEE includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia and Romania. CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

The link between progress in reform and a country's ability to attract capital flows goes beyond FDI, however. Chart 4.10 shows a strong link between commercial

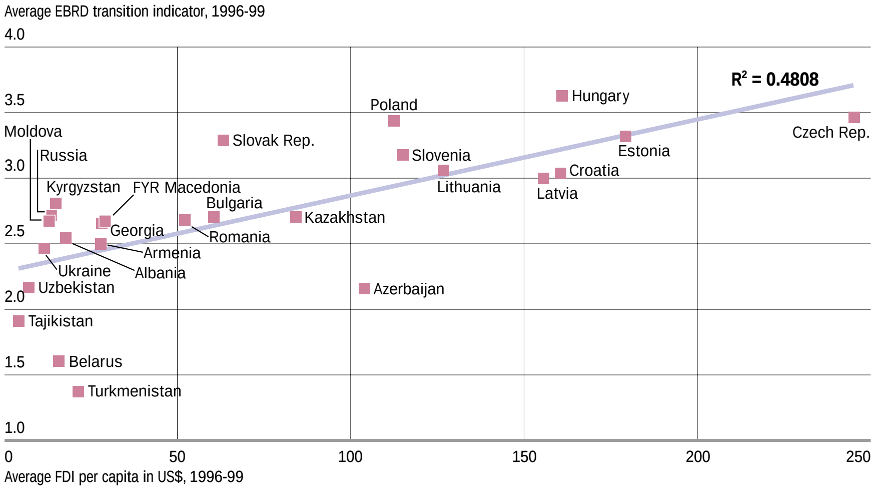
[11] See, for instance, the Business Environment and Enterprise Performance Survey, discussed in the *Transition Report* 1999.

lending to the non-banking private sector and the EBRD's transition score for enterprise restructuring. As privatisation in many countries has moved into a new phase with large enterprises and infrastructure increasingly on offer, the opportunities for project finance in the private sector have increased significantly. The score for enterprise restructuring emphasises the hardening of budget constraints, bankruptcy enforcement and improvements in corporate governance in the corporate sectors of the transition economies. Chart 4.10 confirms, therefore, that an improvement in creditor rights and corporate governance leads to an increase in commercial lending, as observed in market economies more generally.[12] Similarly, Chart 4.11 shows that portfolio equity investment per capita is closely associated with the EBRD's transition score for progress in non-banking financial sector reform.

Finally, Chart 4.12 shows that international bank lending to local banking sectors tends to increase as reform of the banking sector advances. As might be anticipated, the countries more advanced in banking reform – the Czech Republic, Estonia, and Hungary – tend to attract larger amounts of financing from international banks, ranging from 10 per cent of GDP in Estonia to 15 per cent in Hungary. This compares with less than 5 per cent of GDP in most other countries of the region. The link between bank-to-bank lending and progress in banking sector reforms is, however, much weaker than for other types of financial flows. As shown above, bank-to-bank lending was particularly volatile during the 1998-99 crisis. Significant inflows of lending into banking sectors that are weakly regulated and poorly managed can be a major source of macroeconomic and financial turbulence, as experience around the world and particularly in Russia during 1998 amply demonstrates.

Chart 4.9

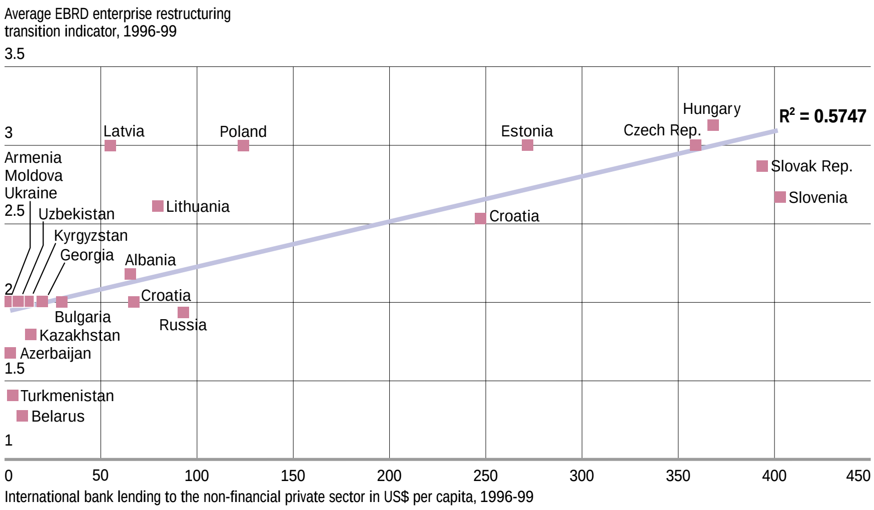
FDI per capita and average EBRD transition indicator



Source: EBRD.

Chart 4.10

International bank lending to the non-financial private sector and EBRD enterprise restructuring transition indicator



Sources: Bank for International Settlements and EBRD.

Experience by region

The analysis above suggests that progress in transition is strongly connected with access to a range of capital flows. This raises the possibility that one of the reasons for the greater resilience of CEB in the face of global capital market volatility is that these countries were able to draw from a selection of financial flows. When portfolio investment declined, FDI was available to partially fill the gap. This argument is tested in the subsequent analysis of regional integration into the international financial system.

Central eastern Europe and the Baltic states

The countries of CEB have experienced some macroeconomic volatility and considerable swings in the current account balances over the years. In 1995 Hungary carried out a strict fiscal austerity package and moved to a crawling peg exchange rate regime after it became apparent that the country's high current account deficit of 8 per cent of GDP would no longer be financed. However, access to the international capital market was not disrupted in the months that followed the austerity package, and the Hungarian economy largely managed a soft landing. Similar episodes were experienced by the Czech Republic in 1997, Estonia in 1998-99 and Poland in 1995 and again more recently.

12 See La Porta, Lopes de Salines, Shleifer and Vishny (1998). Pistor, Raiser and Gelfer (2000) emphasise that it is the enforcement of creditor rights rather than their improvement on paper that matters in the context of transition. The transition indicators of the EBRD blend the concepts of extensiveness and enforcement.

Tensions within the macroeconomic policies of several countries, including Poland in 1995 and the Czech and Slovak Republics in 1996-97, were a major reason for the attraction of short-term capital flows. Significant uncovered interest rate differentials emerged as the result of tight monetary policy and pegged exchange rates, combined with a loose fiscal stance. Yet, in many ways these problems are no longer transition-specific – with the choice of the standard trade-off between sterilisation and inflation depending on the preferences of policy makers. What stands out is the ability of the monetary and fiscal authorities to maintain confidence in the currency throughout these episodes and to avoid a cut-off from the international capital market.

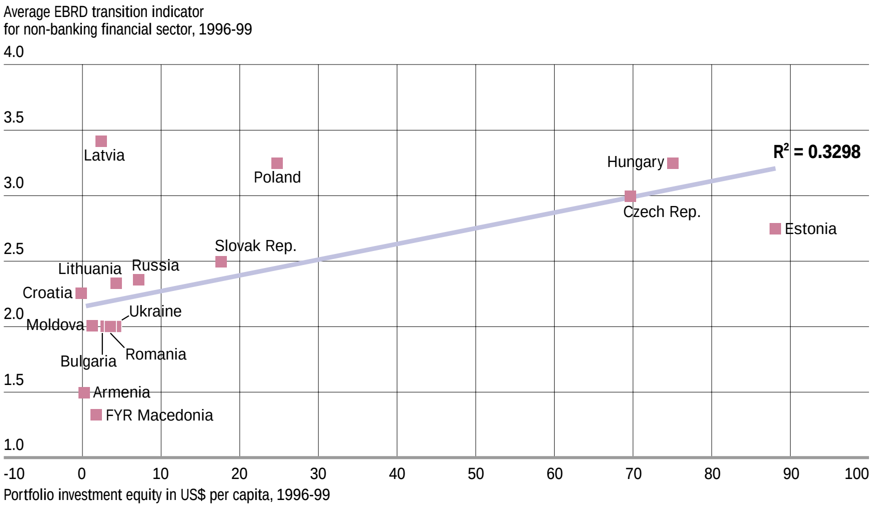
To illustrate the argument that the ability to access a range of foreign financing instruments has been a significant element of CEB's successful integration into international capital flows, Chart 4.13 shows the impact of market turbulence on FDI and portfolio investment flows in the Czech Republic. The increase in portfolio inflows prior to the devaluation in May 1997 can be clearly seen. Even after this policy correction, however, the Czech Republic still attracted substantial portfolio investment of some 2 per cent of GDP in 1998. The Russian crisis led to a significant net outflow of both bond and equity portfolio capital. Yet, this was cushioned by a significant rise in FDI inflows, related to the increasing emphasis of the Czech Government on strategic sales of remaining state assets. As a result of this substitution, the current account deficit remained fully financed, and despite a protracted domestic contraction following the 1997 currency crisis, the Czech Republic never experienced serious balance of payments problems and fully maintained its access to the international capital market.

South-eastern Europe

Economies in SEE have shown an erratic pattern of development over the past decade (see Chapter 3). Following a steep initial decline in output in the early 1990s, both Bulgaria and Romania experienced a second decline in the latter half of the decade amid financial crises.

Chart 4.11

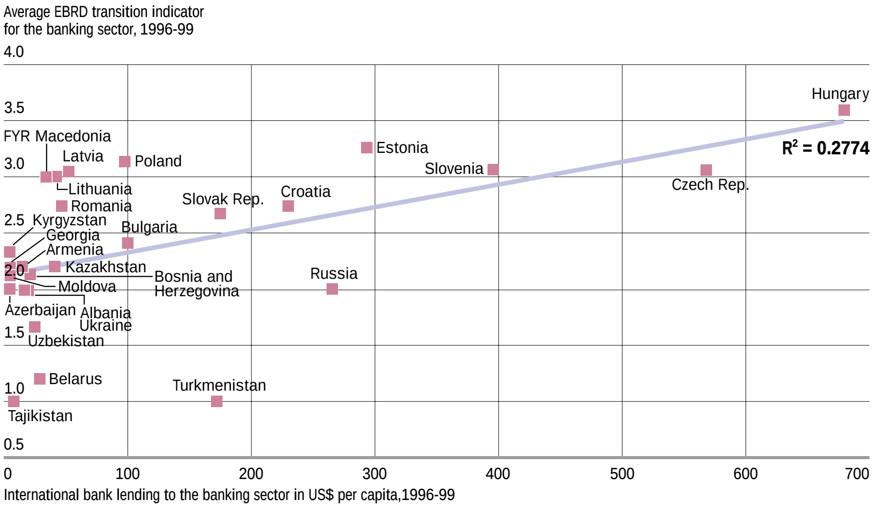
Portfolio equity investment and EBRD transition indicator for non-banking financial sector



Sources: IMF, World Economic Outlook database, and EBRD.

Chart 4.12

International bank lending to the banking sector and the EBRD banking sector transition indicator



Source: Bank for International Settlements and EBRD.

In both countries politically motivated reversals of the imposition of hard budget constraints led to periods of growth fuelled by inflationary financing and characterised by the continued use of parts of the capital stock that would have been liquidated if hard budget constraints had been maintained.

The cases of Bulgaria and Romania highlight that international capital flows can play different roles in an unstable macroeconomic environment. In Bulgaria the need to repay Brady bond obligations limited the room for manoeuvre prior to the crisis of 1996-97. As a result, the Government needed to rely on inflationary financing from domestic sources, using state-owned banks for the creation of directed credit. When the system erupted in an inflationary burst and a run on the domestic banks, capital flight was already rampant – and had been prior to the collapse of the commercial banking system. Since then, however, Bulgaria has been able to rely on increasing inflows of FDI and official financing, which may over time support a more stable and diversified financing mix as investment demand strengthens during the present recovery.

In Romania the low external debt at the start of transition[13] initially provided good access to the international capital market. Commercial funding, therefore, was used by the Government to compensate for the losses in official financing, which resulted from the country's unwillingness to comply with the economic policy conditions required by the IMF and the World Bank. Chart 4.13 shows increases in net portfolio investment in 1996 and 1997, when Romania's short-lived recovery was at its peak. By 1998 it became clear that the Government's policies were not sustainable and in 1999, when Romania nearly defaulted on its external debt repayments, there were large net outflows of portfolio bond investment. At the same time FDI was greatly reduced, exacerbating the financing gap. A large current account correction and continuing worries about Romania's creditworthiness resulted, temporarily excluding the country from international private financing and forcing the authorities to renew negotiations with the IMF.

Chart 4.13

FDI and portfolio investment in selected countries

Sources: IMF, World Economic Outlook database, and EBRD.

CIS

The integration of most CIS economies into the international capital market remains very limited. Public sector borrowing prevails, often from official sources. Where private capital flows have played an important role, such as in Russia, they have often been used by governments and banks to prop up unprofitable businesses or build industrial empires with limited consideration for long-term profitability.[14] Yet, the most damaging aspect of the limited integration of the CIS into the international capital market has been the concentration on just a few types of largely short-term flows and the almost complete absence of FDI outside the natural resources sector. The resulting vulnerability to volatility is best illustrated by the example of Russia.

Having successfully stabilised, Russia started to attract significant capital flows after 1995. By all available indicators, however, the rate of investment and output continued to decline. Yet, Russia succeeded in bringing down financing costs substantially. Throughout 1997, when access to capital markets greatly improved on the back of a successful Eurobond issue, and during the first half of 1998 massive inflows allowed for longer maturities and lower interest rates. At the same time, the inability of

13 The Ceaucescu regime repaid all foreign debt during the 1980s.

14 The high real interest rates that have to be offered to lure money from foreign and domestic sources actually deter investment in real productive assets. Funds, free to flow where the return is highest, will not necessarily flow to their most productive use. Channelled through the government, they will flow into sustaining unproductive assets instead.

the administration to collect taxes put in doubt Russia's repayment capacity. When the Asian crisis triggered a general loss of confidence, investors pulled out without discrimination.

Chart 4.13 shows the large net inflows of portfolio bond investment in 1997 and most of 1998. It also shows the almost complete absence of FDI, related to the unwillingness of the authorities to consider transparent privatisation methods to attract strategic investors, and the distortions in the domestic market that made foreign investment a highly risky and not very profitable operation. When portfolio flows reversed massively in 1999, FDI also declined. The adjustment was entirely borne, therefore, by the exchange rate and the current account, as Russia temporarily lost all access to foreign financing (including from official sources). The loss of reputation is likely to raise financing costs for some years to come. However, the increased competitiveness following exchange rate devaluation is presently limiting the need to access any external finance. Russian companies are flush with cash, while the budget is in surplus. If Russia can invest these domestic surpluses wisely, it may be given a second chance to integrate into the global capital market on a more stable footing.

4.7 Policy implications and conclusions

This chapter has shown that capital inflows into the region remain highly uneven. The revival in 2000 is a welcome sign of increased confidence following improved macroeconomic indicators. But, as the analysis shows, progress in transition remains fundamental to accessing a wide range of capital flows and making use of foreign savings in a way that does not increase the vulnerability of the region to external setbacks.

FDI remains by far the most stable and most important type of capital inflow into the transition economies. Success in attracting FDI is closely related to progress in transition and the quality of the investment climate. FDI in turn is closely associated with improved corporate performance.[15] Foreign strategic investment embodies many of the qualitative features of foreign capital that are particularly important in the context of transition: new technologies, managerial and financial skills, integration into worldwide networks of suppliers in addition to the flow of financial resources. As shown by the different regional experiences with accessing capital flows, FDI has played the role of a stabiliser when global market turbulence has led portfolio flows to emerging markets to be reversed. Creating the conditions for attracting FDI, both through appropriate privatisation policies and through improvements in the tax and regulatory framework, should remain high on the policy agenda across the region.

The analysis in this chapter has also shown the close association between improvements in financial market regulation, in enterprise restructuring and in corporate governance and the attraction of portfolio equity investments as well as direct lending to non-bank private enterprises. While these flows remain comparatively small in most countries, in the more advanced reformers in CEB non-FDI private capital flows have at times been important sources to complement domestic savings and to finance rapidly rising investment in this part of the region. The close association of these inflows with progress in financial and corporate sector reforms is important for two reasons. First, it shows that even the more volatile types of private capital flows differentiate clearly between market destinations – and this has become very apparent since the Russian crisis. Second, the progress made in financial sector regulation and in encouraging enterprise restructuring has allowed countries in CEB to avail themselves of a range of financing options. This not only reduces the cost of financing for enterprises but also leads to resilience against volatility in certain types of flows.

Despite the strong association of international capital inflows into the region with progress in transition, some countries have opened up to foreign capital and at times attracted sizeable inflows without an accompanying improvement in the institutional basis for sound finance. In this context, capital inflows carry considerable risks and may indeed magnify underlying macroeconomic and structural weaknesses. First, capital inflows may themselves be a cause of rising external and internal imbalances. If these inflows are used to cover excessive public borrowing or a rapid increase in consumption rather than lay the foundation for productivity improvements and future export earnings, they may exacerbate the underlying imbalances and eventually precipitate a loss of investor confidence. Second, the financial institutions and markets that act as intermediaries for some of these funds are still highly immature in many countries in transition. This heightens the risk of bank failures and associated dangers of volatility in capital flows. A well-functioning, supervised and regulated banking system is therefore essential to contain the risks of instability and is a key element of an investment climate that attracts long-term foreign investors.

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15 See *Transition Report* 1999, Chapter 9.

Annex 4.1: Intra-regional FDI

While the transition economies have primarily been recipients of inward FDI, outward flows are rising. Some estimates suggest that by 1998 the total stock of outward FDI of the region was around US$ 12 billion, equivalent to 14 per cent of the stock of inward FDI. This may indicate the beginnings of a new stage of private sector development, the creation of multinational companies.

In the advanced transition economies of central and eastern Europe and the Baltic states (CEE), outward FDI reflects local companies' growing ability to build and rebuild foreign trade and investment links, especially within the region. FDI by CEE companies is in large part driven by market access. In the case of Russia, however, outflows appear to be due partly to the desire of investors to diversify assets as a safeguard against domestic instability. It appears that a significant share of the outward flows from Russia are also driven by firms' desire to secure their share of natural resources exploration in the CIS.

Transition economies registering significant outward FDI flows tend to be those economies where inward FDI has been greatest (for example, Croatia, the Czech Republic, Estonia, Hungary, Poland, Russia and the Slovak Republic – see Table A.4.1). Rather than making investments via major cash privatisations or into greenfield manufacturing sites, intra-regional foreign investors have typically acquired existing private manufacturing plants and have concentrated on building regional supply and distribution networks.

Table A.4.1

Direct investments abroad, selected countries

(US$ million)

Country of origin	1997	1998	1999
Croatia	157	91	na
Czech Republic	25	79	197
Estonia	137	6	74
Hungary	431	481	184
Poland	36	163	127
Russia	1,060	2,584	na
Slovak Republic	95	135	29

Source: National Balance of Payments Statistics.

Central and eastern Europe and the Baltic states

The *World Investment Report* 2000 (published by the UN Conference on Trade and Development) includes a list of the top 25 outward investors among non-financial multinational corporations in CEE (see Table A.4.2).

The country composition of the top 25 list is quite diverse. The most significant outward investors from CEE are from small countries. The small size of their markets, combined with the openness of their economies, has pushed several "blue chip" companies in these countries to invest abroad. Polish companies, however, are still to a large extent oriented towards their domestic market. Of the top ten outward investors from CEE, four companies are from Croatia, two are from the Czech Republic, two from Slovenia, one from Hungary and one from Latvia (see Table A.4.2). In terms of industry composition of the top 25, transport is the most strongly represented sector, followed by mining, including petroleum and gas, and chemicals and pharmaceuticals.

The "transnationality index" – calculated as the average of the ratios of foreign assets to total assets, foreign sales to total sales, and foreign employment to total employment – highlights the low degree of international orientation of foreign investors from the region, with the median at 20 per cent. This is low compared with the average transnationality index of multinational companies in other developing countries – not to mention industrial countries. This suggests that firms in CEE are still at a nascent stage of "transnationalisation" and there is much scope for further expansion.

Russia

The globalisation of Russian companies is confined to several large oil and gas companies, in particular Lukoil and Gazprom. Lukoil is the biggest outward investor in the region, with US$ 2.3 billion in direct investments abroad. Data on Lukoil confirm that the leading Russian foreign direct investors are significantly bigger than the leading foreign investors from CEE. Foreign assets of Lukoil in 1998 were five times as large as assets from the largest foreign investor based in CEE. Relative to foreign investors from CEE, Lukoil also had a large lead in terms of employment and sales abroad.

Table A.4.2

Top 25 non-financial transnational corporations based in CEE,[1] ranked by foreign assets, 1998

Ranking by foreign assets	Corporation	Country	Industry[2]	Assets (US$ million) Foreign	Assets Total	Sales (US$ million) Foreign	Sales Total	Employment (number of employees) Foreign	Employment Total	Transnationality index[3] (per cent)
1	Latvian Shipping Company	Latvia	Transportation	493.0	504.0	214.0	214.0	1,631	2,275	89.8
2	Hrvatska Elektroprivreda d.d.	Croatia	Utilities	363.0	2,924.0	0.2	898.0	–	15,728	4.1
3	Podravka Group	Croatia	Food & beverages/pharmaceuticals	285.9	477.1	119.4	390.2	501	6,898	32.6
4	Gorenje Group	Slovenia	Domestic appliances	256.4	645.9	642.2	1,143.3	607	6,717	35.0
5	Motokov a.s.	Czech Republic	Trade	163.6	262.5	260.2	349.1	576	1,000	64.8
6	Atlantska Plovidba d.d.	Croatia	Transportation	152.0	167.0	47.0[4]	47.0	0	528	95.5
7	Pliva Group	Croatia	Pharmaceuticals	142.1	855.1	334.3	463.0	1,616	6,680	37.7
8	Skoda Group Plzen	Czech Republic	Diversified	139.1	973.4	150.7	1,244.5	1,073	19,830	10.6
9	Adria Airways d.d.	Slovenia	Transportation	129.4	143.7	97.7	97.7	0	585	95.0
10	MOL Hungarian Oil & Gas Plc.	Hungary	Petroleum & natural gas	128.3	2,881.6	203.4	2,958.1	628	20,140	5.1
11	Krka d.d.	Slovenia	Pharmaceuticals	118.4	490.4	226.9	300.3	375	3,253	37.1
12	VSZ a.s. Kosice	Slovak Republic	Iron & steel	110.0	1,445.0	815.0[4]	1,528.9	58	26,191	20.4
13	Petrol d.d.	Slovenia	Petroleum & natural gas	70.6	584.2	112.4[4]	706.0	10	3,349	9.4
14	Slovnaft a.s.	Slovak Republic	Petroleum & natural gas	65.5	1,496.0	518.6	984.5	124	5,734	19.7
15	Matador j.s.c.	Slovak Republic	Rubber & plastics	51.9	305.0	34.0	203.4	5	3,878	11.3
16	Zalakerámia Rt.	Hungary	Clay product & refractory	35.0	125.0	9.0	35.0	0	4,500	17.9
17	KGHM Polska Miedz S.A.	Poland	Mining & quarrying	34.0	1,536.0	401.0	1,236.0	25	33,000	11.6
18	Malev Hungarian Airlines Ltd.	Hungary	Transportation	32.9	149.1	238.0	316.9	49	3,215	32.9
19	TVK Ltd.	Hungary	Chemicals	31.6	542.9	122.6	401.3	181	6,099	13.1
20	Graphisoft	Hungary	Software consultancy	28.0	50.0	25.0	25.0	188	188	85.3
21	Croatia Airlines d.d.	Croatia	Transportation	27.6	211.4	97.4[4]	121.2	40	846	32.7
22	Elektrim S.A.	Poland	Trade and diversified	21.0	1,228.0	42.0	874.0	62	26,475	2.2
23	Pilsner Urquell a.s.	Czech Republic	Food & beverages	20.0	251.0	16.0	253.0	356	2,918	8.8
24	Moldova Steel Works	Moldova	Iron & steel	19.9	335.9	1.0	15.6	5	4,562	4.2
25	Budimex Capital Group	Poland	Construction	17.8	153.9	55.8[4]	316.4	644	1,095	29.3
Total				**2,937.0**	**18,738.0**	**4,783.8**	**15,122.4**	**8,754**	**205,684**	**–**
Average				*117.5*	*749.5*	*191.4*	*604.9*	*365*	*8,227*	*32.3*
Median				*70.6*	*490.4*	*119.4*	*349.1*	*153*	*4,500*	*20.4*

Source: UNCTAD survey of top transnational corporations in central and eastern Europe.

1 Based on survey responses.

2 Industry classification for companies follows the United States Standard Industrial Classification as used by the United States Securities and Exchange Commission (SEC).

3 The index of transnationality is calculated as the average of three ratios: foreign assets to total assets, foreign sales to total sales and foreign employment to total employment.

4 Including export sales by parent firm.

Part II

Employment, skills and transition

Labour markets, unemployment and poverty during the transition

5

The transition process has profoundly affected the lives of almost everyone in central and eastern Europe and the Baltic states (CEE) and the Commonwealth of Independent States (CIS). For some people, it has given them the opportunity to acquire new skills and training, to live and work in other regions and countries, and to engage in entrepreneurial activity in the new, expanding private sector. For others, the transition has caused considerable hardship, with widespread layoffs in state-owned enterprises, rising unemployment and poverty, and a shrinking social safety net. Now that growth and stabilisation have taken root in most transition economies, the "human" dimension of transition is becoming increasingly important. There is little doubt that a well-functioning labour market is essential if the progress towards a market economy is to be sustained and if the level of poverty is to be reduced. Labour mobility, a skilled workforce, an entrepreneurial spirit, modern labour laws that balance employer flexibility with workers' rights, and an adequate social safety net are all key requirements for a more successful transition.

This chapter examines how the dynamics of the transition process have affected individuals over the past decade and how people in turn have responded with a mixture of active and passive strategies. The chapter has three broad messages. The first is that informal activities, such as subsistence farming and casual jobs, have played a crucial role in providing employment and earnings for many people but the driving forces for these activities differ markedly across the region. In the more advanced reformers, the motives tend to be market-related, including tax evasion and the avoidance of bureaucratic delays and impediments. In contrast, informal activities in countries at the earlier stages of reform are driven by the lack of opportunities in the formal sector and are undertaken as a means of survival.

The second message is that the transition has created both "winners" and "losers", with the most obvious beneficiaries being owners of firms and the self-employed. Entrepreneurship has proved to be very rewarding for some people, but the relatively low number of entrepreneurs implies that impediments remain significant. The unemployed are among those who have suffered the largest decline in living standards, although the link between unemployment and poverty is stronger in CEE than in the CIS, where poverty is more closely associated with under-employment. These findings lead to the third message, which is that labour market performance could be enhanced substantially by institutional reforms. However, the policies needed in the advanced countries of central eastern Europe and the Baltic states (CEB) are different from those required in south-eastern Europe (SEE) and the CIS. A major task for all countries in CEB is to adapt their labour laws in the run-up to EU accession. Further south and east, the main challenge is to break the cycle of low productivity and subsistence levels of employment and, by doing so, bring more activity into the formal economy.

The chapter is organised as follows. Section 5.1 focuses on the increasing divergence in employment rates between countries in CEB and SEE, where total employment has risen since the early years of transition, and the CIS where it continues to fall. It also documents the magnitude of the unemployment problem across the region. Section 5.2 draws on labour force and household surveys from selected countries to show the extent to which people engage in informal activities, such as occasional or family-based work and multiple-job holding. For many people, taking steps to cope with transition, such as changing jobs or moving to new regions and becoming self-employed or starting new businesses, are playing an increasingly important role, at least in the more advanced CEB countries. These responses to the transition process are explored in more detail in Section 5.3. Section 5.4 evaluates who the main beneficiaries of the transition have been, and Section 5.5 concludes by assessing the need for both active and passive labour market policies.

5.1 Labour market flows and unemployment

One of the main features of the transition process is the reallocation of labour from the (initially predominant) state sector to the private sector, comprising both privatised enterprises and new firms. When the process began, there was general agreement among analysts that the early phase of transition would see a fall in total employment and a rise in unemployment. It was recognised that cutting jobs in the state sector in many circumstances would be easier than creating them in the private sector, and that this would give rise to unemployment, some of which might be persistent. Unemployment would therefore be an inevitable stopgap. This view of labour reallocation, with unemployment as a buffer zone between state and private sectors, quickly achieved popularity.[1]

Within this framework, there was disagreement about how long and how severe the effects of transition – in particular the persistence of unemployment – would be. These different views led to considerable debate about how quickly governments should press ahead with reforms that, however necessary for long-term benefit, would cause considerable hardship in the short term.[2] However, it has become increasingly clear that the distinction between fast and slow speeds of reform camouflages many important similarities and provides limited guidance on the policies that need to be taken.

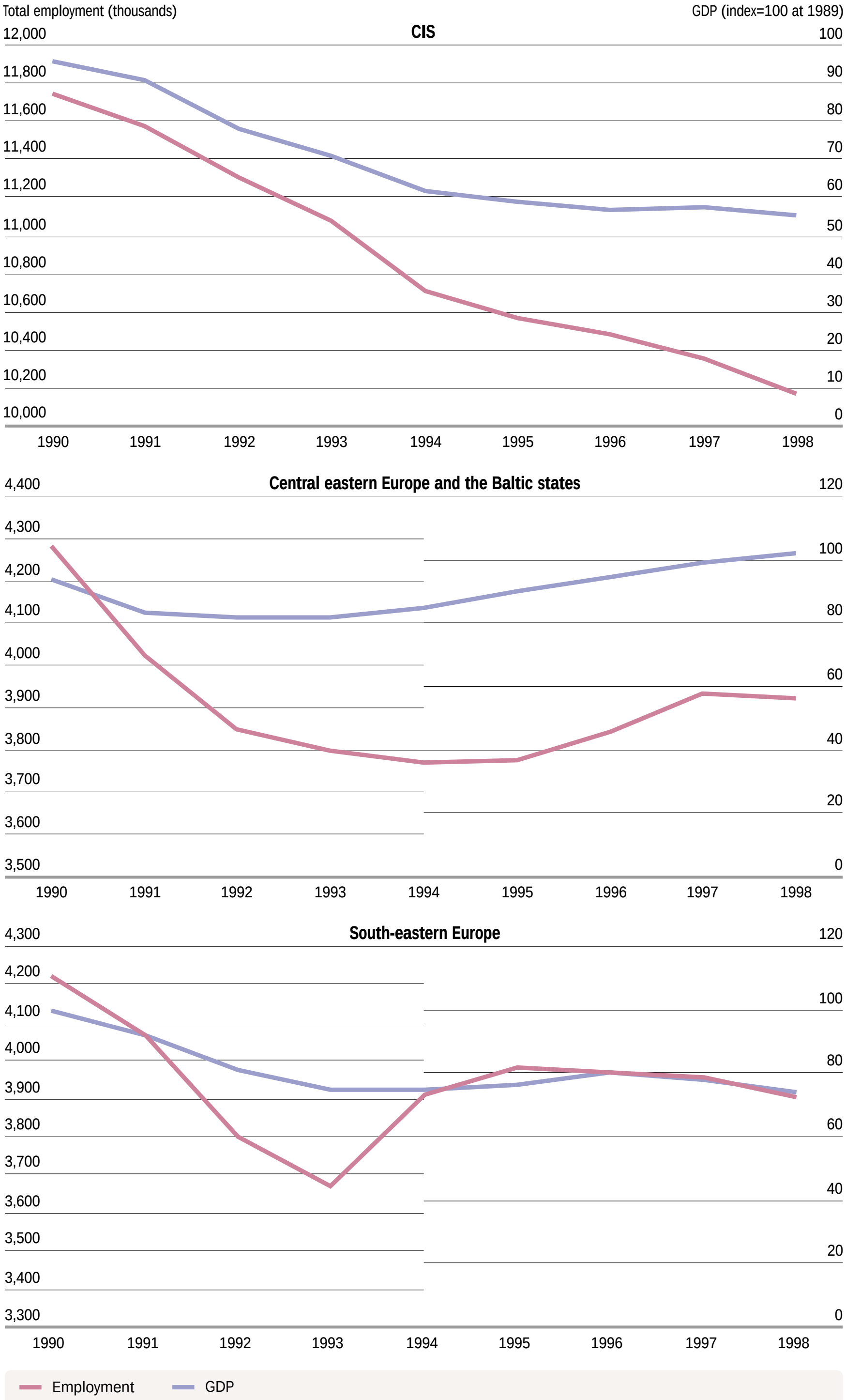
Chart 5.1 compares trends in output and employment over the past decade in CEB, SEE and the CIS. A sharp contrast

1 The academic literature on this topic includes Aghion and Blanchard (1994), Chadha and Coricelli (1997) and Gavin (1996).

2 See Boeri (1999) for a useful summary of the literature on this debate.

Chart 5.1

Trends in output and total employment



Sources: Data for 1990-98 represent the most recent official estimates of unemployment rates as reflected in publications from the national authorities, the IMF, the World Bank and the OECD.

between CEB and the CIS is immediately apparent. In CEB the level of total employment has a similar U-shape pattern to GDP, but the recovery in employment took place about two years after GDP started growing again. In contrast, employment in the CIS, which initially stayed relatively stable, has declined steadily throughout the decade, to the point where in 1998 it was 14 per cent below the 1990 level.

Employment in SEE showed a sharp increase in 1994, although this reflects in part a statistical revision to employment data in certain countries (for example, Romania).

The patterns highlighted above reflect an important difference in approach to labour market restructuring. In general, countries in CEB have made more rapid progress in reforms, both in liberalisation and privatisation, and, crucially, in providing a favourable climate for new enterprises (see Chapter 2) – hence the more rapid decline in employment in the early stages, and the improvement in later years. Within this region there is some evidence of a wage-employment trade-off. In 1990-92 employment fell in the Czech Republic by only 9 per cent while real product wages dropped by 24 per cent. In contrast, employment in Hungary fell by 21 per cent while real product wages rose by 17 per cent. Poland adopted a "middle way", with employment down by 11 per cent and wages by 0.5 per cent.[3] Overall, however, the early years of transition in CEB appear to have had a much bigger effect on employment than on wages.[4] Furthermore, workers have had very little collective "voice" – the influence of trade unions on wage and employment outcomes has been marginal or non-existent (see Box 5.1).

In the CIS the much slower pace of reform initially led to a less dramatic decline in employment. The adjustment has come instead through large real wage reductions and in many cases the build-up of substantial wage arrears (see Section 5.4). The different trade-off adopted in the CIS is due in part to the fact that many workers still receive specific benefits from their employers, such as housing benefit.[5] This strategy of retaining jobs has led to a particularly severe rise in poverty in the CIS; the poverty headcount in western CIS countries rose from only 2 per cent in 1987-88 to over 50 per cent by 1993-95, and in Central Asia from 15 per cent to 66 per cent over the same period.[6] As later sections of this chapter demonstrate, workers in the CIS have had to rely

3 See Basu, Estrin and Svejnar (2000).

4 See Estrin and Svejnar (1998).

5 For the labour market implications and a discussion of possible remedies, see Commander and Schankerman (1997).

6 See *Transition Report* 1999, Table 1.1.2. The poverty headcount is defined as the number of people falling below the poverty line, divided by the total population.

Box 5.1

The role of trade unions

The collapse of communism offered the trade unions an opportunity to stop being the transmission belts of the Communist Party and to assume an active role in shaping the process of transition. Ten years on, it is clear that the role played by the trade unions in the transition process has been marginal. This applies to not only the old, official unions, left over from the communist era, but also to the new, independent ones, such as Solidarity, that emerged towards the end of the period of communist rule or immediately afterwards.

Under the communist system, the unions' task was to administer – within a clearly defined, narrow framework – social and welfare benefits in enterprises. Any bargaining between management and unions was over issues such as training, health and safety, welfare and transport. Very different issues came to the fore in the transition period, including privatisation, price liberalisation, unemployment and salaries, and the unions have found it difficult to adjust to the new agenda. Nevertheless, the unions were allowed to keep most of the extensive assets of their official predecessors, even in Russia where in August 1991 the Communist Party of the Soviet Union (CPSU) was banned and its assets seized, together with those of the Komsomol and other mass organisations, but the unions were spared. Rivalry between the reformed former official unions and the new, independent ones has hampered trade union development, with the division of assets a major bone of contention. In the former Soviet republics – especially in the Caucasus and Central Asia – the former communist trade unions have seen off the challenge from the independent unions, managing to remain dominant and often working hand-in-glove with the state – just like in the old times.

Trade unions and wage bargaining in selected transition economies[1]

	Employees in trade unions (%)	Wage bargaining level			Union workers involved in bargaining (%)
		National	Sectoral	Enterprise	
Central and eastern Europe and the Baltic states					
Albania	33		+		na
Bosnia and Herzegovina[2]	50	+			50
Bulgaria	40			+	na
Croatia	90		+		10
Czech Republic	35			+	20
Estonia	13			+	29
FYR Macedonia	75	+	+	+	na
Hungary	40	+			40
Latvia	28	+			28
Lithuania	10			+	90
Poland	61		+		10
Romania	50	+	+	+	5/7/30[3]
Slovak Republic	32		+	+	na
Slovenia	42	+			na
Commonwealth of Independent States					
Armenia[4]	20				na
Azerbaijan	70			+	60
Belarus	85	+	+	+	80
Moldova	85	+			92
Tajikistan	96	+		+	60
Turkmenistan	60[5]	na	na	na	na
Ukraine	90			+	67
Uzbekistan	90			+	50

Source: Information provided by national authorities in July/August 2000. See also Dutz et al. (2000b).

Note: A "+" indicates that wage bargaining occurs at the level indicated.

1 Information not available for Georgia, Kyrgyzstan and Russia.

2 Federation of Bosnia and Herzegovina only.

3 5% at national, 7% sectoral and 30% enterprise levels.

4 In Armenia unions do not engage in wage bargaining at any level.

5 All public sector employees (60% of total) are trade union members.

Despite significant variations, the ending of compulsory union membership has led to a general drop in numbers, although it remains well over 50 per cent in most CIS countries (see table). Membership is generally lower in CEE, especially in the Baltic states. In Poland, Solidarity is said to have 1.2 million members compared with 10 million two decades ago (although it has to be borne in mind that Solidarity was always unique: part trade union, part political movement).

Solidarity's case illustrates the particular difficulty facing new, independent unions in the era of transition compared with the reformed official unions associated with the old order. Their main problem is how to survive by carving out new identities different from the old, discredited ones, but not committed to the new order either. In a sense, this makes their evolution into conventional, Western-type trade unions easier. Unlike these reformed unions, and more awkwardly for itself, Solidarity fought for the end of communism in the late 1980s. Yet what came after communism has proved problematic. Solidarity remains officially pro-market. Both its wings, the political and the trade union one, have come out in favour of restructuring and change. But the specifics of the reform environment – privatisation, foreign investment, the re-emergence of small firms – are difficult for the bulk of Solidarity's members to swallow. To this must be added the increasingly pressing challenge of globalisation. There is no sign yet that the trade union movement – not only in Poland but also in the other countries undergoing transition – has devised a constructive response to this twin challenge. Yet its own survival depends on this response.

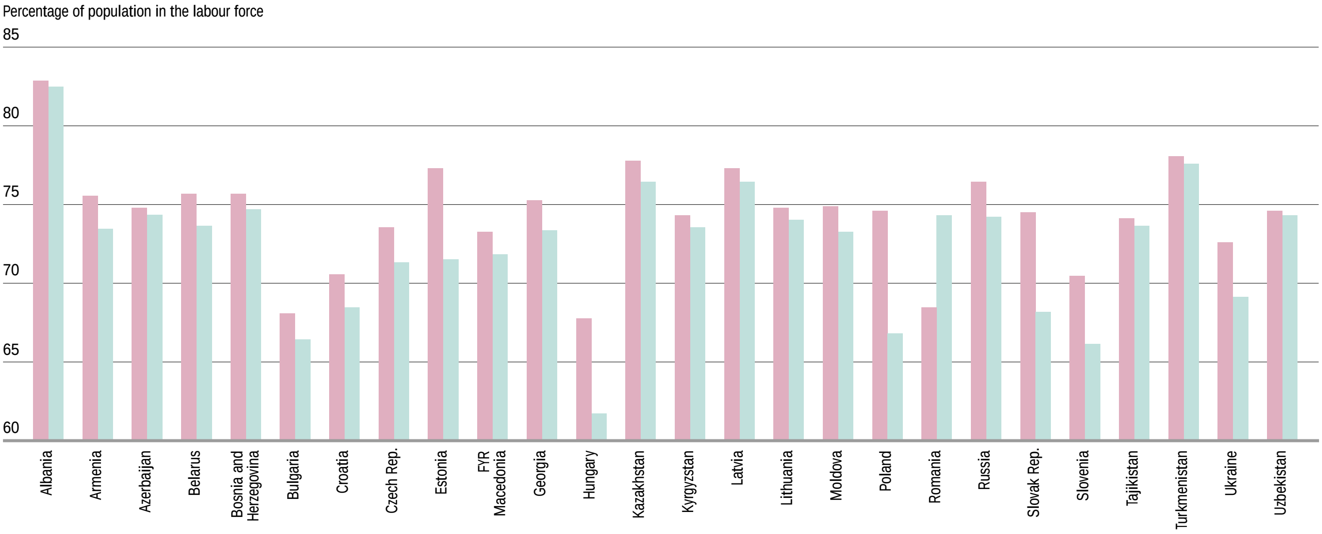
increasingly on a variety of coping strategies to compensate for the drastic fall in real income and associated poverty.

The analysis of employment flows outlined above implies that the share of private sector employment in the total should rise over time.[7] In Poland and the Czech Republic, for example, about 70 per cent of employees were in the private sector (mostly in privatised firms) by 1998. Data on the state-private split in the CIS are less reliable, but later sections of this chapter demonstrate the importance of private sector activity, especially in the informal economy. Considerable reallocation of labour has also taken place across sectors, with a sharp increase in services and a decline in manufacturing in almost all countries. Agriculture has become increasingly important in many CIS countries.

7 Because a large proportion of private sector activity takes place in the informal economy, estimates of private sector shares in employment are approximations only.

Chart 5.2

Labour force participation rates



Source: *Key Indicators of Labour Market*, International Labour Organization.

The employment trends noted above have been accompanied by a falling percentage of people in the labour force and rising unemployment. Chart 5.2 compares labour force participation rates in all countries for two years – 1990 and 1995. The percentage of people in the labour force has fallen in most countries since 1990, although it remains at comparable levels to Western economies. The most significant declines have been in some of the advanced central European countries, such as the Czech Republic, Hungary and Poland. Interestingly, there is little evidence of a decline in female participation in the labour force, with the rate remaining around 43-47 per cent in the large, central European countries (Czech Republic, Hungary, Poland and Romania) and in Russia.

Table 5.1 presents the unemployment rates for each country from 1990 to 1999. It should be noted that in many countries, especially in the CIS, labour force surveys do not exist, and the official unemployment rate is based on registrations. This usually underestimates the actual rate for two reasons.[8] First, unemployment benefits are so low or non-existent and job prospects so poor that it is not worthwhile registering. Second, many people stay officially employed in state enterprises even though there is often effectively no work to do and wages are not being paid. Such people would be classified as unemployed under the standard definition of the International Labour Organization if they are willing to take alternative employment.

With this caveat in mind, it is clear that most countries have had substantial increases in unemployment throughout the decade. Double-digit unemployment is now the norm in the majority of countries across the region, at least when the figures are based on labour force surveys. However, the employment trends highlighted earlier suggest that unemployment rates are expected to fall in CEB and SEE, although strong trends are not yet apparent from the data. In contrast, unemployment rose in all CIS countries between 1998 and 1999 (except Belarus and Russia) and this trend is likely to continue over the medium term.

Rising unemployment has also been accompanied by a sharp increase in the numbers of long-term unemployed (defined as unemployment for more than one year).[9] Chart 5.3 shows the share of unemployment accounted for by long-term unemployment for selected CEE countries and Russia as well as a comparison with several major market economies. The problem is acute in some cases; in Bulgaria and Hungary the long-term unemployed exceeded 50 per cent of the unemployment total by 1997. Other countries, such as the Czech Republic, Poland and Russia, show rates of long-term unemployment in line with countries such as France, Germany and the UK.

Long-term unemployment presents a particular problem for policy-makers because it is concentrated among certain groups of the population, in particular the young and those with vocational education.[10] A long spell of unemployment can also make someone virtually unemployable and plunge them into poverty. In Russia, for example, over 30 per cent of the long-term unemployed belong to the poorest 20 per cent of the population (measured by consumption profiles).[11] Section 5.5 returns to the issue of the appropriate policies to tackle this problem.

5.2 Types of labour market activity

The framework outlined in the previous section is useful for analysing the reallocation of labour during the transition, and especially the stark differences between

8 It can also inflate the unemployment rate if incentives to register are strong, as in a number of CEB and SEE countries.

9 The initial increase in long-term unemployment was inevitable given that the previous system in most countries had guaranteed full employment, with only short periods of unemployment permitted.

10 See Boeri et al. (1998).

11 These results are based on the Russian Longitudinal Monitoring Survey (RLMS), round 8, 1998, described later in the text, and are available on request.

Table 5.1

Unemployment rates in central and eastern Europe, the Baltic states and the CIS

(in per cent)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Central and eastern Europe and the Baltic states										
Albania	9.5	8.9	27.9	28.9	19.6	16.9	12.4	14.9	17.8	18.0
Bosnia and Herzegovina	na	na	na	na	na	na	na	37.0	38.0	40.0
Bulgaria	1.7	11.1	15.3	16.4	12.8	11.1	12.5	13.7	12.2	16.0
Croatia	9.3	13.2	13.2	14.8	14.5	14.5	10.0	9.9	11.4	13.6
Czech Republic	0.7	4.1	2.6	3.5	3.2	2.9	3.5	5.2	7.5	9.4
Estonia	0.6	na	na	6.6	7.6	9.8	10.0	9.7	9.9	12.3
FYR Macedonia	18.5	19.2	27.8	28.3	31.4	37.7	na	36.0	34.5	32.4
Hungary	1.8	8.2	9.3	11.9	10.7	10.2	9.9	8.7	7.8	7.0
Latvia	0.5	0.6	3.9	8.7	16.7	18.1	19.4	14.8	14.0	14.4
Lithuania	na	0.3	1.3	4.4	3.8	17.5	16.4	14.1	13.3	14.1
Poland	6.5	12.3	14.3	16.4	16.0	14.9	13.2	8.6	10.4	13.0
Romania	na	3.0	8.2	10.4	10.1	8.2	6.5	7.4	10.4	11.5
Slovak Republic	1.2	9.5	10.4	14.4	14.6	13.1	12.8	12.5	15.6	19.2
Slovenia	na	7.3	8.3	9.1	9.1	7.4	7.3	7.1	7.6	7.4
Commonwealth of Independent States										
Armenia	na	na	3.5	6.3	5.8	8.4	10.1	11.3	8.9	11.6
Azerbaijan	na	na	15.4	9.6	10.4	11.7	12.1	12.7	12.9	13.9
Belarus	na	0.1	0.5	1.4	2.1	2.7	3.9	2.8	2.3	2.1
Georgia	na	0.1	5.4	9.1	3.6	3.1	2.8	7.5	14.7	14.9
Kazakhstan	na	0.1	0.4	0.6	7.5	11.0	13.0	13.0	14.0	14.1
Kyrgyzstan	na	na	na	na	3.1	4.4	6.0	4.3	na	na
Moldova	na	0.0	0.7	0.7	1.1	1.4	1.8	1.5	1.9	2.0
Russia	na	na	5.3	6.0	7.8	9.0	9.9	11.2	13.3	11.7
Tajikistan	na	0.0	0.3	0.8	1.2	1.3	1.6	1.8	1.8	1.8
Turkmenistan	2.0	2.0	na	na	na	na	na	na	na	na
Ukraine	na	0.0	0.2	0.3	0.3	0.5	1.3	2.3	3.7	4.3
Uzbekistan	na	0.0	0.1	0.3	0.4	0.4	0.4	0.4	0.5	0.6

Source: Data for 1990-99 represent the most recent official estimates of unemployment rates as reflected in publications from the national authorities, the IMF, the World Bank and the OECD.

Note: Figures for 1999 are preliminary estimates.

CEB, SEE and the CIS. However, a key argument of this chapter is that this framework cannot convey the full variety of activities that people engage in across the region and the different progress in transition that results from this. Individual and household surveys allow the separation of broad employment categories into more detailed subsets. This section uses such surveys to document the widespread existence of activities that do not fit neatly into conventional definitions of employment or unemployment, and highlights the characteristics of people who enter different types of employment, including activities outside of the formal economy.

The data are based on responses of a very large number of individuals across seven countries.[12] The choice of country coverage was dictated partly by data availability but also by the desire to cover countries from different geographical locations and at different stages of transition. As such, Hungary and Poland represent advanced transition countries, both in the first wave of EU accession negotiations. In contrast, Croatia has made slower progress in reform than these two countries and has not yet been formally invited to start EU accession negotiations. Russia and Ukraine are the largest CIS economies, while Armenia and Kyrgyzstan represent smaller countries, in the Caucasus and Central Asia respectively.

Composition of employment

Table 5.2 shows that, even though rates of employment are approximately the same in most countries, the composition of employment varies widely across economies. A first important pattern is that the share of full-time employees is generally higher in the CIS countries than in CEE. One explanation is that full-time employment is closely associated with state sector employment, which remains more prominent in CIS countries.[13] Of course, there may also be important differences in measurement, with many of those recorded as full-time in the CIS actually working a decreasing number of hours.[14] A second important pattern is

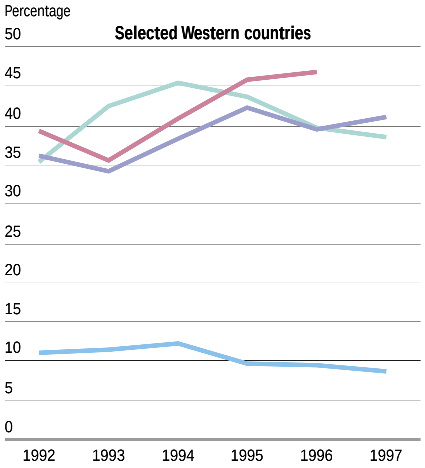
12 Survey dates are as follows: Armenia 1996 and 1999, Croatia 1998, Hungary 1999, Kyrgyzstan 1997, Poland 1996 and 1998, Russia 1998 and Ukraine 1999. In addition to individual or labour force surveys, household living standard surveys were available for Armenia, Croatia, Kyrgyzstan and Ukraine.

13 The state sector hires 64.2% of the employed in Russia, but only 22.2% in Poland.

14 In Russia the share of full-time employees reporting working less than 40 hours per week is 25.9%, whereas in Poland the comparable share is only 12.2%.

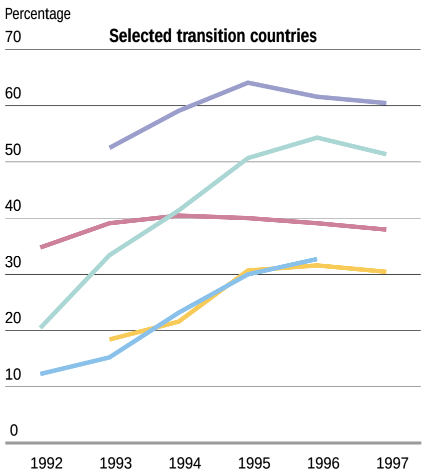
Chart 5.3

Share of long-term unemployment in total unemployment



France Germany UK US

Source: *Key Indicators of Labour Market*, International Labour Organization.



Bulgaria Czech Rep. Hungary Poland Russia

Source: *Key Indicators of Labour Market*, International Labour Organization.

the relatively high share of self-employed and employers in CEE countries, with shares in Hungary and Poland significantly higher than in the CIS. Even before the transition, setting up a business was not unusual in these countries, whereas it was discouraged in others – Ukraine, for example – by a punitive use of taxation and other measures.

Armenia and Kyrgyzstan stand out as deviating from the general patterns. Kyrgyzstan exhibits a higher share of employment than all other countries. Part of the explanation is no doubt related to its demographic profile, in particular substantially fewer inactive elderly people.[15] It is also partly explained by the fact that a large portion of the population undertakes occasional work. In Armenia the share of employees in the formal economy (both full-time and part-time) is significantly lower than in other countries, due to a lower level of development of formal labour markets. The variety of labour market activities reported by respondents in these countries underlines the need for a careful breakdown of different types of informal employment.

Table 5.3 reclassifies the survey data to present an indication of two broad ways of coping with employment difficulties: “subsistence” informal work and multiple-job holding. One type of subsistence informal work is “family helpers”, which in turn can be divided into two categories, “unpaid family workers” and “inactive but owning land”. These two categories do not relate to any formal type of work, representing individuals registered neither as full or part-time employees nor as self-employed (either non-agricultural or farmers). Whereas the first category is part of the overall employed statistics and can be interpreted as the number of dependent family members that help self-employed individuals, the second comprises inactive people reporting agricultural earnings or helping their land-owning families. These two categories together represent informal work undertaken to maintain a subsistence level rather than informal labour motivated by market incentives, such as tax evasion or the business environment. The contrast between the very low share of “inactive but owning land” in Poland (1.3 per cent) relative to Russia (30.4 per cent) highlights the ambiguities in interpreting individuals’ self-declared assignment. A plausible explanation of the difference in this case might be linked to the prevailing type of land ownership and the quality of agriculture. Polish farmers tend to own their land and to be officially registered as employed (with farmers accounting for 6.9 per cent of the population over 16) in contrast to Russia, where farmers do not declare themselves as employed (only 0.8 per cent) but merely subsist on land.

A second distinct measure of subsistence informal work is the share of occasional workers, namely those who engage occasionally in work to earn a basic living. By definition, this category includes all individuals who are not formally registered as employed, comprising those who are unemployed, inactive or family helpers. According to both measures, the figures suggest very high levels of subsistence working in the CIS and in Croatia (with, for instance, family helpers accounting for over 25 per cent of the total population over 16 in Armenia, Croatia, Kyrgyzstan and Russia, and occasional workers accounting for over 25 per cent in Kyrgyzstan and Ukraine), but a very low level in CEE as represented by Poland (less than 5 per cent for both indicators).[16]

Changes in subsistence working in Armenia and Poland can be tracked over time. In the case of Poland the pool of family helpers has remained relatively stable. By contrast, it has sharply increased in Armenia, compensating for a decrease in the share of full-time employees and explaining most of the significant growth of the pool of employed (from 40.3 per cent to 46.4 per cent). Thus, while the quantity of overall employment rose in Armenia, its composition shifted towards more subsistence work.

Another key feature of the transition process that the survey data highlight is the extent of multiple-job holding. While subsistence working is a way for the inactive or unemployed to cope with transition by providing them with some income, multiple-job holding is an equivalent strategy for the formally employed facing low pay or wage arrears. Table 5.3 also reports the number of employees – working either full time or temporarily – reporting other activities or earnings, as a share of the pool of the formally employed. As far as measurement problems allow us to compare across countries, Ukraine experiences the highest level of multiple-job

15 Only 19.7% of the population above 16 is aged 50 or more in Kyrgyzstan, compared with more than 30% in other countries, including up to 38.7% in Ukraine.

16 The data did not allow comparable statistics to be derived for Hungary.

Table 5.2

Basic employment categories

(percentages)

	Armenia 1996	Armenia 1999	Croatia 1998	Hungary[1] 1999	Kyrgyzstan 1997	Poland 1996	Poland 1998	Russia 1998	Ukraine 1999
Employed	40.25	46.36	47.19	48.08	70.34	50.09	50.70	49.72	45.60
of which:									
Full-time employees	18.06	15.25	33.14	32.41	16.00	32.92	32.69	40.91	38.55
Part-time and temporary employees	1.81	4.68	2.21	8.23	23.39	2.42	2.14	4.82	5.11
Self-employed and employers	3.64	2.72	2.68	5.62	4.28	4.85	5.25	3.13	0.64
Farmers	7.23	5.38	3.74	0.86	5.23	7.16	6.94	0.16	0.84
Unpaid family workers	8.84	18.33	5.42	0.34	21.44	2.74	2.71	0.78	0.12
Unemployed	14.61	16.53	6.20	3.65	2.27	6.44	6.04	7.99	13.23
Inactive	45.81	37.12	46.61	48.26	18.20	43.46	44.23	42.22	41.52

Sources: Labour Force Surveys for Armenia, Croatia, Hungary, Kyrgyzstan, Poland and Ukraine; Longitudinal Monitoring Survey for Russia.

Note: The table distinguishes between three basic categories: employed (individuals reporting work or having a job that they can go back to even if not pursuing it at the time of the survey), unemployed (people who, according to the ILO definition, do not report work but are currently and actively looking for a position and ready to take it up) and inactive (others minus children below 16). The pool of employed is in turn broken down by status revealing the percentages of people in the population over 16 belonging to permanent wage employment, temporary wage employment, self employed and employers, agricultural self-employment or unpaid family workers.

1 In the case of Hungary, percentages do not add up to 100 because of missing data (some people declare working but do not report any status).

Table 5.3

Passive coping strategies

(percentages)

	Armenia 1996	Armenia 1999	Croatia 1998	Kyrgyzstan 1997	Poland 1996	Poland 1998	Russia 1998	Ukraine 1999
Subsistence informal work								
Family helpers[1]	23.95	26.36	28.09	30.62	4.27	4.00	31.16	17.99
of which:								
Unpaid family workers	8.84	18.33	5.42	21.44	2.74	2.71	0.78	0.12
Inactive but owning land	15.11	8.03	22.67	9.18	1.53	1.29	30.38	17.87
Occasional workers[2]	3.47	1.19	6.96	39.36	2.47	2.08	5.57	26.65
Multiple-job holding[3]	6.64	16.21	18.78	4.10	9.65	10.04	12.79	27.49

Sources: Labour Force Surveys for Armenia, Croatia, Kyrgyzstan, Poland and Ukraine; Longitudinal Monitoring Survey for Russia.

1 Family helpers comprises both unpaid family workers and the inactive population owning land. It is calculated as a percentage of the population over 16.

2 As percentages of total population over 16.

3 As percentages of the pool of employees.

holding, with over one-quarter of employees having more than one job, compared with around 10 per cent for Poland.[17]

In summary, these two coping approaches – subsistence working and multiple-job holding – appear to be more commonplace in CIS countries than in CEE. This helps explain why the unemployment rate derived from the individual and household surveys is sometimes at odds with its aggregate counterpart. As discussed above, employment in CEE has a higher formal share than in the CIS. In the latter region under-employment as well as occasional working and multiple-job holding are common features. People who are officially considered as working (even if only sporadically) might see themselves as currently looking for a job, and are therefore in general classified as unemployed in Table 5.2.

Characteristics of the employed and unemployed

Although the boundaries between different labour market categories appear to be quite blurred, clear patterns arise in terms of the characteristics that individuals share when belonging to the same category. First, males tend to be in the majority in permanent and self-employment categories (both agricultural and non-agricultural) whereas females constitute the majority in the subsistence categories – unpaid family workers and inactive but owning land – as well as in the remainder of the inactive category.

Second, the categories of permanent employees, self-employment and entrepreneurship are obviously skill-intensive activities since the education level of people in these categories is above the average of the population. The agricultural

17 The Russian figure is probably a significant underestimate in light of high wage arrears and the consequent need to complement income from other sources. In principle, such under-reporting may be driven by a number of factors, including concerns that additional income sources would also be subject to taxation.

sector and the inactive pools, on the contrary, comprise mostly people with only primary education. Such features are consistent across countries and confirm some matching between skills and jobs.

Third, it is important to note that the unemployed display characteristics similar to the employed rather than to the inactive in that they are relatively well educated. However, as Chart 5.4 shows, there is a significant contrast between Poland and Russia in the employment categories of those with higher education. In Poland two-thirds of those with higher education are in permanent employment and only 3 per cent are unemployed whereas in Russia the equivalent ratios are one-half and 9 per cent.

With regard to age, the general pattern across surveys is that younger people have a higher representation in the unemployment pool or in low-skills jobs. Middle-aged people can be found mostly in the bulk of permanent and regular employees and the self-employed. The eldest tend to belong to the inactive pool but some of them still perform unpaid work either as family workers or inactive but owning land.

5.3 Mobility, self-employment and entrepreneurship

The previous section has highlighted the importance of coping activities such as multiple-job holding and subsistence work. In contrast, this section explores in more detail two "active" approaches. The first is mobility, both across jobs – the extent to which people are able or willing to move out of inactivity, unemployment or existing jobs to new jobs – and across space, involving moving to another region or country. The second approach is self-employment and entrepreneurship. The section explores in more detail the profile of the self-employed, the extent to which trends in self-employment are associated with economic growth, and the implications of entrepreneurship for the rest of the economy.[18] It is important to stress at the outset that the way individuals have adjusted in terms of mobility in general and self-employment in particular is constrained not only by initial skills but also by the investment climate and prevailing rate of economic growth.

Mobility across jobs and space

As previous sections have highlighted, the extent to which individuals move between jobs and from unemployment or inactivity to new jobs is at the core of economic transition. However, recent empirical work has shown that higher mobility is not necessarily desirable in itself. What is desirable is reallocation from less to more productive enterprises. Recent work based on an EBRD/World Bank survey of more than 3,000 enterprises in 20 countries shows that the process of desirable reallocation or market selection – that is, the creation of jobs by productivity-increasing firms and the contraction of employment in productivity-decreasing firms – has been more prevalent in CEE than in the CIS.[19] A similar pattern can be inferred from an analysis of the mobility reported by individuals.

Table 5.4 provides details of the extent and nature of worker mobility in several types of countries: Poland and Hungary for the group of advanced reformers, Russia and Armenia for the early-stage reformers. The first row presents the percentage of employees that did not declare changing employment throughout the survey year. The last row reports a measure of job turnover, namely those employed at the end of the period that moved at least once during the survey year, based on both movements between jobs and inflows from unemployment or inactivity.

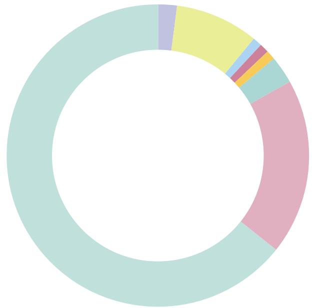
Interestingly, overall turnover is higher for Russia than for Poland and Hungary, with around 13-14 per cent of the Polish and Hungarian workforce in new jobs over a one-year period and almost 17 per cent of Russians in a similar situation (roughly 9 per cent for Armenia).[20] However, two additional findings regarding turnover in Poland and Hungary are more favourable, to the extent that jobs in the private sector on average are more productive than those in the state sector.

First, although job-to-job mobility is highest for Russia (at over 10 per cent of the workforce), the ratio of switches to private sector jobs (from state or alternative private employment) is highest for Poland (78 per cent of such movers in 1998) followed by Hungary (62 per cent) and lowest for Russia (only 40 per cent).[21] Second, of the 8 per cent of newly-employed from unemployment or inactivity in Poland and 9 per cent in

Chart 5.4

Employment categories of individuals with higher education, Poland and Russia

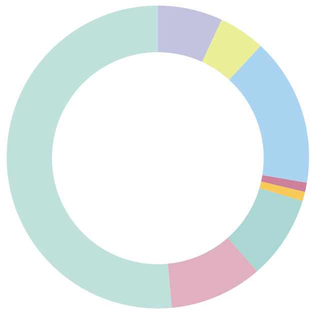
Poland



Full-time employees 65%
Temporary employees 2%
Self-employed and employers 9%
Inactive but owning land <1%
Unpaid family workers 1%
Farmers 1%
Unemployed 3%
Otherwise inactive 19%

Source: Polish Labour Force Survey, 1998.

Russia



Full-time employees 52%
Temporary employees 7%
Self-employed and employers 5%
Inactive but owning land 16%
Unpaid family workers 1%
Farmers <1%
Unemployed 9%
Otherwise inactive 10%

Source: Russian Longitudinal Monitoring Survey, round 8, 1998.

18 Another active strategy that people can adopt is to acquire new skills and training. This issue is explored in detail in Chapter 6.

19 This indicator of market selection has been constructed by Dutz and Vagliasindi (2000). Their work also provides strong evidence on the relationship between business environment indicators and market selection.

20 Lehmann (1999) finds similar results for Poland 1996 (14.3) but a higher turnover for Russia (19.7) although the latter is also based on 1996 data. On this simple measure, the pace of re-allocation is not much faster in transition economies than in advanced market economies, similar to a British fraction (18.2) also by Lehmann and a comparable estimate by Farber (1997) for the United States.

21 Sabirianova (2000) argues that the restructuring process in Russia has had a significant increase on occupational mobility, with a strong increase in flows to services.

Table 5.4

Worker mobility in Armenia, Hungary, Poland and Russia

(as a percentage of the employed)

	Armenia 1999	Hungary 1999	Poland 1996	Poland 1998	Russia 1998
Permanently employed throughout the year	90.8	85.8	85.8	87.1	83.4
Job-to-job mobility	4.8	5.4	4.9	4.9	10.2
of which:					
Private sector	47.9	62.1	74.6	78.0	40.1
State sector	50.2	16.8	25.4	22.0	51.4
Inflows from unemployment and inactivity	4.6	8.9	9.4	8.0	6.5
of which:					
Private sector	51.7	54.1	71.0	77.6	28.8
State sector	45.9	27.4	29.0	22.4	61.6
Turnover	9.3	14.3	14.3	12.9	16.7

Sources: Labour Force Surveys for Armenia, Hungary and Poland; Longitudinal Monitoring Survey for Russia.

Note: The turnover is the sum of the job mobility and the inflows from unemployment and inactivity. In the cases of Armenia, Hungary and Russia, the disaggregation between private and state sector does not add up to 100 because of the existence of a mixed sector.

Hungary, 78 and 54 per cent respectively went to private sector jobs. This is in contrast to both a lower inflow from unemployment or inactivity in Russia (6.5 per cent) and a lower share going to the private sector (29 per cent).[22] Armenia had an even lower inflow to the workforce from unemployment or inactivity (4.6 per cent), with roughly half going to private and half to state sector jobs.

Of particular interest is the type of employment that people changing jobs are able to secure. Across the four countries, movements to full-time employment are roughly proportional to the share of existing full-time employees in total employment. Not surprisingly, the occasional employee category has the most mobility, while family workers and especially farmers are the least likely to move. In particular, occasional employment is the most likely route out of unemployment in all countries, especially in Poland. In contrast, self-employment and entrepreneurship are not in general a coping response to unemployment in Poland or in Russia, as shown by the very low inflows from unemployment and inactivity to these categories. Of all those exiting from joblessness, only 6 per cent in Poland and less than 1.5 per cent in Russia became self-employed.[23]

A more detailed statistical analysis based on the most recent Russia longitudinal survey sheds some additional light on the background and motivations of job-to-job movers. As expected, younger individuals are more willing to change jobs, reflecting the unwillingness of older employees to forgo existing salaries to experience an uncertain outcome. Individuals living in rural areas and women are also less inclined to change jobs.

If relevant new jobs are not available in the same area, job-to-job mobility requires movement to another region or country. There are three broad types of labour migration associated with CEE and CIS countries. The first is the flow of workers emigrating from CEE to western Europe. While some move directly from the CIS to EU countries, these flows so far have been relatively insignificant. The second is cross-border movement within the region, especially from the CIS to CEE. To some extent, countries in CEE act as a buffer between the CIS and the EU. This point is illustrated by Chart 5.5, which uses evidence from two countries, Germany and the Czech Republic. In the former, migration from the East is dominated by former Yugoslavia and Poland, with former Soviet Union countries amounting to only 4 per cent of immigrants from transition countries. In the Czech Republic, however, migrants from the former Soviet Union make up nearly half of the total from transition economies.

The third type of migration flows is movement across regions within a country. Mobility within countries of CEE is still relatively low, even though regional economic differences are high in many cases. Explanations include the existence of undeveloped property markets, whereby people face difficulties in selling or even renting their houses, and the legacy of communism, under which people had a job for life.[24]

Self-employment and entrepreneurship

Non-agricultural self-employed people and employers are overwhelmingly male, as highlighted in Table 5.5. The proportion of males is greater than in any other labour

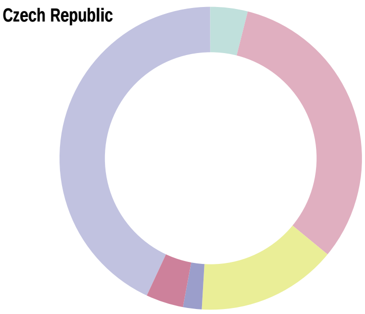
22 Lehmann (1999) reports more detailed but similar results based on matched individuals across three waves of the Polish and Russian surveys. The higher share of job movers ending up in the state sector in Russia is driven by the much larger share of the workforce still belonging to that sector given its earlier stage of transition, although a re-allocation is still occurring from state to private. Poland has already reached a very high share of private sector employment, while Hungary is in an intermediate position. Boeri and Flinn (1999) report that Poland performs well relative to Hungary and also the Slovak Republic in terms of individual mobility between public and private firms, based on transition matrices derived from matched labour force survey waves across time.

23 Relative to a total self-employed and employer pool of 9.7% of the workforce in Poland and 6.3% in Russia. See Dutz et al. (2000a) for these results and those reported in the following paragraph.

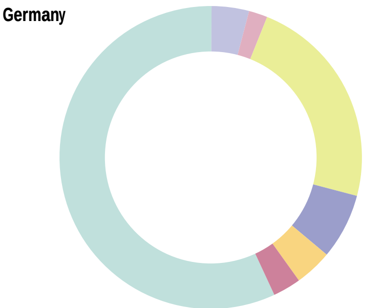
24 See Barr (1994).

Chart 5.5

Foreigners living in the Czech Republic and Germany in 1998 by country of origin



Source: OECD, based on population registers.



Source: OECD, based on population registers.

category throughout the region (except for agricultural self-employment in Hungary, Russia and Ukraine). Entrepreneurial self-employed individuals are also significantly better educated than the bulk of the population in all countries. Compared with temporary or irregular workers, the share of the self-employed with higher education ranges from slightly higher in Armenia and Russia to more than twice the rate in Poland and more than three times in Croatia. Similar distinctions are evident with respect to age, with the self-employed being older or more experienced on average than temporary workers (except in Armenia) and than the population as a whole. A more detailed statistical analysis, using regression techniques, of self-employment by gender, education and age in Croatia and Poland confirms these results. For most CIS countries, however, the self-employed are not significantly different from the general pool of employees. The significance of these characteristics for CIS countries only re-emerges when comparing the self-employed with the total population.[25]

The self-employed in most countries tend to be better trained and more experienced (older) than other workers – in particular, temporary or irregular workers. This suggests that self-employment is not a coping strategy for the unskilled but rather a creative labour market choice that brings high rewards, as the following section shows. Moreover, self-employment rates tend to stay constant or even increase during times of economic growth. Based on an analysis of the self-employment rate in Hungary between 1992 and 1999, there is little evidence that unemployment leads to more self-employment. Instead, economic growth influences self-employment positively by increasing the demand for services.[26]

One of the most important reasons why self-employment and entrepreneurship are so critical for the rest of the economy is the link to job creation, not only directly but also indirectly by providing employment opportunities both for other family members and more generally for a larger number of paid employees. As highlighted by the earlier breakdown of the pool of employed individuals, self-employment is playing a far more important role in the advanced CEE countries than in the CIS. In terms of direct employment, the share of the self-employed in total employment ranges from over 10 per cent in Poland and Hungary to less than 1.5 per cent in Ukraine. In addition, there is an important indirect effect. The bulk of "non-paid family workers" receiving work from the self-employed is substantial in a number of cases, ranging from roughly 1 per cent in Hungary, Russia and Ukraine, where self-employment is less labour-intensive, to 5 per cent in Poland, 11 per cent in Croatia and almost 40 per cent in Armenia.[27]

In terms of employers, less than 60 per cent of Russian employers run micro enterprises with less than five people whereas in Poland this figure is about 76 per cent. This would indicate that entrepreneurship is more vibrant in Poland, where there is a greater proportion of smaller enterprises and of entrepreneurs than in Russia.

5.4 High earnings and poverty in the transition

Previous sections have focused on the types of activity that people engage in and the steps they have taken to cope with the changes brought about by the transition process. This section assesses the extent to which different groups have gained or suffered as a result of these changes. It examines how wages and the benefits of education have evolved. It also highlights links between employment status and consumption levels, and it discusses recent poverty trends.

Across all transition economies, the loss of stable income is the overwhelming cause of poverty.[28] To gain a better understanding of how inequality and poverty vary across countries and how they are linked to labour markets, we need to explore how wages have varied within each country. During the communist period a large proportion of those in the labour force had their wages set according to a centrally determined wage grid. This was used to set and maintain extremely small wage differentials and compressed earnings structures. Consequently, education had little impact on wages, leading to one of the most egalitarian distributions of income in the world.[29]

The transition process has resulted in a gradual but significant increase in wage dispersion, with education being rewarded in some countries at west European levels by the mid-1990s. In the Czech Republic, for instance, the difference in wages according to levels of schooling increased dramatically; whereas in 1989 a university-educated man earned on

25 See Dutz et al. (2000a), with results similar to those of Earle and Sakova (2000).

26 See Chapter 4, Scharle (2000), for Hungary, and Maloney (1997) for similar evidence on other developing countries.

27 The Russian results are consistent with the notion that a large number of Russian self-employed are intermediaries.

28 A decline in state benefits reportedly comes a close second, although the two may be highly correlated. See World Bank (2000), Chapter 2.

29 Using individual-based Czech data going back to 1955, Munich, Svejnar and Terrell (1999) show that the estimated rate of return on education was very small prior to 1991 and constant for decades. On the egalitarian income distribution, see also Atkinson and Micklewright (1992).

Table 5.5

Demographic characteristics of employers / self-employed

(in per cent)

	Armenia 1999	Croatia 1998	Hungary 1999	Kyrgyzstan 1997	Poland 1996	Poland 1998	Russia 1998	Ukraine 1999
Self-employed								
Males	73.2	73.2	65.9	51.1	67.2	69.1	59.3	56.5
Population								
Males	44.6	46.1	47.2	47.9	47.2	47.5	45.6	43.1
Higher education								
Self-employed	31.3	26.3	18.7	17.1	17.0	17.0	33.4	51.1
Temporary	27.5	6.8	16.8	13.7	5.8	8.3	29.7	32.8
Population	19.3	11.8	10.1	8.7	9.2	9.8	20.9	28.6
Age 36-50								
Self-employed	42.6	na	46.8	27.0	51.5	50.6	43.6	48.9
Temporary	45.4	na	28.6	29.8	25.7	29.9	31.2	30.1
Population	29.9	na	26.6	22.8	29.9	29.4	26.4	28.9

Sources: Labour Force Surveys for Armenia, Croatia, Hungary, Kyrgyzstan, Poland and Ukraine; Longitudinal Monitoring Survey for Russia.

Note: The figures represent the shares of males, higher education and 36-50 year-olds in the corresponding category. For example, 73.2 per cent of the self-employed and employers in Armenia are males.

Table 5.6

Wage differentials and poverty lines

	Bulgaria	Czech Rep.	Hungary	Kazakhstan	Kyrgyzstan	Poland	Romania	Russia	Slovak Rep.
Wage differential[1]	2.1	2.2	2.7	3.9	3.7	2.4	1.9	3.8	2.3
Poverty line at US$ 2.15 a day[2]	3.1	0	1.3	5.7	49.1	1.2	6.8	18.8	2.6
Poverty line at US$ 4.30 a day[2]	18.2	0.8	15.4	30.9	84.1	18.4	44.5	50.3	8.6

Sources: Wage differentials: *Annual Statistical Yearbooks*, 1996. Poverty rates: World Bank (2000).

1 Wage differentials are defined as the ratio between average wage in financial services to average wage in agriculture.

2 Percentage of workforce.

average just 28 per cent more than someone with only a junior high school education, other things being equal, by 1996 he earned 72 per cent more. Similar results have been found in other countries. In Hungary the differential increased from 43 per cent in 1986 to 78 per cent by 1996.[30]

To provide a recent picture of wage dispersion across selected countries, Table 5.6 presents data on the ratio of average monthly earnings in financial services, generally one of the highest earning sectors, to earnings in one of the lowest sectors – agriculture. Wage differentials are significantly larger in CIS countries, where financial-related employment receives more than 3.5 times the earnings of agricultural employment, than in CEE, where the differential rarely exceeds 2.5 times (the exception being Hungary, at 2.7).[31] Strikingly, the magnitude of wage differentials is strongly linked to conventional measures of absolute poverty as reflected in the numbers of people on a two-dollar-a-day poverty line.[32] While the incidence of poverty is in the low single digits for CEE countries, it approaches 20 per cent in Russia and 50 per cent in Kyrgyzstan, highlighting the subsistence levels of existence for many people, especially in the CIS.[33]

To make comparisons of the employment status of the poor within a particular country, it is helpful to use consumption data rather than income.[34] The available survey data allow a focus on a few CIS countries (Armenia, Kyrgyzstan, Russia and Ukraine) as well as Croatia. Chart 5.6 shows the percentage of each category of employment falling into different consumption groups. These capture the share of people falling into five different

30 For the Czech Republic, see Munich, Svejnar and Terrell (1999), and for Hungary, see Kertesi and Köllő (1999). Results are based on augmented Mincer-type earnings function estimates that control for factors such as experience, location and industry effects.

31 Comparable and reliable earnings data are not available for many countries, especially in the CIS. Therefore, we rely on sectoral average wages. In contrast to the reported wage differential pattern between CEE and the CIS, available evidence suggests that rewards from education are actually lower in the CIS than in CEE, explained by the lower share of higher educated individuals in CEE and by the fact that other factors such as personal connections are more important determinants of employment opportunities. See World Bank (2000), Chapter 2.

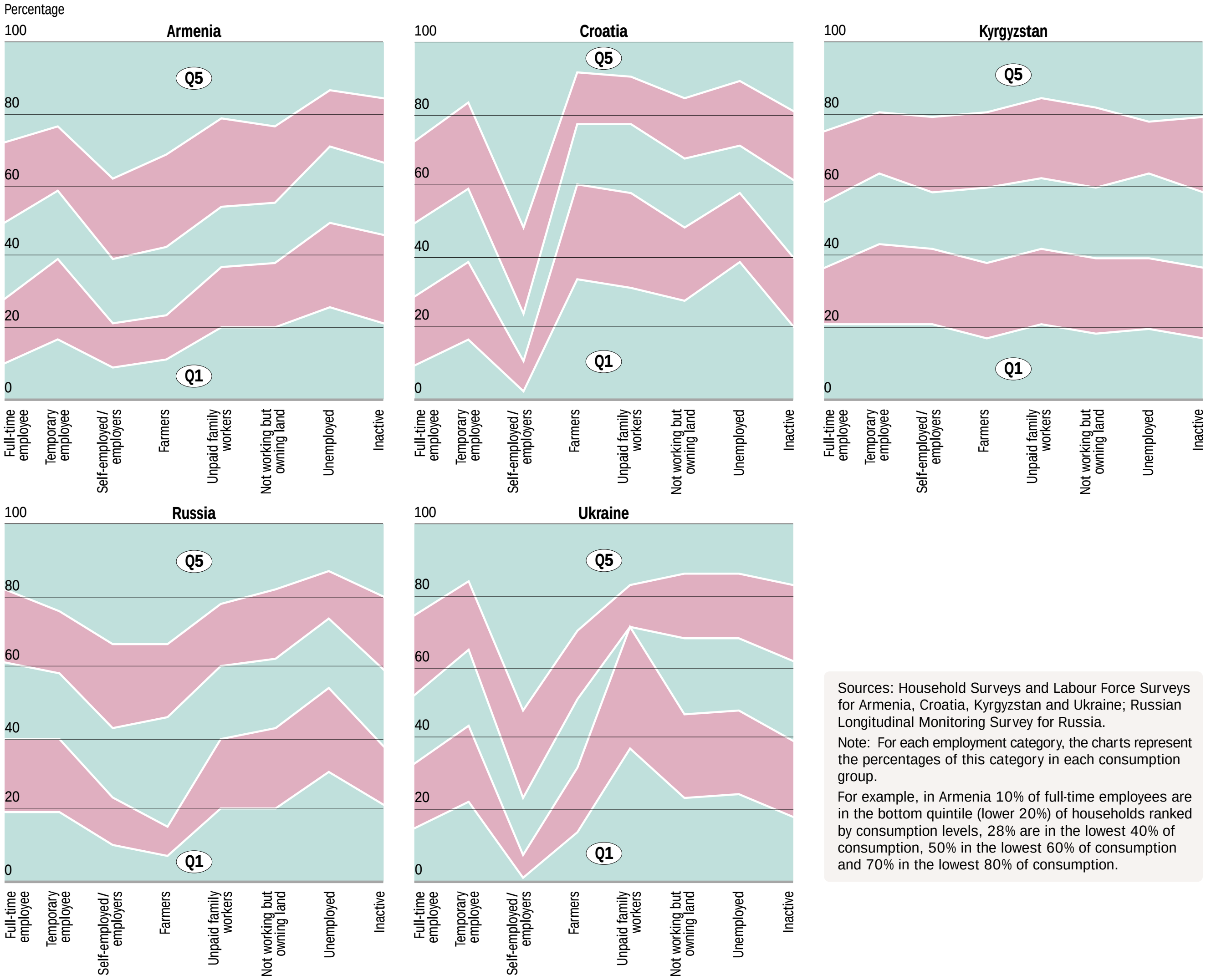
32 The two-dollar-a-day absolute poverty line is actually US$ 2.15 per person per day in 1996 purchasing power parity. See World Bank (2000), Chapter 1.

33 In terms of this measure, only Tajikistan (68.3) and Moldova (55.4) are poorer than Kyrgyzstan.

34 Consumption is used as a measure of welfare rather than income because the latter is measured very imprecisely in these countries and is subject to much larger fluctuations.

Chart 5.6

Employment categories and consumption groups



Sources: Household Surveys and Labour Force Surveys for Armenia, Croatia, Kyrgyzstan and Ukraine; Russian Longitudinal Monitoring Survey for Russia.

Note: For each employment category, the charts represent the percentages of this category in each consumption group.

