Transition report 2001
Energy in transition

European Bank
for Reconstruction and Development

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

Guide to readers

Country groupings

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

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

Abbreviations

The Bank, EBRD	The European Bank for Reconstruction and Development
BIS	Bank for International Settlements
CEB	central eastern Europe and the Baltic states (see country groupings above)
CEE	central and eastern Europe and the Baltic states (see country groupings above)
CEFTA	Central European Free Trade Agreement
CIS	Commonwealth of Independent States (which includes as full or associate members all countries of the former Soviet Union, except the Baltic states)
CPI	consumer price index
CSFR	Czech and Slovak Federal Republic
EC	European Community
ECE	Economic Commission for Europe
EFTA	European Free Trade Area
EIB	European Investment Bank
EIU	Economist Intelligence Unit
ESCO	energy service company
EU	European Union
FDI	foreign direct investment
FRY	Federal Republic of Yugoslavia
FYR	Former Yugoslav Republic
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
IAS	international accounting standards
IFC	International Finance Corporation
IFI	international financial institution
ILO	International Labour Organization
IMF	International Monetary Fund
IPO	initial public offering
IOSCO	International Organisation of Securities Commissions
ISPA	Instrument of Structural Policies for Pre-Accession
IT	information technology
MEBO	management-employee buy-out
MFI	mutual financial intermediary
na	not available
NGOs	non-governmental organisations
OECD	Organisation for Economic Cooperation and Development
PPP	purchasing power parity
PSA	production sharing arrangements
R&D	research and development
RPI	retail prices index
SEE	south-eastern Europe (see country groupings above)
SMEs	small and medium-sized enterprises
SOEs	state-owned enterprises
Tacis	Technical assistance for CIS countries (EU)
UN	United Nations
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VAT	value added tax
WTO	World Trade Organization

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Transition report 2001

Energy in transition

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Foreword

This *Transition Report,* with its special topic of energy in transition, is the eighth in an annual series. Taken together, the Reports chart the progress of transition from a command to a market economy in each of the 27 countries of central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) 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 27 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* therefore take 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 economic performance. 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. It also highlights the pitfalls in transition that have impeded reforms in other countries. Central to this analysis is an assessment of the role of economic liberalisation and democratic political processes in helping to sustain progress in market-oriented reform. It is also recognised that progress in international integration can complement – but not replace – these domestic factors in underpinning progress in reform. This effect can be seen most clearly in the strong reform progress and macroeconomic performance in those transition economies that are EU accession candidates. A key challenge for the region is to strengthen the process of international integration in those countries that are not EU accession candidates, in particular through accelerated accession to the World Trade Organization (WTO) for the large CIS economies.

Each *Transition Report* also has a special theme. These themes have developed a detailed analysis of the transition and the forces shaping its progress. They have also examined 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;
- 1999 – Ten years of transition (a special issue); and
- 2000 – Employment, skills and transition.

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

Part II of this year's *Transition Report* contains an analysis of the primary and secondary energy sectors of the transition economies. Recognising the importance of energy resources as a potential source of future economic prosperity in Russia and the Caspian region, the Report highlights the policy challenges that must be addressed to fulfil this potential. It emphasises in particular the importance of a stable investment regime, a redefinition of the role of the state in the energy sector, including macroeconomic management of energy resource income and environmental protection, and improvements in access to transport infrastructure on a competitive basis. Addressing the last challenge will require regional cooperation and international assistance.

The Report also analyses progress in the reform of the electric power sector. It shows that improvements in energy efficiency are closely linked with energy price reform. However, for this price reform to be sustained, there must be a regulatory and institutional framework that supports private investment in the secondary energy sector and that protects the most vulnerable segments of the population from price adjustments. With appropriate policies, both net energy-producing and net energy-consuming countries in the region are likely to emerge with higher standards of living, more energy efficient technology and a cleaner environment.

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 early October 2001.

Willem Buiter
Chief Economist and Special Counsellor to the President

19 October 2001

Executive summary

Chapter 1: Globalisation and regional integration

Globalisation and regional integration have transformed the world economy in the past half-century. Nowhere have these two processes been more dramatic than in the 27 countries of central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) in which the EBRD operates.

These countries have emerged from long periods of communism and economic self-sufficiency within the Council for Mutual Economic Assistance (CMEA), the Soviet-era trade bloc. Their transition towards a market economy has involved in most – but not all countries – a clear outward focus through trade liberalisation and openness to foreign investment. The resulting changes in the structure and direction of trade and the inflow of capital have been substantial. The change in the structure of production has also been dramatic. While initial disruptions to production were severe, and in some countries prolonged, the region has in recent years seen a strong and increasingly broad recovery.

The impact of globalisation, however, is not confined simply to changes in output. Globalisation dramatically increases the freedom of choice of consumers and producers and of savers and employees, which is important in its own right. Globalisation has had a significant influence on the role of government in industrialised market economies and it is a key factor in driving reform of the state in transition economies, too. Indeed, to benefit from globalisation, governments not only need to tear down barriers to trade and investment but also to build strong institutions that support markets and provide social assistance to those losing out.

The process of globalisation also reveals the need for effective governance at the regional and global levels. For example, the need for global environmental protection requires a global response. Similarly, the expansion of trade from the transition economies to global markets requires the regional integration of transport infrastructure, for which regional government cooperation is crucial.

On balance, the processes of globalisation and regional integration have been and will continue to be beneficial to those affected by them. Where there have been losers – and where there may be more in the future – the response should be not to raise the drawbridge but to create mechanisms to safeguard the losers against deprivation and hardship. Where there are increased interdependencies among countries, the response should be to develop mechanisms and institutions that support the effective management of these ties.

Part 1: Transition and economic performance

Chapter 2: Progress in transition

The past year has seen sustained progress in reform across most dimensions of transition. A number of countries that have been lagging behind in reform have taken significant strides over the past year, including Bosnia and Herzegovina, the Federal Republic of Yugoslavia and Romania on the basis of favourable political and economic developments in SEE. Supported by a strong recovery, a number of CIS countries also achieved significant reform gains, in particular Russia but also Azerbaijan, and, from low levels, Belarus and Uzbekistan. At the same time, many countries at more advanced stages of transition that are candidates for accession to the European Union continued to make steady progress in strengthening the performance of their market-supporting institutions. Only in Turkmenistan, where the political commitment to reform has been weak, was there backtracking in reform.

These recent reform developments largely conform with well-established patterns of transition. In most countries of the region, this includes liberalisation and small-scale privatisation ahead of large-scale privatisation and the development of market-supporting institutions. Moreover, the foundations for sustained progress in market-oriented reform appear to have been laid in countries where liberalisation has taken root and where a private sector has begun to develop through small-scale privatisation and the elimination of market entry barriers. Well-functioning democratic political systems also point towards sustained progress. This process is not guaranteed, however. It is also important to recognise that the process of international integration can complement domestic factors and help to sustain reform progress. The prospect of EU accession has had a significant influence on the extent of reforms in many CEB and SEE countries. For the CIS this highlights the need to promote greater international trade and investment through accession to the World Trade Organization (WTO).

Chapter 3: Macroeconomic performance and prospects

Following record growth in 2000, weakening world economic performance has begun to have an impact on the transition economies. Moreover, the events of 11 September have heightened the uncertainty surrounding the outlook for the region. Nonetheless, the region as a whole is still expected to record its third successive year of positive growth in 2001 at 4.4 per cent. Unfolding world events are, however, expected to affect the various parts of the region in different ways.

Having redirected their activity towards Western markets and investors, CEB is most exposed to a slowdown in western Europe, with growth in 2001 likely to slow down to 2.9 per cent and to 2.7 per cent in 2002. While this year will be the first in which SEE and CIS growth is expected to exceed that of CEB, at 4.0 per cent and 5.8 per cent respectively, the outlook for 2002 in both regions is more uncertain. In SEE, growth in 2002 is still expected to remain robust at 3.8 per cent but could suffer as exports decline and foreign financing becomes less available. In the CIS the outlook depends on developments in the price of oil. The EBRD's forecast of 4 per cent growth for 2002 is based on the assumption that prices will decline only moderately from present levels.

While the emerging macroeconomic challenges will vary by sub-region, so too will the ability of policy to respond to those challenges. In CEB the main policy challenge will be to support growth against a backdrop of falling net exports without exacerbating already high fiscal and external deficits. A combination of fiscal tightening and flexible monetary policy will be necessary to support balanced growth. Fiscal policy is even more constrained in SEE while monetary policy is also less flexible due to high inflation rates or exchange rate arrangements. Consequently SEE should focus on encouraging FDI flows through improvements in the investment climate, continued privatisation and effectively targeted investment incentives.

As the outlook for oil prices remains uncertain, Russia and the resource-rich CIS countries must adapt and strengthen financial policies to reduce the impact of commodity price volatility on domestic stability. Finally growing intra-CIS trade has underpinned the recent recovery in the sub-region, highlighting the potential benefits of reducing intra-CIS trade barriers in conjunction with measures aimed at international integration.

Part II: Energy in transition

Chapter 4: Managing energy resource wealth

Transition countries are rich in both traditional and renewable energy resources. Russia and the Caspian countries in particular are increasingly dependent on their energy wealth and have the potential to become important international suppliers of energy, particularly of natural gas. However, so far these countries have not taken full advantage of their resource wealth. A large fraction of the generated income has been dissipated unproductively, often in the form of energy subsidies. Energy-rich countries have, on average, also made less progress on market liberalisation and reform.

Huge investments are required if the region is to realise its energy potential. Much of this capital will have to come from external sources. To attract foreign funds, energy-rich countries will have to provide a stable investment climate and competitive tax arrangements. Equally, the incumbent domestic producers need to improve their corporate governance and financial transparency to become attractive to outside investors. Another crucial reform step, therefore, is to change the role of the state in the energy sector.

Governments need to divest from productive assets and focus on regulatory supervision of the sector, on reducing widespread corporate governance violations, and on ensuring compliance with environmental best practice. A particularly important role for government is to foster competitive market access by regulating existing transport monopolies and by creating the conditions – including through intergovernmental cooperation – for alternative pipelines to be built. Finally, as energy revenues are beginning to flow, better resource management is increasingly needed to avoid macroeconomic instability and to ensure long-term sustainable development.

Chapter 5: Improving efficiency in energy conservation and use

The centrally planned economies were highly inefficient in the use of energy. Since the start of transition, energy consumption and associated emissions of pollutants have fallen significantly. However, this is largely due to the fall in output by heavy energy users, particularly in the CIS. While energy efficiency, measured as the ratio of energy consumption per unit of output, has improved in CEB and SEE, all transition countries still lag significantly behind the OECD in this respect.

Slow progress in energy sector reform and flawed tariff policies have been the main factors delaying improvements in energy efficiency. As a result, pollution levels remain high while more efficient and environmentally sustainable technologies have not been widely introduced. In addition, old-style energy “guzzlers” have been allowed to survive on low energy prices and weak cash collection, at significant costs to society.

Price reform is the key to improved energy efficiency. However, if they are to be politically and socially acceptable, price increases need to be accompanied by explicit support for poor households. The current policy of across-the-board subsidisation should be replaced with targeted support, which costs less and enhances incentives to reduce waste. Price reforms also need to be complemented by institutional changes. This should involve the progressive introduction of the private sector alongside steps to improve the regulatory and competitive environment. The order in which these reforms are introduced is critical.

Experience shows that a sound regulatory framework must be established prior to privatisation. Privatisation should, where possible, involve strategic investors and, given the widespread absence of payments discipline, should generally focus first on distribution, with privatisation of generation coming later. The experience of countries most advanced in energy sector reforms reveals that comprehensive steps undertaken in the correct order can help to save energy, reduce pollution and increase the reliability of power and heat supplies while constraining social hardship and limiting the fiscal costs of energy subsidies.

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The authors of the chapters and annexes are:

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José Carbajo, Mark Dutz, David Kennedy and Maria Vagliasindi contributed to the infrastructure section in Chapter 2, Wim van Aken to Box 2.2, and Elizabeth Smith and Caroline Webb to Box 4.2. Daliborka Strika provided valuable research support for Chapter 2, Lionel Artige for Chapter 3, Natalya Shevchik for Chapter 4 and Mikkel Barslund, Jan Cornillie and Natalya Shevchik for Chapter 5.

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Lucie Ryan prepared the text tables and charts for publication.