For example, in Armenia 10% of full-time employees are in the bottom quintile (lower 20%) of households ranked by consumption levels, 28% are in the lowest 40% of consumption, 50% in the lowest 60% of consumption and 70% in the lowest 80% of consumption.

levels of consumption, ranging from the bottom 20 per cent of consumption to the top 20 per cent.[35]

One of the most important findings shown by the chart is that self-employment has been a very successful means of achieving high earnings for individuals who have been able to adapt actively to the transition. In all countries except Kyrgyzstan, the self-employed account for the largest share of individuals in the top consumption group. The largest proportion of self-employed top earners (as reflected by consumption) is in Croatia and Ukraine, with a striking 52 per cent of self-employed in the top group in both countries (and less than 2 per cent in the bottom group). The comparable figures for Armenia and Russia are 38 per cent and 33 per cent respectively in the top group (and less than 10 per cent in the bottom group). The relationship is much weaker in Kyrgyzstan, the poorest country in the selection, where there is approximately an equal number of self-employed across each of the groups.

A second important result is that the unemployed are the worst-off in most countries and at a higher risk of poverty than all other labour market categories. For the unemployed, the largest proportions in the poorest consumption group are in Croatia (almost 40 per cent of the unemployed), in Russia (over 30 per cent) and in Armenia (over 25 per cent). The fact that the inactive do not fare as badly as the unemployed is no doubt related to their alternative sources of income, such as pensions, shared earnings from a working head of household, or consumption from ownership and cultivation of land.

The two countries where the poverty risk for the unemployed is the least evident are Ukraine and Kyrgyzstan, where the proportion of unemployed in the poorest consumption group is not very different from the share for temporary workers or non-paid family workers. This is probably due to the fact that the proportion of unemployed feeling the need to hold informal jobs as occasional workers is so much higher in these two countries, which is in turn driven by the absence

35 This measure is based on the total consumption per household and then adjusted for the number of people in the household, with all additional members assigned a lower weight than the head of the household (following a standard Eurostat equivalence scale).

of alternative labour market support systems. This explanation ties in with the findings in Armenia, where the very low rate of occasional employment may be due to the availability of other sources of income, in particular the significant level of remittances received by households from abroad.

A final important result is that reported employment, temporary or even full-time, does not necessarily diminish sharply the likelihood of poverty in some CIS countries. While the proportion of full-time workers in the bottom consumption group is only 10 per cent in Croatia, it is over 19 per cent in Russia and over 20 per cent in Kyrgyzstan. More generally, the link between poverty and conventional labour market status in Kyrgyzstan is extremely weak, with very little differentiation of levels of consumption according to employment status. A more detailed analysis of several household surveys yields clues as to the reasons for this weaker link between employment status and poverty.[36]

In contrast to CEE (and as noted earlier), many individuals who are nominally employed have suffered large collapses in real wages, are on involuntary or administrative leave and receive little or no pay. Their pay is often subject to considerable arrears. In particular, in Armenia in 1996 a quarter of all officially employed workers were on involuntary leave, 80 per cent of whom were not being paid. In Georgia, on average 22 per cent of poor wage earners were owed back wages by their employers compared with 8 per cent for the non-poor. Wage arrears in Russia in 1998 in industry, agriculture, transport and construction amounted to nearly 3 per cent of GDP. Such workers have frequently remained at their jobs in the hope or expectation of eventually receiving back-pay.

The picture that emerges is complex, with improvements in income not only dependent on lower barriers for the entry of new firms and entrepreneurship but also on additional public and private measures that lower unemployment and raise enterprise productivity. In addition, whether salaries are paid and if not, whether workers have the opportunity and ability to move to more remunerative forms of employment appear to be important factors affecting poverty.

5.5 Conclusions and policy implications

Several clear themes have emerged from the analysis in this chapter. Principal among these are the increasing differences in employment trends between eastern and western parts of the region, the importance of informal activities and multiple-job holding, the potentially high rewards for mobility and entrepreneurship, and the link between different labour market categories and poverty. This concluding section discusses ways in which the functioning of labour markets in the region could be improved and the role for policy-makers.

The main problems identified in the chapter are the high degree of informal, low-level activities that people are forced to engage in, the lack of sufficient entrepreneurship and the subsistence levels of existence for many, especially in the CIS. How can these problems be overcome? This section attempts to answer this question by evaluating some of the options.

One way in which the labour market might be improved is for governments to tackle unemployment and poverty directly by active labour market policies, such as job training and subsidies to employment. Such policies cannot work, however, without appropriate “passive” policies, such as changes in laws and regulations that inhibit firms and entrepreneurs from hiring workers or entering new markets and changes to the unemployment benefit system that encourage labour mobility. As the following discussion indicates, the appropriate mix of policies for each country depends on the existing institutional framework, such as the structure of bargaining and the constraints on mobility across regions. For EU accession countries, there is the additional constraint that changes in labour laws should be consistent with the requirements of the *acquis communautaire* (see Box 5.2).

Active labour market policies

Active programmes to improve the labour market have been more common in CEE than in the CIS because such policies typically require the existence of a strong formal economy. Indeed one of the reasons why informal activities can have harmful consequences for the long term is that individuals in the informal economy are often unable to participate in formal programmes. In addition, active policies are unlikely to work when there is a basic lack of demand, as shown by programmes targeted at the long-term unemployed in Bulgaria.[37]

Studies of the more advanced central European economies show that the performance of active policies is mixed. Positive outcomes have been observed in the Czech Republic and Poland. In the former, there is some evidence that these policies have lowered the length of unemployment for groups that tended to have longer unemployment spells (for example, women, Romanies, less educated people and those who have been unemployed before).[38] In the latter case, the employment rate is significantly higher for those who have undertaken training (leading to higher retention rates in the case of men and a higher rate of job entry for women).[39]

Such results, however, should not overshadow the fact that entering an active labour market programme might prove as difficult for certain categories of people as finding a job. In the Slovak Republic, for instance, women, the poorly educated and older unemployed workers stand a slimmer chance of being accepted in such a programme.[40] From that perspective, the jobs created by the programme appear complementary to the functioning of the labour market rather than compensating for specific labour market rigidities.

36 The following findings are reported in World Bank (2000), Chapter 2, for Georgia based on Yemtsov (1999) and for Russia on Pinto et al. (2000).

37 See Kotseva et al. (1996).

38 See Terrell and Sorm (1998).

39 See Kluve, Lehman and Schmidt (1998).

40 See Lubyova and Van Ours (1998).

Box 5.2

Labour law in advance of EU accession

One of the key challenges over the medium term for the ten countries in CEE that have entered formal EU accession negotiations is to adapt their labour legislation to EU norms and regulations. In some areas, EU regulations are stricter than in accession countries and the adoption of legislation may present problems to firms, especially if no phase-in periods are granted. This is particularly true in the area of health and safety at work. Nevertheless, as argued in Section 5.5, existing labour codes in a number of accession countries are more constraining than those in EU countries, and adoption of the *acquis* is unlikely to impose excessive burdens on firms in CEE, although pressure to comply with labour laws is likely to increase as countries join the EU.[1]

The guidelines for employment and social policy are based upon the European Commission White Paper of 3 May 1995.[2] This sets out the minimum provisions required for the establishment of an internal market. These provisions cover the following areas: equal opportunities for women and men; coordination of social security schemes; health and safety at work; and labour law and working conditions. For each of these areas, the White Paper provides a description of the EC legislation in force and describes in detail the technical and administrative structures needed to ensure that the legislation is effectively implemented and complied with. It also points to key measures that should be adopted as a priority.

Equal opportunities for women and men
EC legislation in this area is contained in Article 141 of the Treaty establishing the European Community, in five directives on equality (the equal pay principle): namely, access to employment, vocational training and promotion, social security, occupational social security schemes, and self-employed activities. There is also a directive relating to the protection at work of pregnant women. In contrast to other areas of reform, such as agriculture, no specific infrastructure is required other than the existence of a legal system for accession countries to comply with this legislation. The EU gives priority to the establishment of equal pay and access to employment, vocational training and the promotion of women.

Coordination of social security schemes
The EC provisions on social security offer practical and satisfactory solutions to most of the cross-border problems arising in the field of social security. No harmonisation is envisaged, but some technical adaptation of legislation is required.

Health and safety at work
The legislative framework requires an effective enforcement infrastructure, entailing proper management of undertakings, appropriate training of workers and efficient labour inspectorates.

Labour law and working conditions
Within the social policy area, health and safety at work are priorities. Eight directives are in place, with priority being given to the directives on collective redundancies, transfers of undertakings, insolvency of employers and the protection of young people. These have been prioritised because of their impact on the internal market.

The Commission monitors annually the developments of employment and social affairs in the accession countries in its regular reports on progress towards accession. The table summarises the most recent reports from October 1999. It is clear that all countries have some way to go before reaching the required standard.

1 See, for example, Mayhew (1999).

2 "Preparation of the associated countries of central and eastern Europe for integration into the internal market of Europe" (ref: COM(95) 163, May 1995).

Moreover, the employment programmes appear to have led to significant distortions in several countries. For example, in the short term the Slovenian public works programme has helped participants to find a job, but there appears to be no longer-term benefit.[41] One explanation is that participants may have been stigmatised by the programme in the eyes of potential employers.

The previous section identified self-employment as leading to high rewards. So far, however, there is little evidence that governments are willing or able to support entrepreneurship through direct subsidies and the provision of other assistance, such as training or assistance with business plans. In 1999 a total of about 1,000 people were given loans or grants for self-employment in Armenia, Azerbaijan and Belarus combined, whereas both the Hungarian and Polish governments each supported more than 8,000 potential entrepreneurs in the same period.[42]

Labour market flexibility

One argument often used to explain high unemployment and low mobility is that there is insufficient flexibility in the labour market. While the argument about the link between flexibility and economic performance is unresolved, it is generally agreed that a selective relaxation of constraints on employers' ability to remove redundant employees can in certain cases improve economic performance while at the same time preserving the rights of workers.[43]

A survey of current labour laws across the region shows that in some areas the laws are as restrictive as, or even more than, in EU countries.[44] For example, when an employee is dismissed, notification to a third party is generally required although permission from a third party is usually not necessary. This is broadly in line with EU practice. However, the notice period is much longer than the EU mean – averaging two months compared with an EU average of 12.3 days.[45] Also, dismissal without any attempt by the employer to retrain the redundant employee is often grounds for unfair dismissal in CEE countries, although less so in the CIS.

Another area where reforms could be introduced is in the area of severance pay. On the surface, the period for which laid-off workers are entitled to unemployment benefits appears to be quite long, usually in the range of three to nine months, although longer periods of benefit payment occur in some countries.

41 See Vodopivec (1998).

42 Based on a survey to relevant labour market institutions across countries.

43 Bertola (1992) uses a theoretical, partial equilibrium, model to show that labour turnover costs can either increase or decrease average employment, depending on the form and size of different factors, such as the rate of attrition and the relative size of hiring and firing costs. On the empirical link between turnover costs and aggregate rates of employment and unemployment in OECD countries, see OECD (1994).

44 See Dutz et al. (2000b).

45 The EU average is taken from OECD (1994).

Summary of European Commission evaluations on employment and social affairs, October 1999

Progress towards accession in the area of employment and social affairs of the EU acquis and recommendations

Bulgaria
- Further alignment in health and safety at work legislation and strengthening of institutions is necessary.
- Social dialogue needs more active employers and unions at all levels, with a view to information and consultation requirements of labour law directives.

Czech Republic
- Legislative alignment has been limited to two directives fully satisfied, and a third partially satisfied.
- Greater effort is necessary to adopt the social *acquis*.

Estonia
- Very limited progress has been made and a serious and sustained effort is necessary.
- Greater effort should be made to develop bipartite collective bargaining.
- Capacity to enforce the social *acquis* is a serious concern.

Hungary
- Relatively advanced in terms of legal transposition of the employment and social affairs *acquis*.
- Attention needs to be paid to the implementation and enforcement of the health and safety at work and the labour law *acquis*.

Latvia
- Further efforts are required in the area of health and safety at work, equal treatment for women and men and bipartite collective bargaining.
- Institutions require significant strengthening as well as improved information and communication flows between them.
- Capacity to implement and enforce the social *acquis* continues to be a serious cause for concern.

Lithuania
- Progress has been made in terms of the *acquis* adoption and reinforcement of the administrative capacity.
- Capacity to enforce the social *acquis* still constitutes a source of concern.
- More emphasis is needed on the development of bipartite collective bargaining.

Poland
- Limited tangible progress has been made in adoption and enforcement capacity of the social *acquis*.
- Efforts remain to be undertaken in the social field, in the areas of health and safety, public health, labour and equal opportunities for women and men.
- Considerable efforts are required to strengthen institutional capacity in the National Labour Office, and social dialogue requires strengthening.

Romania
- Limited progress has been made on the legislative side: the overall pace of reform remains slow.
- Particular efforts remain to be undertaken in public administration and enforcement structures in most areas of social policy and particularly on health and safety at work, public health and labour market and employment policies.
- Consolidation of the social dialogue is of particular importance.

Slovak Republic
- Further efforts are required to secure adoption of the *acquis* with particular reference to health and safety at work, insolvency and workers' representation.
- The institutional set-up and the lack of co-ordination between the bodies responsible for enforcing health and safety provisions are causes for concern.

Slovenia
- Adoption of *acquis* legislation has advanced, in particular with the adoption of the new Law on Health and Safety at Work.
- Substantial work remains to be done in the area of the implementation of the legislation on health and safety at work *acquis*.
- There continues to be a need to strengthen the public employment service.

For example, a laid-off worker who has been employed for 20 years in Poland is entitled to benefits for up to 18 months. However, the amount received by the unemployed is often negligible, especially in the CIS, and by itself would put the recipient below the poverty line.[46] This discourages people from leaving employment to search for a new job or start a new business, and delays the necessary restructuring.[47]

Governments in the CIS need to realise that the absence of assistance outside the employee's firm – targeted social assistance together with a workable system of unemployment benefits – means that little restructuring will take place. Importantly, the fiscal costs of explicit and time-limited support for dismissed workers are likely to be less than the current implicit and open-ended support for non-restructured firms. Such an approach must be coupled with programmes that allow workers to find better-paid jobs. This is why a combination of active and passive policies is required. On the basis of evidence presented in this chapter, countries in the CIS face much bigger challenges than those in CEB and SEE in reaching the desired combination of policies. Of course the problems identified above reflect to a large extent the lack of restructuring in these economies, and the success of any labour market policy depends on sustained progress in general reforms throughout the economy.

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[46] For example, unemployment benefit in Belarus is currently around US$ 3 per month, which is only about one-seventh of the estimated minimum subsistence level.

[47] Ham, Svejnar and Terrell (1999) argue that unemployment compensation schemes in the Czech and Slovak Republics have had only a moderate effect on unemployment duration.

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Human capital, technology and skills 6

The preceding chapter analysed how workers in the transition countries have reacted to the changes in product and labour markets. This chapter looks at how enterprises have adapted the composition of their workforces to changes in market demand and in production and to the introduction of new technologies. The availability of workers with the appropriate skills as well as the adaptability of employees are likely to influence the types of jobs that firms will create through fresh investment. Moreover, during the transition process rapid technological change has taken place in industrialised market economies. One aspect of this has been the rising demand for skilled labour at the expense of unskilled workers despite increases in the relative wages of skilled workers. Such changes appear to be strongly associated with the introduction of computer-intensive technologies.[1] Therefore, the adjustments that firms in transition countries must make have to be seen in a wider context of structural change.

This chapter uses data from a survey of foreign investors and a survey of domestic enterprises to gauge how employers perceive the quality of workers in transition and the size of the gap between the skills available and those needed. It also looks at the extent to which firms have adopted new technologies and have made new use of skills, as well as the incentives to acquire skills.

The evidence from both surveys suggests that transition economies lag behind advanced industrialised countries in terms of the quality of their workforce. This result qualifies the view that the region has abundant human capital resources,[2] despite the considerable achievements in formal education. It seems that the educational systems and the experience of workers in the period before transition did not prepare them adequately for the requirements of the market economy. Furthermore, this chapter finds that there are significant quality gaps even for workers with higher levels of education and that these gaps are generally greater in the Commonwealth of Independent States (CIS) than in central and eastern Europe and the Baltic states (CEE).

The survey of domestic enterprises, moreover, finds a general lack of restructuring in terms of technology upgrades involving computers and information technologies (IT) in the less advanced reformers. However, there is some evidence of restructuring and use of new technologies in advanced countries, such as Hungary. The lack of restructuring has been accompanied by little change in the composition of employment across skill or educational categories over the period of the survey (1997-2000). This evidence as well as other data indicate that adjustments in the composition of the workforce are far from complete, particularly in less advanced transition economies. One negative consequence is that many skilled workers are performing jobs that do not reflect their levels of education. Over time, there will be a gradual loss of skills, leading to an even greater gap in quality.

The implications for public policy are twofold. First, governments and firms need to pay increased attention to training, including improved systems of vocational training, as well as providing better incentives for firms to make on-the-job training available in order to reduce such quality gaps. Second, the creation of new jobs ultimately will depend on improved conditions for investment (see Chapter 5 regarding the recent increase in levels of employment in CEE). Only where such conditions exist can countries hope to capitalise on the relative abundance of well-educated workers that remains a legacy from the planned economy.

The next section introduces the major factors that are likely to drive the demand for different types of workers during the course of transition. Section 6.2 turns to the results of the survey of foreign investors, while Section 6.3 analyses the survey of domestic firms in three selected countries (Hungary, Romania and Russia). Section 6.4 looks in more detail at skill gaps and training needs and the implications for public policy, while Section 6.5 provides some conclusions.

6.1 The demand for skills: Initial conditions and reasons for change

The demand for different types of workers depends in general on their relative cost and on the nature of the technology used in production. The centrally planned economies tended to have a high level of expenditure on public education compared with countries at similar levels of income. They also had a system of administered wages, set at low levels with limited variation in both earnings and incomes.[3] These characteristics led many observers to emphasise the low cost of highly qualified skilled labour as a key asset of the transition economies.

At the same time, technological change around the world in recent years has been associated with an increased demand for skilled labour. This has been one consequence of the introduction of new equipment, such as IT/personal computers (PCs), whose operation has required skilled staff as well as organisational changes that have placed additional emphasis on worker flexibility and adaptability.[4] Given their prior isolation and relative technological backwardness, the transition economies could have been expected to experience extensive technological and organisational change as they

1 See Autor, Katz and Krueger (1998) and Berman, Bound and Machin (1998).

2 See, for instance, Flanagan (1993); Chase (1998); and Munich et al. (2000).

3 See Atkinson and Micklewright (1992). However, these authors also point to very significant diversity in the initial distribution of earnings across the region, with a much higher degree of initial inequality in much of the CIS. It is not clear (although plausible) whether this also reflected greater variance in the distribution of skills.

4 See Aghion (1999).

opened up to foreign competition and investment. At first approximation, this combination of an initial endowment of cheap skilled labour, structural change and the direction of technological innovation worldwide suggests that the demand for skills should have increased significantly in the transition economies.

However, a number of factors may have mitigated the extent to which these forces have influenced the demand for skilled workers. First, while workers in centrally planned economies may have received extensive technical education, their adaptability or flexibility has been called into question. For instance, early investors in the region noted that a high emphasis on vocational education at an early age lowered worker adaptability and flexibility.[5] Many of the skills acquired on the job were process and product specific, and became partially obsolete as old production lines were discontinued. Nevertheless, it bears emphasis that in a recent literacy survey carried out by the OECD, literacy scores of the adult working population in a number of central European countries were very close to those in other OECD countries.[6]

Second, the extent to which technological and organisational change has influenced the demand for skilled labour obviously depends on the extent of such structural change itself. There has been enormous variation across the region in the extent of structural change, as documented in the *Transition Report* 1999 as well as the analysis in Section 6.3. Where the investment climate has discouraged the introduction of new technologies, the associated shift in the demand for skills would have been less pronounced. By the same token, the degree to which the transition economies have become integrated into the global economy has also differed. With less foreign trade and less foreign investment, the extent to which transition economies would be able to capitalise on their inheritance of a highly qualified labour force would be diminished.

Third, the transition has required significant fiscal adjustment, some of which has fallen on government expenditure on health and education. This in turn has had an impact on the qualifications of new entrants into the labour force. While the composition of the labour force would change only slowly as a result of lower educational attainment among younger workers, the implications could be considerable. In the advanced industrialised economies, increasing educational attainments by the young have supported skills upgrading in the most dynamic sectors of the economy. Where qualified young people are not available, the adoption of new technologies will tend to be correspondingly slower.

The following sections examine the processes of trade liberalisation, technological change and changes to education spending in more detail, as a background to the analysis of the demand for skills based on the enterprise surveys.

Trade liberalisation, technological change and relative wages

In view of high educational attainments and relatively low wage costs, one might have expected the region to specialise in the production and export of skill-intensive products and to have invested heavily in the necessary technology following trade liberalisation in the early 1990s.

The evidence, however, does not support these expectations. Investment rates have been falling in most of the region, with the exception of the countries in central eastern Europe and the Baltic states (CEB – see Chapter 3). Only a few advanced transition economies have been able to attract significant inflows of foreign direct investment (FDI). Estimates for these countries do show a shift towards skill-intensive exports,[7] although, with the exception of Hungary, most trade in CEB continues to be in labour-intensive and not skill-intensive goods.[8] In the CIS, however, export revenues have relied almost exclusively on natural resources despite extremely low labour costs.

This evidence suggests that changes in the demand for skills resulting from a change in the structure of production may have been limited so far. Still, the possibility arises that an increase in the demand for skills would occur within sectors of the economy as enterprises adopt new technical and organisational processes.[9] This would benefit skilled workers through higher wages even without a change in the composition of production and employment. Changes in the relative prices of skill-intensive goods as a result of trade liberalisation may also increase the relative wages of skilled workers.

There is some evidence that wages of skilled workers have increased relative to the average (see Chapter 5) throughout the region. Moreover, trade data show that skill-intensive imports rose sharply in CEB in the 1990s, signalling important underlying investments in new plant and equipment.[10] The close association between new technologies and skills may, therefore, have been one factor behind the increase in wages for skilled workers. However, it is difficult to disentangle changes as a result of international trade and the adoption of new technologies from changes associated with dismantling the artificial structure of relative wages imposed by central planners.

Because the evidence on wage premia is hard to interpret, better inference may be drawn from the examination of technological change in the transition economies. Chart 6.1 shows that the process of technological upgrading is far from complete even in the most advanced transition economies. The chart focuses on the most conspicuous aspect of recent technological innovations in advanced market economies, namely the introduction of IT into production processes. By 1999 both PC and Internet use in transition

5 For example, at Tungsram in Hungary after its acquisition by General Electric. See World Bank (1996). Relative wages of workers with vocational education have tended to fall since the start of transition suggesting that market-based incentives have downgraded these skills. See Boeri (2000).

6 However, the transition economies performed better with respect to quantitative, rather than prose or document, literacy. See OECD (2000).

7 See Landesmann and Burgstaller (1997).

8 See, for instance, Chapter 9 of the *Transition Report* 1999.

9 International evidence suggests that recent technological change has been skill-biased. In other words, the demand for skills has been going up across the board as a result of technical progress not necessarily related to trade. See Berman, Bound and Machin (1998) and Richardson (1995).

10 Between 1993 and 1997 skill-intensive imports rose from 4% to 7% of GDP in CEB compared with 3% to 4% in the CIS.

economies remained well below levels in the European Union and the United States. In fact, even the leading countries – such as Hungary – had levels of use that were far below these countries. However, when compared with other emerging market economies, use of PCs and the Internet in central Europe is comparable to use in East Asia and significantly above the level for Latin America, India and China. In most CIS countries use is actually below the level in India and China while Russian levels are comparable to those in Latin America.

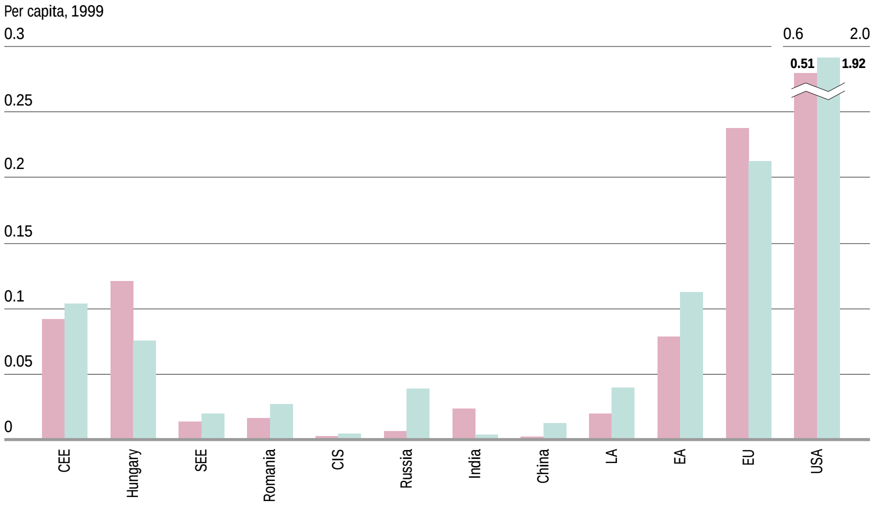
The overall picture that emerges is that the advanced transition countries in central Europe have begun to introduce new technology, although they continue to lag significantly behind EU levels. Further east, adoption tends to lag behind other emerging market economies. In short, in the bulk of transition economies, much of the technological change under way in market economies has yet to be set in motion. Section 6.4 examines this argument and its implications for the demand for skilled labour in more detail.

Changes to education spending and enrolment rates

As noted above, government investment in training and education affects the availability of skills in the labour market and therefore should determine the composition of employment in the long run. Investment in training and education under central planning was very high. However, the transition has negatively affected government revenues and hence the ability to finance large outlays on public education. Although the proportion of government expenditure devoted to education has not generally fallen, Chart 6.2 shows that spending on education compared with GDP – particularly in some CIS countries – has declined between 1992-94 and 1995-98. However, there have been significant differences across countries and regions. For example, in the countries of the Caucasus, public spending on education at the start of the transition was roughly comparable to levels in OECD countries, but this share subsequently fell by over half in the 1990s. In CEB educational spending has tended to remain more stable or has registered relatively

Chart 6.1

Internet hosts and personal computers



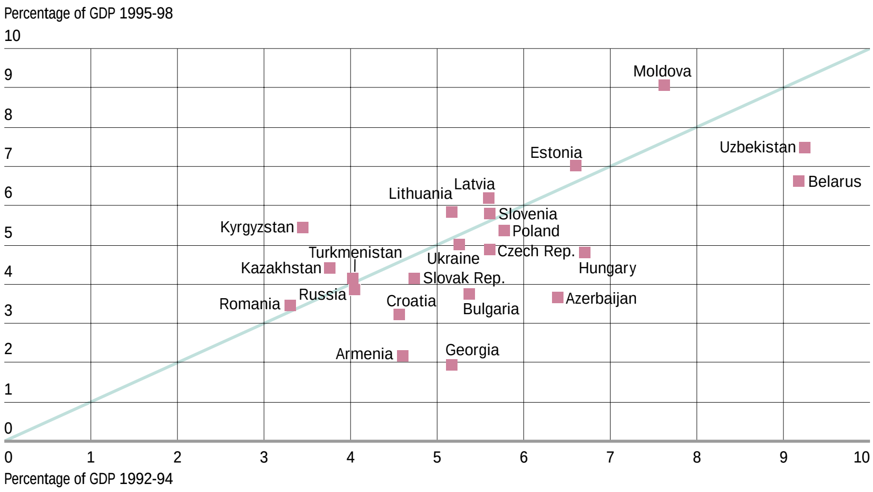
Internet hosts   Personal computers

Source: International Telecommunications Union (2000).

Note: The first bar indicates the number of Internet hosts in 1999 on a per capita basis (multiplied by 10). The second bar indicates the number of personal computers on a per capita basis in 1999. LA and EA indicate respectively the average for Latin America and East Asia.

Chart 6.2

Education expenditure as share of GDP, 1992-94 and 1995-98



Source: Transmonee2000, UNICEF.

small declines. A small decline has also occurred in south-eastern Europe (SEE).

Enrolment rates at secondary and tertiary levels have generally not declined, with the exception of the CIS. Even there, the decline in secondary enrolment rates has not been large. This development suggests that changes in the supply of skills may not have been significant. However, in parts of the CIS, particularly in Central Asia and the Caucasus, there has been a deterioration in enrolment rates at primary school level. Moreover, one of the most significant cuts in educational spending has been to publicly funded pre-school institutions, resulting in a significant drop in pre-school enrolment rates throughout most of the region.[11] International evidence suggests that pre-school learning can make a big contribution to improving the learning abilities of children. These cuts may lead to lower educational standards among the present intake of pupils.

[11] See UNICEF (1999).

Other indicators of the quality of educational services – including ad hoc privatisation and pricing of education that has tended to penalise lower income households – point to substantial deterioration in the quality of education, again particularly in the poorer CIS countries.[12] Given that educational attainment remains the main predictor of literacy proficiency, skills and, hence, earnings, it is not surprising to find that those countries – principally in central Europe – that have maintained educational spending and quality have continued to sustain good literacy scores during the transition process.[13] After a decade of reform, only in these countries may the picture of an abundant and cheap skilled labour force still be accurate.

6.2 Skills, productivity and quality gaps – a foreign investor perspective

The pressure on educational spending and the widespread evidence of a declining quality in educational services suggest that some of the advantages traditionally possessed by the transition economies might have been eroded over time. To assess whether this has indeed been the case requires going beyond aggregate data to assess the views of firms and investors. This section reports on the results of a survey of foreign investors regarding the quality of their workforces in the region and examines the extent to which the quality of the available labour force was a major factor in their investment decisions.

The views of foreign investors are interesting for several reasons. For a start, FDI is an important avenue for the transfer of technology. Firms with foreign investor participation have tended to be at the leading edge of technological change and productivity enhancement. One factor determining the choice of technology by foreign investors is likely to be the availability of appropriate local skills. Furthermore, by asking foreign investors to rate the qualifications of their local employees relative to employees in their home market with similar levels of education, it should be possible to assess the difference in the quality of workers between market and transition economies that fail to be captured by conventional schooling indicators.

The results reported below are based on a postal survey targeted at the largest foreign investors in the region. The first part of the survey asked investors to rate the importance of factors for investing abroad by region.[14] The second part – addressed to investors in eastern Europe and the former Soviet Union – asked them to rate the productivity, the skills and the major deficiencies of the local workforce compared with their home country. As with most postal surveys, response rates were low. A total of 428 responses were received, the vast majority being from west European investors. For the second part of the survey, the number of responses was significantly lower, at 130. Clearly, such coverage is incomplete and non-representative. However, the survey does provide useful insights into the factors governing investment decisions. In presenting the results, four regions are distinguished: CEB, SEE, the CIS and non-transition economies.

Chart 6.3 summarises the main factors for foreign investors by region. The chart clearly shows that the cost of labour (including both skilled and unskilled labour) is an important factor for investors in SEE but less so in the other regions. For CEB, proximity to the home market is clearly the dominant motive. This is not surprising given the large proportion of west European firms in the sample. Overall, it would seem that a combination of high skills and low wages has not generally been a key attribute that has attracted investors to the transition economies. This conclusion is confirmed by Chart 6.4, which shows responses for the importance of labour across the regions. The differences across regions on the importance of labour cost are relatively slight.[15]

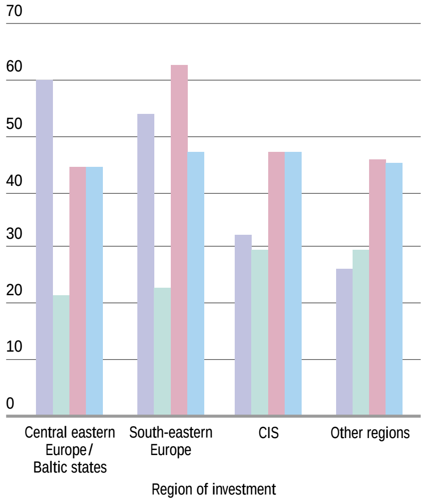
Chart 6.5 compares the productivity of unskilled labour, skilled labour and capital in the region with the average level in the investors' home countries. It is striking that for all regions the relative productivity of factors is viewed as significantly lower on average – in the range of 20-50 per cent – than in investors' home countries. The gap is large for both skilled and unskilled labour and the productivity gap is most substantial for the CIS. The difference in productivity for labour and capital between CEB and SEE may also point to some underlying substitution between labour and capital by investors, which is consistent with the perception of lower labour costs in SEE.

The productivity differences reported above may be due to a variety of factors, including the use of different technologies, different working habits and differences in the underlying quality of labour. To assess the latter, the survey asked investors how many months' training a worker would need to achieve the same productivity level as a comparable worker in the investors' parent company. Skills were proxied by the level of education of workers. Chart 6.6 shows some differences across regions in terms of a training or quality gap. In general, workers

Chart 6.3

Motivating factors for foreign investors

Percentage of firms regarding each factor as important



Source: EBRD Survey of Foreign Investors, 2000.
Note: Sample includes firms from Western Europe.

12 See Micklewright (1999).

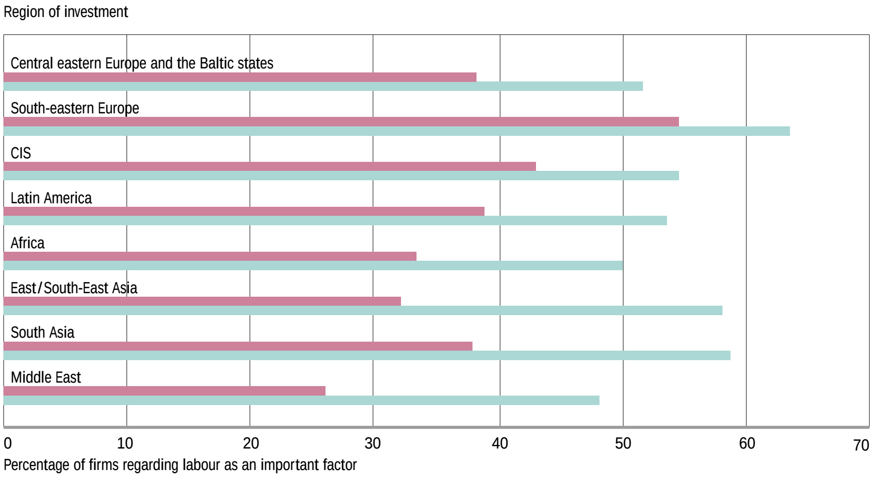
13 See OECD (2000). However, it is interesting to see that the probability of getting employer-supported training has been significantly lower in the central European transition economies than in comparable OECD ones.

14 The sample frame was drawn from the WorldScope database that includes the largest companies in the world. The present sample consisted of 10,000 companies, stratified by geographic region, with 40% of all surveys sent to Europe, 20% to the United States and Japan, and 20% shared among East Asia, Latin America, Australia, Africa and Canada. The survey instrument and summary statistics can be found on the EBRD's Web site: www.ebrd.com.

15 This is confirmed by regression analysis; the relative importance of the different motivating factors was related to region of destination, controlling for main line of work of the parent company. The SEE regional dummy was positive and significant for both skilled and unskilled labour; not so for any of the other regional dummies.

Chart 6.4

Importance of labour as a motivating factor for foreign investors

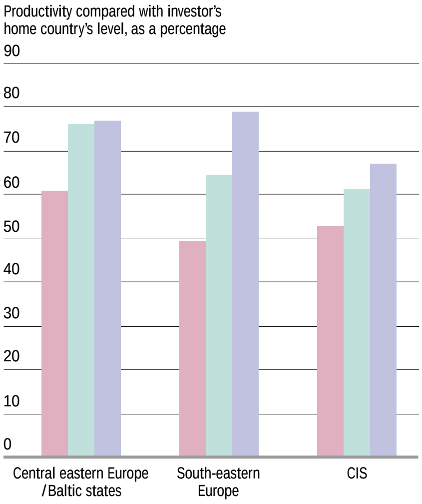


Cheap labour   Cheap skilled labour

Source: EBRD Survey of Foreign Investors, 2000.

Chart 6.5

Productivity of labour and capital

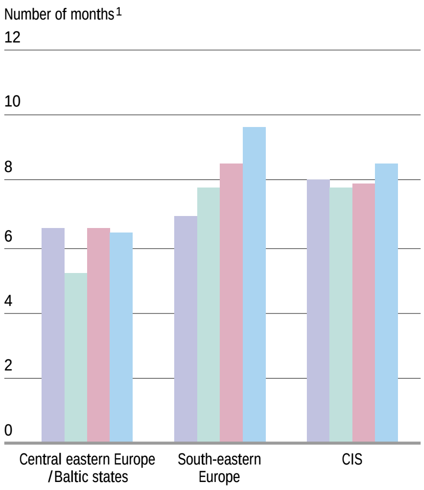


Unskilled labour   Skilled labour   Capital

Source: EBRD Survey of Foreign Investors, 2000.

Chart 6.6

Duration of training



University graduates   Vocational education
Secondary education   Primary education

Source: EBRD Survey of Foreign Investors, 2000.

[1] Duration of training required for achieving the productivity level similar to a comparable worker in investor's parent company.

in CEB required less training than those in SEE or the CIS, even though for the sample average the differences across educational groups were not statistically significant. However, when controlling for sector and firm size, differences across both regions and educational categories became strongly significant.[16]

The general finding is that workers in CEB require less training, but it is also striking that workers with university education do not generally require less training than those with lower levels of formal education. This suggests that deficiencies at the level of managerial and skilled employment – the types of jobs occupied by university graduates – have remained substantial. The evidence presented so far indicates that from the perspective of foreign investors the quality of workers differs markedly across transition economies, despite the fact that indicators, such as years of schooling, show a relatively consistent picture of educational attainment across the region.

The survey also sought to identify the main deficiencies of workers by asking investors to distinguish between three types of skills – technical skills, IT skills, and general flexibility or adaptability. Responses have again been grouped by educational categories in Chart 6.7. The responses reveal that a lack of general flexibility or adaptability is by far the greatest perceived deficiency across all educational categories. Around 40 per cent of respondents cited insufficient flexibility as a major deficiency. While IT skills were found to be lacking in workers with vocational education but not in university graduates, the latter were commonly viewed as lacking technical skills – a finding consistent with the training gap discussed above.

In conclusion, the results of this survey – with major caveats regarding coverage – show that labour quality in transition economies varies greatly across countries and is generally less favourable than the levels indicated by literacy tests or data on educational attainment. Moreover, the results suggest that quality gaps in the workforce are negatively related to the progress achieved in transition to date. This would be consistent with a loss of skills in the less advanced transition economies as restructuring and investment in new technology are delayed. The link between restructuring decisions, technological upgrading and the demand for different types of workers is investigated in more detail below.

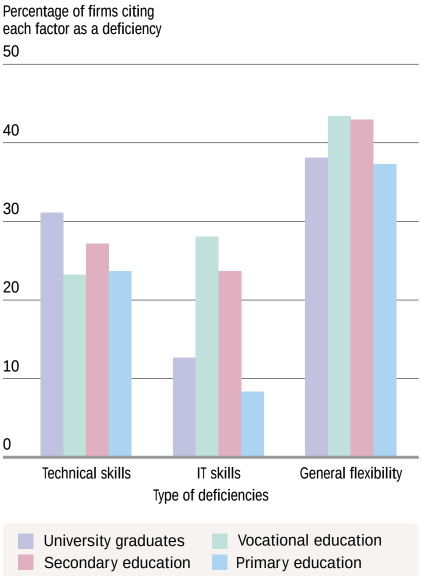
6.3 Enterprise responses to transition

To allow for a more detailed assessment of the ways in which firms have restructured and invested and how this has affected the structure of employment and wages, a large survey of 935 firms was carried out in three countries: Hungary, Romania and Russia. For each country, the sample was stratified both by employment size and sector. At least 300 observations were collected per country. Farms and rural firms were excluded from the sample. While sampling was not random, implementation was over a wide regional base and reasonably representative. In Russia, firms were interviewed in 25 *oblasts* or regions,

[16] Regression results are available upon request.

Chart 6.7

Main deficiencies of workers relative to investors' parent companies



Source: EBRD Survey of Foreign Investors, 2000.

in Romania in seven regions and in Hungary in five districts. The majority of questions covered 1997 to mid-2000, yielding four datapoints.

Country selection was guided by the wish to capture three distinct business environments. While all three countries had relatively similar endowments of human capital at the start of transition – at least for the non-rural population – the subsequent reform policies and associated paths of output and employment have differed substantially. As such, these countries characterise different stages of transition, depicting the variation in overall progress in reform. Using the findings from the *Transition Report* 1999, countries were selected that loosely represented advanced, middle and lagging reform types.

Hungary has attracted major outside and strategic investment, resulting in structural change and accelerating growth. Privatisation has been pushed forward and entry of new firms has been substantial across most sectors. Romania has been unable to attract significant amounts of FDI, large parts of manufacturing remain partially restructured, and privatisation procedures have mostly failed to improve corporate governance and performance. New firms have entered but they have largely remained small-scale and limited to services. These limitations have been magnified in Russia, where insider privatisation appears to have sanctioned asset stripping rather than investment. Foreign investors have been hesitant, and substantial numbers of firms continue to operate under soft budget constraints. Entry and exit costs remain high, leading to the proliferation of an informal economy alongside a stagnant manufacturing sector.

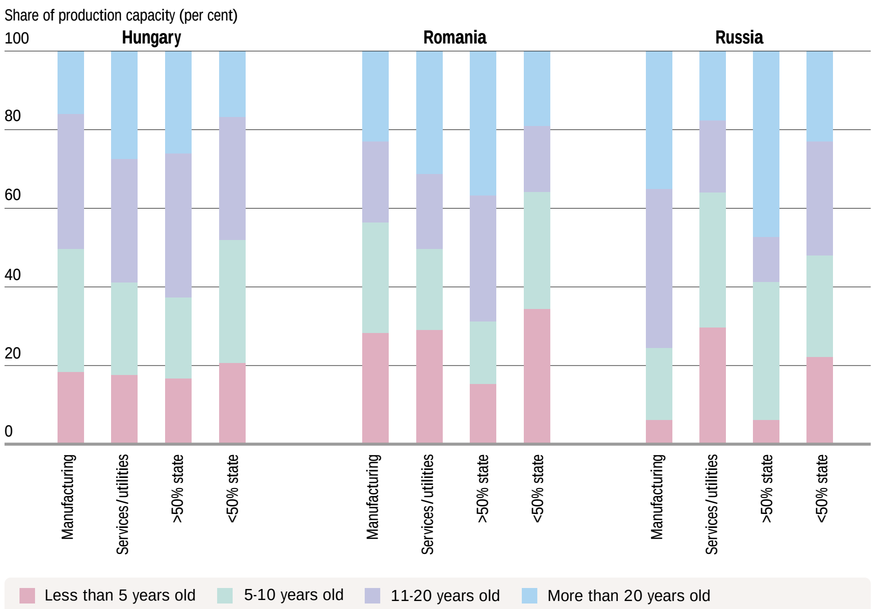
Age of equipment and restructuring

The extent of restructuring and investment by firms varies significantly across the region. Chart 6.8 shows the distribution of plant and equipment by age for Hungary, Romania and Russia broken down by sector and ownership. While there are relatively small differences between Hungary and Romania – between 50-60 per cent of respondents reported plant and equipment less than 10 years old – in Russia the picture is substantially different. Nearly 40 per cent of firms had machinery that was more than 20 years old, and the bulk of these firms are the larger manufacturing companies. Yet, this lack of capital investment in manufacturing stands in clear contrast to the situation in services, where new capital investment has occurred. The chart also shows that, in all countries, majority privately owned firms have substantially newer plant and equipment than majority state-owned firms. Lastly, the survey points to some complementarities between capital investment and skills. In all countries, there is clearly a strong link between the age of machinery and the share of non-production workers in employment, even when taking into account other factors.

Chart 6.9 shows that the bulk of firms in all three countries have initiated a range of restructuring activities.[17] However, there are some important strategic differences. While the overwhelming majority of firms have either introduced new product lines or upgraded or discontinued existing product lines,[18] export growth and use of new technologies – PCs and other forms of IT – have been far more frequent in Hungary than elsewhere. Indeed, over 75 per cent of Hungarian firms in the sample reported introducing PCs/IT in a significant way over the past three years. In both Hungary and Romania the adop-

Chart 6.8

Distribution of plant and equipment by age



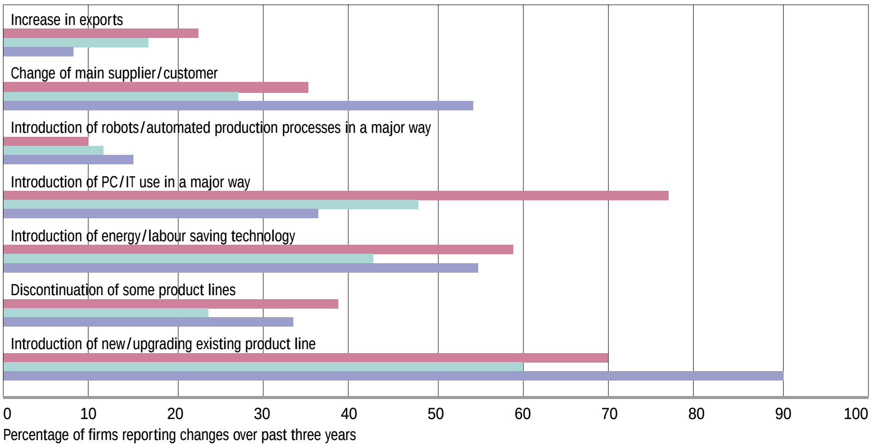
Source: EBRD Enterprise Survey, 2000.

17 Regression analysis further confirms that in all countries, restructuring has been negatively associated with soft budget constraints, and positively with being in private ownership and with exposure to export markets, among other factors. These findings are consistent with those reported in the wider literature.

18 Change in supplier and customer networks in Russia is likely to be related to the use of barter and other non-monetary transactions. For a more in-depth discussion, see Commander, Dolinskaya and Mumssen (2000).

Chart 6.9

Restructuring indicators



Hungary Romania Russia
Source: EBRD Enterprise Survey, 2000.

tion of IT has been fairly uniform across sectors. In Russia, by contrast, just over a third of firms have adopted PCs/IT in a significant way, with the bulk of this concentrated in firms in the services sector. In line with the findings on the age of equipment, Russian manufacturing firms have rarely introduced new technology.

In conclusion, restructuring has many dimensions. The survey suggests that most restructuring in Russia and, to a lesser extent, in Romania has involved changes in product lines and in suppliers. However, the extent of new technology appears to be closely related to progress in transition and the presence of a better business environment.[19] In Romania and Russia the adoption of new technology is at an early stage and in Russia, in particular, the gap between services and manufacturing is large. This suggests that much of the dynamism has been concentrated in new service sector firms.

The emerging structure of employment and wages

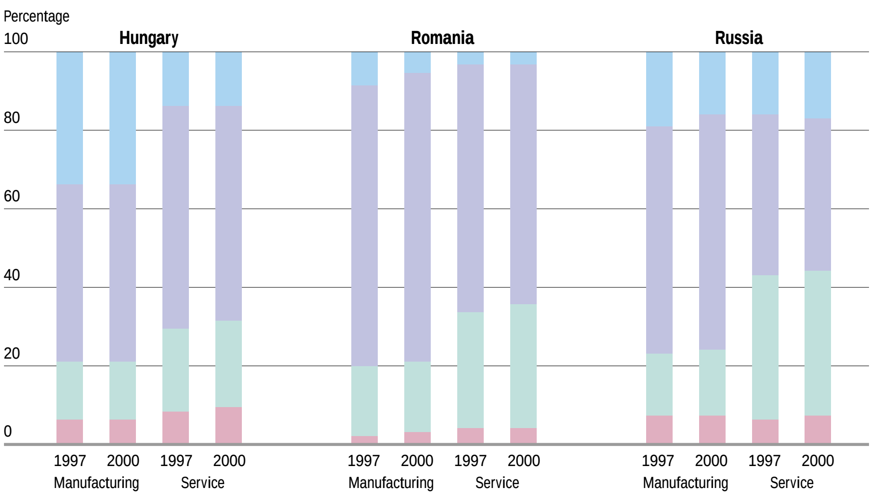
Restructuring and the entry of new firms should result in changes to the composition of employment and to relative wages. In addition, institutional and other changes outside of the firm could also exert a major impact on the wage structure. The advanced market economies have shown significant shifts in the structure of both employment and wages in recent decades. In particular, there has been a sharp growth in the proportion of college-educated employees in the workforce, despite a significant increase in their wages relative to workers with lower educational attainment.

Chart 6.10 shows the breakdown of employment by skill types in 1997 and May 2000 in the transition economies. Although there is evidence of a small increase in the proportion of skilled production workers, the size of the change is not large.[20] Moreover, while the share of non-production workers is consistently greater in services and still increasing, once again the change is not large. Overall, there is only weak evidence of an increase in the share of non-production workers and skilled workers in general in total employment from 1997 to mid-2000. A similar result holds for educational attainment. Furthermore, when this is extended to branches of manufacturing, there is little evidence that those branches increasing the share of skilled workers in total employment in advanced market economies are in a similar position in these three transition economies.[21] These results may partly be due to the short reference period of the survey.

Even if the composition of employment has changed little in the transition economies so far, the adoption of new technologies may still signal changes in the demand for skills that may take place within educational or functional categories. The survey allows one to observe the differences across countries and sectors in the adoption of new technology, as measured by the relative intensity of use of PCs/IT in everyday work and

Chart 6.10

Structure of employment by skill categories



Managers White-collar workers Skilled blue-collar workers Unskilled blue-collar workers
Source: EBRD Enterprise Survey, 2000.

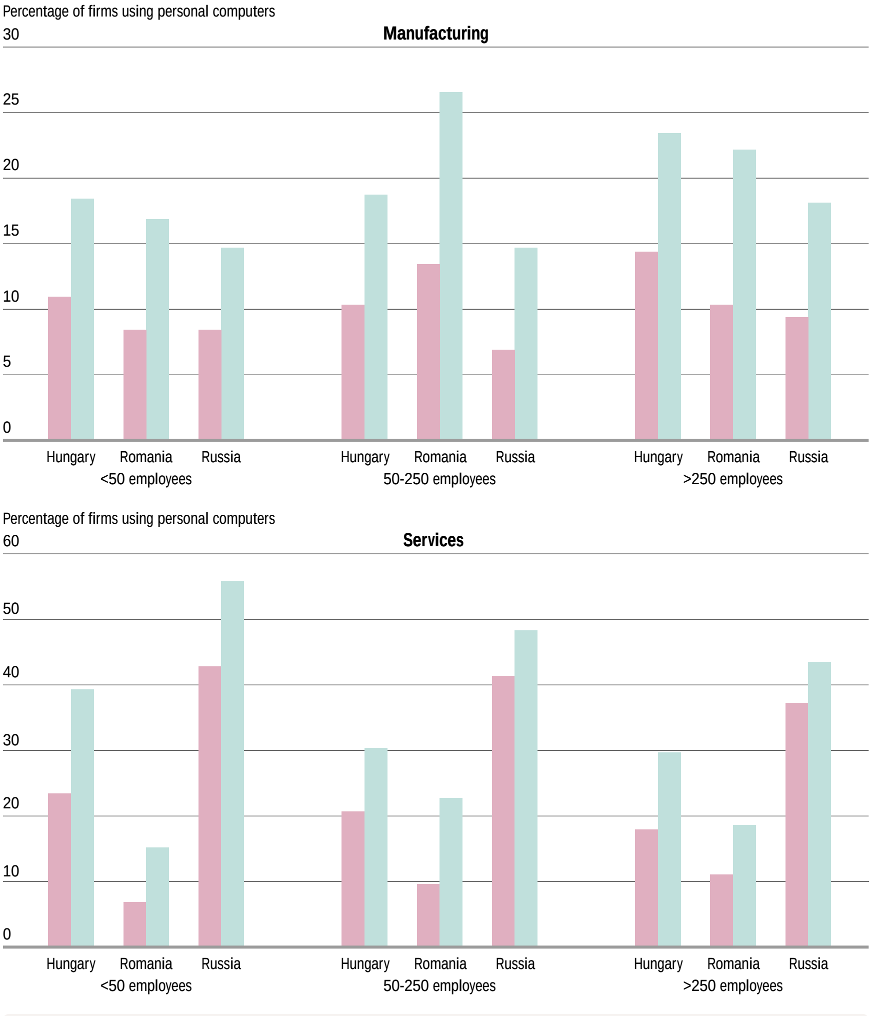
19 Interestingly, in all countries relative ease of access to short-term bank finance has tended to be positively related to the adoption of new technology.

20 There is a strong, common and positive relationship between firm size (as measured by employment) and the share of blue-collar or production workers. On average, firms with less than 50 employees had a blue-collar share around 10 percentage points lower than the level for the largest firm size category (>250 employees).

21 Such sectors include printing and publishing, transportation and machinery. See Berman, Bound and Machin (1998) and Mellander (2000).

Chart 6.11

Use of information technology and personal computers



Source: EBRD Enterprise Survey, 2000.

the share of workers using such technology. Chart 6.11 shows the share of the labour force making intensive use of PCs/ IT equipment. There is considerable variation across countries, sectors and size of firm. Hungary stands out as the country with the highest use of PCs in manufacturing and the highest use of PCs on average among all firms in the sample.[22] Russia, on the other hand, stands out for very significant differences in the use of PCs across sectors and the lowest use of PCs among manufacturing firms of all sizes. This highlights the rather segmented nature of modernisation among Russian firms, with the services sector – particularly new entrants – operating with a technology set-up and labour force that are significantly different from existing manufacturing firms.

As might be expected, use in service sector firms – particularly smaller companies – is substantially higher than in manufacturing in all three countries. Use of new technology in services has continued to grow from a relatively high base, with the rates of increase being fairly comparable for all sizes of firms. The survey also indicates that there tends to be a higher share of skilled non-production workers in newly established firms than in existing firms for both manufacturing and services.

The survey results also show that skilled workers receive substantially better wages in all countries. The ratio of skilled to unskilled workers' wages ranges between 2.5 and 4. With the exception of Romania, there is little evidence of an increase in this differential since 1997.

However, when looking at relative wages between the top and the bottom of the skill distribution – as represented by managers and unskilled workers respectively – there is evidence for a significant rise in wage inequality in Romania and Russia, but not in Hungary. High and rising wage differentials in less advanced transition economies are consistent with the picture of a segmented labour market with only pockets of restructuring and innovation concentrated in a small number of new entrants.[23]

6.4 Skills shortages and the need for training

This chapter has already established that there have been significant differences across countries and sectors in the degree of restructuring and the associated changes in the demand for skills. The analysis now turns to the question whether firms are constrained by shortages of required skills. This section takes a closer look at these issues, linking the survey results to more general conclusions regarding best practice.

Chart 6.12 provides a snapshot of how firms perceive imbalances in employment. It distinguishes between types of employees and the extent to which firms perceive themselves to be inadequately staffed in these categories. In addition, the chart distinguishes between firms that have experienced an increase or decrease in employment over the past three years. This measure gives an indication of the general performance of the firm.

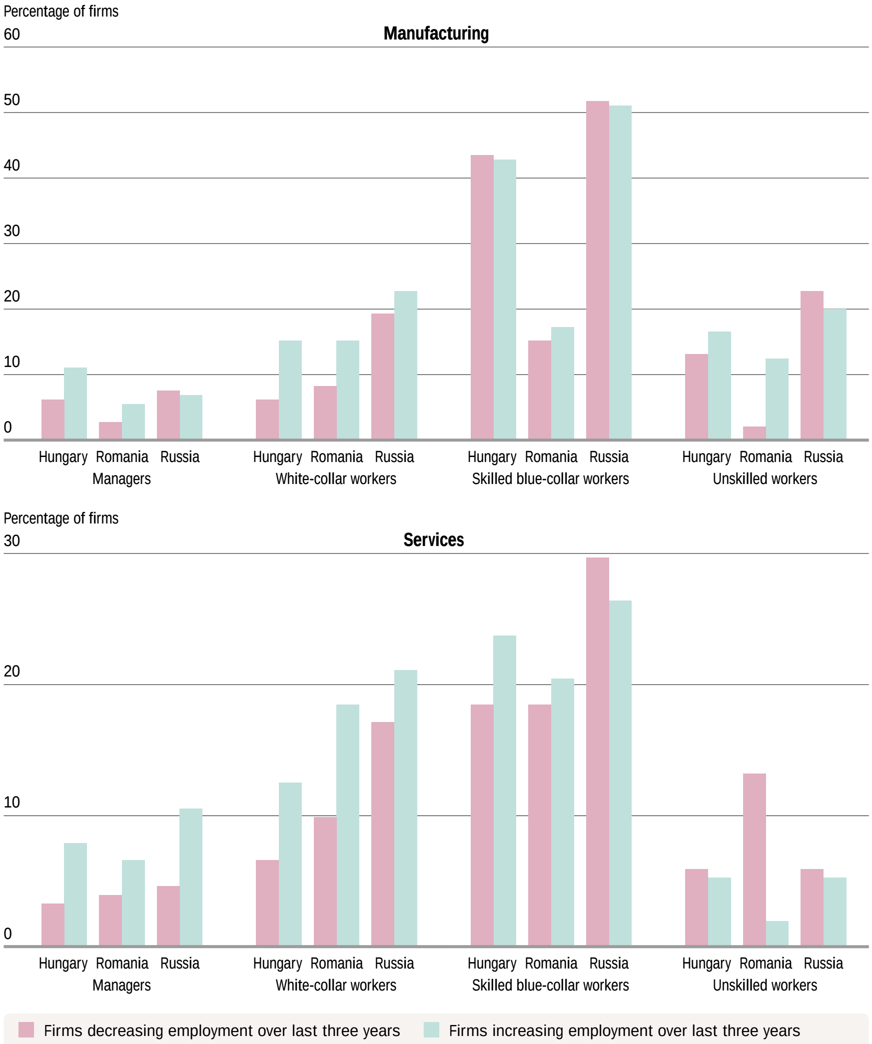
There is clearly a perceived shortage of skilled production workers in Hungarian manufacturing. Over 40 per cent of manufacturing firms considered themselves to fall below the desired staffing levels for skilled production workers. This share was even higher in Russia, where roughly 50 per cent of firms – irrespective of the change in employment level – reported that their staffing levels were below the desired level. In Romania, this share is much lower at below 20 per cent.

22 This holds because of the large representation of manufacturing firms in the sample.

23 Relative wages of skilled service sector workers compared with skilled manufacturing sector workers were significantly higher in Russia than in the other countries.

Chart 6.12

Share of firms with lower than desired level of employment (by skill type)



Source: EBRD Enterprise Survey, 2000.

For firms that have increased their employment levels, there also appear to be shortages of white-collar, non-production workers. In Russia around 20 per cent of firms did not have the desired staffing levels for unskilled workers. In fact, perceived shortages of production workers in Russia have been associated with substantial gross flows of workers to and from such jobs.

In short, the survey confirms that there are shortages of skilled labour but indicates that there are not – as might have been expected in the face of large-scale technological innovation – shortages of non-production workers. Indeed, the shortages appear to be primarily concentrated among skilled production workers and to a significantly lesser extent among non-production categories.

In view of these apparent shortages, an obvious issue is the role of training or retraining of workers, not least to limit these skill shortages. The foreign investor survey (see Section 6.3) has already highlighted the apparent productivity gap between workers in transition economies and those in parent firms. It also identified deficiencies in technical and IT skills and underlined a widespread problem with lack of worker adaptability. This section uses the survey of firms to assess the extent to which firms need to train or retrain workers and the type of training that is required. In addition, this section examines the ways in which such training can be effectively addressed, not least in terms of financing.

Evidence from the survey suggests that a combination of inadequate skills – including inadequate IT knowledge – and lack of adaptability by workers remains a persistent obstacle to the development and growth of firms. Table 6.1 presents responses regarding such obstacles as well as information on the share of the workforce perceived to require additional training and the type of training. It can be seen that in Hungary and, to a lesser extent, in Romania, worker adaptability is still viewed as a significant obstacle to the future growth of firms. Indeed, despite being the leading reformer, between 30 and 40 per cent of respondents in Hungary cited lack of worker adaptability as a substantial obstacle. Similarly, inadequate IT knowledge was seen by roughly a third of both Hungarian and Romanian firms as being a major impediment. It is interesting to observe that Russian firms tend to downplay both the lack of adaptability and of IT knowledge as barriers to growth. This is consistent with the lower levels of technology introduction and restructuring in Russia, as noted above.

Looking in more detail at the type of training gaps, Table 6.2 indicates the share of the workforce, broken down by skill category, in need of training. It is striking that managerial training is a major requirement. In Russia around 30 per cent of managers and professional staff were thought to require managerial training, compared with 10-20 per cent in Hungary and Romania. Russia also had a substantially higher share of professional and white-collar workers in need of additional PC/IT training. There is some weaker evidence of a need to upgrade the technical knowledge of skilled blue-collar workers, particularly in Romania and Russia. In view of this evidence of certain skill shortages and requirements for training, how can these problems be effectively addressed?

Designing effective training

While the general arguments for training are in principle quite clear, in practice designing effective training policies can be very challenging. Aside from important differences in the type of training that is required, there are a number of complex incentive issues that affect the financing of training. The possibility of workers leaving the company may discourage firms from providing training, while labour and capital market imperfections may in

Table 6.1

Obstacles to future development of business

(percentage of firms citing each factor as significant obstacle)

	Hungary		Romania		Russia	
	Manufacturing	Services	Manufacturing	Services	Manufacturing	Services
Adaptability of workers	40	29	27	30	16	13
Inadequate IT knowledge of workers	34	28	31	29	20	20
Insufficient public resources for training	27	18	36	36	47	27
Lack of incentives for firm to provide training	26	25	55	45	47	24

Source: EBRD Enterprise Survey, 2000.

Table 6.2

Percentage of workforce that requires training

	Language	PC/IT skills	Management	Client training
Hungary				
Managers	7	11	12	2
White-collar workers	3	15	0	2
Blue-collar skilled workers	1	1	na	0
Unskilled blue-collar workers	0	0	na	0
Romania				
Managers	17	12	24	19
White-collar workers	12	21	6	13
Blue-collar skilled workers	2	3	na	3
Unskilled blue-collar workers	1	1	na	2
Russia				
Managers	22	30	38	30
White-collar workers	17	34	26	23
Blue-collar skilled workers	na	11	na	na
Unskilled blue-collar workers	na	1	na	na

Source: EBRD Enterprise Survey, 2000.

turn discourage workers from acquiring adequate training. Market failures in the acquisition of skills can arise when workers and firms are not fully rewarded for the training costs they have to bear. Because training cannot easily be separated into general or specific components, simple financing prescriptions do not apply.[24]

A number of specific features of the transition economies also need to be considered. First, the strong emphasis on early and relatively low-level vocational training and on-the-job skill acquisition tended to reduce severely the adaptability of workers. Second, while the provision of education was relatively wide, the quality was not necessarily appropriate to a market economy. Although this points to a need for a different emphasis in education, it does not necessarily imply a wholesale reduction in vocational education. In fact, apprenticeship contracts for young workers that provide a mix of work-based training and off-the-job vocational training will continue to be relevant.[25]

Recent experience in western Europe highlights the importance of vocational training, apprenticeships and other training programmes that improve work experience and skills. In the United Kingdom, for example, the framework for raising skills has become business-led, with greater collaboration between prospective employers and public education authorities. The objective has been to establish clear vocational paths from secondary school onwards for new entrants into the labour force. It is also important in the transition economies to improve the adaptability of workers. In Hungary, for example, an increase in the minimum age of entry into vocational training schemes appears to have increased worker adaptability.

In view of the importance of creating new firms and entrepreneurship, there is significant scope for providing basic business training and finance skills. In both central Europe and the CIS such training programmes – linked to networks of local business groups – have aimed to improve basic business skills, such as accounting, marketing and other components of business strategy. These types of programmes have the potential to generate substantial benefits and there is clearly substantial scope for additional training – partly provided through technical assistance programmes – in the CIS.

Financing mechanisms

In principle, one solution to market failures in education and training owing to credit constraints and training risk can be addressed through government provision of loans for training and education. These loans can, in turn, be financed through taxes on future earnings. By letting tax payments rise with earnings, the government could spread the training risk across the intake of trainees. However, such an approach would be particularly difficult to enforce due to high monitoring costs and institutional weaknesses in the transition economies.

A less information- and monitoring-intensive approach that would be more suitable for the transition economies could be to provide workers with training vouchers financed by general government revenue. Workers could use these vouchers to secure training from firms. The voucher would in effect provide firms with a subsidy to supply training and would motivate workers to take up training, not least because the acquisition of additional skills could allow workers to negotiate higher pay. While such an approach would require some public

24 It has been widely argued that employees should normally finance general training, while specific training costs should be shared between firms and employees.

25 The literature on the German apprenticeship system concludes that firms are willing to pay a share of the training costs of apprentices, even though the qualifications of apprentices are largely general skills. This may be because a significant part of overall skills development still depends on on-the-job training.

financing, the emphasis would be on the provision of training by firms rather than on provision by the state.

For the unemployed, linking training subsidies to unemployment benefits and other welfare payments may also have a role. In particular, the unemployed could be given the opportunity to use a fraction of their unemployment benefits to finance training vouchers for firms that would hire them. The government would effectively be paying an employment and training subsidy to firms hiring the unemployed. Unemployed workers would gain an incentive to find jobs and acquire skills. To help the scheme succeed, training vouchers would require firms to pay wages in excess of the trainee's previous unemployment benefits. Clearly, this type of approach can only work in a strong institutional environment with appropriate monitoring. It will have little or no relevance, for example, in Russia.

6.5 Conclusions

The transition economies appeared to start the transition process with highly skilled workforces. However, with transition now in its second decade, the benefits of this legacy do not appear to have been fully realised. This chapter has demonstrated that, from the perspectives of foreign investors and domestic firms, there has been substantial variation across countries in the ability to preserve and enhance worker skills. In central Europe – particularly in Hungary – there is evidence that restructuring and innovation has taken place alongside the introduction of new technology and skills upgrading. Nevertheless, there is clear evidence of a persistent shortage of skills and a shortfall in training, not least for managers. In south-eastern Europe and the CIS the picture is far less promising. There, the main priorities are to improve the business environment and to strengthen the competitive process, including lowering the entry and exit costs of firms. These issues have blocked major restructuring and an efficient shakeout of firms.

The survey of Russian firms shows, in particular, limited restructuring and little use of new technology by firms in the manufacturing sector. This lack of innovation has tied the workforce to old technology and has contributed to a lack of skills appropriate to a market economy. Small segments of the services sector have experienced relatively high capital investment, however, which has raised the demand for skills and skilled workers' wages in this sector. The segmented nature of adjustment has contributed to the substantial rise in wage inequality in Russia. There is little evidence of widespread upgrading of skills and there is a danger in Russia of being caught in a low productivity, low skills trap.

In Russia and, indeed, most of the CIS, the highest priority at the present moment is a change in the policy framework to promote the entry of new firms and restructuring. From a labour market perspective, such changes would need to include: (i) the establishment of effective institutional mechanisms for providing support to redundant workers, with time-bound unemployment benefits tapering to social assistance; (ii) measures to promote the movement of workers across regions, including better labour market information and policies to promote a more effective housing market, including rentals and mortgage markets; and (iii) tax incentives for firms to provide workers with the upgrading of skills. Finally, there is the difficult issue of educational reform and the need to establish spending priorities and an effective delivery system – through both public and private provision – for educational services.

For Hungary and, to a lesser extent, Romania the policy requirements are somewhat different. Certainly in the former, this chapter has provided substantial evidence of the introduction of new technology prompted by foreign direct investment. The main challenge is the lack of worker adaptability, primarily because their skills are tied to a particular firm or specific process. In this regard, training related to the development of skills in a particular firm may, given ongoing structural change, be less desirable than training that raises the general adaptability of workers. Part of this can be achieved through the reform of vocational training. Delivery and financing of training should be through the private sector, primarily via the employer. However, fiscal incentives may be required, through the use of vouchers, for example.

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Country assessments

Since 1994, the EBRD has presented annual assessments of progress in transition for each country in its *Transition Reports*. These assessments have highlighted key developments and issues central to the process of transition in a wide range of areas, including liberalisation, macroeconomic stabilisation, privatisation, enterprises, infrastructure, financial sector and social sector. The key reform challenges facing the country are summarised at the beginning of the text. The assessment is complemented by a timeline of important historical events in the transition process.

To provide a quantitative foundation for analysing progress in transition, each country assessment includes a table of structural and institutional indicators. This table is grouped into the same categories as the text of the transition assessment, except for macroeconomic stabilisation. This aspect is covered by a separate table on macroeconomic performance. At the top of the structural indicators table are a set of "snapshots" to provide an overview of selected institutional and legal arrangements as of October 2000. The table itself provides indicators of progress in institutional change within each category. These data help to describe the process of transition in a particular country, but they are not intended to be comprehensive. Given the inherent difficulties of measuring institutional change, they cannot give a complete account or precise measurement of progress in transition. Moreover, some entries, such as the exchange rate regime and the privatisation methods, are useful only for information and carry no normative content. Other variables may have normative content, but their evaluation may vary depending on the specific country context.

The data should be interpreted with caution also because their quality varies across countries and categories. The data are based on a wide variety of sources, including national authorities, EBRD staff estimates, and other international organisations. To strengthen the degree of cross-country comparability, much of the data were collected through standardised EBRD surveys of national authorities. The technical notes at the end of this section provide definitions of the variables, along with country-specific qualifications.

Albania

Key reform challenges

- **With large-scale privatisation still at an early stage, successful privatisation of some larger enterprises to strategic investors would enhance the credibility of the privatisation programme and demonstrate the potential for sound business.**

- **Despite recent investment climate improvements, enterprises continue to face major obstacles, particularly unfair competition from the informal economy. Effective law enforcement would bring more enterprises into the formal sector.**

- **Privatisation of the dominant state savings bank should be vigorously pursued to strengthen the supply of credit to enterprises and to complete the sale of state banks.**

Liberalisation

Albania joins the WTO.
Full membership to the WTO for Albania was ratified in July 2000, with formal accession taking place in September 2000. Albania has also made progress in lowering tariff barriers to imports. In December 1999, it reduced the maximum tariff rate on goods from 20% to 18%, with the unweighted average tariff rate declining to 13% from 14%. A further reduction of the maximum tariff to 15% is planned for 2001.

Progress towards negotiations on an EU Stabilisation Agreement.
Albania has made progress towards opening negotiations on an EU Stabilisation and Association Agreement (SAA). In the short-run, agreed trade liberalisation will be asymmetrically in favour of Albania. Since October 1999, the EU has granted unilateral trade preferences to Albania, including exemptions from duties and abolition of quantitative restrictions for industrial goods, special concessions for selected agricultural and fishery products, and provision of specific tariff ceilings for textiles. About 90% of all exports from Albania to the EU are now duty-free. However, customs duty continues to be an important element of the Albanian government's revenues and about 90% of imports are from the EU. Trade liberalisation, therefore, is expected to be gradual, as the government develops other revenue sources.

Stabilisation

Tax and customs administration strengthened significantly.
Government revenues relative to GDP in Albania have been among the lowest of all transition countries. Efforts are therefore being directed at strengthening revenue collection agencies. Training courses for tax inspectors are being conducted with the assistance of the IMF and World Bank. An EU Customs Assistance Mission is also helping in a number of areas, including the valuation of trade and the application of customs duties. In January 2000, the General Customs Directorate introduced bonus payments for successful measures against fraud and contraband. These measures appear to be yielding results. In the first eight months of 2000, revenues from the collection of VAT and customs duties were 30% higher than for the same period in 1999. At the same time, the number of small businesses paying taxes climbed to 26,000 by the end of June 2000 and is expected to reach 30,000 by the end of the year; a 30% increase from the end of 1999.

Privatisation

Preparations for large-scale privatisation advance.
After successfully concluding the privatisation or liquidation of most state-owned SMEs, the government is concentrating on larger enterprises and utilities. In October 1999, parliament passed a law that defines tendering as the privatisation method for packages of shares of the commercial companies that operate in non-strategic sectors. Five medium-sized state-owned companies (a brewery, winery, dairy factory, pharmaceutical factory and cement factory) were put up for sale in April 2000. The privatisation of the cement factory, Fushe Kruje, was completed in July 2000 and the others are expected to be finalised by the end of the year. The government is also planning to privatise or liquidate all core copper and chrome mines during 2000, including 80% of Albchrom, which may be offered to a strategic investor through an international open tender. Parts of the oil sector are also to be prepared for sale before the end of the year.

Land registration programme progresses slowly.
The programme of registration of private property in the agricultural sector, begun in 1998, is proceeding, but is likely to take longer than originally expected. By the middle of 2000, the project, whose US$ 27 million cost is being covered mainly by the United States and the European Union, was completed in about 40% of all cadastral zones in the country (1,230 out of a total of 3,046). Completion will probably be in 2002. The programme has led to an increase in property sales (mainly of houses and land).

Liberalisation, stabilisation, privatisation

1991
Mar Small-scale privatisation begins

1992
Jul Full current account convertibility introduced
Jul Exchange rate unified
Jul All quantitative controls on foreign trade removed
Aug Most prices liberalised

1993
Apr Restitution law for non-agricultural land adopted
May Privatisation of housing begins
Jun Privatisation agency established

1994
Jan Modernisation of tax administration begins
Aug Treasury bills market initiated
Dec Most small-scale privatisation completed

1995
Apr Voucher privatisation begins
Jul Land titles introduced

1996
Feb Central bank independence law adopted
Jul VAT introduced

1997
Mar Widespread rioting and looting
Oct VAT increased
Nov Emergency IMF assistance approved

1998
May Three-year ESAF programme agreed with IMF
Dec Comprehensive tax reforms adopted

1999
Apr Major influx of refugees from Kosovo

2000
Sep Accession to WTO

Enterprise reform

New laws to spur enterprise performance.
The enterprise sector remains dominated by very small businesses (about 98% of enterprises have ten employees or fewer), many of which operate in the informal economy and have little or no access to formal sources of finance. The investment climate has improved over the past two years, notwithstanding difficulties in 1999 associated with the Kosovo crisis, but all enterprises continue to face the problems of poor infrastructure, delays with property

Enterprises, infrastructure, finance and social reforms

1992
Apr Two-tiered banking system established

1993
Jul First foreign-owned bank opened
Jul Enterprise restructuring agency established

1995
Jul Competition law enacted
Oct Bankruptcy law enacted

1996
Mar Securities and exchange commission established
May Stock exchange established
Jul First large enterprise liquidated
Dec First pyramid scheme collapsed

1997
Jul Law on transparency adopted
Nov Pyramid schemes placed under international administration

1998
Mar State-owned Rural Commercial Bank closed
Jul Banking law amended

1999
May Capital adequacy ratio raised to 12%
Nov Credit ceilings lifted for private banks

2000
Jan Secured transactions law enacted
Jun National Commercial Bank sold to foreign investor
Jul Mobile telecommunications company sold to foreign investor

registration, and a judicial system that is often slow or corrupt. However, new laws are expected to spur improvements in enterprise performance. A law on secured transactions was approved in January 2000 and a new bankruptcy law is expected to be approved later in the year. The recent approval of the industrial zone law in July 2000 may also help in attracting much-needed foreign investment.

Infrastructure

Efforts to restructure the state-owned energy company redoubled.
Despite the establishment of an energy task force in 1999 with the Italian government's assistance, the state-owned Power Generation and Distribution Company, KESH, remains in serious financial difficulties. More than 40% of the electricity generated in Albania is not paid for, either because of technical defects or illegal consumption. To help counter these problems, an 18-month contract to manage KESH was awarded in May 2000 to the Italian company ENEL, with the objectives of cutting technical losses and theft. The EBRD and the World Bank are also assisting in restructuring the sector by extending new loans to the company in December 1999.

The state-owned mobile phone company has been sold.
An 85% stake of the state-owned mobile phone company, Albanian Mobile Communications, was sold in July 2000 to a consortium comprising Telenor of Norway and Cosmote of Greece for US$ 96 million. 15% will remain for the company employees and for the owner of the land where its headquarters is located. A 51% share of the equity in the fixed-line operator, Albtelecom, is to be offered to a private investor, but the sale is unlikely to take place until 2001. Its monopoly of fixed-line services is to end in January 2003.

Implementation of key transport projects has been delayed.
The rehabilitation of the road network in Albania is a priority under the Stability Pact. Transport in the north of Albania was improved to cope with the influx of NATO troops and aid workers during the Kosovo crisis. However, there have been project implementation delays due to property expropriation issues. These are expected to be resolved, following the approval in March 2000 of the land expropriation law. The government has approved master plans for the construction of a new airport terminal in Tirana and for the development of the Port of Durres, a key project in the framework of the Stability Pact.

Financial institutions

One of the two remaining state banks has been privatised.
The sale by the government of the second-largest bank in the country, the National Commercial Bank (NCB) to Kentbank of Turkey, the EBRD and the IFC, was signed in June 2000. Kentbank bought a 60% stake in NCB, with the EBRD and IFC each taking 20%. This leaves only the Savings Bank, the largest bank in the country with by far the widest branch network and deposit base, in state hands. It too is being prepared for privatisation and bids will be invited in early 2001. A government recapitalisation to cover the negative capital of this bank (currently estimated at Lek 12-15 billion, about 2-2.5% of GDP) will take place before the privatisation.

Bank intermediation remains low, despite an easing of credit restrictions.
In order to foster competition in the financial sector and improve the supply of credit to enterprises, the central bank has granted licences to several new banks in the past year (including the micro-enterprise bank FEFAD, the Greek-owned Inter Commercial Bank and a branch of First Investment Bank) and has eased tight prudential controls by lifting credit ceilings on privately owned banks in November 1999. However, banks remain reluctant to extend credit, preferring instead to buy treasury bills, which currently yield around 9-13% in real terms. The central bank is also working towards establishing internationally accepted accounting standards for banks and is planning to introduce a real-time gross settlement system for payments within two years.

Social reform

Poverty remains widespread.
Despite recent impressive growth rates, Albania is still the poorest country in south-eastern Europe. According to a national survey in late 1999 by the Albanian Institute of Statistics, over one-third of Albanian families live with only one income source, averaging around US$ 64 per month. The government is working closely with the IMF and World Bank to develop a comprehensive plan over the next 12 to 18 months for poverty reduction. Key priorities are likely to include ensuring access to primary healthcare, reversing the recent falls in secondary education enrolment, improving the targeting of social assistance and developing the rural land market.

New pension benefits extended to farmers.
Due to the low number of farmers paying insurance contributions (about 8.5% by end 1999), during the period from October 1998 to June 2000 the government instituted a new amendment to the pension scheme of 1993. This amendment assists farmers by waiving the delay fee of contribution payments and thereby giving farmers better prospects to receive pensions, even for the period 1992-2000 when they were not paying insurance contributions. Farmers can obtain pension coverage for these years retroactively by paying a small amount (about 5% of the regular pension as stated in the original scheme of 1993) without paying delay fees for each year.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – **full**	Primary privatisation method – **MEBOs**	Independent telecoms regulator – **yes** [1]	Share of the population in poverty – **na**
Interest rate liberalisation – **limited de jure**	Secondary privatisation method – **vouchers**	Separation of railway accounts – **no**	Private pension funds – **no**
Wage regulation – **no**	Tradability of land – **limited de facto**	Independent electricity regulator – **yes** [1]	

Stabilisation	Enterprises	Financial sector
Share of general government tax revenue in GDP – **16.5%**	Competition office – **yes**	Capital adequacy ratio – **12%**
Exchange rate regime – **managed float**		Deposit insurance system – **no**
		Secured transactions law – **yes**
		Securities commission – **yes**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	na	na	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Share of total trade with non-transition countries (in per cent)	na	na	na	na	na	na	na	95.6	96.3
Share of trade in GDP (in per cent) [2]	na	95.3	60.1	38.4	35.8	42.9	37.3	33.8	38.1
Tariff revenues (in per cent of imports)	na	3.5	5.7	10.9	9.9	8.0	8.7	10.1	7.4
EBRD Index of price liberalisation	1.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	1.1	1.8	3.0	3.1	3.3	3.6	3.6	3.9
Private sector share in GDP (in per cent)	5.0	10.0	40.0	50.0	60.0	75.0	75.0	75.0	75.0
EBRD index of small-scale privatisation	2.0	2.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	8.0	1.9	1.2	0.6	0.4	0.5	0.5	0.5
Effective/statutory social security tax rate (in per cent)	na	na	na	na	na	na	37.3	na	na
Share of industry in total employment (in per cent)	na	na	na	10.2	8.3	7.6	8.0	7.8	na
Change in labour productivity in industry (in per cent)	na	na	na	na	23.8	26.5	-8.8	9.0	na
Investment rate (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of enterprise reform	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7
Infrastructure									
Main telephone lines per 100 inhabitants	1.3	1.3	1.3	1.4	1.3	1.9	2.3	3.1	3.7
Railway labour productivity (1989=100)	47.9	34.0	33.7	33.6	33.3	37.6	21.4	28.5	32.1
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	na	4.8 (91)	4.3 (84)	3.0 (72)	3.2 (70)	3.5 (58)
Electricity consumption/GDP (1989=100)	96.6	120.9	131.9	79.7	78.5	96.6	86.1	78.8	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	1.8	1.8
Financial institutions									
Number of banks (of which foreign owned) [3]	na	na	na	6 (3)	6 (3)	8 (3)	9 (3)	na	na
Asset share of state-owned banks (in per cent) [3]	na	na	na	97.8	94.5	93.7	89.9	na	na
Bad loans (in per cent of total loans) [4]	na	na	na	na	34.9	40.1	91.3	na	na
Domestic credit to enterprises (in per cent of GDP)	na	na	na	3.9	3.6	3.9	3.8	3.2	3.6
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.3	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	2.0	2.0	2.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	2.0	2.0	1.7
Social sector									
Expenditures on health and education (in per cent of GDP)	na	na	na	na	na	na	na	na	5.1
Mortality rate (per 1,000 male adults)	na	na	na	na	122.0	na	122.0	171.0	na
Basic school enrolment ratio (in per cent)	88.5	85.9	86.6	87.6	na	na	na	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Independent regulators are in place, but most regulatory functions are still carried out by the government.

2 In 1992, shows large increase as a result of devaluation.

3 Excludes branches of foreign banks.

4 Includes loans of banks under forced administration.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	Projection
Output					(Percentage change in real terms)				
GDP	-7.2	9.6	8.3	13.3	9.1	-7.0	8.0	7.3	7.0
Industrial gross output	-51.2	-10.0	-2.0	6.0	13.6	-5.6	4.1	6.4	na
Agricultural gross output	18.5	10.4	8.3	13.2	3.0	1.0	5.0	3.7	na
Employment					(Percentage change)				
Labour force (annual average)	-10.2	-1.8	-3.0	2.2	-7.5	2.1	1.5	0.1	na
Employment (annual average)	-28.9	-3.2	9.7	5.7	-2.5	-0.8	-2.0	-0.4	na
					(In per cent of labour force)				
Unemployment (annual average) [1]	27.9	28.9	19.6	16.9	12.4	14.9	17.8	18.0	na
Prices and wages					(Percentage change)				
Consumer prices (annual average)	226.0	85.0	22.6	7.8	12.7	33.2	20.6	0.4	0.4
Consumer prices (end-year)	236.6	30.9	15.8	6.0	17.4	42.1	8.7	-1.0	1.7
Gross average monthly earnings in state sector (annual average)	na	64.6	46.9	25.6	20.0	0.0	26.1	17.3	na
Government sector [2]					(In per cent of GDP)				
General government balance	-23.1	-15.5	-12.6	-10.1	-12.1	-12.6	-10.4	-11.3	-9.5
General government expenditure	46.7	40.4	36.4	33.4	30.3	29.4	30.7	32.6	na
General government debt	na	na	na	na	na	na	na	62.0	na
Monetary sector					(Percentage change)				
Broad money (M3, end-year)	152.7	75.0	40.6	51.8	43.8	28.5	20.6	22.3	na
Domestic credit (end-year)	68.0	152.6	17.8	-10.0	48.1	43.0	13.2	12.3	na
					(In per cent of GDP)				
Broad money (M3, end-year)	56.8	40.2	38.4	46.8	55.0	58.1	52.0	57.9	na
Interest and exchange rates					(In per cent per annum, end-year)				
Refinancing rate	40.0	34.0	25.0	20.5	24.0	32.0	22.9	17.8	na
Treasury bill rate (3-month maturity)	na	na	10.0	14.7	21.1	35.3	19.9	14.8	na
Deposit rate (one year) [3]	32.0	23.0	16.5	13.7	19.1	28.5	16.5	9.1	na
Lending rate (one year) [4]	39.0	30.0	20.0	21.0	28.8	43.0	25.0	25.8	na
					(Leks per US dollar)				
Exchange rate (end-year)	98.7	100.9	95.0	94.5	103.7	149.8	141.4	135.2	na
Exchange rate (annual average)	81.3	105.6	95.4	93.0	104.8	149.6	151.2	138.1	na
External sector					(In millions of US dollars)				
Current account	-427	-357	-279	-177	-245	-276	-186	-293	-332
Trade balance	-454	-490	-460	-475	-692	-518	-621	-846	-692
Merchandise exports	70	112	141	205	229	167	205	275	330
Merchandise imports	524	602	601	680	921	685	826	1,121	1,022
Foreign direct investment, net	20	45	65	89	97	42	45	51	92
Gross reserves (end-year), excluding gold	72	147	204	240	275	306	384	481	na
External debt stock	811	936	1,012	683	732	757	874	972	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	1.4	2.3	2.9	2.7	4.0	3.8	4.2	4.9	na
					(In per cent of exports of goods and services)				
Debt service	37.1	16.9	19.7	2.5	6.0	6.1	6.2	3.9	na
Memorandum items					(Denominations as indicated)				
Population (annual average, millions)	3.2	3.2	3.2	3.2	3.3	3.3	3.4	3.3	na
GDP (in millions of lek)	50,697	125,334	184,393	229,793	280,998	341,716	460,631	506,200	543,973
GDP per capita (in US dollars)	195	375	604	761	817	687	908	1,102	na
Share of industry in GDP (in per cent)	16.9	13.9	12.5	11.7	12.2	12.4	11.9	11.9	na
Share of agriculture in GDP (in per cent)	54.2	54.6	54.6	54.6	51.5	56.0	54.4	52.6	na
Current account/GDP (in per cent)	-68.5	-30.1	-14.4	-7.2	-9.1	-12.1	-6.1	-8.0	-8.5
External debt – reserves (in US$ millions)	739	789	808	443	457	451	490	491	na
External debt/GDP (in per cent)	130.1	78.9	52.4	27.6	27.3	33.1	28.7	26.5	na
External debt/exports of goods (in per cent)	1,158.6	838.7	716.2	333.3	319.7	453.3	426.3	353.5	na

1 Figures do not account for emigrant workers abroad who accounted for an estimated 18% of the total labour force in 1995.

2 General government includes the state, municipalities and extrabudgetary funds. Budget balance on a commitment basis.

3 Until 1995 the figures show the floor of the band set by the central bank. Thereafter data refer to weighted average interest rates on new 1-year deposits in commercial banks.

4 Until 1995 data refer to the guideline rate announced by the central bank. Thereafter data refer to weighted average interest rates for 1-year loans by commercial banks.

Armenia

Key reform challenges

- **With high fiscal and current account deficits, restoration of tax discipline is needed to maintain fiscal balance while safeguarding core public services.**
- **After a year of paralysing political uncertainty the reform process needs to regain momentum, including privatisation of power distribution and measures to improve the investment climate.**
- **Non-transparent or inconsistent regulation, gaps in the legal framework and the uneven application of the rule of law impede investment and call for accelerated institutional reform.**

Liberalisation

Memberships in the Council of Europe and WTO would promote openness and international integration.
Armenia is expected to join the Council of Europe in November 2000. Membership in the Council will help to firm up Armenia's democratic and human rights record and lead to closer integration with Europe. Negotiations to join the WTO are nearing completion, and accession is expected for 2001. The main remaining stumbling block in the negotiations is the level of competition in the telecommunications sector. In addition, a series of legal and regulatory adjustments (e.g., on intellectual property rights) is needed to bring Armenian laws into compliance with WTO standards. WTO membership will consolidate Armenia's open trade policies, and may in the medium term help to re-establish regional trade links. However, the immediate impact of trade liberalisation on domestic competition and market access will be limited due to Armenia's remoteness and its current regional isolation related to the Nagorno-Karabakh conflict.

Stabilisation

Stabilisation policies are largely successful ...
The Central Bank of Armenia continues to pursue a tight monetary policy. In 1999, the monetary base grew by only 1.1%, the lowest growth rate in five years. Such cautious monetary policy has lowered inflation and kept the exchange rate relatively stable. Maintaining fiscal balance, on the other hand, is proving more difficult. Despite a series of austerity measures, the budget deficit rose by almost two-thirds in 1999 to 5.9% of GDP and government arrears are growing. Wage arrears to healthcare workers now stand at 8-12 months. Insufficient revenue collection is the key reason for the difficult fiscal situation.

... but large external imbalances prevail.
The current account deficit is among the highest in the region and reliance on external financial assistance is significant. While the size of the Armenian diaspora ensures a continued flow of transfers and remittances, the country needs to increase domestic saving and improve export competitiveness to reduce external imbalances. In 1999, exports amounted to less than 13% of GDP. Armenia already has a relatively open trade regime, but its export sector suffers under weak transport infrastructure, insufficient communication links and poor customs administration. Exports are also hampered by the absence of trade relations with Turkey and Azerbaijan following the Nagorno-Karabakh conflict. It has been estimated that the blockade prevents Armenia from having direct access to over 40% of its immediate trading neighbourhood.

Privatisation

Privatisation slows with a shift toward sales to strategic investors.
The privatisation process has slowed over the last two years as the emphasis shifted from quick sales toward attraction of suitable strategic investors. The change in strategy was caused by a recognition that the insider-led privatisations of the past did not result in the desired inflow of capital and know-how. The privatisation schedule for 2000 includes three of the large remaining state-owned enterprises: the Shogakn diamond-processing plant, Almast, a producer of diamond processing tools, and the Tranzistor electronics enterprise. Shogakn has been sold to an Israeli investor, but no suitable investors have been found for the other two companies. Several other high profile strategic enterprises, such as the Nairit industrial complex, are also still awaiting privatisation. With the privatisation programme 1998-2000 coming to an end, enterprises that are not sold in 2000 will be shifted to a new privatisation programme for 2001-02. Companies that cannot be sold in three attempts are now liquidated, in accordance with the privatisation law. Some 190 enterprises have already been or are currently being liquidated.

Enterprise reform

Tax simplification helps to improve a difficult investment climate.
Private sector activity continues to be hampered by a difficult investment climate. The business community is affected by cumbersome administrative procedures, irregularities in their application, inconsistencies in the nascent regulatory and legal framework, and unclear legal procedures. The poor protection of creditors' rights in particular has deterred investors and exacerbates existing difficulties to access finance. Tax laws and procedures are often perceived as cumbersome. Efforts to streamline taxation are being discussed. As an initial step, a new simplified tax code for small enterprises was approved in summer 2000. Small enterprises are now allowed to replace existing taxes with a flat tax on sales revenues.

Liberalisation, stabilisation, privatisation

1991
- Jan Land reform begins
- May Small-scale privatisation begins
- Sep Independence from Soviet Union

1992
- Jan VAT introduced
- Jan Foreign trade registration abolished
- Aug Privatisation law adopted
- Dec Central bank law adopted

1993
- Nov New currency (dram) introduced

1994
- Jan First privatisation programme adopted
- Feb Tradability of land permitted
- May Cease-fire in Nagorno-Karabakh
- Oct Voucher privatisation begins

1995
- Apr Large-scale privatisation begins
- Apr Export surrender requirement eliminated
- Jul Most prices liberalised
- Sep Treasury bills market initiated

1997
- May Full current account convertibility introduced
- May Major tax reform
- Nov First international tenders launched
- Dec New privatisation law adopted

1998
- Dec New customs law adopted

1999
- Apr New law on property rights adopted
- Jun EU Partnership Agreement

2000
- Jun European Parliament approves Council of Europe accession
- Jul Law on privatisation of power distribution passed

Enterprises, infrastructure, finance and social reforms

1993

May	Stock exchange established

1995

May	Bankruptcy law adopted
Jun	Foreign bank ownership allowed
Sep	Banking crisis peaked

1996

Mar	First foreign-owned bank opened
Jun	Banking law amended
Jul	IAS audit of banking system

1997

Jan	Bankruptcy law enacted
Jun	Energy Regulatory Commission established
Jun	Energy law adopted
Jul	Financial rehabilitation plan for the energy sector adopted
Dec	National telecommunications operator privatised

1998

Feb	Telecommunications law adopted
Feb	Transport law adopted
Mar	IAS accounting for banks introduced
May	Law on accountancy adopted
Nov	Securities and Exchange Commission established

1999

Jan	New poverty benefits system introduced
Jan	New civil code introduced
Jan	Increase in energy tariffs
Apr	New reserve requirements for commercial banks

2000

Jun	New securities market law adopted
Jul	First private management of water utility

Industrial sector remains slow to restructure.
In the first five months of 2000, industrial output grew by 3.1% (year-on-year). Several industrial flagship enterprises have restarted production. However, these positive results mask continuing structural weaknesses in the sector. Restructuring is progressing slowly, with little new investment, and few improvements in corporate governance. Insolvent enterprises continue to operate, owing to the tolerance of tax arrears and ineffective bankruptcy enforcement. Moreover, the insider-dominated privatisation process has left enterprises with little access to finance for investment and no injection of new management skills.

Infrastructure

Privatisation of electricity distribution companies has been delayed.
The sale of the country's four electricity distribution companies, originally scheduled for spring 2000, was delayed following political disagreement over the course of power sector reform. The issue now appears to be resolved with the adoption in July 2000 of a special law on power distribution privatisation, and the government is resuming the search for strategic investors. A short-list of four qualified operating companies has already been prepared and conclusion of the transaction is expected for spring 2001. Privatisation is to be achieved without tariff adjustments and the government is expected to assume most of the sector's outstanding obligations. Total debt in the energy sector amounts to about US$ 220 million. Tariffs currently cover costs, but without substantial efficiency gains they will not be sufficient to finance the full rehabilitation programme. Efforts for the sale of generation assets also continue, including the privatisation of the Hrazdan thermal power plant.

Armentel, the privatised telecommunications operator, continues to face difficulties.
The controversy surrounding Armentel, in which the Greek telecommunications company OTE is the main shareholder, continues. Two lingering tax disputes were settled during the last 12 months, primarily in the government's favour. The broad exclusivity enjoyed by Armentel has affected Armenia's negotiations to join the WTO. Disagreements also continue over the level of investment that has occurred since OTE took over Armentel in December 1997. OTE is behind schedule in the US$ 100 million investment programme agreed during privatisation.

Financial institutions

The banking sector is growing, as regulations are tightened.
The Armenian banking sector has enjoyed considerable growth in recent months, with total assets increasing by 28% in real terms between January 1999 and April 2000. At the same time, the central bank has continued to tighten regulatory requirements. Minimal capital requirements for existing banks have been raised to US$ 1 million by January 2000, and will gradually rise to US$ 5 million. The schedule for this adjustment has not yet been determined, however. A minimum capital requirement of US$ 5 million already applies for new banks. Nevertheless, the banking sector remains weak, and the level of financial intermediation is still low. Few of the country's 30 banks have a capital base much above the regulatory minimum, and the level of deposits is small. Real interest rates have started to fall, but the terms offered to potential borrowers are still relatively unattractive, and much of the lending, particularly to SMEs, occurs through donor-supported, concessionary credit lines.

Movement on privatisation of Armsberbank.
Preparatory steps are under way for the privatisation of Armsberbank, the last remaining state-owned bank. The search for a strategic investor is expected to start in early 2001. The buyer will be expected to maintain Armsberbank's network of branches, which is one of the largest in Armenia.

New law on securities market regulation.
A new law on securities market regulation was approved by parliament in June 2000. The new law foresees the creation of an independent securities market regulator, improved rules on information disclosure and better investor protection. It is hoped that the new law will increase market efficiency, reduce system risks and lead to an increase in trading volume. Efforts to introduce leasing and other non-banking services have been slow to bear fruit. The most developed types of insurance are for property, accidents and health, aviation, and cargo.

Social reform

Initial steps to reform the social safety net.
To improve the financial sustainability of the state pension system, the government has increased the level of contributions for certain income groups. With help from donors, efforts are under way to improve the pension administration, including a better system to monitor individual contributions, which would replace the current system with payments made in proportion to contributions. Under the current system, pensioners receive a uniform payment. The family benefit system is also being reformed so as to target and improve services for the most needy.

Liberalisation

Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation

Share of general government tax revenue in GDP – **22.6%**
Exchange rate regime – **floating** [1]

Privatisation

Primary privatisation method – **direct sales (since 1999) / vouchers (pre 1999)**
Secondary privatisation method – **MEBO**
Tradability of land – **full except foreigners**

Enterprises

Competition office – **no**

Infrastructure

Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector

Capital adequacy ratio – **12%**
Deposit insurance system – **no**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform

Share of the population in poverty – **28%** [2]
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	100.0	na	8.9	12.8	6.2	7.7	7.0	7.0	9.3
Number of goods with administered prices in EBRD-15 basket	15.0	3.0	3.0	2.0	2.0	1.0	1.0	0.0	0.0
Share of total trade with non-transition countries (in per cent)	na	na	na	34.3	52.4	55.5	55.4	60.0	62.0
Share of trade in GDP (in per cent)	na	97.0	87.7	94.0	73.4	65.8	62.7	54.7	52.1
Tariff revenues (in per cent of imports)	na	0.2	6.1	0.7	1.0	1.9	2.7	2.8	3.0
EBRD Index of price liberalisation	1.0	2.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	2.0	2.0	2.0	3.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised (in per cent)	na	4.4	4.4	7.7	28.1	55.8	77.8	82.6	na
Privatisation revenues (cumulative, in per cent of GDP)	na	na	3.3	3.4	3.4	3.4	3.4	9.9	11.8
Private sector share in GDP (in per cent)	30.0	35.0	40.0	40.0	45.0	50.0	55.0	60.0	60.0
EBRD index of small-scale privatisation	1.0	2.0	2.0	2.3	2.7	3.0	3.0	3.3	3.3
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	2.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	na	12.8	0.9	0.1	0.6	0.1	na
Effective / statutory social security tax rate (in per cent)	na	74.4	na	12.9	19.1	19.3	na	na	na
Share of industry in total employment (in per cent)	27.4	25.7	23.5	23.9	20.5	18.1	16.5	15.2	na
Change in labour productivity in industry (in per cent)	-0.3	-41.5	0.5	7.4	19.0	20.4	12.4	7.8	na
Investment rate (in per cent of GDP)	28.5	17.1	12.5	20.2	16.2	17.9	16.2	17.2	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Infrastructure									
Main telephone lines per 100 inhabitants	15.8	15.7	15.6	15.6	15.5	15.4	15.0	15.7	15.7
Railway labour productivity (1989=100)	91.5	42.7	28.8	26.3	20.3	16.9	19.9	19.0	14.0
Electricity tariffs, USc / kWh (collection rate in per cent)	na	na	na	0.4 (na)	1.5 (na)	2.2 (76)	3.3 (80)	4.9 (87)	4.7 (88)
Electricity consumption / GDP (1989=100)	114.4	142.1	92.6	75.0	69.1	74.6	89.1	77.2	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.1	2.3
Financial institutions									
Number of banks (of which foreign owned)	na	na	na	41 (1)	35 (3)	33 (4)	30 (4)	31 (10)	32 (11)
Asset share of state-owned banks (in per cent)	na	na	na	1.9	2.4	3.2	3.4	3.7	2.4
Bad loans (in per cent of total loans)	na	na	na	34.0	36.1	22.6	7.9	na	na
Domestic credit to enterprises (in per cent of GDP)	na	0.2	8.3	11.1	7.3	5.6	6.0	8.6	9.2
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	0.2	1.0	1.0	1.3
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	2.0	2.0	2.3	2.3	2.3
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	3.0	4.0	3.7
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	3.0	3.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	10.3	11.7	7.8	3.4	4.4	3.4	3.1	3.5	3.3
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	164.0	162.0	na
Basic school enrolment ratio (in per cent)	89.0	88.7	84.6	81.3	81.1	82.4	82.4	83.2	na
Earnings inequality (GINI-coefficient)	29.6	35.5	36.6	32.1	38.1	na	na	na	na

1 Rare interventions, but no explicit exchange rate target.

2 Based on national poverty line. Using an international poverty line of US$ 4 per day at PPP exchange rates yields a poverty rate of 44%.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	-41.8	-8.8	5.4	6.9	5.9	3.3	7.2	3.3	3.5
Private consumption	-12.8	-26.3	5.2	9.0	3.8	7.3	5.3	0.4	na
Public consumption	-12.9	2.2	-3.2	0.2	-2.4	-2.3	-2.2	-0.6	na
Gross fixed capital formation	-87.2	-7.8	44.9	-17.3	10.3	2.1	12.0	0.5	na
Exports of goods and services	na	na	na	-7.8	-9.7	28.9	-34.0	5.9	na
Imports of good and services	na	na	na	-10.3	-5.5	24.4	-6.7	-11.2	na
Industrial gross output	-48.2	-10.3	5.3	1.5	1.4	0.9	-2.5	5.2	na
Agricultural gross output	2.1	-18.5	3.2	4.7	1.8	-5.9	13.1	1.3	na
Employment					*(Percentage change)*				
Labour force (end-year)	-3.8	1.4	-2.2	-0.8	-0.9	-2.5	-2.4	0.5	na
Employment (end-year)	-5.6	-2.2	-3.6	-0.8	-4.4	-1.6	-1.9	-2.5	na
					(In per cent of labour force)				
Unemployment (end-year) [1]	3.5	6.3	5.8	8.4	10.1	11.3	8.9	11.6	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	1,346	3,732	5,273	176.7	18.8	13.8	8.7	0.6	-0.2
Consumer prices (end-year)	1,341	10,896	1,885	31.9	5.8	21.8	-1.3	2.0	2.8
Producer prices (annual average)	na	na	na	228.6	29.6	21.7	14.9	2.3	na
Producer prices (end-year)	na	na	na	na	16.8	19.4	15.0	3.8	na
Gross average monthly earnings in the state sector (annual average)	326.9	751.0	2,727	243.6	45.7	19.5	36.6	20.0	na
Government sector [2]					*(In per cent of GDP)*				
General government balance	-13.9	-54.7	-16.5	-9.0	-8.6	-5.8	-3.7	-5.9	-6.3
General government expenditure	46.7	82.9	44.1	28.9	26.2	25.5	24.5	28.3	na
General government debt	na	na	na	na	na	na	na	na	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	na	1,072	737.1	68.9	32.1	29.7	37.1	14.4	na
Domestic credit (end-year)	na	910.5	1,511	68.0	27.8	6.3	62.4	4.2	na
					(In per cent of GDP)				
Broad money (M3, end-year)	0.4	68.2	13.0	7.9	8.3	8.8	10.2	11.3	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinancing rate	30.0	210.0	210.0	52.0	60.0	54.0	39.0	45.0	na
Money market rate	na	na	na	70.8	40.7	37.9	21.1	35.2	na
Deposit rate [3]	na	na	na	63.2	32.2	26.1	24.9	18.0	na
Lending rate [3]	na	na	na	77.3	59.1	35.6	44.4	36.2	na
					(Drams per US dollar)				
Exchange rate (end-year)	2.1	75.0	405.5	402.0	435.1	495.0	522.0	523.8	na
Exchange rate (annual average)	226.2	9.1	288.7	405.9	414.0	490.8	504.9	535.1	na
External sector					*(In millions of US dollars)*				
Current account	na	-67	-104	-218	-291	-307	-390	-277	-269
Trade balance	-102	-98	-178	-403	-469	-559	-578	-462	-490
Merchandise exports	83	156	215	271	290	234	229	249	261
Merchandise imports	185	254	394	674	760	793	806	711	751
Foreign direct investment, net	0	1	8	25	18	52	221	131	150
Gross reserves (end-year), excluding gold	1	14	32	100	156	229	315	319	na
External debt stock	na	na	200	375	614	786	812	855	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	0.6	0.9	1.6	2.1	2.9	3.8	4.3	na
					(In per cent of exports of goods and services)				
Debt service	na	na	3.4	20.9	20.2	14.7	12.6	17.0	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions) [4]	3.7	3.7	3.8	3.8	3.8	3.8	3.8	3.8	na
GDP (in billions of drams)	62.5	4.3	187.1	522.3	661.2	804.3	955.4	987.1	1,019.5
GDP per capita (in US dollars)	74.3	125.2	172.7	341.6	422.4	432.2	498.2	485.5	na
Share of industry in GDP (in per cent)	43.4	30.7	25.6	24.5	23.4	23.0	20.9	28.3	na
Share of agriculture in GDP (in per cent)	28.7	46.3	37.0	36.1	34.8	32.2	33.8	31.4	na
Current account/GDP (in per cent)	na	-14.3	-16.0	-17.0	-18.2	-18.7	-20.6	-15.0	-14.4
External debt – reserves (in US$ millions)	na	na	167.9	275.7	458.2	557.3	496.7	536.4	na
External debt/GDP (in per cent)	na	na	30.9	29.2	38.4	48.0	42.9	46.3	na
External debt/exports (in per cent)	na	na	87.4	125.3	166.7	238.0	225.8	220.7	na

1 Registered unemployment. Unofficial estimates indicate substantially higher unemployment.

2 Consolidated accounts of the Republican government and the local authorities.

3 Weighted average rate for maturities of 15 days to less than one year.

4 Official (de jure) population. Actual population may be significantly lower, as official emigration data is incomplete.

Azerbaijan

Key reform challenges

- **Public accountability and fiscal control of Oil Fund resources, as well as unbundling and restructuring of SOCAR, would be key steps if the government wishes to demonstrate its commitment to improving its poor governance record.**
- **A rapid launching of the second privatisation programme, based on a transparent framework with minimal scope for discretion, should be a priority step to support private sector development.**
- **Repeated power shortages earlier in 2000 revealed the need for comprehensive reform of the energy sector, including tariff adjustment, unbundling of generation and distribution, and introduction of competition and private investment.**

Liberalisation

WTO accession not likely before 2002.
Azerbaijan has largely liberalised its trade and foreign exchange regime, without any backtracking. The relatively low and uniform general tariff still stands at 15%. Azerbaijan currently has associate WTO status and is not likely to rush accession given outstanding issues surrounding customs procedures, subsidies and the protection of local industry. Negotiations for WTO accession are likely to start by late 2000 or early 2001 and are anticipated to last two years.

Stabilisation

A more flexible exchange rate regime has been adopted.
The manat was allowed to depreciate about 11% against the US dollar during 1999. As a result, the real effective exchange rate has returned to around the level prior to the onset of the Russian financial crisis. With strong inflows of primarily oil-related export earnings, the central bank was able to rebuild reserves and the resulting remonetisation has pushed up inflation from an annual average -8.5% in 1999 to 1.4% in July 2000. On the back of a solid current balance of payments and foreign debt position, Azerbaijan received its first sovereign credit rating (Fitch IBCA) in July 2000 at B+ for long-term foreign currency, putting it between Kazakhstan (BB) and Russia (B).

Stalled public sector reforms may now be moving forward.
Until recently, the government has appeared unwilling to address the type of comprehensive public sector reforms and improved governance advocated by the World Bank and the IMF. The package of public expenditure management, administrative and civil service, legal and judicial, and anti-corruption reforms discussed with these institutions has not been adopted in full by the government, and implementation remains slow. However, a civil service law was passed in July, and a report prepared on the restructuring of the Cabinet of Ministers. Any increase in lending by the IFIs also will depend on financing needs, which currently are modest given the country's strong balance of payments position.

An oil fund is being established.
In December 1999, a decree was issued announcing the intention to establish the State Oil Fund of Azerbaijan. While it would be desirable to save revenues in the form of foreign financial assets and transfer any resources to be spent to the general government budget in a transparent and accountable manner, the detailed operation of the fund has not yet been finalised. Full public accountability will be essential to avoid mismanagement.

Privatisation

Progress on medium- and large-scale privatisation has slowed …
While small-scale privatisation for cash, privatisation of agricultural land and issuance of land titles are nearly completed, sales of larger enterprises have stagnated. From the beginning of the programme, 1,065 medium-sized and large enterprises were transformed into joint-stock companies and privatised by the end of 1999. In September 1998, a new phase of case-by-case privatisation began with the adoption of competitive tenders. However, by end of the first quarter 2000, only five companies had been privatised through this mechanism. The most important of them was the sale of the Garadag cement factory to Holderbank (Switzerland), second in the tender process after the winner could not fulfil all conditions of the tender.

… and programme implementation has continued to lack transparency.
At the end of 1999, the State Property Committee was abolished and in February 2000 a new State Property Ministry was started. A new privatisation law was adopted in May 2000, and is complemented by a new privatisation programme (implementing regulations) which has recently been approved by the President. The privatisation law itself is a vague framework document that does not commit the government to concrete and transparent processes. It foresees international investment tenders on a case-by-case basis for the largest state-owned enterprises. The previously issued vouchers and options (majority held by foreigners) have been extended beyond their August 2000 expiry date.

Enterprise reform

Foreign investments in oil and gas slow down, though prospects remain good.
Net foreign investments declined from US$ 1 billion in 1998 to US$ 0.5 billion in 1999, reflecting increased operating cost recovery by Azerbaijan International Operating Company (AIOC) as well as postponement of investments under several Production

Liberalisation, stabilisation, privatisation

1991
- Jun — Law on private ownership adopted
- Oct — Independence from Soviet Union

1992
- Jan — Most prices liberalised
- Jan — VAT introduced
- Apr — Foreign investment law adopted
- Aug — Central bank law enacted
- Aug — New currency (manat) introduced

1993
- Jan — Small-scale privatisation law adopted
- Aug — Inter-bank currency exchange begins trading

1994
- Jan — Manat becomes sole legal tender
- May — Cease-fire in Nagorno-Karabakh

1995
- Mar — Exchange rate unified
- Apr — First IMF programme approved
- Sep — Law on large-scale privatisation adopted

1996
- Mar — Small-scale privatisation begins
- Jun — Export surrender requirement abolished
- Jun — Central bank law amended
- Aug — Land reform law adopted
- Sep — Treasury bills market initiated

1997
- Mar — Voucher privatisation begins
- Jun — New customs code adopted
- Jul — Adoption of new simplified tariff schedule

1999
- Feb — New labour code adopted
- Dec — Decree for establishing Oil Fund signed

2000
- Feb — State property ministry created
- May — New privatisation law adopted
- Jul — New tax code adopted

Enterprises, infrastructure, finance and social reforms

1994

Jul	Bankruptcy law adopted
Jul	Bank consolidation begins
Sep	First international oil PSA
Nov	Law on joint-stock companies adopted

1995

Jun	Law on unfair competition adopted
Aug	Railway law adopted

1996

Jun	Banking law enacted
Aug	Law on natural monopolies adopted
Sep	Bank restructuring begins

1997

Feb	Law on competitive government procurement adopted
Jun	BIS capital adequacy enacted
Jun	Amended bankruptcy law adopted
Jul	Telecommunications law adopted
Dec	Northern pipeline to Novorossiisk opened

1998

Apr	Electricity law adopted
Aug	Pledge law adopted
Sep	New securities law adopted
Nov	Tender for privatisation of International Bank authorised
Dec	Western pipeline to Georgia opened

1999

Dec	Decree on Oil Fund issued

2000

May	Baku Ceyhan agreement ratified

Sharing Agreements (PSAs) and delays in the negotiations regarding the main export pipeline. On the positive side, 20 PSAs (mainly for exploration of new oil fields) had been signed by June 2000, with four of these since the beginning of 1999. In addition, the 1999 discovery of major gas reserves (possibly 1 trillion cubic metres) will substantially boost investment and government receipts over the medium term. However, no attempt has yet been made to restructure the state oil company, SOCAR, and its privatisation is not foreseen.

Lack of restructuring worsens arrears problem.
The bankruptcy law of June 1997 continues to be little used for fear of high social costs. However, the actual costs, by preventing the re-deployment of assets of non-profitable enterprises to alternate more efficient uses, are reflected in the economy's increased dependence on oil with a severe non-payments problem. Cumulative arrears in enterprise accounts stood at 102% of GDP as of April 2000. Non-payments do not simply keep loss-making enterprises alive and distort competition, they also encourage the use of barter and discourage proper accounting practices, both key aspects hindering a more level playing field for private entrepreneurship.

Tax reforms fail to rectify deeper discrimination against new private enterprises.
Some tax changes took place in early 2000, while further changes will take place next year with a new tax code to become effective in January 2001. In particular, the average effective income tax rate was reduced as the initial taxable threshold was increased and the highest rate reduced to 35% from 40%. Employer contributions to the social protection fund were reduced to 30% from 33%. Other reductions include: corporate profit tax to 28% and then to 27% by the beginning of 2001 from 30%, and VAT to 18% from 20%. However, in spite of reductions in specific rates, unequal forms of harassment such as arbitrary enforcement of tax, licensing and other regulatory requirements continue to block entry and expansion of investors that do not have favourable local connections. This helps explain why foreign investment in non-oil and gas sectors, not benefiting from the protective shell of PSAs, remains very low.

Infrastructure

Reform of power is urgently required.
Electricity is available to nearly all households, and central gas to over half the population. However, shortages and rationing are common, with electricity blackouts scheduled for peak consumption hours in regions outside of Baku. Growing demand has been fuelled by low tariffs, poor collection discipline and non-payment as power continues to be used to subsidise the general population and bolster the competitiveness of local industry. Power utilities, in turn, are subsidised via accepted non-payment for their fuel oil inputs. As a result, SOCAR has become the largest tax debtor, with the large implicit subsidy financed by depleting oil wealth. The absence of a clear regulatory structure has hampered attempts to promote full-cost recovery and allowed tariffs to continue to be decided by political considerations. Nevertheless, decrees on transferring the electricity distribution networks of the three main cities into joint-stock companies and preparing them for some form of privatisation have been issued in June-July 2000. Reforms in telecoms, transport and water are also pressing.

Financial institutions

Bank restructuring and privatisation move ahead very slowly …
The International Bank of Azerbaijan (IBA), which dominates the sector, was recapitalised in January 1999 and a decree for its privatisation was issued. However, there is still no clear indication of the timing of the sale, nor of acceptance of the need for strategic investors. The three other state-owned banks have been restructured by merging their assets into a single new bank, the United Universal Bank, and by transferring non-performing assets to an asset collection agency. The completion of this restructuring and the successful privatisation of IBA and UUB remains a major challenge, as does the creation of a more balanced system given that IBA continues to benefit from privileges.

… as the banking system remains financially vulnerable.
With the restructuring of the state banks, the banking system as a whole will include 68 banks, down from 180 in 1995. The level of non-performing loans has tripled since 1996, reaching 62% of total loans outstanding at the end of 1999 (though this may partly reflect improved monitoring). This reflects the high concentration of loans to unrestructured public enterprises, with outstanding loans to public enterprises comprising roughly 75% of the banking system's loan portfolio at the end of 1999. While the recent restructuring of state-owned banks will help (more than 90% of the loan portfolios of the recently merged banks, Agroprombank and Prominvest Bank, were non-performing), the lack of progress in privatising loss-making state-owned enterprises is likely to continue endangering systemic solvency. Of the 66 privately owned banks, more than half have failed to comply with the central bank's capital adequacy and minimum capital requirements.

Social reform

Social spending is low and skewed away from basic needs.
Public expenditures on education increased slightly in 1999 to just under 5% of GDP, from roughly 4% in previous years, while health expenditures fell to 1% of GDP. In comparison, total spending on education and health is roughly equivalent to tax arrears from SOCAR. Of concern is the distribution of spending which is skewed away from basic education and health towards wages and salaries, with salaries increasing to 81% of overall education spending in 1999. Over 60% of all spending in health takes place in hospitals with the bulk going to acute care facilities staffed by specialised doctors, and little to preventive and basic health. Existing social safety nets do not keep the unemployed out of poverty, with benefits independent of income. The government intends to work on a participatory poverty reduction strategy to make progress in this area.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenue in GDP – **15.3%**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **cash auctions**
Tradability of land – **limited de jure**

Enterprises
Competition office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **8%**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **60%**
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	77.0	77.0	8.0	6.0	6.0	na
Number of goods with administered prices in EBRD-15 basket	na	na	na	12.0	12.0	3.0	2.0	2.0	na
Share of total trade with non-transition countries (in per cent)	na	na	na	58.4	58.3	53.1	43.8	43.7	na
Share of trade in GDP (in per cent)	79.7	126.6	109.8	116.8	67.7	66.9	55.1	57.4	61.5
Tariff revenues (in per cent of imports)	0.0	0.1	1.4	1.1	1.6	1.9	4.3	4.4	5.4
EBRD Index of price liberalisation	1.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	1.0	1.0	1.0	2.0	2.0	2.3	3.0	3.3
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	na	na	23.2	50.2	76.2	85.4
Privatisation revenues (cumulative, in per cent of GDP)	na	na	0.0	0.0	0.0	0.1	1.1	1.9	2.7
Private sector share in GDP (in per cent)	10.0	10.0	10.0	20.0	25.0	25.0	40.0	45.0	45.0
EBRD index of small-scale privatisation	1.0	1.0	1.0	1.0	1.0	2.0	3.0	3.3	3.3
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	1.0	1.0	2.0	2.0	1.7
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	11.2	4.6	5.4	2.2	2.1	0.7	0.1	na
Effective/statutory social security tax rate (in per cent)	na	39.2	44.8	39.6	23.5	31.0	34.5	na	na
Share of industry in total employment (in per cent)	12.3	11.5	10.5	10.3	9.7	7.7	6.6	6.5	na
Change in labour productivity in industry (in per cent)	7.3	-18.4	-12.0	-21.0	-16.6	na	17.3	3.5	na
Investment rate (in per cent of GDP)	na	na	19.0	26.3	15.6	29.1	38.0	40.6	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7	1.7
EBRD Index of competition policy	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	8.7	9.0	8.8	8.5	8.3	8.5	8.7	8.9	9.5
Railway labour productivity (1989=100)	76.1	37.1	28.3	15.3	8.6	9.2	11.7	15.9	17.5
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	0.67 (na)	1.98 (39)	2.48 (41)	2.7 (56)	na	na
Electricity consumption/GDP (1989=100)	102.4	92.7	113.4	142.3	152.4	151.9	137.3	135.0	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	1.8	1.8
Financial institutions									
Number of banks (of which foreign owned)	43 (na)	120 (na)	164 (1)	210 (1)	180 (2)	136 (3)	99 (3)	79 (3)	na
Asset share of state-owned banks (in per cent)	na	88.7	80.4	77.6	80.5	77.6	80.9	65.5	na
Bad loans (in per cent of total loans) [1]	7.1	6.7	26.6	15.7	22.3	20.2	19.9	19.6	na
Domestic credit to enterprises (in per cent of GDP)	na	10.8	9.6	3.3	1.2	1.2	2.4	3.3	3.4
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.7	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	2.3	3.0	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	1.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	1.0	9.4	10.9	6.8	4.9	5.2	4.8	4.6	5.9
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	213.0	209.0	na
Basic school enrolment ratio (in per cent)	88.0	88.5	89.2	90.4	90.3	90.4	91.4	91.6	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	45.8	na	na	na

1 Refers to overdue credits.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	-22.6	-23.1	-19.7	-11.8	1.3	5.8	10.0	7.4	7.5
Industrial gross output [1]	-30.4	-19.7	-24.7	-21.4	-6.7	0.3	2.7	3.6	na
Agricultural gross output	-25.0	-15.4	-13.0	-6.8	3.0	-6.9	3.9	7.1	na
Employment [2]					*(Percentage change)*				
Labour force (end-year)	-2.3	-0.6	-1.4	1.0	2.5	0.9	0.4	1.2	na
Employment (end-year)	-0.3	-0.2	-2.3	-0.5	2.0	0.2	0.2	0.0	na
					(In per cent of labour force)				
Unemployment (end-year)	15.4	9.6	10.4	11.7	12.1	12.7	12.9	13.9	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	912.0	1,129	1,664	412.0	19.7	3.5	-0.8	-8.5	1.5
Consumer prices (end-year)	1,395	1,294	1,788	85.0	6.5	0.4	-7.6	-0.5	1.7
Producer prices (annual average)	na	na	na	1,734	98.0	11.8	-12.4	-6.1	na
Producer prices (end-year)	na	na	na	na	na	na	na	-9.3	na
Gross average monthly earnings in economy (annual average)	750.0	708.3	601.5	307.6	43.1	58.5	18.9	9.5	na
Government sector					*(In per cent of GDP)*				
General government balance [3]	2.7	-15.3	-12.1	-4.9	-2.8	-1.6	-4.2	-5.4	-7.7
General government expenditure [3]	48.4	55.9	45.9	22.5	20.3	20.8	21.2	24.9	na
General government debt	na	na	25.7	19.6	14.1	13.5	15.8	na	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	na	818.0	1,114.6	24.0	18.9	33.6	-17.0	22.2	na
Domestic credit (end-year)	na	480.0	841.0	61.0	33.2	11.1	11.4	-9.8	na
					(In per cent of GDP)				
Broad money (M3, end-year)	39.0	54.9	55.9	12.2	11.3	13.1	10.6	12.7	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinance rate (6 months)	na	na	na	80.0	20.0	12.0	14.0	10.0	na
Interbank interest rate (3 months) [4]	na	na	na	na	36.0	22.9	23.2	20.5	na
Deposit rate [5]	10.0	34.0	406.0	90.0	13.0	11.5	10.9	9.9	na
Lending rate [5]	60.0	257.0	406.0	107.0	33.0	21.5	27.7	27.5	na
					(Manats per US dollar)				
Exchange rate (end-year)	45.0	256	4,330	4,440	4,098	3,888	3,890	4,378	na
Exchange rate (annual average)	14.8	120	1,433	4,417	4,300	3,983	3,869	4,126	na
External sector					*(In millions of US dollars)*				
Current account	-198	-160	-123	-318	-821	-914	-1,363	-600	-253
Trade balance	-153	-122	-163	-275	-549	-567	-1,046	-408	100
Merchandise exports	1,263	697	682	680	789	808	678	1,025	1,700
Merchandise imports	1,417	819	845	955	1,338	1,375	1,724	1,433	1,600
Foreign direct investment, net	na	0	22	282	661	1,093	1,024	510	274
Gross reserves (end-year), excluding gold	na	0	2	119	214	467	449	676	na
External debt stock	na	52	239	425	466	406	506	964	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	na	0.0	1.1	1.5	2.7	2.2	4.2	na
					(In per cent of exports of goods and services)				
Debt service	na	na	0.4	5.2	7.4	7.3	4.7	4.1	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	7.4	7.5	7.6	7.7	7.8	7.9	8.0	8.0	na
GDP (in billions of manats)	24.1	157.1	1,873.4	10,669.0	13,663.2	15,791.4	16,177.0	16,488.5	17,991.0
GDP per capita (in US dollars) [6]	218.8	173.4	171.0	312.6	407.4	503.3	525.7	498.5	na
Share of industry in GDP (in per cent)	29.4	24.9	20.4	27.3	25.9	25.3	25.1	23.5	na
Share of agriculture in GDP (in per cent)	25.9	26.9	32.2	25.1	24.7	20.0	19.7	21.7	na
Current account/GDP (in per cent)	-12.2	-12.2	-9.4	-13.2	-25.8	-23.1	-32.6	-15.0	-6.3
External debt – reserves (in US$ millions)	na	52	237	306	252	-61	57	288	na
External debt/GDP (in per cent)	na	4.0	18.3	17.6	14.7	10.2	12.1	24.1	na
External debt/exports (in per cent)	na	6.3	29.2	49.9	49.7	35.3	50.1	75.2	na

1 Industrial output excludes crude oil production.

2 Employment and labour force estimates differ from official statistics. Labour force data is corrected for the working age population outside the labour force. Unemployment is based on survey data. Less than 5% of all unemployed are registered.

3 General government includes the state, municipalities and extrabudgetary funds.

4 90 days Interbank offer rate in manats, nominal.

5 1993-95: minimum rate for household time deposits, minimum lending rate for private enterprises respectively. From 1996, 3 month deposit and lending rates of bank-client deals in manats, nominal.

6 GDP per capita figures for 1992-93 are estimated from the IMF. The manat became official legal tender only in January 1994.

Belarus

Key reform challenges

- **While steps have recently been taken to liberalise access to foreign exchange and the commitment has been made to achieve full current account convertibility, widespread administrative price controls and obstacles to exports must also be abandoned to free the economy.**

- **High inflation and little progress with industrial restructuring reflect pervasive soft budget constraints, such as directed lending and subsidised energy inputs; these practices need to be abolished if the economy's growth potential is to be realised.**

- **With relatively little private sector activity compared with other transition economies, a political commitment to privatisation, especially small-scale, in both industry and agriculture is still required.**

Liberalisation

Widespread administrative price controls remain …

While Belarus had liberalised many producer prices and most prices for food and agricultural products by 1995, the authorities have subsequently reversed these measures and resorted to direct administrative controls on most prices. In May 1999, a presidential decree banned any price increase that was not compensated by social protection measures and set annual limits on price inflation. The decree also re-introduced state price regulation for a wide range of goods and services, including food products and spirits. Over the past year, the government has continued to rely on price controls as a means of limiting inflation and allocating resources. While inflation has slowed recently, it remains the highest in all the CIS countries.

… but the foreign exchange market has been liberalised.

The stated aims of policy have been to achieve convergence between the official rate and the rates quoted on the four main non-official markets (cash, inter-bank, currency and stock market and the non-resident market) and to remove exchange restrictions. The inter-bank foreign exchange market was partially liberalised in December 1999 with the abolition of restrictions on trading volumes. In March 2000, the central bank liberalised the afternoon session of the currency and stock market by allowing banks to buy foreign currency and by removing the tax on the difference between the official and the afternoon session rates. In September, the afternoon trading session was unified with the main session and the remaining restrictions were lifted. The black market for foreign currency has almost been eliminated after exchange booths were allowed to set their exchange rates freely and keep their foreign currency surplus in January 2000, when restrictions on payments in Belarussian roubles for exports were also relaxed. However, special permission of the National Bank of Belarus (NBB) is still required to make payments in Belarussian roubles to non-residents and the 30% export surrender requirement (which does not apply to all exports) remains in place.

Stabilisation

Economic growth is supported by soft credits.

According to preliminary figures, GDP rose approximately 4% in the first half of 2000 in contrast to 2.5% growth during the same period in 1999. Increased demand for exports to Russia, which accounts for more than 50% of total exports, has helped to lift the economy. However, this expansion was supported by soft credits from commercial banks, especially for housing construction and agriculture.

The exchange rate was unified in September.

In September 1999, the authorities approved the Concept of Currency and the Monetary Policy for 2000, which envisages the unification of exchange rates and gradual introduction of a crawling peg exchange rate regime. The NBB, therefore, accelerated the depreciation of the official exchange rate in 2000 from BRB 320/US$ 1 at the beginning of the year to 1,020 in mid-September.The official exchange rate was then unified with the four main non-official exchange markets, which had by then converged to within 2% of each other from 25% at the beginning of 2000. The plan calls for a maximum rate of devaluation of 2% per month and for a 1% of GDP ceiling on the amount of monetary financing of the budget deficit. The plan envisages full currency convertibility for current account transactions and positive real interest rates. The latter was achieved by February 2000.

Privatisation

Privatisation process slows down.

According to the five-year economic development programme presented by the government in May 2000, the state will continue to play a dominant role in the economy. Reflecting this approach, progress in privatisation has slowed even further. In 1999, 238 Central Government Property (CGP) enterprises (mainly large industrial and agricultural companies) and 677 communal firms (mainly SMEs) were either transformed into joint-stock companies or changed ownership. In the first quarter of 2000, however, only 19 CGP enterprises and 39 communal enterprises were transformed. Even with these changes, relatively few companies have been truly privatised (defined as a reduction in the state share to less than 50%), with the majority having

Liberalisation, stabilisation, privatisation

1990

Oct	Small-scale privatisation begins

1991

Jul	Independence from Soviet Union

1992

Jan	VAT introduced
May	New currency (Belarussian rouble) introduced

1993

Jan	Privatisation law adopted

1994

Feb	Treasury bills market initiated
Apr	Voucher privatisation begins
Aug	Belarussian rouble becomes sole legal tender

1995

Jan	Customs Union with Russia and Kazakhstan
Jun	Most prices liberalised

1996

Jan	Currency corridor established
Apr	Interbank currency exchange nationalised
Dec	Price controls re-introduced

1997

Feb	Currency corridor abandoned
Apr	Belarussian-Russian Union Treaty

1998

Mar	Central bank control transferred to government
Jul	New custom code adopted
Jul	First voucher auction held in two years
Nov	Dual exchange rates introduced

1999

Mar	Profit and income tax laws amended
Mar	Dual exchange rates abolished
Dec	Inter-bank exchange market liberalised

2000

Feb	Presidential decree on land purchases
Mar	Currency exchange trading liberalised

Enterprises, infrastructure, finance and social reforms

1991
May Bankruptcy law adopted

1992
Dec Competition law adopted

1993
Mar Stock exchange established

1995
Apr Investment funds' licences suspended

1996
Feb All enterprises required to re-register
May State share in commercial banks increased

1997
Dec Energy regulation transferred to Ministry of Economy

1998
Jan Golden share rights for state in private companies introduced
Jul Belarus Stock Exchange nationalised
Sep Registration of new private businesses suspended

1999
Jan Railway Law adopted
Jan New civil code adopted
Mar New (unfavourable) business registration procedures adopted

been sold from one state entity to another. Only about 10% of republican enterprises and about 40% of communal enterprises have been genuinely privatised so far.

Soviet-style enterprises to continue dominating agriculture.
The presidential decree on private ownership of land signed in February 2000 excludes agricultural land. The agricultural sector remains largely unreformed and production has fallen in recent years, but the President has reiterated that collective farms and state enterprises should remain the foundation of the agricultural sector.

Enterprise reform

Slow restructuring in the industrial sector and inadequate growth of new private business.
Preliminary official data indicate that industrial production in Belarus grew by 5.6% in the first half of 2000, while capital investment increased by 4.4%. The structure of output, however, has not changed significantly since 1995, which points to a lack of restructuring. Moreover, 29% of industrial enterprises (both private and state-owned) recorded losses in the first quarter of 2000, pointing to the need for a hardening of enterprise budget constraints. Low levels of genuine privatisation, price and wage controls and pervasive soft budget constraints impede the restructuring of industry. The difficult business environment has meant that many smaller companies operate in the shadow economy. The introduction of re-registration and statutory minimum capital requirements will continue to inhibit the growth of new private business and foreign direct investment.

Recourse to barter has receded.
During the first quarter of 2000, there has been a reduction in the share of barter trade in comparison with the corresponding period of 1999. The share of barter in exports fell from 38% to 29%; the share of barter in imports fell from 36% to 22%. This reflects primarily increased cash transactions in trade with Russia. The demand for payments in cash for Russian exports of energy and the partial liberalisation in the Belarussian foreign exchange market have helped to lower the share of barter in trade with Russia in the first quarter of 2000 to less than 30% of imports and to under 50% of exports. Part of the decline in the share of barter trade may also reflect the imposition of the 15% barter fee that was introduced in July 1999. However, there were many exemptions and the fee was removed in August 2000.

Privatisation of Beltelecom, the dominant telecommunications operator, has been delayed.
The government has postponed its plan to privatise the national telecommunications operator, Beltelecom, in 2000. In June, explaining this postponement, the Belarussian President cited two main reasons for the delay: unfavourable market conditions (low potential price of the utility) and a desire to avoid mistakes made from rapid privatisations in other countries. He reiterated, however, that a new tender was being prepared. No time frame for its implementation has been set.

Energy subsidies provided by Gazprom remain pervasive.
Gazprom cut its gas supplies to Belarus by nearly one-third in March 2000, after it became increasingly less willing to tolerate arrears. Responding to this pressure, and influenced by the fact that the price of Russian gas has remained at the same level as 1999 (US$ 30 per 1,000 cubic metres), Belarus subsequently paid for almost all of the gas supplied by Russia between January and May 2000. However, the Belarussian gas company, Beltransgaz, has acknowledged that it still owes US$ 359 million (as of June) compared with US$ 423 million in September 1999, including US$ 250 million to Gazprom (US$ 274 million in September 1999).

Financial institutions

Banking sector continues to finance the state rather than the private sector.
The Belarussian banking sector consists of 28 commercial banks. However, four major banks (Belagroprombank, Belvnesheconombank, Belarusbank and Belbusinessbank), all of them directly or indirectly controlled by the state, dominate the banking system and account for nearly 60% of the assets, while the share of all state-owned banks together exceeds 80%. The activities of these banks focus on state-directed operations in the Belarussian GKO market to finance the government deficit, as well as support for loss-making enterprises. Lending to the private sector and bond operations are limited by the slow pace of both privatisation and growth of the new private sector. At end March 2000, the stock of credit to the private sector amounted to about 9% of GDP.

Social reform

Despite recorded growth, poverty is increasing.
While official statistics show positive GDP growth in both 1999 and in the first half of 2000, they also indicate a deterioration in living standards. Measured against the Minimum Subsistence Level of US$ 50 per month (Q2 2000), a poverty-line indicator introduced by the government in 1994, the share of the population with very low incomes rose to almost 47% in the first quarter of 2000 compared with under 44% by the end of 1998 and 32% in 1997. At the same time, the system of social support inherited from the planned economy relies heavily on price control for basic food, housing and communal services. This approach inhibits the efficient targeting of budget support to those most in need and contributes to significant price distortions and strains on the public finances.

Liberalisation
Current account convertibility – **limited**
Interest rate liberalisation – **limited de facto**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenues in GDP – **22.7%**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **vouchers**
Tradability of land – **limited de jure**

Enterprises
Competition office – **no**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **10%**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **no**

Social reform
Share of the population in poverty – **47%**
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	90.0	80.0	70.0	60.0	45.0	30.0	27.0	na	na
Number of goods with administered prices in EBRD-15 basket [1]	6.0	5.0	5.0	5.0	5.0	5.0	5.0	na	na
Share of total trade with non-transition countries (in per cent)	na	na	na	28.5	20.5	19.0	19.3	17.3	22.6
Share of trade in GDP (in per cent)	na	na	121.9	113.4	98.8	91.9	118.4	109.3	158.4
Tariff revenues (in per cent of imports) [2]	na	na	3.7	5.4	3.2	4.3	3.9	3.8	2.4
EBRD Index of price liberalisation	1.0	2.0	2.0	2.0	3.0	3.0	3.0	2.0	1.7
EBRD Index of forex and trade liberalisation	1.0	1.0	1.0	1.0	2.0	2.0	1.0	1.0	1.0
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	na	5.3	10.4	15.4	19.2	22.0
Privatisation revenues (cumulative, in per cent of GDP)	na	0.0	0.1	0.4	0.5	0.7	0.9	1.0	1.1
Private sector share in GDP (in per cent)	5.0	10.0	10.0	15.0	15.0	15.0	20.0	20.0	20.0
EBRD index of small-scale privatisation	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of large-scale privatisation	1.0	1.0	1.7	1.7	1.7	1.0	1.0	1.0	1.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	8.7	15.8	4.4	1.9	4.2	4.7	5.6	na
Effective/statutory social security tax rate (in per cent)	na	56.1	45.7	49.3	58.7	59.9	63.4	na	na
Share of industry in total employment (in per cent)	31.2	30.4	29.6	29.0	27.6	27.5	27.6	28.4	28.7
Change in labour productivity in industry (in per cent)	0.7	-4.7	-6.3	-13.1	-0.9	na	18.6	10.5	7.5
Investment rate (in per cent of GDP)	22.3	25.4	33.9	33.2	25.0	22.0	24.7	26.0	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	1.7	1.7	1.0	1.0	1.0
EBRD Index of competition policy	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	16.4	17.1	17.8	18.6	19.0	20.8	22.6	24.3	26.1
Railway labour productivity (1989=100)	67.4	52.6	46.5	33.6	29.9	28.8	32.6	32.2	35.9
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	na	na	1.5 (80)	1.1 (87)	na	na
Electricity consumption/GDP (1989=100)	107.5	104.6	100.0	101.7	102.8	100.3	94.3	90.3	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	1.1	1.3
Financial institutions									
Number of banks (of which foreign owned)	na	na	na	48 (na)	42 (1)	38 (1)	38 (2)	37 (3)	na
Asset share of state-owned banks (in per cent)	na	na	na	69.2	62.3	54.1	55.2	59.5	na
Bad loans (in per cent of total loans) [3]	na	na	na	8.4	11.8	14.2	12.7	16.5	na
Domestic credit to enterprises (in per cent of GDP)	na	na	na	17.6	6.2	6.7	8.5	17.1	9.7
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	2.0	1.0	1.0	1.0	1.0
EBRD index of reform of non-banking financial institutions	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	2.0	2.0	2.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	2.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	na	8.7	15.1	12.9	10.4	11.2	13.0	12.1	11.4
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	333.0	332.0	na
Basic school enrolment ratio (in per cent)	93.9	93.8	93.3	93.2	93.7	93.4	93.8	96.5	na
Earnings inequality (GINI-coefficient)	na	34.1	39.9	na	na	na	na	na	na

1 Data on price controls for coal, wood, rents and inter-city bus services were not available. Adding these to the number of controlled prices would bring the total up to 10 in 1991 and 9 in all subsequent years.

2 Refers to taxes on international trade.

3 Includes prolonged and doubtful debts.

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					(Percentage change in real terms)				
GDP	-9.6	-7.6	-12.6	-10.4	2.8	11.4	8.3	3.4	2.0
Private consumption	-7.9	-1.5	-14.5	-12.3	4.5	10.0	8.7	5.0	na
Public consumption	-15.3	-10.5	-3.0	-2.9	-0.2	8.4	5.8	2.0	na
Gross fixed investment	-18.1	-15.4	-17.2	-28.7	7.2	21.4	11.8	-13.7	na
Exports	na	na	28.1	90.8	27.1	23.9	-3.4	-2.3	na
Imports	na	na	21.4	79.8	26.5	24.9	-1.2	-8.6	na
Industrial gross output	-9.4	-10.0	-17.1	-11.7	3.5	18.8	11.0	9.7	na
Agricultural gross output	-8.5	3.7	-14.4	-4.7	2.4	-4.9	-0.4	-8.4	na
Employment					(Percentage change)				
Labour force (annual average)	-2.9	-0.6	-2.4	-5.7	0.1	-2.5	-1.1	1.2	na
Employment (annual average)	-2.6	-1.3	-2.6	-6.2	-1.0	0.1	-2.6	0.9	na
					(In per cent of labour force)				
Unemployment (end-year) [1]	0.5	1.4	2.1	2.7	3.9	2.8	2.3	2.1	na
Prices and wages					(Percentage change)				
Consumer prices (annual average)	970.8	1,190	2,221	709.3	52.7	63.8	73.2	293.8	168.4
Consumer prices (end-year)	1,559	1,996	1,960	244.0	39.3	63.4	181.7	251.3	105.8
Producer prices (annual average)	1,939	1,536	2,171	462.0	33.6	88.0	72.0	355.0	na
Producer prices (end-year)	3,270	2,320	1,867	122.0	31.0	89.0	200.1	242.5	na
Gross average monthly earnings in economy (annual average)	837.5	1,107	60	668.9	60.5	87.3	104.2	335.5	na
Government sector [2]					(In per cent of GDP)				
General government balance	-3.3	-5.2	-1.3	-6.9	-1.9	-1.2	-0.6	-5.6	-4.5
General government expenditure	47.8	57.8	47.3	43.0	42.7	46.1	46.5	47.9	na
General government debt	na	na	na	na	4.0	4.1	5.1	na	na
Monetary sector					(Percentage change)				
Broad money (M3, end-year)	na	na	1,888.3	164.1	52.4	111.4	276.0	132.7	na
Domestic credit (end-year)	na	na	2,030.9	226.5	58.8	115.1	300.5	142.5	na
					(In per cent of GDP)				
Broad money (M3, end-year)	na	34.6	38.1	15.0	14.8	16.2	32.8	17.5	na
Interest and exchange rates					(In per cent per annum, end-year)				
Refinancing rate	30.0	210.0	300.0	66.0	35.0	40.0	48.0	120.0	na
Treasury bill rate (3-month maturity)	na	na	320.0	70.0	37.0	38.4	43.2	80.0	na
Deposit rate (one year)	na	65.1	89.6	100.8	32.3	15.6	14.3	23.8	na
Lending rate (one year)	na	71.6	148.5	175.0	62.3	31.8	27.0	51.0	na
					(Belarussian roubles per US dollar)				
Official non-cash exchange rate (end-year) [3]	0.02	0.7	10.6	11.5	15.5	30.7	107.0	838.6	na
Official non-cash exchange rate (annual average) [3]	0.02	0.3	3.7	11.5	13.3	26.2	46.4	366.3	na
External sector					(In millions of US dollars)				
Current account	na	-435	-444	-458	-516	-788	-989	-257	-430
Trade balance	na	-528	-490	-666	-1,149	-1,335	-1,447	-599	-750
Merchandise exports	na	1,970	2,510	4,803	5,790	7,383	7,081	5,949	6,000
Merchandise imports	na	2,498	3,000	5,469	6,939	8,718	8,528	6,548	6,750
Foreign direct investment, net	na	18	11	15	73	198	142	225	100
Gross reserves (end-year), excluding gold	na	37	101	377	469	394	339	299	na
External debt stock [4]	na	na	2,197	2,684	2,142	2,345	2,612	2,457	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	0.2	0.4	0.8	0.8	0.5	0.5	0.5	na
					(In per cent of exports of goods and services)				
Debt service [5]	na	0.4	4.3	2.9	2.3	2.0	1.6	2.4	na
Memorandum items					(Denominations as indicated)				
Population (end-year, millions)	10.3	10.3	10.3	10.3	10.2	10.2	10.2	10.1	na
GDP (in millions of Belarussian roubles)	92	986	17,815	119,813	184,174	356,079	662,370	2,890,320	7,872,769
GDP per capita (in US dollars)	519.4	355.2	472	1,012	1,354	1,332	1,403	777	na
Share of industry in GDP (in per cent) [6]	40.4	30.9	30.8	31.4	34.6	35.8	36.5	35.0	na
Share of agriculture in GDP (in per cent) [6]	23.8	18.3	15.0	17.7	16.0	14.7	12.7	12.0	na
Current account/GDP (in per cent)	na	-11.9	-9.1	-4.4	-3.7	-5.8	-6.9	-3.3	-6.3
External debt – reserves (in US$ millions)	na	na	2,096	2,307	1,673	1,951	2,273	2,158	na
External debt/GDP (in per cent)	na	na	45.2	25.8	15.5	17.2	18.3	31.1	na
External debt/exports of goods and services (in per cent)	na	na	79.6	50.9	32.0	28.2	32.8	35.9	na

1 Officially registered unemployment.

2 General government includes the state budget, social funds, and extrabudgetary funds, excluding interbudgetary transfers.

3 A significant paralell market premium existed until mid-2000, peaking around 300% in December 1999.

4 Medium and long-term public and publicly guaranteed debt. From 1994 the debt stock includes short-term external debt.

5 Amortisation of public and publicly guaranteed debt and total interest payments.

6 Figures are based on current prices. Variations in the shares thus reflect *inter alia* changes in relative prices.

Bosnia and Herzegovina[1]

Key reform challenges

- **With privatisation proceeding slowly and sales being marred by irregularities, an acceleration of the privatisation process together with greater transparency in sales are urgently required.**
- **The restructuring and privatisation of state banks remains a major challenge; further delays to this programme would continue to stunt development of the banking sector.**
- **Existing labour and pension laws impose heavy burdens on employers and government finances; key reforms in these areas are needed both to decrease obstacles to investment and to improve government finances.**

Liberalisation

Excise taxes have finally been harmonised in the two Entities.
The governments of the two Entities agreed in June 1999 that they would harmonise excise taxes both between the two Entities and between domestically produced and imported goods, in order to eliminate distortions to cross-border trade and tax evasion. The final implementation of these measures, however, was delayed until March 2000. Inter-Entity trade appears to be rising (KM 27.6 million of goods traded in the first quarter of 2000, according to official data), although this level is low relative to external trade.

Konvertible Marka is now widely accepted in both Entities.
Following its introduction in 1998, the Konvertible Marka (KM) has gained rapid and widespread acceptance throughout the country and the use of other currencies such as the Deutschmark, the Croatian kuna and the Yugoslav dinar has greatly declined. From October 1999, all non-cash transactions between the two Entities and within the Federation have been in KM only. New KM1 and KM2 coins were issued in July 2000.

Stabilisation

Macroeconomic stability has been maintained and growth boosted by external aid.
The Bosnian economy successfully weathered the Kosovo crisis in 1999, with growth for the year estimated at 8-10%. Inflation remains subdued, due to both the currency board arrangement and relatively tight fiscal policies. However, the tax system remains complex and enforcement is often arbitrary, while military expenditures continue to be a substantial burden on the budget. The high growth rates of recent years have been sustained by external aid rather than private investment and a continuation of growth requires the pace of structural reform to be accelerated significantly.

Privatisation

Small-scale privatisation is making progress …
An important milestone in transition was the beginning of small-scale privatisation in the Federation in the second half of 1999. Enterprises are being sold either by auction or tender. By May 2000, the Federal Privatisation Agency and the ten Cantonal Privatisation Agencies had held 813 auctions or tenders, for a total value of KM 218 million (about 2% of BH GDP), two-thirds of which are to be paid in vouchers. Concerns have been raised in a number of cases about the lack of transparency of the process. In RS, small enterprises are being privatised through a mixture of cash and coupon sales. Vouchers are being issued to citizens based on registration, which started in January 2000. Following a pilot cash auction in July 1999, 53 small enterprises (including large enterprise spin-offs) had been privatised by August 2000.

… but large-scale privatisation has encountered delays.
Large, state-owned enterprises continue to dominate the economy in both Entities and progress in their privatisation has been slow. However, the pace of progress has increased recently. By August 2000, 40 large enterprises had been sold in tenders in the Federation, and 22 in RS. The International Advisory Group (IAG) on privatisation has been assisting the authorities to move ahead with the process by providing active assistance in a number of cases. In the Federation, about 1,000 large enterprises will be offered in the mass privatisation programme. In addition, the Federation Privatisation Agency and the IAG have agreed on a list of 86 companies (including telecommunications and power companies, railways and Air Bosnia) to be privatised by tender of a majority share, with minority stakes to be offered to the public. The IAG will appoint and pay for international experts for the tendering process. Tenders started in September 2000 and the process is expected to last two to three years. In RS, about 1,000 medium-sized companies will be offered through a mixture of vouchers and commercial sales, with sales expected to be completed before the end of the year.

In the strategic sector, the authorities in RS are close to agreement with the IAG on a full list of companies where the IAG will offer assistance, and these will then be offered for tender.

Enterprise reform

Labour laws in both Entities impede enterprise restructuring.
The labour laws applying in both Entities reflect in many ways the legacy of the former socialist system, with relatively generous benefits, high payroll taxes, and a large degree of rigidity in recruitment and redundancies. A new labour law passed by the Federation parliament in October 1999 failed to address these problems. In June 2000, the governments of both Entities announced their commitment to revising the laws, with help from the international community, in order to introduce more flexibility in the labour market. These measures, which include the elimination of waiting lists and the reduction of severance costs for those already on them, more flexible provisions on fixed-term contracts and less restrictive provisions on cancelling employment contracts, were approved by the Federation parliament in August 2000 and are expected

Liberalisation, stabilisation, privatisation

1992

Mar	Independence from Yugoslavia

1995

Dec	Civil war ends

1996

Oct	Law on privatisation agencies in the Federation enacted

1997

Aug	Central bank of BH established
Aug	Currency board established
Dec	Federation law on privatisation enacted

1998

Jun	Enterprise privatisation law adopted in RS
Jun	Konvertible Marka bank notes introduced
Jul	State umbrella law on privatisation adopted
Aug	VAT introduced in RS

1999

Apr	KM becomes convertible abroad
May	Preferential trade regime with Croatia and FRY abolished
Jun	Small-scale privatisation begins

2000

May	Framework privatisation law amended

Enterprises, infrastructure, finance and social reforms

1996

Jan	Federation banking agency established

1998

Mar	RS banking agency set up
Apr	Bank privatisation law enacted in the Federation
Jun	New company law adopted
Jun	Federation bank privatisation agency established
Jul	RS bank privatisation agency set up
Sep	New telecommunications law adopted
Oct	New banking law adopted in the Federation
Dec	Joint Power Coordination Center (JPCC) established

1999

Apr	Minimum bank capital requirements raised
Apr	Securities commission in the Federation established
Jul	Banking law adopted in RS

to be approved shortly in the RS parliament. Over the medium term, these measures should help to reduce unemployment, currently estimated at around 40% of the labour force.

Investors have been given greater protection from restitution claims.
In May 2000, the High Representative made an important amendment to the framework law on privatisation of enterprises and banks. This measure was designed to overcome two problems. One is the lack of a restitution law at the state level and the second is the often-unclear ownership of enterprises and banks scheduled for privatisation. The new amendment ensures that future restitution laws exclude restitution-in-kind of enterprises and banks that have been privatised. If restitution claims and previous ownership rights are upheld, adequate compensation must be paid to the new owners.

Infrastructure

Roads and railways are being upgraded with international support.
The infrastructure of BH continues to be upgraded with support from the international community. Under the Stability Pact's "Quick Start" infrastructure programme, the European Investment Bank (EIB) and bilateral donors are financing the upgrade of the road network through three new road projects. A second loan from the EIB, possibly with co-financing from other donors, to help rehabilitate the rail network is being considered.

Electricity generation remains separated along ethnic lines.
Electricity production in BH remains divided along ethnic lines. There are three power companies, one in RS and two in the Federation, of which one serves the Croat majority and the other the Bosniak-majority areas. Each operates in distinct geographical zones as vertically integrated, publicly owned monopolies. A large restructuring programme is in preparation, involving the EBRD, the EIB, the World Bank and bilateral donors in the framework of the Stability Pact. The programme is designed to reform the power sector by facilitating private participation in the sector and by introducing competition both among the utilities and from outside the country, in accordance with EU directives on the supply of electricity.

Financial institutions

Bank privatisation is proceeding very slowly …
At the end of 1999, there were 62 banks operating in BH; 44 in the Federation and 18 (including one postal savings bank) in RS. By March 2000, the total number had fallen to 56 (39 in the Federation and 17 in RS), of which six (all in the Federation) were in receivership. Despite the large number of banks, the sector is relatively concentrated with most assets in a small number of state-owned banks. Many banks are too small and under-capitalised to survive over the medium term and further consolidation in the sector is inevitable. 17 banks (ten in the Federation, seven in RS) are mainly or entirely state-owned and the privatisation programme for these banks is well behind schedule. New deadlines for their privatisation by the middle of 2001 have now been set in both Entities. Banks that fail to meet the deadline will be liquidated, even if they are solvent.

… but closure of the payments bureaux is on track.
Reforms to the payments system are proceeding on schedule. By the end of 2000, all payments bureaux are to be closed and their payments functions transferred to commercial banks. Banking agencies in both Entities are issuing licences to existing commercial banks for this purpose. By June 2000, 22 banks in the Federation and two banks in RS had received a licence. To assist the process, the central bank has decided to introduce a real-time gross settlement system as a means of settling accounts among commercial banks. An international tender for this system was issued in April 2000 and won by Logica of the United Kingdom.

Access to capital for SMEs remains very limited.
Slow progress in both Entities in restoring confidence to the banking system has meant that virtually the only sources of finance available to SMEs are from IFI and bilateral donors programmes. However, these programmes are insufficient to meet the demands of the sector, and SMEs face very high real interest rates on commercial bank loans. The recent entry of foreign strategic investors in the banking sector is expected to provide competitive pressure, which may improve borrowing terms for SMEs. Most programme funding is made available to SMEs outside the banking system, using a network of NGOs. The majority of these are aimed at providing highly subsidised loans to SMEs rather than building sound banking institutions that can sustain SME lending over the medium term. A more commercially oriented approach to programme funding of SMEs could enhance the sustainability of these important efforts.

Social reform

Proposed pension reforms are facing strong resistance.
The governments of both Entities continue to face substantial difficulties in many areas of social reform. Pension reform is a key priority, as the existing system contains large and unsustainable obligations to a number of groups, including war veterans. Legislation is currently before both parliaments to tackle the pension fund problems. Measures under consideration in both Entities include a reduction in eligibility for early retirement, the gradual establishment of a closer link between pension benefits and lifetime contributions, the elimination of discretionary pension increases, the month-to-month adjustment of benefits in line with available resources and increased transparency of pension and health fund finances. All of these measures are necessary to achieve sustainability, but are encountering considerable opposition.

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. FBH and RS are referred to as the "Entities".

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenues in GDP – **32%; 16%** [1]
Exchange rate regime – **currency board**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises
Competition office – **no**

Infrastructure
Independent telecoms regulator – **na**
Separation of railway accounts – **na**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **8%**
Deposit insurance system – **no**
Secured transactions law – **no**
Securities commission – **yes in the Federation**

Social reform
Share of the population in poverty – **na**
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	na	na	na	na	na
Share of total trade with non-transition countries (in per cent)	na	na	na	58.3	67.3	57.2	53.9	59.0	67.4
Share of trade in GDP (in per cent)	26.4	67.1	5.5	78.5	66.1	80.9	85.0	86.9	76.1
Tariff revenues (in per cent of imports)	na	na	na	na	na	10.5	8.6	9.2	na
EBRD Index of price liberalisation	na	na	na	na	na	na	na	3.0	3.0
EBRD Index of forex and trade liberalisation	na	na	na	na	na	na	na	2.0	2.7
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	na	na	na	na	na	na	na	na
Private sector share in GDP (in per cent)	na	na	na	na	na	na	na	35.0	35.0
EBRD index of small-scale privatisation	na	na	na	na	na	na	na	2.0	2.0
EBRD index of large-scale privatisation	na	na	na	na	na	na	na	2.0	2.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	na	na	na	1.1	0.1	0.3	na
Effective/statutory social security tax rate (in per cent)	na	na	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	na	na	na	na	na	na	na	na	na
Change in labour productivity in industry (in per cent)	na	na	na	na	na	na	na	na	na
Investment rate (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of enterprise reform	na	na	na	na	na	na	na	1.7	1.7
EBRD Index of competition policy	na	na	na	na	na	na	na	1.0	1.0
Infrastructure									
Main telephone lines per 100 inhabitants	na	14.2	14.6	7.1	5.4	9.0	8.4	9.1	9.6
Railway labour productivity (1989=100)	na	na	na	na	na	100.0	85.5	88.7	97.5
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	na	na	4.4 (60)	3.6 (60)	3.5 (86)	5.1 (94)
Electricity consumption/GDP (1989=100)	143.3	150.4	164.1	28.6	26.6	16.2	12.8	11.8	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	na	1.7
Financial institutions									
Number of banks (of which foreign owned)	na	na	na	na	na	na	na	na	na
Asset share of state-owned banks (in per cent)	na	na	na	na	na	na	na	na	na
Bad loans (in per cent of total loans)	na	na	na	na	na	na	na	na	na
Domestic credit to enterprises (in per cent of GDP)	na	na	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	na	na	na	na	na	na	na	2.0	2.3
EBRD index of reform of non-banking financial institutions	na	na	na	na	na	na	na	1.0	1.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	2.0	2.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	1.0	1.0
Social sector									
Expenditures on health and education (in per cent of GDP)	na	na	na	na	na	na	na	na	na
Mortality rate (per 1,000 male adults)	na	19.0	na	na	na	na	170.0	165.0	na
Basic school enrolment ratio (in per cent)	na	na	na	na	na	na	na	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

[1] The figures are for 1998 and refer to the Federation and Republika Srpska respectively.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	Projection
Output and expenditure					(Percentage change in real terms)				
GDP	na	na	na	20.8	69.0	30.0	12.4	10.0	15.0
Total consumption	na	na	na	4.8	52.5	15.0	7.6	na	na
Gross fixed investment	na	na	na	67.1	175.1	61.3	5.2	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	na	na	na	33.0	38.1	51.4	18.5	na	na
Agricultural gross output	na	na	na	-9.7	28.4	22.8	8.6	na	na
Employment					(Percentage change)				
Labour force (end-year)	-12.5	-10.5	-12.5	-12.5	-12.5	4.1	na	na	na
Employment (end-year) [1]	na	-54.3	11.2	67.8	69.4	0.1	16.9	2.5	na
					(In per cent of labour force)				
Unemployment (end-year)	na	na	na	na	na	37.0	38.0	40.0	na
Prices and wages					(Percentage change)				
Consumer prices (annual average) [2]									
Federation (KM based)	na	na	780.0	-4.4	-24.5	14.0	5.1	-0.3	3.0
Republika Srpska (DM based)	na	na	1,061.0	12.9	16.9	-7.3	2.0	14.0	3.0
Consumer prices (end-year)									
Federation (KM based)	na	na	na	na	7.7	13.6	1.8	-1.0	3.0
Republika Srpska (DM based)	na	na	na	na	-17.7	-10.0	5.6	14.0	3.0
Net average monthly earnings in economy (annual average)									
Federation	na	na	na	na	289.5	66.6	6.3	17.2	na
Republika Srpska	na	na	na	na	41.7	62.4	52.2	60.0	na
Government sector					(In per cent of GDP)				
General government balance	na	na	na	-0.3	-4.4	-0.5	-7.4	-5.7	-5.0
General government expenditure	na	na	na	39.3	52.7	40.9	53.3	50.5	na
Monetary sector					(Percentage change)				
Broad money (end-year) [3]	na	na	na	8.5	96.2	52.0	31.3	33.9	na
Domestic credit (end-year)	na	na	na	-9.0	13.3	24.7	11.2	-1.3	na
					(In per cent of GDP)				
Broad money (end-year) [3]	na	na	17.9	14.8	18.8	19.8	22.6	26.0	na
Exchange rates					(Dinar/KM per DM)				
Exchange rate (annual average) [4]	na	na	na	100.0	100.0	1.0	1.0	1.0	na
External sector					(In millions of US dollars)				
Current account	na	na	-177	-193	-748	-1,060	-1,043	-767	-800
Trade balance	66	-53	-803	-930	-1,546	-1,758	-1,709	-1,415	-1,460
Merchandise exports [5]	495	7	91	152	336	575	817	973	1,000
Merchandise imports [5]	429	60	894	1,082	1,882	2,333	2,526	2,388	2,460
Foreign direct investment, net [6]	na	na	0	0	0	0	100	60	100
Gross reserves (end-year), excluding gold	na	na	na	na	235	80	175	475	na
External debt stock [7]	na	na	na	3,361	3,620	4,076	2,981	3,226	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	na	0.6	0.6	1.2	0.4	0.7	2.2	na
					(In per cent of exports of goods and services)				
Debt service due [7]	na	na	na	118.0	53.0	16.0	16.6	8.0	na
Memorandum items					(Denominations as indicated)				
Population (end-year, millions) [8]	4.2	4.1	4.2	4.2	4.1	4.2	4.2	4.3	na
GDP (in millions of markas)	na	na	203,498	267,568	412,463	5,936	6,860	8,110	9,600
GDP per capita (in US dollars)	325	297	299	445	669	815	928	1,027	na
Share of industry in GDP (in per cent)	na	na	na	23.9	21.4	22.6	22.5	na	na
Share of agriculture in GDP (in per cent)	na	na	na	24.6	20.5	17.5	16.0	na	na
Current account/GDP (in per cent)	na	na	-14.1	-10.3	-27.3	-31.0	-28.2	-17.4	na
External debt – reserves (in US$ millions)	na	na	na	3,154	3,162	3,797	2,643	2,677	na
External debt/GDP (in per cent)	na	na	na	180.0	132.1	119.1	76.5	70.6	na
External debt/exports of goods and services (in per cent)	na	na	na	882.2	550.2	406.8	218.2	199.4	na

1 Bosniak-majority area prior to September 1996, Federation thereafter. Before September 1996 data include personnel who are not actually working but for whom contributions (pension, health) are paid.

2 Before 1995, Retail Price Index (RPI) is used. From 1995, Consumer Price Index (CPI) is used.

3 Country-wide monetary aggregates.

4 Pre-1997 refers to Bosnian dinar. Since August 1997, Bosnia and Herzegovina has a common cental bank. The new currency, the Konvertible Marka (KM) is pegged to the Deutschmark at 1:1 under currency board rules.

5 Data for 1992-93 are based on limited customs data for the Bosniak-majority area. 1994-98 data are rough estimates for the whole territory of Bosnia and Herzegovina.

6 Excludes capital transfers for reconstruction.

7 Projected external debt and debt service for 1998 exclude debt relief.

8 Includes refugees abroad.

Bulgaria

Key reform challenges

- **While privatisation is nearly complete, restructuring of privatised enterprises, particularly those sold to management, remains a challenge owing to ineffective corporate governance and bankruptcy procedures.**
- **Due to the implementation of the new energy law, partial privatisation of the energy sector should now advance, but privatisation of the dominant telecommunications operator needs to be relaunched.**
- **Financial intermediation remains scarce and credit to the private sector low. Although significant progress has been made with bank and insurance privatisation, the regulatory framework needs strengthening.**

Liberalisation

Bulgaria was invited to start EU accession negotiations.
Following a shift in the EU enlargement strategy, Bulgaria was invited to start EU accession negotiations in December 1999. Although actual EU membership is many years off, the EU decision to accept Bulgaria as a candidate should have tangible benefits including in the form of greater policy stability.

Stabilisation

Budgetary reforms aim to ensure fiscal sustainability.
Most extrabudgetary funds were closed in 1999. Substantial steps are being taken towards creating a Unified Revenue Agency which will consolidate the collection of taxes and social contributions under a single agency. This should enable the presently high tax and contribution rates to be reduced over the medium term and also help to curb widespread evasion and underreporting.

Public external debt is decreasing, but dependence on official financing remains high.
The external debt to GDP ratio at the end of 1999 was about 80%, down from 96% in 1997. The short-term debt to reserve ratio has also fallen to less than 18% in 1999 from 57% in 1996. Export and GDP growth are likely to reduce external debt ratios over the medium term to levels that, while still high by international standards, are financially manageable. No sovereign Eurobond has yet been issued by the government, and dependence on official financing remains large.

Privatisation

With a record number of sales, privatisation nears completion.
Enterprise privatisation made remarkable progress in 1999, with 1,224 transactions completed. By the end of the year, over 70% of privatisable assets had been sold, compared with 42% a year earlier. Major sales in the industrial and service sectors included the oil refinery Neftochim, the steel giant Kremikovtsi, the fertiliser producer Agropolychim and Balkan Airlines. Management buy-outs remained the most common form of privatisation in 1999. However, the year also saw several privatisations of majority stakes of large enterprises annulled because of purchaser non-payments. The Privatisation Agency has cancelled these transactions and opened new privatisation procedures. In the first half of 2000, the government continued with the sale of enterprises, including Geosol (salt) and Stomana (steel).

Land restitution advances significantly.
By the end of 1999, land restitution was 96% complete, up from 80% at the end of 1998. However, only about 40% of the land subject to restitution has been titled. Further steps are also needed to instigate the emergence of a functioning land market, including improvements in the process of land registration.

Enterprise reform

Programme to promote financial discipline has been largely completed.
A programme of “isolation” and liquidation targeting the largest loss-making state-owned enterprises was launched in 1996 when 30 state-owned utilities (group A) and 48 state-owned commercial enterprises (group B) were cut off from bank credit, thereby forcing a fundamental restructuring of their operations. The programme has helped to improve the operational and financial performance of many targeted enterprises. All group B enterprises have now exited the programme, with 31 being privatised, 13 under liquidation, and three under insolvency proceedings. By the end of 1999, production in all group B enterprises under liquidation had ceased, and by the middle of 2000, the majority of assets put under liquidation had been sold. The financial performance of some of the group A enterprises remains a source of concern.