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Globalisation and regional integration

1

Globalisation and regional integration have transformed the world economy in the past half-century. Nowhere have these two processes been more dramatic in their scope and speed than in the 27 countries of central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) in which the EBRD operates.

The transition economies have emerged from long periods of communism and economic self-sufficiency within the Council for Mutual Economic Assistance (CMEA, the Soviet-era trade bloc). Their transition towards a market economy has involved in most – but not all – countries an outward focus demonstrated through trade liberalisation and openness to foreign investment. The resulting changes in the structure and direction of trade and the inflow of capital have been substantial. The change in the structure of production has also been dramatic. While initial disruptions to production were severe and in some countries prolonged, the region has in recent years seen a strong recovery. Beginning in 1994 in CEB, this recovery has in recent years extended to SEE and the CIS (see Chapter 3).

The impact of globalisation, however, is not confined simply to changes in output over the medium term. Globalisation dramatically increases freedom and domain of choice for consumers and producers and for savers and employees, which is important in its own right and fundamental to sustained growth. This in turn has a significant influence on what is required of government and, in a democratic system, demanded from it. For example, producers require from government economic policies that are predictable and effective market-supporting institutions that enable them to compete in the global economy. At the same time, employees require access to education and training, health care and a "safety net" that enable them to participate in the market economy.

The process of globalisation has had a significant influence on the role of government in industrialised market economies. This has been just as significant in the transition economies, particularly in the EU accession countries (see Chapter 2). The transition economies stand to benefit substantially from international integration, gaining from trade between economies with very different resource endowments and from the influence of globalisation on the effective development of market-supporting institutions.

As well as exerting a significant influence on the role of government within countries, globalisation reveals the need for effective governance at the regional and global levels. For example, the need for global environmental protection and management of greenhouse gas emissions requires a global response (see Chapter 5). Similarly, the expansion of trade requires the regional integration of the transport infrastructure to facilitate the flow of trade, particularly in transition economies where infrastructure was designed for a trade system that was largely confined to the communist countries (see Chapter 4). These examples point to the need for international or intergovernmental mechanisms to support the effective management of the global economy.

On balance, the processes of globalisation and regional integration have been and will continue to be beneficial to those affected by them. Where there have been losers – and where there may be more in the future – the response should be not to raise the drawbridge but to create mechanisms to safeguard them against deprivation and hardship. Where there are increased interdependencies between countries, the response should be to develop mechanisms and institutions that support this process. However, before it is possible to make an assessment of the impact of globalisation and regional integration on central and eastern Europe and the CIS, some key concepts need to be defined and put into context.

1.1 Globalisation: a definition

Globalisation involves steady declines in the importance of national political boundaries and geographical distance and increasingly complex interdependencies among countries. A new phase of this process began at the end of the Second World War. People, goods and services, raw materials, financial capital, enterprises, technology, brand names, knowledge, ideas, culture and values now move more easily across national frontiers than at any time since the beginning of the First World War. There is also greater potential for environmental spillover effects, such as acid rain and ozone depletion, as a result of expanding populations and industrial activity. These processes are referred to collectively as globalisation and it affects virtually every nation or region in the world.

Much of the recent surge in globalisation is due to technological advances that reduce the cost of transportation and communication and to deliberate political decisions to reduce or even to eliminate artificial barriers to international mobility. The first of the two driving forces is irreversible, barring a catastrophe that reverses technological progress. However, setbacks to the ongoing reduction in the cost of transportation and communication can occur. An example is the global increase in the cost of air travel and in other costs of engaging in international trade resulting from the terrorist attack on the United States on 11 September.

The political forces supporting the lowering of artificial obstacles to international trade and mobility cannot be taken for granted. They have been reversed in the past and can be reversed again. Between 1870 and 1914 international trade in goods and services was as free as it is today. International lending and borrowing were also highly developed and subject to few official restrictions. The range of financial instruments traded internationally was of course much more limited in those days. However, mobility of people, including international migration, was less restricted during the Gold Standard days than it is today.

Governments can attempt, with varying degrees of success, to build "firewalls" around their countries to control rigidly the movement of people and the level of information transmitted through the media and the Internet. A few countries have succeeded in cutting off their populations from virtually any form of contact with the rest of the world. Current examples are North Korea and Myanmar. Even for these countries, however, gradually widening cracks are appearing in the walls of these "isolation ward" nations.

Globalisation has even produced a global movement against globalisation. Its most vocal critics include such diverse groups as environmentalists, blue-collar trade union members from the industrialised countries and groups fighting to eliminate Third World debt. It also includes violent anarchists and nihilists. In fact, these disparate elements are sometimes brought together by the same technological innovations and political developments that support globalisation, such as the Internet and the relaxation of visa requirements.

1.2 Pathological globalisation

The universal nature of the globalisation process is undeniable but it has both negative and positive aspects. On the negative side, national frontiers and geographical distance have become increasingly less effective in preventing the spread of disease, pollution, crime and terrorism. Examples of "pathological globalisation" – unambiguously negative aspects of globalisation – include the following:

- The international spread of contagious diseases has accompanied the increased mobility of people and animals. Historically, smallpox and measles have destroyed societies. Today, tuberculosis, HIV-AIDS, Ebola virus, Nile virus and the flu virus can spread with alarming speed. So can bovine spongiform encephalopathy (BSE) and foot-and-mouth disease.

- Global capital flows combined with instantaneous worldwide communications have increased the threat of international contagion in financial markets, of global panics and of worldwide swings from irrational exuberance to groundless despondency.

- With an expanding population and increasing industrial activity, environmental problems, such as ozone depletion and greenhouse gas emissions, have global implications. The first is being effectively tackled through international agreements but the second has yet to be addressed adequately.

- Crime (the drugs trade, money laundering, tax evasion and Internet viruses) has become a global industry.

- Terrorism has become a worldwide threat perpetrated by loose global networks of terrorists.

- Threats to national or regional cultures and identities are sometimes seen to be posed by a global culture of consumerism that is spread rapidly through the media.

Apart from possibly the last example, these pathological forms of globalisation can only be tackled effectively through global action – worldwide coordinated measures by governments, international organisations and pressure groups. Safety through withdrawal, exclusion or isolation is not an option.

1.3 The benefits of globalisation

Globalisation brings many benefits. It is first and foremost about increasing opportunity, choice and freedom. The simple fact is that globalisation brings greater scope for mutually beneficial trade through specialisation, division of labour and diversification of risk. It boosts learning opportunities by helping countries to benefit initially from the experience of others and subsequently to invest in new knowledge and skills. While it is not yet possible for people to move to opportunities anywhere in the world, the obstacles to the international movement of people – as tourists, consumers, investors and economic migrants – have been diminishing for the past 50 years. Concerns about global terrorism have hampered this process but once the lessons have been learned and proper measures have been implemented, the process of globalisation will resume.

As a result of globalisation, regions and nations can safely specialise in the production of far fewer goods and services than they wish to consume because specialist products can be traded internationally for a wide selection of consumer goods. Access to global financial markets and international portfolio diversification makes it possible, in principle, to insure a nation against the risks (for example, in terms of trade fluctuations) associated with specialising in the production of a relatively narrow range of goods and services in an uncertain global environment. Young workers can move from countries with a predominantly young population and limited opportunities to countries that have an ageing population and a "youth deficit" but ample employment.

If the causes of disease travel internationally, so do cures and the means of administering them. The international community of learning is more than the sum of its constituent national parts. Knowledge, once it has been developed, is not diminished by being shared. Existing knowledge should therefore be shared freely by all. The creation or development of new knowledge, however, involves a costly investment process. The problem of striking the right balance between the efficient or free dissemination of existing knowledge and the creation of the right incentives for investing in the development of further knowledge will have to be resolved through global cooperation, legislation, rule making and enforcement. Access to the learning and cultural achievements of the rest of the world can enrich every nation.

The key political issue of our time is to ensure that institutions are created – at local, national, regional and global levels – to ensure that the gains from globalisation are shared widely and fairly. Global cooperation and effective global institutions are also necessary to eliminate, or at least to control, the negative aspects of globalisation. The rewards from globalisation will not be reaped without active institution-building efforts at all levels. It is not enough for governments to lower or even abolish all artificial barriers to trade and mobility and to wait for spontaneous order to emerge.

The benefits and costs of globalisation are not evenly distributed across countries, regions, sectors, industries or people with different skills or other characteristics. Some countries' experience of globalisation is limited to its negative aspects. Afghanistan, for example, has tasted the bitter fruits of military invasion, the global drugs trade and terrorism. For many decades, it has tasted very few of globalisation's sweeter fruits: the gains from international trade in goods and services and from international risk-sharing through financial portfolio diversification; the benefits of access to global expertise through foreign direct investment (FDI); and cultural and educational exchanges.

1.4 Obstacles to realising the gains from globalisation

A key obstacle to realising the potential gains from globalisation and distributing them fairly is the growing gap between, on the one hand, the increased mobility of people and trade, and, on the other hand, the effectiveness of jurisdictions in regulating this. The gains from the free movement of trade and the rewards of financial integration, global specialisation and diversification cannot be reaped without legal and regulatory measures. They require the rule of law and an effective supervisory and regulatory regime. In addition, political institutions and mechanisms are needed to ensure that the final distribution of income is widely perceived to be fair or at least acceptable.

Markets, international enterprises, investors, workers and consumers currently exceed the control of legislators and regulators in many ways, as shown below.

- Financial markets are global but financial regulation and supervision are mostly national.
- There is no international institution to serve as global lender of last resort in an international financial crisis.
- There is no effective mechanism for dealing efficiently with international sovereign debt defaults.
- Even when trade liberalisation results in global gains, individual countries may end up worse off. For example, a reform to global markets may weaken a country's monopoly power in a particular sector. Mechanisms for compensating for consequent losses exist but they tend to be organised at the national level, through the tax system. Assistance to help companies adapt to the advantages of the trade liberalisation programme also tends to be organised and funded at the national level. If those who lose out are numerous and/or well-organised, trade liberalisation may not be politically supported.
- Even if trade liberalisation makes a particular country potentially better off on the whole, there are likely to be both winners and losers.

Owners of raw materials specific to a sector that becomes more exposed to international competition may see their income eroded. Some of the blue-collar workers demonstrating at the World Trade Organization Ministerial Meeting in Seattle in September 2000 were responding to the real threat to their existing livelihoods posed by trade liberalisation.[1]

Within a particular country, redistribution or compensation measures may have limited scope and effectiveness. This is particularly the case in countries where the capacity of the state to administer and to tax is limited. In all the EBRD's countries of operations the least advanced aspect of the transition process is the establishment of the state as a limited but competent regulator, supervisor and financier of public goods and services, such as macroeconomic stability and an effective social safety net. Reforms and liberalisation that could have universal benefits are often not implemented because, in the absence of effective compensation, the reformers cannot gather sufficient political support. When workers move internationally, pension systems (including social security) and medical insurance remain overwhelmingly a national responsibility. Enterprises and owners of capital can move globally but taxation of enterprises and of capital owners remains national. Environmental, labour and safety standards also remain mostly national.

1.5 Globalisation and the EBRD's countries of operations

During the era of central planning, the countries of central and eastern Europe and the former Soviet Union were forced into a massively inefficient pattern of regional specialisation and division of labour. Trade between the CMEA countries and the rest of the world was artificially restricted to very low levels.[2] Also, within the CMEA area, excessive specialisation took place. Production of goods was concentrated in plants of extreme size. Public services, such as health and education, were given priority but market services or private services were starved of resources. Specialisation in industrial production was excessive and paid little attention to the basic economics of proximity to raw materials or markets.

While some CMEA governments, including Hungary, Poland and the USSR, borrowed in the international financial markets prior to the collapse of the Soviet Union, the CMEA was not integrated into the international financial system. There was no internal, domestic financial market and only a very rudimentary system of retail and saving banks.[3] There was an occasional FDI initiative but no regular or systematic exploration by foreign strategic investors of commercial opportunities. Labour mobility was practically non-existent between the CMEA and the rest of the world. The exchange of know-how and learning opportunities were severely restricted.

If there was ever a group of countries for which the benefits of globalisation would be positive and far-reaching, it was the area of central and eastern Europe and the former Soviet Union in 1991. The countries of CEB, which were richly endowed with a well-trained workforce and with the memory of the market economy still alive among the old, needed access to global markets, foreign technology and capital to overcome the damage done by 45 years of central

1 This does not deny that technological change has posed a greater threat than trade liberalisation to traditional blue-collar standards of living in the industrial countries.

2 The former Socialist Federal Republic of Yugoslavia was not part of the CMEA. As a result, the enforced specialisation was much less pronounced than elsewhere in central and eastern Europe and the former Soviet Union. Albania pursued a strategy of almost complete self-sufficiency – at enormous cost to its population. Some central European countries, especially Hungary, had begun to pursue trade opportunities outside the CMEA for some time before the break-up of the Soviet Union.

3 The Socialist Federal Republic of Yugoslavia had greater integration in the international financial system than the EBRD's other future countries of operations.

planning. Free trade in goods and services and FDI were key to economic regeneration. The liberalisation of portfolio capital movements was not essential from the point of view of generating capital as long as the proceeds from privatisation were sufficient to finance both fiscal and external deficits.

For individual private savers (including pension funds and other institutional investors), international portfolio diversification would have been desirable from the outset of the transition process. However, capital account liberalisation for portfolio transactions could have contributed to systemic instability without the establishment of a strong, well-supervised and regulated domestic banking sector, non-banking financial sector and capital market. Even today, not all CEB countries have created sufficiently robust and efficient domestic financial systems to ensure that international financial integration for portfolio investment purposes is likely to be a boon rather than a source of instability.

The CEB countries were able to finance and administer a social safety net that helped to alleviate the hardship and deprivation experienced by those whose traditional livelihoods were destroyed as a result of integration in world markets. This assisted in maintaining political support for trade liberalisation and other areas of reform.

The excessive degree of specialisation in production inherited from central planning made it essential for all countries in central and eastern Europe and the former Soviet Union to open up to the global economy. Like the CEB countries, the CIS started the transition with a highly educated and skilled labour force. Unlike the CEB countries, there was no surviving memory of a formal market economy although informal markets were thriving in a number of countries, notably in republics on the periphery of the former Soviet Union, such as Georgia. For the internationally exposed sectors, world prices provided the benchmarks that guided domestic producers and consumers towards the efficient use of resources. For the internationally sheltered sectors, domestic markets often had to be created from scratch without the benefit of readily created price and cost benchmarks. This has turned out to be a long and costly process.

Unlike the countries in CEB and SEE, a number of CIS countries had independence thrust upon them. Some had no tradition and experience of self-government. Creating a limited but capable state – including regulation, supervision and administration of the rule of law, and the enforcement of property rights and contracts – has turned out to be the greatest transition challenge of all. Many CIS countries have struggled to finance and administer a social safety net that provides effective insurance for the losers in the transition process while maintaining popular support for necessary market reforms. They have also faced the challenge of providing education and health care to help ensure that their citizens are able to participate in the market economy. The cost and administrative complexity of putting together an effective state in the transition process have proved to be beyond the reach of many CIS countries so far. The result is widespread poverty and hardship.

Is trade liberalisation and limited capital account liberalisation – often restricted to FDI – to blame for this? The answer is no. The collapse of central planning was not a choice of any country or government. Communism and central planning collapsed because these economic and political systems were dysfunctional and could not survive. Trying to preserve the central planning apparatus in the individual successor states of the former Soviet Union was not a viable option. Also, economic self-sufficiency was not feasible even for Russia, the largest and most diversified of the CIS countries. Integration in the global economy was a matter of survival.

1.6 Regionalism and the EBRD's countries of operations

There are two distinct but potentially complementary reasons for pursuing regional economic and/or political integration. First, certain issues are addressed most effectively at the regional rather than the national or global level. For example, issues involving an entire region, such as acid rain, river pollution, fishing rights and exploitation of a common resource, are best addressed at a regional level. Second, although certain issues are best addressed globally, the political institutions for effective action only exist – or have the possibility of being created – at a regional level.

There are several regional economic integration efforts under way in the EBRD's area of operations. The EU enlargement process is the most significant of these for the EBRD. It directly involves ten of the Bank's countries of operations (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia) and indirectly concerns the remaining 17 countries since they are excluded from the process. It also has a direct impact on the EBRD's mandate to promote the transition. Many of the requirements of the *acquis communautaire* for the EU accession countries will also support the transition process for these economies. Other regional initiatives under way include the Stability Pact for SEE and economic, political or security-focused arrangements that bring together different groups of CIS countries.

1.7 EU enlargement

European economic and political integration, including the current phase of EU enlargement, is a means of ending a millennium of intra-European conflicts. Economic integration – the creation of a customs union and a single European market and the adoption of a common currency (by 12 of the 15 existing EU members) – has been the primary way of achieving the political objective of ending armed conflict among European nations. European economic integration has also been the method used by the west European and other nations to reap the rewards from freer trade, enhanced financial integration, common regulatory and supervisory rules, and greater mobility of people.

However, regional trade liberalisation is not always desirable from a global point of view. The benefits of trade creation among the members of a customs union may be counterbalanced by the loss of trade with those countries excluded from the union. In the case of the EU, trade creation has outweighed loss of trade in most areas, with the common external tariff of the European Union being lower than the average of the national external tariffs that previously existed. There has also been significant progress in reducing non-tariff barriers to trade.

Notable exceptions to this positive assessment can be found in agriculture, where the Common Agricultural Policy (CAP) is regarded by many observers as a tax not only on the European consumer but also on farmers in the rest of the world, including some of the very poorest. Also, in industries such as textiles, footwear and other semi-skilled manufactured goods, tariffs, quotas and other non-tariff barriers to trade in the industrialised market economies have hampered the efficient allocation of global resources and caused hardship in many emerging markets and developing countries.

To realise the gains from globalisation, certain global arrangements or institutions are required. However, sharing sovereignty at a global level is only feasible to a limited extent. Regional integration efforts have a greater chance of success but should not involve the creation of additional barriers between the region and the rest of the world.

The 15 EU members and the 12 countries in the process of joining the EU will create the largest single market in the world (until China or India develop their full potential or until the two American continents achieve a common market). Enlargement means the removal of artificial (legal, regulatory or tax) obstacles to the movement of goods and services, finance and enterprises. After a transitional period this will also apply to the movement of EU residents looking for work in the European Union. Enlargement also entails the implementation of the *acquis communautaire* throughout the enlarged EU. It should be an example at the regional level of many of the potential benefits of globalisation. The existing EU members and the candidate countries have enough in common, through geography, history and culture, to create the institutions that will permit the potential gains from globalisation to be shared fairly.

It is essential for the EU enlargement process to be outward-looking and inclusive instead of inward-looking and exclusive. In the field of trade, care must be taken to ensure that the enlarged EU is "trade creating" for the world as a whole rather than "trade diverting" at the expense of the countries left outside the enlarged Union. In all dimensions of the accession process – economic, environmental, political and social – the EU enlargement needs to enhance the transition process for all of the EBRD's 27 countries of operations. It must not divert the transition process towards the accession countries at the expense of the 17 countries of operations that are not candidates for accession.

The enlarged EU should open its markets to the goods and services produced outside its boundaries. This could take the form of free trade agreements with at least some of the 17 transition economies that are not EU candidate members and it should not exclude products such as agricultural commodities, textiles, footwear and steel and light engineering products (see Chapter 2). The cost to the European Union would be small and the benefits to the transition economies would be large.

In addition, visa and work permit arrangements should be implemented for countries adjacent to the expanded EU borders, which would otherwise be deprived by the Schengen Agreement (regarding the free movement of people between EU countries) of the current opportunities for employment in countries such as Poland and other accession candidates. The unique geographical position of Kaliningrad as a Russian enclave in an enlarged EU makes a flexible interpretation and application of the Schengen Agreement unavoidable.

For 40 years, Europe was divided by an Iron Curtain. It is vital that a "Brussels Lace Curtain" is not created on the new frontiers of the enlarged EU. EU enlargement can show how the potential gains from globalisation may, with the right institutional framework, be turned into regional gains that are not achieved at the expense of those left outside the enlarged Union.

1.8 WTO accession and the transition countries

To ensure that the gains from globalisation are widely distributed, further progress is needed in the liberalisation of trade and in the movement towards greater uniformity of the rules governing trade between countries and regions. This is particularly relevant in the context of the transition economies. A substantial number of these countries have already acceded to the World Trade Organization (WTO), including all CEB countries as well as Albania, Georgia and Moldova. Others, such as Russia, Ukraine and the Caspian countries, have started the process of accession but major challenges remain for these countries – particularly Russia – if accession to the WTO is to be achieved in the near future (see Chapter 2).

Much depends on the progress with Russian accession, in part because of the example it would set to other countries in the CIS region, but also because of the sheer size and economic importance of the country. Recently there have been encouraging signs. On a multilateral level there has been substantial progress in harmonising Russian legislation with WTO requirements. In bilateral negotiations with current WTO members, Russia has made considerable progress on market access for industrial products. Nevertheless, discussions regarding both agriculture and services have barely begun. Discussions concerning agriculture remain complicated by the ongoing debate about agricultural reform that is currently under way in Russia. More generally, in many of the CIS countries existing legislation and practices in important areas such as industrial subsidies, taxation, customs policy and anti-dumping remain substantially different from the requirements of the WTO.

The importance of WTO accession and any new round of multilateral negotiations – issues that are to be discussed at the WTO Ministerial Meeting scheduled for November 2001 – have been heightened by recent economic and political uncertainties and their negative impact on global output. The tendency to seek protection behind trade barriers in a difficult and challenging economic environment must be resisted. Moreover, a renewed impetus for trade liberalisation that addresses such sensitive sectors as agricultural commodities, textiles and steel could strengthen the incentive for those transition economies that remain relatively inward-looking to embrace a more outward orientation. It would also significantly broaden the benefits from globalisation throughout the world.

1.9 Market integration: the case of energy

Reducing the barriers to trade is of course only one aspect of a wider policy. Greater international collaboration is also increasingly needed in a range of areas. This *Transition Report* focuses on two related issues that have substantial cross-border implications: energy supply (see Chapter 4) and energy efficiency (see Chapter 5). In the first case, the region is growing in importance as a supplier of energy to west European and Asian markets. Greater cross-border cooperation and investment will be needed if the region's resource wealth is to be developed.

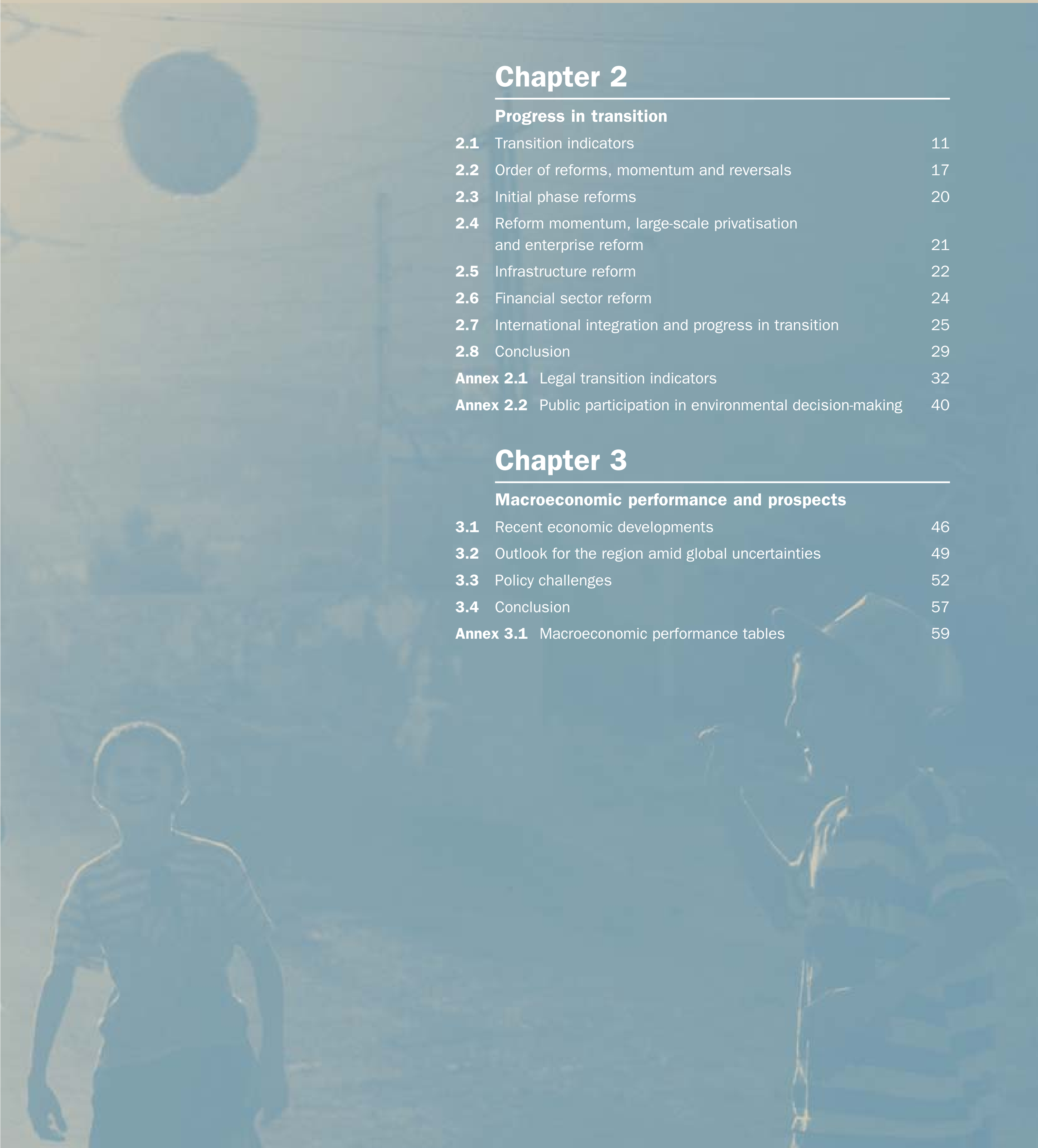
In the case of energy efficiency, the legacy of wasteful energy use raises issues of domestic efficiency and global environmental protection, which have yet to be adequately addressed. Greenhouse gas emissions have dropped significantly over the last decade in SEE and the CIS – allowing the countries to meet the targets under the Kyoto Protocol – but energy use relative to GDP remains between nine and 13 times higher than in the European Union. Furthermore, compared with the countries of the European Union, transition countries still emit between three to nine times as much greenhouse gases per unit of output.