Enterprise restructuring remains sluggish.
Despite measures taken in the wake of the 1996 to 1997 crisis to promote financial discipline and to provide incentives for restructuring, its pace remains slow. Labour productivity growth in Bulgaria has been well below that of other countries in the region. In addition to weak bankruptcy implementation, the underdeveloped state of the capital market limits the mechanisms for disciplining and removing ineffective management. Restructuring is also impeded by the scarcity of new commercial credit and by insider ownership.

Liberalisation, stabilisation, privatisation

1991

Feb	Most consumer prices liberalised
Feb	Import controls removed
Feb	Interest rates liberalised
Feb	Unified exchange rate introduced
Jul	Treasury bills market initiated

1992

Feb	Restitution law enacted
Apr	Privatisation law adopted

1993

Jan	Small-scale privatisation law adopted
Feb	Large-scale privatisation begins
Jul	EFTA membership

1994

Mar	Currency crisis
Apr	VAT introduced
Nov	Debt-equity swaps added to privatisation

1995

Jan	EU Association Agreement
Oct	Price controls reinstalled

1996

Oct	First voucher privatisation round begins
Dec	WTO membership

1997

Feb	Macroeconomic crisis peaks
Jul	Currency board introduced
Oct	New Foreign Investment Act adopted

1998

Jan	Comprehensive tax reform begins
Mar	Privatisation law amended
May	First company privatised through the stock exchange
Sep	Full current account convertibility introduced

1999

Jan	CEFTA membership
Jan	Second voucher privatisation round begins
May	First municipal Eurobond issued
Jul	Currency redenominated

2000

Jan	Extrabudgetary funds closed
Mar	EU accession negotiations begin

Enterprises, infrastructure, finance and social reforms

1991

May	Competition law adopted
May	Competition agency established
Jun	Commercial code enacted
Nov	First Bulgarian Stock Exchange established

1992

Mar	Banking law adopted
Mar	Loan classification and provisioning introduced
May	Stock exchange begins trading

1993

Mar	BIS capital adequacy enacted

1994

Jul	Bankruptcy law adopted

1995

Feb	Railway law adopted
Jul	Securities law adopted
Jul	Securities commission established
Dec	Social insurance law adopted

1996

May	Bankruptcy law amended
May	Special restructuring programme enacted

1997

Feb	Financial crisis peaks
Jul	First bank privatisation
Jul	New banking law adopted
Oct	Stock exchanges consolidated

1998

Jul	New telecommunications law adopted
Sep	Energy sector reform begins

1999

Jul	Law on additional voluntary pension insurance passed
Jul	New energy law enacted
Jul	Health Insurance Fund established
Aug	First corporate Eurobond issued
Dec	Law on reformed state pension scheme passed

2000

Jan	Law on securities offerings adopted

Infrastructure

Comprehensive reform strategy for the energy sector advances …

The strategy envisages the phasing out of energy subsidies over a three-year period that began in September 1998. A new energy law was adopted in the middle of 1999, providing the legal and regulatory framework for the market-based development of the energy sector and for an independent regulatory agency. The National Electricity Company (NEK) has been unbundled into separate corporate entities specialising in power generation, transmission and distribution. The law also allows for some third-party access to the transmission networks for electricity and gas once prices are liberalised in 2001. Advanced discussions are taking place regarding the sale of two power plants, Maritza East 1 and 3.

… but privatisation of the telecommunications company has failed.

Two years since the start of the privatisation, the government announced in August 2000 that the negotiations to sell 51% of the state-owned operator, Bulgarian Telecommunications Company (BTC), to a consortium of KPN Telecom and OTE had failed. Although this is an important setback to investor confidence, a new tender for the sale will be held. Completion of the privatisation is now scheduled for 2001.

Financial institutions

Bank privatisation is nearing completion …

A 98% share of Express Bank has been sold to Société Générale and a 98% stake in HebrosBank was acquired by the Regent Pacific Group in late 1999. The largest bank, Bulbank, was sold in the middle of 2000 to a consortium led by UniCredito with Allianz. The privatisation process for Biochim Bank experienced a setback when it was cancelled after the selection of a bidder. A new procedure will be initiated in the autumn of 2000. Completion of these sales would leave only the State Savings Bank (SSB) in public ownership.

… although bank intermediation remains limited.

Although the banking sector is liquid and profitable, bank credit available to the private sector remains very low, at only 12% of GDP at the end of 1999. Banks continue to hold government bonds instead of extending commercial loans. Several steps are being taken to promote prudent credit expansion, including continued bank privatisation, the creation of a central credit registry (improving the information on which credit decisions are based), the training of judges and a new law on land registration and cadastre, which would facilitate the use of land as collateral.

Regulation of the financial sector has improved …

Following bank consolidation and a tightening of regulation and supervision since 1997, banking sector soundness has improved substantially. The incidence of violations of major requirements (including capital adequacy, open foreign currency positions, and loan concentrations to individual borrowers) has been reduced significantly. Nevertheless, accounting standards and disclosure rules for banks still need to be applied more stringently and supervision efforts need to be strengthened. The regulaory and supervisory foundations for securities and the non-banking financial sector are largely in place. The new Law on Public Offerings of Securities became effective in January 2000, bringing the legal framework of Bulgaria's securities markets in line with EU requirements. Also in line with international practice, the new Law on Insurance defines two-tier insurance supervision, and the insurance industry is now operating under the regulations and supervision of the Insurance Directorate. However, some financial institutions such as finance companies and investment holdings are still unregulated.

… but the securities market remains limited.

Although a large number of companies are listed on the Bulgarian Stock Exchange (BSE), overall trade volumes are extremely low and many of the smaller companies have not traded at all. Public information on listed companies needs to be improved to foster market transparency. Some companies have pioneered the bond market in 1999 with small issues.

Social reform

Ambitious reforms to the pension and health systems were initiated.

Under 1999 health reforms, a Health Insurance Fund was created, which will gradually contract out health care provision to competing agencies including a mix of public and private providers. The government is also implementing a much-needed reform of the pension system. The proposed three-pillar system consists of a public pay-as-you-go system, a mandatory privately managed second pillar, and a voluntary third pillar. Legislation for the reformed state scheme (first pillar) was passed in August 1999 in the form of the Social Insurance Code, and its phased implementation, including a raising of the minimum retirement age and a substantial reduction in early retirement categories, started in 2000. The legislative base for the third pillar (additional voluntary private contributions) was also adopted in July 1999, paving the way for the introduction of regulated private pension funds. So far about a dozen funds have been established.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Social reform
Share of the population in poverty – **33%**
Private pension funds – **yes**

Stabilisation
Share of general government tax revenues in GDP – **30.8%**
Exchange rate regime – **currency board**

Enterprises
Competition office – **yes**

Financial sector
Capital adequacy ratio – **12%**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	24.0	16.0	26.0	43.0	46.0	52.0	14.4	15.8	17.2
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	3.0	3.0	3.0	3.0	2.0	1.0	1.0
Share of total trade with non-transition countries (in per cent)	80.0	85.1	84.2	76.1	65.4	66.2	72.0	76.9	80.4
Share of trade in GDP (in per cent)	98.4	94.4	77.0	81.2	80.6	97.6	93.2	71.5	73.3
Tariff revenues (in per cent of imports)	2.2	4.5	7.2	7.6	7.3	4.6	4.8	5.5	2.8
EBRD Index of price liberalisation	3.0	3.0	3.0	3.0	2.0	2.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	3.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.3
Privatisation									
Share of small firms privatised (in per cent)	na	na	0.9	2.6	7.2	15.2	21.1	na	na
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.0	0.0	0.2	0.7	1.5	4.7	6.4	8.7
Private sector share in GDP (in per cent)	20.0	25.0	35.0	40.0	50.0	55.0	60.0	65.0	70.0
EBRD index of small-scale privatisation	1.0	1.0	1.7	2.0	3.0	3.0	3.0	3.0	3.3
EBRD index of large-scale privatisation	1.0	1.7	2.0	2.0	2.0	2.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	2.0	1.4	1.9	1.4	1.1	0.8	0.7	2.1	1.5
Effective/statutory social security tax rate (in per cent)	49.7	47.8	45.3	45.2	43.1	43.6	44.2	na	na
Share of industry in total employment (in per cent)	34.5	32.6	30.4	29.1	28.1	27.5	26.6	24.7	23.9
Change in labour productivity in industry (in per cent)	-3.8	7.9	2.3	9.9	-3.3	na	-4.3	12.3	-2.8
Investment rate (in per cent of GDP)	18.2	16.2	13.0	13.8	15.7	8.4	11.4	14.7	16.4
EBRD index of enterprise reform	1.0	1.0	1.0	2.0	2.0	2.0	2.3	2.3	2.3
EBRD Index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	24.7	26.3	27.2	33.5	30.6	31.3	32.3	32.9	34.2
Railway labour productivity (1989=100)	58.2	62.9	70.0	69.9	76.9	74.0	80.7	73.4	65.3
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	1.42 (82)	2.18 (85)	3.5 (85)	1.9 (89)	2.4 (110)	2.8 (112)
Electricity consumption/GDP (1989=100)	101.9	102.7	103.3	101.3	108.6	123.8	137.3	na	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.7	3.0
Financial institutions									
Number of banks (of which foreign owned)	75 (0)	79 (0)	41 (0)	40 (1)	41 (3)	42 (3)	28 (7)	na	na
Asset share of state-owned banks (in per cent)	na	na	na	na	na	82.2	66.0	na	na
Bad loans (in per cent of total loans)	na	na	6.6	6.8	12.6	14.6	12.9	na	na
Domestic credit to enterprises (in per cent of GDP) [1]	7.2	5.8	3.7	3.8	21.1	35.6	12.6	12.7	14.6
Stock market capitalisation (in per cent of GDP)	na	na	na	na	0.5	0.2	0.0	7.7	6.0
EBRD index of banking sector reform	1.0	1.7	2.0	2.0	2.0	2.0	2.7	2.7	2.7
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	3.0	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	3.0	4.0	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	11.0	12.6	10.4	8.6	7.7	6.5	7.4	7.4	na
Mortality rate (per 1,000 male adults)	na	na	na	na	213.1	na	213.0	222.0	na
Basic school enrolment ratio (in per cent)	97.3	95.1	94.0	94.3	93.7	93.6	94.0	94.3	na
Earnings inequality (GINI-coefficient)	26.2	na	25.1	na	na	29.1	na	na	na

1 Credit expansion in 1995 and 1996 was followed by a banking crisis in 1997, greatly reducing the stock of credit to the enterprise sector.

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					*(Percentage change in real terms)*				
GDP	-7.3	-1.5	1.8	2.1	-10.9	-6.9	3.5	2.4	4.0
Private consumption	1.0	-0.7	-2.6	-1.8	-2.1	-15.7	8.1	5.2	na
Public consumption	-14.6	-12.6	-11.5	-7.4	28.7	-11.5	4.1	-0.4	na
Gross fixed investment	-7.3	-17.5	1.1	8.8	-52.8	-23.9	16.4	25.3	na
Exports of goods and services	na	na	na	na	na	3.1	-15.6	-5.2	na
Imports of goods and services	na	na	na	na	na	-2.7	-2.8	5.1	na
Industrial gross output	-6.4	-6.2	5.9	-5.4	-11.8	-11.3	4.3	-12.5	na
Agricultural gross output	-14.8	-30.2	9.4	14.5	-7.4	32.9	1.4	0.6	na
Employment					*(Percentage change)*				
Labour force (annual average)	-3.3	-0.1	-3.1	-0.6	1.6	-2.2	-1.7	na	na
Employment (annual average)	-8.1	-1.6	0.6	1.3	0.1	-3.9	-0.1	-6.9	na
					(In per cent of labour force)				
Unemployment (end-year)	15.3	16.4	12.8	11.1	12.5	13.7	12.2	16.0	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	82.0	73.0	96.3	62.0	123.0	1,082	22.2	0.7	7.0
Consumer prices (end-year)	79.2	63.9	121.9	32.9	310.8	578.6	0.9	6.2	5.0
Producer prices (annual average)	55.9	26.9	75.0	52.7	126.9	901.8	20.8	2.0	na
Producer prices (end-year)	40.2	24.9	105.3	38.9	356.7	472.6	0.2	18.6	na
Gross average monthly earnings in economy (annual average)	113.5	57.8	53.5	53.2	89.4	815.9	46.5	5.1	na
Government sector [1]					*(In per cent of GDP)*				
General government balance	-2.9	-8.7	-3.9	-5.7	-10.4	-2.1	0.9	-0.9	-1.5
General government expenditure	43.6	48.1	45.7	41.3	42.3	33.5	35.8	40.7	na
General government debt	158.7	150.9	159.6	104.1	145.0	109.1	96.6	96.6	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	53.7	47.6	78.6	39.6	124.5	359.3	9.6	11.4	na
Domestic credit (end-year)	57.2	56.0	37.1	16.8	216.8	155.5	-17.7	0.2	na
					(In per cent of GDP)				
Broad money (M3, end-year)	79.0	78.3	79.5	66.3	74.9	35.3	30.6	32.3	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Base interest rate	41.0	52.0	72.0	34.0	180.0	6.7	5.1	4.5	na
Interbank interest rate (up to 30-day maturity)	na	68.3	108.0	44.2	448.8	1.6	2.9	2.6	na
Deposit rate (one month)	45.3	53.6	72.3	25.3	211.8	3.0	3.3	3.3	na
Lending rate (less than one year)	64.6	83.7	117.8	51.4	480.8	13.9	13.3	14.1	na
					(Leva per US dollar)				
Exchange rate (end-year)	0.024	0.033	0.066	0.071	0.487	1.777	1.675	1.947	na
Exchange rate (annual average)	0.023	0.028	0.054	0.067	0.178	1.674	1.760	1.836	na
External sector					*(In millions of US dollars)*				
Current account	-360	-1,099	-31	-26	16	428	-62	-681	-700
Trade balance	-212	-885	-17	121	188	380	-381	-1,081	-1,200
Merchandise exports	3,956	3,727	3,935	5,345	4,890	4,940	4,193	4,006	4,500
Merchandise imports	4,169	4,612	3,952	5,224	4,703	4,559	4,574	5,087	5,700
Foreign direct investment, net	42	40	105	98	138	507	537	806	500
Gross reserves (end-year), excluding gold	902	655	1,002	1,236	518	2,121	2,679	2,900	na
External debt stock	13,806	13,836	11,338	10,148	9,602	9,760	10,260	9,989	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	2.0	1.3	2.3	2.3	1.0	4.4	5.4	5.3	na
					(In per cent of current account revenues, excluding transfers)				
Debt service	8.6	8.6	27.4	13.5	16.8	13.8	19.0	16.9	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	8.48	8.46	8.43	8.38	8.34	8.28	8.23	8.20	na
GDP (in millions of levas)	201	299	526	880	1,749	17,055	21,577	22,776	25,500
GDP per capita (in US dollars)	1,014	1,281	1,152	1,563	1,179	1,230	1,490	1,513	na
Share of industry in GDP (in per cent) [2]	39.0	32.7	29.9	31.0	28.5	25.3	25.5	24.6	na
Share of agriculture in GDP (in per cent) [2]	11.6	9.9	11.5	12.7	14.5	23.8	18.8	15.9	na
Current account/GDP (in per cent)	-4.2	-10.1	-0.3	-0.2	0.2	4.2	-0.5	-5.5	-5.5
External debt – reserves (in US$ millions)	12,904	13,181	10,337	8,912	9,084	7,639	7,581	7,089.3	na
External debt/GDP (in per cent)	160.4	127.7	116.8	77.4	97.7	95.8	83.7	80.5	na
External debt/exports of goods and services (in per cent)	274.6	282.5	218.4	149.8	153.5	155.5	171.5	172.5	na

1 General government includes the state, municipalities and extrabudgetary funds.

2 After 1995, the industrial classification is changed. Using the old classification, industry as a share of GDP was 32.4% in 1996 and the share of agriculture in GDP was 12.8%.

Croatia

Key reform challenges

- **While an economic recovery is under way, addressing the structural weaknesses in government finances, particularly welfare expenditures and contingent liabilities, is necessary to maintain macroeconomic stability.**
- **Privatisation, including liquidation, of remaining state-owned enterprises would not only help the budget, but would also harden budget constraints and strengthen corporate governance.**
- **Improving bankruptcy procedures and court administration and increasing transparency in the corporate sector would promote enterprise restructuring and investment finance, including foreign direct investment.**

Liberalisation

Croatia joins the WTO.
In July 2000, the WTO general council approved the entry of Croatia, which has committed to reduce agricultural and industrial protection. Agreed measures include reductions in rates of duty and increases in tariff rate quotas for beef, port, wheat, sugar and chocolate by 2005. For most industrial products, maximum tariff rates will be 10% or less by the end of the transition period. These reductions will be phased in over the period to 2005, although some will be introduced immediately. However, duties on textiles will only be reduced to 14%. In services, Croatia has committed to liberalise fixed-line telecommunications services from 2003.

Stabilisation

The central bank commits to maintain a managed float …
The new central bank governor announced that monetary policy would continue to focus on exchange rate stability. The policy of the central bank has been (since the introduction of a new currency in 1994) to maintain exchange rate stability through a managed float regime and its ability to achieve this aim has been reinforced by the steady accumulation of international reserves, which now stand at more than 200% of the monetary base. However, the independence of the central bank has recently been weakened by politicisation of the decision of the central bank in March 2000 to place two small regional banks under bankruptcy procedures. In April, the parliament rejected the central bank's report on its activities in 1998 and all the board members including the governor offered their resignations to the parliament, which were subsequently accepted. New board members have since been appointed.

… but growing structural deficits pose risks to macroeconomic stability.
The fiscal deficit (excluding privatisation receipts) widened from 0.4% of GDP in 1998 to 6.2% of GDP in 1999. Increasing deficits in the pension and health funds were one of the main reasons. These shortfalls reached 8% of GDP in 1999. Approval of a three-pillar pension system in 1998 was aimed at restoring the balance of the pension fund over the long term, but in the short term it will add to the fiscal burden. Contingent liabilities of the government have also increased in recent years. These liabilities include guarantees to troubled industries (such as shipbuilding, tourism and agriculture) and to enterprises being prepared for privatisation, provision of deposit insurance to partially cover liabilities of the bankrupt banks (80%), and pension liabilities based on the constitutional court ruling in 1998 which ruled illegal certain changes in the pension benefits. These liabilities are estimated to have reached HRK 41 billion (29% of 1999 GDP) by the end of 1999. If these structural imbalances are not addressed in the medium term, they will result either in the explosion of government debt or further increases sin taxes.

Privatisation

Significant privatisation challenges remain.
While voucher privatisation implemented in 1998 has accelerated the divestiture of residual stakes held by the privatisation fund, the state still retained at the end of 1999 stakes in 1,610 enterprises, of which 851 were loss-making. It held majority stakes in 329 companies. Offsetting the sales by the privatisation fund has been the acquisition of shares by the bank rehabilitation agency through the resolution of bank insolvencies. In the middle of 2000, the government decided to consolidate state holdings of shares by various agencies (except for shares of large enterprises in infrastructure and shipbuilding) into the privatisation fund so they could be managed more effectively. In the case of strategic companies (mainly in infrastructure) there is a renewed determination to privatise the remaining state shareholding in Croatia Telecoms (HT) and to begin the privatisation of INA (an oil and gas company) and Croatian Energy.

Liberalisation, stabilisation, privatisation

1991

Apr	First privatisation law adopted
Jun	Independence from Yugoslavia
Dec	New currency (Croatian dinar) introduced

1992

Jul	Large-scale privatisation begins

1993

Jan	Croatian privatisation fund established
Oct	Macroeconomic stabilisation programme

1994

May	New currency (kuna) introduced

1995

May	Full current account convertibility introduced

1996

Mar	New privatisation law enacted
Jul	Most non-tariff import barriers removed
Jul	Treasury bills market initiated

1997

Jan	Restitution law enacted
Feb	First sovereign Eurobond

1998

Jan	VAT introduced
Jun	Voucher privatisation programme begins

2000

Jul	WTO membership

Enterprise reform

Many enterprises operated with soft-budget constraints …
Over the past two years, as the economy experienced recession, total arrears (tax arrears, inter-enterprise arrears and government arrears to enterprises) rose to an unprecedented 20% of GDP by the end of 1999. The number of insolvent enterprises in the economy has also increased. Ineffective bankruptcy laws and procedures have allowed many insolvent enterprises to remain active. Despite the amendment of the law in March 1999 to strengthen creditor rights and to accelerate the judicial and receivership processes, bankruptcies have been held back by slow court procedures. However, the new government has begun to liquidate state-owned enterprises held by the privatisation fund in an effort to reduce its exposure to losses. The total arrears in the economy began to decline by the second quarter of 2000 as the government settled outstanding arrears to enterprises through cash payments, issuance of government notes that could be discounted by banks and tax off-sets.

Enterprises, infrastructure, finance and social reforms

1993

Jan	IAS becomes effective
Oct	Banking law adopted
Nov	Company law enacted

1994

Mar	Stock exchange begins trading
Jun	Railways established as joint-stock company
Jun	Bank rehabilitation law enacted

1995

Jan	Electricity law adopted
Jun	Competition law adopted
Nov	Bank rehabilitation begins
Dec	Capital adequacy requirement becomes effective
Dec	Securities and investment fund laws adopted

1996

Mar	Pliva lists shares in London
Oct	Securities and exchange commission established

1997

Jan	New bankruptcy law becomes effective
Mar	Competition agency established

1998

Apr	Dubrovacka Banka crisis
Jul	First pension reform law adopted
Jul	First rehabilitated bank privatised
Dec	New banking law becomes effective

1999

Jan	Separation of post and telecoms
Mar	New bankruptcy law enacted
Jun	Telecommunications privatisation law adopted
Oct	Croatia Telecommunications partially privatised

… while an unfavourable investment climate impeded foreign investment.

Compared to other advanced transition economies, Croatia ranks among the middle group with respect to cumulative per capita FDI inflows through 1999. FDI has concentrated on a few large privatisations (most notably, Pliva, HT and several banks). There has been little FDI in other sectors, reflecting a privatisation process that was dominated by management and employee buy-outs. Foreign investment was also deterred by the non-transparent relationships between the former ruling party and favoured business-persons. Asset stripping by the incumbent management has been widespread and there were many reported incidents of foreign investors that have been defrauded by their local partners. The lack of effective outside ownership, including foreign investors, in privatised companies has weakened corporate governance and constrained restructuring.

Infrastructure

Croatia Telecoms is partially privatised …

In 1999, reflecting in part budgetary financing needs, the government privatised a 35% strategic stake of the fixed-line telecommunications monopoly, Croatia Telecoms (HT), to Deutsche Telekom for about US$ 850 million. The government is preparing to privatise further stakes through domestic and international public offerings in 2001. Ahead of the sale of HT, a new law providing for the establishment of a fresh regulatory framework and an independent regulator was adopted. However, the regulator has yet to be established. This step is necessary for the further liberalisation of the sector under WTO commitments.

… while reforms of the integrated electric power monopoly advance.

The new government is planning to accelerate market liberalisation of the electricity sector for which the privatisation of Croatian Energy (HEP) would be a key element. It is currently developing a new energy law that will determine the ways in which the company will be restructured and privatised. The draft law currently discussed by the parliament envisages vertical unbundling of the company into generation, transmission and distribution by the end of 2000. The final version of the law is likely to be adopted in the autumn of 2000. The government also plans to privatise INA, which has a monopoly in gas distribution and which also engages in oil exploration, refining and distribution.

Financial institutions

Consolidation of the banking sector continues …

With the expansion of its powers under the new banking law (in effect from December 1998), the central bank has overseen a period of bank consolidation. During the past two years, bankruptcy procedures have been initiated against 11 banks and temporary administrators had been placed in three others. In addition, in early 2000, the central bank placed two small banks, Istarska Banka and Cibalae, under temporary administration. While Cibalae is now undergoing bankruptcy procedures, the state has partially recapitalised Istarska Banka and it has been given time to recapitalise. Consolidation is also taking place through mergers and acquisitions. Erste Group of Austria has added to its initial investment in Bjelovarska Banka with recent acquisitions of Trgovacka Banka and Cakovecka Banka. Erste Group is now finalising the merger of these three banks, while Zagrebacka Banka acquired Varazdinska Banka in June 2000. The banking system is now dominated by eight banking groups and they account for more than 75% of total banking assets.

… and privatisation of rehabilitated banks nears completion.

The privatisation of the banks that have been taken into rehabilitation between 1996 and 1998 is almost complete. Following the successful privatisation of Slavonska Banka to Kartner Landes-und Hypothekenbank (KLUH) in 1998, a 66% share in the second-largest bank, Privredna Banka, was sold to Banca Commerciale Italiana for €301 million in late 1999. Splitska Banka (third-largest bank) and Rijecka Banka (fourth-largest bank) had been sold to UniCredito Italiano and Bayerische Landesbank, respectively. Remaining banks to be privatised are Dubrovacka Banka and Croatia Banka. The privatisation of these large banks to foreign strategic investors is likely to strengthen the system further. Foreign-owned banks now account for 75% of total bank assets.

Capital markets remain subdued.

Capital markets, once buoyed by Pliva and Zagrebacka Banka listings in both domestic and international markets, have subsequently lost momentum. Market capitalisation of the Zagreb Stock Exchange at 13% of GDP in 1999 is among the lowest of the advanced transition countries. It was expected that the market would be given a further boost by the introduction of the pension reform. However, the introduction of a private voluntary tier (the “third” pillar) has been delayed until an independent pension regulator is established.

Social reform

Pension reform held back by the immediate fiscal burden.

While a “three-pillar” pension system was approved by the parliament in 1998, the introduction of a privately managed compulsory tier (the “second” pillar) has been delayed until January 2002 due to the short-run impact on the government budget and delays in setting up technical and regulatory infrastructure (see above). The government decision in July 2000 to compensate pensioners who had lost out during the freeze on pension indexation from 1993 to the present day is expected to increase the fiscal burden by HRK 2.1-2.3 billion (around 1.5% of 1999 GDP) annually over the next ten years. Fiscal burden has also increased by pensioners taking early retirement following the introduction of reforms in 1998. The ratio of pensioners (including the recipients of old-age, disability and survivor’s pensions) to employees increased from 0.65 in 1998 to 0.95 by 2000.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of central government tax revenues in GDP – **42.9%** [1]
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **voucher**
Tradability of land – **full except foreigners** [2]

Enterprises
Competition office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **10%**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **na**
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	4.0	4.0	4.0	4.0	3.0	3.0	3.0	3.0	3.0
Share of total trade with non-transition countries (in per cent)	na	na	72.3	69.1	68.9	65.1	61.3	64.9	69.8
Share of trade in GDP (in per cent)	39.2	64.0	78.4	66.5	66.6	64.3	67.9	61.5	59.7
Tariff revenues (in per cent of imports) [3]	5.4	10.9	7.4	10.7	9.5	8.9	8.0	7.6	8.1
EBRD Index of price liberalisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	3.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, in per cent of GDP) [4]	na	na	na	0.4	0.9	1.4	1.5	2.5	6.8
Private sector share in GDP (in per cent)	20.0	25.0	30.0	35.0	40.0	50.0	55.0	55.0	60.0
EBRD index of small-scale privatisation	3.0	3.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	1.0	2.0	2.0	2.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	3.9	3.8	3.6	2.0	1.8	1.9	1.9	2.4	2.4
Effective/statutory social security tax rate (in per cent)	na	na	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	35.4	34.9	34.7	34.7	34.0	33.8	20.1	20.0	19.7
Change in labour productivity in industry (in per cent)	-13.1	-0.8	-2.8	1.6	5.8	11.4	14.1	7.4	3.8
Investment rate (in per cent of GDP)	11.3	13.8	14.4	13.6	15.7	20.5	24.2	23.7	22.8
EBRD index of enterprise reform	1.0	1.0	1.0	2.0	2.0	2.7	2.7	2.7	2.7
EBRD Index of competition policy	1.0	1.0	1.0	1.0	1.0	2.0	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	18.6	20.0	21.5	25.2	27.2	30.9	33.5	34.8	36.5
Railway labour productivity (1989=100)	56.9	35.6	40.9	42.4	49.4	44.1	46.0	52.1	52.9
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	7.3 (na)	8.2 (na)	7.9 (na)	7.0 (na)	7.0 (na)	6.8 (na)
Electricity consumption/GDP (1989=100)	108.5	102.2	111.2	105.5	103.0	99.7	100.9	99.3	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.3	2.3
Financial institutions									
Number of banks (of which foreign owned)	na	na	43 (na)	50 (na)	54 (1)	58 (4)	61 (7)	60 (10)	53(13)
Asset share of state-owned banks (in per cent)	na	na	58.9	55.5	51.9	36.2	32.6	37.5	39.6
Bad loans (in per cent of total loans)	na	na	na	12.2	12.9	11.2	10.1	13.7	23.8
Domestic credit to enterprises (in per cent of GDP)	na	na	37.7	21.2	22.9	21.4	25.3	26.5	21.8
Stock market capitalisation (in per cent of GDP)	na	na	na	3.3	3.1	15.3	21.6	14.4	13.8
EBRD index of banking sector reform	1.0	1.0	2.0	2.7	2.7	2.7	2.7	2.7	3.0
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	2.0	2.0	2.0	2.3	2.3	2.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	4.0	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	4.0	3.0	2.7
Social sector									
Expenditures on health and education (in per cent of GDP)	19.0	15.7	na	15.1	5.4	3.5	1.0	4.0	4.3
Mortality rate (per 1,000 male adults)	na	na	na	na	176.2	na	176.0	216.0	na
Basic school enrolment ratio (in per cent)	79.0	85.0	89.0	88.0	89.0	94.4	94.3	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Includes tax revenues of extrabudgetary funds.

2 Land is tradable, but the right to trade land applies to foreigners only on a reciprocity basis and foreigners cannot acquire certain types of land (including agricultural) from the state.

3 Refers to all taxes on international trade.

4 Excludes swaps with frozen foreign currency deposits.

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					(Percentage change in real terms)				
GDP	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	-0.3	3.5
Private consumption	na	na	na	na	1.1	12.8	0.3	-3.0	na
Public consumption	na	na	na	na	-2.9	3.0	3.2	-0.1	na
Gross fixed investment	na	na	na	na	37.6	23.3	3.0	-5.9	na
Exports of goods and services	na	na	na	na	9.8	7.6	6.9	-0.2	na
Imports of goods and services	na	na	na	na	6.8	25.1	-4.6	-3.9	na
Industrial gross output	-14.6	-6.0	-2.7	0.3	3.1	6.8	3.7	-1.4	na
Agricultural gross output	na	na	-0.3	0.7	1.3	4.0	10.2	na	na
Employment [1]					(Percentage change)				
Labour force (annual average)	na	na	-1.0	-1.3	0.9	3.4	-1.5	-1.0	na
Employment (annual average) [1]	-12.7	-2.6	-4.2	-3.3	-1.4	3.4	-3.1	-3.4	na
					(In per cent of labour force)				
Unemployment (annual average)	13.2	14.8	14.5	14.5	10.0	9.9	11.4	13.6	na
Prices and wages					(Percentage change)				
Retail prices (annual average)	665.5	1,518	97.6	2.0	3.5	3.6	5.7	4.2	6.5
Retail prices (end-year)	938.2	1,149	-3.0	3.8	3.4	3.8	5.4	4.4	8.0
Producer prices (annual average)	825.2	1,512	77.6	0.7	1.4	2.3	-1.2	2.6	na
Producer prices (end-year)	1,079	1,076	-5.5	1.6	1.5	1.6	-2.1	5.9	na
Gross average monthly earnings in economy (annual average) [2]	309.2	1,477	137.1	34.0	12.3	13.1	12.6	10.2	na
Government sector [3]					(In per cent of GDP)				
General government balance	-3.9	-0.8	1.2	-1.4	-1.0	-1.4	-0.4	-6.2	-6.7
General government expenditure	36.1	35.0	40.6	44.9	45.3	44.4	46.4	49.0	na
General government debt	na	na	22.2	19.3	28.5	27.3	25.8	32.2	na
Monetary sector					(Percentage change)				
Broad money (M4, end-year)	na	na	75.7	39.3	49.1	38.3	13.0	-1.1	na
Domestic credit (end-year)	na	na	36.3	18.6	3.1	44.4	22.4	-6.6	na
					(In per cent of GDP)				
Broad money (M4, end-year)	na	25.8	20.2	25.0	34.0	41.0	41.4	39.5	na
Interest and exchange rates					(In per cent per annum, end-year)				
Refinancing rate (3 months)	na	97.4	14.0	27.0	9.5	9.0	10.5	11.6	na
Interbank interest rate (daily)	2,182.3	86.9	17.8	27.2	10.4	9.4	15.8	12.7	na
Deposit rate [4]	434.5	27.4	5.0	6.1	4.2	4.4	4.1	4.3	na
Lending rate [4]	2,332.9	59.0	15.4	22.3	18.5	14.1	16.1	13.5	na
					(Kuna per US dollar)				
Exchange rate (end-year)	0.8	6.6	5.6	5.3	5.5	6.3	6.2	7.6	na
Exchange rate (annual average)	0.3	3.6	6.0	5.2	5.4	6.2	6.4	7.1	na
External sector [5]					(In millions of US dollars)				
Current account	326	606	826	-1,451	-1,148	-2,343	-1,550	-1,537	-798
Trade balance	-303	-742	-1,172	-3,267	-3,690	-5,224	-4,169	-3,302	-3,313
Merchandise exports	3,127	3,904	4,260	4,633	4,546	4,210	4,605	4,372	4,590
Merchandise imports	3,430	4,646	5,432	7,900	8,236	9,435	8,773	7,674	7,904
Foreign direct investment, net	13	78	106	96	509	302	781	1,350	450
Gross reserves (end-year), excluding gold	167	616	1,405	1,895	2,314	2,539	2,816	3,025	na
External debt stock	2,736	2,638	3,020	3,809	5,308	7,452	9,588	9,764	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	0.4	1.3	2.5	2.4	2.8	2.7	3.2	3.7	na
					(In per cent of current account revenues, excluding transfers)				
Debt service	8.8	9.7	8.9	9.6	8.9	10.0	13.1	14.4	na
Memorandum items					(Denominations as indicated)				
Population (mid-year, millions)	4.5	4.6	4.6	4.7	4.5	4.6	4.5	4.5	na
GDP (in millions of kuna)	2,707	39,003	87,441	98,382	107,981	123,811	138,392	143,500	157,747
GDP per capita (in US dollars)	2,291	2,349	3,137	4,029	4,422	4,398	4,833	4,467	na
Share of industry in GDP (in per cent)	na	na	na	28.4	26.5	26.9	25.4	25.1	na
Share of agriculture in GDP (in per cent)	na	na	na	10.7	10.3	9.6	8.9	8.6	na
Current account/GDP (in per cent)	3.2	5.6	5.7	-7.7	-5.8	-11.6	-7.1	-7.6	-4.1
External debt – reserves (in US$ millions)	2,569	2,022	1,615	1,914	2,994	4,913	6,773	6,739	na
External debt/GDP (in per cent)	26.7	24.2	20.7	20.2	26.7	37.1	44.1	48.4	na
External debt/exports of goods and services (in per cent)	60.0	42.6	42.4	53.8	67.7	90.6	111.9	120.6	na

1 Employment Service and enterprise data until 1996. From 1997, based on labour force surveys.

2 Per employee. Until 1994 net wages, gross wages thereafter.

3 Consolidated central government. Government expenditure includes net lending.

4 Weighted average over all maturities.

5 For 1992, data exclude trade with republics of former Yugoslavia.

Czech Republic

Key reform challenges

- **Further progress in enterprise restructuring requires reform of the judiciary, particularly improved enforcement of creditor rights, effective bankruptcy procedures and reduction in bureaucracy.**
- **As part of the banking sector's restructuring, an effective workout strategy for bad loans transferred to the Consolidation Bank needs to be agreed and implemented in order to strengthen financial discipline.**
- **Reform of social welfare is necessary to avoid rapid increases in fiscal deficits and public debt. Generous social benefits decrease incentives to work among the less skilled, while low expenditures on education can hinder future growth.**

Liberalisation

Rents are to be decontrolled.
The government announced a decision to abolish state regulation of rents at the end of 2001 and to replace the current rules with a system of contractual rents. The present system hinders investment into the existing housing stock, distorts the housing market and restricts labour mobility. The Constitutional Court had declared the state regulation of rents inappropriate as it amounts to an enforced subsidy that is not reimbursed by the state.

Stabilisation

Off-budget deficits and contingent liabilities have proliferated.
The macroeconomic stability is endangered by rapid growth of fiscal deficits and an increase in the public debt. The official fiscal deficit must be adjusted for the deficits of off-budget entities (primarily the Consolidation Bank) and official public debt for the state guarantees. These guarantees are mainly for infrastructure projects (equivalent to about 8% of GDP at the end of 1999) and bad loans placed with the Consolidation Bank (about 11% of GDP at the end of 1999). Apart from two new extrabudgetary funds, the Road Fund and the Housing Fund, bank restructuring and privatisation and ongoing industrial restructuring are further increasing the amount of state guarantees, either through the Consolidation Bank or through direct state guarantees.

Recovery from long structural recession achieved.
The strong inflow of foreign direct investment in the last few years, combined with an improved investment climate and the diminished role of the large domestic conglomerates, radically changed the structure of the economy. This change has contributed to the nascent recovery from the protracted recession that began in 1997. At the same time, the external balance has improved and the structure of exports has moved towards higher value-added goods.

Privatisation

Large-scale privatisation has been revived.
The government re-invigorated the privatisation process in 2000. The remaining 30% state share in Skoda Auto was sold to Volkswagen in June 2000. Privatisation of Ceske Radiokomunikace, a large telecommunications firm, and Paramo, an oil refinery, among others, is expected to be completed within a year. The state is also actively involved in a number of ownership changes in troubled privately held companies, either through the Consolidation Bank or through the Revitalisation Agency (see enterprise reform below).

Enterprise reform

Legislative framework for industrial restructuring has been strengthened …
The new amendment to the bankruptcy legislation, enacted in May 2000, aims at strengthening creditor rights and increasing the efficiency and speed of bankruptcy procedures. The number of bankruptcy cases exceeded 3,000 in 1999, but it is estimated that more than 10,000 companies are technically bankrupt and about one-third of Czech companies have overdue debts. Despite the legislative improvements, including new banking and investment funds laws which have been implemented, enforcement remains the key to achieving tangible results, as the justice system is overly bureaucratic and slow.

… and some ailing companies have been restructured and sold to strategic investors.
With mounting problems in a number of large industrial conglomerates, several were declared bankrupt in late 1999 and early 2000, such as CKD Dopravni Systemy and ZPS Zlin. Others avoided the threat of bankruptcy by reaching out-of-court settlements with the creditors (including the state), such as Zetor Brno and Vitkovice. Despite cumbersome bankruptcy procedures and a lack of coordination among restructuring bodies and creditor groups, several companies were sold to foreign strategic investors, including Vagonka Studenka, Moravske Chemicke Zavody and ZPS Zlin. This progress in industrial restructuring was assisted by bank privatisation, by efforts of the Revitalisation Agency and by growing fiscal pressures associated with requests for new state guarantees.

Liberalisation, stabilisation, privatisation

1990
Jul First Czechoslovak Eurobond

1991
Jan Exchange rate unified
Jan Fixed exchange rate regime adopted
Jan Most prices liberalised
Jan Most foreign trade controls lifted
Jan Small-scale privatisation begins
Feb Restitution law adopted
Mar Skoda Auto sold to Volkswagen

1992
Feb Treasury bills market initiated
May First wave of voucher privatisation begins
Jul EFTA agreement

1993
Jan Czechoslovakia splits into Czech and Slovak Republics
Jan VAT introduced
Jan Income tax law adopted
Feb New currency (koruna) introduced
Mar First Czech Eurobond
Mar CEFTA membership

1994
Mar Second wave of voucher privatisation begins

1995
Jan WTO membership
Oct Full current account convertibility introduced
Dec OECD membership

1996
Feb Exchange rate band widened

1997
Mar Managed float exchange rate regime adopted
Apr Austerity package announced
May Currency crisis
May Second austerity package announced

1998
Apr Investment incentives adopted
Nov Substantive negotiations for EU accession started

Enterprises, infrastructure, finance and social reforms

1990
Jan Two-tiered banking system established

1991
Mar Competition law adopted
Oct Bankruptcy law enacted

1992
Jan Commercial code adopted
Feb Banking law enacted
Mar Telecommunications act amended
Apr Investment companies law enacted
May First bank privatised
May Insurance law adopted
Nov Securities law adopted

1993
Apr Stock exchange begins trading
Apr Bankruptcy law amended

1994
Sep First pension fund obtains licence
Nov First corporate Eurobond

1995
Jan Bad loan provisioning regulation adopted
Jan Energy law enacted
Jun Telecommunications privatisation begins
Jul Mortgage banking law enacted

1996
Jan BIS capital adequacy regulation enacted
Jul Securities law amended
Oct Forced administration of largest private bank
Nov Competition agency established

1997
Oct First large power company sold

1998
Jan Bankruptcy law amended
Apr Independent securities regulator established
Jun Law on investment funds adopted
Jul Utility prices increased significantly
Sep Banking law amended

1999
May Enterprise restructuring agency established

2000
Mar Largest savings bank privatised
May New bankruptcy law enacted
May New telecommunications law adopted
Jun Third largest bank, IPB, fails

Infrastructure

Energy sector reform is advancing …
The authorities approved the adjustment of energy prices to be completed by the end of 2002, resulting in an increase in household electricity prices by cumulative 47% and household gas prices by cumulative 25%. The first price increases took place at the beginning of 2000, but recent international oil price rises necessitate larger price adjustments than originally anticipated. Full liberalisation of the energy market is not envisaged before 2007, although large customers will be able to freely choose suppliers by 2002. The authorities also plan to sell state stakes in CEZ, the dominant power company, Transgas, the gas transmission company, and regional gas distribution companies by 2002.

… but railway reform has stalled.
Despite deteriorating performance and extensive losses, reform of the state railway monopoly is not envisaged due in part to strong union resistance. The railways still employ around 100,000 workers. Their productivity has decreased by 30% in the last ten years despite downsizing of the labour force by a third over the same period. The railways' debt amounts to 1.6% of GDP and payment arrears are negatively affecting the performance of private servicing firms. However, there are a few successful operators of small private rail lines and the upgrade of the main cross-country railway corridor is proceeding despite procurement problems.

New law on telecommunications defines future liberalisation steps.
The parliament approved the new telecommunications law in May 2000, which opens the sector to competition from January 2001, to free operator selection from July 2002 and to number transferability from January 2003. Full opening of the telecommunications sector is in line with the WTO and EU requirements and will likely result in further improvements in the fixed-line segment of the telecommunications sector. The mobile network is developing fast. The penetration ratio doubled in 1999 to about 20% of the population at the end of the year. The third mobile operator, Cesky Mobil, officially started providing its services in March 2000. The Czech Telecommunications Office opened tenders for three fixed wireless access (FWA) network licences in June 2000, excluding the four existing operators, fixed-line monopoly and three mobile operators, from placing the bids to increase the competition in the sector.

Financial institutions

Restructuring and privatisation of the banking sector progresses …
Following the sale of Ceska Sporitelna in March 2000, the state controls only Komecni Banka, the largest commercial bank by assets. As a part of the pre-privatisation restructuring, the state transferred to Consolidation Bank CZK 33.3 billion (equivalent to 1.8% of GDP) worth of bad loans from Komercni Banka and CZK 23 billion (equivalent to 1.3% of GDP) worth of bad loans from Ceska Sporitelna in the second half of 1999. In June 2000, Investment and Post Bank (IPB) was put into enforced administration after its largest investor, Nomura, failed to improve its bad loan portfolio and did not increase capital to meet capital adequacy requirements. IPB's assets and liabilities were sold immediately to CSOB, the former trade bank majority-owned by Belgian KBC Bank, with full state guarantees. The combined banking entity will control 46% of the local market.

… but capital markets are still underdeveloped.
The operations of the local stock market improved in recent years, particularly following strengthening of the Securities and Exchange Commission. New legislation on securities aligning local regulations with the EU standards is to be enacted in January 2001. However, market liquidity is still associated with only a handful of stocks and the local capital market does not serve as a source of capital for enterprises. There has not been a single initial public offering since the Prague Stock Exchange was re-established in the early 1990s.

Social reform

Generous social welfare system is increasingly costly.
Transfers to households from the budget reached 53% of total expenditures in 1999, equivalent to 20% of GDP. In 2000, the social system will be in a deficit of over CZK 40 billion (equivalent to over 2% of GDP). The largest item in the state social system is pensions, expenditures on which are above 10% of GDP. The pension system is currently in deficit of CZK 13 billion (0.7% of GDP). The minimum retirement age is to increase gradually to reach 62 years in 2006 and the government is proposing stricter criteria for early retirement.

Improvements in the education system and in R&D are a priority.
Expenditures on education are around 5-6% of GDP and have been falling for a number of years. Low pay for teachers and their high average age are likely to undermine the educational system in the near future. While there is an increasing number of small, specialised tertiary education providers, the share of the population with a higher education is still well below EU standards. Similarly, local firms spend only 1-2% of their turnover on research and development and state expenditures on R&D amount to less than 0.6% of GDP.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenues in GDP – **35.7%**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **full except foreigners**

Enterprises
Competition office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **8%**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **1%**
Private pension funds – **yes**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	27.9	18.3	17.9	18.1	17.4	17.4	13.3	13.3	13.3
Number of goods with administered prices in EBRD-15 basket	9.0	5.0	5.0	4.0	2.0	2.0	2.0	2.0	2.0
Share of total trade with non-transition countries (in per cent)	na	na	na	68.6	68.1	71.3	72.1	74.3	73.9
Share of trade in GDP (in per cent)	66.9	63.1	82.8	80.9	89.6	85.0	95.2	99.1	104.2
Tariff revenues (in per cent of imports)	na	na	3.5	3.5	2.6	2.6	1.7	1.5	1.2
EBRD Index of price liberalisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	3.0	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	na	na	1.6	4.3	6.2	7.2	8.2	9.1
Private sector share in GDP (in per cent)	15.0	30.0	45.0	65.0	70.0	75.0	75.0	75.0	80.0
EBRD index of small-scale privatisation	3.0	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	1.0	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies (in per cent of GDP) [1]	na	na	6.4	7.1	8.3	8.0	7.8	7.8	7.7
Effective/statutory social security tax rate (in per cent)	na	na	73.7	73.4	71.3	70.5	72.1	na	na
Share of industry in total employment (in per cent)	37.6	35.6	33.5	32.2	32.1	31.6	32.9	33.4	34.7
Change in labour productivity in industry (in per cent)	-9.5	26.3	-1.0	8.7	11.2	12.0	0.7	3.4	-2.5
Investment rate (in per cent of GDP)	23.1	28.5	26.6	29.5	34.0	36.6	35.1	33.6	32.6
EBRD index of enterprise reform	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of competition policy	2.0	2.0	2.7	2.7	2.7	3.0	3.0	3.0	3.0
Infrastructure									
Main telephone lines per 100 inhabitants	16.6	17.7	19.0	20.9	23.2	27.3	31.8	36.4	37.1
Railway labour productivity (1989=100)	81.8	91.8	76.8	80.0	84.0	83.2	80.2	73.0	69.2
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	3.23 (95)	3.72 (95)	3.83 (95)	3.69 (95)	4.96 (na)	5.12 (na)
Electricity consumption/GDP (1989=100)	107.4	86.0	85.2	85.9	85.5	85.4	85.1	86.1	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.8	2.8
Financial institutions									
Number of banks (of which foreign owned)	na	na	52 (12)	55 (13)	55 (13)	53 (14)	50 (15)	45 (16)	42 (17)
Asset share of state-owned banks (in per cent) [2]	na	na	11.9	17.9	17.8	16.9	17.4	18.8	23.2
Bad loans (in per cent of total loans) [3]	na	na	na	na	32.9	28.2	26.6	26.3	31.4
Domestic credit to enterprises (in per cent of GDP)	na	na	51.0	50.3	46.7	47.1	54.7	48.0	43.8
Stock market capitalisation (in per cent of GDP)	na	na	na	14.2	30.2	31.3	26.6	20.1	23.1
EBRD index of banking sector reform	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3
EBRD index of reform of non-banking financial institutions	1.0	1.0	2.0	2.7	2.7	2.7	2.7	3.0	3.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	4.0	4.0	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	4.0	4.0	2.7
Social sector									
Expenditures on health and education (in per cent of GDP)	na	10.1	12.6	11.9	11.8	11.7	11.2	10.8	na
Mortality rate (per 1,000 male adults)	na	na	na	na	195.4	na	181.0	177.0	na
Basic school enrolment ratio (in per cent)	98.7	99.2	99.1	99.5	99.4	99.2	99.1	97.6	na
Earnings inequality (GINI-coefficient)	21.2	21.4	25.8	26.0	28.2	25.4	25.9	na	na

1 Subsidies to enterprises and financial institutions, including Konsolidacni Banka.

2 Excludes Ceska Sporitelna and Komercni Banka.

3 Excludes loans on the books of Kosolidacni Banka, banks in receivership and the loan of CSOB to Slovenska Inkasni.

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					(Percentage change in real terms)				
GDP	-0.5	0.1	2.2	5.9	4.8	-1.0	-2.2	-0.2	2.0
Private consumption	8.8	1.2	5.6	5.8	6.9	1.8	-2.9	1.4	na
Public consumption	6.7	3.6	3.1	-4.2	3.5	0.8	-0.9	-0.1	na
Gross fixed investment	16.5	0.2	9.1	19.8	8.2	-2.9	-3.9	-5.5	na
Exports of goods and services	9.5	15.8	1.7	16.7	9.2	8.1	10.7	6.6	na
Imports of goods and services	29.7	23.7	14.7	21.2	14.3	7.2	7.9	5.8	na
Industrial gross output	16.6	-5.8	2.9	11.8	11.1	0.1	2.8	-0.4	na
Agricultural gross output	-27.6	-3.8	-6.6	3.2	2.5	-1.5	-1.8	2.3	na
Employment					(Percentage change)				
Labour force (end-year)	-5.1	0.4	-1.1	0.8	0.7	0.1	0.5	0.4	na
Employment (end-year)	-2.5	0.2	0.7	2.8	1.2	-1.7	-2.5	-1.7	na
					(In per cent of labour force)				
Unemployment (end-year)	2.6	3.5	3.2	2.9	3.5	5.2	7.5	9.4	na
Prices and wages					(Percentage change)				
Consumer prices (annual average)	11.1	20.8	10.0	9.1	8.8	8.5	10.7	2.1	3.9
Consumer prices (end-year)	12.7	18.2	9.7	7.9	8.6	10.0	6.8	2.5	4.1
Producer prices (annual average)	10.0	9.2	5.3	7.6	4.8	4.9	4.9	1.0	na
Producer prices (end-year)	9.3	11.4	5.6	7.2	4.4	5.7	2.2	3.4	na
Gross average monthly earnings in economy (annual average)	22.5	25.3	18.5	18.5	18.4	10.5	9.4	8.2	na
Government sector					(In per cent of GDP)				
General government balance [1]	-3.1	0.5	-1.1	-1.4	-0.9	-1.7	-2.0	-3.3	-4.2
General government expenditure [1]	49.6	41.2	41.8	41.5	40.6	40.9	40.8	42.0	na
Public debt [2]	na	18.8	17.6	15.3	13.1	13.0	13.4	15.0	na
Monetary sector					(Percentage change)				
Broad money (end-year)	na	22.5	20.8	19.4	7.8	8.7	5.2	8.1	na
Domestic credit (end-year)	na	19.2	16.0	12.2	12.0	8.6	3.4	0.9	na
					(In per cent of GDP)				
Broad money (end-year)	69.8	70.6	73.6	75.3	71.3	73.0	71.2	75.4	na
Interest and exchange rates					(In per cent per annum, end-year)				
2-week repo rate	na	na	na	11.3	12.4	14.75	9.5	5.25	na
3-months PRIBOR	na	8.0	12.7	10.9	12.7	17.5	10.1	5.6	na
Deposit rate [3]	6.3	7.0	6.9	6.9	6.7	8.0	6.7	4.0	na
Lending rate [3]	13.3	14.1	12.8	12.7	12.5	13.9	10.5	8.0	na
					(Koruna per US dollar)				
Exchange rate (end-year)	28.9	29.8	28.2	26.7	27.3	34.7	30.0	35.7	na
Exchange rate (annual average)	28.3	29.2	28.8	26.6	27.1	31.7	32.3	34.3	na
External sector					(In millions of US dollars)				
Current account	na	456	-787	-1,369	-4,292	-3,211	-1,336	-1,058	-1,770
Trade balance [4]	-1,902	-525	-1,381	-3,678	-5,877	-4,540	-2,554	-2,060	-3,170
Merchandise exports [4]	8,448	14,229	15,929	21,463	21,691	22,777	26,351	26,846	29,500
Merchandise imports [4]	10,350	14,754	17,310	25,140	27,568	27,317	28,905	28,906	32,670
Foreign direct investment, net	983	563	749	2,526	1,276	1,275	2,641	4,912	6,000
Gross reserves (end-year), excluding gold	843	3,872	6,243	14,023	12,435	9,800	12,623	12,894	na
External debt stock	7,082	8,496	10,694	16,549	20,845	21,352	24,047	22,615	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	2.5	3.4	5.6	4.4	3.6	4.4	4.5	na
					(In per cent of current account revenues, excluding transfers)				
Debt service	na	5.9	11.3	8.9	10.5	15.0	14.5	14.1	na
Memorandum items					(Denominations as indicated)				
Population (end-year, millions)	10.3	10.3	10.3	10.3	10.3	10.3	10.3	10.3	na
GDP (in billions of koruna)	842.6	1,020.3	1,182.8	1,381.1	1,572.3	1,668.8	1,798.3	1,836.3	1,946.3
GDP per capita (in US dollars)	2,892	3,386	3,977	5,040	5,620	5,109	5,412	5,189	na
Share of industry in GDP (in per cent)	39.4	33.3	33.6	33.3	32.4	34.3	35.3	34.3	na
Share of agriculture in GDP (in per cent)	4.6	5.3	4.9	4.7	4.7	4.7	4.6	3.7	na
Current account/GDP (in per cent)	na	1.3	-1.9	-2.6	-7.4	-6.1	-2.4	-2.0	-3.5
External debt – reserves (in US$ millions)	6,240	4,624	4,451	2,526	8,409	11,552	11,424	9,721	na
External debt/GDP (in per cent)	23.8	24.3	26.0	31.8	36.0	40.6	43.1	42.3	na
External debt/exports of goods and services (in per cent)	83.8	44.8	50.7	58.7	69.8	71.3	71.1	67.0	na

1 General government excludes privatisation revenues and grants to transformation institutions.

2 Consolidated outstanding debt including state budget, health insurance, extra-budgetary funds and local governments, but excluding the indirect debt of transformation institutions.

3 Weighted average over all maturities.

4 Data for 1992 represent the Czech Republic's share of the total for Czechoslovakia. Break in series in 1995 due to a change in the reporting system.

Estonia

Key reform challenges

- **With the privatisation of most medium-sized and large industrial enterprises complete, the focus is on the restructuring and privatisation of some of the remaining state infrastructure enterprises.**
- **In the financial sector, reform priorities are strengthening the supervision of the non-bank sectors and the transition to a unified financial sector supervision with budgetary and operative independence.**
- **The introduction of the fully funded second pillar for pensions and an increase in the retirement age would ensure the sustainability of the pension system and address the demographic shift.**

Liberalisation

Estonia joins the WTO.
After five years of negotiations, Estonia became a member of the WTO in November 1999. Under the accession agreement, Estonia has accepted the obligations of all WTO multilateral agreements without transition periods. It has committed itself not to raise import duties on goods above maximum levels that range for most industrial products between 0% and 10%, and for most agricultural products between 15% and 45%. In services, Estonia has agreed that by 2003, it will open its telecommunications market to foreign providers of long-distance and international services, in both the fixed-line and mobile sectors, and give free access to foreign providers of financial, freight, education, environment and tourism services. Most of these requirements are already met.

New customs duties introduced to meet EU accession requirements.
Estonia, which has not applied tariffs since the middle 1990s, endorsed a customs bill in July 1999 that creates a general framework for the application of customs duties in preparation for EU accession. From January 2000 Estonia introduced new customs duties on agricultural goods from non-EU countries (excluding those with which it has free trade agreements). The duties are levied at rates varying from 5% to 59% on live animals, animal and vegetable products, prepared foodstuffs and alcohol and tobacco.

Stabilisation

Corporate income tax on reinvested profits abolished.
Key elements of the budget for 2000 include a freeze on pension and public sector wages, the abolition at the beginning of the year of corporate income tax on reinvested profits, an increase in personal income tax exemptions and compensating increases in other taxes (VAT and excise). The budgetary target for 2000 is a small deficit of 1.2% of GDP. The latest indications are that the target is likely to be met, despite shortfalls in excise taxes and the lower-than-expected VAT increase on heating fuel.

Currency board likely to remain in place.
Under EU rules, a country must be a member of the 15-nation bloc and its exchange rate mechanism (ERM) for two years before adopting the single currency. The European Central Bank has agreed that a currency board system based on the euro could be used as transition to full EMU membership in ERM II. As a result of this decision, there is now stronger likelihood than ever that the Estonian currency board (according to which the currency is pegged to the DM at the rate of EEK 8:DM 1) will remain in place until full EMU membership.

A new Stand-By Arrangement agreed with the IMF.
In March 2000 the IMF approved a US$ 39 million precautionary Stand-By Arrangement for Estonia. The main objective of the programme will be a reduction in the budget deficit to around 1.25% of GDP in 2000 from 4.6% in 1999. Key components of the structural reform agenda under the programme are the privatisation and restructuring of the remaining state-owned infrastructure companies, improved supervision in the financial sector, reform of public administration, and reform in the pension and health areas.

Privatisation

Privatisation of large industrial enterprises is near completion.
In 1999, shares in 13 enterprises were sold by tender for the total purchase price of EEK 677 million and eight were sold in auctions for a total purchase price of EEK 17 million. The biggest sales included stakes in the Estonian Maritime Transport Company, the Narva electricity grid and the Liviko alcohol distillery. In January 2000, the government approved the State Privatisation Programme for 2000, which is probably the last privatisation programme. Apart from several infrastructure companies (see below), the programme includes a hotel complex in Tallinn, a regional airport and a broadcasting company.

Enterprise reform

Minority shareholder protection enhanced.
In January 2000, parliament approved changes to the securities and related laws designed to protect minority shareholders and improve transparency in takeovers. The amendments require an investor purchasing a majority stake in a publicly traded company to offer to buy out minority shareholders.

Liberalisation, stabilisation, privatisation

1989

Dec	Bank of Estonia re-established

1990

Dec	State trading monopoly abolished
Dec	Law on small-scale privatisation enacted
Dec	Government decree on SOE transformation passed

1991

Jun	Law on ownership reform enacted
Aug	Independence from the Soviet Union
Oct	Law on private ownership of land adopted
Oct	Tradability of land rights enacted
Dec	Small-scale privatisation started

1992

Jun	New currency (kroon) and currency board introduced
Nov	Large-scale privatisation commenced via tender method
Dec	Most consumer prices liberalised

1993

May	Central bank independence granted
Jun	Law on compensation fund enacted
Jun	Law on property rights enacted
Jun	Privatisation act adopted
Aug	Estonian Privatisation Agency established
Nov	Remaining tariffs abolished

1994

Jan	VAT introduced
Jan	Non-tariff trade restrictions removed
Jan	Flat-rate income tax introduced
Aug	Government decree on the public offering of shares in SOEs passed
Aug	Full current account convertibility introduced

1996

Oct	Law on property rights amended

1998

Apr	Estonia invited to start EU accession negotiations

1999

Nov	Estonia joins WTO

2000

Jan	New customs duties introduced on agricultural goods

Enterprises, infrastructure, finance and social reforms

1991

Sep	Law on foreign Investment enacted
Oct	Telecommunications law adopted
Dec	Electricity law enacted

1992

Jun	Bankruptcy law enacted
Nov	First foreign-owned bank established

1993

Apr	Banking regulations adopted
Jun	Securities markets law enacted
Jun	Securities commission established
Jun	Competition law passed
Oct	Competition agency established
Dec	Law on electricity sector regulation approved

1994

Sep	BIS capital adequacy requirements introduced

1995

Jan	IAS introduced
Feb	First state-owned bank privatised
Feb	Commercial code enacted

1996

May	Stock exchange established
May	Electric power pricing reformed
May	Money laundering regulations adopted
Jun	Trade in fully listed shares begins
Nov	Energy law approved
Dec	Insolvency law amended

1998

Apr	Major adjustment to utility prices
Jun	Pension reform law adopted
Jul	Third pension tier introduced
Oct	Deposit insurance law takes effect
Oct	EU compatible competition law adopted

1999

Jan	First pension tier becomes operational
Feb	First Estonian Eurobond issue by Ühispank
Feb	Eesti Telekom floated
Feb	Telecommunications law amended
Feb	Banking law amended

2000

Jun	Last state-owned bank privatised

In addition, a company targeted in a takeover bid would be prohibited from triggering certain defensive actions or attempting to frustrate a bid, under certain circumstances, and would have to provide full and identical information to all shareholders on the takeover bid. A complete new securities market law is currently being drafted in line with EU directives.

Infrastructure

The sale of Narva Power was signed.
After almost four years of negotiations, in August 2000 the Estonian government signed an agreement under which the US company NRG is to buy a 49% stake in Narva Power (which owns two power stations and a 51% interest in the state-owned oil shale company). The state-owned Eesti Energia is to retain 51% in Narva Power. According to preliminary details of the terms, the sale is valued at US$ 70.5 million of which US$ 65.5 million will be a down payment. Under the terms of the agreement, Narva plants will sell 6.2 TWh of electricity to Eesti Energia annually at the weighted average price of 2.39 US cents per kilowatt-hour, excluding inflation. NRG will also invest around US$ 300 million in the power stations over the coming years. In addition, NRG has committed to set up a US$ 5 million social security fund for workers made redundant from the plants. However, opposition to the sale has mounted with claims that the terms of the agreement are economically unsound. Moreover, in August 2000, a working group was set up to develop proposals for the liberalisation of the energy market and the integration of the system with the EU.

Privatisations of the railways are moving ahead.
In April 2000, the government announced the privatisation tender for a 66% stake in Eesti Raudtee (the largest rail freight operator). In the first stage of the privatisation process, four bidders for the tender submitted their business plans by July 2000. In August 2000, the government took a decision to start talks with all four bidders. In addition, negotiations on the sale of a 100% stake in the largest passenger service, Edelaraudtee, are progressing with the British GB Railways Group. Although the government slashed offered subsidies to half the original proposal (to around US$ 51 million for the next ten years), GB Railways has announced that it would continue negotiations.

Telecommunications market to be liberalised.
In February 2000, the Estonian parliament adopted a new telecommunications law in line with EU directives that will open the fixed-line telephone market to competition in January 2001, ending the seven-year monopoly of Eesti Telefon (the fixed-line arm of Eesti Telekom). However, the government announced that a plan to sell its remaining 27% stake in Eesti Telekom will be delayed until the second half of 2001, to await the effects of the market liberalisation and given current unfavourable market conditions.

Financial institutions

The sale of Optiva Bank has been agreed.
In June 2000, the central bank reached an agreement with Finnish Sampo Finance for the sale of its 58% stake in Optiva Bank, the third-largest bank in Estonia. Under the deal, Sampo Finance will pay a total of EEK 214 million (approximately €14 million) and the central bank will provide partial indemnity to cover the quality of the bank's assets. In addition, Sampo offered to purchase the rest of Optiva shares owned by minority shareholders (including the 19% stake of Eesti Ühispank, Estonia's second-largest bank) at a price of EEK 7.8 per share. Following the sale of Optiva Bank, the central bank and the government have no more shares in the banking sector (excluding some residual ownership of less than 1%). A further strengthening of the sector is under way after the announcement in August 2000 by the Swedish SE Banken of their intention to buy 100% of its three subsidiaries in the Baltics, which includes Estonia's Ühispank, through a cash offer for outstanding shares. This would create the Baltics' largest financial group.

Supervision is strengthening.
Banking supervision has gradually strengthened and, according to the authorities, legal arrangements are now mostly in compliance with the Basle core principles. Plans are under way to establish an integrated financial supervisory authority for banking, securities and insurance. The government intends to submit to parliament all the necessary legislation for this agency by June 2001. In preparation, a new insurance business law has been passed by parliament in June 2000 and a new securities market law and the Investment Funds Act will be submitted to parliament in the second half of 2000, all of which are in line with EU directives.

Social reform

Pension reform may be delayed.
In response to the build-up of pension liabilities, the authorities are moving from the pay-as-you-go pension system to a three-tier partially funded scheme. The first tier became operational in January 1999 and is financed by a 33% social tax (20% is designated for pensions and 13% for health care). The third tier (introduced in July 1998) consists of voluntary contributions administered by private pension funds and insurance companies. The fully funded second tier will offer additional pension coverage financed by mandatory individual contributions. However, it seems likely that the second pillar will be delayed by one year, until January 2002. Moreover, the introduction of the second pillar may not be sufficient to address the looming demographic shift and a faster increase in the retirement age may also be required.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – **full**	Primary privatisation method – **direct sales**	Independent telecoms regulator – **no**	Share of the population in poverty – **40%**
Interest rate liberalisation – **full**	Secondary privatisation method – **vouchers**	Separation of railway accounts – **yes**	Private pension funds – **yes**
Wage regulation – **no**	Tradability of land – **full**	Independent electricity regulator – **yes**	
Stabilisation	**Enterprises**	**Financial sector**	
Share of general government tax revenues in GDP – **33.2%**	Competition office – **yes**	Capital adequacy ratio – **10%**	
Exchange rate regime – **currency board**		Deposit insurance system – **yes**	
		Secured transactions law – **yes**	
		Securities commission – **yes**	

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	21.1	18.0	24.0	24.0	25.6	25.6
Number of goods with administered prices in EBRD-15 basket	na	na	na	3.0	3.0	3.0	3.0	3.0	3.0
Share of total trade with non-transition countries (in per cent)	na	na	54.8	54.5	61.6	59.5	73.1	64.3	76.3
Share of trade in GDP (in per cent)	na	93.8	108.3	123.1	114.3	106.5	123.3	124.6	112.7
Tariff revenues (in per cent of imports) [1]	na	na	0.9	0.9	0.2	0.0	0.0	0.0	0.0
EBRD Index of price liberalisation	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	2.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised (in per cent)	16.3	50.3	69.1	78.9	88.1	94.7	99.6	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	na	2.2	6.9	9.4	10.6	12.9	13.7	14.8
Private sector share in GDP (in per cent)	10.0	25.0	40.0	55.0	65.0	70.0	70.0	70.0	75.0
EBRD index of small-scale privatisation	1.0	2.0	3.0	4.0	4.0	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	1.0	1.0	2.0	3.0	4.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	1.5	0.9	0.5	0.9	0.3	0.9	0.9
Effective/statutory social security tax rate (in per cent)	na	55.1	63.4	61.0	57.6	61.4	62.3	na	na
Share of industry in total employment (in per cent)	na	na	na	22.5	23.4	22.6	22.8	21.9	23.6
Change in labour productivity in industry (in per cent)	na	na	na	na	3.7	8.2	-1.0	9.6	-10.9
Investment rate (in per cent of GDP) [2]	20.9	21.0	24.4	27.0	26.0	27.8	30.9	29.4	25.4
EBRD index of enterprise reform	1.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of competition policy	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.7
Infrastructure									
Main telephone lines per 100 inhabitants	21.2	21.5	23.1	24.5	27.7	29.9	32.1	34.4	35.3
Railway labour productivity (1989=100)	92.2	53.1	55.0	47.7	50.8	55.0	74.2	98.6	124.6
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	1.6 (99)	3.0 (100)	3.2 (98)	3.4 (97)	4.1 (99)	4.1 (na)
Electricity consumption/GDP (1989=100)	121.8	121.4	106.8	114.6	105.2	107.1	101.1	94.1	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	3.3	3.7
Financial institutions									
Number of banks (of which foreign owned)	na	na	21 (1)	22 (1)	18 (4)	15 (3)	12 (3)	6 (2)	7 (2)
Asset share of state-owned banks (in per cent) [3]	na	na	25.7	28.1	9.7	6.6	0.0	7.8	7.9
Bad loans (in per cent of total loans) [4]	na	na	na	3.5	2.4	2.0	2.1	4.0	3.1
Domestic credit to enterprises (in per cent of GDP)	18.8	7.6	11.2	14.1	14.4	18.2	25.9	25.3	26.3
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	24.6	9.4	37.1
EBRD index of banking sector reform	1.0	2.0	3.0	3.0	3.0	3.0	3.3	3.3	3.7
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.7	1.7	1.7	2.0	3.0	3.0	3.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	4.0	3.0	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	4.0	4.0	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	na	na	na	na	14.1	13.0	11.8	11.8	12.4
Mortality rate (per 1,000 male adults)	na	na	na	na	283.7	na	284.0	300.0	na
Basic school enrolment ratio (in per cent)	93.8	91.1	91.4	91.5	92.3	92.6	93.5	95.0	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Excludes differential excise taxes on imports.

2 Source: World Bank *World Development Indicators.*

3 Increase in 1998 is due to the renationalisation of Optiva bank, following its insolvency in late 1998.

4 Refers to provisions for non-collectible loans.

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					(Percentage change in real terms)				
GDP	-14.2	-9.0	-2.0	4.3	3.9	10.6	4.7	-1.1	5.0
Private consumption	na	na	0.8	5.4	8.3	8.9	6.2	-2.2	na
Public consumption	na	na	2.2	18.8	-0.8	1.3	3.9	7.9	na
Gross fixed investment	na	na	6.2	4.0	11.4	17.5	11.3	-15.2	na
Exports of goods and services	na	na	3.8	5.5	2.2	30.4	12.5	-2.4	na
Imports of goods and services	na	na	12.5	5.4	7.5	29.8	12.5	-6.4	na
Industrial gross output	-35.6	-18.7	-3.0	1.9	2.9	14.6	4.1	-7.7	na
Agricultural gross output	na	na	na	0.2	-6.3	-1.5	-5.0	na	na
Employment					(Percentage change)				
Labour force (annual average)	-3.0	-4.0	-1.8	-3.0	-1.3	-0.6	-1.2	-1.2	na
Employment (annual average)	-5.2	-7.5	-2.2	-5.3	-1.6	-0.2	-1.2	-4.1	na
					(In per cent of labour force)				
Unemployment (annual average) [1]	na	6.6	7.6	9.8	10.0	9.7	9.9	12.3	na
Prices and wages					(Percentage change)				
Consumer prices (annual average)	1,076	89.8	47.7	29.0	23.1	11.2	8.2	3.3	3.8
Consumer prices (end-year)	953.5	35.6	41.7	28.9	14.8	12.5	4.2	3.8	4.5
Producer prices (annual average)	na	75.2	36.3	25.6	14.8	8.8	4.2	-1.2	na
Producer prices (end-year)	na	na	32.8	21.8	9.9	7.7	0.1	2.2	na
Gross average monthly earnings in economy (annual average)	na	94.2	62.7	37.0	25.7	19.7	15.4	10.4	na
Government sector [2]					(In per cent of GDP)				
General government balance	na	-0.7	1.3	-1.3	-1.9	2.2	-0.3	-4.6	-1.2
General government expenditure	na	40.5	40.8	41.7	40.7	38.2	38.7	41.6	na
General government debt	na	na	na	na	na	6.7	5.9	6.6	na
Monetary sector					(Percentage change)				
Broad money (M2, end-year)	na	na	40.1	34.5	35.6	42.3	0.1	23.6	na
Domestic credit (end-year)	na	na	42.3	41.0	132.8	86.2	23.1	10.4	na
					(In per cent of GDP)				
Broad money (M2, end-year)	na	33.1	33.8	33.1	34.8	40.4	35.5	42.7	na
Interest and exchange rates					(In per cent per annum, end-year)				
Interbank interest rate (up to 30 days maturity)	na	na	0.0	6.0	5.8	14.7	18.2	4.3	na
Deposit rate (over 12 months) [3]	na	na	8.8	8.7	10.5	10.8	8.9	8.9	na
Lending rate (over 12 months) [4]	na	na	17.5	15.8	13.9	11.2	16.3	8.6	na
					(Kroons per US dollar)				
Exchange rate (end-year)	12.9	13.9	12.4	11.5	12.4	14.3	13.4	15.6	na
Exchange rate (annual average)	12.1	13.2	13.0	11.5	12.0	13.9	14.1	14.7	na
External sector					(In millions of US dollars)				
Current account	na	22	-167	-158	-398	-563	-478	-294	-343
Trade balance	-90	-145	-357	-666	-1,019	-1,125	-1,115	-877	-1,003
Merchandise exports	461	812	1,226	1,697	1,813	2,294	2,690	2,452	2,991
Merchandise imports	551	957	1,583	2,363	2,832	3,419	3,805	3,329	3,994
Foreign direct investment, net	na	156	212	199	111	130	574	222	250
Gross reserves (end-year), excluding gold	na	388	511	650	703	821	876	944	na
External debt stock	na	298	534	785	1,387	2,562	2,900	2,871	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	3.8	3.1	2.7	2.5	2.4	2.2	2.7	na
					(In per cent of current account revenues, excluding transfers)				
Debt service [5]	na	2.0	1.6	1.7	2.6	3.7	5.1	6.1	na
Memorandum items					(Denominations as indicated)				
Population (end-year, millions)	1.5	1.5	1.5	1.5	1.5	1.5	1.4	1.4	na
GDP (in millions of kroons)	13,054	21,610	29,600	40,705	52,446	64,324	73,325	75,360	82,135
GDP per capita (in US dollars)	707	1,084	1,530	2,405	2,982	3,187	3,607	3,564	na
Share of industry in GDP (in per cent)	na	na	na	na	18.9	17.8	15.8	14.7	na
Share of agriculture in GDP (in per cent)	na	na	na	na	6.1	5.3	4.5	4.3	na
Current account/GDP (in per cent)	na	1.3	-7.3	-4.4	-9.1	-12.2	-9.2	-5.7	-6.9
External debt – reserves (in US$ millions)	na	-90	23	135	684	1,741	2,023	1,927	na
External debt/GDP (in per cent)	na	18.2	23.4	22.1	31.8	55.3	55.6	56.0	na
External debt/exports of goods and services (in per cent)	na	26.0	30.7	30.5	47.5	70.9	69.5	72.9	na

1 Series based on the ILO methodology.

2 General government includes the state, municipalities and extrabudgetary funds. General government expenditure includes net lending.

3 Weighted average annual interest rate of time deposits.

4 Weighted average annual interest on kroon loans.

5 The data from 1996 onwards is from the Central Bank of Estonia. The central bank calculation of gross debt involves taking total liabilities and subtracting (a) equity capital and reinvested earnings and (b) equity securities.

FYR Macedonia

Key reform challenges

- **While the reversal of temporary tariff increases and the more transparent administration of oil prices have strengthened markets, their further de-control and successful negotiations with the EU and WTO would consolidate liberalisation.**
- **Large-scale privatisation has accelerated recently, but significant foreign investment in future transactions would strengthen ownership and enterprise performance.**
- **A successful sale of the state-owned telecommunications company, MT, could build confidence for future privatisations, while an early end to the fixed-line monopoly of MT would help to liberalise telecommunications.**

Liberalisation

Negotiations on an EU Stabilisation Agreement begin.
In April 2000, FYR Macedonia became the first country in south-eastern Europe to begin negotiations with the EU on a Stabilisation and Association Agreement. An agreement is expected to be reached by the end of 2000. The negotiations are focusing on regional economic and financial cooperation and adaptation of legislation in FYR Macedonia to EU norms. The World Bank is helping the country reach EU customs standards as part of its Trade and Transport Facilitation in Southeastern Europe project. FYR Macedonia has observer status with the WTO and opened formal accession negotiations in July 2000. New programmes with the IMF and World Bank are also being negotiated.

Pricing of oil products has become more transparent.
The government continues to regulate the domestic price of oil and oil products. However, since privatisation of the Okta refinery in July 1999, the pricing mechanism has become more transparent. Producer prices are adjusted by an independent price commission in line with producer costs so as to maintain a constant profit margin (currently 8%) for the refinery, whereas retail prices are set by the government. The government initially hesitated to pass on rising world oil prices in full to the consumer, but the failure to do so was threatening the achievement of revenue targets for excise taxes on oil, so an adjustment was made in December 1999. Further increases in the world oil price in 2000 have also been passed on fully to the consumer.

Import tariffs imposed during Kosovo crisis have been removed.
During the Kosovo crisis in spring 1999, the government responded to the disruption of export routes by imposing import restrictions, including higher tariffs, on a number of goods, mostly food. Some of these restrictions were removed during 1999, with the remainder lifted at the beginning of 2000.

Stabilisation

VAT has been introduced.
After several delays, the government introduced in April 2000 a value added tax (VAT), replacing the existing sales tax. The basic rate is 19%, with a reduced rate of 5% applying to a number of goods and services, including most food and agricultural products, books and newspapers, and fuel and energy supplies. Various goods and services are exempt from VAT (or zero-rated), including exports and services related to exports and imports. Although the introduction of VAT gave a one-off boost to prices, the authorities have successfully maintained a low rate of inflation.

Privatisation

Privatisation of large-scale enterprises has accelerated.
The privatisation programme continues to move forward. By May 2000, 1,572 companies had been privatised and a further 138 enterprises were in the process. Significant progress has been made in the agricultural sector, where 394 companies are now privatised (compared to 323 at the end of 1998) and a further 32 are in the process. Meanwhile, a programme to sell or liquidate 12 large, loss-making enterprises, launched in 1998, has accelerated recently after encountering significant delays. The government had been reluctant to add to the already very high levels of unemployment and the Kosovo crisis in 1999 appears to have deterred potential investors. Nevertheless, by August 2000, nine of these enterprises had either found private investors, been sold to workers or liquidated, with the three remaining enterprises scheduled for sale or closure by the end of March 2001. A new list of 40 loss-making state-owned companies has been drawn up, with a target of sale or liquidation by the end of 2001.

Enterprise reform

Enterprise performance is hampered by insider privatisations.
Although the economy overcame the effects of the Kosovo crisis in 1999 to grow by nearly 3%, the performance of the enterprise sector remains sluggish. Inter-enterprise arrears are estimated to have risen by 63% in 1999. This rise reflects a number of factors, including the way in which the privatisations were carried out (mostly management-employee buy-outs), the absence of hard budget constraints and effective bankruptcy procedures and the weak enforcement of creditor and shareholder rights. Lack of working capital is also a pervasive problem, especially for SMEs, and restrictive labour laws and high labour taxes discourage enterprises from expanding employment. Recent reforms in privatisation and labour markets may give a much-needed boost to the enterprise sector.

Liberalisation, stabilisation, privatisation

1991
Sep Independence from Yugoslavia

1992
Apr New currency (denar) introduced

1993
Jun Privatisation law adopted
Nov First credit auction by central bank

1994
Jan Sales taxes streamlined
Feb Greek embargo imposed

1995
Sep Greek embargo lifted

1996
Feb Major tax reforms introduced
Apr Agriculture privatisation law adopted
Jul Rationalisation of tariff structure
Aug Import restrictions eliminated

1997
Jul Devaluation of denar
Jul New land law enacted

1998
Jan EU partnership and cooperation agreement
Jun Full current account convertibility introduced

1999
Apr Large influx of Kosovar refugees
Jul Major oil refinery sold to foreign investor

2000
Apr VAT introduced
Apr Negotiations on an EU Stabilisation Agreement begin

Enterprises, infrastructure, finance and social reforms

1992
Apr Two-tiered banking system established
Jun Securities and exchange commission established

1993
May BIS capital adequacy adopted

1994
Jan Bank credit ceilings introduced

1995
Mar Banking rehabilitation law adopted

1996
Mar Stock exchange begins trading
Apr Banking law adopted
Jun Telecommunications law adopted

1997
Mar TAT Savings House collapsed
Jul Securities law enacted
Nov Electricity law adopted

1998
May New bankruptcy law enacted

1999
Dec Competition and anti-monopoly laws adopted

2000
Mar Pension reforms introduced
Apr Credit ceilings on domestic banks lifted
Apr Largest state bank fully privatised
Jul New mortgage law enacted
Jul Law on banks enacted
Jul Law on securities enacted

Foreign direct investors remain cautious.
After a surge in 1998, foreign direct investment fell back in 1999 to around US$ 30 million. While the Kosovo crisis deterred investors, there are signs of increased interest following renewed stability in the region. Several enterprises were sold in the first quarter of 2000 to foreign investors. The government is also undertaking a number of measures to address concerns raised by foreign investors. These measures include plans to set up a one-stop shop for registration of foreign investors, amendments to strengthen legislation on mortgages, bankruptcy and property rights, and possible increased tax exemptions. The government recently adopted a new law on free-trade zones and the first zone is under construction.

New competition laws have been introduced.
FYR Macedonia introduced two new competition laws at the end of 1999, a law on restricted competition and an anti-monopoly law. This is a new area for the judiciary in the country and it remains to be seen whether enforcement will be effective.

Infrastructure

A tender has been announced for a majority stake in Macedonian Telecoms.
The government announced in April 2000 that it would sell between 51% and 66% of Macedonian Telecoms (MT) to a strategic investor, building on the pre-privatisation programme of the previous government. The sale had been delayed by the Kosovo crisis, but is now expected to take place in late 2000 or early 2001. Six international companies have expressed an interest in bidding. MT has a monopoly in fixed-line and other telecommunications services. No date for ending this monopoly has been set.

Infrastructure projects are to be accelerated as part of the Stability Pact.
As part of the Stability Pact initiative for south-eastern Europe, a number of infrastructure projects throughout the region are being targeted under the "quick start" programme, coordinated by the European Commission and the World Bank. In FYR Macedonia, projects include new roads in the east-west and north-south corridors and a programme to improve water and wastewater infrastructure. Funding for these programmes will come primarily from the EBRD, EIB and bilateral donors and work is expected to begin in early 2001.