The transition countries still do not use energy as efficiently as they could. Many of the inefficiencies are linked to delays in the transition process, in particular the slow restructuring of energy-intensive industries and the lack of reform in the power sector, and energy subsidies have been widely used as a way of supporting failing firms. This is of particular significance in terms of the ongoing WTO accession discussions. However, the main factor that explains high energy intensity is pricing. In most transition countries, energy prices and collection rates remain too low to provide sufficient incentives for energy conservation.

Reforming tariffs and establishing institutional mechanisms for compensating poor households are the primary challenges for the region if it is to use its abundant energy resources efficiently while further protecting the environment.

Part I

Transition and economic performance



Chapter 2

Chapter 3

Progress in transition

2

Reform momentum in most countries of central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE) and the Commonwealth of Independent States (CIS) was sustained in 2001. Several SEE countries benefited from favourable political and economic developments and achieved strong reform gains, particularly Bosnia and Herzegovina, FR Yugoslavia and Romania.

Many CEB and SEE countries that are EU accession candidates continued to make steady progress as measured by the EBRD transition indicators. The vigorous economic recovery in Russia and other CIS countries (see Chapter 3) also supported advances in reform. Russia saw a significant improvement in corporate governance and business practices which was supported by an upturn in corporate profits. In Belarus and Uzbekistan, where the political commitment to market-oriented reform has been weak, administrative controls on access to foreign exchange were eased. However, it remains to be seen whether these countries will build on these recent measures to sustain progress. Turkmenistan, another CIS country with little political commitment to reform, retreated further from the reform process by abandoning the institutional framework for large-scale privatisation that was established in 1997.

This chapter outlines recent progress in market-oriented reform, placing these changes in the context of the reform patterns that have emerged since the start of transition in late 1989 (see the 2000 *Transition Report*, Chapter 2). These patterns include the order in which reforms have been undertaken. For example, liberalisation of markets and trade and small-scale privatisation have usually been tackled ahead of large-scale privatisation and the development of institutions that support markets and private enterprise. Where liberalisation of markets and trade has been sustained, and where democratic political institutions have been allowed to function, there tends to be sustained progress in large-scale privatisation and institutional development. This reflects the ability of liberal and open markets to foster the development of a competitive private sector while a democratic political system can direct government activities towards the development of market-supporting institutions. Domestic economic and political factors therefore have a major influence on sustained progress in transition.

This process, however, is neither automatic nor assured. For example, economic liberalisation does not ensure that created markets are competitive or that enterprises are free to enter and exit the market. 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.[1] Moreover, governments facing the pressure of an election can resort to populist policies that distribute short-term benefits to privileged groups at the expense of long-term growth. Such pressures were evident in the run-up to the Polish parliamentary elections in September 2001 when the grip on fiscal policy was loosened (see Chapter 3). They are also evident in Hungary, where the government has imposed punitive capital gains taxes and slowed private pension reforms, with detrimental effects on the local capital market.

It is therefore important to recognise that international integration can complement domestic factors in advancing reforms and in strengthening economic performance. The EU accession process has been a strong influence on the direction and pace of reform for the ten candidate countries of CEB and SEE, and this has helped to counter the influence of domestic vested interests. However, the influence of external factors is not welcomed in all quarters, as illustrated by the performance of nationalist political parties that are indifferent or opposed to EU accession in the recent parliamentary elections in Poland. While international integration can be a catalyst for reform and growth, it can also give rise to economic disruption and social costs that must be addressed. Moreover, not all countries in the region benefit from the process of EU accession. Russia and the other CIS countries are outside this process and remain relatively less open to the global economy. A key challenge for the large CIS economies and their Western partners is to develop a sustainable approach to outward-oriented development that combines accession to the World Trade Organization (WTO) with institutional developments that reflect the needs of domestic savers and investors.

The first section of this chapter introduces the EBRD transition indicators (see Tables 2.1 and 2.2). Section 2.2 examines the patterns of transition, focusing on the order of reforms and the domestic factors that sustain progress in reform or that contribute to reversals. This framework sets the context for the discussion on recent reform developments. Section 2.3 assesses progress in initial phase reforms (liberalisation of markets and trade and small-scale privatisation) in those countries that remain at the early stages of transition while Sections 2.4 to 2.6 discuss reform momentum and progress in large-scale privatisation and institutional development in countries at more advanced stages. Section 2.7 complements this analysis by examining the process of international integration of transition economies and the influence of this process on domestic reforms (and vice versa).

2.1 Transition indicators

The EBRD's *Transition Reports* have provided assessments of progress in transition for CEB, SEE and the CIS since 1994. Assessments are made for a number of core areas of reform that

[1] See the 1999 *Transition Report*, Chapter 6, Hellman, Jones and Kaufmann (2000) and Hellman and Schankerman (2000).

Table 2.1

Progress in initial reforms in central and eastern Europe, the Baltic states and the CIS

			Enterprises	Markets and trade	
Countries	Population (millions, mid-2001)	Private sector share of GDP in %, mid-2001 (EBRD estimate)[1]	Small-scale privatisation	Price liberalisation	Trade & foreign exchange system
Albania	3.4	75	4	3	4+
Armenia	3.8	60	4–	3	4
Azerbaijan	8.1	60	3+	3	3+
Belarus	10.0	20	2	2	2
Bosnia and Herzegovina	4.3	40	3–	3	3
Bulgaria	8.1	70	4–	3	4+
Croatia	4.6	60	4+	3	4+
Czech Republic	10.3	80	4+	3	4+
Estonia	1.4	75	4+	3	4+
FR Yugoslavia	8.6	40	3	3	3
FYR Macedonia	2.0	60	4	3	4
Georgia	5.4	60	4	3+	4+
Hungary	10.0	80	4+	3+	4+
Kazakhstan	14.9	60	4	3	3+
Kyrgyzstan	4.7	60	4	3	4
Latvia	2.4	65	4+	3	4+
Lithuania	3.7	70	4+	3	4+
Moldova	4.3	50	3+	3+	4+
Poland	38.7	75	4+	3+	4+
Romania	22.3	65	4–	3+	4
Russia	145.4	70	4	3	3–
Slovak Republic	5.4	80	4+	3	4+
Slovenia	2.0	65	4+	3+	4+
Tajikistan	6.2	45	4–	3	3+
Turkmenistan	5.4	25	2	2	1
Ukraine	49.3	60	3+	3	3
Uzbekistan	25.0	45	3	2	2–

[1] The "private sector share" of GDP represents 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]

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.

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 and current account convertibility.
4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership in WTO.

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 1994 *Transition Report*. To refine further the classification system, pluses and minuses have been added to the 1-4 scale to indicate countries on the borderline between two categories.

correspond with four main elements of a market economy – markets and trade, enterprises, infrastructure and financial institutions. Progress in each of these areas represents an improvement in how well markets, enterprises, infrastructure services and financial institutions function. Progress is measured against the standards of industrialised market economies, recognising that there is neither a perfectly functioning market economy nor a unique end-point for transition. The measurement scale for the indicators ranges from 1 to 4+, where 1 represents little or no change from a rigidly planned economy and 4+ represents the standard of an industrialised market economy.

Within the broad categorisation of market-oriented reforms, the EBRD transition indicators in Table 2.1 measure those reform areas in which significant progress was achieved relatively early in transition. They include liberalisation of markets and trade and small-scale privatisation. 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.[2] On privatisation, the indicators measure the extent to which ownership of small-scale enterprises has been transferred to the private sector. A few countries also pursued mass privatisation programmes for large-scale enterprises relatively early in transition, including the Czech Republic, Lithuania, Russia and the Slovak Republic. However, most countries in the region tended to pursue a more gradual pace in the privatisation of larger enterprises. This pace often reflected the economic and social constraints on restructuring large-scale enterprises that were not commercially viable.[3] These early-stage reforms are largely complete in most transition economies. A notable exception is FR Yugoslavia, which recently embarked on a comprehensive reform programme following the collapse of the autocratic regime of former President Milosevic in October 2000.

The EBRD transition indicators included in Table 2.2 go beyond initial phase reforms to include privatisation of large-scale enterprises and a range of institutional reforms required to support competitive markets and private enterprise. On competitive markets, the indicator assesses the extent and effectiveness of competition policy in combating the abuses of market dominance and anti-competitive practices. In relation to enterprises, the measures indicate: progress in large-scale privatisation; the implementation of reforms to cut production subsidies; the introduction of effective bankruptcy procedures; and sound corporate governance practices. On infrastructure, the indicators measure: the extent of tariff reform; the commercialisation of infrastructure enterprises; and the extent of regulatory and institutional development. Regarding financial institutions, the indicators measure: the extent to which interest rates have been liberalised; the establishment of two-tier banking; and the creation of securities markets. They also assess the extent to which prudential regulations have been raised towards international standards, whether they have been enforced effectively and if procedures exist for resolving the failure of financial institutions.

Chart 2.1 shows the overall transition indicator scores from 1989 to 2001 averaged across all countries of the region and across two broad dimensions of reform – liberalisation and small-scale privatisation on the one hand and large-scale privatisation and institutional development on the other. These averages provide a summary of region-wide

2 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.

3 For a discussion of enterprise restructuring, see the 1999 *Transition Report*, Chapter 9, and the 2000 *Transition Report*, Chapter 6.

Table 2.2

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

	Enterprises		Markets	Infrastructure					Financial institutions	
Countries	Large-scale privatisation	Governance and enterprise restructuring	Competition policy	Telecoms	Electric power	Railways	Roads	Water and waste water	Banking reform and interest rate liberalisation	Securities markets and non-bank financial institutions
Albania	2+	2	2–	3+	2+	2	2	1	2+	2–
Armenia	3	2	2	2+	3+	2	2+	2	2+	2
Azerbaijan	2	2	2	1	2	2+	1	2	2+	2–
Belarus	1	1	2	2	1	1	2	1	1	2
Bosnia and Herzegovina	2+	2–	1	3+	2	2+	2	1	2+	1
Bulgaria	4–	2+	2+	3	3+	3	2+	3	3	2
Croatia	3	3–	2+	3+	3	2+	2+	3+	3+	2+
Czech Republic	4	3+	3	4	3	2+	2+	4	4–	3
Estonia	4	3+	3–	4	4	4	2+	4	4–	3
FR Yugoslavia	1	1	1	2	2	2	2	2	1	1
FYR Macedonia	3	2+	2	2	2+	2	2+	2	3	2–
Georgia	3+	2	2	2+	3+	3	2	2	2+	2–
Hungary	4	3+	3	4	4	3+	3+	4	4	4–
Kazakhstan	3	2	2	2+	3	3	2	1	3–	2+
Kyrgyzstan	3	2	2	2+	2+	1	1	1	2+	2
Latvia	3	3–	2+	3	3	3+	2+	3+	3+	2+
Lithuania	3+	3–	3	3+	3	2+	2+	3+	3	3
Moldova	3	2	2	2+	3+	2	2	2	2+	2
Poland	3+	3+	3	4	3	4	3+	4	3+	4–
Romania	3+	2	2+	3	3	4	3	3	3–	2
Russia	3+	2+	2+	3	2	2+	2	2+	2–	2–
Slovak Republic	4	3	3	2+	3	2+	2+	2+	3+	2+
Slovenia	3	3–	3–	3	3	3+	3	4	3+	3–
Tajikistan	2+	2–	2–	2+	1	1	1	1	1	1
Turkmenistan	1	1	1	1	1	1	1	1	1	1
Ukraine	3	2	2+	2+	3+	2	2	1	2	2
Uzbekistan	3–	2–	2	2	2	3	1	1	2–	2

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.