Financial institutions

The state has sold its remaining shares in the largest bank ...
At the end of 1999, the share of total bank capital in the country that was privately owned reached 77%, with five banks 100% privately owned. The full privatisation of the largest bank in the country, Stopanska Banka (SB), was completed in April 2000. The strategic investor is the National Bank of Greece, which now holds approximately two-thirds of the capital of the bank. The EBRD and IFC have each taken a 10% stake. Prior to privatisation, SB was forced to provision heavily against bad loans, due to its large exposure to loss-making companies. Under the privatisation agreement, the four largest exposures have been removed from its books and replaced with government bonds.

... but consolidation of smaller banks is needed.
As of December 1999, there were 23 banks in FYR Macedonia, a large number for a country with a population of 2 million and where financial intermediation is relatively low. The sector remains highly concentrated, with the two largest banks (Stopanska Banka and Komercijalna Banka) holding more than half of total assets and two-thirds of total deposits in the banking system. Many of the smaller banks are weak and some are unlikely to be able to meet the new capital requirements, scheduled for April 2001, of DM 21 million for a full foreign operations licence, or even the lower requirement of DM 7 million for domestic operations. Some of these banks are exploring merger possibilities.

New banking law moves legislation towards international standards.
A new banking law passed in July 2000 has led to significant changes in legislation. The law brings supervisory standards closer to EU standards and those recommended by the Basle Committee. In addition, it sets new frameworks for credit approval procedures and for strengthening corporate governance of banks. The new legislation will also allow foreign banks to establish branches and subsidiaries in the country.

Social reform

Unemployment remains very high.
The unemployment rate (32% at the end of 1999) is among the highest of all transition countries. There is anecdotal evidence that many of those who register for unemployment benefits are in fact working in the informal economy, but the problem also reflects high labour taxes, institutional rigidities in relation to hiring and dismissing workers, and a relatively generous system of unemployment benefits. A law introduced in 1998 that attempted to alleviate the problem by granting exemptions from labour taxes for new hiring had very limited success and was repealed in 1999. Recent reforms announced in March 2000 include an easing of restrictions on hiring and dismissing workers and a tightening of eligibility rules for unemployment benefits. The government is also preparing a Poverty Reduction Strategy.

Pension reform is progressing.
The government has enacted a number of reforms, effective from September 2000, to the pay-as-you-go pension system. They include a gradual increase in the retirement age for men from 63 to 65 years of age, and for women from 60 to 63, and indexing pensions to both the CPI and wages (as opposed to the former system of wages only). The legal framework for a fully funded mandatory second pillar is now in place and the system will be introduced in the medium term.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenues in GDP – **33.9%**
Exchange rate regime – **fixed to euro**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises
Competition office – **no**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **na**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **8%**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **20%**
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	24.8	17.7	15.0	15.5	15.0	19.6	19.6	na	na
Number of goods with administered prices in EBRD-15 basket	4.0	4.0	3.0	2.0	2.0	2.0	2.0	na	na
Share of total trade with non-transition countries (in per cent)	na	na	na	55.5	54.2	74.7	75.6	83.1	84.7
Share of trade in GDP (in per cent)	54.0	103.8	82.4	69.6	59.0	59.2	77.0	85.7	82.1
Tariff revenues (in per cent of imports)	8.9	6.0	8.5	10.5	12.6	11.4	6.8	7.3	9.1
EBRD Index of price liberalisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	3.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	na	na	na	na	na	na	na	na
Private sector share in GDP (in per cent)	15.0	15.0	35.0	35.0	40.0	50.0	50.0	55.0	55.0
EBRD index of small-scale privatisation	3.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	1.0	1.0	2.0	2.0	2.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	8.3	5.2	5.1	2.9	2.4	0.7	0.3	0.1	0.1
Effective/statutory social security tax rate (in per cent)	na	na	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	40.3	39.6	39.8	39.9	38.3	28.9	27.4	28.2	27.7
Change in labour productivity in industry (in per cent)	-10.3	-10.1	-9.7	-4.1	5.2	-7.8	14.0	-0.2	-1.9
Investment rate (in per cent of GDP)	na	17.3	16.8	14.4	16.5	17.4	17.5	17.9	na
EBRD index of enterprise reform	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Infrastructure									
Main telephone lines per 100 inhabitants	14.3	15.2	15.6	16.1	16.5	17.0	19.9	22.0	23.4
Railway labour productivity (1989=100)	85.3	66.8	56.2	21.8	24.8	47.8	50.9	69.9	68.0
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	2.73 (90)	2.81 (90)	3.1 (90)	3.54 (90)	3.73 (88.2)	3.30 (86.5)
Electricity consumption/GDP (1989=100)	112.1	110.7	107.1	105.1	113.9	119.4	121.9	124.5	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.2	2.1
Financial institutions									
Number of banks (of which foreign owned) [1]	na	na	na	6 (3)	6 (3)	22 (5)	22 (5)	24 (6)	23(5)
Asset share of state-owned banks (in per cent) [1, 2]	na	na	na	na	na	0.0	0.0	1.4	2.5
Bad loans (in per cent of total loans) [3]	na	na	na	na	na	21.7	21.1	7.8	9.4
Domestic credit to enterprises (in per cent of GDP)	na	na	59.3	45.3	23.1	26.5	27.4	18.1	11.3
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	2.3	0.3	0.2	0.2
EBRD index of banking sector reform	1.0	1.0	1.3	2.0	3.0	3.0	3.0	3.0	3.0
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.7	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	2.0	3.0	3.7
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	2.0	4.0	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	na	15.0	14.3	14.4	13.8	10.9	na	na	na
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	164.0	162.0	na
Basic school enrolment ratio (in per cent)	87.1	86.2	86.2	86.8	86.5	86.9	na	na	na
Earnings inequality (GINI-coefficient)	26.7	23.5	27.2	25.3	27.0	25.0	25.9	na	na

1 Number and assets of banks exclude branches of foreign banks.

2 Increase in 1998 is due to the establishment of the Macedonian Bank for Development Promotion.

3 Includes loans of banks under forced administration.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	-8.0	-9.1	-1.8	-1.2	1.2	1.4	2.9	2.7	5.0
Industrial gross output	-16.0	-14.3	-9.7	-8.9	5.0	2.9	4.5	-2.5	na
Agricultural gross output	0.4	-20.4	7.8	2.3	-2.9	0.0	3.9	0.3	na
Employment [1]					*(Percentage change)*				
Labour force (annual average)	-3.6	-2.4	-2.4	-1.5	na	1.4	2.9	na	na
Employment (annual average)	-4.8	-5.6	-6.0	-9.9	na	-4.7	5.4	1.0	na
					(In per cent of labour force)				
Unemployment (annual average) [2]	27.8	28.3	31.4	37.7	na	36.0	34.5	32.4	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	1,664	338.4	126.5	16.4	2.5	1.5	0.6	-1.3	8.5
Consumer prices (end-year)	1,935	241.8	55.0	9.0	-0.6	2.6	-2.4	2.3	5.5
Producer prices (annual average)	2,198	258.3	84.6	3.9	-0.2	4.5	3.4	na	na
Producer prices (end-year)	2,149	177.8	28.5	2.2	-0.6	8.6	-0.1	4.2	na
Gross average monthly earnings in economy (annual average)	984	498.9	103.8	10.4	2.7	2.8	3.7	2.9	na
Government sector [3]					*(In per cent of GDP)*				
General government balance	-9.8	-13.4	-2.7	-1.0	-1.4	-0.4	-1.8	0.0	1.0
General government expenditure	49.1	53.6	45.8	39.0	37.1	35.3	35.8	38.0	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	na	na	8.9	-59.3	0.5	19.6	14.0	30.0	na
Domestic credit (end-year)	na	na	31.2	-48.8	-11.5	6.8	-31.7	12.8	na
					(In per cent of GDP)				
Broad money (M3, end-year)	na	89.1	39.2	13.8	13.3	15.2	16.8	21.5	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Basic rate of the NB [4]	719.0	848.0	66.0	16.0	11.0	15.2	18.3	11.8	na
Interbank interest rate	na	na	na	35.7	22.5	21.1	18.1	11.6	na
Deposit rate [5]	435.0	322.0	117.6	24.1	12.8	11.6	11.7	11.3	na
Lending rate [6]	1,100.0	367.0	159.8	46.0	21.6	21.4	21.0	20.0	na
					(Denars per US dollar)				
Exchange rate (end-year)	12.4	44.5	40.6	38.0	41.4	55.4	51.8	60.0	na
Exchange rate (annual average)	5.1	23.6	43.2	38.0	40.0	49.8	54.5	56.9	na
External sector					*(In millions of US dollars)*				
Current account	-19	15	-180	-222	-289	-277	-309	-135.0	-320.0
Trade balance	-7	43	-186	-221	-317	-386	-419	-408.0	-486.0
Merchandise exports	1,199	1,056	1,086	1,204	1,147	1,237	1,292	1,192.0	1,345.0
Merchandise imports	1,206	1,013	1,272	1,425	1,464	1,623	1,711	1,600.0	1,831.0
Foreign direct investment, net	0	0	24	12	12	18	175	27.0	100.0
Gross reserves (end-year), excluding gold	53	105	165	257	240	256	304	427.7	na
External debt stock	758	818	844	1,062	1,118	1,139	1,437	1,484.0	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	0.5	1.0	1.2	1.7	1.6	1.6	1.8	2.7	na
					(In per cent of exports of goods and services)				
Debt service	na	13.1	15.8	10.4	11.1	8.7	10.1	12.7	na
Memorandum items					*(Denominations as indicated)*				
Population (mid-year, millions)	2.2	2.2	1.9	2.0	2.0	2.0	2.0	2.0	na
GDP (in millions of denars)	11,793	59,164	146,409	169,521	176,444	184,982	190,827	193,520	220,468
GDP per capita (in US dollars)	1,053	1,141	1,742	2,267	2,225	1,856	1,752	1,701	na
Share of industry in GDP (in per cent)	27.1	25.6	24.3	19.6	19.5	20.7	21.8	20.7	na
Share of agriculture in GDP (in per cent)	9.4	8.2	9.1	10.6	10.7	10.7	10.0	9.2	na
Current account/GDP (in per cent)	-0.8	0.6	-5.3	-5.0	-6.5	-7.5	-8.8	-4.0	-9.3
External debt – reserves (in US$ millions)	705.3	713.4	678.6	805.0	878.5	882.8	1,133.1	1,056.3	na
External debt/GDP (in per cent)	32.7	32.6	24.9	23.8	25.3	30.7	41.0	43.6	na
External debt/exports of goods and services (in per cent)	60.2	71.8	67.1	76.5	85.9	83.4	101.0	103.1	na

1 Figures on employment and labour force up to 1995 are based on census data and are not comparable with later years, which are based on the ILO definition of unemployed.

2 The figure provided in this table up to 1995 refers to officially registered unemployment. From 1996, they are based on a labour force survey.

3 General government includes the state, municipalities and extrabudgetary funds.

4 Refinancing rate until 1994. Weighted interest rate of deposits sold at auction (7 days maturity) thereafter.

5 Minimum household deposit rate (3-6 months) until 1993.

6 Minimum lending rate offered to small enterprises until 1995, midpoint rates for short-term lending to all sectors thereafter.

Georgia

Key reform challenges

- **With a serious structural weakness in government revenues, improvements in tax collection on a sustained basis are necessary to reach an agreement with the IMF and to safeguard core public expenditures.**
- **Large-scale privatisation and FDI remain hampered by lack of transparency and regulatory and tax uncertainty; implementation of regulation in the power sector and privatisation of the telecommunications industry could boost investor interest.**
- **Standards are gradually increasing in the banking sector with increased minimum capital requirements, which should foster much-needed consolidation, and the introduction of IAS auditing.**

Liberalisation

Georgia joins the WTO.
Georgia became a member of the WTO in June 2000. Upon accession, Georgia adopted without the transitional period available to new members WTO rules on customs valuation, technical barriers to trade, sanitary measures, trade-related investment and trade-related property protection. In addition, Georgia agreed to provide an annual report on its progress with privatisation, join the agreement on Civil Aircraft, and negotiate the acceptance of the Government Procurement Agreement. These commitments are not part of the compulsory WTO package.

Stabilisation

Revenue shortfalls and failure to agree an IMF programme threaten stability.
According to IMF estimates, Georgia collects around half of potential revenue from the existing tax system. In 1999, tax revenues amounted to just 14% of GDP, among the lowest in the region. In the first quarter of 2000, tax revenues were again 20% below target. The reduction in excise tax rates for petroleum in April 2000 will further hurt revenues. At the end of 1999, internal and external public debt had risen to 75% of GDP and external debt arrears (over 90% of which are for gas deliveries from Turkmenistan) were around 4.5% of GDP. High debt levels and persistent budget deficits threaten macroeconomic stability. The IMF has stated that it will support Georgia's request to bilateral creditors for a general debt rescheduling agreement on condition that a strong fiscal adjustment and structural reform programme is in place. An improved track record on revenue collection, expenditure management and governance issues would be required before IMF financial assistance could be resumed.

Privatisation

Following progress in land registration, a land market is developing.
Registration of agricultural land began in 1999 with assistance from the World Bank and USAID and, by the end of the year, 333,000 plots had been titled. This is the first step in the development of a land market, a necessary condition for improving credit access to the sector. Titling of non-agricultural land, started in 1998, continued to progress, with 3,200 privatised enterprises having registered holdings by the end of 1999. The sale of privatised land is allowed under the law. Shortcomings in the initial draft of the legislation for privatisation of state-owned non-agricultural land (for example, preference for leasing as opposed to privatisation, discretionary powers for government agencies) were overcome in 1999. Regulations for enforcement of the law on land privatisation, however, remain undeveloped.

Large-scale privatisation remains a major reform challenge.
Of the 1,300 medium-sized and large enterprises in Georgia, around 80% have been privatised. Large-scale privatisation has proceeded mainly through strategic sales. However, progress has been slow, due to a lack of financial viability and high reservation prices, exacerbated by the loss of investor appetite following the crisis in Russia. In May 1999, a new law allowed for the sale of enterprises without floor prices. During 1999, 50 medium-sized and large enterprises were sold through tender, direct sale and public auction or were liquidated. Sales included companies from the cement, tobacco, textiles, construction and mining sectors. Privatisation revenues were low (totalling around US$ 25 million) due to companies' debts, the poor state of equipment and restrictions on restructuring. Under a USAID-funded programme, the government is now targeting 30 companies for privatisation or liquidation; currently it is focusing on nine companies.

Enterprise reform

Poor investment climate impedes market entry and restructuring.
According to a recent EBRD survey, Georgian enterprises pay the highest proportion of revenues in bribes in the region. Predatory tax enforcement, lack of confidence in the competence of lower court judges, absence of reliable property registries, corruption and onerous licensing requirements have encouraged informal business activity and discouraged investment. Productivity improvements in industry are sluggish. Several measures are under way to address the situation. In the judicial sector, serving judges are now required to pass exams to retain seats, and 150 new judges were appointed in May 1999 following the completion of entry tests that were deemed fair by international observers. In the corporate sector, a World Bank restructuring project is currently targeting

Liberalisation, stabilisation, privatisation

1991

Apr	Independence from Soviet Union
Aug	Exchange rate unified
Aug	Interest rates liberalised

1992

Jan	Personal income tax and corporate profit taxes introduced
Feb	Most prices liberalised
Mar	Controls on foreign trade lifted
Mar	VAT introduced

1993

Mar	Small-scale privatisation begins

1994

Dec	Export tax to non-CIS countries abolished
Dec	Unified import tariff structure introduced

1995

Jan	Trade regulations streamlined
Jun	State order system abolished
Jun	Voucher privatisation begins
Jun	Large-scale privatisation commenced
Oct	New currency (lari) introduced

1996

Mar	Tradability of land rights enacted
Jun	Voucher privatisation ends
Dec	Full current account convertibility introduced

1997

May	New privatisation law adopted
Aug	Treasury bills market initiated

1998

Dec	Freely floating exchange regime adopted

1999

Jan	Registration of agriculture land titles begins
Apr	Council of Europe membership
May	Privatisation law amended

2000

Jun	WTO membership

Enterprises, infrastructure, finance and social reforms

1994
Jan First foreign-owned bank opened

1995
Jun Two-tiered banking system established

1996
Jun Competition law enacted
Jul Basle capital adequacy requirement introduced
Aug Loan classification and provision requirements introduced
Sep Anti-Monopoly Office established (not independent)
Dec First bank privatised

1997
Jan Bankruptcy law takes effect
Apr Securities regulator established (not independent)
Jun Electricity law adopted
Jun Independent electricity regulator established

1998
Oct Law on non-state pension insurance adopted
Nov Major electric utility privatised
Dec Law on securities market adopted

1999
Apr Oil pipeline Baku-Supsa completed

2000
Jan Minimum capital requirements for banks increased
Mar Stock exchange trading commences
May Baku-Ceyhan pipeline agreement ratified
Jun Independent telecommunications regulator established

36 newly privatised enterprises offering assistance on physical and financial restructuring, business planning and commercial management. In addition, international consultants are training 40 enterprise managers under the programme.

Infrastructure

Power sector privatisation moves closer to completion.
Following its purchase of the Telasi power distribution company in 1998, AES reached an agreement with the government to purchase two 300 MW thermal power stations in March 2000. The purchase price for the relatively new assets was US$ 5 million, with a commitment to invest US$ 35 million over the next five years. A second tender for a package of generation and distribution assets failed after the winning French consortium had insufficient financial backing. The plan is now to consolidate remaining state-owned distribution assets into six companies and then introduce the private sector under management contracts by year-end. In August 2000 two contracts were offered for international tender, one for management of the national grid, and one for management of the wholesale power market. The latter commenced in July 2000, operating on the basis of bilateral contracts, though the rules are still being developed, with the regulator currently determining prices. The ultimate success of the ambitious reform agenda in this sector will depend on good regulatory practice, which is only beginning to be tested by private investors.

Preparation for telecommunications privatisation advance.
Advisers were appointed in June 2000 to organise the privatisation of the telecommunications industry. Also in June 2000, an independent regulator was appointed. The biggest challenge in privatisation comes from the fact that, while the long-distance operator (Sakartvelos Telekom) is highly profitable, the local operator (Sakartvelos Elektrokavshiri) is loss-making. Another challenge stems from the fact that numerous industry operating licences have already been allocated. While they remain valid, investment incentives are undermined (due to the threat of potential entry by licence holders). Legislation relating to wholesale and retail tariffs and to terms/conditions of access is currently underdeveloped.

Oil pipeline revenues begin to flow.
An initial oil pipeline linking the Caspian Sea in Azerbaijan with the Georgian port of Supsa was completed in April 1999. Capacity of the pipeline is 150,000 barrels per day, and revenue for 1999 was around US$ 5 million. At the end of 1999, a series of agreements was concluded between Azerbaijan, Georgia, Turkey and Turkmenistan. They include construction of the Baku-Ceyhan oil pipeline, at an estimated cost of US$ 2.4-4 billion and worth an annual US$ 52 million to Georgia in transit revenue. In addition, an agreement on a parallel (Trans Caspian) pipeline was reached. The estimated construction cost is around US$ 2-3 billion. However, problems remain regarding financing of these projects given the high levels of political and commercial risk.

Financial institutions

Increased capital requirements lead to banking sector consolidation.
After a high profile legal battle, the National Bank of Georgia signalled its resolve to implement regulations by revoking the licence of a bank in September 1999 for failing to meet minimum capital requirements. From January 2000, the minimum capital requirement for banks increased from GEL 2-3 million (US$ 1-1.5 million) resulting in five small banks going out of business. Further consolidation is expected as minimum capital requirements are to rise progressively to GEL 5 million by January 2001. This would be desirable given the large number of banks (34) relative to the size of the banking sector (total assets are around 10% of GDP). IAS was introduced for the 10 largest banks in 1999 and will be mandatory for all banks from January 2001.

Stock market trading commences.
The Securities Commission of Georgia was set up in 1999 under a USAID-funded programme following the 1998 law on securities markets. This independent five-member body, chaired by an American, regulates the Georgian Stock Exchange (GSE), established in early 1999. Firms quoted on the upper tier of the exchange are required by the Commission to provide accounts based in IAS, to have minimum capital of US$ 100,000 and at least 50,000 shares, and to have achieved profit for two out of the three previous years. Trading on the GSE began in March 2000. After suspension in the wake of the Russian crisis, the treasury bills market resumed trading in August 1999. Demand has been limited, resulting in 91-day paper being cancelled towards the end of 1999, and the government borrowing directly from banks.

Social reform

Poverty has risen dramatically over the past two years.
The proportion of people below the *official* poverty line increased from 43% in 1997 to 58.5% in 1999. The poverty increase was highest in urban areas driven by the high incidence of wage and social transfer arrears. Weak agricultural performance, the fallout from the Russian crisis and worsening earnings inequality have also hurt the poor. The benefits system includes pensions (GEL 14 or US$ 7 per month), unemployment benefits (GEL 13 or US$ 6.50 per month), and family allowance (GEL 9 or US$ 4.50 per month), all paid at flat rates. In addition, the government funds 100% electricity tariff discounts for war veterans, and 50% discounts for tax, customs, defence and security personnel. Many poor survive on the basis of subsistence farming, support from family members and the sale of personal assets.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenues in GDP – **14%**
Exchange rate regime – **floating**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **limited for foreigners**

Enterprises
Competition office – **yes (not independent)**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **12%**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **58%**
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	13.4	13.0	13.0	8.3	3.0	3.0
Number of goods with administered prices in EBRD-15 basket	15.0	5.0	5.0	5.0	4.0	3.0	3.0	1.0	1.0
Share of total trade with non-transition countries (in per cent)	na	na	na	33.3	33.1	27.6	35.7	58.7	70.0
Share of trade in GDP (in per cent)	na	123.2	154.8	90.2	37.0	26.3	45.5	47.4	53.8
Tariff revenues (in per cent of imports)	na	na	na	0.3	0.5	2.0	4.4	4.2	1.7
EBRD Index of price liberalisation	1.0	2.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	1.0	1.0	1.0	2.0	3.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised (in per cent)	na	na	11.1	22.7	62.5	81.5	93.8	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	na	10.4	14.6	19.1	19.6	20.2	21.8	23.0
Private sector share in GDP (in per cent)	15.0	15.0	20.0	20.0	30.0	50.0	55.0	60.0	60.0
EBRD index of small-scale privatisation	1.0	1.0	2.0	2.0	3.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	2.0	3.0	3.3	3.3	3.3
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	na	13.8	1.1	1.0	2.3	2.5	2.1
Effective/statutory social security tax rate (in per cent)	na	62.5	5.6	6.6	9.3	13.2	17.4	na	na
Share of industry in total employment (in per cent)	19.7	17.9	16.9	15.8	14.5	10.4	5.1	6.9	na
Change in labour productivity in industry (in per cent)	-14.9	-20.5	-7.7	-34.4	-0.6	49.9	2.8	-7.3	na
Investment rate (in per cent of GDP)	19.3	16.4	3.1	1.6	4.0	6.0	7.2	7.8	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	10.3	10.5	10.5	9.6	10.3	10.5	11.4	11.6	11.6
Railway labour productivity (1989=100)	71.8	37.2	17.2	23.1	18.9	18.0	31.8	38.9	46.7
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	1.6 (20)	3.5 (35)	2.8 (55)	3.1 (68)	3.5 (51)	3.0 (32)
Electricity consumption/GDP (1989=100)	117.5	165.5	189.4	151.8	147.4	141.8	127.2	136.3	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.4	2.7
Financial institutions									
Number of banks (of which foreign owned)	na	75 (na)	179 (na)	226 (1)	101 (3)	61 (6)	53 (8)	43 (9)	34 (9)
Asset share of state-owned banks (in per cent)	92.5	77.6	72.7	67.9	45.8	0.0	0.0	0.0	0.0
Bad loans (in per cent of total loans)	11.0	12.9	10.3	23.9	40.5	6.6	6.6	6.5	4.9
Domestic credit to enterprises (in per cent of GDP)	na	na	na	na	6.1	3.4	3.8	5.0	5.8
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	2.0	2.0	2.3	2.3	2.3
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	3.0	3.0	2.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	2.0	3.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	10.3	6.7	9.7	8.3	1.7	1.9	4.2	4.8	na
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	197.0	194.0	na
Basic school enrolment ratio (in per cent)	94.2	91.2	82.3	82.0	80.4	79.4	80.0	81.8	na
Earnings inequality (GINI-coefficient)	na	36.9	40.0	na	na	na	49.8	na	na

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					*(Percentage change in real terms)*				
GDP	-44.8	-25.4	-11.4	2.4	10.5	10.8	2.9	3.0	3.0
Industrial gross output	-43.3	-21.0	-40.0	-10.0	7.7	8.1	-2.7	7.4	na
Agricultural gross output	-34.2	-42.0	11.6	19.9	5.1	7.1	na	8.0	na
Employment [1]					*(Percentage change)*				
Labour force (annual average)	-16.9	-6.0	-8.0	9.9	5.0	13.5	-18.3	3.1	na
Employment (annual average)	-21.2	-9.7	-2.4	-1.1	0.6	28.3	-22.5	3.5	na
					(In per cent of labour force)				
Unemployment (end-year) [2]	5.4	9.1	3.6	3.1	2.8	7.5	14.7	14.9	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	887	3,125	15,607	162.7	39.4	7.1	3.6	19.3	4.4
Consumer prices (end-year)	1,177	7,488	6,474	57.4	13.7	7.3	7.2	10.9	10.0
Producer prices (annual average)	na	649.7	211.6	36.8	32.4	29.0	2.3	na	na
Producer prices (end-year)	na	na	na	na	na	na	3.7	15.7	na
Gross average monthly earnings in economy (annual average)	na	1,300	22,043	122.6	110.1	89.3	19.8	14.4	na
Government sector [3]					*(In per cent of GDP)*				
General government balance	-25.4	-26.2	-7.4	-5.3	-4.9	-7.0	-6.5	-6.7	-6.3
General government expenditure	35.7	35.9	23.5	12.3	14.1	21.8	22.9	22.3	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	464.0	4,319	2,229	135.1	41.9	45.6	-1.2	17.4	na
Domestic credit (end-year)	724.0	2,048	3,448	80.7	59.6	56.1	28.9	19.4	na
					(In per cent of GDP)				
Broad money (M3, end-year)	44.6	20.1	5.6	4.9	4.5	8.3	7.7	7.7	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Interbank credit rate (3-month) [4]	na	na	na	na	27.0	31.0	40.0	na	na
Treasury bill rate (3-month maturity) [5]	na	na	na	na	na	44.0	39.1	19.8	na
Deposit rate (3-month)	na	na	na	17.9	16.1	12.6	10.0	12.0	na
Lending rate (3-month)	na	na	na	69.8	53.2	45.0	38.0	35.0	na
					(Laris per US dollar)				
Exchange rate (end-year)	na	0.10	1.28	1.23	1.28	1.32	1.71	1.94	na
Exchange rate (annual average)	na	0.02	1.1	1.29	1.27	1.33	1.38	2.01	na
External sector					*(In millions of US dollars)*				
Current account	-248	-354	-278	-216	-275	-375	-389	-221	-199
Trade balance	-378	-448	-365	-338	-351	-559	-685	-528	-502
Merchandise exports	267	457	381	363	417	494	478	485	536
Merchandise imports	645	905	746	700	768	1,052	1,164	1,013	1,038
Foreign direct investment, net	na	0	8	6	54	236	221	96	109
Gross reserves (end-year), excluding gold	1	1	41	157	158	173	118	129	na
External debt stock	95	597	999	1,212	1,352	1,516	1,636	1,754	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	0.0	0.6	2.3	2.2	1.5	1.0	1.2	na
					(In per cent of current account revenues, excluding transfers)				
Debt service	na	na	na	7.2	9.2	4.7	13.4	17.2	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4	na
GDP (in millions of lari from 1993)	na	16	1,373	3,694	5,724	4,505	4,795	5,594	6,013
GDP per capita (in US dollars)	137	163	232	535	838	633	644	517	na
Share of industry in GDP (in per cent)	12.8	6.7	25.4	14.0	11.4	12.5	11.9	13.0	na
Share of agriculture in GDP (in per cent)	55.4	71.8	34.2	29.8	27.0	35.5	30.9	28.0	na
Current account/GDP (in per cent)	-33.5	-40.2	-22.3	-7.5	-6.1	-11.0	-11.2	-7.9	-6.9
External debt – reserves (in US$ millions)	94.1	596	957	1,055	1,194	1,342	1,518	1,625	na
External debt/GDP (in per cent)	12.8	67.8	80.0	63.7	44.9	44.6	47.2	63.0	na
External debt/exports (in per cent)	na	112.7	206.9	250.1	264.7	229.2	227.2	234.3	na

1 Figures from 1997 onwards are from the SDS Household Survey.

2 Up to 1996 unemployment is calculated based on registered employment. From 1997 onwards, ILO methodology is used. 1999 data as of QIII 1999.

3 General government includes the state, municipalities and extrabudgetary funds.

4 Determined at credit auctions at which central bank and commercial banks participate.

5 Treasury bills were introduced in August 1997. Market was suspended Sep 1998-Aug 1999.

Hungary

Key reform challenges

- **Tariff reform, particularly in the domestic energy market, is critical to complete liberalisation and restructuring in this sector and to prepare it for open competition in the European Union.**
- **Recent deterioration in the profitability of banks reflects increased competition and expansion in the retail and small enterprise segments. This trend is expected to give a boost to local SMEs, which are still lagging behind foreign direct investment (FDI) dominated sectors.**
- **Social reforms, particularly in the health sector, should be accelerated both to improve services and to reduce underlying fiscal imbalances.**

Liberalisation

Price liberalisation put on hold.
Administered prices were increased by up to 6% in early 2000 for electricity, gas, phone, post, water, sewerage services, radio and television broadcasting, rail passenger transport, bus transport and local public transport. The 2000 budget plan, which assumes average inflation of 6-7%, suggests that the government intends to put price liberalisation on hold in the energy sectors and to let the utilities bear the costs of higher energy prices.

Stabilisation

The crawling peg regime is to be gradually phased out.
Reflecting the high degree of integration with the EU, the currency composition of the basket to which the currency is pegged was changed in January 2000 to comprise only the euro. The monthly rate of crawl in the peg was reduced to 0.3% in April 2000. The government plans to move from the present regime to a fixed exchange rate target with wide intervention bands as soon as inflation falls below 5% and the inflation differential with major trading partners falls below 3%.

Privatisation

While retaining some residual shares, the state remains a largely passive shareholder.
As prescribed by law, the State Property Agency (APV Rt) will retain a permanent stake in 93 companies. This provision includes eight companies, primarily in the energy, telecommunications and agribusiness sectors, in which the state will retain a golden share. So far, APV Rt has acted as a passive shareholder in almost all those companies where it is a minority investor. The state-owned oil and gas company, MOL, is a notable exception.

Divestiture of other state assets continues.
The sale of the remaining state assets continues, in particular holdings in the television broadcaster Antenna Hungaria (July 2000) and in the airline, Malev, and the steel maker, Dunaferr (preparations under way for tender). APV Rt is also examining prospects of privatising Postabank. However, sales of the real estate portfolio of APV Rt are proceeding only slowly.

Enterprise reform

Foreign-owned firms lead robust output and export growth.
Sectors dominated by foreign-owned companies, including machinery, computers, telecommunications equipment, electrical and electronic goods and transport equipment, continue to be the driving force of robust GDP and export growth. Despite the phasing out of most foreign investment incentives, a stable and favourable business environment and a large pool of skilled and adaptable workers continue to attract a robust flow of FDI, increasingly into capital and skill intensive sectors. The local corporate sector, however, consisting largely of SMEs, has lagged behind foreign-owned enterprises in terms of restructuring and modernisation. In those manufacturing sectors where FDI dominates (machinery and equipment, electrical and optical equipment and transport equipment), labour productivity rose by 19% in 1999, versus 11% for manufacturing as a whole.

Infrastructure

The electricity market is preparing for liberalisation …
A strategic plan for the sector has been drafted by the Ministry for Economic Affairs, the Hungarian Energy Office and consultants PriceWaterhouseCoopers. It encompasses two alternative scenarios: fast liberalisation which would be completed in 2005 and a slower one which would be completed in 2010-12. The choice of scenarios will depend in part on the outlook and timing for EU accession.

Liberalisation, stabilisation, privatisation

1990
Mar Large-scale privatisation begins
Mar State property agency established

1991
Jan Most prices liberalised
Jan Small-scale privatisation begins

1992
Jan Treasury bills market introduced
Mar EU Association Agreement

1993
Mar CEFTA membership
Oct EFTA membership

1995
Jan WTO membership
May Privatisation law adopted
May State property agency and asset management company merge
Dec Restitution law enacted

1996
Jan Full current account convertibility introduced
Apr Customs law enacted
May OECD membership

1997
Jan Currency basket changed
Jan Corporate and personal income tax rates reduced
Jul Import surcharge abolished

1998
Jan Capital account liberalised
Feb IMF programme completed

2000
Jan Currency basket changed

… but liberalisation of the gas market has been delayed.
Locally produced gas is currently priced below imported gas, reflecting relative low domestic production costs. The pricing reform proposal to link the price of domestically produced natural gas to gas import costs has been withdrawn and the government limited its administrative increase of gas prices to 12% in July 2000 instead of the 30-35% proposed by the national oil and gas company, MOL Rt. The decision to postpone gas tariff reform and to limit price increases has caused, in a context of surging world gas prices, substantial losses for MOL, which has set aside its plans for expansion in the region. Moreover, MOL has a dispute with the government on oil product prices, which are not administered. The competition

Enterprises, infrastructure, finance and social reforms

1990
Jan	Securities law enacted
Jun	Stock exchange established
Oct	Banking law adopted

1991
Jan	Competition law enacted
Jul	MATAV transformed into joint-stock company
Sep	Bankruptcy law adopted
Dec	Electricity board transformed into joint-stock company

1992
Nov	Telecommunications law adopted

1993
Jan	BIS capital adequacy enacted
Sep	Bankruptcy law amended
Oct	Railway law enacted
Dec	First major utility partially privatised, MATAV

1994
Apr	Electricity law adopted
Apr	Independent electricity regulator established
Jul	First state bank privatised

1995
Dec	Securities and exchange commission established
Dec	MATAV becomes majority privately owned

1996
Jan	Restructuring of MAV (national railway) begins
Dec	Financial sector supervision law adopted
Dec	IAS introduced

1997
Jan	New banking law enacted
Jan	Competition law amended
Jul	Pension reform adopted
Oct	Land Credit and Mortgage Bank established

1998
Apr	Venture capital law enacted
Aug	Health insurance fund reformed

2000
Jun	Insurance law amended

office has been asked to investigate whether recent price hikes were justified. MOL has a dominant market position in petrol.

Rail sector reform is under way.
The state-owned MAV (National Railways Company) holds the monopoly for rail traffic. The loss-making company employs over 60,000 people and benefits from subsidies of about 0.8% of GDP. In October and December 1999 the government adopted two resolutions to reform MAV. By 2001 an independent track company will be put in charge of the state-owned railway infrastructure. Commercial activities will be divided into railway freight (to be privatised) and passenger transport, which will continue to be subsidised. Moreover, one-third of subsidiary lines will be closed or transferred to other operators and a differentiated tariff system for passenger services will be introduced.

Financial institutions

Profits fall in the banking sector as competition heats up …
The sector is generally sound following a long-lasting and extensive consolidation effort. Foreign participation is high and privatisation almost complete. Despite the sound fundamentals, the potential for growth deriving from lending to large blue-chip companies appears to be exhausted. Intensive competition for prime clients is reflected in very low margins (at most 2.5%). Non-interest revenues are still low at around 30% of total banking income. Competition for low-cost funds has intensified with the rise of alternative savings instruments in insurance, pension funds and equity investments.

… and access to credit for second-tier borrowers improves.
Banks are rapidly increasing their presence in the retail market. Loans to households increased by 40% between end of 1998 and February 2000. Loans to SMEs also grew by 20% during this period. However, household loans only account for 12% of the non-financial private sector credit. Small enterprises, which are perceived as riskier by the banks, receive an even smaller share of private credit, about 4%. With the expansion into retail banking and into riskier market segments, such as the SME sector, several leading Hungarian banks face significant set-up costs in information technology and the modernisation of their branch network. This effort is causing a short-term drain on profitability, but it should improve future prospects.

New legislation raises prudential standards in the insurance sector.
Hungary has developed a competitive insurance sector with the participation of several foreign companies. In June 2000, parliament adopted amendments to the 1995 insurance law that would bring it in line with EU standards. The main changes include a rise in the minimum capital requirement for insurance unions and abolition of the concept of specialised insurance unions, increased transparency of ownership structures and consolidated accounting, and strengthened prudential supervision. The new legislation entered into force in July 2000.

Social reform

Health reform remains a significant challenge.
After passing a law in February 2000 that set up a government-funded loan guarantee programme for doctors wishing to set up their own practice, the government declared that it would not proceed with healthcare reform until after new elections. As a stopgap strategy, the government is financing the structural deficit in the health service by forcing it to sell its assets. At the same time, trade margins on pharmaceutical prices are still administered. The lack of progress with price reform is seen as a particular obstacle by local manufacturers, including foreign-owned companies, due to reduced profitability.

Measures adopted to improve labour market flexibility and training.
From February 2000, the period of eligibility for unemployment benefits has been cut from 12 to nine months, although participation in training increases this period to 18 months. From May 2000, automatic provision for the long-term unemployed has been abolished and substituted with compensation to those long-term unemployed who endeavour to take part in public works organised by local authorities.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenues in GDP – **40%**
Exchange rate regime – **pre-announced crawling peg with band to euro**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **MEBOs**
Tradability of land – **full except foreigners**

Enterprise
Competition office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8%**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **2%**
Private pension funds – **yes**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	11.0	10.9	10.8	11.8	12.9	12.8	15.9	na	na
Number of goods with administered prices in EBRD-15 basket	6.0	4.0	2.0	2.0	2.0	2.0	2.0	na	na
Share of total trade with non-transition countries (in per cent)	82.3	80.6	78.2	79.1	77.7	77.0	81.2	84.3	87.9
Share of trade in GDP (in per cent)	54.9	54.0	50.4	45.4	62.8	68.6	90.2	93.3	93.8
Tariff revenues (in per cent of imports)	9.1	11.8	12.0	12.6	12.9	9.6	4.0	2.6	2.4
EBRD Index of price liberalisation	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3
EBRD Index of forex and trade liberalisation	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3	4.3
Privatisation									
Share of small firms privatised (in per cent)	2.0	10.6	40.4	57.5	66.0	77.2	87.7	na	na
Privatisation revenues (cumulative, in per cent of GDP)	0.1	1.2	1.8	2.7	5.9	9.6	12.6	13.0	13.0
Private sector share in GDP (in per cent)	30.0	40.0	50.0	55.0	60.0	70.0	75.0	85.0	80.0
EBRD index of small-scale privatisation	1.0	2.0	3.0	3.7	3.7	4.0	4.3	4.3	4.3
EBRD index of large-scale privatisation	2.0	2.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	6.6	5.4	5.2	5.9	4.9	5.6	4.9	5.2	4.8
Effective/statutory social security tax rate (in per cent)	53.4	49.9	47.0	48.4	47.0	49.5	51.0	na	na
Share of industry in total employment (in per cent)	30.8	28.0	28.4	27.6	26.7	26.7	26.7	27.8	27.4
Change in labour productivity in industry (in per cent)	-8.2	3.9	16.4	14.8	10.5	4.3	9.3	7.4	9.5
Investment rate (in per cent of GDP)	20.9	19.9	18.9	20.1	20.0	21.4	22.2	23.2	na
EBRD index of enterprise reform	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3
EBRD Index of competition policy	2.0	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0
Infrastructure									
Main telephone lines per 100 inhabitants	10.9	12.6	14.6	16.9	18.5	26.1	30.4	33.6	40.2
Railway labour productivity (1989=100)	74.9	80.8	72.9	85.6	92.6	93.2	108.4	112.9	117.0
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	3.99 (90)	5.85 (90)	5.96 (90)	6.75 (90)	6.97 (na)	7.26 (na)
Electricity consumption/GDP (1989=100)	107.7	107.4	103.8	101.7	101.4	103.1	99.1	95.1	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	3.8	3.8
Financial institutions									
Number of banks (of which foreign owned)	35 (8)	35 (12)	40 (15)	43 (17)	42 (21)	41 (25)	41 (30)	40 (27)	39 (27)
Asset share of state-owned banks (in per cent)	75.3	74.4	74.9	62.8	52.0	16.3	10.8	11.8	9.1
Bad loans (in per cent of total loans)	na	na	25.6	17.6	10.3	7.2	3.6	5.4	2.8
Domestic credit to enterprises (in per cent of GDP)	29.9	23.4	20.7	21.4	18.6	18.7	20.4	20.0	20.6
Stock market capitalisation (in per cent of GDP)	1.5	1.6	2.3	4.2	5.8	12.4	35.2	30.0	35.7
EBRD index of banking sector reform	2.0	2.0	3.0	3.0	3.0	3.0	4.0	4.0	4.0
EBRD index of reform of non-banking financial institutions	2.0	2.0	2.0	2.0	3.0	3.0	3.3	3.3	3.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	4.0	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	4.0	4.0	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	13.0	14.0	13.5	13.9	12.4	11.4	na	na	na
Mortality rate (per 1,000 male adults)	na	na	na	na	330.0	na	259.0	255.0	na
Basic school enrolment ratio (in per cent)	99.2	99.2	99.1	99.1	99.1	99.2	99.2	99.2	na
Earnings inequality (GINI-coefficient)	na	30.5	32.0	32.4	na	na	34.8	na	na

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					*(Percentage change in real terms)*				
GDP	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.5	6.0
Private consumption	0.0	1.9	-0.2	na	-3.4	1.7	4.9	4.6	na
Public consumption [1]	4.9	27.5	-12.7	na	-4.2	5.7	-0.3	2.2	na
Gross fixed investment	-2.6	2.0	12.5	-4.3	6.7	9.2	13.3	6.6	na
Exports of goods and services	2.1	-10.1	13.7	na	8.4	26.4	16.7	13.2	na
Imports of goods and services	0.2	20.2	8.8	na	6.2	24.6	22.8	12.3	na
Industrial gross output	-9.7	4.0	9.6	4.6	3.4	11.1	12.4	10.4	na
Agricultural gross output	-20.0	-9.7	3.2	2.6	7.0	-1.8	-0.3	-2.8	na
Employment					*(Percentage change)*				
Labour force (end-year) [2]	-3.3	-9.0	-3.3	-2.6	-1.2	-1.3	0.4	2.1	na
Employment (end-year) [2]	-4.4	-11.7	-2.0	-1.9	-0.8	0.0	1.4	3.1	na
					(In per cent of labour force)				
Unemployment (end-year) [3]	9.3	11.9	10.7	10.2	9.9	8.7	7.8	7.0	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	23.0	22.5	18.8	28.2	23.6	18.3	14.3	10.1	9.5
Consumer prices (end-year)	21.6	21.1	21.2	28.3	19.8	18.4	10.3	11.2	9.2
Producer prices (annual average)	11.5	10.8	11.3	28.9	21.8	20.4	11.3	5.0	na
Producer prices (end-year)	18.8	10.3	19.9	30.2	20.1	19.5	7.1	7.3	na
Gross average monthly earnings in economy (annual average)	24.3	21.9	22.6	16.8	20.4	22.3	18.3	16.1	na
Government sector [4]					*(In per cent of GDP)*				
General government balance	-7.2	-6.6	-8.4	-6.7	-5.0	-6.6	-5.6	-5.6	-3.6
General government expenditure	59.6	57.5	58.7	52.2	48.2	50.9	49.4	44.8	na
General government debt	79.0	90.4	88.2	86.4	72.8	63.9	62.3	60.7	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	27.6	15.7	13.0	20.1	22.5	19.6	15.2	16.1	na
Domestic credit (end-year) [5]	11.8	20.8	18.1	13.7	7.6	12.0	13.9	-5.6	na
					(In per cent of GDP)				
Broad money (M3, end-year)	59.2	56.8	52.2	48.7	48.6	46.9	45.8	46.2	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinance rate	na	na	25.0	28.0	23.0	20.5	17.0	14.5	na
Interbank interest rate (up to 30-day maturity)	na	21.8	31.3	27.8	23.2	19.7	17.3	14.4	na
Deposit rate (one year)	17.6	17.2	23.6	26.1	20.1	17.6	15.4	12.8	na
Lending rate (one year)	28.8	25.6	29.7	32.2	24.0	20.8	18.8	15.4	na
					(Forints per US dollar)				
Exchange rate (end-year)	84.0	100.7	110.7	139.5	164.9	203.5	219.0	252.5	na
Exchange rate (annual average)	79.0	92.0	105.1	125.7	152.6	186.8	214.5	237.3	na
External sector					*(In millions of US dollars)*				
Current account	324	-3,453	-3,912	-2,480	-1,678	-982	-2,298	-2,076	-1,700
Trade balance [6]	-48	-3,246	-3,635	-2,442	-2,645	-1,963	-2,353	-2,184	-1,748
Merchandise exports [6]	10,028	8,094	7,613	12,810	14,183	19,637	20,749	21,827	29,466
Merchandise imports [6]	10,076	11,340	11,248	15,252	16,828	21,600	23,102	24,011	31,214
Foreign direct investment, net	1,471	2,328	1,097	4,410	1,987	1,653	1,453	1,414	1,650
Gross reserves (end-year), excluding gold	4,347	6,691	6,727	11,967	9,681	8,400	9,312	10,948	na
External debt stock	21,644	24,566	28,526	31,449	27,617	23,747	26,747	29,279	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	4.1	5.8	5.7	7.6	5.7	4.0	4.1	4.7	na
					(In per cent of exports of goods and services)				
Debt service	35.5	45.0	58.2	48.0	48.7	37.2	29.7	18.4	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	10.3	10.3	10.2	10.2	10.2	10.1	10.1	10.1	na
GDP (in billions of forints)	2,942.6	3,548.3	4,364.8	5,614.0	6,893.9	8,540.7	10,083.0	11,599.3	13,461.3
GDP per capita (in US dollars)	3,613	3,752	4,052	4,374	4,441	4,512	4,659	4,853	na
Share of industry in GDP (in per cent)	20.4	21.3	21.9	23.1	23.5	25.0	25.9	na	na
Share of agriculture in GDP (in per cent)	6.5	6.1	5.9	5.9	6.1	5.8	5.4	na	na
Current account/GDP (in per cent)	0.9	-9.0	-9.4	-5.6	-3.7	-2.1	-4.9	-4.2	-3.4
External debt – reserves (in US$ millions)	17,297	17,875	21,799	19,482	17,936	15,347	17,435	18,331	na
External debt/GDP (in per cent)	58.1	63.7	68.7	70.4	61.1	51.9	56.9	59.9	na
External debt/exports of goods and services (in per cent)	162.3	225.4	267.2	184.0	143.9	96.9	104.2	109.1	na

1 Data for public expenditure and imports in 1993-94 include payments for Russian military equipment. Government consumption excludes social transfers, which are included in household final consumption.

2 Data on labour force and employment are from the Labour Force Balance. Data from Labour Force Survey indicate a decline for 1997 and a higher increase for 1998.

3 Registered unemployed. Data from the labour force survey for 1996 to 1998 indicate lower rates of respectively 9.9%, 8.7% and 7.8%.

4 Government sector data are reported on a national accounts basis (SNA). Official data record consistently smaller deficits (-3.7 in 1999, -4.8 in 1998, -4.8 in 1997).

5 Changes in domestic credit are adjusted to account for bank recapitalisation in 1993-95.

6 Data from balance of payments.

Kazakhstan

Key reform challenges

- **The proposed Oil Fund should help to reduce the risks associated with oil price fluctuations. However, the Fund should be subject to clear guidelines and parliamentary oversight and its management should be by a reputable investment company.**

- **Despite significant potential in areas such as mining, Kazakhstan has attracted little foreign investment outside the oil and gas sectors, owing to non-transparent side deals, insecurity of property and contract rights, and unfavourable tax and regulatory regimes.**

- **The funded pension system remains at risk from domestic volatility unless pension funds diversify further into foreign assets; in the medium term this would also have the benefit of cushioning the impact of oil revenues on the balance of payments.**

Liberalisation

Temporary trade and currency restrictions have been lifted …
Following the abolition of selected customs tariffs against neighbouring countries in August 1999, the 50% surrender requirement on current account transactions was lifted in November. Kazakhstan has committed to a simplification of its tariff schedule under the December 1999 IMF agreement. Currently, the unweighted average tariff stands at 6.8%. Negotiations on WTO accession are unlikely to conclude before end 2001.

… but some interventionist tendencies remain.
During 2000, the controversy over alleged transfer-pricing practices by foreign investors has intensified. Planned new tax legislation would give the Ministry of Revenues wide-ranging powers to recalculate tax liabilities based on world prices and assumed profitability. Following the temporary introduction of oil export quotas between December 1999 and April 2000, new delivery quotas to domestic refineries were adopted in August.

Stabilisation

Substantial balance of payments surpluses risk fuelling inflation.
High commodity prices and buoyant export growth have been reflected in balance of payments surpluses since the fourth quarter of 1999. In its attempt to prevent the tenge from appreciating, the National Bank (NBK) has been rebuilding reserves and allowed base money to expand by 56% in 1999. Part of the inflows during 2000 has been matched by increases in government deposits at NBK with no direct impact on domestic liquidity. However, further currency purchases by NBK at the current pace carry significant risks for price stability. The government could issue domestic debt to buy back foreign liabilities and thus increase available instruments for sterilisation. In the medium term, diversification of pension funds into foreign assets may also relieve some pressure for real appreciation.

The tax code and interregional fiscal relations are undergoing important revisions.
The 1995 tax code is being revised with a specific focus on delineating the rights and responsibilities of the taxpayers *vis-à-vis* the state. The budget systems law of January 1999 considerably changed fiscal arrangements between the centre and the oblasts. While progress was made in making revenue-sharing transparent, the transfer of responsibilities for the social sector to the local level, together with significant variations in per capita tax revenues across regions, still creates considerable need for further equalisation. Present practices of ad hoc allocations to compensate for the variation offset some of the positive effects of fiscal decentralisation on local fiscal management.

A National Oil Fund is to be created.
In August 2000, the government sold off a 5% stake in the Tengiz Oilfield for US$ 450 million (plus US$ 210 million in up-front bonus payments) to Chevron. The money is to be the first payment into a new National Oil Fund. According to government proposals, the Fund would mainly invest contributions in safe assets abroad and withdraw resources only to cushion against oil price volatility or for strategic public investment projects. Parliamentary accountability and professional management of the Fund will be key to ensuring its success.

Privatisation

Privatisation has lagged behind expectations.
In the first half of 2000, only US$ 65 million was raised in privatisation revenues, less than in 1999 and only 17% of the annual target. The blue chip privatisation programme is effectively stalled. One potential cause is the reluctance of existing private blockholders to adhere to the strict disclosure requirements that public offerings on the stock exchange would entail.

Land reform remains disappointing.
After political resistance forced the government to reconsider a draft new land law in 1999, the revised draft no longer provides for the possibility of full private ownership over agricultural land. While the existing 99-year long-term leases are transferable and can be used as collateral, with low land values and remaining legal uncertainty, a rural land market has so far failed to develop. The process of acquiring non-agricultural land is subject to enormous political discretion of local *akims* (appointed governors) and can be a severe barrier for new businesses.

Liberalisation, stabilisation, privatisation

1991

Dec	Independence from Soviet Union

1993

Nov	New currency (tenge) introduced

1994

Apr	Beginning of mass privatisation: first voucher auction
Apr	First treasury bills issued
Nov	Most prices liberalised
Dec	Law on foreign investment enacted

1995

Jan	Customs union with Russia and Belarus
Feb	Directed credits eliminated
Feb	Most foreign trade licences abolished
Apr	Central bank law adopted
Jun	State orders in agriculture abolished
Jul	New tax code introduced
Jul	Customs code introduced
Jul	Barter trade prohibited
Aug	Foreign exchange surrender abolished
Dec	Edict on Land enacted
Dec	Privatisation law enacted

1996

Jun	IMF programme agreed
Jun	Last voucher auction
Jun	Cash sales to strategic investors begin
Jul	Full current account convertibility introduced
Dec	First sovereign Eurobond

1999

Jan	Temporary trade restrictions on neighbours introduced
Jan	Major budgetary reforms introduced
Apr	Foreign exchange surrender re-introduced temporarily
Nov	Sovereign Eurobond issue (first in CIS after Russian crisis)

2000

Jan	Oil export quota introduced temporarily
Jul	Constitution changed to give Nazarbayev presidential privileges for life
Aug	Minority stake in TC Oil sold to Chevron

Enterprises, infrastructure, finance and social reforms

1991
- Jun Securities and stock exchange law adopted
- Jun Competition law adopted

1993
- Apr Law on banking adopted

1994
- Jan Prudential regulations introduced
- Jun Competition agency established
- Dec New civil code enacted

1995
- Apr Presidential decree on bankruptcy issued
- Apr Bank and enterprise restructuring agency set up
- Apr Anti-monopoly legislation introduced
- Dec Telecommunications law adopted

1996
- Jan Subsoil code enacted
- May First major privatisation in power sector
- Nov New accounting standards adopted

1997
- Jan New bankruptcy law enacted
- Jun Pension reform law adopted
- Jul First ADR issue
- Jul National power grid formed
- Oct Stock exchange begins trading

1998
- Jan Pension reform launched
- Apr Privatisation of Turan-Alem Bank – largest to date
- Sep Law on natural monopolies adopted
- Dec Small business support programme approved

1999
- May New telecommunications law adopted
- Jul New energy law introduced
- Jul First municipal bond issue
- Aug First domestic corporate bond issue
- Oct Decree on inspections passed

2000
- Jun Tractebel leaves Kazakhstani energy sector
- Jul Wholesale power trading company (KOREM) set up

Enterprise reform

Attempts to rebuild the reputation of the mining sector have so far failed.
The mining sector in 1999 accounted for a third of exports, almost as much as fuel and oil products. Nevertheless, foreign investment in the sector at cumulative US$ 160 million over 1998-99 was a fraction of inflows into oil and gas at US$ 2.3 billion. During earlier periods, many companies acquired licences under non-transparent conditions, and allegations of transfer pricing and corruption have since plagued the sector. Attempts at attracting new strategic investors have been stymied by onerous tax treatment, the lack of public availability of necessary geological survey data and the apparent reluctance of the government to offer mineral deposits for open international tenders.

Bankruptcy numbers up but enterprise sector dynamics remain weak.
By March 2000, the number of companies in which liquidation procedures were concluded had risen to 2,170 from 451 at end 1998, as bankruptcy enforcement tightened. Liquidation procedures in 822 companies led to the resumption of operations by newly incorporated entities, saving a total of 64,800 jobs. Yet, bankruptcy procedures often tend to protect insiders rather than creditors. The State Agency for Restructuring and Liquidation claims that only small companies are effectively closed down as a result of liquidation. Enterprise entry remains hampered in particular by onerous registration procedures (in particular for land) and a string of unnecessary inspections prone to corruption. The decree on inspections of October 1999 aims to target the latter problem by limiting the number of inspections per relevant government department and establishing a logbook to record their frequency.

Infrastructure

Tractebel exit shakes confidence in power sector reforms.
In May 2000 Tractebel sold its assets in the gas distribution network and Almaty's power sector back to the government for reportedly US$ 100 million in compensation. Tractebel's exit followed repeated difficulties to gain the Anti-Monopoly Committee's (AMC) approval for tariff increases. Although blame for the failure of this investment may be equally shared, other investors are experiencing similar difficulties with the tariff rulings of the AMC. This may thwart the success of the planned privatisation of distribution companies during the latter part of 2000. Regulatory practice of the AMC is a concern for investors also in other sectors.

KazTransOil hikes tariffs on flush oil exporters.
In April 2000, state-owned pipeline operator KazTransOil (KTO) increased transit tariffs on its network from US$ 9 to US$ 15 per ton for 1,000 km. This boosts Kazakh tariffs to around three times the level charged by Transneft. The tariff was approved by the AMC and justified following an asset revaluation with the need for higher depreciation costs. Yet, the present tariff may in fact be a disguised form of taxing oil exporters while prices are high and alternatives to the current main Atyrau-Samara route (such as the CPC pipeline) are not yet operational. Rail transportation tariffs were similarly raised in September 2000.

Financial institutions

Banking system continues to strengthen.
All major banks survived the liquidity squeeze of early 1999 and the subsequent 50% devaluation relatively unscathed. A partial deposit conversion scheme and the introduction of limited deposit insurance have bolstered confidence in the banking system. This and higher corporate profits have swelled bank deposits, which stood at KZT 245 billion (US$ 1.72 billion) by July 2000. Bank supervision has been strengthened although concerns persist over the implementation of liquidation orders on banks by the local courts. The limit of total foreign equity in the banking system was raised to 50% from 25%. Increased competition is driving lending margins down and maturities up. While this will increase private sector access to funds, tight supervision will continue to be needed to avoid imprudent lending.

Securities market poised for growth as liquidity builds up.
The Russian crisis saw an almost complete dry-up of the state securities market, while trading of corporate securities has traditionally been minimal and reached barely US$ 30 million in 1999 (up from US$ 7 million in 1998). However, demand for government paper has been picking up strongly since early 2000 and yields have come down rapidly to around 13% (for six-month maturities) as of June 2000. A major impetus is coming from the pension funds, which have accumulated US$ 630 million in assets since the start of the fully funded system in January 1998. Following a one-year, local bond issue by Mangistau oblast in 1999, Kazakhoil issued a two-year dollar bond with a 9% coupon in June 2000, and Halykbank, Kazakh Rail (KTZ) and KTO are all readying domestic issues. This activity follows the build-up of liquidity in the banking and pension systems and will provide welcome diversification for pension funds.

Social reform

After successful pension reform, attention shifts to social security.
The doubling of minimum capital requirements for private pension funds to KZT 180 million in August 2000 has led to the forced merger of two out of 15 private funds with stronger institutions. Well over half of all contributions are now invested in private funds. However, the transferability of individual accounts between funds remains low, while the 5% limit on investment abroad creates significant risks to domestic macroeconomic volatility. Following the success of pension reforms, international assistance is now focusing on improved targeting of social assistance and making it less dependent on local governments' financial situation.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **limited de jure**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Social reform
Share of the population in poverty – **35%**
Private pension funds – **yes**

Stabilisation
Share of general government tax revenues in GDP – **16.1%**
Exchange rate regime – **managed float**

Enterprises
Competition office – **yes**

Financial sector
Capital adequacy ratio – **8%**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	10.4	2.5	2.5	2.5	0.0	0.0	0.0	0.0	0.0
Number of goods with administered prices in EBRD-15 basket	5.0	3.0	3.0	3.0	0.0	0.0	0.0	0.0	0.0
Share of total trade with non-transition countries (in per cent)	na	na	na	33.2	39.9	41.7	52.4	47.3	58.7
Share of trade in GDP (in per cent)	na	na	na	64.3	64.9	61.8	63.6	56.9	73.8
Tariff revenues (in per cent of imports) [1]	0.0	17.2	0.5	5.6	3.9	2.0	1.5	1.9	1.6
EBRD Index of price liberalisation	1.0	2.0	2.0	2.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	1.0	2.0	2.0	3.0	4.0	4.0	4.0	3.0
Privatisation									
Share of small firms privatised (in per cent) [2]	na	na	27.3	41.7	60.0	79.5	100.0	na	na
Privatisation revenues (cumulative, in per cent of GDP)	0.0	3.4	6.1	6.4	6.7	8.9	12.3	16.2	18.0
Private sector share in GDP (in per cent)	5.0	10.0	10.0	20.0	25.0	40.0	55.0	55.0	60.0
EBRD index of small-scale privatisation	1.0	2.0	2.0	2.3	3.0	3.3	4.0	4.0	4.0
EBRD index of large-scale privatisation	1.0	1.0	2.0	2.0	2.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP) [3]	na	na	na	3.2	3.6	2.6	1.8	0.7	0.7
Effective/statutory social security tax rate (in per cent)	na	37.7	na	39.8	55.3	56.3	51.5	na	na
Share of industry in total employment (in per cent)	na	na	na	20.7	20.5	20.9	22.2	12.6	11.4
Change in labour productivity in industry (in per cent)	-2.4	-10.7	-1.0	-21.2	0.0	-3.1	18.6	1.8	13.8
Investment rate (in per cent of GDP)	na	30.4	27.9	22.6	20.5	11.8	12.9	11.5	15.0
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	8.5	8.8	11.7	11.7	11.8	11.6	10.8	10.9	10.8
Railway labour productivity (1989=100)	85.7	69.5	51.4	37.6	32.6	30.4	30.0	31.2	28.5
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	4.2 (73)	3.2 (75)	3.0 (70)	3.8 (50)	4.7 (na)	3.2 (na)
Electricity consumption/GDP (1989=100)	113.4	110.3	102.4	110.4	110.0	97.0	81.9	76.3	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.4	2.4
Financial institutions									
Number of banks (of which foreign owned)	72 (1)	155 (1)	204 (5)	184 (8)	130 (8)	101 (9)	81 (22)	71 (20)	55 (18)
Asset share of state-owned banks (in per cent) [4]	19.3	4.6	na	na	24.3	28.4	45.4	23.0	19.9
Bad loans (in per cent of total loans)	na	na	na	na	14.9	19.9	6.0	5.1	5.8
Domestic credit to enterprises (in per cent of GDP)	na	na	49.3	26.6	7.1	6.3	5.2	6.6	9.3
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	6.1	8.2	16.5
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	2.0	2.0	2.3	2.3	2.3
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	1.7	1.7	1.7	1.7	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	2.0	2.3	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	2.0	2.0	3.3
Social sector									
Expenditures on health and education (in per cent of GDP)	na	6.1	6.5	5.3	7.5	7.2	7.1	6.2	6.5
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	383.0	382.0	na
Basic school enrolment ratio (in per cent)	94.4	94.2	94.0	93.6	94.3	94.6	93.7	93.2	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Refers to taxes on international trade.

2 Data in this row give the number of privatised enterprises included in the original privatisation programme. As a share of all small enterprises, around 80% were privatised by 1999. Remaining small enterprises are largely in the social sector.

3 Data for 1998 and 1999 refer to expenditures on the economy (fuel and energy, agriculture and mining).

4 The state share of banking sector assets increased in 1997 following the merger of privately owned Alem bank and state-owned Turan bank into a new state-owned institution. In 1998 the merged bank was reprivatised.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	-2.9	-9.2	-12.6	-8.2	0.5	1.7	-1.9	1.7	8.2
Industrial gross output	-14.0	-14.0	-27.5	-8.6	0.3	4.1	-2.1	2.2	na
Agricultural gross output	28.7	-6.9	-21.0	-24.4	-5.0	1.9	-18.9	21.6	na
Employment					*(Percentage change)*				
Labour force (annual average)	-1.7	-7.7	1.6	3.4	1.8	-0.7	-4.2	na	na
Employment (annual average)	na	na	na	-0.5	-0.5	-0.7	-5.3	-0.3	na
					(In per cent of labour force)				
Unemployment (annual average)	0.4	0.6	7.5	11.0	13.0	13.0	14.0	14.1	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	1,381	1,662	1,892	176.3	39.1	17.4	7.3	8.4	13.2
Consumer prices (end-year)	2,984	2,169	1,158	60.4	28.6	11.3	1.9	18.1	8.6
Producer prices (annual average)	na	na	2,920	231.2	24.3	15.6	0.8	18.8	na
Producer prices (end-year)	na	na	1,924	40.2	18.5	11.7	-4.5	57.2	na
Gross average monthly earnings in economy (annual average)	860.0	2566.7	1248.2	177.3	42.9	26.4	13.0	18.9	na
Government sector [1]					*(In per cent of GDP)*				
General government balance [2]	-7.3	-4.1	-7.7	-3.4	-5.3	-7.0	-7.7	-5.3	-0.2
General government expenditure [3]	31.8	25.2	18.4	20.8	18.6	20.4	25.8	24.4	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	391.0	692.0	576.1	109.0	16.6	28.2	-13.3	81.7	na
Domestic credit (end-year)	1,342.9	653.0	745.4	-22.5	-12.4	21.6	46.7	34.0	na
					(In per cent of GDP)				
Broad money (M3, end-year)	42.9	27.9	13.1	11.4	9.5	10.3	8.6	14.4	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinancing rate	na	240.0	230.0	52.5	35.0	18.5	25.0	18.0	na
Treasury bill rate (3-month maturity)	na	na	354.8	59.7	32.2	15.1	25.6	16.6	na
Deposit rate [4]	na	na	na	44.4	30.0	12.6	14.5	13.4	na
Lending rate [4]	na	na	na	58.3	45.0	22.8	18.4	21.4	na
					(Tenge per US dollar)				
Exchange rate (end-year)	0.8	6.3	54.3	64.0	73.8	75.9	84.0	138.0	na
Exchange rate (annual average)	0.4	5.3	36.4	61.1	67.8	75.6	78.6	120.1	na
External sector					*(In millions of US dollars)*				
Current account	-1,900	-400	-905	-213	-750	-802	-1,225	-171	690
Trade balance [5]	-1,100	-400	-920	114	-335	-276	-801	344	2,250
Merchandise exports	3,600	4,800	3,285	5,440	6,292	6,899	5,871	5,989	8,800
Merchandise imports	4,700	5,200	4,205	5,326	6,627	7,176	6,672	5,645	6,550
Foreign direct investment, net	na	473	635	964	1,137	1,320	1,143	1,584	1,500
Gross reserves (end-year), excluding gold [6]	na	640	840	1,138	1,286	1,480	1,261	1,553	na
External debt stock	1,478	1,848	3,265	3,480	4,443	6,336	8,218	7,905	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold [6]	na	1.5	2.2	2.2	2.0	2.1	1.9	2.8	na
					(In per cent of exports of goods and services)				
Debt service	4.3	1.4	4.2	7.9	15.9	24.5	22.5	27.7	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	16.9	16.9	16.2	16.0	15.9	15.6	15.5	14.9	na
GDP (in millions of tenge)	3,406	29,423	423,469	1,014,190	1,415,750	1,672,143	1,733,264	1,893,478	2,319,251
GDP per capita (in US dollars)	357	328	721	1,038	1,317	1,415	1,423	1,058	na
Share of industry in GDP (in per cent)	30.1	28.5	23.6	23.5	23.5	24.0	23.2	na	na
Share of agriculture in GDP (in per cent)	16.2	16.6	15.0	12.3	11.7	11.3	9.4	na	na
Current account/GDP (in per cent)	-31.5	-7.2	-7.8	-1.3	-3.6	-3.6	-5.6	-1.1	4.2
External debt – reserves (in US$ millions)	na	1,208	2,425	2,343	3,158	4,855	6,957	6,353	na
External debt/GDP (in per cent)	24.5	33.4	28.0	21.0	21.3	28.6	37.3	50.1	na
External debt/exports of goods and services (in per cent)	38.4	35.9	87.7	58.2	63.8	81.8	121.4	115.8	na

1 General government includes the state, municipalities and extrabudgetary funds. Balance excludes privatisation revenues and includes quasi-fiscal operations. The deficit gross of privatisation revenues (as presented by the government) was -3.8% of GDP in 1997, -3.7% in 1998 and -3.5% of GDP in 1999.

2 Government balance includes quasi-fiscal operations (zero after 1995). It is reported as revenue-expenditure and is higher than below the line financing requirements due to a statistical discrepancy, which varies around 0.5% of GDP each year.

3 Expenditures include extrabudgetary funds after 1998, leading to a break in the series. Following the old series expenditures increased by only 1.4% of GDP in 1998.

4 Deposit rate for time deposits of individuals. Lending rate for short-term credits. Following a change in definition, data for 1997 are not comparable to previous years.

5 Exports are at declared customs prices and are not corrected for underinvoicing of oil and gas exports, estimated at some US$ 400 million for 2000 by the IMF.

6 The figure for 1993 includes gold and is in months of merchandise imports only.

Kyrgyzstan

Key reform challenges

- **Although most of the foreign debt is concessional, government debt service payments already amount to one-third of total expenditures, increasing pressure to reduce the fiscal deficit.**
- **The investment climate needs to be improved substantially to reverse the fall in private and foreign investment and this will require progress specifically in civil service and tax reform.**
- **The financial system needs revitalisation, including the transfer of the banks under central bank administration to private ownership; however, much-needed capital infusions will depend on improvements in regulatory framework and supervision.**

Liberalisation

Liberalisation is sustained despite regional trade pressures.
Kyrgyzstan has a very liberal trade regime and no capital account restrictions. The top customs duty was reduced by 10% at the beginning of the year, and the average tariff is now 5.2%. Nevertheless, according to a World Bank study, trade is considerably hampered by corruption in the customs service. The country's WTO accession in 1998 poses some difficulties within the region because of Kyrgyzstan's simultaneous membership in a customs union with Belarus, Kazakhstan, Russia and Tajikistan. For example, Kazakhstan temporarily raised tariffs for imports from Kyrgyzstan, partly to prevent importers from using Kyrgyzstan to avoid paying Kazakhstani customs duties.

Stabilisation

Macroeconomic stability has been regained …
Following a nominal fall of 100% against the US dollar since the middle of 1998, the exchange rate has stabilised in recent months. Inflation, which accelerated to 40% at the end of 1999, has fallen below 20% year-on-year. The real depreciation of the som has greatly helped to redress external imbalances. The terms of trade with Russia and Kazakhstan are now close to those prior to the Russian crisis. However, with a projected decline of official net capital inflows a further adjustment of the exchange rate may be needed unless the productivity of the private sector is significantly boosted.

… but efforts are needed to raise revenues and cut an excessive investment programme.
Reducing fiscal imbalances remains the key macroeconomic challenge. Kyrgyzstan's tax intake is among the lowest in the region. For instance, with a VAT rate of 20% Poland collects 13% of GDP in taxes, while in Kyrgyzstan the same tax rate yields only 5.8% of GDP. Low revenue collection is largely due to inefficient administration. There are also major asymmetries in the taxation of different sectors. The biggest sector in the economy, agriculture, for example, paid only 0.8% of GDP in taxes in 1998, which could be greatly improved by applying the land tax to the actual land value. On the expenditure side, following major cuts in current expenditure during 1999, the main challenge will be to cut the excessive public investment programme (PIP), which absorbs about 6-7% of GDP in 2000. The IMF agreement of mid-1999 foresees a reduction in the PIP by half over the next two years.

Privatisation

Large-scale privatisation is waiting for a boost.
While privatisation of small-scale enterprises is largely complete, large-scale privatisation has proceeded very slowly since 1997. Further delays in the privatisation of strategic public monopolies have occurred in 1999-2000. The slowdown is partly due to frequent government reshuffles and to the electoral cycle, but also to ongoing economic difficulties, which have decreased investors' interest. The main sectors scheduled for privatisation in 2000 are telecommunications, one energy distribution company and the national airline. Additionally, two banks are scheduled for privatisation. The successful conclusion of these sales will be key to shoring up crumbling investor confidence in the country.

Enterprise reform

Major civil service reform is needed.
The state employs currently about one-quarter of the total workforce, a level much too high for a country at its level of development and with a low tax intake. As a result, the average wage in the public administration is below the average wage in industry. Furthermore the distribution of wages is artificially compressed. The low pay for tax inspectors and judges, which are well-paid professionals in most countries, is one reason why Kyrgyzstan is reported to have one of the most corrupt tax services and one of the least well funtioning judiciaries in the region. A major civil service reform is being drawn up with the help of the UNDP and the EU, which is concentrating on the downsizing of the sector and the decompression of wages to allow for competitive remuneration of qualified staff.

Liberalisation, stabilisation, privatisation

1991
- Aug — Independence from Soviet Union
- Dec — Small-scale privatisation begins

1992
- Jan — Most prices liberalised

1993
- Apr — Free trade agreement with Russia
- May — Exchange rate unified
- May — New currency (som) introduced
- May — Treasury bills market initiated

1994
- Apr — Interest rates liberalised
- May — Most export taxes eliminated
- Jul — First IMF ESAF programme introduced

1995
- Mar — Full current account convertibility introduced

1996
- Jan — VAT introduced
- Jul — New tax code introduced

1997
- Jul — Customs union with Russia, Kazakhstan and Belarus

1998
- Jan — New central bank law becomes effective
- Jul — Abolition of all remaining foreign exchange controls
- Oct — Private land ownership passed in referendum
- Dec — WTO membership

1999
- Jul — Comprehensive Development Framework initiative launched

However, it is not expected to be implemented before 2001.

Property and contract rights are not well protected.
While legislative reforms have been extensive, the effectiveness of new laws is often weakened by inconsistencies with other pieces of legislation. One example is the law on pledge, considered largely adequate on paper. In practice, court procedures as well as inconsistencies with regulations under the Civil Code effectively prevent rapid out-of-court settlement, while delays and high fees (amounting to as much as 20% of the realised value of the pledge) discourage enforcement through the courts. As a result of this deficiency some banks have virtually suspended lending to the real sector.

Enterprises, infrastructure, finance and social reforms

1991

Jun	Banking laws adopted

1992

Dec	Comprehensive central bank law adopted

1994

Jan	Kyrgyz State Energy Holding Company established
Feb	Telecommunications company corporatised
Apr	Competition law introduced
May	Enterprise restructuring agency established

1995

May	Stock exchange begins trading
Jun	BIS capital adequacy enacted
Oct	First enterprise liquidations

1996

Sep	Securities and exchange commission established

1997

Jan	Electricity law adopted
May	Utilities privatisation suspended
Jun	Restructuring of state energy company
Jul	IAS introduced
Oct	New bankruptcy law enacted
Oct	National Agency for Communication established

1998

Jun	Major amendments to pension law
Oct	New telecommunications law enacted
Dec	Foreign investor advisory council established

1999

Feb	Largest bank placed under conservatorship

Little evidence of active restructuring in industry.
In contrast to the strong recovery in neighbouring countries, industrial output fell by 2% in 1999 and only started to recover in the second quarter of 2000. Moreover, there is little sign of active restructuring. For example, out of 526 medium-sized and large enterprises, almost one-quarter (123) were reported as not operating in 1999 and a further significant share was operating at less than one-half their reported capacity. Furthermore, Kyrgyzstan still has large areas of under-utilised or unused agricultural land in the north. Better use of land could be promoted by imposing a more comprehensive land tax that increases the cost of not using land productively.

Infrastructure

Reform of telecommunications is relatively well advanced.
A new telecommunications law was enacted in 1998 and an independent regulator established. However, tariffs remain well below cost-recovery levels. A tender for the sale of 40% of the national telecommunications operator, JSC Kyrgyz Telecom, specifying investment commitments of at least US$ 200 million, is currently under way. Four bidders have passed the initial round and a special government commission is currently making the final choice. Currently, there are two mobile operators – the Kyrgyz-US joint venture Katel, providing AMPS standard cellular communication, and Bitel, providing GSM standard cellular communication. The country has the highest number of direct Internet subscribers in Central Asia and a number of Internet cafés have opened in Bishkek, offering affordable access to the population.

Reforms of the energy sector are under way.
With World Bank support, the state-owned energy company Kyrgyzenergo is being divided into generation, distribution and transmission units. The distribution network has been split into three regional distribution companies, of which at least one is to be privatised by international tender later in 2000. A condition of the World Bank programme is that electricity and heating tariffs are raised to cost-recovery levels by 2002. Significant investments into new hydro power stations continue. Electricity output increased by 22% in 1999. A third of the increased production was exported to Kazakhstan and Uzbekistan, the rest was used to economise on fuel imports. Kyrgyzstan continues to rely on neighbouring Kazakhstan and Uzbekistan for much of its gas and oil requirements, and supplies of gas from Uzbekistan have been repeatedly interrupted over the past years by payments disputes.

Financial institutions

Exchange rate depreciation and bank failures have collapsed the financial system …
Due to the depreciation of the exchange rate and the failures of major financial institutions the combined capital of the banking system has fallen to US$ 15 million. Six of the largest banks were either placed under forced administration by the central bank or were liquidated. Only one domestic and one foreign private bank with a significant asset base are still operating. Since the beginning of 1999 the share of loans classified as substandard, doubtful or losses has risen from 7% to 25%. Access to new credit by the private sector is virtually non-existent.

… but regulatory tightening and planned bank privatisations make for a more optimistic outlook.
The central bank has increased the capital requirement to KGS 50 million (US$ 1 million) by August 2000 and to KGS 100 million (US$ 2 million) by July 2001 to rebuild a more stable banking system. Only two banks have complied with the new capital requirements so far. The savings bank, holding the country's largest client base and branch network, is to be sold to a strategic investor, following its recapitalisation. Kairat Bank, which has the largest share of corporate assets (most of them non-performing) on its books, is also up for sale. The attraction of new investment into the banking sector proves difficult, however, because of low profitability. Banks have to keep their capital and reserves in Kyrgyz som and therefore frequently incur high losses due to the depreciation of the currency. To address this problem, the NBKR introduced an insurance system. Reserves are converted at a fixed rate, which is adjusted only twice a year. Furthermore, the establishment later in 2000 of a major new foreign bank, which has the permission to keep its funds in foreign currency, will be a major step forward.

Social reform

Improved targeting of social expenditures key.
Social spending, including expenditures of the social fund, makes up 28% of the government budget and 7% of GDP. Nonetheless, poverty rates are extremely high at over 60% of the population, according to some household surveys. The current IMF programme protects social expenditures from further fiscal cuts. Nonetheless, improved targeting is key if high payroll tax rates are to be reduced in the future. The government has started discussions with the IMF and the World Bank to develop a Poverty Reduction Strategy Paper to be completed by March 2001.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenues in GDP – **18.6%**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **MEBOs**
Tradability of land – **limited de facto**

Enterprises
Competition office – **no**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **12%**
Deposit insurance system – **no**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **60%**
Private pension funds – **yes**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	60.0	40.0	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	na	na	na	7.0	7.0	7.0	7.0	7.0	na
Share of total trade with non-transition countries (in per cent)	na	na	na	40.2	17.6	19.4	33.5	57.7	55.7
Share of trade in GDP (in per cent)	na	na	na	69.1	63.0	72.1	72.2	78.4	81.4
Tariff revenues (in per cent of imports)	na	na	na	1.0	2.3	2.0	2.2	2.4	1.4
EBRD Index of price liberalisation	1.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	2.0	2.0	3.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.0	0.2	0.6	0.9	1.3	1.4	1.6	1.9
Private sector share in GDP (in per cent)	15.0	20.0	25.0	30.0	40.0	50.0	60.0	60.0	60.0
EBRD index of small-scale privatisation	1.0	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	1.0	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP) [1]	na	na	na	2.1	2.3	1.8	2.2	2.5	2.3
Effective/statutory social security tax rate (in per cent)	na	36.8	na	38.4	49.2	44.2	47.7	na	na
Share of industry in total employment (in per cent)	17.7	16.3	16.0	14.7	12.5	11.1	10.2	8.9	na
Change in labour productivity in industry (in per cent) [2]	7.4	-23.7	-17.0	-14.5	-25.8	16.5	48.8	18.0	na
Investment rate (in per cent of GDP)	16.1	14.6	13.4	5.6	20.7	22.6	12.6	12.2	na
EBRD index of enterprise reform	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	7.5	7.5	8.0	7.3	7.7	7.5	7.6	7.6	7.6
Railway labour productivity (1989=100) [3]	90.5	73.5	54.3	39.7	34.4	32.1	31.7	33.0	30.1
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	0.74 (65)	1.00 (70)	2.25 (75)	2.00 (80)	0.48 (101)	0.37 (93)
Electricity consumption/GDP (1989=100)	109.2	127.7	149.4	180.9	175.7	155.4	135.3	139.7	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	1.9	1.9
Financial institutions									
Number of banks (of which foreign owned)	10 (0)	15 (1)	20 (1)	18 (3)	18 (3)	18 (3)	20 (3)	23 (6)	23 (5)
Asset share of state-owned banks (in per cent)	98.8	na	na	77.3	69.7	5.0	8.0	7.1	21.4
Bad loans (in per cent of total loans) [4]	10.0	na	na	92.3	72.0	26.1	7.5	0.2	6.4
Domestic credit to enterprises (in per cent of GDP)	na	na	na	na	12.5	8.7	3.5	5.3	5.1
Stock market capitalisation (in per cent of GDP) [5]	na	na	na	na	na	0.3	3.2	23.7	na
EBRD index of banking sector reform	1.0	1.0	1.0	2.0	2.0	2.0	2.7	2.7	2.3
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	1.0	1.7	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	3.0	3.0	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	2.0	2.0	3.0
Social sector									
Expenditures on health and education (in per cent of GDP)	0.0	0.0	6.8	9.6	10.5	8.4	8.1	7.7	6.4
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	305.0	303.0	na
Basic school enrolment ratio (in per cent)	90.6	90.3	89.7	89.0	89.2	89.4	89.4	89.7	na
Earnings inequality (GINI-coefficient)	na	30.0	44.5	44.3	39.5	42.8	43.1	na	na

1 Refers to transfers and subsidies.

2 The increase in industrial labour productivity in 1997 was primarily due to the rise in production at the Kumtor gold mine.

3 Data prior to 1993 was not available; the index is based on 1993=100.

4 In 1998 all bad loans in the banking system were transferred to a special bank managed by NBKR. The data reported by the central bank are likely to exclude these bad loans.