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.

Competition policy

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

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 a 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

Classification system for transition indicators[1] (continued)

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

3 There is a fairly large degree of decentralisation and commercialisation. Regulation, resource allocation, and administrative functions have been clearly separated from maintenance and operations of the public road network. Road user charges are based on vehicle and fuel taxes and fairly directly related to road use. A law has been passed allowing for the provision and operation of public roads by private companies under negotiated commercial contracts. There is private sector participation either in road maintenance works allocated via competitive tendering or through a concession to finance, operate and maintain at least a section of the highway network. There is limited public consultation and/or participation and accountability in the preparation of road projects.

4 There is a large degree of decentralisation of road administration, decision-making, resource allocation and management according to government responsibility and functional road classifications. 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 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 no significant, 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 contacts 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-operator-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 incentives and/or full concessions and/or divestiture of water and waste-water services in major urban areas.

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.

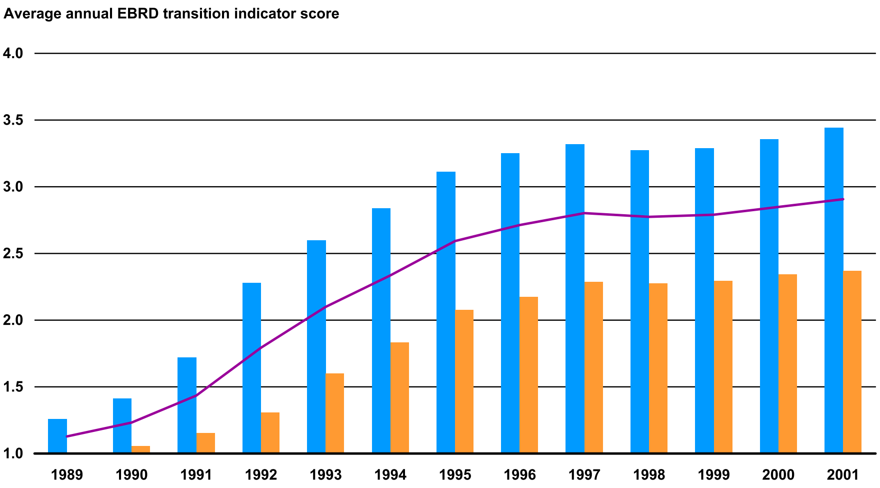
4 Securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalisation; well-functioning non-bank financial institutions and effective regulation.

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. The classification system presented here builds on the 1994 *Transition Report*. To refine further the classification system, pluses and minuses have been added to the 1-4 scale to indicate countries on the borderline between two categories.

Chart 2.1

Average annual EBRD transition indicator score, 1989-2001



Liberalisation/small-scale privatisation
Large-scale privatisation and institutional development (excluding infrastructure) EBRD average
Source: EBRD.
Note: The average excludes the infrastructure indicator scores which begin only in 1998.

progress in reform. The chart shows a period of rapid progress from 1989 to 1995, a marked slowdown from 1996 to 1999 followed by an upturn in 2000. In 2001 reforms advanced further but the extent of the increase diminished slightly. Nevertheless, more than two-thirds of the countries in the region (19 out of 27) achieved increases in their overall scores and seven showed no change. Only Turkmenistan, already lagging in reform, registered a further decline this year.

The transition indicators for 1992-2000 are presented in the country assessments at the back of this Report. This year transition indicators for FR Yugoslavia are included for the first time. The Report also lists for the first time the EBRD's transition indicators from 1992 onwards for both Bosnia and Herzegovina and FR Yugoslavia. 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 Tables 2.1 and 2.2.

In addition to the core areas of transition measured by the *Transition Reports*, this chapter has two annexes that summarise progress in additional areas of reform central to a well-functioning private market economy. Annex 2.1 presents the results of the EBRD's legal transition survey of 136 practising lawyers in 27 countries in the region. The EBRD's Office of the General Counsel implemented and analysed this survey, which measures the extensiveness 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 supplement to the EBRD's economic transition indicators. Annex 2.2 examines progress in environmental protection and assesses the extent of public participation in environmental decision-making.

2.2 Order of reforms, momentum and reversals

Sustained progress in transition requires the comprehensive implementation of reforms in many areas, ranging from market liberalisation to institutional development. While these reforms tend to complement each other and to reinforce their long-term impact on economic performance, it may not be feasible – or necessarily desirable – to move forward on all fronts at once. At the start of the transition process, most governments had limited capacities to implement reforms in terms of their financial and administrative resources, and reform effectiveness often requires learning and adaptation of behaviour in both the public and private sectors (see the 1994 *Transition Report*, Chapter 1). This constrained the effective implementation of institutional reforms in which the state had to take on significant new roles and responsibilities. At the same time, comprehensive reforms were not necessarily desirable because the precise end-point of transition and the impacts of inevitably partial reforms were highly uncertain. There were therefore potential benefits from introducing reforms in stages and from learning about their consequences.[4] For reform-oriented politicians and policy-makers that were confronted with both reform implementation and political viability constraints, the aim was to select feasible reforms that had a high chance of yielding significant benefits in terms of political support and that set the stage for subsequent reform measures.

In most cases, initial reforms consisted of liberalisation of prices and trade, small-scale privatisation and, in some countries, mass privatisation of large-scale enterprises. Mass privatisation using vouchers, as implemented in the Czech Republic, Lithuania, Russia and the Slovak Republic, was unique to the transition economies and was used to increase the pace of reform. Most of the reforms required the state to do less by abandoning administrative controls on prices, trade and exchange rates and by transferring state assets to private ownership.

Consequently, there were relatively few financial or administrative constraints on the implementation of these policies, although implementation of mass privatisation programmes required significant administrative capacity for a short period. Nevertheless, these reforms gave rise to significant economic and social costs. This was due to the discrepancies between planned supplies and market demands, the technological and organisational deficiencies of state-owned enterprises and the disruption to established supply networks.[5] In particular, these and

4 See, for example, Dewatripont and Roland (1995) and Roland (2000), Chapter 2.

5 Roland and Verdier (1999) set out a framework for examining the high adjustment costs experienced by the transition economies.

other economic conditions at the start of transition had a significant impact on macroeconomic performance in the early days, giving rise to significant adjustment costs and political resistance to reform, which needed to be overcome for reforms to advance.[6]

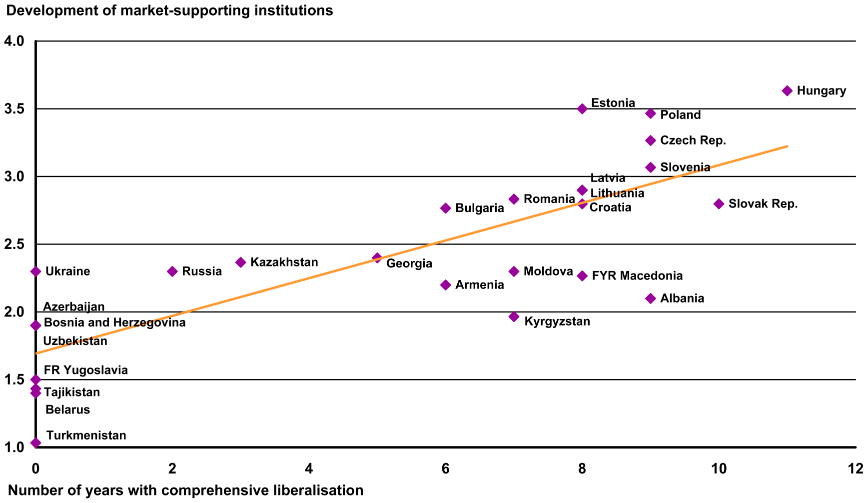
The initial political conditions and strategies following the end of communist regimes also had a significant influence on initial reform choices. The collapse of communism is usually associated with democratic revolutions in central and eastern Europe and the Baltic states, and the rise to power of new reforming governments. However, in some SEE and many CIS countries the first post-communist governments were led by the same political elites that had ruled under communism. Many politicians from the ruling communist parties preferred the status quo, fearing that economic and political reforms would undermine their economic and political interests. In contrast, new political leaders and new elites that supported them often had a greater incentive to introduce reforms. New governments used the liberalisation of markets and trade, rapid small-scale privatisation and democratic reforms to limit the power of government bureaucrats and enterprise managers and to prevent the re-emergence of a political monopoly. Some countries also pursued rapid mass privatisation of large-scale enterprises with the aim of creating sizeable shareholders with vested interests in the continuation of market reforms, albeit with mixed economic and political results.

The introduction of democratic and market-oriented reforms has tended to create forward momentum in many transition economies. This can be seen in the positive link between sustained economic and political liberalisation and progress in large-scale privatisation and institutional development. Chart 2.2 and Table 2.3 show the relationship between progress in large-scale privatisation and institutional development on the one hand, and sustained liberalisation of markets and trade on the other. Chart 2.3 also shows a positive link between sustained political liberalisation and development of market-supporting institutions. However, while domestic support for reforms and local government commitment to their implementation are fundamental to sustained progress in transition, it is also important to recognise that external factors, such as the EU accession process, can help to accelerate progress. For Croatia and the four SEE countries that are not part of the accession process, the EU has begun to negotiate Stability and Association Agreements. A key remaining challenge, however, is to support international integration of the CIS countries. Section 2.7 addresses this issue.

Domestic political changes have led to reform in several countries during the past year, notably in SEE (see Chart 2.4). FR Yugoslavia experienced the most

Chart 2.2

Comprehensive liberalisation and institutional performance

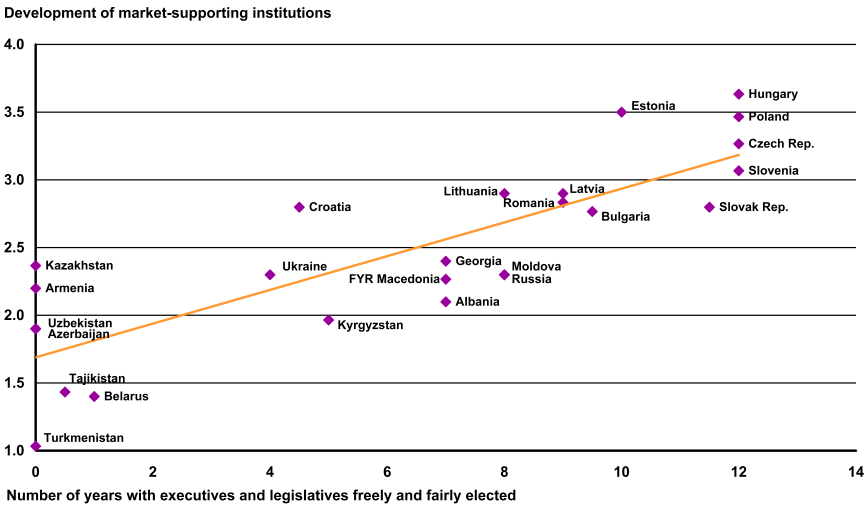


Source: EBRD.

Note: The development of market-supporting institutions denotes the unweighted average of transition indicators in 2001 for large-scale privatisation, governance and enterprise reform, competition policy, infrastructure and financial institutions. Comprehensive liberalisation is defined as achieving a score of at least 3- on price liberalisation and 4- on trade and foreign exchange liberalisation.

Chart 2.3

The functioning of democracy and institutional development



Source: EBRD.

Note: The development of market-supporting institutions denotes the unweighted average of transition indicators in 2001 for large-scale privatisation, governance and enterprise reform, competition policy, infrastructure and financial institutions. The number of years with freely and fairly elected executives and parliaments is calculated from election observations from the Organization for Security and Co-operation in Europe (OSCE) 1991-96; the OSCE Office for Democratic Institutions and Human Rights (ODHIR) 1996-2000; and the Parliamentary Assembly of the Council of Europe, 1990-2000. Bosnia and Herzegovina and FR Yugoslavia are not included due to the complex constitutional structure in each country.

6 See Berg, Borenzstein, Sahay and Zettlemeyer (1999), and Falcetti, Raiser and Sanfey (2000).

Table 2.3

Reform momentum and its determinants

Country	Institutional developments	Initial conditions index	Initial government turnover	Cumulative liberalisation	Cumulative democracy
Hungary	3.6	3.3	Y	11.0	12.0
Estonia	3.5	-0.4	Y	8.0	10.0
Poland	3.5	1.9	Y	9.0	12.0
Czech Republic	3.3	3.5	Y	10.0	12.0
Slovenia	3.1	3.2	Y	9.0	12.0
Lithuania	2.9	0.0	Y	8.0	8.0
Latvia	2.9	-0.2	Y	8.0	9.0
Romania	2.8	1.7	N	7.0	9.0
Slovak Republic	2.8	2.9	Y	10.0	11.5
Croatia	2.8	2.5	W	8.0	4.5
Bulgaria	2.8	2.1	N	6.0	9.5
Georgia	2.4	-2.2	W	5.0	7.0
Kazakhstan	2.4	-2.5	N	3.0	0.0
Moldova	2.3	-1.1	N	7.0	8.0
Ukraine	2.3	-1.4	N	0.0	4.0
Russia	2.3	-1.1	Y	2.0	8.0
FYR Macedonia	2.3	2.5	Y	8.0	7.0
Armenia	2.2	-1.1	W	6.0	0.0
Albania	2.1	2.1	N	9.0	7.0
Kyrgyzstan	2.0	-2.3	Y	7.0	5.0
Azerbaijan	1.9	-3.2	W	0.0	0.0
Bosnia and Herzegovina	1.9	na	W	0.0	na
Uzbekistan	1.9	-2.8	N	0.0	0.0
FR Yugoslavia	1.5	na	W	0.0	na
Tajikistan	1.4	-2.9	W	0.0	0.5
Belarus	1.4	-1.1	N	0.0	1.0
Turkmenistan	1.0	-3.4	N	0.0	0.0

Sources: Council of Europe, EBRD and OSCE.

Institutional development is the unweighted average of transition indicators in 2001 for large-scale privatisation, governance and enterprise reform, competition policy, infrastructure and finance.

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. Some data necessary for the construction of the index were not available for Bosnia and Herzegovina and FR Yugoslavia. See the 1999 *Transition Report*, Chapter 2 for further details.

Initial government turnover indicates those countries that had a change in political leadership in the first post-communist government (Y), those with no change in political leadership (N), and those that 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 and the relevant EBRD transition indicators.

Cumulative democracy denotes the number of years in which executives and legislatives have been freely and fairly elected. The number of years with freely and fairly elected executives and parliaments is calculated on the basis of election monitoring reports of the Organization for Security and Co-operation in Europe (OSCE) 1991-96; the OSCE Office for Democratic Institutions and Human Rights (ODHIR) 1996-2000; and the Parliamentary Assembly of the Council of Europe,1990-2000. Bosnia and Herzegovina and FR Yugoslavia are not measured due to the complex constitutional structure in each country.

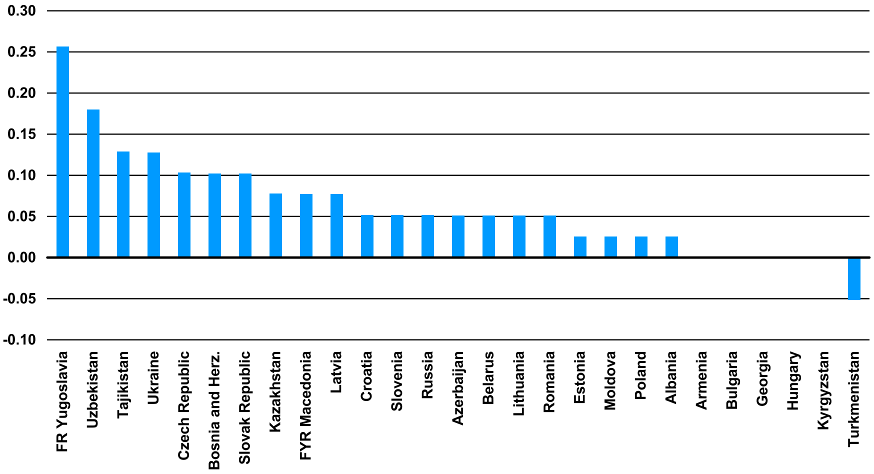
dramatic political change and the authorities are now undertaking a “catch up” programme following ten years of conflict and upheaval. In contrast, the outbreak of internal conflict in neighbouring FYR Macedonia has led to key reforms being slowed down or put on hold. Croatia has built on the political change in January 2000 following the death of former President Tudjman and signed a Stabilisation and Association Agreement with the EU in October 2001. Prospects for an increase in the pace of reform in Bosnia and Herzegovina have improved following the election of non-nationalists to key government positions both at state level and in the two Entities (Federation of Bosnia and Herzegovina and the Republika Srpska).

As a result of sustained economic growth and political stability, Russia has seen significant improvement in the areas of corporate governance and enterprise reform. Some private companies have begun to address poor business practices and the government has strengthened its ownership control over the gas company Gazprom. Other CIS countries that have benefited from Russian growth have also made progress in reform. Belarus and Uzbekistan have reduced some of their pervasive controls and restrictions on prices, trade and access to foreign exchange but there remains little overall progress in transition in these countries. Armenia, Azerbaijan, Kazakhstan and Ukraine have moved forward on large-scale privatisation and banking reform.

Notable progress was also achieved by some of the countries invited to begin negotiations on EU accession at the Helsinki Summit of EU countries in December 1999, particularly Latvia and the Slovak Republic and to a lesser extent Lithuania and Romania. These countries made progress in the areas of large-scale privatisation, implementation of competition policy, infrastructure and banking reform. In addition, Lithuania acceded

Chart 2.4

Change in average transition indicator scores, 2000-01



Source: EBRD.

to the WTO. The first wave of EU accession candidates continued with reforms, with notable progress being made in the Czech Republic, Estonia and Poland.

2.3 Initial phase reforms

More than a decade after the collapse of communist regimes in the region, there is a wide disparity in reform progress and the gap continues to widen between some countries. Advanced countries have sustained reform momentum throughout the period, while others are yet to address adequately the initial reforms of liberalisation, small-scale privatisation and the creation of an environment supportive of private investment and entrepreneurship. This section assesses the progress over the past year of countries that are still addressing initial reforms. These countries can be divided into two groups. Bosnia and Herzegovina, FR Yugoslavia and Tajikistan are dealing with the aftermath of wars, internal conflicts and international isolation while the governments of Belarus, Turkmenistan and Uzbekistan have shown little commitment to reform since independence.

The most dramatic progress in structural reform in the past year has been in FR Yugoslavia. A year ago, the Yugoslav economy was characterised by widespread price controls, restrictions on trade and access to foreign exchange, pervasive enterprise arrears and an insolvent banking sector.[7] Several cautious attempts at privatisation during the 1990s had failed and the only significant foreign investment in the country during this period was the sale in 1997 of 49 per cent of the Serbian telecommunications operator to Greek and Italian operators. The country was effectively bankrupt after ten years of conflict and international sanctions and was in default to almost all of its creditors, including international financial institutions such as the IMF and the World Bank.

New reform-oriented governments from the 18-party coalition, the Democratic Opposition of Serbia (DOS), took over at federal level in October 2000 and at the republic level in Serbia in January 2001 after the December 2000 parliamentary elections.[8] Montenegro has been gradually distancing itself from the Federation of Yugoslavia since 1998 and had already instituted some cautious reforms prior to the political change in October 2000. Kosovo, a province of Serbia but under UN administration since June 1999, is preparing for elections in November 2001, after which the reform agenda for the province can be addressed effectively (see Box 2.1). The new governments at both federal and republic level have demonstrated a strong commitment to reform and a desire to make up for lost time.

In FR Yugoslavia price liberalisation was the first step towards reform. This was initiated in the waning days of the previous government. By the middle of 2001 almost all prices other than those for bread, flour and utility services were liberalised. These measures were accompanied by strict stabilisation policies by the central bank, with the result that annual inflation, in excess of 100 per cent at the end of 2000, is on track to decline to below 50 per cent by the end of 2001. The price of electricity, less than 1 US cent/kiloWatt-hour at the end of 2000, was raised by 60 per cent in April 2001, with further large increases already implemented or planned for the latter part of the year. Other utility prices are being moved closer to cost recovery levels.

The federal authorities abolished the multiple exchange rate regime, replacing it with a managed float, and introduced current account convertibility.[9] A comprehensive trade liberalisation programme in the first half of 2001 followed these measures. In addition, the Serbian government moved quickly to prepare a new law on privatisation, which was approved by parliament in June. An important lesson drawn from the experience of other transition economies is that for larger enterprises, it is essential for the strategic investor to acquire effective control of the company and, under the new Serbian law, strategic investors can acquire majority shares. The authorities in Serbia are also pushing ahead with a number of other laws, including laws on foreign investment, concessions and competition, and are designing a comprehensive reform programme in the banking sector.

In neighbouring Bosnia and Herzegovina, the pace of reform has been relatively slower. This has been mainly due to the devastating effects of the war from 1992 to 1995 – with 200,000 people killed, more than 2 million displaced from their homes and economic activity reduced to a small fraction of pre-war levels. However, another important factor is that the end of the war in late-1995 did not lead to major political reform. Nationalist groups remained in power and were able to block reforms that threatened their

7 See the 2000 *Transition Report*, Annex 1.1.

8 An interim coalition government was in place in Serbia from October 2000 to January 2001, combining members of the old regime and DOS.

9 Montenegro abolished the Yugoslav dinar in November 2000, leaving the German Deutschmark (euro) as the sole legal tender in the republic.

Box 2.1

Recent developments in Kosovo

In June 1999, following the end of NATO's armed conflict with FR Yugoslavia and the withdrawal of the Yugoslav Army and security forces, the UN Security Council's Resolution 1244 placed Kosovo under the authority of the UN Interim Administration Mission in Kosovo (UNMIK). UNMIK has overall responsibility for civilian affairs in Kosovo, including the courts. The early decision to adopt the Deutschmark (euro) as legal tender has ensured overall price stability. The main macroeconomic issue presently faced by UNMIK is the financing of current public expenditure. In 2000 the Kosovo consolidated budget was financed significantly with external grants (almost 50 per cent). The budget for 2001 totals about DM 750 million. Some 70 per cent of this is expected to be financed by domestic revenues (primarily import duties, excises and sales tax), with donor contributions making up the balance.

After the municipal elections in October 2000 some of UNMIK's functions were transferred to the newly elected local councils. Elections will be held in November 2001 for an assembly of 120 seats. Ten of those seats are reserved for ethnic Serbs and ten for Kosovo's other minorities. The Assembly will elect the President who, in turn, will nominate the Prime Minister. Kosovo's government will be expected to run the day-to-day affairs of the province. UNMIK will retain direct control of justice and law and order and will continue to be responsible for the Kosovo Protection Corps, a largely ethnic Albanian body with some Serbian members. The Serbian Parliament has refused to accept UNMIK's constitutional framework for self-rule in Kosovo on the grounds that "it prejudges a final solution for the Kosovo province" and that it has not "provided the minimum conditions for the return of Serbs and other non-Albanian population".

Most regulations enacted by UNMIK deal with security, civil administration, fiscal and administrative matters (the establishment of the various "departments"). In the areas of economic and commercial law, several regulations were recently issued to define the basic principles in the key areas of contract law, protection of foreign investment and the establishment of business organisations. However, some of these regulations are not yet operational, due to the lack of an appropriate institutional framework.