5 The listing of the state energy company, Kyrgyzenergo, accounts for the large increase in capitalisation in 1998.

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					*(Percentage change in real terms)*				
GDP	-19.0	-16.0	-20.1	-5.4	7.1	9.9	2.1	3.6	5
Private consumption	na	na	-20.9	-17.8	3.6	-10.8	15.1	na	na
Public consumption	na	na	-14.4	-8.7	16.4	4.0	15.1	na	na
Gross fixed investment	na	na	-30.2	55.4	-14.2	-30.3	-3.4	na	na
Exports of goods and services	na	na	-19.0	-17.4	6.7	21.1	-8.7	na	na
Imports of goods and services	na	na	-22.2	-18.4	6.9	-20.2	1.5	na	na
Industrial gross output	-26.4	-25.3	-23.5	-36.9	3.9	39.7	4.6	-1.7	na
Agricultural gross output	-5.0	-10.0	-15.0	4.0	-0.9	3.0	11.6	8.7	na
Employment					*(Percentage change)*				
Labour force (annual average)	2.2	-0.4	0.2	1.4	2.6	1.9	na	na	na
Employment (annual average) [1]	4.7	-8.5	-2.1	-0.2	0.6	2.3	0.9	na	na
					(In per cent of labour force)				
Unemployment (end-year) [2]	na	na	3.1	4.4	6.0	4.3	na	na	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	855.0	772.4	228.7	40.7	31.3	25.5	12.0	36.8	18.6
Consumer prices (end-year)	1,259.0	1,363.0	95.7	32.3	34.9	14.7	18.4	39.9	9.0
Producer prices (annual average)	na	649.7	196.7	37.6	26.1	29.0	na	na	na
Producer prices (end-year)	na	224.6	96.7	17.0	23.0	26.0	8.0	53.0	na
Gross average monthly earnings in economy (annual average)	515.4	628.7	178.5	57.8	33.3	38.6	16.0	34.0	na
Government sector [3]					*(In per cent of GDP)*				
General government balance [3]	na	-14.4	-5.7	-8.4	-8.8	-8.8	-11.2	-12.8	-7.2
General government expenditure [3]	na	39.0	32.4	33.2	32.7	32.7	35.6	36.8	na
General government debt	na	na	37.0	40.0	44.2	54.0	76.3	98.7	na
Monetary sector					*(Percentage change)*				
Broad money (M2, end-year)	na	na	na	80.1	21.3	25.4	17.2	33.9	na
Domestic credit (end-year)	na	na	na	71.0	20.9	4.1	32.2	na	na
					(In per cent of GDP)				
Broad money (M2, end-year)	na	na	12.7	17.1	14.3	13.6	14.4	13.6	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinancing rate [4]	na	276.8	89.5	45.8	45.9	23.5	32.9	49.0	na
Treasury bill rate (3-month maturity)	na	na	73.0	44.0	52.3	23.5	32.9	65.5	na
Deposit rate [5]	na	na	na	na	24.8	32.0	29.5	na	na
Lending rate [5]	na	na	na	na	58.3	50.1	42.5	na	na
					(Soms per US dollar)				
Exchange rate (end-year) [6]	511.0	8.0	10.7	11.2	16.7	17.4	29.4	45.5	na
Exchange rate (annual average) [6]	226.2	6.1	10.8	10.8	12.8	17.4	20.8	39.0	na
External sector					*(In millions of US dollars)*				
Current account	na	na	-84.3	-234.8	-424.8	-139.2	-369.4	-184.9	-150.0
Trade balance	na	na	-86.1	-122.0	-251.7	-16.0	-220.0	-84.0	-68.0
Merchandise exports	na	na	340.0	408.9	531.2	630.0	535.0	462.0	505.0
Merchandise imports	na	na	426.1	530.9	782.9	646.0	755.0	546.0	573.0
Foreign direct investment, net	na	na	38.2	96.1	46.8	83.0	108.6	35.4	42.0
Gross reserves (end-year), excluding gold	na	na	67.3	66.3	85.3	169.2	147.5	205.2	na
External debt stock	na	na	413.8	763.9	1,151.2	1,356.1	1,472.6	1,718.7	na
					(In months of imports of current account expenditure, excluding transfers)				
Gross reserves (end-year), excluding gold	na	na	1.6	1.0	1.0	2.3	1.7	na	na
					(In per cent of current account revenues, excluding transfers)				
Debt service	na	na	4.8	22.3	15.5	12.1	21.8	26.4	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	4.5	4.5	4.5	4.5	4.6	4.6	4.7	4.7	na
GDP (in millions of soms) [7]	765,000	5,355	12,019	16,145	23,399	30,686	34,181	48,321	55,900
GDP per capita (in US dollars)	751.7	195.1	249.1	330.7	398.4	382.1	350.2	263.8	na
Share of industry in GDP (in per cent)	32.2	25.1	20.5	12.0	11.1	16.5	16.3	18.4	na
Share of agriculture in GDP (in per cent)	37.6	39.2	38.4	40.7	46.3	41.2	36.1	38.5	na
Current account/GDP (in per cent)	na	na	-7.6	-15.7	-23.3	-7.9	-22.4	-14.9	-12.8
External debt – reserves (in US$ millions)	na	na	347	698	1,066	1,187	1,325	1,513	na
External debt/GDP (in per cent)	na	na	37.3	51.2	63.2	76.8	89.5	138.7	na
External debt/exports of goods and services (in per cent)	na	na	111.0	170.1	204.6	200.9	246.3	326.1	na

[1] An industrial sector enterprise survey conducted by the ILO in 1995 found that employment fell by about one-third between 1991 and 1994.

[2] Registered unemployed. The true rate of unemployment is unofficially estimated to be around 20%.

[3] General government includes the state, municipalities and extrabudgetary funds. They also include expenditure under the foreign financed PIP. General government expenditure includes net lending.

[4] Simple average of National Bank's credit auction rates. Credit auctions were discontinued at the end of January 1997 and the 3-month treasury bill rate has become the official reference rate.

[5] Weighted average over all maturities.

[6] Roubles per dollar until 1992; som per dollar thereafter.

[7] Excluding Kumtor gold imports.

Latvia

Key reform challenges

- **The main challenge for Latvia will be to maintain macroeconomic stability given persistently large current account deficits and the low level of foreign direct investment since the Russian crisis.**
- **In this respect, a political consensus is required on a consistent set of objectives to complete large-scale privatisation and to develop an appropriate regulatory framework to foster competition in the infrastructure sectors.**
- **The development of the capital markets and the sustainability of public finances should be accelerated through the implementation and further reform of private pensions legislation.**

Liberalisation

EU accession negotiations begin.
Following a shift in the EU enlargement strategy, Latvia was invited to start EU accession negotiations in December 1999. The EU's decision to accept Latvia as a candidate should have significant reform benefits including greater policy stability and institutional development. Negotiations on eight chapters of the *acquis communautaire* were opened in March 2000.

Trade protection measures were lifted.
In June 2000, Latvia lifted its pork market protection measures, which were introduced in June 1999 following the Russian crisis. It had imposed extra customs tax at a rate of 70%. The measures were deemed to be temporary, but were extended in December 1999 for a period of two years. In their place, the government will now provide around lat 1 million in subsidies to pork farmers as of July 2000. Latvia lifted the measures in order to implement the agreement on mutual liberalisation of trade in agricultural products with the EU and to avoid counter-measures from neighbouring countries. Moreover, starting in April 2000, agricultural tariff rates were reduced in line with WTO commitments and all tariff rates above EU levels were reduced to EU levels.

Stabilisation

New agreements reached with the IMF and the World Bank, but agreed targets are slipping.
A new stand-by arrangement with the IMF was agreed in December 1999 for the amount of US$ 45 million. The programme calls for strict fiscal tightening (with an agreed target deficit of 2% of GDP in 2000 and 1% in 2001) and a comprehensive schedule for large-scale privatisation (although part of this has already slipped). However, the most recent indications are that the government will deviate from the agreed targets, since the Ministry of Finance in September 2000 proposed to increase the budget deficit to 2.4-2.7% of GDP in 2000 and 1.74% of GDP in 2001. Also, in March 2000, the World Bank approved a Programmatic Structural Adjustment Loan for Latvia, but a further disbursement is at risk due to delays in agreed privatisation and institutional reform timetables.

Privatisation

Political tensions slow remaining large-scale privatisation.
The privatisation of four remaining large-scale enterprises (Latvian Shipping Company, Ventspils Nafta, Latvenergo and Lattelekom) has been consistently delayed. Delays have been due mainly to the influence of rival industrial groups in Latvia that have considerable sway in the domestic political process, the at-times conflicting objectives of retaining domestic control over major enterprises and attracting foreign strategic investors to maximise revenues for the state budget and to enhance enterprise performance. In April 2000, these differences contributed to the resignation of the then Prime Minister Andris Skele and the collapse of his government. However, the new government has agreed that international advisers, selected through public tenders, will be involved in advising the government authorities on each large-scale privatisation.

The privatisation of the Latvian Shipping Company failed for the third time.
Attempts to privatise 44% of the Latvian Shipping Company failed in March 2000 for the third time in three years, when the only bid submitted was rejected by the privatisation agency. Interest has apparently been low because the privatisation did not allow an investor to acquire a controlling stake and the government was to retain a golden share. A decision has now been taken to sell 90% of the company and an agreement with an international consortium of advisers was signed in September 2000.

Plans to privatise part of Ventspils Nafta have been delayed.
In May 2000, the privatisation agency said it was reversing an earlier plan to sell two small stakes in Ventspils Nafta after an attempt to sell a 5% share on the local stock market failed because of the high minimum price and the small size of the stake. Currently, the state intends to divest 38.6% of Ventspils Nafta's shares. In September 2000, an international tender for an adviser ended unsuccessfully due to the low quality of bids submitted and a new tender was announced.

Enterprise reform

Improvements to corporate governance are under way.
Based on the April 1999 World Bank FIAS Report on Administrative Barriers to Investment in Latvia, the subsequent Action Plan approved in May 1999, and the recommendations of the Foreign Investors' Council in Latvia which resulted in a pooled Action Plan approved in February 2000, a number of initiatives are now under way in Latvia to improve the business environment. Among other things these initiatives are aiming to cut red tape, decrease possibilities for corruption and reduce the costs of

Liberalisation, stabilisation, privatisation

1990

Nov	Unified exchange rate introduced

1991

Jan	Personal income tax introduced
Aug	Soviet trade equalisation tax abolished
Sep	Independence from Soviet Union
Oct	Restitution law enacted
Nov	Foreign investment law enacted
Nov	Small-scale privatisation commenced

1992

Jan	Most consumer prices liberalised
Jan	VAT introduced
Jan	Wages liberalised
Jun	Privatisation law enacted
Jun	Large-scale privatisation commenced
Jun	Most controls on foreign trade removed
Jul	Interest rates liberalised

1993

Feb	Tradability of land rights enacted
Mar	New currency (lat) introduced
Dec	Treasury bills market initiated

1994

Feb	Privatisation law amended
Feb	Privatisation agency established
Jun	Full current account convertibility introduced

1996

Jun	EFTA membership

1999

Feb	WTO membership
May	First sovereign Eurobond issued
Dec	Invited to begin EU accession negotiations

2000

Apr	Agricultural tariffs reduced

Enterprises, infrastructure, finance and social reforms

1991	
Dec	Competition law enacted
1992	
May	Two-tiered banking system established
May	Banking law enacted
Oct	IAS accounting introduced
1993	
May	Company law enacted
Dec	Stock exchange established
1994	
Jan	BIS capital adequacy requirement introduced
1995	
May	Banking crisis
Jul	Stock exchange begins trading
Oct	New banking law enacted
Oct	IAS accounting for banks introduced
Oct	First state-owned bank privatised
1996	
Jun	Energy Regulation Council established
Sep	Bankruptcy law enacted
1997	
Jun	New competition law enacted
Aug	First corporate Eurobond issued
Nov	Major adjustments of electricity tariffs
Dec	First corporate GDR issue
1998	
Jan	Anti-monopoly office established
Jul	Private pension law enacted
Sep	New energy law adopted
Sep	New insurance law enacted
Nov	Railway law adopted
1999	
Aug	PAYG pension system reformed
2000	
Feb	Law on second pension pillar passed
May	Law on unified financial sector supervision adopted

creating new businesses, A new EU-compatible commercial code was also passed in April 2000, which enhances minority shareholder rights and further protects creditor interests.

Infrastructure

A stake in the gas utility company was sold …
A 27% stake in the gas utility (AS Latvijas Gaze) was auctioned in March 2000 for US$ 47 million. Most of the existing strategic investors were successful in increasing their respective stakes. As a result of the sale, Ruhrgas increased its stake to 26%, Itera to 21%, Gazprom to 18% and Preussen Elektra to 17%. The state retains a 10% stake. There are plans to sell a further 2% of the state holdings in late 2000.

… but parliament blocked a restructuring and privatisation plan for Latvenergo.
In February 2000, the Latvian government approved a plan for the restructuring of Latvenergo by the end of the year and the privatisation of some of the parts in the first quarter of 2001. According to the plan, the hydropower stations and high voltage network were to remain in state hands, while stakes of up to 49% in the thermal power stations were to be sold. Although the low-voltage distribution network was not to be sold under the plan, the plan did allow for private companies to take over the maintenance of the network and the purchase and sale of energy. However, 23% of eligible Latvians signed a petition for a referendum against privatisation and, in August 2000, parliament adopted amendments to the energy law blocking the sale of any parts of Latvenergo, retaining it as a vertically integrated company.

Negotiations to shorten the fixed-line monopoly of Lattelekom continue.
The sale of the government's residual majority stake in Lattelekom will be delayed until the government succeeds in renegotiating the end of Lattelekom's fixed-line monopoly (bringing it forward from 2013 to 2003 as specified under WTO commitments) and agreeing adequate compensation to the company. The state owns 51% of Lattelekom and Tilts Communications 49% (which in turn is owned 90% by Sonera of Finland and 10% by the IFC). In August 2000, Tilts decided to take the government to the International Court of Arbitration for non-implementation of the umbrella agreement. The government, in turn, has submitted a counter-claim on the basis of non-implementation by the company of the agreed investment plan and failure to modernise the sector as committed. In September 2000, a consortium led by Chase was confirmed as the adviser to the privatisation.

Financial institutions

Banking sector consolidation is under way.
The Latvian banking system was severely affected by the crisis in late 1998 in Russia. Rigas Komercbanka, the country's third-largest bank at the time, was declared insolvent and closed in March 1999, but, after a successful recapitalisation, re-opened in October 1999. In May 2000, 90% of the bank was sold to Norddeutsche Landesbank of Germany. The failure of two smaller banks, and mergers among others, reduced the number of licensed banks from 27 at the end of 1998 to 23 at the end of 1999.

The Bank of Latvia has gradually brought its prudential regulations close to full compliance with the Basle Core Principles on Effective Banking Supervision and the relevant EU directives. To comply with EU standards, the minimum statutory capital for banks was raised to €5 million in January 2000. This requirement and increased competition are leading to further banking sector consolidation, reducing the number of banks to 21 by the middle of 2000. In early 2000, Hansabanka acquired Ventspils Apvienota Baltijas Banka. A further strengthening of the sector is under way following the announcement in August 2000 by the Swedish SE Banken bank to buy 100% of its three subsidiaries in the Baltic region, which includes Latvia's Unibanka, through a cash offer for outstanding shares, creating the region's largest financial group.

Law on unified financial sector supervision passed.
In May 2000, the parliament adopted a law for consolidated financial sector supervision. The Finance and Capital Markets Commission is due to take over in July 2001 the supervision of brokerages, insurers, credit institutions, investment funds, private pension funds and other financial market participants. The Commission will have considerable independence by setting its own budget and raising its own revenue from fees of market participants. The chairman and deputy chairman of the commission shall be nominated by the central bank and finance ministry, and approved by parliament. However, the independence of the Commission may be undermined by a provision in the law allowing the removal of the Chairman and Deputy Chairman from office at the joint request from the Minister of Finance and the Governor of the Bank of Latvia.

Social reform

Pension reforms advance.
In February 2000, parliament adopted the Law on State-Funded Pensions for the second pillar of the pension system. Contributions will be collected starting in July 2001, gradually rising from 2% of income in 2001-06 to 10% by 2010 with the first pillar being reduced accordingly. Participation in the scheme will be mandatory for those who are subject to state pension insurance and under the age of 30, but optional for those aged between 30 and 49 years. For the initial 18 months, the State Treasury will manage the accumulated capital, but starting in 2003 the management will be entrusted to private companies. However, in order to help ensure that the three-pillar system is financially sustainable, the government committed to submit additional amendments to the law to increase the pace at which the retirement age is raised, tighten the rules allowing early retirement and eliminate the current limits on pensions to working pensioners.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **no**

Social reform
Share of the population in poverty – **23%**
Private pension funds – **yes**

Stabilisation
Share of general government tax revenues in GDP – **36.1%**
Exchange rate regime – **fixed**

Enterprises
Competition office – **yes**

Financial sector
Capital adequacy ratio – **10%**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **yes**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	6.1	6.1	16.6	16.6	17.8	19.6	20.4	na
Number of goods with administered prices in EBRD-15 basket	15.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	na
Share of total trade with non-transition countries (in per cent)	na	46.8	43.6	46.4	49.5	50.0	56.7	66.4	na
Share of trade in GDP (in per cent)	na	na	96.7	64.3	74.5	73.5	80.2	84.7	76.8
Tariff revenues (in per cent of imports)	na	na	2.9	3.2	1.8	1.5	1.4	1.1	0.9
EBRD Index of price liberalisation	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.3
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	1.0	10.2	40.8	70.6	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	na	na	0.3	0.7	0.8	2.2	3.3	3.5
Private sector share in GDP (in per cent)	10.0	25.0	30.0	40.0	55.0	60.0	60.0	65.0	65.0
EBRD index of small-scale privatisation	1.0	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	1.0	2.0	2.0	2.0	2.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	na	0.2	0.4	0.8	5.2	4.7	5.5
Effective/statutory social security tax rate (in per cent)	na	65.4	63.7	50.6	53.5	49.5	55.7	na	na
Share of industry in total employment (in per cent)	26.6	26.3	23.8	23.4	20.5	19.8	20.2	18.4	17.3
Change in labour productivity in industry (in per cent)	na	na	-26.7	2.7	10.5	7.4	2.5	11.0	-2.7
Investment rate (in per cent of GDP) [1]	6.2	11.2	13.8	14.9	15.1	18.1	18.7	20.1	na
EBRD index of enterprise reform	1.0	2.0	2.0	2.0	2.0	3.0	2.7	2.7	2.7
EBRD Index of competition policy	1.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	24.3	24.9	26.6	25.8	28.0	29.8	30.2	30.2	30.0
Railway labour productivity (1989=100)	82.5	58.5	54.0	48.8	50.2	65.6	75.4	72.0	73.6
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	2.7 (85)	4.7 (85)	5.6 (94)	6.4 (98)	6.6 (99)	6.7 (99)
Electricity consumption/GDP (1989=100)	102.0	126.0	112.7	106.1	106.7	101.8	95.8	94.2	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.9	3.1
Financial institutions									
Number of banks (of which foreign owned) [2]	14 (na)	50 (na)	62 (na)	56 (na)	42 (11)	35 (14)	32 (15)	27 (15)	23 (12)
Asset share of state-owned banks (in per cent)	na	na	na	7.2	9.9	6.9	6.8	8.5	na
Bad loans (in per cent of total loans)	na	na	na	11.0	19.0	20.0	10.0	6.3	na
Domestic credit to enterprises (in per cent of GDP)	na	na	na	16.4	7.8	7.2	10.5	14.9	16.7
Stock market capitalisation (in per cent of GDP)	na	na	na	na	0.2	3.0	6.1	6.1	6.3
EBRD index of banking sector reform	1.0	2.0	2.0	3.0	3.0	3.0	3.0	2.7	3.0
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	2.0	2.0	2.0	2.3	2.3	2.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	3.3	3.3	3.7
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	3.0	2.0	3.0
Social sector									
Expenditures on health and education (in per cent of GDP)	7.0	7.4	10.1	10.0	10.6	9.6	9.5	10.5	na
Mortality rate (per 1,000 male adults)	na	na	na	na	327.6	na	306.0	301.0	na
Basic school enrolment ratio (in per cent)	94.5	91.1	89.1	88.6	89.1	90.7	91.3	90.9	na
Earnings inequality (GINI-coefficient)	24.7	33.3	28.3	32.5	34.6	34.9	33.6	na	na

1 Source: World Bank *World Development Indicators*. IMF data show considerably higher investment rates of 27.6% in 1998 and 26.3% in 1999.

2 The number of foreign banks is legally defined as banks with foreign shareholders owning more than 50% of share capital.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	Projection
Output and expenditure					*(Percentage change in real terms)*				
GDP	-34.9	-14.9	0.6	-0.8	3.3	8.6	3.9	0.1	4.5
Private consumption	na	na	3.2	0.6	10.3	5.0	6.2	0.8	na
Public consumption	na	na	-0.9	7.7	1.8	0.3	6.1	-6.7	na
Gross fixed investment	na	na	0.8	8.7	22.3	20.7	44.0	-10.4	na
Exports of goods and services	na	na	-8.4	3.3	20.2	13.1	4.9	-5.8	na
Imports of goods and services	na	na	-0.7	1.3	28.5	6.8	19.0	-6.2	na
Industrial gross output	na	-38.1	-9.5	-6.5	1.4	6.1	2.0	-8.8	na
Agricultural gross output	-28.6	-18.2	-15.0	3.1	-5.3	4.9	-5.3	-8.3	na
Employment					*(Percentage change)*				
Labour force (annual average)	-4.1	-2.0	-1.5	-1.9	-1.0	-3.6	-0.4	-1.0	na
Employment (annual average)	-7.3	-6.9	-10.1	-3.5	-2.7	1.9	0.6	-0.5	na
					(In per cent of labour force)				
Unemployment (annual average)	3.9	8.7	16.7	18.1	19.4	14.8	14.0	14.4	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	951.2	109.2	35.9	25.0	17.6	8.4	4.7	2.4	2.9
Consumer prices (end-year)	958.6	34.9	26.3	23.1	13.1	7.0	2.8	3.2	2.3
Producer prices (annual average)	2,554	117.1	16.9	11.9	13.7	4.1	1.9	-4.0	na
Producer prices (end-year)	na	36.3	10.7	15.9	7.7	3.6	-1.9	-1.1	na
Gross average monthly earnings in economy (annual average)	na	119.7	52.2	24.5	10.3	21.6	11.1	5.8	na
Government sector [1]					*(In per cent of GDP)*				
General government balance	na	na	-4.4	-3.9	-1.8	0.3	-0.8	-4.2	-2.7
General government expenditure	na	na	40.5	41.2	39.2	41.0	43.4	46.8	na
General government debt	na	na	14.1	16.1	14.4	12.0	10.5	13.8	na
Monetary sector					*(Percentage change)*				
Broad money (M2X, end-year)	na	na	47.4	-23.1	19.9	38.7	5.9	8.0	na
Domestic credit (end-year)	na	na	72.3	-28.2	6.0	39.3	30.6	15.2	na
					(In per cent of GDP)				
Broad money (M2X, end-year)	na	31.5	33.4	22.3	22.2	26.6	25.7	27.2	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinancing rate	na	27.0	25.0	24.0	9.5	4.0	4.0	4.0	na
Interbank market rate [2]	na	56.6	37.8	21.1	9.7	3.9	7.0	2.7	na
Deposit rate (short-term)	na	28.4	18.8	15.0	10.0	5.3	6.5	4.2	na
Lending rate (short-term)	na	70.8	36.7	31.1	20.3	12.1	16.4	12.5	na
					(Lats per US dollar)				
Exchange rate (end-year)	na	0.60	0.55	0.54	0.56	0.59	0.57	0.58	na
Exchange rate (annual average)	na	0.67	0.56	0.53	0.55	0.58	0.59	0.59	na
External sector					*(In millions of US dollars)*				
Current account	na	417	201	-16	-279	-345	-650	-646	-662
Trade balance	na	3	-301	-580	-798	-848	-1,130	-1,027	-1,123
Merchandise exports	na	1,054	1,022	1,368	1,488	1,838	2,011	1,889	2,172
Merchandise imports	na	1,051	1,322	1,947	2,286	2,686	3,141	2,916	3,295
Foreign direct investment, net	na	50	279	245	379	515	303	331	300
Gross reserves (end-year), excluding gold	na	432	545	506	622	704	728	840	na
External debt stock [3]	na	na	na	1,415	2,025	2,731	3,060	3,803	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	4.1	4.0	2.8	2.5	2.5	2.2	2.8	na
					(In per cent of current account revenues, excluding transfers)				
Debt service	na	na	3.9	8.1	10.0	20.5	12.2	16.8	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	2.6	2.6	2.5	2.5	2.5	2.5	2.4	2.4	na
GDP (in millions of lats)	1,005	1,467	2,043	2,349	2,829	3,275	3,590	3,662	3,961
GDP per capita (in US dollars)	na	848	1,442	1,779	2,070	2,293	2,494	2,582	na
Share of industry in GDP (in per cent)	27.9	27.9	22.5	24.3	23.0	23.9	20.2	17.6	na
Share of agriculture in GDP (in per cent)	16.5	10.7	8.4	9.4	7.9	5.1	3.7	3.6	na
Current account/GDP (in per cent)	na	19.1	5.5	-0.4	-5.4	-6.1	-10.7	-10.3	-9.9
External debt – reserves (in US$ millions)	na	na	na	910	1,403	2,027	2,332	2,962	na
External debt/GDP (in per cent)	na	na	na	31.8	39.4	48.4	50.3	60.7	na
External debt/exports and services (in per cent)	na	na	na	67.8	77.5	95.1	98.1	130.5	na

1 General government includes the state, municipalities and extrabudgetary funds. Privatisation revenues are not included in revenues. Expenditure includes net lending.

2 Weighted average interest rates in the interbank market.

3 Includes non-resident currency and deposits and loans to foreign subsidiaries.

Lithuania

Key reform challenges

- **While macroeconomic performance and external balances are improving, continued fiscal prudence is necessary to maintain the fixed exchange rate regime.**

- **Significant progress in large-scale privatisation has been marred by the lack of transparency in some transactions, although recent disclosure of the full terms of transactions is a step in the right direction.**

- **Reform of the electric power sector is necessary to enhance efficiency and financial performance, but the government should clarify the new electricity market structure before unbundling and privatising the integrated state electricity monopoly.**

Liberalisation

Commitments made to reverse agriculture protection imposed after the Russian crisis.

Import tariffs on meat, milk, sugar, cereals and their products were increased substantially in November 1998 in response to the Russian crisis. Export subsidies were also introduced in order to protect farmers that had exported to the Russian market. These measures have complicated WTO accession negotiations. However, by May 2000, WTO negotiating members had broadly agreed to a Lithuanian proposal to gradually liberalise the agricultural sector over two to three years. Separately, in an IMF Stand-by Agreement, the government has committed to bring back tariff levels on agricultural commodities to their pre-November 1998 levels by November 2000.

Stabilisation

A plan to change the currency peg has been postponed …

Before the crisis in Russia, the central bank had considered changing the currency to which the litas is pegged from the US dollar to the euro or to a basket of the euro and dollar. However, following the crisis the authorities have taken a more cautious approach towards changing the exchange rate regime. Under the March 2000 IMF agreement, the authorities have postponed a decision on the issue until 2001.

… and fiscal tightening is implemented to restore external balance.

While the exchange rate has remained fixed, its vulnerability has increased owing to persistently high current account deficits, estimated at 11% of GDP in 1999. The external imbalance reflects both a sharp fall in external demand following the Russian crisis and strong domestic demand. The loss of competitiveness in industry due to the devaluation of the rouble added pressure to the currency, while the fiscal deficit widened to an estimated 8.6% of GDP in 1999, reflecting in part expenditures on depositor compensation and additional lending to Mazeikiu oil refinery (MN). The government reached a US$ 83 million Stand-by Agreement with the IMF in March 2000. Under the agreement, the government committed to reduce substantially the fiscal deficit in 2000 to 2.8% of GDP. Given the substantial revenue short-falls during the first seven months of 2000, the government has agreed with the IMF to revise the previously agreed fiscal deficit target upwards to 3.3% of GDP.

Privatisation

Progress in large-scale privatisation …

In the past year, the government privatised a number of large-scale enterprises to foreign strategic investors. In November 1999, a 33% stake in MN was sold to a US strategic investor, Williams International, for US$ 150 million (US$ 75 million in cash to the company and US$ 75 million by a promissory note payable to the company under certain conditions in 2002). In June 2000, a 25% stake in the partially privatised Lithuanian Telecom (LT) was sold through a global IPO raising LTL 642 million (US$ 160.5 million) despite the increasingly volatile market in technology stocks. This sale leaves the state with a 10% residual holding. The government has also privatised through an international tender an 81% stake in the oil exploration and production company, Geonafta, to a Polish-Swiss-Lithuanian consortium, Naftos Gavyba, for LTL 52 million (US$ 13 million). The tender for the privatisation of a shipping company, LISCO, was awarded to the Dutch-Israeli consortium B.B. Bredo B.V in July.

… but lack of transparency in some sales has raised concerns.

The privatisation of MN was subject to criticism over the non-transparent conditions of the sale. The final terms involved a US$ 150 million payment by Williams International for a 33% stake, a new government loan of US$ 125 million to MN (in addition to an existing US$ 177 million loan) and a government guarantee over a US$ 75 million loan from Williams to MN. The government also promised guarantees for loans required for the capital expenditure programme. In addition, special benefits (concessions on taxes and railway tariffs and import tariff protection) were promised to the company. Only after the deal was signed were the loans and special benefits disclosed under pressure from the IMF.

Enterprise reform

New competition law strengthens the regulatory powers of the competition authority.

In April 1999, a new competition law in line with the EU competition directives became effective. Under the new law, the regulatory body acquired rights to have access to all the relevant documents and information as

Liberalisation, stabilisation, privatisation

1990

Feb	Central bank established
Mar	Independence from the Soviet Union
May	Personal income tax introduced

1991

Feb	Privatisation law enacted
Feb	Voucher privatisation begins
Jul	Restitution law adopted

1992

Apr	Export surrender requirement abolished
Oct	Most prices liberalised

1993

Jul	Litas becomes sole legal tender
Jul	Trade regime liberalised
Nov	Free trade agreement with Russia

1994

Apr	Currency board introduced
May	VAT introduced
May	Full current account convertibility introduced
Jul	Treasury bills market initiated
Jul	Land law enacted
Oct	Export duties abolished
Dec	Law on central bank enacted

1995

Jan	EFTA membership
Jun	First phase of privatisation completed
Jul	Cash privatisation begins
Dec	First sovereign Eurobond issued

1997

Nov	Privatisation law amended

1998

Oct	Tariffs increased on imports from CIS countries

1999

Jan	Capital gains tax introduced

2000

Mar	IMF stand-by agreement reached

Enterprises, infrastructure, finance and social reforms

1992
Sep Two-tiered banking system re-established
Sep Bankruptcy law enacted
Sep Stock exchange established
Nov First major readjustment of electricity prices
Nov Competition law enacted
Nov Competition office established

1993
Sep Stock exchange begins trading

1994
Jul Company law adopted

1995
Jan New law on commercial banks adopted
Mar Energy law enacted
Dec Banking crisis
Dec Energy utilities and railways corporatised

1996
Jan IAS accounting for banks introduced
Feb Independent securities regulator established
Mar BIS capital adequacy requirement introduced
Jul First GDR issue
Aug Majority foreign ownership in first major bank

1997
Feb Independent energy regulator established
Feb First corporate Eurobond
Jul Lithuanian Telecom corporatised
Oct New bankruptcy law enacted

1998
Apr Company law amended
Apr Pledge law enacted
Apr Mortgage registry established
Jun Lithuanian Telecom privatised
Jun IAS accounting for listed companies introduced
Aug New telecommunications law enacted

1999
Apr New competition law adopted
Jun Private pension funds law enacted

2000
May New energy law adopted

well as the rights to undertake inspections. The Competition Council (previously State Competition and Consumer Protection Office), the independent regulatory body, has reviewed 93 notifications of market concentrations including take-overs and mergers in 1999. In accordance with its rulings, the fixed-line monopoly operator Lithuanian Telecommunications Company has sold shares in the mobile operator BITE GSM and waivered the licences held in GSM 900 and DCS 1800 frequencies. Another prominent case during 1999 involved refusal by the Council to allow Lifosa (a fertiliser conglomerate) to acquire 100% of Malsena (a grain-processing conglomerate) on the grounds of market concentration in the wheat flour market.

Infrastructure

Initial steps taken to restructure and privatise Lithuanian Energy …
In May 2000, a law on the reorganisation of Lithuanian Energy, the state-owned integrated electricity monopoly, was adopted. The law sets out the framework under which the company is to be restructured and privatised. In particular, the law specifies the ways in which different assets could be divided and the company unbundled. In June 2000, CIBC Wood Gundy was appointed as a privatisation adviser through an international tender. Their aim is to separate the electricity distribution network and two power generation facilities in Elekrenai and Mazeikiai from Lithuanian Energy and to privatise the spin-offs by March 2001. It is also envisaged that two distribution networks would be established ahead of their privatisation.

… but the government needs to define the electricity market structure.
The government has yet to clarify a new market structure for electric power. The choice is between a single buyer model, providing stable revenues for the generators, or a more competitive pool/third-party access model. Clarification of this issue is a priority because it would have important implications for the privatisation process. In addition, by defining a competitive market structure the government could move towards a more efficient market where the trade in electricity within Lithuania and also within the Baltic region could take place. Trade within the region would increase the reliability of power supply, even without the operation of the Chernobyl-type Ignalina Nuclear Power Plant.

Plans for the restructuring and privatisation of the gas distribution monopoly advance.
With the intention of selling between 34% and 51% of the gas distribution monopoly, Lithuanian Gas, the government is in the process of selecting a privatisation adviser. A new law regulating the gas industry has been drafted and is currently under discussion by the parliament. Under the proposed law, likely to be adopted in autumn 2000, the gas market will be liberalised in January 2002. Non-discriminatory access of the main pipeline and the elimination of monopoly in gas supply are planned, with the State Price and Energy Control Commission having the responsibilities over the issuance of licences to suppliers.

Financial institutions

Bank privatisation moves ahead.
Privatisation of the state-owned Agricultural Bank, which had been delayed by the Russian crisis, moved forward with the selection of a consortium of the Polish bank Pekao SA and UniCredito Italiano (the majority owner of Pekao SA) for further negotiations. The government has also issued a tender notice for the privatisation of the Savings Bank.

Regulation of private pension funds and insurance companies is strengthened.
Following the passage of the law on pension funds in June 1999, secondary legislation that governs the licensing and auditing procedures of private pension funds has been drafted and is pending before parliament. The Lithuanian Securities Commission (LSC), which is the regulator of pension funds, has yet to provide licences. In the insurance sector, amendments were made to the insurance law (effective from April 2000) to provide better protection of policy holders in line with EU directives.

Lithuanian Telecom IPO boosts market capitalisation and trading volumes.
In the global IPO of Lithuanian Telecom in June 2000, about one-quarter of the shares offered were sold in Lithuania, Latvia and Estonia and listed on the National Stock Exchange of Lithuania (NSEL). The IPO had a significant impact on the market capitalisation and the trading volumes on the NSEL. The capitalisation of listed shares rose by over 50%, from LTL 4.18 billion to LTL 6.64 billion. Daily trading volume also increased significantly. Nevertheless, Lithuania has to further amend the current securities law to fully meet IOSCO standards and applicable EU directives.

Social reform

Pension reform advances gradually.
In June 1999, parliament approved the law on pension funds, which came into force in January 2000. The law establishes the legal foundations for private voluntary pension funds and will pave the way for the eventual establishment of a multi-pillar pension system as indicated in government proposals issued in May 2000. However, the funding gap of the Social Security Fund, which has been increasing in recent years, reached 1.3% of GDP in 1999. As a short-term measure to close this gap, the government increased the social security tax from 31% of wages to 34% in 2000.

Liberalisation

Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation

Share of general government tax revenues in GDP – **30.5%**
Exchange rate regime – **currency board (US dollars)**

Privatisation

Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **full** [1]

Enterprises

Competition office – **yes**

Infrastructure

Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector

Capital adequacy ratio – **10%**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform

Share of the population in poverty – **46%**
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	15.0	9.0	6.0	6.0	2.0	2.0	2.0	2.0	2.0
Share of total trade with non-transition countries (in per cent)	na	na	75.0	35.0	43.0	38.8	54.6	46.6	50.9
Share of trade in GDP (in per cent)	na	na	na	100.3	101.4	97.8	99.4	87.8	72.4
Tariff revenues (in per cent of imports) [2]	na	na	1.1	3.2	1.4	1.2	1.3	1.1	na
EBRD Index of price liberalisation	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	na	0.9	1.3	1.4	1.4	1.6	6.9	8.0
Private sector share in GDP (in per cent)	10.0	20.0	35.0	60.0	65.0	70.0	70.0	70.0	70.0
EBRD index of small-scale privatisation	1.0	2.7	3.3	4.0	4.0	4.0	4.0	4.0	4.3
EBRD index of large-scale privatisation	1.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	1.4	1.7	1.1	1.3	0.9	0.7	na
Effective/statutory social security tax rate (in per cent)	na	66.6	50.2	62.2	53.7	55.7	54.0	na	na
Share of industry in total employment (in per cent)	na	28.9	25.7	22.5	20.9	20.7	21.6	21.2	na
Change in labour productivity in industry (in per cent)	na	na	-23.1	-11.1	14.1	6.5	2.4	8.0	na
Investment rate (in per cent of GDP)	22.5	23.0	23.1	23.1	23.0	23.0	24.4	24.3	22.5
EBRD index of enterprise reform	1.0	1.0	2.0	2.0	2.0	3.0	2.7	2.7	2.7
EBRD Index of competition policy	1.0	1.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	21.9	22.5	23.1	24.1	25.4	26.8	28.3	30.0	31.4
Railway labour productivity (1989=100)	75.2	51.2	50.7	35.4	32.3	35.9	38.2	36.3	34.9
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	na	5.0 (85)	5.0 (85)	5.5 (85)	5.5 (111)	5.5 (90)
Electricity consumption/GDP (1989=100)	106.4	110.4	122.6	133.2	127.9	139.3	128.9	125.5	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.6	2.6
Financial institutions									
Number of banks (of which foreign owned)	na	na	26 (0)	22 (0)	15 (0)	12 (3)	12 (4)	12 (5)	13 (4)
Asset share of state-owned banks (in per cent)	na	na	53.6	48.0	61.8	54.0	48.8	44.4	41.9
Bad loans (in per cent of total loans)	na	na	na	27.0	17.3	32.2	28.3	12.5	11.9
Domestic credit to enterprises (in per cent of GDP)	na	na	13.8	17.6	15.2	8.7	8.6	8.9	10.1
Stock market capitalisation (in per cent of GDP)	na	na	na	1.0	2.6	11.4	17.8	10.0	10.7
EBRD index of banking sector reform	1.0	1.0	2.0	2.0	3.0	3.0	3.0	3.0	3.0
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.7	2.0	2.0	2.0	2.3	2.3	2.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	4.0	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	3.0	3.0	3.0
Social sector									
Expenditures on health and education (in per cent of GDP)	na	na	7.8	9.3	9.3	8.8	7.5	7.9	na
Mortality rate (per 1,000 male adults)	na	na	na	na	304.3	na	269.0	264.0	na
Basic school enrolment ratio (in per cent)	92.0	92.5	91.6	92.1	93.2	93.3	95.1	96.1	na
Earnings inequality (GINI-coefficient)	na	37.2	na	34.9	34.1	35.0	34.5	na	na

1 Full for non-agricultural land but ownership of agricultural land is constitutionally prohibited for foreigners and partially restricted for Lithuanian legal persons.

2 Refers to all taxes on foreign trade.

	1992	1993	1994	1995	1996	1997	1998	1999 *Estimate*	2000 *Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	-21.3	-16.2	-9.8	3.3	4.7	7.3	5.1	-4.2	2.2
Industrial gross output	-28.5	-34.4	-26.5	5.3	5.0	3.3	8.2	-9.9	na
Agricultural gross output	-23.0	-6.0	-20.0	8.0	9.0	6.0	-3.0	na	na
Employment [1]					*(Percentage change)*				
Labour force (end-year)	-1.2	-1.1	-6.4	0.7	-2.1	-5.7	0.8	1.0	na
Employment (end-year)	-2.2	-4.2	-5.8	-1.9	-0.7	-3.1	1.7	0.0	na
					(In per cent of labour force)				
Unemployment (annual average)	1.3	4.4	3.8	17.5	16.4	14.1	13.3	14.1	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	1,020.5	410.4	72.1	39.6	24.6	8.9	5.1	0.8	1.0
Consumer prices (end-year)	1,161.1	188.8	45.0	35.7	13.1	8.4	2.4	0.3	1.3
Producer prices (annual average) [2]	1,514.7	392.0	44.8	28.3	16.5	6.0	-3.9	3.0	na
Producer prices (end-year) [2]	2,407.1	131.6	33.8	20.3	12.3	0.9	-8.3	23.3	na
Gross average monthly earnings in economy (annual average)	651.7	223.7	95.9	47.8	28.5	25.9	19.5	8.9	na
Government sector [3]					*(In per cent of GDP)*				
General government balance	na	-5.3	-4.8	-4.5	-4.5	-1.8	-5.8	-8.6	-3.3
General government expenditure	na	35.4	37.4	36.8	34.2	33.7	37.9	40.6	na
General government debt	na	na	na	na	na	21.1	22.4	28.4	na
Monetary sector					*(Percentage change)*				
Broad money (M2, end-year)	245.9	100.2	63.0	28.9	-3.5	34.1	14.5	7.7	na
Domestic credit (end-year)	na	na	na	na	1.8	37.6	16.8	24.4	na
					(In per cent of GDP)				
Broad money (M2, end-year)	0.5	23.1	25.8	23.3	17.2	19.0	19.4	21.1	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Interbank interest rate	98.3	24.9	22.4	10.7	7.6	5.8	6.1	4.6	na
Treasury bill rate (3-month maturity)	na	na	20.6	22.4	10.6	9.1	11.5	12.3	na
Deposit rate [4]	42.3	19.7	7.6	7.4	4.3	1.9	2.4	5.6	na
Lending rate [5]	120.2	88.2	29.8	23.9	16.0	11.9	12.6	13.0	na
					(Litai per US dollar)				
Exchange rate (end-year) [6]	110.0	3.9	4.0	4.0	4.0	4.0	4.0	4.0	na
Exchange rate (annual average) [6]	177.3	4.3	4.0	4.0	4.0	4.0	4.0	4.0	na
External sector					*(In millions of US dollars)*				
Current account	na	-86	-94	-614	-723	-981	-1,298	-1,194	-664
Trade balance	na	-155	-205	-698	-896	-1,147	-1,518	-1,405	-1,073
Merchandise exports	na	2,026	2,029	2,706	3,413	4,192	3,962	3,147	3,933
Merchandise imports	na	2,181	2,234	3,404	4,309	5,340	5,480	4,551	5,006
Foreign direct investment, net [7]	na	30	31	72	152	328	921	478	295
Gross reserves (end-year), excluding gold	44	350	525	757	772	1,010	1,409	1,195	na
External debt stock [8]	na	na	529	1,374	2,081	3,146	3,577	4,335	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	1.7	2.4	2.3	1.9	1.9	2.7	2.7	na
					(In per cent of current account revenues, excluding transfers)				
Debt service	na	na	2.3	3.7	6.9	10.5	16.7	26.3	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	na
GDP (in millions of litai)	3,406	11,590	16,904	24,103	31,569	38,340	42,990	42,535	43,922
GDP per capita (in US dollars)	374	716	1,143	1,623	2,129	2,588	2,904	2,880	na
Share of industry in GDP (in per cent)	46.6	33.4	25.5	23.6	23.3	22.1	20.6	20.1	na
Share of agriculture in GDP (in per cent)	25.2	13.9	10.1	10.7	11.2	10.5	9.1	7.9	na
Current account/GDP (in per cent)	na	-3.2	-2.2	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0
External debt – reserves (in US$ millions)	na	na	4	617	1,309	2,136	2,168	3,140	na
External debt/GDP (in per cent)	na	na	12.4	22.8	26.4	32.8	33.3	40.8	na
External debt/exports of goods and services (in per cent)	na	na	22.5	43.1	49.4	60.2	70.5	102.3	na

1 Based on labour force survey data.

2 Producer prices excluding electricity, gas and water until 1995; total industry from 1996.

3 General government sector includes the state, municipalities and extra-budgetary funds. General government expenditure includes net lending.

4 Average interest rate on demand deposits in litai.

5 Average interest rate on loans in litai.

6 Roubles per US dollar for 1990 and 1991; talonai per US dollar for 1992; and litai per US dollar for 1993-95.

7 Covers only investment in equity capital for 1993 and 1994; equity capital and reinvested earnings for 1995 onwards.

8 Includes non-resident currency and deposits and loans to foreign subsidiaries.

Moldova

Key reform challenges

- **Constitutional reform should be completed to foster a more stable political environment, improving the prospects for the resumption of essential concessional IFI lending and for more investment.**
- **Privatisation of the wine and tobacco industries should be key priorities given their importance to the economy and growth prospects.**
- **Following the successful privatisation of some power distribution companies, the government should strive to complete privatisation in both the energy and telecommunications sectors.**

Liberalisation

Negotiations to join the WTO advance.
The government aims to complete WTO negotiations by the end of the year. An agreement has already been reached on a wide range of issues, including standards for customs valuation, trade classification and safeguards. An important unresolved issue is state support of agriculture. Moldova retains a liberal and simple tariff regime with a minimum 5% tariff on all non-energy imports; the other rates range between 10% and 15%. After allowing for exemptions, the weighted average tariff rate was 4.8% in 1999, down from 11.6% in 1997.

Stabilisation

IFI programmes suspended with failure to implement key privatisations …
While the economy contracted by almost 4.5% in 1999, mainly because of the impact of the Russian crisis on exports, there have been a number of other setbacks. Failure of the parliament to approve the privatisation of the wine and tobacco industries in November 1999 contributed to the fall of the government. It also led the IMF to suspend drawings under the extended fund facility (EFF) and the World Bank to suspend disbursements from its Structural Adjustment Credit, thus increasing the financial pressures on the government. Although the government met the other conditions of the IMF during the first quarter of 2000, parliament continued to refuse approval of the privatisation of these entities, resulting in the effective termination of the EFF in May 2000.

… while a severe drought and political uncertainties add to the stabilisation challenges.
While the new government has contained the budget deficit and has maintained a stable (floating) exchange rate during the first half of 2000, a severe drought resulted in a 10% fall in agricultural output in this period. The immediate effect is that GDP is likely to decline for a further year. These events make it imperative that the government work effectively with both the IMF and World Bank and other institutions on a new poverty reduction and growth programme. Greater political stability would assist this process and, following a prolonged debate between the President and parliament over their respective powers, legislation was approved making Moldova a parliamentary republic. There is now some optimism that IFI funding might be resumed towards the end of the year.

Privatisation

Progress in privatisation has been mixed.
With the essential completion of the small and medium-scale mass privatisation, the government has continued with the policy of selling shares in larger enterprises for cash under the privatisation programme for 1999-2000. During 1999, the state sold stakes in over 250 enterprises, which raised MDL 140 million (1.1% of GDP), almost double the amount of the previous year. The sales were conducted via auctions, tenders and through the Moldovan Stock Exchange. The government plans to sell 120 enterprises via investment tenders in 2000, although only a few sales had been completed by the end of May, including the sale of 83% of the state-owned tourist company to an Israeli strategic investor. However, there was only one viable bidder for the sale of 82% of the state-owned oil distribution company, Tirex Petrol, in June. As noted above, the government was also unable to overcome parliamentary opposition to the privatisation of wine-making, tobacco fermentation and cigarette production plants.

Privatisation and registration of land advance.
By the end of 1999, almost 900 of the 961 state or collective farms at independence had either been privatised or were going through the process. Land titles have now been distributed to 1 million farmers and it is estimated that some 60% of agricultural output is now produced by farmers either in the private sector or on collectives that are being transformed into private farms. Important progress has also been made with the land registration programme. Over 200,000 parcels of land were registered in 1999, thus reducing much of the uncertainty surrounding property rights.

Liberalisation, stabilisation, privatisation

1991
Aug Independence from Soviet Union

1992
Jan Most prices liberalised
Jan State trading monopoly abolished
Jun New tax system introduced
Sep Exchange rate unified

1993
Mar Cash privatisation begins
Mar Privatisation with patrimonial bonds begins
Apr Most quantity controls on exports removed
Nov New currency (leu) introduced

1995
Jan VAT introduced
Mar Treasury bills market initiated
Jun Full current account convertibility introduced

1996
Jan New central bank law enacted

1997
Jun First sovereign Eurobond issued
Jul New VAT law enacted
Jul New land law adopted
Sep New privatisation law adopted

1998
Feb National land cadastre introduced
Jun Open market operations begin
Aug Most tax and duty exemptions removed
Dec VAT and income taxes amended

1999
Apr All remaining trade restrictions removed
Nov IMF suspends the EFF programme

2000
Jun Poverty reduction and growth programme adopted
Jul Moldova becomes a parliamentary republic

Enterprise reform

Restructuring among privatised companies has been limited …
The Agency for Enterprise Restructuring (ARIA), funded by the World Bank, has continued to give companies technical assistance to support the implementation of rationalisation plans. The government established a Creditor's Council to deal with companies that have large tax arrears. Firms that fail to provide suitable plans for debt restructuring may then be referred to the Economic Court, the first stage in the

Enterprises, infrastructure, finance and social reforms

1991
Jun Two-tiered banking system established

1992
Feb Competition law adopted

1994
Jul Securities and exchange commission established

1995
Jun Stock exchange established
Jun Trade in listed shares begins
Jun Enterprise restructuring agency established

1996
Jan New financial institutions law enacted

1997
Aug Independent energy regulator established

1998
Jan IAS introduced
Oct Restrictions on bank accounts abolished
Dec Law on energy sector privatisation enacted
Dec Pension reform launched

1999
May Moldovgaz privatised

2000
Jan Minimum bank capital requirements raised
Feb Electricity distribution companies privatised
Jun Regulation on bank mergers approved

bankruptcy process under the amended 1997 law. In the first half of 2000, 180 companies, including 24 large companies, were reported to face bankruptcy procedures, a large increase compared with 1999. Although these various initiatives have been successful in promoting restructuring, overall progress has been slowed by the weak economy and the lack of foreign direct investment.

… while SMEs face a difficult investment climate.
According to survey data, there are an estimated 22,000 small companies in Moldova. During the first half of 2000 they accounted for 45% of net sales of output and 27% of all employment in the economy. The survey revealed that the main constraints on the development of SMEs remain high taxes, conflicting legislation, and arbitrary bureaucratic administration of taxes and regulations.

Infrastructure

The initial phase of power sector privatisation has been completed …
Three of the five power distribution companies were sold via tender to a Spanish strategic investor (Union Fenosa) in February 2000. Union Fenosa purchased 100% of the shares in the three companies for an initial investment of US$ 25 million, with a commitment to invest a further US$ 78 million in the future.

… and it is expected to lead to greater efficiency in the sector.
Electricity tariffs were raised by 30% in April 2000 and Union Fenosa has attempted to improve payments discipline by banning barter and mutual offsets and negotiating payment terms. The government also launched tenders for the sale of 100% stakes in the two remaining distribution companies and for the sale of 70% stakes in the three generating companies. The sales were temporarily delayed, partly because of a lack of suitable offers. Following a parliamentary ruling in July 2000, which enabled the sales of the generators to proceed at the same time as the sales of the remaining distribution companies, they are now expected to proceed in autumn 2000.

The mobile telephone network expands with the entry of a second operator …
The Moldovan-Turkish joint venture, Moldcell, the second GSM mobile telephone operator in the country, commenced operations in April 2000, having been awarded a licence at the end of 1999. The licence, however, was disputed in court on the grounds that it contravened the terms of the contract that the government signed with the first mobile operator, Voxtel. Moldcell committed to invest US$ 100 million to expand the network throughout the country.

… but privatisation of the fixed-line telephone monopoly has been postponed.
While the government had planned to privatise 51% of the fixed-lined telecommunications monopoly, Moldtelecom, by the end of 2000, in June 2000 it decided to delay the privatisation by at least a year. This decision reflected concerns over whether further tariff adjustments were necessary before the entity was privatised as well as over the unfavourable investment climate and the potential lack of investor interest. The tender for a financial adviser for the sale was also cancelled.

Financial institutions

Higher capital requirements for banks are likely to promote their consolidation.
By the middle of 2000, the banking sector comprised 21 commercial banks, of which the majority were either wholly foreign owned or joint ventures. Their combined capital was about US$ 95 million. Over the last year the central bank has concentrated on strengthening and consolidating the banking sector, primarily by ensuring that banks meet the new minimum capital requirements (which will increase to MDL 2.5-7.5 million – US$ 240,000-710,000 at the current exchange rate – depending on the licence) by the beginning of 2001. A direct consequence was the proposal for the merger of the majority state-owned Savings Bank and the Municipal Bank of Chisinau, representing the first bank merger in Moldova. The merger of two private banks was also announced in August. Both mergers will follow the regulations on bank mergers approved by the central bank council in June 2000, which includes a requirement that the total assets of the new entity must not exceed 30% of the sector's assets.

Social reform

Pensions reform advances slowly despite mounting arrears.
Moldova remains one of the poorest countries in the region and pensioners, estimated to account for 20% of the population, are particularly disadvantaged. The average pension at the beginning of 2000 was MDL 83 per month, covering about 20% of the minimum consumption budget. The government intends to introduce private pensions to supplement the current state pension system, the viability of which is affected by payment arrears. In August 1999 a law on private pensions came into effect, which allows for the establishment of open and closed pension funds based on voluntary contributions. However, growth of this market will also depend on developing a capital market.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Privatisation
Privatisation method – **vouchers, direct sales**
Tradability of land – **full**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Social reform
Share of the population in poverty – **65%**
Private pension funds – **no**

Stabilisation
Share of general government tax revenues in GDP – **19.7%**
Exchange rate regime – **floating**

Enterprises
Competition office – **no**

Financial sector
Capital adequacy ratio in per cent – **12%**
Deposit insurance system – **no**
Secured transactions law – **yes**
Securities commission – **yes**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	na	na	na	na	na
Share of total trade with non-transition countries (in per cent)	na	na	na	8.9	16.5	15.4	19.4	29.2	40.3
Share of trade in GDP (in per cent)	na	na	88.7	110.6	107.3	112.5	110.3	98.7	91.5
Tariff revenues (in per cent of imports) [1]	na	0.8	2.1	1.1	1.4	1.9	2.2	2.0	3.4
EBRD Index of price liberalisation	1.0	2.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	2.0	2.0	2.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised (in per cent) [2]	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	na	0.0	0.5	0.9	1.4	4.1	4.9	na
Private sector share in GDP (in per cent)	10.0	10.0	15.0	20.0	30.0	40.0	45.0	50.0	45.0
EBRD index of small-scale privatisation	1.0	1.0	1.0	2.0	3.0	3.0	3.0	3.3	3.3
EBRD index of large-scale privatisation	1.0	1.0	2.0	2.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	na	na	na	na	na	na	na
Effective/statutory social security tax rate (in per cent)	na	32.5	39.4	52.8	55.0	55.9	47.4	na	na
Share of industry in total employment (in per cent)	20.5	20.2	14.5	13.8	16.0	14.7	14.3	14.3	na
Change in labour productivity in industry (in per cent)	-4.4	-20.0	7.3	-23.6	12.0	8.6	10.5	-3.2	na
Investment rate (in per cent of GDP)	17.0	16.2	15.5	19.3	16.0	19.4	19.9	21.9	na
EBRD index of enterprise reform	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	1.7	1.7	1.7	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	11.3	11.6	11.9	12.3	13.0	14.0	14.6	15.0	na
Railway labour productivity (1989=100)	80.0	60.4	43.0	32.2	28.3	26.5	27.6	25.2	na
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	4.3 (64)	3.2 (92)	3.1 (87)	4.7 (92)	5.2 (na)	na
Electricity consumption/GDP (1989=100)	129.4	165.0	160.1	191.3	172.6	182.2	164.7	164.5	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.2	2.4
Financial institutions									
Number of banks (of which foreign owned)	15 (na)	16 (na)	16 (na)	21 (1)	22 (1)	21 (2)	22 (4)	23 (7)	na
Asset share of state-owned banks (in per cent) [3]	na	na	na	0.0	0.0	0.0	0.0	0.0	na
Bad loans (in per cent of total loans) [4]	na	na	na	16.3	9.2	17.3	10.2	4.6	na
Domestic credit to enterprises (in per cent of GDP)	5.9	5.9	5.0	3.7	6.7	7.7	7.0	13.9	12.0
Stock market capitalisation (in per cent of GDP) [5]	na	na	na	na	na	2.8	3.8	4.6	3.6
EBRD index of banking sector reform	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	3.0	4.0	3.7
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	2.0	3.0	3.0
Social sector									
Expenditures on health and education (in per cent of GDP)	8.5	11.0	11.0	14.9	14.7	16.9	16.0	11.3	7.6
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	316.0	315.0	na
Basic school enrolment ratio (in per cent)	93.9	79.9	79.1	78.8	79.4	79.2	92.5	92.5	na
Earnings inequality (GINI-coefficient)	na	41.1	43.7	37.9	39.0	na	na	na	na

1 Refers to all taxes on foreign trade.

2 In 1997, 90 small enterprises were privatised through cash auctions. No data are available on the total number of small enterprises. Around 1,350 SMEs were privatised through voucher auctions during 1994-95.

3 Zero for all available years, after four state-owned banks were majority privatised in 1994 (and fully privatised by the end of 1995).

4 Refers to doubtful and non-performing credits.

5 Data from survey to Moldovan Stock Exchange, including government securities. Data from the IFC give a figure of 4.56% of GDP for listed companies in 1997.

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					*(Percentage change in real terms)*				
GDP	-29.1	-1.2	-31.2	-1.4	-7.8	1.3	-8.6	-4.4	-2.0
Industrial gross output	-21.7	0.3	-27.7	-3.9	-6.5	0.0	-11.0	-9.0	na
Agricultural gross output	-16.4	9.9	-24.3	3.7	-11.9	11.4	-11.0	-8.0	na
Employment					*(Percentage change)*				
Labour force (annual average)	-0.2	-1.0	0.0	-0.2	-0.8	-0.6	0.0	na	na
Employment (annual average) [1]	-1.0	-17.7	-0.4	-0.5	-0.8	-0.8	-0.2	na	na
					(In per cent of labour force)				
Unemployment (end-year) [2]	0.7	0.7	1.1	1.4	1.8	1.5	1.9	2.0	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	1,276.4	788.5	329.7	30.2	23.5	11.8	7.7	39.3	32.0
Consumer prices (end-year)	2,198.0	837.0	116.1	23.8	15.1	11.1	18.2	43.8	22.0
Producer prices (annual average)	na	na	205.1	52.9	31.2	14.9	9.7	47.1	na
Producer prices (end-year)	na	6,947.0	214.5	46.6	20.4	13.6	13.6	58.6	na
Gross average monthly earnings in economy (annual average)	735.0	783.4	247.4	32.1	31.2	16.3	15.3	18.9	na
Government sector [3]					*(In per cent of GDP)*				
General government balance	-26.6	-7.5	-5.9	-5.8	-9.7	-7.5	-3.3	-3.2	-2.9
General government expenditure	49.0	28.0	36.3	36.7	36.3	40.5	33.2	28.6	na
General government debt	na	na	58.8	53.6	57.6	65.3	76.9	121.4	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	367.6	309.7	115.8	65.3	14.8	34.5	-8.3	42.9	na
Domestic credit (end-year)	560.0	331.3	101.5	64.7	18.8	26.8	29.2	18.1	na
					(In per cent of GDP)				
Broad money (M3, end-year)	44.4	19.2	15.9	19.2	18.3	21.6	19.3	20.6	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinancing rate	na	na	na	21.0	19.5	16.0	28.4	31.0	na
Interbank interest rate (up to 30 days maturity)	na	na	na	na	31.2	24.5	30.9	33.5	na
Deposit rate (one year)	na	na	na	32.5	25.4	23.5	21.7	27.5	na
Lending rate (one year)	na	na	na	41.9	36.7	33.3	30.8	35.5	na
					(Lei per US dollar)				
Exchange rate (end-year) [4]	0.4	3.6	4.3	4.5	4.7	4.7	8.3	11.6	na
Exchange rate (annual average) [4]	0.2	1.5	4.1	4.5	4.6	4.6	5.4	10.5	na
External sector					*(In millions of US dollars)*				
Current account	-39	-150	-82	-98	-202	-285	-323	-33	-80
Trade balance	-37	-148	-53	-70	-260	-348	-388	-123	-180
Merchandise exports	868	483	619	739	823	890	644	469	540
Merchandise imports	905	631	672	809	1,083	1,238	1,032	592	720
Foreign direct investment, net	17	14	18	73	23	75	86	33	100
Gross reserves (end-year), excluding gold	2	77	179	257	315	366	140	200	na
External debt stock	16	256	620	668	815	1,048	1,014	1,055	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	0.0	1.5	2.9	3.0	3.0	3.1	1.4	3.2	na
					(In per cent of exports of goods and services)				
Debt service	na	na	2.3	8.2	5.7	14.0	22.5	34.5	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	4.4	4.3	4.4	4.3	4.3	4.3	4.3	4.3	na
GDP (in millions of leis)	192	1,821	4,737	6,480	7,798	8,917	9,122	12,204	13,575
GDP per capita (in US dollars)	293	289	268	332	391	447	395	271	na
Share of industry in GDP (in per cent)	na	38.9	31.4	25.0	23.1	20.2	16.7	16.2	na
Share of agriculture in GDP (in per cent)	na	31.2	27.3	29.3	27.5	26.0	25.8	22.3	na
Current account/GDP (in per cent)	-3.0	-11.9	-7.0	-6.8	-11.9	-14.8	-19.0	-2.8	-8.0
External debt – reserves (in US$ millions)	14	179	441	412	500	682	874	855	na
External debt/GDP (in per cent)	1.3	20.4	53.1	46.3	48.1	54.3	59.7	105.7	na
External debt/exports of goods and services (in per cent) [5]	1.8	53.0	95.1	75.6	87.0	102.2	131.2	181.9	na

1 Break in series in 1993, due to exclusion of Transnistria.

2 Figures refer to registered unemployment.

3 General government includes the state, municipalities and extrabudgetary funds.

4 Up to July 1993 the Russian rouble was the legal tender in Moldova. On 9 August 1993 the Moldovan rouble was introduced. On 29 November 1993 the Moldovan leu, equal to 1,000 Moldovan roubles, was introduced.

5 Figures for 1992 and 1993 refer to exports of goods only.

Poland

Key reform challenges

- **Much of the high current account deficit is financed with FDI attracted by large-scale privatisations. As major privatisations near completion, further improvements in the investment climate will be needed to sustain these capital inflows.**

- **In contrast to the sustained productivity gains in manufacturing, the unreformed agricultural sector lags well behind; major investments in rural infrastructure and education are needed to close the gap.**

- **Progress in reforms of heavy industry, including the restructuring and privatisation of steel mills and mining companies, is required to raise competitiveness of the economy.**

Liberalisation

Restrictions on short-term capital flows maintained while currency is floated.
Despite an agreement with the OECD to abolish the requirement to obtain central bank approval for non-bank short-term capital flows by the end of 1999, the authorities postponed this step owing to concerns about currency volatility. However, the controls constitute little impediment to capital flows due to the existence of large offshore zloty markets.

Stabilisation

The high current account deficit is financed largely with FDI.
Rapid import growth and collapse of demand in CIS markets following the Russia crisis contributed to a widening of the current account deficit to above 7% of GDP in 1999. A similar outcome is expected in 2000 despite an upturn in the EU and a recovery in the CIS. At the same time, Poland has attracted about 5% of GDP in foreign direct investment, much of it through large-scale privatisations. Nevertheless, corruption and a complex system of licences and red tape hinder some investors. As the privatisation programme nears completion, improvements in the investment climate will be necessary to sustain high levels of FDI.

Major tax reform has been adopted.
In January 2000 a major tax reform was launched. Corporate income tax will be lowered from 34% in 1999 to 30% in 2000, to 28% in 2001-02, to 24% in 2003 and to 22% in 2004. In addition, tax incentives and a complex system of investment allowances were eliminated and some rules regarding depreciation of assets and revaluation of fixed assets simplified. Furthermore, the VAT tax base was broadened and, in July 2000, the parliament approved introduction of VAT for agricultural products at a reduced 3% rate. Although reform of personal income tax was also proposed, lowering the marginal rates and simplifying the rules, the amendment was vetoed by the President.

Privatisation

Privatisation of large-scale enterprises is well-advanced.
The government is successfully proceeding with the privatisation. A minority 10% stake in LOT, the national airline, was sold in October 1999 and a 30% share in PZU, the dominant insurance provider, was sold in November 1999. Following the initial public offering of a 30% share in the dominant oil refinery, PKN Orlen, in November 1999, a further 26% was floated on the stock market in June 2000. However, as the privatisation advances and the state runs out of saleable assets, the Ministry of Treasury estimates that privatisation revenues will halve in 2002, down to PZL 10 billion from the expected level of PZL 20 billion in 2001.

Enterprise reform

Restructuring of mining and steel industries advances.
The government is implementing a coal sector restructuring plan with the assistance of the World Bank. The focus of restructuring is on closures of unprofitable mines, reduction in the workforce, financial restructuring, strengthened management and environmental improvements. Due to higher than expected losses and redundancy packages for laid-off miners, the total costs to the budget exceeded 0.5% of GDP in 1999. Although restructuring in the steel sector was relaunched in 1999, with the emphasis on downsizing the workforce (from about 87,000 in 1997 to 38,000 by 2003) and on rapid privatisation, strong union resistance to restructuring plans and limited interest of strategic investors may delay the process.

Rural development is lagging well behind the rest of the economy.
The agricultural sector reportedly employs about 20% of the labour force, but produces only 5% of GDP. While agricultural employment is likely to be over-stated due to numerous subsidies and preferential treatment by state authorities, rural development is a major challenge, which needs to be addressed in the context of the EU accession. It is estimated that hidden unemployment in the agricultural sector totals between 1 million

Liberalisation, stabilisation, privatisation

1990
Jan Most prices liberalised
Jan Most foreign trade controls removed
Jan Small-scale privatisation begins
Jan Fixed exchange rate introduced
Apr Privatisation law adopted

1991
May Treasury bills market initiated
May Crawling peg exchange rate regime introduced

1992
Jan Corporate and personal income taxes reformed
Mar EU Association Agreement

1993
Mar CEFTA membership
Apr Mass privatisation programme begins
Jul VAT introduced
Nov EFTA agreement

1994
Oct Major external debt restructuring
Dec National Investment Funds (NIFs) established

1995
Jan Wage restrictions redefined
May Agricultural import restrictions changed
May Managed float with fluctuation band introduced
Jun First sovereign Eurobond
Jun Full current account convertibility introduced
Jul WTO membership
Jul State enterprises allocated to NIFs

1996
Aug New privatisation law adopted
Nov OECD membership

1997
Jun NIF shares listed on WSE

1998
Feb Independent Monetary Policy Council established
Nov EU accession negotiations started

1999
Jan New foreign exchange law enacted
Dec Import tariffs on agricultural products increased

2000
Jan Corporate tax reform implemented
Apr Exchange rate floated

Enterprises, infrastructure, finance and social reforms

1990
Jan Competition law adopted
Jan Competition agency established
Dec Insurance law enacted

1991
Jan Telecommunications law enacted
Mar Securities law adopted
Apr Stock exchange begins trading
Sep Banking law enacted

1992
Dec Banking law amended

1993
Feb Financial restructuring law adopted
Apr First bank privatised
May BIS capital adequacy adopted

1994
Sep IAS introduced

1995
May Telecommunications law amended
Jul Railway law adopted
Oct Insurance law amended

1996
Apr First corporate Eurobond
Aug Gdansk Shipyard declared bankrupt

1997
Mar First toll motorway concession awarded
May Energy law adopted
Jun Securities law amended
Dec Electricity law adopted

1998
Jan Banking act amended
Jan Independent banking regulator established
Jan Bankruptcy law amended
Feb Investment funds law enacted
Nov Telecommunications privatisation begins
Nov Mine restructuring law adopted

1999
Jan Pension reforms implemented
Jan Health care system reformed
Jan Insurance law amended

2000
May New telecommunications law adopted
Jul Strategic investor acquires TPSA stake

and 1.5 million. This factor increases importance of investment in rural infrastructure and higher standards of rural education.

Infrastructure

Railway reform proceeds …
The authorities plan to implement radical reform of the railway, which is PZL 7 billion in debt, equivalent to 1% of GDP, mainly due to loss-making passenger services. Among planned measures are downsizing of the 200,000 strong workforce by a quarter, cutting some services, splitting infrastructure, freight transport, passenger services and non-core activities, and privatisation of these new entities. However, despite well-designed plans and approval of the programme by the parliament in July 2000, necessary reform may be delayed due to the forthcoming elections and strong opposition from both unions and communities affected by rail line closures.

… but gas sector reform remains stalled.
There has been little progress in restructuring of the gas sector. A privatisation plan for Polish Oil and Gas Company, a dominant state-owned gas company, has yet to be agreed. Although the price of gas is below cost recovery, price increases set by the regulator, the Energy Regulatory Authority, at 12.5% a year do not match international gas price increases. There is a tentative agreement on separation of generation/production, transmission and distribution. However, it is unlikely that the gas sector will be liberalised in the medium term.

New telecommunications law approved as the TPSA privatisation advances.
The parliament approved a new telecommunications law in May 2000. The local and long-distance markets will be fully liberalised in 2002, while the international long-distance market will be opened to competition in 2003. There is already some competition on the local call market and three long-distance operators started providing services in July 2000. The new law establishes the rules for interconnection fees and creates an independent regulator while eliminating licences for phone services operators. There are three mobile operators, but the penetration ratio was just 11% at the end of 1999, below the regional and EU averages. In July 2000 a consortium led by France Telecom bought a 35% stake in TPSA, the dominant service provider, for US$ 4.3 billion, increasing prospects for improved telecommunications services.

Privatisation in the energy sector continues.
Several electricity generating companies were sold to foreign strategic investors in early 2000 and privatisation of other electricity generating and distribution companies is well advanced, with their sale expected within the next 18 months. However, the power market is dominated by long-term contracts, currently covering about 70% of demand and 50% of generating capacity, and the environmental standards in energy companies are low. The negotiations on EU accession may imply sizeable expenditures on environmental upgrades, while energy sector liberalisation will adversely affect repayment capacity of power companies in need of substantial investment.

Financial institutions

Consolidation in the banking sector proceeds …
Bank privatisation has advanced significantly over the last two years, with more than two-thirds of the banking sector by assets now in private ownership. At present, only two large banks are controlled by the state – PKO Bank Polski, the savings bank, and BGZ, the agricultural bank. However, the government has some scope to intervene in the governance of privatised banks through its remaining direct and indirect stakes. During the last 12 months, there have been several high-profile take-over cases, including BIG Bank Gdanski and Bank Handlovy, in which active involvement of the authorities affected the final outcome of ownership changes. Although the share of bad loans increased marginally from 12% in 1998 to 14% in 1999, the strong presence of foreign strategic investors, including control of about 50% of banking sector assets, and ongoing consolidation contribute to strengthening of the banking sector.

… and stock market liquidity improves further.
Warsaw Stock Exchange is the largest central European market, well regarded for its prudent supervision and developed legal framework. The total number of shares listed now exceeds 200 and the capitalisation of about US$ 30 billion is comparable to that of the smallest EU exchanges. The development of the stock market was also enhanced by the pension reform begun in 1999, under which Compulsory Open Pension Funds manage contributions made by eligible employees, equal to 7.3% of their monthly salaries, and further Voluntary Pension Schemes are available. Currently, there are 21 pension funds, which have attracted placements from over 80% of the eligible population.

Social reform

Costs of social sector reforms are higher than originally expected.
The social sector reforms implemented in 1999 had a mixed reception and their costs were higher than expected. Principal causes of the rising social security financing deficit were systemic inefficiencies, including a loophole in the legislation reforming social security that allowed contributors to postpone all the contributions by one month, persistent occurrence of fraud in the sickness benefit system, and low collection ratios due to financial difficulties in some state-owned enterprises as well as technological problems complicating collection of contributions.

Liberalisation	Privatisation	Infrastructure	Social reform
Current account convertibility – **full**	Primary privatisation method – **direct sales**	Independent telecoms regulator – **no**	Share of the population in poverty – **13%**
Interest rate liberalisation – **full**	Secondary privatisation method – **MEBOs**	Separation of railway accounts – **yes**	Private pension funds – **yes**
Wage regulation – **yes**	Tradability of land – **full except foreigners**	Independent electricity regulator – **yes**	
Stabilisation	**Enterprises**	**Financial sector**	
Share of general government tax revenues in GDP – **34.7%**	Competition office – **yes**	Capital adequacy ratio – **8.0%**	
Exchange rate regime – **floating**		Deposit insurance system – **yes**	
		Secured transactions law – **yes**	
		Securities commission – **yes**	

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	11.0	14.0	16.0	17.0	17.0	15.0	12.0	10.0	9.0
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	3.0	3.0	2.0	2.0	2.0	1.0	0.0
Share of total trade with non-transition countries (in per cent)	83.2	84.4	87.7	86.3	82.3	79.3	75.5	77.4	79.3
Share of trade in GDP (in per cent)	32.7	32.6	34.5	37.7	40.0	42.4	48.5	47.0	43.6
Tariff revenues (in per cent of imports)	12.7	14.6	15.0	12.0	9.6	7.4	5.6	4.0	3.4
EBRD Index of price liberalisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3
EBRD Index of forex and trade liberalisation	3.0	3.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
Privatisation									
Share of small firms privatised (in per cent)	86.0	95.0	na	na	na	na	na	na	na
Privatisation revenues (cumulative, in per cent of GDP)	0.2	0.4	0.9	1.7	2.6	3.6	5.1	6.4	7.7
Private sector share in GDP (in per cent)	40.0	45.0	50.0	55.0	60.0	60.0	65.0	65.0	65.0
EBRD index of small-scale privatisation	3.0	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	2.0	2.0	2.0	3.0	3.0	3.0	3.3	3.3	3.3
Enterprises									
Budgetary subsidies (in per cent of GDP)	3.3	1.7	1.4	1.2	1.1	0.8	0.8	0.5	0.4
Effective/statutory social security tax rate (in per cent)	60.8	53.8	54.9	56.7	60.0	59.3	57.8	na	na
Share of industry in total employment (in per cent)	27.5	25.9	24.6	22.5	23.1	22.2	21.9	21.7	21.1
Change in labour productivity in industry (in per cent)	0.0	12.5	13.8	13.0	6.5	9.1	11.6	4.3	9.1
Investment rate (in per cent of GDP)	18.5	15.8	14.9	18.0	18.7	20.9	23.6	25.3	na
EBRD index of enterprise reform	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of competition policy	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Infrastructure									
Main telephone lines per 100 inhabitants	9.3	10.3	11.5	13.1	14.8	16.9	19.4	22.8	26.0
Railway labour productivity (1989=100)	71.1	68.5	76.2	78.4	83.0	84.4	87.4	83.8	83.6
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	4.94 (90)	6.19 (95)	6.53 (97)	6.24 (97)	6.68 (na)	6.42 (na)
Electricity consumption/GDP (1989=100)	107.0	100.3	97.4	93.3	89.2	86.9	82.5	78.8	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	3.2	3.2
Financial institutions									
Number of banks (of which foreign owned)	na	na	87 (10)	82 (11)	81 (18)	81 (25)	83 (29)	83 (31)	77(39)
Asset share of state-owned banks (in per cent)	na	na	86.2	80.4	71.7	69.8	51.6	48.0	25.0
Bad loans (in per cent of total loans)	na	na	36.4	34.0	23.9	14.7	11.5	11.8	14.5
Domestic credit to enterprises (in per cent of GDP)	10.9	11.4	12.2	12.0	12.7	15.9	17.1	17.6	18.8
Stock market capitalisation (in per cent of GDP)	0.2	0.3	3.7	3.5	3.9	6.6	9.6	13.1	20.0
EBRD index of banking sector reform	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3
EBRD index of reform of non-banking financial institutions	2.0	2.0	2.0	2.0	3.0	3.0	3.3	3.3	3.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	4.0	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	4.3	4.0	3.0
Social sector									
Expenditures on health and education (in per cent of GDP)	10.5	10.8	10.4	10.7	9.7	10.8	11.2	9.9	na
Mortality rate (per 1,000 male adults)	275.0	266.0	250.0	247.0	250.0	239.0	238.0	208.0	na
Basic school enrolment ratio (in per cent)	97.3	97.1	97.2	97.1	97.2	97.4	98.0	98.1	na
Earnings inequality (GINI-coefficient)	23.9	24.7	25.6	28.1	29.0	30.2	30.0	na	na

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					*(Percentage change in real terms)*				
GDP	2.6	3.8	5.2	7.0	6.1	6.9	4.8	4.1	5.0
Private consumption	2.3	5.2	4.3	3.6	8.7	7.0	4.9	7.0	na
Public consumption	6.4	3.8	2.8	2.9	3.4	3.4	3.0	3.5	na
Gross fixed investment	2.3	2.9	9.2	16.9	20.6	21.9	14.5	5.0	na
Exports of goods and services	10.8	3.2	13.1	23.6	12.5	9.9	11.0	1.0	na
Imports of goods and services	1.7	13.2	11.3	24.3	28.0	16.7	14.0	6.0	na
Industrial gross output	2.8	6.4	12.0	9.6	8.3	11.5	4.8	4.4	na
Agricultural gross output	-12.7	6.8	-9.3	10.7	0.7	1.0	1.0	-2.0	na
Employment					*(Percentage change)*				
Labour force (end-year)	-0.4	0.7	0.6	-0.9	1.4	-2.7	-4.0	-1.0	na
Employment (end-year)	-2.8	-1.7	1.1	0.3	3.5	1.3	1.4	-1.5	na
					(In per cent of labour force)				
Unemployment (end-year)	14.3	16.4	16.0	14.9	13.2	8.6	10.4	13.0	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	43.0	35.3	32.2	27.8	19.9	14.9	11.8	7.3	9.9
Consumer prices (end-year)	na	37.6	29.5	21.6	18.5	13.2	8.6	9.8	8.2
Producer prices (annual average)	34.5	31.9	25.3	25.4	12.4	12.2	7.3	5.7	na
Producer prices (end-year)	31.5	37.0	27.9	18.9	11.2	11.5	4.9	8.1	na
Gross average monthly earnings in economy (annual average) [1]	na	na	34.6	31.6	26.5	21.5	16.7	10.6	na
Government sector [2]					*(In per cent of GDP)*				
General government balance	-4.9	-2.4	-2.2	-3.1	-3.3	-3.1	-3.2	-3.3	-3.0
General government expenditure	50.0	49.9	50.5	49.2	49.3	48.0	44.0	44.7	na
General government debt	147.3	88.7	72.4	57.9	51.2	49.8	43.2	43.3	na
Monetary sector					*(Percentage change)*				
Broad money (end-year)	57.5	36.0	38.2	34.9	29.3	30.9	25.2	19.3	na
Domestic credit (end-year)	55.6	44.2	30.1	20.8	31.9	26.5	22.1	20.2	na
					(In per cent of GDP)				
Broad money (end-year)	35.8	35.9	36.7	36.1	37.2	39.6	40.2	43.1	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Reference rate [3]	na	35.0	33.0	29.0	26.0	28.0	15.5	16.5	na
Market interest rate (3-months WIBOR) [4]	41.4	33.7	27.0	24.2	21.7	25.4	15.2	17.9	na
Deposit rate [5]	32.0	25.0	26.0	19.5	17.0	18.0	11.0	7.5	na
Lending rate [6]	39.0	35.0	31.0	24.0	20.5	22.5	15.5	14.4	na
					(Zloty per US dollar)				
Exchange rate (end-year)	1.6	2.1	2.4	2.5	2.9	3.5	3.5	4.2	na
Exchange rate (annual average)	1.4	1.8	2.3	2.4	2.7	3.3	3.5	4.0	na
External sector					*(In millions of US dollars)*				
Current account	900	-600	677	5,310	-1,371	-4,312	-6,858	-11,644	-11,500
Trade balance	500	-2,482	-895	-1,912	-8,179	-11,320	-13,720	-14,462	-15,000
Merchandise exports	14,000	13,598	17,024	22,878	24,453	27,229	30,122	26,386	28,000
Merchandise imports	13,500	16,080	17,919	24,790	32,632	38,549	43,842	40,848	43,000
Foreign direct investment, net	284	580	542	1,134	2,741	3,041	4,966	6,642	10,000
Gross reserves (end-year), excluding gold	4,099	4,281	6,029	14,963	18,033	20,298	26,317	24,400	na
External debt stock	47,600	47,200	43,600	45,200	47,354	48,914	56,867	59,000	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	2.9	3.6	6.5	6.0	5.8	6.6	6.5	na
					(In per cent of current account revenues, excluding transfers)				
Debt service	na	na	18.8	11.8	7.5	7.4	6.9	9.8	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	38.4	38.5	38.6	38.6	38.6	38.7	38.7	38.7	na
GDP (in millions of zlotys)	114,944	155,780	210,400	288,700	362,800	445,100	549,500	611,600	705,856
GDP per capita (in US dollars)	2,197	2,234	2,399	3,085	3,483	3,511	4,066	3,987	na
Share of industry in GDP (in per cent)	34.0	32.9	32.2	29.2	27.1	28.1	28.1	28.2	na
Share of agriculture in GDP (in per cent)	6.7	6.6	6.2	6.4	6.0	5.7	5.5	5.2	na
Current account/GDP (in per cent)	1.1	-0.7	0.7	4.5	-1.0	-3.2	-4.4	-7.6	-7.1
External debt – reserves (in US$ millions)	43,501	42,919	37,572	30,237	29,321	28,616	30,550	34,600	na
External debt/GDP (in per cent)	56.4	54.9	47.1	38.0	35.2	36.0	36.2	38.3	na
External debt/exports of goods and services (in per cent)	340.0	305.4	228.0	173.4	170.1	158.0	168.3	205.1	na

1 Gross wages are those before deducting income taxes.

2 General government includes the state, municipalities and extrabudgetary funds. General government balance excludes privatisation receipts.