The main outstanding legal and political issue relates to the ownership of the so-called socially owned enterprises (SOEs), which constitute the bulk of Kosovo's industrial sector. In late 2000 and early 2001 a handful of SOEs were tendered for management contracts. Local managers and employees generally resisted this move and it did not raise much interest among investors. More recently UNMIK circulated a proposal for the privatisation of SOEs. It suggests a three-pronged approach, based on spin-offs, restructuring plans or liquidations. The political and legal endorsement of such a proposal is being pursued within the UN organisation and with the local Kosovar authorities.

own interests. It is only in recent years that significant reform progress has been achieved, first with enhanced intervention by the UN High Representative and subsequently with the improved performance of non-nationalist parties in the November 2000 elections.

Politically the country remains divided into two Entities but economically it has recently made progress in its long-term goal of establishing a single economic space. Excise taxes are now harmonised and an agreement on a common sales taxes is close. Inter-Entity trade has increased substantially in the past couple of years. Banks based in one Entity can open branches in the other. However, progress on privatisation has been slow, foreign investor interest has been limited and it is not clear whether sales have led to real improvements in corporate governance.

In Tajikistan the legacy of civil war and political instability have also been major factors in its slow progress in transition. The country is one of the poorest in the region, with 95 per cent of the population living on an income level below the World Bank poverty threshold of US$ 4.30 a day. In spite of these difficulties, the authorities have undertaken several important reform measures during the past year. Tajikistan has applied to join the WTO (although membership is probably several years away) and it has largely completed small-scale privatisation. It has also made some progress in restructuring public utilities and the banking sector. Despite these reform measures, the foundations for economic and political stability remain weak. The government failed to implement agreed reforms in the IMF-supported adjustment programme in August 2001 while the military intervention in neighbouring Afghanistan has increased uncertainty.

Despite a weak political commitment to market-oriented reforms, Belarus and Uzbekistan have made significant progress in the past year in the liberalisation of access to foreign exchange. Belarus unified the exchange rates in September 2000 and liberalised the market further in July 2001 by allowing foreigners to take part in inter-bank trade. In Uzbekistan access to foreign exchange has been significantly liberalised and most imports are now conducted at the over-the-counter rate, which is close to the market rate. Export surrender requirements are now also implemented at this rate, increasing the attractiveness of export sales. However, in Turkmenistan there has been steady backtracking from market-oriented reforms in recent years. Because of the abandonment of previous plans to implement large-scale privatisation, the EBRD has lowered its transition score for Turkmenistan in contrast with all other countries in the region. Responsibility for large-scale privatisation was transferred from a special-purpose agency created with World Bank support in 1997 to the Ministry of Finance. There have been no large-scale privatisation transactions since 1998.

2.4 Reform momentum, large-scale privatisation and enterprise reform

While some countries in the region remain focused on initial reforms, most are advancing steadily with large-scale privatisation and institution-building initiatives. Initial approaches to the privatisation of medium and large-scale enterprises were significantly shaped by political considerations. This resulted in large-scale privatisation being based on voucher-based programmes and generous concessions being made to insiders (existing managers and workers) as a way to ensure support for continued reforms.[10] However, pro-reform politicians do not appear to have benefited greatly from the rapid mass privatisation of large state-owned enterprises and, in some cases,

10 See Boyko, Shleifer and Vishney (1995) on the design of the Russian privatisation programme.

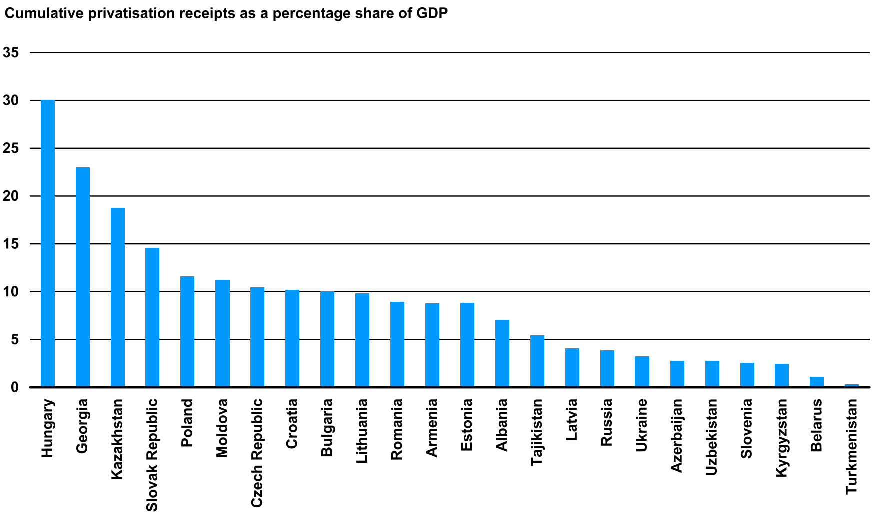
the distribution or sale of state assets to favoured groups in return for political support may have undermined the credibility of reformers and their policies. The only form of privatisation that has clearly contributed to improving the post-privatisation performance of enterprises is the sale of assets to strategic investors. Therefore, medium and large-scale privatisation now focuses on economic factors, including the effectiveness of post-privatisation corporate governance and the generation of revenue from privatisation.[11]

While most governments have now shifted away from mass privatisation programmes towards direct sales through tenders and auctions, privatisation revenue has varied considerably across the transition economies (see Chart 2.5). This variation reflects the approaches chosen in large-scale privatisation and the attractiveness of the assets on offer. The greatest revenue has been achieved by Hungary, which used direct sales as its primary method of privatisation. In most countries, however, privatisation revenue is mainly generated by a few prominent deals, such as the sale of the dominant telecommunications company, power generation and distribution companies, natural resources such as oil fields and mines, and the main banks. The value of these assets depends in part on the quality of the local business environment as well as the size of the market and its economic potential.

Over the past year Albania, Azerbaijan, Bosnia and Herzegovina, Lithuania, Romania and Ukraine have been particularly active in the privatisation of medium and large-scale industrial enterprises and this activity is reflected in an improvement in their transition indicator scores for large-scale privatisation. Foreign investors have participated extensively in the privatisation programme in Lithuania, Romania and Ukraine (see Table 2.4) while in Albania, Azerbaijan and Bosnia and Herzegovina domestic investors have been more prominent. In addition to the privatisation of industrial firms, there have been significant transactions involving the sale of state-owned infrastructure enterprises and financial institutions (see below) in a number of countries.

Chart 2.5

Cumulative privatisation receipts, 1989-2000



Source: EBRD.
Note: Figure for Belarus is for cumulative privatisation receipts from 1989-99 only. Data for Bosnia and Herzegovina, FYR Macedonia and FR Yugoslavia were not available.

Three countries (Estonia, Poland and Russia) achieved increases in their transition indicator score for enterprise reform. Importantly, corporate governance and business practices in Russia, which had reached a low point in the period following the August 1998 crisis, saw significant improvement over the past year. The improvement is being driven largely by the changing behaviour of controlling shareholders and managers who are beginning to act in ways that increase share values rather than to strip corporate assets and income for private gain. It is also being supported by the government through its involvement as a major shareholder in some companies. The change in approach is fostered by the turnaround in profitability of companies and by their long-term potential. It is significant that companies that have strengthened their commitment to sound corporate governance and business practices have seen significant increases in their share values and have achieved relatively high stock market returns.

2.5 Infrastructure reform

Infrastructure networks and services in transition economies, which were designed for centrally planned economies and authoritarian political regimes, are poorly suited to the needs and standards of market economies. Use of electric power and water, for example, is excessive due to a structure of production and prices that paid scant regard to the costs of production (see Chapter 5 for a detailed assessment of the electric power sector). Rail networks are extensive and heavily staffed while road networks remain inadequate. Telecommunications services are still vastly under-supplied.

The transition economies therefore face considerable challenges in replacing old technology and building new infrastructure networks. This requires tariff reform, increased commercialisation and competition in the provision of infrastructure services, and regulatory and institutional development. Over the past year 13 countries achieved upgrades in their infrastructure indicator scores. These improvements were due not only to growing demands for cost-effective services from the private sector in response to market competition and international integration but also to EU accession-related reforms in the electric power, telecommunications, water and waste-water sectors. This progress also arises from the need to attract commercial finance for urgent investments in the infrastructure sector and to raise government finance through the sale of state-owned utilities.

11 For evidence on the impact of privatisation on enterprise performance, see the 1999 *Transition Report*, Chapter 7, Djankov and Murrell (2000), and Carlin, Fries, Schaffer and Seabright (2001). Shleifer and Treisman (2000) assess the political impact of Russian privatisation.

Table 2.4

Selected large-scale privatisations in transition economies, October 2000 to September 2001

Company	Country	Sector	Date	Value (in US$ millions)
Fabrika Cementa Lukavac	Bosnia and Herzegovina	Chemicals and allied products	Jul 2001	9.8
Cement Plant Kakanj	Bosnia and Herzegovina	Construction materials	Oct 2000	24.6
Bulbank AD	Bulgaria	Commercial banks	Oct 2000	316.2
Sodi Devnya	Bulgaria	Chemicals and allied products	Oct 2000	2.3
Pirinska Bistritsa	Bulgaria	Electricity, gas and water	Nov 2000	15.0
Pamporovo Mountain Resort	Bulgaria	Hotels and casinos	Dec 2000	11.0
Despred	Bulgaria	Transport and shipping	Dec 2000	6.6
Tankerska Plovidba dd	Croatia	Transport and shipping	Jan 2001	155.9
Excelsior Hotel	Croatia	Hotels and casinos	Feb 2001	36.3
Severomoravska Plynarenska	Czech Republic	Electricity, gas and water	Dec 2000	19.9
Prazske Vodovody A Kanalizace	Czech Republic	Electricity, gas and water	Apr 2001	162.6
Sklo Zelezny Brod	Czech Republic	Stone, glass, concrete etc	May 2001	6.8
Broadcasting Transmissions	Estonia	Radio and television	Nov 2000	5.3
Estonian Broadcasting Centre	Estonia	Radio and television	Nov 2000	6.1
Tallinna Vesi	Estonia	Water and sewerage	Dec 2000	75.6
Tallinna Vesi	Estonia	Electricity, gas and water	Jan 2001	83.3
Parnu Soojus	Estonia	Electricity, gas and water	Feb 2001	1.8
Estonian Railways	Estonia	Transport and shipping	Aug 2001	57.4
Maktel	FYR Macedonia	Telecommunications	Jan 2001	323.5
Epinal Hotel	FYR Macedonia	Hotels and casinos	Feb 2001	1.3
ICN Magyarorszag Rt	Hungary	Drugs	Nov 2000	4.4
Nitrokemia 2000 Rt (APV Rt)	Hungary	Chemicals and allied products	Nov 2000	1.5
Trafficom Kft (BKV Kft)	Hungary	Telecommunications	Feb 2001	9.1
Budapest Bank	Hungary	Commercial banks	Mar 2001	1.5
MAV Hajdu	Hungary	Construction firms	Jun 2001	3.5
Sary-Arka Airport	Kazakhstan	Air transport and shipping	Feb 2001	3.5
Development Bank	Lithuania	Commercial banks	Dec 2000	10.1
Vilniaus Vingis	Lithuania	Electronic and electrical	Jan 2001	2.7
LISCO	Lithuania	Transport and shipping	Apr 2001	47.6
Lithuanian Taupomasis	Lithuania	Commercial banks	Jun 2001	37.5
Moldkarton	Moldova	Paper and allied products	Nov 2000	2.2
Tarnow Ceramics Plant	Poland	Stone, glass, concrete etc	Dec 2000	2.7
Gornoslaski Zlad Elektro	Poland	Electricity, gas and water	Jan 2001	152.3
Bialystok Power Plant	Poland	Electricity, gas and water	Feb 2001	45.0
Gdansk Stocznia Remontowa	Poland	Transport equipment	Mar 2001	28.9