3 Refinancing rate until 1997, reference rate since 1998.

4 Yield on 28-days treasury bill until 1995, 3-months WIBOR since 1996.

5 The lowest rate offered on 6-month time deposits.

6 The lowest rate charged by commercial banks to prime borrowers.

Romania

Key reform challenges

- **The avoidance of a crisis in 1999 and the agreements with IMF and World Bank on a resumption of lending provide an opportunity to regain credibility with international investors.**
- **While the 1999 privatisation law has helped to advance the transition process, enterprise restructuring remains slow due to continued state subsidies and to the toleration of arrears.**
- **Restructuring of the financial sector, further privatisation of state-owned banks, and regulatory and supervisory improvements remain central to macroeconomic and financial stability and are necessary for a sustained recovery.**

Liberalisation

Romania was invited to start EU accession negotiations.
Following a shift in the EU enlargement strategy, Romania was invited to start EU accession negotiations with the EU in December 1999. The start of negotiations was made conditional on the reform of state child-care institutions and the development of a medium-term strategy on a programme of economic reform. In addition, Romania has to keep on track the adjustment programmes agreed with the IMF and the World Bank. The EU decision to accept Romania as a candidate, together with public development and discussion of the medium-term economic strategy, may help to galvanise reform efforts and could have tangible long-term benefits, including much-needed policy stability and institutional development.

Stabilisation

Avoidance of debt default and IFI agreements have raised expectations for reform.
The external liquidity pressures that affected Romania in 1999 and put the sovereign repayment capacity at risk have eased. The peak of external debt payments was reached in summer 1999 and official reserves have since recovered (to a level that covers around three months of imports). The trade and current account deficits have also fallen dramatically, following a 1999 exchange rate adjustment, and access to official financing has been restored. In June 1999 the World Bank approved a new adjustment programme and in August the IMF followed up with a new Stand-by Agreement. Together these programmes promised US$ 850 million to support the government's economic stabilisation and reform programme, supplemented by an EU macroeconomic adjustment loan of US$ 200 million. Nevertheless, inflation levels continue to be the highest of all accession countries.

Tax reforms have taken effect.
Tax reforms have been geared towards lowering tax rates, broadening the tax base and reducing distortions. A new corporate income tax law was introduced in January 2000, reducing the corporate income tax rate from 38% to 25%. A new global personal income tax law has also been introduced. In the area of indirect taxation, a new uniform VAT rate of 19% has replaced the previous rates of 11% and 22%. A variety of laws offering tax incentives (including to foreign investors) that had been suspended during 1999 were repealed. A 5% profit tax on exports has also been introduced.

Corruption remains a serious problem.
While many of the important laws on a market economy are in place, institutions enforcing them are often weak or non-existent. The frequency of changes in regulations and their discretionary interpretation by public officials has encouraged corruption. Property rights are still not firmly and clearly established.

Privatisation

While there was some progress in privatisation in 1999, the pace remains slow.
The privatisation law adopted in the middle of 1999 has helped to simplify and unify earlier regulations relating to the privatisation, restructuring and liquidation of enterprises. Privatisation is now proceeding through three channels: (i) direct sales of state enterprises by the State Ownership Fund (SOF); (ii) privatisation/liquidation through sales agents; and (iii) privatisation of national companies (formerly regies autonomes). The SOF privatised through direct sales about 1,470 enterprises in 1999. The sale of the car manufacturer, Dacia, to Renault was the sole large enterprise privatisation involving a foreign investor in 1999. The cumulative total of privatised enterprises at the end of 1999 stands at 35% of SOF capital. Further advances in privatisation are constrained by the fact that almost two-thirds of the companies held in the SOF portfolio are loss-making, including most of the large firms, and by the SOF preference for restructuring rather than privatisation or closure. In the first five months of 2000 the SOF sold a further 789 companies. However, only 17 of these were large – a much smaller number than in previous years.

Liberalisation, stabilisation, privatisation

1991
- Aug — Privatisation law enacted
- Sep — First voucher privatisation round begins

1992
- Jan — Small-scale privatisation begins
- May — State trading monopoly abolished
- May — Significant price liberalisation

1993
- May — EFTA member
- Jul — VAT introduced

1994
- Mar — Treasury bills market initiated

1995
- Jan — WTO membership
- Mar — New privatisation law adopted
- Jun — Restitution law adopted
- Jul — Most prices liberalised
- Aug — Second voucher privatisation round begins

1997
- Mar — Exchange rate unified
- Mar — Large-scale privatisation commenced
- Jun — First sovereign Eurobond
- Jul — CEFTA membership

1998
- Mar — Full currency convertibility

1999
- Jan — Temporary import surcharge introduced
- Jan — Local public finance law enacted
- May — New privatisation law enacted
- Aug — IMF agreement reached

2000
- Jan — Corporate and income tax reform
- Mar — EU accession negotiations begin

Investment banks have been introduced for key sales.
The 1999 privatisation law also permits the use of investment banks as sales agents in the privatisation/liquidation of 63 large companies, including 50 companies placed in five groups to be sold in "pools". For the 13 largest companies a programme of case-by-case privatisation, liquidation and workout have been initiated. Restructuring goals of this programme include increased efficiency of enterprise and the enforcement of hard budget constraints. Major strategic sales to be carried out include the sales of shares in the national oil company, Petrom, the metallurgical company, Sidex Galati, the national tobacco company and the national airline, Tarom.

Enterprises, infrastructure, finance and social reforms

1990
Dec Two-tiered banking system established

1991
Mar Company law enacted
Apr Banking legislation adopted

1994
Jan BIS capital adequacy enacted
Dec Securities and exchange commission established

1995
Jun Bankruptcy law enacted
Nov Stock exchange trading begins

1996
Jan Bank deposit insurance scheme enacted
Oct OTC market established

1997
Jan Competition law enacted
Feb First corporate Eurobond issued
Feb Enterprise liquidation programme begins
Mar Major adjustments of utility prices
Dec Law on reorganisation of utilities enacted

1998
Mar New banking legislation enacted
Jun First corporate GDR issue
Jul Restructuring of railway begins
Nov Public property and concession laws enacted
Dec Energy law enacted
Dec Privatisation of telecommunications company

1999
Jan Agreement on mine restructuring signed
Mar Privatisation of the first state bank
Apr Second-largest state bank placed under administration
May Amendments to bankruptcy law enacted
Jun First liquidation of large farm started
Oct Independent energy regulator established

2000
Apr New law on public system pensions adopted

Enterprise reform

Despite lower enterprise losses, key structural problems remain.
Romania experienced financial turbulence in 1999, largely because of its failure to tighten financial discipline, including the toleration of tax arrears. Enterprise losses were cut somewhat during 1999 because of the accelerated closure of loss-making coal mines, increases in administered prices and the temporary suspension of operations by two refineries and a few large metallurgical plants after they lost access to foreign financing. However, this reduction reflects mainly temporary factors rather than consistent restructuring. The government continues to channel money into some of the largest loss-making firms through the toleration of tax arrears and cross-subsidisation by the SOF.

Enterprise arrears are growing.
Arrears to the government have continued to grow and repeated measures to reduce the amount of arrears and to encourage taxpayers to settle their dues on time have not been successful. In some instances, they have even given wrong incentives to taxpayers, for example by allowing in-kind payment of tax in arrears. The arrears of large state-owned companies are a particular source of concern, and are symptomatic of incomplete enterprise restructuring and closures. In particular, they are at the origin of most of the accumulation of payment arrears in the economy and of bad loans in the public banks. Allowing these arrears fails to create an appropriate structure of incentives for a thorough restructuring of the supply side of the economy. In addition, domestic arrears to the three major utilities also increased by 20% in real terms during the first half of 2000.

Infrastructure

Reform of the power and gas sector have started.
Regulations for granting licences to power-generating and distribution companies were approved in July 1999. An independent sector regulator (ANRE) was established late in the year and 15 companies were given supply licences in the first half of 2000. The government has prepared strategies for the sale of the distribution and generation subsidiaries of CONEL, the state-owned monopoly. In August 2000, CONEL was broken up into five independent entities: three for power generation (thermal, nuclear and hydro), one transmission company and one distribution company. An independent gas sector regulator (ANRGN) was established in January 2000 and the natural gas monopoly ROMGAZ was broken up in May 2000. Five independent companies were set up: one for exploitation of resources, one for storage, one for national transmission and two for distribution (in the northern and southern parts of the country).

Financial institutions

Some progress has been achieved in restructuring the banking sector …
While Bancorex, which accounted for two-thirds of the losses of the banking system, was closed in July 1999, Banca Agricola (BA), the second-largest ailing state-owned bank with large exposure to loss-making enterprises in the agro-sector, was put under special supervision and subjected to a freeze on new lending. The bank has also been recapitalised. However, the privatisation of BA and that of Banca Comerciala Romana, which were planned for 2000, are encountering delays.

… but banking restructuring is costly and slow.
The closure of Bancorex in July 1999 and the restructuring of BA have helped to improve the financial performance of the banking system. The share of non-performing loans fell by one-half between May and December 1999. However, government support has added US$ 1.3 billion (equivalent to 3.8% of GDP) to the domestic debt. With better enforcement of regulations, several private banks have failed but the exit process for these failed banks has been slow. The Romanian Religion’s Bank was put under special supervision after it was unable to raise capital in May 2000.

Mutual financial intermediaries (MFIs) are causing financial disruption.
In May 2000 the largest investment fund (FNI) collapsed owing to mismanagement and fraudulent practices as well as poor regulatory oversight. The failure of the fund also involved the state-owned Savings Bank (CEC), which was a shareholder in FNI’s management company and which had invested in FNI certificates and issued a guarantee for investments in FNI. The collapse of FNI put pressure on the largely unregulated “popular banks”, that is credit cooperatives without deposit insurance. Banca Populara Romana, the largest credit cooperative, closed its operations in June 2000 after being unable to meet demand for deposit withdrawals. A new emergency ordinance, stipulating that the central bank will be in charge of authorising, regulating and monitoring MFIs, has been in effect since July 2000 and the licensing of new MFIs has been suspended.

Social reform

Some progress was made with pension reform.
At present the pension system includes three elements: (i) a publicly managed pay-as-you-go defined-benefit plan, (ii) a contributory supplemental retirement plan; and (iii) a mostly non-contributory programme for farmers. The current pay-as-you-go pension system is faced with growing difficulties owing to declining employment, accumulated debts to the social security budget and failure to pay contributions. A proposed three-pillar system, envisaged to consist of a public pay-as-you-go system, a mandatory privately managed second pillar and a voluntary third pillar, is scheduled for 2001. In April 2000 a new law on public system pensions and other social security benefits was passed, which is to be implemented in April 2001. The new law also introduces reforms in the first pillar, including the raising of the minimum retirement age.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenues in GDP – **33.7%**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de facto**

Enterprises
Competition office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **12%**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **30%**
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	47.0	29.0	20.0	18.0	18.0	18.0	7.0	na	na
Number of goods with administered prices in EBRD-15 basket	15.0	13.0	7.0	5.0	5.0	5.0	2.0	na	na
Share of total trade with non-transition countries (in per cent)	65.8	74.8	84.4	86.2	88.8	88.9	86.5	88.0	89.5
Share of trade in GDP (in per cent)	33.4	51.8	41.4	42.3	61.7	63.8	59.9	46.3	53.2
Tariff revenues (in per cent of imports)	6.1	4.9	6.6	6.0	4.9	4.2	4.0	5.9	5.5
EBRD Index of price liberalisation	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	3.0	3.0	4.0	4.0	3.0	4.0	4.0	4.0
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	21.7	32.1	63.6	94.0	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	0.0	0.1	0.4	1.2	2.2	4.6	6.4	7.7
Private sector share in GDP (in per cent)	25.0	25.0	35.0	40.0	45.0	55.0	60.0	60.0	60.0
EBRD index of small-scale privatisation	1.0	2.0	2.0	2.3	2.7	3.0	3.3	3.3	3.7
EBRD index of large-scale privatisation	1.7	1.7	2.0	2.0	2.0	2.7	2.7	2.7	2.7
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	13.0	6.8	3.8	4.1	4.3	2.5	1.6	1.9
Effective/statutory social security tax rate (in per cent)	82.4	77.5	81.6	77.2	69.5	65.9	61.9	na	na
Share of industry in total employment (in per cent)	35.3	31.6	30.1	26.4	24.3	25.1	22.2	22.0	na
Change in labour productivity in industry (in per cent)	-18.7	-10.0	10.4	8.6	16.3	na	5.6	-14.9	na
Investment rate (in per cent of GDP)	14.4	19.2	17.9	20.3	24.3	24.7	21.5	21.4	20.2
EBRD index of enterprise reform	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	10.8	11.3	11.4	12.3	13.1	14.0	15.3	16.0	16.7
Railway labour productivity (1989=100)	55.0	47.5	42.8	44.2	53.2	74.7	51.5	54.2	46.0
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	2.2 (88)	2.1 (94)	1.9 (96)	2.3 (96)	3.4 (85)	4.7 (90)
Electricity consumption/GDP (1989=100)	89.2	89.2	86.0	81.3	78.9	79.0	77.7	76.8	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	3.1	3.3
Financial institutions									
Number of banks (of which foreign owned)	na	na	na	20 (3)	24 (6)	31 (8)	33 (13)	36 (16)	34 (19)
Asset share of state-owned banks (in per cent)	na	na	na	80.4	84.3	80.9	80.0	75.3	50.3
Bad loans (in per cent of total loans) [1]	na	na	na	18.5	37.9	48.0	56.5	67.5	36.6
Domestic credit to enterprises (in per cent of GDP)	na	na	na	na	na	11.5	13.7	15.2	10.5
Stock market capitalisation (in per cent of GDP) [2]	na	na	na	0.0	0.4	0.2	2.0	3.0	3.1
EBRD index of banking sector reform	1.0	1.0	1.0	2.0	3.0	3.0	2.7	2.3	2.7
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	3.0	4.0	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	3.0	4.0	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	na	6.9	5.9	6.2	6.3	6.3	5.9	na	na
Mortality rate (per 1,000 male adults)	242.0	256.0	265.0	272.0	270.0	na	270.0	256.0	na
Basic school enrolment ratio (in per cent)	89.4	89.6	90.3	91.4	92.6	93.9	95.0	97.0	na
Earnings inequality (GINI-coefficient)	20.4	na	22.6	27.6	27.8	30.3	42.2	na	na

1 Includes overdue loans and interest classified as doubtful and loss-making; data for bad loans for Credit Bank between 1994 and 1996 and Dacia Felix Bank in 1997 are not included.

2 Includes listings on the Bucharest Stock Exchange and RASDAQ over-the-counter market.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	-8.8	1.5	3.9	7.1	3.9	-6.1	-5.4	-3.2	1.5
Private consumption	-7.5	0.9	2.6	13.1	8.0	-3.1	-4.6	-4.9	na
Public consumption	2.2	2.7	11.0	1.0	1.5	-11.6	14.1	-2.5	na
Gross fixed investment	11.0	8.3	20.7	6.9	5.7	-3.0	-18.1	-5.1	na
Exports of goods and services	-36.6	-20.7	-56.6	-53.7	-21.0	na	na	9.7	na
Imports of goods and services	2.9	11.1	19.0	17.0	na	na	na	-5.1	na
Industrial gross output, unadjusted series	-21.9	1.3	3.3	9.5	9.8	-5.6	-17.3	-8.8	na
Agricultural gross output	-13.3	12.9	0.2	4.5	1.3	3.4	-7.6	5.5	na
Employment					*(Percentage change)*				
Labour force (end-year)	2.4	-1.4	8.1	0.1	-4.6	2.9	-0.5	1.2	na
Employment (end-year)	-3.0	-3.8	8.5	2.2	-1.9	1.0	-3.2	0.3	na
					(In per cent of labour force)				
Unemployment (end-year) [1]	8.2	10.4	10.1	8.2	6.5	7.4	10.4	11.5	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	210.4	256.1	136.7	32.3	38.8	154.8	59.1	45.8	45.0
Consumer prices (end-year)	199.2	295.5	61.7	27.8	56.9	151.4	40.6	54.8	40.0
Producer prices (annual average)	184.8	165.0	140.5	35.1	49.9	156.6	33.2	42.2	na
Producer prices (end-year)	104.0	195.4	73.4	32.0	60.4	154.3	19.8	62.9	na
Gross average monthly earnings in economy (annual average) [2]	170.0	196.5	135.6	50.5	54.2	98.2	60.3	44.3	na
Government sector					*(In per cent of GDP)*				
General government balance	-4.6	-0.4	-2.2	-2.5	-3.9	-4.6	-5.0	-3.5	-4.0
General government expenditure	42.0	34.2	33.9	34.7	33.8	34.3	35.2	36.8	na
General government debt	na	na	na	17.6	28.1	28.0	28.0	34.6	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	79.6	141.0	138.1	71.6	66.0	104.9	48.9	44.9	na
Domestic credit (end-year)	86.1	110.4	109.2	123.6	82.1	82.1	95.2	26.8	na
					(In per cent of GDP)				
Broad money (M3, end-year)	30.8	22.3	21.4	25.3	27.9	24.8	25.1	25.7	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Discount rate	70.0	70.0	58.0	35.0	35.0	40.0	35.0	35.0	na
1-week BUBOR	na	na	na	na	51.7	102.4	159.0	68.9	na
Deposit rate (average)	na	42.5	49.5	32.4	38.9	34.1	42.3	41.3	na
Lending rate (average)	na	86.4	61.8	47.5	53.6	55.6	58.9	62.0	na
					(Lei per US dollar)				
Exchange rate (end-year)	460	1,276	1,767	2,578	4,035	8,023	10,951	18,255	na
Exchange rate (annual average)	308	760	1,655	2,558	3,734	7,960	8,875	15,333	na
External sector					*(In millions of US dollars)*				
Current account	-1,564	-1,174	-428	-1,774	-2,584	-2,137	-2,917	-1,308	-1,750
Trade balance	-1,420	-1,128	-411	-1,577	-2,494	-1,980	-2,625	-1,092	-1,500
Merchandise exports	4,364	4,892	6,151	7,910	8,061	8,431	8,302	8,503	10,250
Merchandise imports	5,784	6,020	6,562	9,487	10,555	10,411	10,927	9,595	11,750
Foreign direct investment, net	73	87	341	417	415	1,267	2,079	949	500
Gross reserves (end-year), excluding gold	85	40	536	278	547	2,090	1,374	1,540	na
External debt stock	3,240	4,249	5,509	6,787	8,597	9,467	9,974	9,233	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	0.2	0.1	0.8	0.3	0.5	2.0	1.3	1.6	na
					(In per cent of current account revenues, excluding transfers)				
Debt service	na	na	na	na	13.6	18.2	22.8	27.5	na
Memorandum items					*(Denominations as indicated)*				
Population (mid-year, millions)	22.8	22.8	22.7	22.7	22.6	22.6	22.5	22.4	na
GDP (in billions of lei)	6,029.1	20,035.8	49,773.2	72,135.5	108,919.6	250,480.2	368,345.0	521,735.0	770,000.0
GDP per capita (in US dollars)	859	1,158	1,323	1,243	1,290	1,395	1,845	1,517	na
Share of industry in GDP (in per cent)	38.3	33.8	36.2	32.9	34.2	35.6	27.5	27.8	na
Share of agriculture in GDP (in per cent)	19.0	21.0	19.9	19.8	19.1	18.8	14.5	13.9	na
Current account/GDP (in per cent)	-8.0	-4.5	-1.4	-6.3	-8.9	-6.8	-7.0	-3.8	-4.9
External debt – reserves (in US$ millions)	3,155	4,209	4,973	6,509	8,050	7,377	8,600	7,693	na
External debt/GDP (in per cent)	16.5	16.1	18.3	24.1	29.5	30.1	24.0	27.1	na
External debt/exports of goods and services (in per cent)	64.9	74.7	76.6	72.2	89.3	95.1	104.8	93.6	na

1 Registered unemployment. The ILO unemployment rate would give lower figures (8.0, 6.7, 6.0 for respectively 1995, 1996 and 1997.

2 Until 1993 figures refer to percentage changes of net monthly earnings in national economy.

Russia

Key reform challenges

- **Political stabilisation since late 1999, combined with a favourable external economic environment and rapid output recovery, have created a window of opportunity for a fresh start in the country's transition process.**
- **The new economic reform programme adopted in July 2000 contains important new priorities, including increased emphasis on reforming the state itself, social sector reforms, and overhauling relations between the centre and the regions.**
- **Early steps to prove the government's reform commitment are urgent to shore up confidence and build support for a broad-based improvement in the investment climate before the beneficial impact of the high commodity prices and the rouble devaluation wears out.**

Liberalisation

Despite higher export taxes, imbalances in the domestic energy market persist.
By now, with the exception of the foreign trade regime, the setbacks in liberalisation in the wake of the 1998 crisis have been reversed. Moreover, major reduction in non-monetary forms of payment substantially improved the functioning of the price system. However, the export taxes reintroduced for oil, gas, metals, petrochemicals and some other goods remain in place and most of them have been further increased. In late summer 2000, the export quota system for oil was also reinstated. Capturing part of the windfall profits stemming from high commodity prices and securing adequate energy supplies to the domestic market are the key motivations for these policies. Yet, unless domestic energy prices are increased, present actions will merely reinforce existing distortions.

Major liberalisation initiatives are planned in the new reform programme.
Among the priorities under the programme, the number of state authorities with powers for administrative controls is to be drastically reduced, and registration and licensing procedures are to be streamlined. Regulated prices and tariffs are to be gradually increased to cost-recovery levels. In the area of foreign trade regulations, the reduction and gradual unification of import duties and the simplification of custom procedures are planned and the process of joining WTO is to be accelerated. However, specific measures in relation to sensitive areas such as the opening of the service sector to foreign competition or the phasing out of export restrictions remain to be developed.

Stabilisation

External surpluses create new challenges for fiscal and monetary policy.
Developments in the first half of 2000 point to a further increase in the current account surplus from US$ 25 billion in 1999. International reserves rose sharply from US$ 12.5 billion at the end of 1999 to US$ 23 billion by August 2000. The primary surplus of the federal budget increased to 5-6% of GDP in recent months from 1.6% of GDP in 1999, allowing the overall balance to move into surplus. The revised budget aims at an overall surplus for 2000 and a balanced budget for 2001. Persistent strong capital inflows, however, will cause increasing inflationary pressures unless the government allows the rouble to appreciate.

Important fiscal reforms have recently been launched.
The bulk of the second part of the Tax Code was approved by the Duma in July 2000. The new system represents a major improvement in the tax regime. Key changes in individual taxes are the introduction of a flat 13% personal income tax, the unification and reduction of the different social security contributions, the reduction in the turnover tax and elimination of a number of smaller taxes. The 2001 budget will already be based on the new Tax Code. Unfunded or only partially funded expenditure programmes are to be abolished or sharply curtailed with the 2001 budget. The rules governing the sharing of revenues and expenditure responsibilities between the regions and the centre will be made more transparent and are likely to change in favour of the federal budget.

Debt rescheduling negotiations continue.
In early 2000 Russia reached a long-term restructuring agreement with the London Club of commercial creditors. The deal involves a 36% write-down of the total US$ 32 billion debt with the balance being converted into Eurobonds. Debt-restructuring or debt-rescheduling arrangements with other Soviet-era creditors will follow suit although probably at different terms. Negotiations with the Paris Club are likely to start once an agreement with the IMF on a new cooperation framework has been reached.

Privatisation

Privatisation has been slow, but a new round is shaping up.
Continued depressed asset prices and unclear policies resulted in modest and controversial privatisation achievements over the past year. The few high-profile privati-

Liberalisation, stabilisation, privatisation

1990

Jun	Sovereignty proclaimed

1991

Oct	Reform programme introduced
Dec	Dissolution of Soviet Union

1992

Jan	VAT introduced
Jan	Most prices liberalised
Jan	State trading monopoly abolished
Jun	Mass privatisation programme adopted
Jul	Exchange rate unified
Oct	Voucher privatisation begins

1993

May	Treasury bills market initiated
Jul	New currency (rouble) introduced
Nov	Rouble zone collapsed

1994

Jul	Cash-based privatisation begins
Oct	Currency crisis

1995

Jun	Currency corridor introduced
Nov	First shares-for-loans auctions conducted

1996

Mar	IMF three-year programme agreed
Apr	Foreign trade liberalisation completed
Jun	Full current account convertibility introduced
Nov	First sovereign Eurobond

1997

May	First regional Eurobond
Sep	Admission to Paris Club

1998

Jun	Western financing package
Aug	Financial crisis

1999

Jan	New Tax Code (Part I) enacted
Jan	Introduction of dual exchange rate regime
Jun	Exchange rate re-unified
Aug	New IMF programme approved
Dec	Parliamentary election
Dec	Yeltsin's resignation

2000

Feb	Agreement with the London Club
Mar	Putin elected as President
May	Appointment of the new government
Jul	Government reform programme adopted
Jul	Adoption of the second part of the Tax Code

Enterprises, infrastructure, finance and social reforms

1990
- Dec Law on banks and banking activities enacted
- Dec Law on central bank enacted (Bank of Russia)

1991
- Mar Russian Federation law on competition enacted
- Mar Anti-Monopoly Committee established

1992
- Jan Federal Energy Commission established
- Feb Law on subsoil resources enacted
- May Bankruptcy law enacted
- Nov RAO UES, Gazprom transformed into joint-stock companies

1994
- Jan 60% of Gazprom shares sold to the public
- Oct New civil code adopted
- Nov Federal securities commission established

1995
- Aug Interbank market crisis
- Aug Law on natural monopolies
- Dec First issue of ADR (Lukoil)
- Dec Law on joint-stock companies
- Dec Securities law adopted

1996
- Jan Federal telecommunications regulator established
- Feb Federal transport regulator established

1997
- Jul First corporate Eurobond

1998
- Mar New bankruptcy law enacted
- Aug Banking crisis resulting from GKO default
- Oct Agency for bank restructuring established

1999
- Feb Law on insolvency of financial institutions enacted
- Feb Law on protection of securities market investors enacted
- Jul Law on restructuring of credit organisations
- Jul Law on foreign investment
- Jul Mortgage law introduced

2000
- Jun Start of the anti-oligarch campaign
- Jul Law on reforming the federal power structure

sation deals, including the sale of minority government stakes in Lukoil and Tyumen Oil Company, were characterised by limited transparency and favours to insiders. The reform programme promises a new approach to privatisation and foresees a reduction of the 27,000 state-owned companies to about 3,000 over the next few years. A detailed privatisation programme is being prepared and is expected to be submitted to the Duma together with the draft budget for 2001. The privatisation law will also be amended. The new policies are expected to aim for accelerated enterprise restructuring rather than maximum budget revenues. Privatisation of 20 major companies is currently earmarked for 2001, including large shareholding blocks in Slavneft and Rosneft and the sale of smaller stakes in Gazprom, Lukoil, Svyazinvest and Aeroflot.

Enterprise reform

The financial condition of the enterprise sector has been improving …
Over the past year, the level of payments arrears has substantially declined while the share of barter transactions in industrial sales dropped from 46% at the start of 1999 to 31% by April 2000. Investment increased by 12% in the first half of 2000, up from 4.5% in 1999 and financed primarily from retained earnings. So far, the output recovery has mainly benefited domestic industries, but with real exchange rate appreciation, increasing opportunities for importers and FDI should arise.

… but large segments of the corporate sector are still loss-making.
The share of unprofitable enterprises, though declining, was still above 40% in the first half of 2000. Most of these companies are surviving only through delaying or avoiding payments, artificially low input prices and special regulatory favours. Tax exemptions alone are estimated to amount to 6% of GDP. Under the government's reform programme, tax exemptions and privileges are to be phased out, prices for energy and public services will increase, and bankruptcy is to be enforced on loss-making firms. The recent tax, corruption and embezzlement investigations against a number of high-profile oligarchs, if credibly concluded, may positively influence the level of legal compliance.

The changing policy environment started to increase transparency and respect for shareholder rights.
While the enterprise restructuring process has continued at a sluggish pace, an increasing number of firms are realising that high business standards and a good reputation are major preconditions for their long-term market success and key to gaining access to external finance. Corporate governance violations are becoming less frequent, effective legal settlement was reached in a number of high-profile debt-restructuring cases, companies are paying more attention to their public image and the circle of self-regulatory business associations and organisations is widening.

Infrastructure

Strengthened commitment of the government to restructure natural monopolies.
The infrastructure monopolies, particularly in the energy sector, continue to be a key source of indirect subsidisation to enterprises. While collection ratios have been improving in recent months, tariff adjustments have lagged behind the rate of inflation, increasing the level of subsidisation. The reform programme outlines an ambitious set of policy guidelines for restructuring of the gas, electricity and railway sectors. The timing and sequencing of the restructuring process is not yet clarified, however. Specific restructuring proposals for UES and the Railway Ministry are under discussion. The conflicts around an earlier UES reform plan are a good indication of the complex challenges ahead.

Financial institutions

Structural weaknesses in the banking sector persist despite improved liquidity.
Bank restructuring has advanced very slowly and the role of the bank restructuring agency, ARCO, in the process has been minimal, as its financial resources and enforcement powers are still weak. Very little has been done in reversing the previous large-scale stripping of assets. The much-improved liquidity situation has not led to a significant upsurge in lending to the real sector, with banks holding most of their assets in liquid reserves. The state banks have strengthened their dominant role in the sector benefiting from special privileges, such as preferential funding sources, capital injections and implicit state guarantees. Although foreign banks have increased their presence to about 11% of total capital of the sector, the banking system remains vulnerable to new crises.

Social reform

Realistic social policies and reforms.
Despite recent growth, average real incomes are still well below their pre-crisis level. Social sector policies and reforms are among the key priority areas of the new programme. Pension reforms are to start in the near future, aiming at increasing pensions in real terms and moving gradually to a three-pillar system. The government also intends to streamline social assistance, targeting it more effectively at the genuinely needy and thereby generating considerable cost savings. For example, general subsidies for housing and utilities are to be phased out by 2003, but housing expenses for poor families will be kept below 20% of the family budget through targeted cash support.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenues in GDP – **22.4%**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises
Competition office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8%**
Deposit insurance system – **no**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **35%**
Private pension funds – **yes**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	15.0	7.0	7.0	6.0	5.0	5.0	5.0	5.0	na
Share of total trade with non-transition countries (in per cent)	na	na	na	66.6	68.2	67.0	65.4	66.9	70.5
Share of trade in GDP (in per cent)	na	na	61.7	42.6	40.9	37.6	36.0	49.2	62.7
Tariff revenues (in per cent of imports) [1]	na	3.8	12.0	15.0	11.0	7.8	7.1	7.2	8.9
EBRD Index of price liberalisation	1.0	3.0	3.0	3.0	3.0	3.0	3.0	2.7	2.7
EBRD Index of forex and trade liberalisation	1.0	3.0	3.0	3.0	3.0	4.0	4.0	2.3	2.3
Privatisation									
Share of small firms privatised (in per cent) [2]	na	na	na	84.0	84.0	89.0	90.0	90.0	90.0
Privatisation revenues (cumulative, in per cent of GDP)	na	0.8	1.1	1.3	1.5	1.7	2.7	3.3	3.6
Private sector share in GDP (in per cent)	5.0	25.0	40.0	50.0	55.0	60.0	70.0	70.0	70.0
EBRD index of small-scale privatisation	1.0	2.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	1.0	2.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3
Enterprises									
Budgetary subsidies (in per cent of GDP) [3]	na	na	na	na	na	8.1	8.2	5.9	5.3
Effective/statutory social security tax rate (in per cent)	na	75.0	43.3	40.6	40.1	44.5	46.1	na	na
Share of industry in total employment (in per cent)	30.4	29.6	29.3	27.1	25.9	24.8	23.1	18.7	na
Change in labour productivity in industry (in per cent)	-6.3	-13.9	-11.9	-11.4	4.5	0.8	12.0	19.1	7.3
Investment rate (in per cent of GDP)	23.3	23.9	20.4	21.8	20.9	21.0	19.1	17.5	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.7	2.0	2.0	2.0	2.0	1.7
EBRD Index of competition policy	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	15.2	15.5	15.8	16.2	17.0	17.5	18.3	19.7	19.7
Railway labour productivity (1989=100)	105.6	89.8	75.4	57.7	56.8	54.6	58.6	60.9	72.1
Electricity tariffs, USc/kWh (collection rate in per cent) [4]	na	na	na	2.2 (50)	2.3 (50)	3.0 (50)	3.2 (50)	2.7 (87)	1.1 (100)
Electricity consumption/GDP (1989=100)	103.6	113.3	116.1	120.5	123.5	125.7	122.5	125.7	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.4	2.4
Financial institutions									
Number of banks (of which foreign owned)	1,306 (na)	1,747 (na)	2,009 (na)	2,456 (na)	2,295 (21)	2,576 (25)	2,526 (29)	2,451 (32)	2,376 (33)
Asset share of state-owned banks (in per cent)	na	na	na	na	na	na	37.0	41.9	na
Bad loans (in per cent of total loans)	na	na	na	na	3.3	4.8	4.0	14.3	13.1
Domestic credit to enterprises (in per cent of GDP)	na	na	11.8	12.1	8.5	7.4	9.1	12.9	11.7
Stock market capitalisation (in per cent of GDP) [5]	2.3	0.5	0.0	0.1	4.6	9.7	29.5	16.5	44.4
EBRD index of banking sector reform	1.0	1.0	1.0	2.0	2.0	2.0	2.3	2.0	1.7
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.7	1.7	2.0	3.0	3.0	1.7	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	3.3	3.7	3.7
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	3.0	2.0	2.3
Social sector									
Expenditures on health and education (in per cent of GDP)	na	6.0	7.2	7.7	6.1	6.6	7.0	6.0	6.8
Mortality rate (per 1,000 male adults)	na	na	na	na	472.0	na	370.0	364.0	na
Basic school enrolment ratio (in per cent)	90.0	89.3	88.3	88.6	88.8	88.5	88.2	89.1	na
Earnings inequality (GINI-coefficient)	32.5	37.1	46.1	44.6	47.1	48.3	na	na	na

1 Refers to all taxes on international trade.

2 In total number of small enterprises.

3 Expenditures on national economy of the consolidated budget (including industry, agriculture, the energy sector and housing subsidies of regional budgets).

4 Figures are averages of the Siberian, Northern, Southern, Volga, Far East and Ural regions and the Federation; collection ratios are estimated.

5 Survey data from the Russian Trading System. IFC data show somewhat higher figures for capitalisation, reaching 16.5% in 1998.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	Projection
Output					*(Percentage change in real terms)*				
GDP	-14.5	-8.7	-12.7	-4.1	-3.5	0.8	-4.6	3.2	6.5
Private consumption	-3.0	1.2	1.2	-2.8	-4.7	5.4	-4.0	na	na
Public consumption	-11.8	-6.4	-2.9	1.1	0.8	-2.4	0.1	na	na
Gross fixed investment	-41.5	-25.8	-26.0	-7.5	-19.3	-5.7	-8.6	1.4	na
Exports of goods and services [1]	na	-2.1	4.9	7.3	-6.0	4.0	-16.5	-2.3	na
Imports of goods and services [1]	na	-9.6	9.2	8.4	-14.7	7.0	-19.1	-30.0	na
Industrial gross output	-18.0	-14.1	-20.9	-3.3	-4.0	1.9	-5.2	8.1	na
Agricultural gross output	-9.0	-4.4	-12.0	-7.6	-5.1	0.1	-12.3	2.4	na
Employment					*(Percentage change)*				
Labour force (end-year)	-0.3	-1.4	-1.4	-1.5	0.5	-0.6	0.2	1.1	na
Employment (end-year)	-2.3	-1.7	-3.4	-3.1	-0.6	-2.1	-2.0	2.8	na
					(In per cent of labour force)				
Unemployment (end-year)	5.3	6.0	7.8	9.0	9.9	11.2	13.3	11.7	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	1,526.0	875.0	311.4	197.7	47.8	14.7	27.6	86.1	20.7
Consumer prices (end-year)	2,506.1	840.0	204.4	128.6	21.8	10.9	84.5	36.8	19.7
Producer prices (annual average)	1,767.9	941.9	337.4	236.5	50.8	19.7	7.0	58.9	na
Producer prices (end-year)	3,279.1	895.0	233.0	175.0	25.6	7.4	23.0	69.8	na
Gross average monthly earnings in economy (annual average)	1,005.4	904.7	277.3	119.5	51.3	29.0	6.4	42.7	na
Government sector [2]					*(In per cent of GDP)*				
General government balance	-18.9	-7.3	-10.4	-6.0	-8.9	-7.6	-8.0	-1.0	2.0
General government expenditure	58.4	43.6	45.1	38.5	41.9	42.9	39.7	36.0	na
General government debt (domestic)	na	na	18.9	14.6	20.9	19.2	28.0	12.5	na
Monetary sector					*(Percentage change)*				
Broad money (M2, end-year)	na	na	200.0	125.8	30.6	29.8	19.8	44.2	na
Domestic credit (end-year)	na	na	335.6	87.8	48.3	22.2	68.2	26.5	na
					(In per cent of GDP)				
Broad money (M2, end-year)	na	19.0	16.0	13.9	13.4	14.4	16.7	14.4	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Central bank refinance rate (uncompounded)	na	210.0	180.0	160.0	48.0	28.0	60.0	55.0	na
Treasury bill rate (all maturities) [3]	na	103.2	263.0	104.1	33.6	36.6	48.1	16.0	na
Lending rate	na	na	na	320.0	146.8	32.0	41.7	38.3	na
Deposit rate	na	na	na	102.0	55.1	16.8	17.1	9.4	na
					(Roubles per US dollar)				
Exchange rate (end-year) [4]	0.5	1.2	3.6	4.6	5.6	6.0	20.7	26.8	na
Exchange rate (annual average) [4]	0.2	1.0	2.2	4.6	5.1	5.8	10.0	24.6	na
External sector					*(In millions of US dollars)*				
Current account [5]	na	na	5,882	5,026	7,001	440	2,094	24,730	36,100
Trade balance [5]	10,634	15,342	17,024	20,151	19,771	14,792	16,896	35,302	46,000
Merchandise exports [5]	53,605	59,646	67,542	81,096	88,599	88,252	74,684	74,663	94,000
Merchandise imports [5]	42,971	44,304	50,518	60,945	68,828	73,460	57,788	39,361	48,000
Foreign direct investment, net	na	na	500	1,663	1,665	4,036	1,734	746	2,000
International reserves (end-year), excluding gold	na	na	5,000	14,400	11,276	12,895	7,801	8,457	na
External debt stock [6]	na	na	120,900	127,000	135,100	134,100	157,700	158,546	na
					(In months of imports of goods and services)				
International reserves (end-year), excluding gold	na	na	0.9	2.1	1.5	1.7	1.3	2.0	na
					(In per cent of current account revenues, excluding transfers)				
Public debt service due [7]	na	na	39.2	20.4	13.6	12.0	10.4	19.1	na
Public debt service paid [7]	na	na	9.2	7.9	7.0	6.8	5.4	10.3	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions) [8]	148.7	148.4	148.3	148.0	147.5	147.1	146.4	145.7	na
GDP (in billions of roubles)	19.0	171.5	610.7	1,585.0	2,145.7	2,602.3	2,684.5	4,476.1	5,800.0
GDP per capita (in US dollars)	565	1,133	1,867	2,343	2,829	3,047	1,840	1,249	na
Share of industry in GDP (in per cent)	33.7	34.4	32.8	29.0	29.5	28.4	29.1	32.9	na
Share of agriculture in GDP (in per cent)	7.2	8.2	6.5	7.2	7.3	6.7	6.0	6.7	na
Current account/GDP (in per cent)	na	na	2.1	1.4	1.7	0.1	0.8	13.6	17.2
External debt – reserves (in US$ millions)	na	na	115,900	112,600	123,824	121,205	149,899	150,089	na
External debt/GDP (in per cent)	na	na	43.7	36.6	32.3	29.8	58.6	87.1	na
External debt/exports of goods and services (in per cent)	na	na	159.2	138.6	133.0	131.0	180.0	189.3	na

1 From balance of payments data in US$ terms.

2 General consolidated government includes the federal, regional and local budgets and extrabudgetary funds and excludes transfers.

3 The 1998 figure is the yield on obligations of the Central Bank of Russia.

4 Data in new (denominated) roubles per US dollar. From 1 January 1998, one new rouble=1,000 old roubles.

5 Data from the consolidated balance of payments, which covers transactions with both CIS and non-CIS countries.

6 Data includes public debt only. From 1992 debt to former COMECON countries is included.

7 Difference between due and paid arises from accumulation of arrears on debt servicing.

8 Data as of 1 January of the following year.

Slovak Republic

Key reform challenges

- **Recent expenditure cuts and revenue growth are encouraging, but the structural budget deficit remains wide due to ongoing restructuring and social safety net expenditures; social welfare reforms are urgently needed to strengthen public finances.**

- **The privatisation of large-scale enterprises has been reinvigorated; however, the pace of industrial restructuring and liquidations needs to be accelerated. Removing barriers to SME development would facilitate restructuring by creating new jobs.**

- **With bank restructuring progressing and telecommunications privatised, priorities now are to privatise the restructured state banks to strategic investors and to accelerate energy sector reform.**

Liberalisation

Regulated prices have been increased substantially.
The government sharply increased utility prices in the last 18 months, following several years of little or no price adjustments. Household electricity prices increased cumulatively by 135%, heating prices increased by 112% and rents increased by 70%. However, as local energy prices are still well below cost-recovery levels, further substantial increases are necessary prior to the EU accession and energy market liberalisation.

The import surcharge is scaled down.
The Slovak authorities introduced an import surcharge of 7% in June 1999 as a part of an austerity package. With a substantial improvement in the trade balance, the import surcharge was lowered to 5% in January 2000 and further to 3% in July as planned. The import surcharge is to be abolished at the end of 2000.

Stabilisation

Further fiscal tightening needed, as the consolidated debt burden remains high.
Austerity measures in 1999 lowered the fiscal deficit to about 3.5% of GDP. Nevertheless, most of the improvement was the result of one-off measures and the effect of recent tax reforms. The deficit is unlikely to fall further due to the high restructuring costs and continuing sizeable expenditures on the social safety net. The public debt is around 20% of GDP. However, this figure does not incorporate debt of social funds, including pensions, health care and unemployment, bank restructuring costs, and other contingent liabilities estimated together at some 30-35% of GDP. In 2001, the authorities face repayment of privatisation bonds issued in 1995, the total value of which is equivalent to 4% of GDP.

Inflationary pressures kept low, despite large regulated price increases.
The National Bank of the Slovak Republic (NBS) gained credibility by fulfilling recent inflation targets in the face of considerable challenges. A large increase in utility tariffs, significant currency depreciation and strong international oil prices placed significant upward pressure on some prices. However, with moderate wage settlements and fiscal consolidation, the NBS was able to reduce nominal interest rates over the past year.

Privatisation

The privatisation of strategic enterprises has progressed.
In April 2000, the Hungarian oil and gas company MOL acquired one-third of an oil refinery, Slovnaft, including the right to increase its stake to above 50% after two years. This is the largest single foreign investment in the country to date, as well as the biggest cross-border deal in the region. Restructuring of VSZ, a large steel mill, which defaulted on its foreign debt in late 1998, was advanced through the sell-off of its core assets to US Steel in September 2000.

Enterprise reform

Industrial restructuring urgently needed.
The financial situation in the enterprise sector deteriorated in recent years, as inter-enterprise arrears and arrears to the government and the banking sector increased. It is estimated that almost half of inter-enterprise claims are overdue. Despite some recent progress, industrial restructuring remains slow, in part because of social concerns about already high unemployment at about 20% of the labour force. There is a need for carrying through and expanding existing government activities that facilitate market-led industrial restructuring, particularly promotion of SME development through removal of administrative barriers.

New bankruptcy law has been adopted.
New bankruptcy legislation enacted in August 2000 considerably strengthens creditor rights, simplifies existing rules and introduces stricter criteria to trigger bankruptcy. The amended law aims to speed up the bankruptcy process; however, improved performance of the court system, where there are few experienced judges, is necessary to reduce a large backlog of outstanding cases. Only 659 bankruptcies were declared in 1999 while there were almost 6,000 unprocessed cases.

Foreign investment incentives have been strengthened further.
The Slovak Republic has a favourable location, a skilled labour force, low labour costs and positive experiences of existing investors, such as Volkswagen and Sony.

Liberalisation, stabilisation, privatisation

1990

Jul	First Czechoslovak Eurobond

1991

Jan	Exchange rate unified
Jan	Fixed exchange rate regime adopted
Jan	Most foreign trade controls lifted
Jan	Most prices liberalised
Jan	Small-scale privatisation begins
Feb	Restitution law adopted

1992

Feb	Treasury bills market initiated
May	Voucher privatisation begins
Jul	EFTA agreement

1993

Jan	Czechoslovakia splits into Czech and Slovak Republics
Feb	New currency (koruna) introduced
Mar	CEFTA membership

1994

Jul	First sovereign Eurobond

1995

Jan	WTO membership
Sep	Second wave of voucher privatisation cancelled
Sep	Strategic enterprises excluded from privatisation
Oct	Full current account convertibility introduced

1997

Sep	New wage regulation enacted

1998

Oct	Koruna is floated
Dec	New wage regulation cancelled

1999

Apr	Investment incentives adopted
Jun	Import surcharge introduced
Jul	Austerity measures introduced
Dec	Foreign Exchange Act amended
Dec	EU accession negotiations started

2000

Sep	OECD membership

Enterprises, infrastructure, finance and social reforms

1990
Jan Two-tiered banking system established
Aug Competition office established

1991
Aug Bankruptcy law adopted

1992
Jan Commercial code adopted
Feb Banking law enacted

1993
Apr Stock exchange begins trading
Jun New bankruptcy law enacted

1994
Jan First corporate Eurobond
Feb New banking law becomes effective
Aug New competition law enacted

1995
Dec First municipal Eurobond

1996
Dec BIS capital adequacy requirements adopted

1997
Aug Enterprise revitalisation law enacted
Dec IRB (third-largest bank) collapsed

1998
Feb Bankruptcy law amended
Nov Enterprise revitalisation law cancelled
Nov Steel producer VSZ defaults

1999
Aug Restructuring programme approved
Sep Privatisation law amended

2000
Jan New investment law adopted
Feb Major increase in utility prices
May New telecommunications law adopted
Jul Strategic investor acquires Slovak Telecom
Aug New bankruptcy law enacted

Nevertheless, the inflow of foreign direct investment has failed to match levels in neighbouring countries, partly due to extensive state interference and corruption. The package of investment incentives approved in early 1999 did not result in increased capital inflow. In the middle of 2000, the incentives were further strengthened by extending tax holidays from five to ten years and eliminating some requirements, such as exporting at least 60% of production and producing goods that were previously not manufactured in the Slovak Republic. The government also set up a central agency for foreign investors.

Infrastructure

Reform and privatisation of telecommunications are well advanced …
In May 2000, the Slovak parliament approved a new telecommunications law, providing for liberalisation of the market by 2003, such as the specification of rules for interconnection charges and the establishment of an independent regulator, and aligning the sector with EU directives. A majority stake in Slovak Telecom, the monopoly telecommunications company, was sold to Deutsche Telecom in July 2000. There are currently two mobile operators, one controlled by Slovak Telecom. A tender for a third mobile licence was suspended in August 1999. Mobile coverage doubled during 1999 to reach 20% of the population by the end of the year, on par with regional levels.

… and reform plans for the energy sector are under discussion.
The government is currently debating reform of the energy sector, which would include the restructuring of existing companies, privatisation to strategic investors and the establishment of an independent regulator for the sector. However, no firm timetable for energy sector liberalisation has been agreed, as this will be an important issue during the EU accession negotiations. Privatisation plans for the power companies, the gas company, SPP, and the oil pipeline operator, Transpetrol, were recently approved, although only minority shares of up to 49% are to be sold.

Financial institutions

Restructuring and privatisation of the banking is progressing …
At the end of 1999, the government transferred SLK 74 billion, equivalent to almost 10% of GDP, of bad loans from the three large state-owned banks to the Consolidation Agency and the Consolidation Bank and increased their capital by SLK 19 billion. As a result of government measures, the state banks now satisfy the 8% capital adequacy requirement and the share of bad loans in their loan portfolio is below 20%. However, a number of loans that are classified as standard due to state guarantees are likely to face repayment difficulties, putting pressure on public finances. Preparations for the sale of three large state banks, Slovenska Sporitelna, Vseobecna and Uverova Banka and Investicni a Rozvojova Banka, are well advanced, but their sale is unlikely to be completed until 2001. A minority stake in CSOB, the former Czechoslovak foreign trade bank, was sold at the end of 1999.

… but the capital markets remain underdeveloped.
The local stock market is underdeveloped, even by regional standards. Although there are more than 800 listed companies, the market is illiquid and its reputation has been tarnished by the suspicion of widespread insider trading. Against this background, it is unlikely that the Bratislava Stock Exchange will be a source of finance for enterprises in the near future, despite government attempts to tighten supervision. However, market liquidity could receive a boost by the flotation of some of the large utilities, including Slovak Telecom and Globtel, as part of the re-invigorated privatisation process.

Social reform

A generous social safety net is the biggest burden on state finances.
The state needs to provide additional SLK 30 billion, equivalent to almost 4% of GDP, to the social welfare system in order to compensate for social contribution arrears and a growing social system deficit. High unemployment is one reason for increased fiscal pressure from social outlays. Another factor is the size of social security payment arrears of the enterprise sector, which for the pension system alone amount to some 5.5% of GDP. A 10% increase in state pensions from August 2000, approved by the parliament to compensate pensioners for the regulated price increases, will further add to financial pressures in the social welfare system and highlights the urgency of reform.

Unemployment rates remain persistently high.
The unemployment rate has increased to nearly 20% of the labour force in recent years. Nearly one-half of the unemployed have been out of work for more than one year and there are wide regional disparities, particularly between the capital and the eastern part of the country. Incentive to search for work is weak, reflecting generous social benefits compared with the level of wages for low-skilled workers. Reform of labour market policies is therefore needed, particularly those aimed at combating unemployment among unskilled workers and the young and long-term unemployed.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **no**

Social reform
Share of the population in poverty – **1%**
Private pension funds – **no**

Stabilisation
Share of general government tax revenues in GDP – **37.1%**
Exchange rate regime – **floating**

Enterprises
Competition office – **yes**

Financial sector
Capital adequacy ratio – **8%**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	21.8	21.8	21.8	21.8	15.1	14.7	15.2
Number of goods with administered prices in EBRD-15 basket	9.0	5.0	5.0	5.0	5.0	5.0	5.0	4.0	4.0
Share of total trade with non-transition countries (in per cent)	na	na	39.5	44.9	45.6	49.4	54.2	62.0	62.0
Share of trade in GDP (in per cent)	na	117.0	93.2	91.6	94.7	100.9	104.6	110.9	109.1
Tariff revenues (in per cent of imports) [1]	na	2.6	2.3	3.4	3.3	2.9	3.3	2.6	2.7
EBRD Index of price liberalisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	3.0	4.0	4.0	4.0	4.0	4.3	4.0	4.3	4.3
Privatisation									
Share of small firms privatised (in per cent)	61.6	94.0	96.5	98.0	98.3	98.3	98.6	98.8	98.8
Privatisation revenues (cumulative, in per cent of GDP)	na	3.7	4.7	6.7	8.4	9.7	10.2	10.8	11.0
Private sector share in GDP (in per cent)	15.0	30.0	45.0	55.0	60.0	70.0	75.0	75.0	75.0
EBRD index of small-scale privatisation	3.0	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	1.0	2.0	3.0	3.0	3.0	3.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	4.0	3.7	3.0	2.6	2.3	2.4	2.0	1.9
Effective/statutory social security tax rate (in per cent)	na	na	48.1	50.0	50.0	56.5	52.9	na	na
Share of industry in total employment (in per cent)	34.2	30.1	27.8	27.5	28.1	27.7	25.0	26.6	24.4
Change in labour productivity in industry (in per cent)	-15.7	7.3	-1.1	9.0	4.0	2.5	3.8	7.8	2.6
Investment rate (in per cent of GDP)	28.3	32.9	32.7	29.4	27.4	36.9	38.6	40.8	na
EBRD index of enterprise reform	2.0	2.0	3.0	3.0	3.0	3.0	2.7	2.7	3.0
EBRD Index of competition policy	2.0	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0
Infrastructure									
Main telephone lines per 100 inhabitants	14.4	15.5	16.7	18.7	20.8	23.2	25.9	28.6	30.8
Railway labour productivity (1989=100)	78.4	67.6	65.4	60.7	68.7	60.8	63.1	60.8	53.0
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	2.9 (95)	3.1 (95)	3.2 (95)	2.9 (95)	2.8 (na)	3.5 (na)
Electricity consumption/GDP (1989=100)	109.2	94.0	93.1	90.9	95.3	92.8	86.4	77.3	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.1	2.1
Financial institutions									
Number of banks (of which foreign owned)	na	na	18 (3)	19 (4)	25 (9)	24 (9)	25 (9)	24 (8)	25(10)
Asset share of state-owned banks (in per cent)	na	na	70.7	66.9	61.2	54.2	48.7	50.0	50.7
Bad loans (in per cent of total loans)	na	na	12.2	30.3	41.3	31.8	33.4	44.3	40.0
Domestic credit to enterprises (in per cent of GDP)	na	na	30.4	23.0	26.3	30.4	42.1	43.9	37.8
Stock market capitalisation (in per cent of GDP)	na	na	na	7.3	6.7	11.5	9.3	4.7	3.8
EBRD index of banking sector reform	2.0	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
EBRD index of reform of non-banking financial institutions	1.0	1.0	2.0	2.7	2.7	2.7	2.3	2.3	2.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	3.0	3.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	3.0	2.0	3.3
Social sector									
Expenditures on health and education (in per cent of GDP)	na	na	9.1	8.5	8.9	11.1	10.7	10.2	9.9
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	208.0	207.0	na
Basic school enrolment ratio (in per cent)	96.5	95.7	94.9	94.4	94.3	93.4	na	93.9	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Refers to import tariffs, customs duties and import surcharge.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	-6.5	-3.7	4.9	6.7	6.2	6.2	4.1	1.9	2.0
Private consumption	-6.4	-1.5	1.0	3.0	8.2	5.6	5.3	0.1	na
Public consumption	9.9	-2.2	-11.4	2.1	21.0	4.0	4.0	-6.9	na
Gross fixed investment	-4.5	-5.4	-5.0	5.3	32.0	12.0	11.1	-18.8	na
Exports of goods and services	na	-0.5	14.2	3.0	0.7	17.6	12.2	3.6	na
Imports of goods and services	na	-0.8	-3.4	9.2	17.2	13.1	19.9	-6.1	na
Industrial gross output	-9.6	-5.4	6.8	8.3	2.5	1.7	3.4	-3.4	na
Agricultural gross output	-21.7	-8.1	4.8	2.3	2.0	-1.0	-5.9	1.0	na
Employment					*(Percentage change)*				
Labour force (end-year)	-0.2	-0.2	2.2	1.2	2.1	1.0	0.9	0.9	na
Employment (end-year)	1.0	-2.6	-1.0	2.4	-1.4	-2.3	-1.0	-1.8	na
					(In per cent of labour force)				
Unemployment (end-year)	10.4	14.4	14.6	13.1	12.8	12.5	15.6	19.2	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	10.0	23.2	13.4	9.9	5.8	6.1	6.7	10.6	11.9
Consumer prices (end-year)	9.1	25.1	11.7	7.2	5.4	6.4	5.6	14.2	8.0
Producer prices (annual average)	5.3	17.2	10.0	9.0	4.1	4.5	3.3	3.8	na
Producer prices (end-year)	6.1	18.8	9.4	7.1	4.7	4.4	1.6	7.7	na
Gross average monthly earnings in economy (annual average)	20.5	18.4	17.0	14.3	13.3	13.1	9.6	7.2	na
Government sector [1]					*(In per cent of GDP)*				
General government balance	-11.9	-6.0	-1.5	0.4	-1.3	-5.2	-5.0	-3.6	-3.3
General government expenditure	58.0	47.6	45.5	45.2	47.0	45.5	42.9	43.3	na
General government debt	na	31.5	28.0	24.6	24.5	23.7	26.0	28.4	na
Monetary sector					*(Percentage change)*				
Broad money (end-year)	na	18.5	18.6	18.9	16.7	8.9	2.7	13.0	na
Domestic credit (end-year)	na	na	-6.4	-1.6	28.9	34.4	3.1	2.5	na
					(In per cent of GDP)				
Broad money (end-year)	64.3	64.8	64.4	65.4	68.8	66.2	62.1	64.6	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinancing rate	na	na	na	na	9.7	19.2	11.3	11.4	na
3-months BRIBOR	na	na	na	na	14.9	26.5	18.3	13.7	na
Deposit rate [2]	na	8.7	9.2	8.2	6.2	8.7	10.4	9.9	na
Lending rate [2]	na	14.1	14.4	14.8	13.2	16.2	16.2	13.5	na
					(Koruna per US dollar)				
Exchange rate (end-year)	28.9	33.2	31.3	29.6	31.9	34.8	36.9	42.3	na
Exchange rate (annual average)	28.3	30.8	32.0	29.7	30.7	33.6	35.2	41.4	na
External sector					*(In millions of US dollars)*				
Current account	na	-601	665	391	-2,098	-1,952	-2,059	-1,083	-680
Trade balance	-714	-932	59	-228	-2,293	-2,081	-2,293	-1,103	-700
Merchandise exports	6,515	5,447	6,691	8,579	8,831	9,639	10,667	10,197	11,000
Merchandise imports	7,229	6,379	6,633	8,807	11,124	11,720	12,959	11,301	11,700
Foreign direct investment, net	100	107	236	194	199	84	374	701	1,500
Gross reserves (end-year), excluding gold	na	395	1,605	3,306	3,403	3,204	2,867	3,366	na
External debt stock	2,829	3,380	4,660	5,678	7,670	9,896	11,902	10,474	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	0.6	2.3	3.7	3.1	2.8	2.3	3.1	na
					(In per cent of current account revenues, excluding transfers)				
Debt service due	na	8.4	8.6	9.1	10.6	12.4	11.2	16.5	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	5.3	5.3	5.3	5.4	5.4	5.4	5.4	5.4	na
GDP (in millions of koruna)	332,300	390,600	466,200	546,000	606,100	686,100	750,800	815,300	931,098
GDP per capita (in US dollars)	2,213	2,384	2,721	3,423	3,679	3,802	3,970	3,650	na
Share of industry in GDP (in per cent)	38.0	35.4	30.6	29.1	29.5	26.8	25.5	24.2	na
Share of agriculture in GDP (in per cent)	6.2	6.6	7.4	6.3	5.9	4.8	4.4	4.4	na
Current account/GDP (in per cent)	na	-4.7	4.6	2.1	-10.6	-9.6	-9.7	-5.5	-3.3
External debt – reserves (in US$ millions)	na	2,985	3,055	2,372	4,267	6,692	9,035	7,108	na
External debt/GDP (in per cent)	24.1	26.6	32.0	30.9	38.8	48.5	55.9	53.1	na
External debt/export of goods and services (in per cent)	na	45.7	52.1	51.8	70.4	83.8	91.8	85.9	na

1 General government includes the state, municipalities and extrabudgetary funds and excludes privatisation revenues.

2 Weighted average over all maturities. Lending rate excludes loans at zero interest rate since 1995.

Slovenia

Key reform challenges

- **While the majority of the "socially owned" enterprises have been privatised, the privatisation of remaining large enterprises should be completed with the focus on attracting strategic investors.**
- **Legislative framework for the liberalisation and privatisation of some infrastructure is taking shape; the government should maintain the momentum and liberalise the market as scheduled.**
- **To further enhance competition in the banking system, renewed efforts should be made to privatise the state-owned banks and to take an open approach to foreign strategic investors.**

Liberalisation

Trade in agricultural products with the EU were partially liberalised.
In May 2000, Slovenia and the EU reached agreement on partial liberalisation of trade in agricultural products. Under the agreement, which took effect in July, Slovenia can freely export a specified range of agricultural products to the EU, while the EU can export an agreed range of products to Slovenia. However, agreement was not reached on reciprocal zero-rate tariffs for sensitive products such as beef, pork, poultry, apples, cheese, powdered milk, butter and wine. A law on customs tariffs, which was adopted in July 2000 and will come into effect in January 2001, will harmonise most external tariffs with those in the EU.

Stabilisation

Pension reform helps to stabilise government expenditures.
The reform of the pay-as-you-go pension system in 2000 is expected to reduce fiscal expenditures during the next five to eight years by 0.4% of GDP annually. This measure will help to counter a trend towards higher spending on pensions and total government expenditure as a percentage of GDP is projected to decline from 44.7% of GDP in 1999 to 43.5% in 2000. The government has also implemented reforms in budget management practices to tighten control of spending. The fiscal outlook is for a balanced budget over the medium term; however, improvements in the targeting of social transfers would help to increase the flexibility of fiscal policy.

Real exchange rate remains stable following capital account liberalisation.
Contrary to expectations, the relaxation of capital controls in 1999 did not appear to have unlocked a large inflow of capital. However, a recent study by the IMF suggests that the differences in productivity growth rates between the tradables and non-tradables sectors have increased over time. This trend implies that in the run-up to EU accession, the real exchange rate will tend to appreciate either through the appreciation of nominal exchange rate or in the form of high rate of inflation.

Central bank set to gain more independence.
In July 2000, the government presented to the parliament a new law on the central bank. Under the new law, the governing board of the central bank would consist of nine members: the governor, four vice governors and four other members. These other members would be either full-time employees of the central bank or university professors working part-time for the bank. Moreover, the new law would prohibit the provision of any credits to the public sector, whereas the existing law allowed the central bank to provide short-term credit to the public sector. The central bank would also gain financial independence in that its financial plans and financial statements would no longer have to be approved by the parliament.

Privatisation

A number of large industries are still under state ownership.
While the majority of the "socially owned" enterprises (mostly SMEs) had been privatised by the end of 1998, the state still holds shares in around 180 mainly large companies (80 with a majority interest and 100 with a minority interest). These shares were transferred to the state-owned Slovene Development Corporation (SDC) with a mandate to liquidate or privatise the enterprises. The plan for 2000 involves the privatisation of 30 companies. For the mostly loss-making enterprises in the aluminium, steel and oil sectors, SDC is undertaking rehabilitation including the provision of subsidised loans. In the steel industry, the government adopted a restructuring programme in March that sets out a timetable for the restructuring and privatisation of four major steel companies. Under the plan, companies are envisaged to be fully privatised by the end of 2002.

Enterprise reform

Law on supervisory board representation of workers judged illegal.
Current company law requires substantial worker representation on the supervisory board (at least 50%) in companies with more than 1,000 employees. This requirement not only has constrained effective privatisation, post-privatisation corporate governance and restructuring, but has also deterred FDI. However, in June 2000, the constitutional court judged the requirement to be

Liberalisation, stabilisation, privatisation

1991
- Jun Independence from Yugoslavia
- Jun Central bank established
- Oct New currency (tolar) introduced
- Dec Law on restitution enacted

1992
- Nov Law on privatisation of socially owned enterprises adopted

1993
- Mar Foreign trade law enacted
- Jun Paris Club agreement
- Jun Law on privatisation of socially owned enterprises amended

1994
- Apr Wage guidelines introduced
- Jun Most prices liberalised
- Oct GATT membership
- Nov New law on privatisation adopted

1995
- Feb Capital account restrictions tightened
- Apr Interbank cartel on deposit rates established
- Jun EU Association Agreement signed
- Jun EFTA agreement
- Sep Full current account convertibility introduced

1996
- Jan CEFTA membership
- Jan London Club agreement
- Jul First sovereign Eurobond
- Jul Capital account restrictions tightened

1997
- Feb Capital account restrictions tightened
- Jun Minimum wage law adopted
- Jun Capital account restrictions eased

1998
- Jan Minimum wage law amended
- Apr Law on privatisation of state-owned enterprises adopted
- Apr Law on privatisation of socially owned enterprises amended
- Dec Excise tax law adopted
- Dec VAT law adopted

1999
- Feb Capital account restrictions eased
- Mar Foreign exchange law adopted
- Sep Capital account restrictions eased

Enterprises, infrastructure, finance and social reforms

1990
Apr Enterprise restructuring agency established

1991
Oct Bank restructuring agency established

1992
Sep Restructuring of socially owned enterprises begins

1993
Jan Bank rehabilitation begins
Apr Competition law adopted
Jun Company law enacted
Jul Electric power sector law adopted
Dec Railway law adopted

1994
Jan IAS introduced
Jan Bankruptcy law enacted
Jan Investment company law adopted
Mar Securities law enacted
Aug BIS capital adequacy adopted
Sep Insurance law adopted

1995
Jan Telecommunications and postal services separated
Sep Competition agency established

1996
Jan First privatised company listed on stock exchange
Dec First bank bankruptcy initiated

1997
Feb First GDR issue
May Telecommunications law adopted
Jul Bank rehabilitation concluded
Jul Takeover law enacted

1999
Feb New banking law effective
Apr Securities dematerialisation law adopted
Jul New securities law enacted
Sep Energy law adopted

2000
Jan Pension reform introduced
Jun Independent insurance regulator established

unconstitutional and the parliament must now act to amend this law. The scope for Slovenia to attract FDI, which has declined in recent years, would be significantly enhanced by the elimination of this investment obstacle.

Competition laws and their enforcement strengthened.
Several competition laws were adopted in Slovenia during the past year in an effort to harmonise existing legislation with EU competition rules. In the area of enforcement of competition rulings, the Prevention of Restriction of Competition Act entered into force in July 1999. Under the new law, the Competition Protection Office (CPO) is empowered to file directly with the court, bypassing the state prosecutor, to impose fines on companies that are found to be in violation of the competition rules. In 1999, the CPO handled 54 cases, of which abuse of dominant position was found in one case.

Infrastructure

Draft law on telecommunications is in line with EU directives.
The draft Telecommunications Act, which is in line with EU directives, was presented to the parliament in June 2000. This act would further liberalise access to the telecommunications network and the provision of services and define the licensing procedures and pricing rules. It would also provide for the establishment of an independent regulatory authority – the Telecommunications Agency. Adoption of this law is a pre-condition for Slovenia to become an EU member. The law is expected to be passed by the end of 2000. In July, the government appointed a privatisation adviser for the sale of its shares in the dominant fixed-line operator, Telekom Slovenije (ST). The government owns 67% of the company.

Power reform moves forward.
In September 1999, the Energy Act was adopted. The act provides for the opening of the markets for electricity and gas and the privatisation of the energy sector. The electricity market will be opened to large users by April 2001 and progressively to smaller customers. On the supply side, competition through imports will be allowed from January 2003. The government has also committed to privatise up to 45% of the shares in the generation and distribution companies. However, a final decision on the timing and method of their sale has not yet been reached. In May 2000, the government adopted additional supporting legislation that provides for the establishment of an independent electricity regulator. However, secondary legislation (for example, on network access prices) has not yet been developed. While electricity tariffs approach cost recovery levels, some cross-subsidisation from commercial to residential customers remains.

Financial institutions

Privatisation in the banking sector advances, but does not aim to attract strategic investors.
The government approved a privatisation plan in July 1999 for two large state banks, Nova Ljubianska Banka (NLB) and Nova Kreditna Bank Maribor (NKBM), which control around 40% of the banking system. Under the plan, an initial share in each of the two banks (10%) would be transferred to the state pension and restitution funds and a further 20% would be offered for sale to portfolio investors. The government transferred 10% of the shares in each of the banks to the state funds in April 2000. The programme does not envisage the participation of strategic investors at the initial stage of sell-off.

Independent insurance regulator has been established and the sector opened to foreign investors.
A new insurance law adopted in January 2000 and effective in March 2000 provided for the establishment of an independent insurance regulator, which was established in June 2000. Licensing and insolvency procedures remain with the Ministry of Finance. The new act also removed restrictions on FDI in the insurance sector and provided for the entry of subsidiaries of foreign insurance companies in Slovenia and for the reinsurance of risk exposures with foreign insurers. The insurance sector is characterised by a number of small companies, including three foreign entrants, and one large insurance company with significant state ownership.

Social reform

Pension and disability insurance reforms are implemented.
After several years of discussion, the parliament passed the Pension and Disability Insurance Act in December 1999, which significantly reformed the pension system. The new system, which became effective in January 2000, consists of a reformed pay-as-you-go (PAYG) principal pillar and a supplementary fully funded pillar, which is voluntary but may become part of wage contracts. The voluntary pensions can be provided by banks and insurance companies provided they obtain the necessary licence. The new law also increased the minimum age for women, bringing it into line with that for men, and provided for the gradual reduction in the amount of full pension relative to the wage rate.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenues in GDP – **41%**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**

Enterprises
Competition office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **8%**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **1%**
Private pension funds – **planned**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	23.7	19.8	18.4	22.5	22.4	20.4	17.0	14.3
Number of goods with administered prices in EBRD-15 basket	5.0	5.0	6.0	5.0	5.0	5.0	4.0	2.0	2.0
Share of total trade with non-transition countries (in per cent)	na	na	74.6	75.2	76.0	73.9	73.3	74.1	na
Share of trade in GDP (in per cent)	63.1	100.4	97.2	97.3	94.2	92.9	96.6	96.9	92.4
Tariff revenues (in per cent of imports)	11.0	6.7	7.3	7.0	7.1	6.2	4.0	2.9	2.6
EBRD Index of price liberalisation	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3
EBRD Index of forex and trade liberalisation	3.0	3.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	0.0	0.0	0.0	0.4	0.9	1.4	2.2	2.5
Private sector share in GDP (in per cent)	15.0	20.0	25.0	30.0	45.0	45.0	50.0	50.0	55.0
EBRD index of small-scale privatisation	3.0	3.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	1.0	1.0	2.0	2.0	2.7	2.7	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	2.8	2.9	2.6	2.0	1.9	1.4	1.4	1.5	1.7
Effective/statutory social security tax rate (in per cent)	na	69.5	75.8	71.2	71.8	73.0	77.6	na	na
Share of industry in total employment (in per cent)	na	na	44.1	42.2	43.2	42.1	40.5	39.5	na
Change in labour productivity in industry (in per cent)	na	na	na	-10.5	-3.9	4.0	2.7	5.4	5.7
Investment rate (in per cent of GDP)	20.6	18.4	18.8	19.8	21.4	22.6	23.5	24.6	26.9
EBRD index of enterprise reform	1.0	1.0	2.0	2.7	2.7	2.7	2.7	2.7	2.7
EBRD Index of competition policy	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	22.9	24.8	25.9	28.7	30.9	33.3	36.4	38.0	38.0
Railway labour productivity (1989=100)	92.1	79.0	76.2	94.2	119.2	103.4	na	na	na
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	6.7 (92)	7.3 (95)	7.4 (95)	9.3 (97)	9.7 (99)	8.7 (99)
Electricity consumption/GDP (1989=100)	105.0	104.4	101.5	101.9	99.4	96.7	96.1	94.9	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.6	2.6
Financial institutions									
Number of banks (of which foreign owned)	40 (1)	45 (2)	45 (5)	44 (6)	41 (6)	36 (4)	34 (4)	30 (3)	31(5)
Asset share of state-owned banks (in per cent)	na	0.3	47.8	39.8	41.7	40.7	40.1	41.3	41.7
Bad loans (in per cent of total loans)	na	na	na	22.0	13.2	14.3	12.5	11.4	10.2
Domestic credit to enterprises (in per cent of GDP)	34.9	23.3	22.1	23.1	27.5	28.8	28.6	32.8	35.9
Stock market capitalisation (in per cent of GDP)	na	na	na	4.1	1.8	3.6	9.3	12.2	11.9
EBRD index of banking sector reform	1.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3
EBRD index of reform of non-banking financial institutions	2.0	2.0	2.0	2.7	2.7	2.7	2.7	2.7	2.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	3.0	3.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	4.0	3.0	4.0
Social sector									
Expenditures on health and education (in per cent of GDP)	10.3	13.5	13.0	11.8	12.1	na	na	na	na
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	173.0	169.0	na
Basic school enrolment ratio (in per cent)	96.8	97.6	97.8	96.7	97.3	99.8	99.8	98.2	na
Earnings inequality (GINI-coefficient)	27.3	26.0	27.6	27.5	35.8	29.8	30.7	na	na

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	-5.5	2.8	5.3	4.1	3.5	4.6	3.8	4.9	5.1
Private consumption	-3.6	13.9	4.0	9.1	2.4	3.3	2.9	5.3	na
Public consumption	-1.7	5.3	2.1	2.5	3.6	4.3	5.9	5.7	na
Gross fixed investment	-12.9	10.7	14.1	16.8	9.2	11.3	11.1	16.1	na
Exports of goods and services	9.3	1.9	9.4	6.9	3.3	11.3	7.2	1.8	na
Imports of goods and services	3.9	13.0	6.0	15.1	2.4	12.2	10.4	7.3	na
Industrial gross output	-13.2	-2.8	6.4	2.0	1.0	1.0	3.7	-0.5	na
Agricultural gross output [1]	-6.7	-4.2	4.2	1.6	1.1	-2.9	3.1	2.3	na
Employment [2]					*(Percentage change)*				
Labour force (end-year)	-1.6	0.1	0.5	1.7	-0.6	2.1	1.8	2.2	na
Employment (end-year)	-5.1	-2.3	0.7	3.6	-0.5	2.3	1.0	-1.7	na
					(In per cent of labour force)				
Unemployment (end-year)	8.3	9.1	9.1	7.4	7.3	7.1	7.6	7.4	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	207.3	32.9	21.0	13.5	9.9	8.4	8.0	6.1	8.6
Consumer prices (end-year)	na	22.8	19.5	9.0	9.0	8.8	6.5	8.0	7.8
Producer prices (annual average)	215.7	21.6	17.7	12.8	6.8	6.1	6.0	2.1	na
Producer prices (end-year)	76.2	18.6	18.2	7.9	5.8	6.8	3.6	3.5	na
Gross average monthly earnings in economy (annual average)	203.4	47.8	25.4	18.4	15.3	11.7	9.6	9.6	na
Government sector [3]					*(In per cent of GDP)*				
General government balance	0.3	0.6	-0.2	-0.3	-0.2	-1.7	-1.4	-0.9	-1.0
General government expenditure	43.0	44.1	43.6	43.4	42.9	43.8	44.4	44.7	na
General government debt	45.6	21.1	18.5	18.8	22.7	23.2	23.7	24.6	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	128.9	63.2	43.3	28.1	20.5	24.3	19.8	13.2	na
Domestic credit (end-year)	90.1	101.4	27.2	35.1	13.2	14.2	22.4	19.3	na
					(In per cent of GDP)				
Broad money (M3, end-year)	30.9	35.7	39.7	42.4	44.4	48.5	51.9	52.6	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Discount rate	25.0	18.0	16.0	10.0	10.0	10.0	10.0	8.0	na
Interbank market rate (average)	60.5	34.7	24.7	15.9	10.2	9.8	5.6	6.9	na
Deposit rate (31-90 days)	48.3	30.2	27.9	20.8	11.2	13.9	7.0	9.6	na
Lending rate (short-term working capital)	72.2	42.6	38.5	28.0	18.3	20.3	12.3	15.2	na
					(Tolars per US dollar)				
Exchange rate (end-year)	98.7	131.8	126.5	126.0	141.5	169.2	161.2	196.8	na
Exchange rate (annual average)	81.3	113.2	128.8	118.5	135.4	159.7	166.1	181.8	na
External sector					*(In millions of US dollars)*				
Current account	926	192	574	-100	31	12	-147	-783	-491
Trade balance	791	-154	-336	-953	-825	-766	-789	-1,245	-962
Merchandise exports	6,683	6,083	6,832	8,350	8,353	8,408	9,091	8,623	9,054
Merchandise imports	5,892	6,237	7,168	9,303	9,178	9,184	9,880	9,868	10,016
Foreign direct investment, net	113	111	131	183	188	340	250	144	50
Gross reserves (end-year), excluding gold [4]	716	770	1,480	1,802	2,279	3,297	3,573	3,059	na
External debt stock	1,741	1,873	2,258	2,970	4,010	4,176	4,959	5,491	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold [4]	1.2	1.3	2.1	2.0	2.6	3.7	3.8	3.2	na
					(In per cent of exports of goods and services)				
Debt service	4.9	5.0	4.9	6.8	8.8	8.8	13.5	8.0	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in billions of tolars)	1,018.0	1,435.1	1,853.0	2,221.5	2,555.4	2,907.3	3,253.8	3,637.4	4,140.5
GDP per capita (in US dollars)	6,280	6,370	7,231	9,418	9,439	9,103	9,793	10,020	na
Share of industry in GDP (in per cent)	32.1	29.3	30.3	28.3	27.9	28.2	28.1	27.5	na
Share of agriculture in GDP (in per cent)	5.2	4.5	4.0	3.9	3.9	3.7	3.6	3.2	na
Current account/GDP (in per cent)	7.4	1.5	4.0	-0.5	0.2	0.1	-0.8	-3.9	-2.6
External debt – reserves (in US$ millions)	1,026	1,103	778	1,168	1,731	879	1,386	2,432	na
External debt/GDP (in per cent)	13.9	14.8	15.7	15.8	21.2	22.9	25.3	27.4	na
External debt/exports of goods and services (in per cent)	22.0	25.1	26.1	28.6	38.2	39.9	44.6	52.2	na

1 Agricultural value added.

2 Based on labour force surveys consistent with ILO definitions conducted during the second quarter of the year.

3 Government balance excludes privatisation revenues. Government expenditure includes net lending.

4 Foreign exchange reserves of the Bank of Slovenia (central bank).

Tajikistan

Key reform challenges

- **With significant successes in liberalisation and macroeconomic stabilisation, economic reform challenges now relate to the improvement of governance, for example in commercial cotton financing, or the implementation of land reform.**
- **Further political consolidation will in part depend on creating job opportunities in the private sector, highlighting the need to reduce the barriers to entry by cutting bureaucracy and improving the protection of property rights.**
- **Despite recent progress in privatisation, the government's role in large domestic enterprises needs to be reduced to lay the basis for improved corporate governance and restructuring.**

Liberalisation

Tajikistan boasts the most liberal trade regime in the Customs Union.
Tajikistan scores the lowest level on the IMF's index of trade restrictiveness among the five members of the Customs Union (including also Belarus, Kazakhstan, Kyrgyzstan and Russia) on account of the lack of non-tariff barriers. Tariff dispersion is low and the average unweighted rate is 8%. Yet, given geographical remoteness, security concerns, low purchasing power and inadequate transport infrastructure, Tajikistan's market remains relatively unpenetrated. Most imports are from the CIS, with consumer items coming mainly from Russia. Tajikistan started its application for WTO membership in 1999. In July 2000, the central bank established an inter-bank foreign exchange market, replacing earlier foreign exchange auctions, which should over time improve access to foreign currency.

Stabilisation

While significant vulnerabilities to external imbalances remain …
Aluminium, cotton and mineral exports account for over 80% of export revenues. The country has benefited from the recent revival in world prices for its main exports, but this has been partially offset by the lower 1999 cotton harvest and higher wheat imports during 2000 following a drought. The limited availability of commercial financing makes the country reliant on official financing – and correspondingly vulnerable to policy slippages under the ambitious IMF stabilisation programme.

… efforts to improve revenues and the fiscal balance are bearing results.
Despite the Russian crisis, the government almost achieved its revenue targets in 1999, closing the year with revenues at 13.1% of GDP – up 1.1% from 1998. The introduction of the new tax code in January 1999, a VAT reform in July 1999, and several other tax adjustments have underpinned improved revenue collection and shifted the tax base somewhat from sales taxes on cotton and aluminium to consumption-based taxation.

On the expenditure side, the treasury system was strengthened during 1999 and the 2000 budget was prepared in accordance with international standards. Given the weight of social expenditures in the total, flexibility in spending remains limited, with the bulk of adjustment to meet IMF targets during the second half of 1999 falling on capital expenditures. The government is preparing a Public Investment Programme to further rationalise its external borrowing. The IMF has calculated the net present value of public external debt (most of it owed to Russia and Uzbekistan) at over 400% of current budgetary revenues – making further debt restructuring in the future almost inevitable.

Privatisation

Swift progress has been made in privatisation.
From the total of 9,500 state enterprises registered before privatisation, 6,150 have been either sold or incorporated as joint-stock companies. Small-scale privatisation is virtually completed with over 90% of all eligible entities auctioned off by mid-2000, predominantly to individual workers or employee collectives. Medium- and large-scale privatisation has been slower, partially as a result of unrealistic price expectations, with only 214 of 733 incorporated units sold. In April 2000 the government successfully sold 15 cotton ginneries through auction and, according to the Ministry of Finance, collected TR 14.6 billion (US$ 9 million) in revenues. The remaining four ginneries still under state control were successfully auctioned in August 2000. Under a World Bank programme, the government is committed to preparing a plan for the restructuring and privatisation of TADAZ, the large aluminium smelter, employing around 12,000 workers. The smelter benefits currently from large implicit energy subsidies, and the net social value of keeping it in operation remains debatable.

Liberalisation, stabilisation, privatisation

1991
- Oct Small-scale privatisation begins
- Dec Central bank law adopted

1992
- Jan Most prices liberalised
- Jan VAT introduced
- Jul Start of civil war

1993
- Jan Price liberalisation partially reversed
- Dec Wage indexation introduced

1994
- Sep Interim cease-fire arranged

1995
- May New currency (Tajik rouble) introduced
- May Exchange rate unified
- May State trading monopoly abolished
- Jun Most consumer prices liberalised
- Aug Licenses for agricultural trade eliminated
- Dec Interest rates fully liberalised

1996
- Feb Export surrender requirement abolished
- Mar Price controls on grain and bread lifted
- May Large-scale privatisation programme launched
- May IMF programme adopted
- Dec Land privatisation started

1997
- May Privatisation law revised
- Jun Peace agreement concluded
- Sep Treasury system reformed

1998
- Apr Customs union membership
- Jul Free tradability of land rights
- Nov Regular credit auctions introduced

1999
- Jan New tax code effective
- Jan State cotton trading company liquidated

2000
- Apr Most state-owned cotton ginneries sold by auction
- Jul Interbank forex market introduced

Land reform has also advanced, although not always to the benefit of individual farmers.
Around 45% of all agricultural land is estimated to be privately farmed. Moreover, the dissolution of the state cotton trading monopoly Glavkhlopokoprom in January 1999 has opened the market to private financiers and input suppliers – notably two large foreign cotton-trading concerns. The process

Enterprises, infrastructure, finance and social reforms

1991
Feb Banking legislation adopted
Dec Joint-stock companies law adopted

1992
Mar Bankruptcy law enacted

1993
Dec Competition law adopted

1994
Jun Law on mortgages enacted

1995
Aug Banking regulations adopted

1996
Jul Electricity tariffs reduced below average cost

1997
Dec Law on natural monopoly adopted

1998
Apr Banking regulations amended
May New banking law adopted

1999
Apr Major bank liquidated
Jul Financial audit of state banks completed
Sep Road link to China completed
Oct Decree prohibiting National Bank from direct lending issued

2000
Jan Prudential regulations on banks tightened
Feb Directed credits by NBT renewed

of reorganising previously state-owned and collective farms has not always proceeded smoothly, however, as farmers have remained highly dependent on the old *kolchoz* and *sovchoz* management for access to key inputs and use of former collective assets, such as tractors.

Enterprise reform

Financial discipline has been tightened, but pressures persist for directed lending.
A presidential decree issued in October 1999 prohibits the National Bank of Tajikistan (NBT) from extending any credits directly to borrowers, including the state budget. Nonetheless, given the virtual absence of a working banking system and shortfalls in expected foreign financing, in early 2000 the NBT once more extended significant directed credits to the cotton sector and state-owned enterprises. This led to the disruption of the IMF programme, but no further directed credits have been recorded since.

Past experience with cotton financing highlights need for improved governance.
During 1997 and 1998, Tajikistan raised a total of US$ 130 million in financing for the cotton sector. The credits benefited from a sovereign guarantee and were extended during a period of high cotton prices and rising production. With rapidly falling cotton prices from the end of 1997, the bulk of these credits could not be honoured. Significant collection efforts have brought the outstanding debt down to US$ 24 million from US$ 84 million in mid-1998, while improved self-financing arrangements have reduced the need for NBT financing despite foreign shortfalls. Indeed, with total cotton exports reaching only US$ 130 million a year, it is questionable whether large up-front financing is truly needed and doubts have surfaced over the use of these funds.

Infrastructure

Power sector reforms are to be tackled with IFI assistance.
Tajikistan has huge hydro-energy potential. However, power generation has fallen sharply with the output collapse during transition and, with the exception of power exports to Uzbekistan, power is sold domestically at tariffs well below production costs. Current industrial tariffs stand at 1.35 US cents per kWh and 0.34 US cents for households. The Asian Development Bank estimates the cost recovery level to be around 2.1 US cents and has made tariff increases a condition for a planned US$ 20 million loan to the sector (part of a US$ 40 million investment programme with other co-financiers). With collection rates in industry at 20%, considerable institutional strengthening will be needed to make further tariff increases viable. A new energy law is being drafted.

Transport and telecommunications face huge investment needs.
Infrastructure has been battered by the civil war and years of neglect. The country's topology cuts it into several almost completely isolated regions. Only one main road links the industrial centre in the north to the capital Dushanbe, and this crosses two high mountain passes. Recently a road link with China was completed, giving Tajikistan access to the Karakoum Highway. In the telecommunications sector, the EBRD plans modernisation investments in the order of US$ 15-20 million. International and fixed domestic connections are extremely limited and the tariff structure unbalanced in favour of local calls and household users. Mobile phones exist in Dushanbe and Khojand, operated by a state-foreign joint venture, whose monopoly position is reflected in excessively high rates (international calls are US$ 8 per minute, national calls US$ 4 per minute).

Financial institutions

The financial system remains very much in its infancy …
With domestic credit equal to only 5% of GDP and the combined capital of the banking system amounting to less than US$ 10 million, Tajikistan has only a very rudimentary financial system. Individual deposits in the banking system are almost non-existent and the largest share of liabilities is refinancing credits from the NBT. While the legislative basis for a primary treasury bills market has been laid, since September 1998 only a total of TR 1.1 billion has been sold. Banks have been reluctant to hold government paper given the precarious fiscal situation. As of early 2000, interest rates on domestic credits of one to three months maturity (longer maturities were hardly available) were 38% in national currency and 15% in US dollars, reflecting considerable expected currency depreciation.

… but banking reforms have made some progress.
With IMF and World Bank assistance, the NBT has considerably tightened prudential regulations during the past year. Minimal capital requirements for existing banks were raised to US$ 1 million as of January 2000, to US$ 1.5 million in 2001, and will rise stepwise to US$ 3 million by 2004. Five of the country's largest banks underwent an international audit in 1999 and IAS standards were introduced for the system in early 1999. According to the audit results only two of the 18 banks met capital requirements as of mid-2000. Risk-weighted capital adequacy ratios were increased twice, from 7% to 9% in July 1999 and again to 12% in January 2000. The NBT has strengthened its supervisory department and closed one of the country's largest banks, Tajikbankbusiness, in 1999. NBT expects all banks to present business plans by mid-2000, although given the fragile situation of the banking system it is not clear whether more bank closures are to follow.

Social reform

Tajikistan remains the poorest country in the region.
With an average per capita income of US$ 176 in 1999, Tajikistan was by far the poorest country in the region. According to a household survey conducted in 1999, around 60% of the population earned less than TR 10,000 (US$ 7) per month and only 5% earned more than TR 30,000. While expenditure data suggest that income may be under-reported, tackling widespread poverty must be a target for the government if it is to achieve political consolidation. With over 50% of the population dependent on agriculture, this will above all require further progress in agricultural reforms.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenues in GDP – **13.3%**
Exchange rate regime – **managed floating**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de facto**

Enterprises
Competition office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **12%**
Deposit insurance system – **no**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **85%**
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	15.0	4.0	2.0	2.0	1.0	1.0	1.0	1.0	1.0
Share of total trade with non-transition countries (in per cent)	na	na	na	75.6	58.9	52.7	28.2	27.6	23.6
Share of trade in GDP (in per cent)	na	na	157.7	153.6	241.9	150.4	138.7	100.6	122.6
Tariff revenues (in per cent of imports)	na	na	0.9	4.0	1.2	0.6	2.6	6.1	2.1
EBRD Index of price liberalisation	1.0	2.0	1.7	1.7	2.7	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.7	2.7
Privatisation									
Share of small firms privatised (in per cent) [1]	0.4	10.5	11.4	15.8	20.9	29.9	39.7	56.9	75.3
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.7	0.9	1.1	1.5	1.6	2.1	2.8	4.0
Private sector share in GDP (in per cent)	10.0	10.0	10.0	15.0	15.0	20.0	20.0	30.0	30.0
EBRD index of small-scale privatisation	1.0	2.0	2.0	2.0	2.0	2.0	2.3	3.0	3.0
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.3
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	10.9	8.0	12.3	6.4	0.7	1.1	0.6	0.4
Effective/statutory social security tax rate (in per cent)	na	40.0	48.6	78.4	na	na	21.4	na	na
Share of industry in total employment (in per cent)	13.0	10.9	11.8	9.3	9.9	10.5	8.5	8.3	na
Change in labour productivity in industry (in per cent)	-1.7	-22.5	8.2	-22.5	-3.2	-23.1	16.6	10.4	na
Investment rate (in per cent of GDP)	na	na	23.1	22.3	14.7	na	na	na	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.7	1.7
EBRD Index of competition policy	1.0	1.0	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure									
Main telephone lines per 100 inhabitants	4.7	4.8	4.6	4.5	4.5	4.2	3.8	3.7	3.7
Railway labour productivity (1989=100)	na	na	na	100.0	121.7	87.3	70.8	100.9	85.9
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	na	na	na	na	na	na
Electricity consumption/GDP (1989=100)	100.7	134.6	132.1	162.3	178.9	183.7	161.9	160.4	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	1.1	1.1
Financial institutions									
Number of banks (of which foreign owned)	1.0 (na)	10.0 (na)	15.0 (na)	17.0 (na)	18.0 (na)	23.0 (na)	28.0 (5.0)	20.0 (5.0)	20.0 (3.0)
Asset share of state-owned banks (in per cent)	na	na	na	na	na	5.3	30.3	29.2	6.9
Bad loans (in per cent of total loans)	na	na	na	na	na	2.9	3.0	3.2	15.8
Domestic credit to enterprises (in per cent of GDP) [2]	na	na	na	na	na	4.0	4.8	7.7	10.0
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	2.0	na
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	3.0	na
Social sector									
Expenditures on health and education (in per cent of GDP)	17.4	11.7	8.5	14.5	3.6	3.5	3.4	3.3	3.1
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	234.0	233.0	na
Basic school enrolment ratio (in per cent)	96.7	92.5	87.1	87.0	86.6	85.1	84.9	87.8	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Data from State Property Committee. According to the IMF, out of 6,000 firms eligible, around 5,500 were privatised by mid-2000.

2 Data from IMF. Excludes special cotton financing from NBT.

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					(Percentage change in real terms)				
GDP	-29.0	-11.0	-18.9	-12.5	-4.4	1.7	5.3	3.7	5.0
Industrial gross output	-24.3	-7.8	-25.4	-13.5	-24.0	-2.1	8.2	5.0	na
Agricultural gross output	-34.8	-7.1	-6.5	-25.9	2.0	3.6	6.3	3.8	na
Employment					(Percentage change)				
Labour force (annual average)	5.9	-2.5	0.6	7.2	1.0	2.4	4.4	na	na
Employment (annual average)	-3.2	-3.3	-0.1	0.5	-6.6	3.4	0.3	na	na
					(In per cent of labour force)				
Unemployment (annual average) [1]	0.3	0.8	1.2	1.3	1.6	1.8	1.8	1.8	na
Prices and wages					(Percentage change)				
Consumer prices (annual average)	1,157	2,195	350.0	609	418.0	87.8	43.6	27.5	24.2
Consumer prices (end-year)	1,364	7,344	1.1	2,133	40.5	163.6	2.7	30.1	28.6
Producer prices (annual average)	1,320	1,080	327.8	1,080	449.0	95.7	27.8	na	na
Producer prices (end-year)	5,926	5,996	301.9	628	77.7	121.7	8.6	na	na
Gross average monthly earnings in economy (annual average)	461.5	746.3	116.1	109.4	283.7	77.4	72.7	30.6	na
Government sector [2]					(In per cent of GDP)				
General government balance	-30.5	-20.9	-5.2	-5.3	-5.8	-3.3	-3.8	-3.1	-1.4
General government expenditure	65.7	54.2	59.0	27.0	19.0	17.0	15.8	16.3	na
Monetary sector					(Percentage change)				
Broad money (M3, end-year)	na	na	na	na	93.2	110.7	30.7	31.3	na
Domestic credit (end-year)	na	na	na	na	94.0	201.8	189.7	46.4	na
					(In per cent of GDP)				
Broad money (M3, end-year)	na	na	na	19.1	8.3	8.6	6.9	7.2	na
Interest and exchange rates					(In per cent per annum, end-year)				
Interbank interest rate (up to 30-day maturity) [3]	na	na	na	152.5	72.0	81.0	36.4	20.1	na
Deposit rate (up to 3 months maturity) [4]	30.0	30.0	30.0	100.0	85.0	89.0	15.7	17.2	na
Lending rate (up to 3 months maturity) [4]	30.0	30.0	30.0	500.0	124.0	74.0	49.7	37.6	na
					(Tajik roubles per US dollar)				
Exchange rate (end-year) [5]	5.1	12	36	285	328	748	977	1,436	na
Exchange rate (annual average) [5]	2.3	10	22	135	298	564	788	1,252	na
External sector					(In millions of US dollars)				
Current account	na	-200	-164	-86	-76	-68	-121	-36	-44
Trade balance	na	-177	-122	-57	-20	-71	-154	-59	-30
Merchandise exports	na	459	561	780	768	742	581	638	750
Merchandise imports	na	636	683	837	788	813	736	697	780
Foreign direct investment, net	na	9	12	20	25	30	24	21	30
Gross reserves (end-year), excluding gold	na	2	1	4	14	30	66	59	na
External debt stock	na	509	760	817	867	1,104	1,178	1,033	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	0.0	0.0	0.1	0.2	0.4	1.0	0.9	na
					(In per cent of exports of goods and services)				
Debt service due [6]	na	5.8	9.9	29.4	31.8	10.3	14.5	20.1	na
Memorandum items					(Denominations as indicated)				
Population (end-year, millions)	5.6	5.7	5.8	5.9	5.9	6.0	6.1	6.1	na
GDP (in millions of Tajik roubles from 1995)	648	7,071	17,865	69,797	308,470	631,984	1,025,211	1,345,000	1,718,398
GDP per capita (in US dollars)	51.5	121.8	140.7	88.2	174.1	185.4	213.3	176.0	na
Share of industry in GDP (in per cent) [7]	36.4	32.8	22.1	34.0	25.7	19.7	18.1	22.5	na
Share of agriculture in GDP (in per cent) [7]	27.1	21.0	19.1	36.2	36.0	27.1	19.8	6.6	na
Current account/GDP (in per cent)	na	-28.9	-20.2	-12.8	-7.4	-6.1	-9.2	-3.3	-4.6
External debt – reserves (in US$ millions)	na	507.0	759.0	813.0	853.0	1,074.0	1,112.7	974.9	na
External debt/GDP (in per cent)	na	73.3	93.8	158.0	83.8	98.5	90.0	94.9	na
External debt/exports of goods and services (in per cent)	na	110.7	135.2	100.9	108.8	138.2	184.2	148.5	na

1 Officially registered unemployed. The World Bank estimates the true unemployment rate in 1998 at about 30% of the labour force.

2 Excludes transfers from the state budget to the Pension Fund and Employment Funds.

3 Rate is determined at the credit auctions held by the National Bank of Tajikistan.

4 Interest rates were set by the parliament until June 1995. Thereafter rates refer to 1-3 month maturity.

5 Until 1994, 100 Russian roubles per US dollar, afterwards Tajikistan roubles.

6 In per cent of exports of goods and services less alumina imports and electricity exports.

7 Figures are based on current prices. Variations in the shares thus reflect *inter alia* changes in relative prices.

Turkmenistan

Key reform challenges

- **With little progress in transition, the priority is to abandon Soviet-style investment plans in favour of a market-driven approach that will create sustainable jobs for a rapidly growing population.**
- **The dual exchange rate mechanism is the single biggest and most costly distortion in the economy; the recent rise in foreign exchange revenues from gas exports should provide scope for rapid exchange rate unification.**
- **Meeting increasingly ambitious volume targets in agriculture has come at the cost of falling quality and complete disregard for sustainable soil and water management.**

Liberalisation

Net transfers out of agriculture reach 15% of GDP …
As a result of below world-market procurement prices for wheat and cotton and the distortions in the foreign exchange market, the agricultural sector in Turkmenistan is very heavily taxed. With bumper harvests in both crops in 1999, the size of these taxes relative to GDP has grown considerably. Net transfers due to official exchange rate overvaluation (relative to an estimated market equilibrium rate of some TMN 9,000/US$ 1) amounted to 13% of GDP alone. The beneficiaries are consumers of locally produced bread and, most importantly, those importers having access to foreign exchange at the favourable official rate (TMN 5,200/US$ 1).

… causing severe misallocation of scarce fertile soils and water.
Given large effective taxation, the government's push for further production increases in wheat and cotton has been based on very limited freedom for farmers to choose what to produce. According to recent estimates, shifting only 25% of agricultural land from cotton and wheat to high-value cash crops such as sun-dried tomatoes and raisins would earn Turkmenistan an additional US$ 1 billion per year. This does not include water savings from lower irrigation needs of fruit and vegetable relative to wheat in particular.

Stabilisation

Inconsistent policies raise doubts over apparent price stability.
According to official statistics, 12-month inflation in July 2000 was only 4.7%. This apparent price stability is partially supported by evidence for an only modest (18%) decline in the curb market exchange rate to TMN 18,000/US$ 1 from 15,200 in December 1999. However, other statistics raise serious doubts as to the accuracy of official price data. Following the doubling of wages in December 1999 and extra-bonus payments for Mother's Day in April 2000, nominal earnings rose by half during January to June. Moreover, directed credits of TMN 900 billion (US$ 100 million) in June swelled domestic money supply by 74% during the first half. It is arguably only a matter of time before such "generosity" spills over into inflation.

Foreign exchange shortages ease with renewed gas exports.
With gas exports to Russia agreed at 20 billion cubic metres in 2000, export revenues are poised to strengthen further after doubling in 1999. This will ease pressure on the balance of payments, as will the good cotton and wheat harvests in 1999. Gas exports have increased resources available to the Central Bank of Turkmenistan (CBT) for sterilisation operations and sales at the foreign exchange auctions have increased from around US$ 6 million per month during late 1999 to US$ 15 million since February 2000. However, debt servicing costs of some US$ 300 million in 2000 and around US$ 700 million in 2001 will continue to place pressure on the balance of payments and may constrain the government's willingness to contemplate early moves towards exchange rate unification.

Privatisation

Small-scale privatisation remains half-finished …
Since 1997, when the first wave of small-scale privatisation came to an end, Turkmenistan has managed to sell only some 200 companies from over 2,000 of the original list of 4,300 privatisable objects still remaining in state hands. It is thus one of the few countries in the region in which small-scale privatisation has not been completed.

… while conflicting objectives hold back privatisation of medium-sized enterprises.
The government has made several attempts in recent years to accelerate the process of medium-scale privatisation. From the total list of 280 companies, a pilot list of 18 enterprises was drawn up in 1999. By mid-2000, however, privatisation was completed for only six of these companies. In most cases, shares were distributed among the workforce, the management and key suppliers to the plant (particularly in food processing). The government's concern seems to have been to minimise potential disruptions that might result from the reorientation of production post-privatisation, by building vertically integrated ownership structures along traditional ministerial lines. Conflicts over the distribution of shares among interested parties have delayed the process in many other cases. In June 2000, the government announced an upcoming tender for 32 medium-sized companies, with starting values at around US$ 200,000-1,000,000.

Liberalisation, stabilisation, privatisation

1991
Oct Independence from Soviet Union

1993
Oct Gas exports to Europe interrupted
Oct VAT introduced
Nov New currency (manat) introduced
Nov Foreign exchange law adopted

1994
May Small-scale privatisation begins
Aug State trading monopoly reinforced
Sep National privatisation programme adopted

1995
Jan State treasury system introduced
Jul Flat rate income tax introduced

1996
Jan Legal unification of exchange rate
Jan Most prices liberalised
May Barter trade in cotton, oil, wool banned
Aug First treasury bills issued
Dec Land reform decreed

1997
Mar Gas deliveries halted to non-paying CIS customers
Apr Large-scale privatisation law adopted

1998
Apr Exchange rate unified
Sep Large forex premium on parallel market re-emerges

1999
Jan Gas exports to Ukraine resumed
Apr Gas exports to Ukraine again interrupted
Dec Gas export agreement with Gazprom concluded
Dec Niyazov made president for life
Dec Soviet-style ten-year plan adopted
Dec Public sector wages doubled

Enterprises, infrastructure, finance and social reforms

1992
Jun Bankruptcy law adopted

1993
Oct Company legislation enacted
Nov Two-tiered banking system established

1995
Dec Inter-bank market established

1996
Apr BIS capital adequacy enacted

1997
Mar Hydrocarbon resources law enacted
Dec Gas pipeline to Iran opened

1998
Dec Directed credits officially abolished
Dec Merger of private and state bank decreed by government
Dec New civil code adopted

1999
Mar Gas sale agreement signed with Turkey
Jul Construction agreement for Trans-Caspian gas pipeline signed
Dec President Bank created

2000
Jun Trans-Caspian pipeline consortium (PSG) reduces presence in Turkmenistan
Jun Directed credits renewed
Jun Citizens banned from holding foreign bank accounts

Enterprise reform

Only very limited use of market mechanisms in the allocation of scarce resources.
Off-budgetary investment funds, the President's control over most foreign currency reserves, the creation of a new President Bank and numerous tax concessions make for a highly discretionary business environment in Turkmenistan. Projects that receive presidential backing are rarely submitted to a market test, with all ensuing problems of endemic soft budget constraints. Moreover, financial discipline remains very limited. The Ministry of Finance was successful in reducing the share of offsets and other netting operations to 37% of all revenues in 1999 from 57% in 1998. However, despite much-improved liquidity in the enterprise sector (combined losses of the enterprise sector fell from TMN 420 billion in 1998 to TMN 94 billion during the first half of 2000) and better revenue collection overall, arrears to the budget still increased by 17% over the first six months of 2000, and arrears to suppliers by 25%.

New PSA legislation remains to be tested.
The introduction of international accounting standards in the energy sector and the adoption of PSA legislation provide a good legal base for foreign investment in the oil and gas sector. After a failed tender process in 1998, Turkmenistan is now conducting direct negotiations over a total of 16 off-shore blocks in its sector of the Caspian. However, the judicial reliability of PSA contracts remains untested – as opposed, for example, to Azerbaijan where they have the force of law – and the operation of foreign companies is often made difficult by a plethora of legal inconsistencies. Against this background, Turkmenistan has yet to attract a significant oil major to the country.

Infrastructure

Government support for large investment projects continues unabated.
President Niyazov has earned a reputation in the region for his prestige construction projects, mostly in the form of public buildings in the capital Ashgabad. Among recent examples in infrastructure is the plan – revived from Soviet times – to build a US$ 4.5 billion water reservoir in the Karashor depression of the Northern Karakum desert. The reservoir would collect the runoff from the country's drainage system, presumably for re-use in irrigation. In June 2000, the first US$ 38 million was approved from budgetary resources for this project. Another existing Soviet project, the Karakum canal linking the Amur Dariya river to the Caspian Sea and providing irrigation for much of Turkmenistan's cash crop agriculture, is badly in need of repair. Experts estimate the costs at several billion US dollars, possibly exceeding the value of agricultural produce harvested from irrigated marginal lands.

State of the Trans-Caspian pipeline remains unclear.
The agreement in December 1999 to renew gas exports to Russia, followed by an agreement in principle to increase such exports from currently 20 billion cubic metres per annum to some 50-60 billion by 2004, has dealt a blow to plans to export Turkmen gas under the Caspian to Turkey. These were earlier called into question by the discovery of large gas reserves in Azerbaijan. Nonetheless, Turkmenistan is likely to attempt to keep all options open, not least to help in negotiations with Gazprom. In July 2000, Turkmenistan also announced a new agreement over gas exports to Ukraine, which at a border price of US$ 42 per 1,000 cubic metres betters the current offer of Gazprom.

Financial institutions

President creates his own bank and bans citizens from holding foreign bank accounts.
In January 2000, President Niyazov set up a new bank with US$ 50 million in starting capital to provide cheap loans primarily to SMEs. By mid-year, however, only one loan had been approved and funding as well as staffing of the bank remained unclear. In June 2000, the President outlawed domestic citizens from holding foreign bank accounts.

Banking sector remains small and access to finance is limited.
With over 95% of credit still going to the state sector, financial intermediation to private businesses is very small. Four of the largest banks now have accounts prepared in accordance with International Accounting Standards and are providing SME credits under an EBRD credit line with around US$ 5 million disbursed. The central bank has issued new minimum capital requirements of US$ 5 million (at the official exchange rate) for all private banks (US$ 10 million for the three largest state banks) and intends to move to IAS accounting for all banks in 2001.

Social reform

Stagnating life expectancy and falling enrolment rates are a cause of concern.
Despite spending around four-fifths of the central budget on health and education, performance in these areas has been below that of the regional average. With life expectancy at 67.5 years for females and 61.2 years for males in 1997, Turkmenistan lies below all other Central Asian countries and has failed to improve since 1989. Primary school enrolment rates have fallen from 94% to 83% over the past ten years, and anecdotal evidence points to significant deterioration in the quality of education. Turkmenistan needs to shift resources from staffing to enhancing quality of services, including preventative treatments in the health sector and investments in modernising the curriculum at all levels of education.

Liberalisation
Current account convertibility – **limited**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenues in GDP – **22.5%**
Exchange rate regime – **fixed**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises
Competition office – **no**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **10%**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **no**

Social reform
Share of the population in poverty – **58%** [1]
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	20.8	20.8	18.8	18.8	18.8	18.8	16.7	6.3	6.4
Number of goods with administered prices in EBRD-15 basket	8.0	7.0	6.0	5.0	5.0	5.0	5.0	4.0	4.0
Share of total trade with non-transition countries (in per cent)	na	na	na	23.3	31.8	32.4	38.8	72.6	61.0
Share of trade in GDP (in per cent)	210.8	136.3	276.2	184.9	137.2	140.9	74.1	72.7	133.0
Tariff revenues (in per cent of imports) [2]	na	na	na	na	0.3	0.3	0.4	0.3	0.5
EBRD Index of price liberalisation	1.0	1.0	1.0	1.7	2.0	2.0	2.0	2.0	2.0
EBRD Index of forex and trade liberalisation	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Privatisation									
Share of small firms privatised (in per cent)	na	na	0.3	20.1	27.0	30.5	31.5	33.0	34.2
Privatisation revenues (cumulative, in per cent of GDP)	na	na	na	0.1	0.2	0.2	0.2	0.2	0.3
Private sector share in GDP (in per cent)	10.0	10.0	10.0	15.0	15.0	20.0	25.0	25.0	25.0
EBRD index of small-scale privatisation	1.0	1.0	1.0	1.0	1.7	1.7	2.0	2.0	2.0
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	1.0	1.0	2.0	1.7	1.7
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	na	1.6	1.7	0.8	0.6	1.6	na
Effective/statutory social security tax rate (in per cent)	na	na	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	10.1	9.8	10.4	10.0	9.9	10.3	11.2	12.3	na
Change in labour productivity in industry (in per cent)	9.4	-12.3	-5.9	-25.9	21.4	26.0	-38.7	4.3	na
Investment rate (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	1.0	1.0	1.7	1.7	1.7
EBRD Index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Infrastructure									
Main telephone lines per 100 inhabitants	6.3	6.5	6.8	7.6	7.1	7.4	8.2	8.2	8.2
Railway labour productivity (1989=100) [3]	100.0	74.8	60.4	41.2	34.0	28.7	27.9	27.8	26.9
Electricity tariffs, USc/kWh (collection rate in per cent) [4]	na	na	na	na	na	na	na	0.8 (na)	0.5 (na)
Electricity consumption/GDP (1989=100)	106.4	74.3	79.6	79.9	82.4	82.9	77.3	76.9	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	1.1	1.1
Financial institutions									
Number of banks (of which foreign owned) [5]	na	na	na	na	67 (3)	68 (4)	67 (4)	13 (4)	13 (4)
Asset share of state-owned banks (in per cent)	na	na	na	na	26.1	64.1	68.3	77.8	96.6
Bad loans (in per cent of total loans)	na	na	na	na	11.2	11.4	13.9	2.2	0.5
Domestic credit to enterprises (in per cent of GDP) [6]	na	na	na	na	na	5.7	7.8	10.1	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	na
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	na	na	na
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	na	na	na
Social sector									
Expenditures on health and education (in per cent of GDP)	9.4	6.2	6.3	5.3	5.1	4.4	8.0	10.4	8.3
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	282.0	282.0	na
Basic school enrolment ratio (in per cent)	92.5	91.7	92.0	91.8	83.9	83.2	83.1	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Estimate based on official poverty line of TMN 80,000 per month. According to World Bank estimates in 1998, 7% of the population had incomes below US$ 2 per day at purchasing power parity exchange rates.

2 Refers to differential excise taxes on imports; Turkmenistan does not levy import tariffs.

3 The index starts in 1991.

4 Households are entitled to a free electricity allowance of 45 kWh per family member per month; excess usage is charged at just under 1 US cent per kWh.

5 The number of banks until 1997 includes all branches of agricultural bank. In 1998 these were unified into one agricultural bank.

6 Manat credit to state-owned and private firms.

	1992	1993	1994	1995	1996	1997	1998	1999	2000
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	-5.3	-10.0	-17.3	-7.2	-6.7	-11.3	5.0	16.0	20.0
Industrial gross output	-14.9	4.0	-27.9	21.4	30.7	-33.0	25.8	13.0	na
Agricultural gross output	-8.5	8.0	-17.6	4.5	-45.2	123.7	8.7	35.0	na
Employment					*(Percentage change)*				
Labour force (end-year)	3.6	3.1	2.5	9.2	-0.1	0.2	5.5	na	na
Employment (end-year)	0.1	4.4	1.4	0.5	-0.4	0.5	9.7	na	na
					(In per cent of labour force)				
Unemployment [1]	na	na	na	na	na	na	na	na	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	493	3,102	1,748	1,005	992	83.7	16.8	24.2	10.0
Consumer prices (end-year)	644	9,750	1,328	1,262	446	21.5	19.8	21.2	16.0
Gross average monthly earnings in the public sector (annual average)	664.5	2,119.3	587.7	639.8	757.1	220.0	46.3	25.0	na
Government sector [2]					*(In per cent of GDP)*				
General government balance	-9.4	-4.1	-2.3	-2.6	0.3	0.0	-2.7	0.9	0.2
General government expenditure	30.3	19.4	19.2	23.1	16.3	25.3	24.5	19.6	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year) [3]	na	na	983.9	448.0	411.7	81.2	83.2	22.6	na
Domestic credit (end-year)	na	na	915.0	402.8	1,389.3	88.4	77.8	24.6	na
					(In per cent of GDP)				
Broad money (M3, end-year) [3]	na	22.2	25.6	18.8	8.1	10.2	15.7	14.9	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinance rate	na	na	50.0	15.0	105.0	35.0	30.0	27.0	na
Interbank market rate	na	na	na	55.0	121.4	45.2	30.0	27.0	na
Deposit rate (one year) [4]	na	50.0	206.0	80.0	130.0	41.1	24.2	27.1	na
Lending rate (one year) [4]	na	108.0	300.0	70.0	200.0	52.6	58.6	41.8	na
					(Manats per US dollar)				
Exchange rate (end-year) [5]	na	30	75	2,442	5,126	5,222	8,148	9,200	na
Exchange rate (annual average) [5]	na	na	42	240	3,546	4,627	5,500	9,159	na
External sector					*(In millions of US dollars)*				
Current account	927	776	84	24	2	-580	-935	-527	-10
Trade balance	1,140	1,100	485	441	304	-231	-523	-166	600
Merchandise exports [6]	2,149	2,693	2,176	2,084	1,692	774	614	1,162	2,400
Merchandise imports [6]	1,009	1,593	1,691	1,644	1,388	1,005	1,137	1,328	1,800
Foreign direct investment, net	na	79	103	233	108	108	62	89	100
Gross reserves (end-year), excluding gold [7]	na	818	927	1,165	1,172	1,285	1,379	1,514	na
External debt stock	na	na	418	550	668	1,356	1,750	2,050	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold [7]	na	4.5	4.5	5.8	7.0	9.3	9.2	9.1	na
					(In per cent of exports of goods and services)				
Debt service	na	na	1.7	11.7	13.6	26.5	73.6	46.6	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	3.8	3.9	4.0	4.5	4.6	4.6	4.7	4.9	na
GDP (in billions of manats)	306.0	5,584.0	87.2	652.0	7,751.7	11,108.8	13,241.0	17,147.0	22,627.9
GDP per capita (in US dollars)	351.8	1,389.7	517.0	606.7	480.2	520.6	511.3	381.7	na
Share of industry in GDP (in per cent)	59.0	55.1	38.1	52.8	54.4	32.9	29.2	na	na
Share of agriculture in GDP (in per cent)	19.0	11.5	32.7	16.2	12.6	20.2	24.6	na	na
Current account/GDP (in per cent)	68.5	14.1	4.0	0.9	0.1	-24.2	-38.8	-28.2	-0.5
External debt – reserves (in US$ millions)	na	na	-509.0	-615.0	-504.0	70.5	370.7	536.0	na
External debt/GDP (in per cent)	na	na	20.0	20.2	30.6	56.5	72.7	109.5	na
External debt/exports of goods and services (in per cent)	na	na	16.9	22.9	33.5	132.4	214.9	149.2	na

1 Every Turkmen citizen is guaranteed employment, thus official unemployment does not exist. According to a household survey, urban unemployment was 19% in 1998.

2 Significant off-budget expenditures occur through extrabudgetary funds and directed lending. The overall deficit was 15% of GDP in 1998 and 10% of GDP in 1999.

3 There is a break in the broad money series in 1998. Prior data are from IMF, 1998 and 1999 data from CBT.

4 Deposit and lending rates are quoted for legal entities at joint-stock banks accounting for the bulk of financial transactions in the banking sector. For 1996-99, data are average for loans and deposits of 3-6 months maturity. Lending and deposit rates for 1993-96 are the highest of the total range. All interest rates are annual uncompounded.

5 Refers to Russian rouble until 1993. Turkmenistan has had dual exchange rates for most months after the introduction of the manat in November 1993. The series refers to a weighted average between the official exchange rate (60% weight) and the commercial rate (40%) weight, given as the buying rate offered at commercial banks until September 1998 and the black market rate thereafter.

6 From 1996 exports of gas are recorded free-of-board and transit costs are added to imports.

7 Foreign exchange reserves of the central bank plus the foreign exchange reserve fund.

Ukraine

Key reform challenges

- **High tariff and non-tariff barriers remain a significant obstacle to trade, despite the removal of the temporary import surcharge; further trade liberalisation and negotiations on accession to the WTO should be accelerated.**
- **While the renewed large-scale privatisation programme can create investment opportunities, attracting more FDI also depends on an improvement in the business environment, including comprehensive tax reforms.**
- **Sustaining the recent improvement in cash collection rates is the main challenge in the power sector, which would lay the basis for renewed investment and effective organisational reforms in the sector.**

Liberalisation

Despite some recent reductions in tariff barriers, licensing requirements still hamper foreign trade.
The trade-weighted average tariff on non-energy imports rose to over 12.5% in 1999. However, at the beginning of 2000 the temporary 2% import surcharge was removed and some preferential import duties were lowered. At the Council for Cooperation between Ukraine and the EU in May 2000, some progress was also made on specific trade issues, including tax privileges in the auto sector and the registration of pharmaceutical imports. Negotiations on Ukraine's application to join the WTO continue, but the resort to certification procedures and other non-tariff barriers to protect domestic industry has slowed progress. The maintenance of the export duty on sunflower seeds and a recent presidential decree on intervention in the grain market have also raised concerns that production will be adversely affected.

Stabilisation

Fiscal austerity and debt rescheduling provide the basis for improved stability.
Following the collapse of the domestic securities market as well as the uncertainties surrounding the provision of external finance, the government became very dependent on the National Bank of Ukraine (NBU) for funding the budget deficit. It was therefore essential to reduce the deficit, and the budget for 2000 provides for a (revised) deficit of just 1.8% of GDP, to be almost fully financed by privatisation revenues. The budget includes a number of measures to boost revenues, including limits on tax offsets and reductions to tax exemptions, and also aims to bring off-budget expenditures into the budget. In March 2000 the government announced that almost all commercial bondholders had agreed to reschedule US$ 2.6 billion of debt into medium-term bonds, thus smoothing a very peaked external debt service profile.

The currency was floated in November 1999.
The NBU attempted to keep the currency within its band during 1999, although pressures on the currency necessitated changes to the band. When the Hryvnia moved out of its then band (UAH 4.6/US$ 1) in November, and with only limited reserves, the NBU let it float, a policy that was confirmed in February 2000.

A draft tax code has been submitted to the Rada.
The significant tax burden on enterprises arises from a combination of the large number of taxes (there are 22 central taxes and 16 different local taxes although six main taxes account for most of the revenues) and high tax rates, accentuated by restrictive depreciation allowances. The proposed tax code would simplify the tax system and reduce certain tax rates. In addition following the formal (though not necessarily practical) ending of *kartoteka* in 1999 (whereby the tax authorities could freeze the bank account of a company suspected of tax evasion), the government is preparing legislation on a tax collateral system to replace it.

Privatisation

Progress with cash sales of large enterprises has been slow so far …
Voucher-based mass privatisation was concluded in 1999. However, initial attempts to sell shares of larger enterprises via open tenders were less successful owing to a lack of transparency. The winners of some tenders also failed to pay, so the State Property Fund (SPF) increasingly has resorted to sales through stock exchanges. In 1999 over 1,930 enterprises were more than 70% privatised (taking the total to 11,450 enterprises from 1995), although the budget proceeds were less than the target of UAH 800 million (0.6% of GDP).

… but there are renewed efforts to accelerate the process.
Fiscal pressures and the need to promote large-scale privatisation led the government to propose a more radical approach to privatisation for the period 2000-02, which was approved by the Rada in May 2000. The emphasis will be on sales of state shares in some of the largest enterprises in major sectors of the economy, including metallurgy,

Liberalisation, stabilisation, privatisation

1991
Aug Independence from Soviet Union

1992
Mar Small- and large-scale privatisation begins
Nov Interim currency (karbovanets) introduced
Dec VAT introduced

1993
Jan Income tax law adopted
Aug Multiple exchange rates reintroduced

1994
Oct Most prices liberalised
Oct Most export quotas and licences abolished
Oct Exchange rate unified
Nov Voucher privatisation begins

1995
Jan New corporate profits tax introduced
Mar Treasury bills market initiated
Dec Indicative export prices removed

1996
Jan Licensing requirement for grain exports abolished
Sep New currency (hryvnia) introduced

1997
Apr Full current account convertibility introduced
Jun Export surrender requirement revoked
Jul New corporate tax rate introduced
Oct VAT rate changed

1998
Mar Limits on auto imports imposed
Sep Foreign exchange restrictions re-introduced
Sep Currency band widened
Sep Domestic debt rescheduling starts
Dec Agricultural sector given VAT exemption

1999
Feb Currency band widened further
Mar Inter-bank currency market liberalised
Jun New central bank law approved
Dec Presidential decree on reform of agricultural collectives

2000
Feb Introduction of floating exchange rate regime confirmed
Mar Commercial debt rescheduling agreement

Enterprises, infrastructure, finance and social reforms

1991
Mar Land code enacted
Oct Central bank law adopted
Dec Securities and stock exchange law adopted

1992
Feb Competition agency established
May Bankruptcy law enacted
Jun Stock exchange begins trading

1995
Jun Securities and exchange commission established

1996
Mar Grado bank placed under forced administration

1997
Mar Land code amended
Aug First sovereign Eurobond

1998
Jan IAS introduced for commercial banks
May Limits on foreign ownership of banks lifted

1999
Apr Large increase in utility tariffs
Jul Law on concessions adopted
Aug Presidential decree on privatisation of electric power utilities
Oct Law on production sharing agreement takes effect

2000
Jan New bankruptcy law becomes effective
Feb Law providing tax breaks to joint ventures repealed
Jun Law on payments reform in the electricity sector adopted
Jul Law on telecommunications privatisation enacted

energy and chemicals, as well as some of the main utilities. The sales will be to strategic investors and for cash – the programme is intended to raise UAH 2.5 billion for the budget in 2000 (an estimated 1.5% of GDP), and substantially more in each of the following two years. By mid-year a number of sales had occurred owing to the greater effectiveness of tenders as the SPF has sold controlling blocks of shares.

Privatisation is proceeding in the agrarian sector.
A presidential decree of December 1999 allows former members of collective farms to leave with their share of land and property. Although land cannot currently be sold, leasing to private operators has increased. By April 2000, 11,000 collective farms had been transformed into private ownership or cooperatives. In July the Rada approved the Land Code at first reading. If the Code is adopted it would allow farmers to trade land and use it as collateral, which should lead to an increase in finance for agriculture. However, higher agricultural output will also depend on reduced state interference in the sector.

Enterprise reform

Recent legislation aims to improve the investment climate …
Flows of FDI, estimated at US$ 420 million in the first half of 2000, remain low. The extent of regulation, the tax burden and the difficulties of enforcing contracts remain the main obstacles according to most surveys. However, the passage in 1999 of the laws on production sharing and on concessions could provide investors with incentives to invest in natural resources and in infrastructure respectively. In addition, in February 2000 a law was adopted introducing the concept of national treatment between domestic and foreign-owned enterprises with respect to tax and currency regulations.

… but operating conditions for SMEs remain difficult.
An IFC survey of SMEs, conducted in the three months to February 2000, indicated that excessive government interference (especially inspections), a high tax burden and difficulties in gaining access to credit are among the main obstacles. However, the earlier introduction of a simplified tax system for SMEs has reduced the costs of tax compliance. In 1999, SMEs accounted for 11% of GDP and 9% of the labour force.

Infrastructure

The Rada approved a bill to begin the privatisation of Ukrtelecom …
This important development follows numerous occasions in the past when the Rada voted against the privatisation, including a government bill introduced earlier in 2000. A 25% stake will be sold to a strategic investor and, although the state will retain 50% plus one share, the successful bidder can have management control of up to half of this share. The tender is likely to go ahead towards the end of 2000.

… and the government is taking measures to improve operation of the power market.
Low cash payments have limited the ability of the generators to purchase fuel, have affected the efficiency of the wholesale market and have also contributed to the problems of non-monetary payments in the economy. In 1999, while total payments by the distributors to the power market were about 80%, less than 9% were in cash. Cash collection ratios have, however, risen in recent months. In July 2000 a law took effect to improve cash payments in the wholesale power market. Power distribution companies are required to pay cash for the electricity they have contracted to purchase from the energy market, while the regulator will determine the proportion of these receipts that will be paid to the generating companies. However, lasting improvements will depend on the sale of the remaining state shares in the distribution companies (already about 40% privatised) to strategic investors. These sales are to proceed via tenders during 2000-01, following the appointment of a financial adviser for the sale of the first batch of companies.

Financial institutions

A gradual process of consolidation is under way in the banking sector.
The number of registered banks fell to 199 by April 2000 (compared with 214 at the beginning of 1999), of which 160 were active. More mergers and more effective procedures by the NBU for the liquidation of banks contributed to the decline. In May, the Rada approved the first reading of a new banking law, which should strengthen the regulatory framework, and in July the President stressed the importance of developing the sector. These developments could lead to a more rapid consolidation through a more determined enforcement of licensing and other regulations. The volume of total credits rose during the first half, and while 13 banks reported losses during this period, the share of bad loans fell to 22% of total credit portfolios. However, banks remain cautious – the spread between lending and deposit rates is high and most loans to the real sector are very short term.

Social reform

Reform of the pension system is a key government objective.
The low basic pension and pension arrears continue to accentuate social deprivation among pensioners. The existing state scheme is affected by the number of privileged pensioners, by the need to meet other social security payments and by the size of the shadow economy which limits the revenue base. Some changes have been introduced, for example records of individual contributions. More fundamental reforms are being considered including the promotion of private savings for funded schemes under draft laws. However, this would depend not only on adequate records of contributions, but also on effective regulation of pension funds and the development of the capital market.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenues in GDP – **24.4%**
Exchange rate regime – **independently floating**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **MEBOs**
Tradability of land – **limited de facto**

Enterprises
Competition office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio in per cent – **8%**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **41%**
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	15.0	11.0	11.0	6.0	2.0	2.0	2.0	2.0	na
Share of total trade with non-transition countries (in per cent)	na	na	na	38.7	40.3	45.5	57.1	53.6	57.4
Share of trade in GDP (in per cent)	na	112.3	85.3	80.7	84.3	79.4	69.9	71.7	82.5
Tariff revenues (in per cent of imports) [1]	na	na	na	1.7	1.7	1.2	1.9	2.4	2.3
EBRD Index of price liberalisation	1.0	1.0	1.0	2.0	3.0	3.0	3.0	3.0	3.0
EBRD Index of forex and trade liberalisation	1.0	1.0	1.0	1.0	3.0	3.0	3.0	2.7	3.0
Privatisation									
Share of small firms privatised (in per cent)	na	na	na	na	na	na	na	na	na
Privatisation revenues (cumulative, in per cent of GDP)	na	0.0	0.1	0.3	0.4	0.7	0.8	1.3	1.9
Private sector share in GDP (in per cent)	10.0	10.0	15.0	40.0	45.0	50.0	55.0	55.0	55.0
EBRD index of small-scale privatisation	1.0	1.0	2.0	2.0	2.0	3.0	3.3	3.3	3.3
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	2.0	2.0	2.3	2.3	2.3
Enterprises									
Budgetary subsidies (in per cent of GDP) [2]	na	na	na	13.3	5.8	6.5	5.0	na	na
Effective/statutory social security tax rate (in per cent)	na	65.7	58.9	69.3	57.5	56.2	58.9	na	na
Share of industry in total employment (in per cent)	31.1	30.2	29.3	28.2	26.2	25.6	24.6	21.0	na
Change in labour productivity in industry (in per cent)	-4.0	-1.8	-3.0	-20.3	-4.5	2.5	7.3	2.8	na
Investment rate (in per cent of GDP)	20.0	27.1	24.3	25.5	23.3	20.7	19.8	19.3	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	14.2	14.7	15.2	15.7	16.1	18.1	18.5	19.1	19.1
Railway labour productivity (1989=100)	81.0	66.7	53.3	46.9	46.1	40.7	42.4	42.2	41.7
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	1.8 (60)	3.5 (65)	2.4 (70)	3.1 (80)	2.9 (79)	2.2 (84)
Electricity consumption/GDP (1989=100)	105.1	113.2	121.0	137.4	149.6	150.5	148.7	144.2	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	2.0	2.0
Financial institutions									
Number of banks (of which foreign owned)	na	133 (na)	211 (na)	228 (1)	230 (1)	229 (6)	227 (12)	175 (12)	161 (15)
Asset share of state-owned banks (in per cent)	na	na	na	na	na	na	13.5	13.7	12.5
Bad loans (in per cent of total loans)	na	na	na	na	na	na	0.5	2.3	3.3
Domestic credit to enterprises (in per cent of GDP)	na	0.0	0.0	0.0	0.0	1.4	2.5	7.8	8.8
Stock market capitalisation (in per cent of GDP) [3]	na	na	na	na	na	na	7.4	1.9	4.6
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
EBRD index of reform of non-banking financial institutions	1.0	1.7	1.7	1.7	2.0	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	2.0	2.0	2.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	2.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	7.8	10.5	8.5	10.1	10.0	8.7	9.5	7.9	6.6
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	350.0	351.0	na
Basic school enrolment ratio (in per cent)	91.9	91.5	91.0	90.7	90.9	90.8	90.2	89.0	na
Earnings inequality (GINI-coefficient)	na	25.1	36.4	na	na	41.3	na	na	na

1 Refers to taxes on international trade and transactions.

2 Refers to consumer and producer subsidies. The figure for 1998 is an estimate based on the first six months of the year.

3 Data from Stock Market Survey. IFC data show much lower capitalisation of 2% of GDP in 1998.

	1992	1993	1994	1995	1996	1997	1998	1999 Estimate	2000 Projection
Output and expenditure					(Percentage change in real terms)				
GDP	-13.7	-14.2	-23.0	-12.2	-10.0	-3.0	-1.9	-0.4	3.0
Industrial gross output	-6.4	-8.0	-27.3	-12.0	-5.1	-1.8	-1.0	4.3	na
Agricultural gross output	-8.3	1.5	-16.5	-3.6	-9.5	-1.9	-9.8	-5.7	na
Employment					(Percentage change)				
Labour force (annual average)	-1.0	-0.3	0.1	2.4	-0.7	-0.5	0.4	0.3	na
Employment (annual average)	-2.0	-2.3	-3.8	3.0	-2.1	-2.7	-1.1	-0.7	na
					(In per cent of labour force)				
Unemployment (end-year)	0.2	0.3	0.3	0.5	1.3	2.3	3.7	4.3	na
Prices and wages					(Percentage change)				
Consumer prices (annual average)	1,210	4,735	891	377.0	80.0	15.9	10.6	22.7	28.0
Consumer prices (end-year)	2,730	10,155	401	181.7	39.7	10.1	20.0	19.2	24.0
Producer prices (annual average)	2,384	4,619	1,134	489.0	52.1	7.7	13.2	31.0	na
Producer prices (end-year)	3,828	9,668	774	172.0	17.3	5.0	35.3	15.7	na
Gross average monthly earnings in state sector (annual average)	1,220	2,255	786	483.9	71.4	13.3	7.2	15.8	na
Government sector [1]					(In per cent of GDP)				
General government balance	-25.4	-16.2	-7.7	-6.1	-6.1	-5.0	-3.0	-2.5	-1.5
General government expenditure	58.4	54.5	51.4	33.0	42.8	43.0	39.0	37.1	na
General government debt	na	na	na	27.0	21.0	28.2	45.7	49.1	na
Monetary sector					(Percentage change)				
Broad money (M3, end-year)	na	na	540.0	117.4	35.1	33.9	22.3	41.0	na
Domestic credit (end-year)	na	na	na	166.1	22.1	32.5	58.0	30.5	na
					(In per cent of GDP)				
Broad money (M3, end-year)	na	33.6	26.5	12.7	11.5	13.4	14.9	17.0	na
Interest and exchange rates					(In per cent per annum, end-year)				
Refinancing rate	80	240	252	110	40	35	60	45.0	na
Treasury bill rate (3-month maturity) [2]	na	na	na	164	51	44	40	45.0	na
Deposit rate [3]	82	149	209	70	24	19	24	21.0	na
Lending rate [3]	77	184	250	123	61	43	54	55.0	na
					(Hryvnias per US dollar)				
Exchange rate (end-year)	0.01	0.13	1.04	1.79	1.89	1.90	3.43	5.22	na
Exchange rate (annual average)	0.002	0.05	0.32	1.47	1.83	1.86	2.45	4.13	na
External sector					(In millions of US dollars)				
Current account	na	na	-1,163	-1,152	-1,185	-1,335	-1,295	834	500
Trade balance	-600	-2,500	-2,575	-2,702	-4,296	-4,205	-2,584	-482	-700
Merchandise exports	11,300	12,800	13,894	14,244	15,547	15,418	13,699	12,463	13,300
Merchandise imports	11,900	15,300	16,469	16,946	19,843	19,623	16,283	12,945	14,000
Foreign direct investment, net	na	na	151	257	526	581	747	489	750
Gross reserves (end-year), excluding gold	469	162	651	1,051	1,960	2,341	761	1,046	na
External debt stock	na	na	7,167	8,142	9,170	11,807	11,700	11,481	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	na	0.4	0.7	1.1	1.3	0.5	0.8	na
					(In per cent of exports of goods and services)				
Debt service	na	na	12.1	9.3	6.0	9.4	19.7	12.1	na
Memorandum items					(Denominations as indicated)				
Population (end-year, millions)	52.1	51.9	51.7	51.5	51.1	50.5	50.1	49.7	na
GDP (in millions of hryvnias)	40.9	1,483	12,038	54,516	81,519	93,365	102,593	127,126	167,600
GDP per capita (in US dollars)	396.5	635.5	727.6	718.6	872.2	992.9	834.8	619.5	na
Share of industry in GDP (in per cent)	44.6	27.6	30.0	34.4	27.5	26.4	24.6	na	na
Share of agriculture in GDP (in per cent)	20.3	21.6	16.0	14.5	12.2	11.8	11.4	na	na
Current account/GDP (in per cent)	na	na	-3.1	-3.1	-2.7	-2.7	-3.1	2.7	1.7
External debt – reserves (in US$ millions)	na	na	6,517	7,091	7,210	9,466	10,939	10,435	na
External debt/GDP (in per cent)	na	na	19.1	22.0	20.6	23.5	28.0	37.3	na
External debt/exports of goods and services (in per cent)	na	na	43.1	47.6	45.1	58.0	66.4	70.7	na

1 General government includes the state, municipalities and, from 1994, extrabudgetary funds. Data are on a cash basis until 1995, and on an accrual basis thereafter.

2 Treasury bills were introduced in March 1995.

3 Weighted average over all maturities.

Uzbekistan

Key reform challenges

- **With trade and foreign exchange restrictions as well as state interference in credit allocation sheltering uncompetitive industries and preventing firms in potentially profitable industries from developing, their removal is an urgent priority.**
- **Substantial net transfers from agriculture to support industrialisation are economically costly, lower incentives for productivity increases in Uzbekistan's largest economic sector and hold back growth.**
- **Improving living conditions in rural areas through fundamental reforms in agriculture will be key to responding to the appeal of Islamic groups and to maintaining political stability.**

Liberalisation

Some steps towards exchange rate unification are taken, but most important distortions remain.
Restrictive trade practices introduced in 1997 remain largely in place, including registration and prepayment requirements for imports and high average import tariffs. However, in recent months, two encouraging steps were taken. The official exchange rate, at which mainly budgetary operations were calculated, and the inter-bank rate, at which companies with import permissions could obtain foreign currency, were unified at the end of April 2000 at the higher commercial exchange rate, thus bringing the average administrative rate closer to the underlying market rate. Furthermore, at the end of June, the government allowed banks to buy currency from the public at a rate close to the black market rate and excluded the import of consumer goods from the list of goods imported at the lower inter-bank rate. Yet, full convertibility seems to have been postponed another six months to the middle of 2001. Following accelerated official exchange rate depreciation from April to July, the pace has slowed in recent weeks, raising further doubts over the government's commitment to real systemic change.

Stabilisation

Rising external imbalances with no IMF agreement in sight.
Although the government's compression of imports limits the trade deficit, the level of external debt is rising quickly and has reached around 70% of GDP, if calculated at the underlying market exchange rate. With limited support from international financial institutions and as private creditors have become hesitant, Uzbekistan has been forced into expensive short-term commercial borrowing to service existing foreign obligations. This year's debt service payments will amount to more than a third of total exports. If the current strategy is not altered, debt service payments will rise further raising the likelihood of a liquidity crisis. Access to much-needed long-term financing is likely to be pre-conditioned on obtaining an IMF agreement, which appears doubtful over the near term.

State budget is increasingly difficult to balance.
The accelerated depreciation of the official exchange rate since April 2000 is putting pressure on the budget because it increases the costs of foreign debt service and of centralised imports channelled through the budget. A 50% increase in public sector wages, social benefits and pensions in August 2000 will put further pressure on the budget. In this context, limiting access to the official exchange rate market to capital goods importers was a welcome step. Without access to any significant non-monetary financing, any budgetary imbalance would inevitably result in considerable increases in inflation.

Privatisation

Government warms (slightly) towards strategic foreign investors.
The state remains a majority shareholder in most large enterprises. Given the reluctance of the government to give up control to foreign investors, the World Bank-supported case-by-case privatisation programme has not been successful. It was revitalised late in 1999 when a new list of 27 companies to be privatised was drawn up. Priority sales, with majority stakes on offer to strategic investors, include the state oil and gas company, the telecommunications company, two large cement companies and Uzcable, Central Asia's largest cable producer. Included in the list are also Tashkent Chkalov Aviation Production Association and Almalyk mining metallurgical combine, but the state is not prepared to give up management control in either of them. With respect to the oil and gas sector the authorities initially proposed a stepwise privatisation plan, starting with the largest refinery and subsequently moving upstream to oil and gas extraction and transportation. After the failure of this proposal to attract any investor interest, a new proposal foresees that Uzbekneftegaz will be split into four businesses and all four will go on sale at the same time.

Liberalisation, stabilisation, privatisation

1991

Sep	Independence from Soviet Union

1994

Jan	New currency (som) introduced
May	Foreign investment law adopted

1995

May	Foreign investment law amended
Oct	IMF programme adopted

1996

Mar	First treasury bills issued
Jun	Privatisation programme adopted
Oct	IMF programme suspended

1997

Nov	Custom duties and export licensing abolished but tariffs increased
Dec	Customs code enacted

1998

Jan	Tax code enacted
Feb	Import tariffs further increased
Dec	Tender for six large enterprises announced

1999

Jan	Export surrender increased to 50%
Feb	Trade barriers against Kazakhstani and Kyrgyzstani imports introduced
Jun	Tender for large copper plant cancelled
Jul	Partnership and cooperation agreement with EU effective
Dec	New privatisation programme for 27 large enterprises

2000

May	Two administrative exchange rates unified
Jun	Access to subsidised hard currency restricted

Enterprise reform

Import substitution policies in industry fail to boost output …
According to an index of industrial production at constant prices, output has fallen by more than 10% over the last two years. The decline is most pronounced among industries with a high share of foreign joint ventures, originally attracted to Uzbekistan as part of the country's industrialisation drive. Some companies have decreased their output because of declining subsidies but most of them reduced their production because of increasingly distorted prices and attempted government interventions in production plans.

Enterprises, infrastructure, finance and social reforms

1990
Jun Decree on joint-stock companies adopted

1991
Feb Company law adopted

1992
Dec Pledge law adopted
Jul Competition law adopted

1993
Sep Securities law enacted

1994
Apr Stock exchange established
May Bankruptcy law adopted
Jul Decree on securities market

1995
Aug Telecommunications law adopted

1996
Apr Banking law adopted
Apr Land law amended
Aug Bankruptcy law amended

1997
Mar Bank accounting standards adopted

1998
Aug Law on depositories enacted
Oct Presidential decree to reform commercial banks

1999
Apr Largest commercial bank partially privatised

2000
Jul National and international telecommunications companies merged and offered for sale

… while state intervention in agriculture is not sustainable.
Although state-owned farms only produce 2% of total output, the government is still able to exercise tight control on the sector. Even for formally privatised agricultural enterprises, the government continues to set production targets for specific crops. Through a system of implicit and explicit taxation, every year the authorities transfer about 15% of GDP out of agriculture into the import substituting industries. As a result, wages for farmers are a quarter of those in industry and there is under-investment in the sector's infrastructure, an issue particularly important with respect to the vital irrigation network. Even though this policy has not led to a decrease of yields so far, according to official statistics, it has led to the deterioration in the quality of agricultural output. Agricultural productivity is further reduced by the authorities' continued insistence on the replacement of cotton and fodder crops with wheat.

Infrastructure

Reform of telecommunications advances.
Two decrees were signed at the beginning of July 2000 that specify the restructuring of the telecommunications sector. The first decree combines the local and the international fixed-line businesses into one company, Uztelekom. A tender for 49% of this company that will also have a second generation mobile licence will be offered later in 2000. A further 2% of shares may be offered under a management contract to allow majority control. Uztelekom will have a five-year monopoly on international calls while free entry to domestic telecommunications will be maintained. The second decree addresses regulatory issues. An independent agency is to be created, which will be in charge of interconnection charges and tariffs.

Financial institutions

State interference hampers the sector's development.
The state continues to hold majority stakes in most banks in the country and it interferes in the credit allocation under the National Investment Plan (NIP). About two-thirds of all outstanding loans were extended under state direction, carry a sovereign guarantee and often have negative real interest rates. Since all guaranteed loans are automatically classified as performing, an assessment of the health of the banking system is difficult. Prudential regulations in the sector have improved following programmes of the World Bank and USAID. However, a framework to allow for bank exit is still missing and the central bank's supervisory capacity has to be strengthened. Another factor that hampers the development of the banking system is its current role in both tax enforcement and tax collection. A key element of this system is the distinction between cash and non-cash transactions. Cash withdrawals by enterprises are permitted only for purposes of payment of wages and travel expenses. This system discourages enterprises from holding liquid assets in the banking sector and has fuelled the development of a cash-based informal sector.

Bank privatisation plans contingent on reducing NBU's dominance in the sector.
The banking sector is very concentrated. While the state savings bank, Narodny Bank, has around 80% of all household deposits, the largest bank, NBU, holds about 55% of total assets held in the banking sector. It furthermore controls 90% of all foreign currency transactions and additionally holds parts of the government's foreign currency and gold reserves. It has very close connections with many ministries. A presidential decree on 2 October 1998 required the state's shares in commercial banks with the exception of Narodny Bank to be reduced to a maximum of 50% by July 1999. The decree has, however, not been implemented so far. Bank privatisation is supported by both the World Bank, through a technical assistance programme, and the EBRD. Nevertheless, the high sector concentration and, in particular, NBU's privileged position pose significant obstacles to privatisation. Under current proposals Asaka Bank or UzPromstroyBank would be sold as pilot cases, if strategic investors can be found willing to invest in Uzbekistan's considerably distorted financial system.

Social reform

Social spending is relatively high.
Compared with other transition countries, Uzbekistan maintains relatively high levels of social assistance. Expenditures on the social safety net continue to account for about 3.5% of GDP and spending on health and education is about 11.4% of GDP. Benefits are usually increased in line with wages rather than with official inflation. They are paid through the national Malhalla foundation, which uses traditional Uzbek local social structures to channel its resources to the most needy. The foundation collects information on claimants' needs independently of the state. However, the state usually interferes in the allocation of resources among regions, which tilts expenditures towards the better-earning large cities. Wages in the agricultural sector are rapidly falling behind the national average, largely as a result of the government's taxation policies. These policies have contributed to increased civil unrest, specifically in the Ferghana valley, and have contributed substantially to the rising popularity of Islamic groups in the country.

Liberalisation
Current account convertibility – **limited**
Interest rate liberalisation – **limited de facto**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenues in GDP – **30%**
Exchange rate regime – **multiple exchange rates**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises
Competition office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **8%**
Deposit insurance system – **no**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **29%**
Private pension funds – **no**

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	na	na	na	na	na	na	na	na	na
Share of total trade with non-transition countries (in per cent)	na	na	na	45.6	34.9	47.3	38.2	47.4	53.5
Share of trade in GDP (in per cent)	na	156.0	120.4	99.6	73.2	64.5	69.0	54.0	71.4
Tariff revenues (in per cent of imports) [1]	na	1.3	2.4	2.5	2.6	1.6	1.6	1.9	0.7
EBRD Index of price liberalisation	1.0	2.0	2.0	3.0	3.0	3.0	2.7	2.0	2.0
EBRD Index of forex and trade liberalisation	1.0	1.0	1.0	2.0	2.0	2.0	1.7	1.7	1.0
Privatisation									
Share of small firms privatised (in per cent) [2]	0.5	1.2	7.1	16.5	25.7	34.3	42.3	49.6	56.7
Privatisation revenues (cumulative, in per cent of GDP)	na	0.0	0.2	0.7	1.6	2.4	2.5	2.6	2.7
Private sector share in GDP (in per cent)	10.0	10.0	15.0	20.0	30.0	40.0	45.0	45.0	45.0
EBRD index of small-scale privatisation	1.0	1.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of large-scale privatisation	1.0	1.0	1.0	2.0	2.7	2.7	2.7	2.7	2.7
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	10.7	7.6	2.7	3.4	4.0	3.2	na	na
Effective/statutory social security tax rate (in per cent)	na	na	5.4	na	33.5	35.9	na	na	na
Share of industry in total employment (in per cent)	14.6	13.9	14.1	13.1	12.9	12.9	12.8	12.7	12.8
Change in labour productivity in industry (in per cent)	0.5	-1.7	2.3	10.5	-1.6	4.4	6.3	5.3	na
Investment rate (in per cent of GDP)	26.8	12.9	14.6	18.3	27.3	29.3	21.7	19.2	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0
EBRD Index of competition policy	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	7.0	6.7	6.6	6.9	7.6	6.7	6.4	6.5	6.7
Railway labour productivity (1989=100)	98.2	69.2	52.3	33.1	28.1	27.3	26.9	27.1	26.6
Electricity tariffs, USc/kWh (collection rate in per cent)	na	na	na	na	na	na	1.7 (na)	1.9 (80)	1.2 (90)
Electricity consumption/GDP (1989=100)	89.6	119.1	118.3	120.1	118.2	117.6	116.1	110.8	na
Average of EBRD index of infrastructure reform	na	na	na	na	na	na	na	1.7	1.7
Financial institutions									
Number of banks (of which foreign owned)	30 (na)	30 (na)	21 (1)	29 (1)	31 (1)	29 (2)	30 (4)	33(4)	35(5)
Asset share of state-owned banks (in per cent)	na	21.7	15.9	46.7	38.4	75.5	70.6	67.3	65.8
Bad loans (in per cent of total loans)	na	0.0	0.0	0.0	0.0	0.0	0.4	0.1	0.1
Domestic credit to enterprises (in per cent of GDP)	na	na	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	1.3	3.8	na	0.9
EBRD index of banking sector reform	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7	1.7
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	na	2.3	2.3	2.7
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	2.0	2.0	2.3
Social sector									
Expenditures on health and education (in per cent of GDP)	na	14.8	13.4	11.8	11.0	11.1	10.4	11.2	11.4
Mortality rate (per 1,000 male adults)	na	na	na	na	na	na	230.0	229.0	na
Basic school enrolment ratio (in per cent)	87.9	87.5	87.9	88.6	na	89.0	89.7	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

1 Refers to custom duties and export taxes.

2 Between 1994 and 1997, Uzbekistan privatised a total of 18,264 firms, mostly small and medium-sized. These include firms with only a minority private stake. Their share in the total number of firms is not known.

	1992	1993	1994	1995	1996	1997	1998	1999 *Estimate*	2000 *Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	-11.1	-2.3	-4.2	-0.9	1.6	2.5	4.4	4.1	1.0
Private consumption	na	na	na	-30.2	22.8	15.9	8.3	na	na
Public consumption	na	na	na	6.7	-2.2	-17.2	16.0	na	na
Gross fixed investment	na	na	na	na	na	17.0	20.0	na	na
Industrial gross output	-6.2	4.1	1.0	0.2	6.3	6.5	5.8	na	na
Agricultural gross output	-6.4	1.3	2.2	2.3	-6.5	5.8	4.0	na	na
Employment					*(Percentage change)*				
Labour force (end-year)	2.0	-20.4	-1.3	3.7	1.4	1.4	1.4	na	na
Employment (end-year)	0.2	-0.1	-1.3	3.7	1.3	1.4	1.4	0.4	na
					(In per cent of labour force)				
Unemployment (end-year) [1]	0.1	0.3	0.4	0.4	0.4	0.4	0.5	0.6	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	645	534	1,568	304.6	54.0	58.9	17.8	29.1	30.0
Consumer prices (end-year)	910	885	1,281	116.9	64.3	27.6	26.1	25.2	40.0
Producer prices (annual average)	3,275	2,545	1,428	499.0	107.0	52.0	na	na	na
Producer prices (end-year)	na	1,919	1,425	217.4	75.4	40.3	48.4	na	na
Gross average monthly earnings in the public sector (annual average)	-99.4	1,148	1,314.6	276.6	99.7	75.2	57.5	60.2	na
Government sector [2]					*(In per cent of GDP)*				
General government balance	-18.3	-10.4	-6.1	-4.1	-7.3	-2.4	-3.0	-1.8	-3.0
General government expenditure	49.7	46.4	35.3	38.7	41.6	32.5	34.5	34.0	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	468.0	785.1	725.9	144.3	113.3	45.6	28.1	38.0	na
Domestic credit (end-year)	na	854.4	525.3	80.0	188.8	51.4	74.7	na	na
					(In per cent of GDP)				
Broad money (M3, end-year)	68.9	53.5	34.7	18.2	21.0	17.5	16.1	15.5	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinancing rate	na	na	na	84.0	60.0	48.0	48.0	42.0	na
Treasury bill rate (3-month maturity)	na	na	na	na	36.0	26.0	17.6	16.0	na
Deposit rate (1 year)	10.0	30.0	60.0	90.0	28.0	15.0	12.0	12.0	na
Lending rate (1 year)	na	na	100.0	105.0	50.0	28.0	33.0	30.0	na
					(Soms per US dollar)				
Exchange rate (end-year) [3]	415.0	1	28.0	39.3	67.2	108.5	176.8	347.0	na
Exchange rate (annual average) [3]	226.2	1.0	11.4	33.0	46.4	90.3	130.9	260.8	na
External sector					*(In millions of US dollars)*				
Current account	-237	-429	119	-21	-979	-548	-39	-202	-140
Trade balance	-235	-378	213	237	-706	-72	171	125	306
Merchandise exports	1,424	2,877	2,940	3,475	3,534	3,695	2,888	2,719	2,900
Merchandise imports	1,659	3,255	2,727	3,238	4,240	3,767	2,717	2,594	2,594
Foreign direct investment, net	9	48	73	-24	90	167	226	201	231
Gross reserves (end-year), excluding gold	55	856	676	815	772	374	533	783	na
External debt stock	62	1,039	1,107	1,771	2,381	2,594	3,484	4,289	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold [4]	0.6	3.8	3.0	2.9	2.2	1.1	2.2	3.3	na
					(In per cent of exports of goods and services)				
Debt service	0.4	0.7	10.5	17.0	9.0	9.0	13.0	17.8	na
Memorandum items					*(Denominations as indicated)*				
Population (annual average, millions)	21.4	21.9	22.3	22.7	23.1	23.6	24.0	24.5	na
GDP (in millions of soms)	447	5,095	64,878	302,787	559,100	976,830	1,358,780	1,942,000	2,549,846
GDP per capita (in US dollars)	92.5	233.1	255.4	404.4	521.1	459.3	432.5	304.2	na
Share of industry in GDP (in per cent)	26.6	22.4	19.8	20.0	20.0	19.0	na	na	na
Share of agriculture in GDP (in per cent)	35.4	27.9	38.0	32.0	26.0	29.0	na	na	na
Current account/GDP (in per cent)	-12.0	-8.4	2.1	-0.2	-8.1	-5.1	-0.4	-2.7	-2.4
External debt – reserves (in US$ millions)	7	183	431	956	1,609	2,220	2,951	3,506	na
External debt/GDP (in per cent)	3.1	20.4	19.5	19.3	19.8	24.0	33.6	57.6	na
External debt/exports of goods and services (in per cent) [5]	4.4	36.1	35.9	47.1	60.8	64.0	108.9	157.7	na

1 Officially registered unemployment. No labour force survey based estimates available.

2 Includes extrabudgetary funds but excludes local government.

3 Roubles per US dollar until 1993. Since 1996, dual exchange rates are in operation. Data show the weighted average of the official exchange rate (40%), the bank rate (30%) and the parallel market rate (30%). In 1999, the parallel market premium rose to 500% over the official rate by year-end.

4 As a share of merchandise imports only for the years 1992 and 1993.

5 Figures for 1992 and 1993 refers to exports of goods only.

Methodological notes

Definitions and data sources for country snapshot variables

Liberalisation

Current account convertibility
Options: *full* (full compliance with Article VIII of IMF Agreement), *limited* (restrictions on payments or transfers for current account transactions).

Source: International Monetary Fund, *International Financial Statistics*.

Interest rate liberalisation
Options: *full* (banks are free to set deposit and lending rates), *limited de facto* (no legal restrictions on banks to set deposit and lending rates, but limitations arise from substantial market distortions, such as directed credits or poorly functioning or high illiquid money or credit markets), *limited de jure* (restrictions on the setting of interest rates by banks through law, decree or central bank regulation).

Source: EBRD staff assessments.

Wage regulation
Restrictions or substantial taxes on the ability of some enterprises to adjust the average wage or wage bill upward; options: *yes, no.*

Source: EBRD staff assessments.

Stabilisation

Share of general government tax revenues in GDP
General government includes central government, extrabudgetary funds and local government.

Source: See the Macroeconomic Indicators tables.

Exchange rate regime
Options: *currency board, fixed, fixed with band, crawling peg, crawling peg with band, managed float, floating.*

Source: International Monetary Fund, *International Financial Statistics*.

Privatisation

Primary privatisation method since the start of transition
Options: *vouchers* (distribution of investment coupons at a symbolic price), *direct sales* (sales to outsiders), *MEBOs* (management/employee buy-outs), *liquidations*.

Source: EBRD staff assessments.

Secondary privatisation method since the start of transition
Options and definitions as above.

Source: EBRD staff assessments.

Tradability of land
Options: *full* (no substantial restrictions on the tradability of land rights beyond administrative requirements; no discrimination between domestic and foreign subjects), *full except foreigners* (as "full", but with some differential treatment of foreigners), *limited de facto* (substantial de facto limitations on the tradability of land, for example due to the lack of enforceability of land rights, a non-existent land market, or significant obstruction by government officials), *limited de jure* (legal restrictions on the tradability of land rights), *no* (land trade prohibited).

Source: EBRD staff assessments.

Enterprises

Competition office
Competition or anti-monopoly office exists separately from any ministry, though it may not be fully independent; options: *yes, no.*

Source: EBRD staff assessments.

Infrastructure

Independent telecommunications regulator
Independent body, but the scope of power may differ across countries; options: *yes, no.*

Source: EBRD staff assessments.

Separation of railway accounts
Accounts for freight and passenger operations are separated; options: *yes, no.*

Source: EBRD staff assessments.

Independent electricity regulator
Independent body, but the scope of power may differ across countries; options: *yes, no.*

Source: EBRD staff assessments.

Financial sector

Capital adequacy ratio
Ratio of bank regulatory capital to risk-weighted assets; regulatory capital includes paid-in capital, retentions and some forms of subordinated debt.

Source: EBRD staff assessments.

Deposit insurance system
Deposits in all banks are covered by a formal deposit insurance scheme; options: *yes, no.*

Source: EBRD staff assessments.

Secured transactions law
Non-possessory security over movable assets permitted; options: *yes, restricted, no.*

Source: EBRD staff assessments.

Securities commission
Securities and exchange commission exists separately from any ministry, although it may not be fully independent; options: *yes, no.*

Source: EBRD staff assessments.

Social reform

Share of the population in poverty
For most countries, this is given as the percentage of the population living on less than US$ 4 (in 1990 US$ at PPP) a day per person. For some countries, national estimates are given. See footnotes for further details.

Sources: United Nations Development Programme, *Human Development Report*; World Bank, *World Development Indicators;* and national authorities.

Private pension funds
Options: *yes, no.*

Source: EBRD staff assessments.

Liberalisation

Share of administered prices in CPI (%)
Administered prices are defined as those prices subject to regulation by the state.

Sources: EBRD survey of national authorities and IMF country reports.

Number of goods with administered prices in EBRD-15 basket
The EBRD-15 basket consists of flour/bread, meat, milk, gasoline/petrol, cotton textiles, shoes, paper, cars, television sets, cement, steel, coal, wood, rents, inter-city bus service.

Source: EBRD survey of national authorities.

Share of trade with non-transition countries (%)
Ratio of merchandise exports and imports to non-transition economies to total trade (exports plus imports).

Source: IMF, *Directions of Trade Statistics*. Data for CIS countries suffer from under-reporting of intra-CIS trade for the early 1990s and are reported for 1994 onwards only.

Share of trade in GDP (%)
Ratio of exports plus imports to GDP.

Source: See the Macroeconomic Indicators tables.

Tariff revenues (% of imports)
Tariff revenues include all revenues from international trade. Imports are those of merchandise goods.

Sources: EBRD surveys of national authorities and IMF country reports.

Privatisation

Share of small firms privatised (cumulative, % of total to the total number of small firms identified for privatisation)
Ratio between the cumulative number of small firms privatised by year-end to the total number of small firms initially identified for privatisation.

Sources: EBRD survey of national authorities and EBRD staff assessments.

Definitions and data sources for structural and institutional indicators

Privatisation revenues (cumulative, % of GDP)
Government revenues from cash sales of enterprises, not including investment commitments.

Sources: EBRD survey of national authorities and IMF country reports.

Private sector share in GDP (%)
The "private sector shares" of GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available.

Sources: EBRD staff estimates, 1994-99, and IMF staff estimates, 1989-93.

Enterprises

Budgetary subsidies (% of GDP)
Budgetary transfers to enterprises and households, excluding social transfers.

Sources: EBRD surveys of national authorities and IMF country reports.

Efficiency of tax collection for social security (%)
Ratio of effective collection of social security taxes over total labour income in the economy, divided by the statutory social security tax rate. A collection of 6% of total payroll for a statutory rate of 10% would give an efficiency of tax collection of 0.6. The EU average is 0.65.

Sources: IMF, *Government Finance Statistics*; OECD, *Revenue Statistics*; UN, *National Account Statistics*; World Bank, *World Bank Atlas*; World Bank, *CIS Statistical Yearbook*; national statistical publications and IMF country reports.

Share of industry in total employment (%)
Industry includes electricity, water, power, mining and manufacturing.

Sources: ILO, *Labour Statistics Yearbook*; UN, *National Account Statistics*; national statistical publications and IMF country reports.

Change in labour productivity in industry (%)
Labour productivity is calculated as the ratio of industrial production to industrial employment and the changes in productivity are calculated on the basis of annual averages.

Sources: National statistical publications and IMF country reports.

Infrastructure

Main telephone lines per 100 inhabitants
Fixed lines only, excluding mobile telephones.

Sources: International Telecommunications Union, *World Telecommunications Development Report*.

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.

Electricity tariffs, US cents per kilowatt-hour (collection ratio in %)
The average retail tariff; the collection ratio is defined as the ratio of total electricity payments received (in cash and non-cash) and total electricity charges.

Sources: *Financial Times*, *Power in Eastern Europe*, national authorities and World Bank.

Ratio of electricity consumption to GDP (1989=100)
Electricity consumption is defined as production, minus net exports, minus transmission losses.

Source: International Energy Agency.

Financial institutions

Number of banks (of which foreign-owned)
Number of commercial and savings banks, excluding cooperative banks. Foreign-owned banks are defined as those with foreign ownership exceeding a 50% share, end-of-year.

Source: EBRD survey of central banks.

Asset share of state-owned banks (% of total bank assets)
Share of total bank assets of majority state-owned banks in total bank sector assets. The state is defined to include the federal, regional and municipal levels as well as the state property fund and the state pension fund. State-owned banks are defined as banks with state ownership exceeding 50%, end-of-year.

Source: EBRD survey of central banks.

Bad loans (% of total loans)
Ratio of non-performing loans to total loans. Non-performing loans excludes loans transferred to a state rehabilitation agency or consolidation bank, end-of-year.

Source: EBRD survey of central banks.

Domestic credit to enterprises (% of GDP)
Ratio of total outstanding bank credit to the private sector at end-of-year, including households and enterprises, to GDP.

Sources: IMF, *International Financial Statistics* and IMF country reports.

Stock market capitalisation (% of GDP)
Market value of all shares listed on the stock market as a percentage of GDP, end-of-year.

Source: EBRD survey of national stock markets. In some cases, the data differ notably from capitalisation as reported by the Standard & Poors/IFC *Handbook of Emerging Markets*. The difference in most cases is due to the exclusion in the Standard & Poors/IFC data of companies listed on the third tier.

Social sector

Expenditures on health and education (% of GDP)
Expenditures of general government, excluding those by state-owned enterprises.

Sources: EBRD survey to ministries of finance; IMF country reports; World Bank, *World Development Indicators*.

Mortality rate (per 1,000 adult males)
The adult mortality rate is the probability of an adult male dying between the ages of 15 and 60 – that is the probability of a 15-year-old dying before reaching the age of 60 given the current age-specific mortality rates between the ages of 15 and 60.

Source: World Bank, *World Development Indicators*.

Basic school enrolment ratio (%)
Gross rates of school enrolment, % of relevant population between 7 and 15 years old. Basic school includes 8 years of schooling from the age of 7/8 to 14/15.

Sources: UNICEF, International Child Development Centre; TransMONEE Database.

Earnings inequality (Gini coefficient)
The Gini coefficient measures the distribution of employees' earnings. A higher coefficient implies a higher degree of earnings inequality. The Gini coefficient is derived from the cumulative distribution of earnings across the workforce ranked in order of ascendance. It is defined as one half of the mean difference between any two observations in the earnings distribution divided by average earnings. Its possible values range between 0 and 1. The Gini coefficients presented in the table are calculated using monthly earnings data as reported by employers. Small employers are often excluded, and some data refer to the public sector only.

Sources: UNICEF, International Child Development Centre; TransMONEE Database.

EBRD transition indicators

The transition indicator scores, from 1 to 4 with 0.3 decimal points added or subtracted for + and – ratings, that were first introduced in 1997 and retroactively added to years 1989-96 in this year's *Transition Report*. For definitions of the rating scores, see Table 2.1, Annex 2.2 (for legal transition indicators) and Annex 2.3 (for infrastructure indicators). The infrastructure rating is an unweighted average of four sector-specific reform ratings for power, railways, telecommunications and water.

Source: EBRD staff assessments.

Methodological notes

Definitions and data sources for macroeconomic indicators

Definitions and data sources for macroeconomic indicators
Data for 1992-99 represent official estimates of out-turns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the Institute of International Finance and Tacis Economic Trends. Data for 2000 reflect EBRD staff assessments, based in part on information from these sources. Because of frequent revisions to official data sources, there may be changes to all series published in the *Transition Report* and *Transition Report Update* from year to year.

Country-specific notes can be found under each country table.

Output

Official estimates of GDP, industrial and agricultural production. Growth rates can lack precision in the context of transition due to large shifts in relative prices, the failure to account for quality improvements, and the substantial size of and change in the informal sector. In some countries, national authorities have started to incorporate the informal sector into their estimates of GDP.

Employment

For most countries, data reflect official employment records from the labour registries. In many countries, small enterprises are not recorded by official data. A number of countries have moved towards ILO-consistent labour force surveys in recording changes in labour force, employment and unemployment. Where available these data are presented.

Prices and wages

Data from the statistical offices or IMF. In some countries, notably Belarus, Turkmenistan and Uzbekistan, official CPI data may underestimate underlying inflation because of price controls and inadequate measurement of price increases on informal markets. Wage data are from national authorities and often exclude small enterprises as well as the informal sector.

Government sector

Data for the general government, including local government and extrabudgetary funds, where available. Data for most countries are from IMF country reports. Budget balance data can differ from official estimates due to different budgetary accounting, in particular with respect to privatisation revenues and net 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 from 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. Belarus, Turkmenistan and Uzbekistan operate dual exchange rate systems or have substantial parallel markets with high premiums on the official exchange rate. Please refer to the country-specific notes for details on the reported exchange rates. Data 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. Country notes provide further details. Trade data are on a balance of payments basis as published by the monetary authorities and IMF country reports. External debt are EBRD staff estimates based on IMF country reports and national authorities.

Transition report 2000

The *Transition Report* is a unique source of information on developments in central and eastern Europe, the Baltic states and the Commonwealth of Independent States. Drawing on the EBRD's experience as an investor in 26 countries in the region, the Report offers comprehensive analysis of each country's progress in the transition towards a market economy.

Country-by-country assessments and statistical tables provide invaluable information on progress in the key areas of market liberalisation and competition, macroeconomic stabilisation, enterprise restructuring and privatisation, reform of finance and infrastructure and legal reform. Offering extensive coverage of structural reforms, institutional and behavioural change and economic performance, this annual publication makes essential reading for investors, policy-makers and researchers.

The special theme of this year's *Transition Report* is "Employment, skills and transition". The Report focuses, in particular, on recent trends in employment and on the way that both the people and enterprises of the region have adapted to the introduction of markets and private enterprises as well as to rapid technological change in the advanced market economies. In assessing the diverse patterns of the labour market across the region, the Report looks at the ways in which individuals have adapted, including multiple job holdings and entrepreneurial activities, and examines the suitability of available skills to the requirements of employers. It also covers recent trends in poverty arising from both unemployment and under-employment in many transition countries and from weaknesses in social safety nets.

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