Company	Country	Sector	Date	Value (in US$ millions)
Gornoslaski Zlad Elektro	Poland	Electricity, gas and water	Jan 2001	152.3
Dyrekcja Ekspoatacji Cystern	Poland	Transport and shipping	Mar 2001	76.3
Rybnik Power Plant	Poland	Electricity, gas and water	Apr 2001	120.0
MEC Koszalin	Poland	Electricity, gas and water	Apr 2001	3.9
Olsztynkie Kopalnie Surowcow	Poland	Mining	Apr 2001	3.0
Kopalnie Sorowcow Skalnych	Poland	Mining	Jun 2001	2.0
Drobimex Heintz	Poland	Agriculture/forestry/fishing	Jul 2001	4.0
Polmos Poznan	Poland	Food and kindred products	Jul 2001	71.0
Polmos Starogard Gdanski	Poland	Food and kindred products	Aug 2001	8.6
WSK Gorzyce	Poland	Metal and metal products	Aug 2001	18.0
Combinatul Siderurgic Resita	Romania	Metal and metal products	Oct 2000	4.5
Petromidia	Romania	Oil and gas	Nov 2000	50.0
Parc Turism Craiova (Romania)	Romania	Hotels and casinos	Dec 2000	4.3
Petromidia SA	Romania	Oil and gas	Dec 2000	390.0
Banca Agricola SA	Romania	Commercial banks	Jul 2001	7.0
Chita Mining Co	Russia	Mining	Oct 2000	12.3
Kenotek	Russia	Mining	Oct 2000	3.9
Sokolovskoye	Russia	Mining	Nov 2000	1.6
Khakasugol	Russia	Mining	Dec 2000	1.0
Kuznetskugol Mining Company	Russia	Mining	Dec 2000	2.3
Chelyabkomzembank	Russia	Commercial banks	Apr 2001	2.0
Avtovazbank	Russia	Commercial banks	May 2001	4.1
Pyotr Pervy Bank	Russia	Commercial banks	Jun 2001	3.3
Moscow River Navigation	Russia	Measuring equipment	Jul 2001	4.5
Plastik	Russia	Rubber and plastics	Jul 2001	1.1
Rosgosstrakh	Russia	Insurance	Sep 2001	8.0
Slovenska Sporitelna	Slovak Republic	Commercial banks	Jan 2001	372.6
Globtel GSM	Slovak Republic	Telecommunications	Jun 2001	180.0
Mykolayivsky Hlynozemny Zavod	Ukraine	Metal and metal products	Oct 2000	1.6
Mykolayivsky Hlynozemny Zavod	Ukraine	Metal and metal products	Nov 2000	15.3
Ordzhonikidze	Ukraine	Mining	Nov 2000	30.0
Kherson Oil Refinery	Ukraine	Oil and gas	Nov 2000	6.4
Galichina Oil Refinery	Ukraine	Oil and gas	Jun 2001	2.1
Zhytomyroblenergo	Ukraine	Electricity, gas and water	Apr 2001	35.0
Sevastopolgorenergo	Ukraine	Electricity, gas and water	Apr 2001	18.6

Source: Privatisation International Database.

Note: The dates and amounts refer to actual transactions rather than to the signed agreement.

In the electric power sector five countries achieved upgrades in their transition indicator scores: Croatia, the Czech Republic, the Slovak Republic, Ukraine and Uzbekistan. Ukraine in particular has made significant progress after a number of previous false starts, in particular the premature introduction of an electric power pool, privatisation of a number of companies without the participation of strategic investors and failed attempts to improve cash collection. In the past year, however, tariff collections have improved and a better system has been established for the allocation of revenue to generation and distribution companies. In addition, a long-term programme for setting tariffs has been developed and six electric power distribution companies have been sold to strategic investors. The challenges are to strengthen the predictability and credibility of the sector regulator's decisions to encourage strategic investors to improve the performance of their companies and to privatise the remaining state-owned distribution companies through the involvement of strategic investors.

The Croatian parliament passed several new laws governing the energy sector in 2001. The new laws provide for the establishment of an independent regulator, who is appointed for a fixed term. The regulator will be funded through industry licence fees and may be replaced only in certain circumstances. Both these measures help to limit the influence of outside parties. The law also presents models for restructuring the integrated power provider, Croatian Energy (HEP), which is due to be privatised in 2002. In the Slovak Republic a government resolution in September 2000 called for the electric power industry to be unbundled and for minority stakes in generation and distribution companies to be sold. The recent law on regulation in network industries sets out the framework for sector regulation. This includes the establishment of an independent regulator who will set tariffs to cover costs, consult industry participants on major issues and publish explanations of all decisions.

The Czech Republic adopted a new energy law in November 2000 which provides for phased liberalisation of the sector. The government has appointed a privatisation adviser, with the aim of selling the power industry as an integrated company prior to elections in mid-2002. An independent energy sector regulator was established in early 2001. In Uzbekistan an initial step was taken towards sector reform when the national power company was corporatised.

In the railway sector, three countries have seen increases in their infrastructure rating: Bosnia and Herzegovina, Kazakhstan and Uzbekistan. A new railway law was recently approved in Bosnia and Herzegovina encompassing the introduction of medium-term business plans and compensation for losses incurred in providing passenger services. In Kazakhstan the new railway law provides for the separation of infrastructure from operations and the introduction of competition through third-party access for the provision of freight services. In Uzbekistan two government resolutions have paved the way for the transformation of the state-owned railway into a joint-stock company, the divestment of ancillary businesses and the privatisation of supply industries and construction activities. In addition, a new regulatory office has been established to license operators and regulate safety. The appointment of an independent regulator is still pending.

In its assessment of the road sector, the EBRD has benefited from the results of a questionnaire submitted to national authorities. As a result, ratings for Bosnia and Herzegovina, Estonia, FYR Macedonia and Tajikistan, which were not available last year, have been included, and scores for six other countries have been revised. However, no country achieved an increase in this indicator score. The relatively low level of reform reflects the time and effort required to achieve significant progress in this sector, particularly in private sector participation. Nevertheless, Poland and Romania are moving forward slowly in their efforts to involve private companies in the construction and operation of motorway concessions and in the divestment of road maintenance equipment respectively.

In telecommunications, two countries achieved increases in their transition indicator scores: Slovenia and Tajikistan. The Slovenian parliament passed a new telecommunications law in April 2001. This is in line with EU accession requirements and strengthens the regulatory framework. In Tajikistan telecommunications reform advanced with the signing of a protocol by the Ministry of Communications in February 2001. This defines the key milestones of reforms in the sector, including the establishment of a regulatory authority, the adoption of a new law by 2001 and the gradual liberalisation of each segment of the market.

In the water and waste-water sector the Latvian parliament passed a new law on the regulation of public services. This provides for the establishment of independent local government regulators for water and waste water, waste management and district heating. The regulators, who were established in June 2001, have full authority to review and enforce tariff levels and performance quality standards. Their independence is strengthened by a provision in the law that decisions should not be subject to influence by local government. This is supported by the appointment of the regulator for a four-year term, with removal only for criminal offences. Separate budgets have been established based on income from fees. In FYR Macedonia water and waste-water tariffs have been raised towards cost recovery levels in several municipalities in which the EBRD has undertaken projects.

2.6 Financial sector reform

Development of the financial sector in transition economies has been one of the more difficult areas of reform since at the start of transition there were virtually no relevant financial institutions or markets.[12] Over the past year financial sector reform has continued to advance, primarily in the banking sector. These reform gains were largely in CEB countries that were nearing the completion of bank privatisation and further aligning their prudential regulation and supervision with EU and international standards. The driving forces for these measures were the growing demand for banking services and the prospect of EU accession for the candidate countries.

However, there were no significant advances in the reform of securities markets and non-bank financial institu-

[12] See Fries and Taci (2001) on banking development in transition economies.

tions. With the globalisation of financial services, the securities markets in the region face an increasingly challenging environment. Many of the larger and more profitable firms from the region are gaining listings on west European stock exchanges, which are more liquid than those in the region. At the same time, medium-sized companies have been slow to embrace the financial transparency and corporate governance requirements associated with publicly listed and traded securities. This leaves the securities markets in the region relatively under-developed.

In the banking sector five countries achieved upgrades in their transition indicator scores: Azerbaijan, the Czech Republic, Kazakhstan, Latvia and the Slovak Republic. The Czech Republic completed the process of bank privatisation with the sale of a 60 per cent share of Komercni Banka to Société Générale (France) for US$ 1 billion. The consolidation agency began the task of recovering bad loans by selling them to private investors at a discount. In the Slovak Republic the two largest state banks were sold – Slovenska Sporitelna to Erste Bank (Austria) for €425 million and Vseobecna Uverova Banka to the Italian banking group Intesa BCI for €550 million. A new banking law was also adopted, which aligned banking legislation with EU directives and strengthened banking supervision.

The Latvian banking sector continued its process of consolidation following the Russian crisis in 1998 with the merger of two large banks (Rietumu Banka and Saules Banka) in July 2001 and the court-supervised restructuring of Bank Paritate. A new unified financial regulator of the banking, insurance and securities sectors was also established. In Azerbaijan three state banks were restructured and the licence of the agricultural bank was revoked as minimum capital requirements were increased significantly. In Kazakhstan there was a significant increase in bank intermediation following the introduction of deposit insurance, the tightening of banking supervision and the improvement in corporate liquidity.

In the securities sector there have not been sufficient advances to warrant an upgrade of the transition indicator scores over the past year. However, there were a number of notable developments. In May 2001 the Helsinki stock exchange acquired control of the Tallinn stock exchange. It plans to develop a common trading environment for the two exchanges, with the aim of increasing the liquidity of Estonian securities. This could be seen as the first step towards the merger of stock exchanges in CEB countries with those in the EU. This would be beneficial as many exchanges in the region are struggling to attract new listings and to build liquid markets. In Kazakhstan and Poland private pension funds have become increasingly significant participants in the local securities markets. However, recent government decisions in Hungary have stifled further development of the domestic market. These have included the introduction of a punitive capital gains tax and delays to the implementation of pension reform.

2.7 International integration and progress in transition

In addition to the domestic factors that influence progress in transition, the experience of recent years has shown that the process of international integration can have a significant bearing on the reform process. For example, the process of EU accession for the ten candidate countries in CEB and SEE is an important external influence on sustained progress in transition.[13] In addition, the trade commitments related to WTO accession and the currency convertibility commitments related to Article VIII of the IMF agreement have tended to promote international integration.

Table 2.5 summarises the main commitments of transition economies in the area of international economic integration. A striking feature of the table is the extent to which the acceptance of these international commitments is concentrated among the ten EU candidate member countries. A key challenge is therefore to strengthen the process of international integration beyond these countries.

Accession to and association with the European Union

The objective of acceding to the EU is a key political priority in almost all countries of CEB and SEE. This aspiration stems both from security concerns and from political and economic ambitions to join the West. Accession requires candidate countries to adhere to the political principles of democracy and pluralism and to commit to specific economic policy objectives aimed at deepening economic and monetary integration. These objectives relate to the progressive liberalisation of trade, capital flows and migration, and to the development of institutions to support the single European market in areas such as company law, competition policy, transport, energy and telecommunications policy, financial regulation and agriculture. The long-term prospect of reaching west European living standards through greater economic integration and institutional harmonisation has helped to counter resistance to reform from local vested interests.

The EU Association Agreements with the ten candidate countries in CEB and SEE from 1991 to 1996 established the framework for free trade in industrial goods. At the Luxembourg European Council in December 1997 it was decided to open accession negotiations with all ten candidate countries and to start early negotiations with five CEB countries: the Czech Republic, Estonia, Hungary, Poland and Slovenia.

Subsequently, at the Helsinki European Council in December 1999 the decision was taken to open accession negotiations with the other five candidate countries: Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic. At this time, the EU also noted that it would be possible for the so-called "second-wave" countries to catch up with the first-wave countries if they made sufficient progress in their preparations. Each candidate country will be assessed individually in terms of its fulfilment of the membership criteria (see Box 2.2).

The impact of accession on progress in transition is difficult to measure because the direction of influence can run both ways. A credible prospect of accession can help to advance market-oriented reforms while progress in transition for other reasons can strengthen the prospects of EU membership. One

[13] See Berglöf and Roland (2000).

Table 2.5

International commitments of transition economies as of 2001

	GATT/WTO membership	IMF Article VIII status	EU Association Agreement	Stabilisation and Assoc. Agreement	EU Partnership and Coop. Agreement
EU accession countries					
Bulgaria	Dec 96	Sep 98	Mar 93	-	-
Czech Republic	Jan 95	Oct 95	Oct 93	-	-
Estonia	Nov 99	Aug 94	Jun 95	-	-
Hungary	Jan 95	Jan 96	Dec 91	-	-
Latvia	Feb 99	Jun 94	Jun 95	-	-
Lithuania	May 01	May 94	Jun 95	-	-
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	-	-
Non-accession countries in CEB and SEE					
Albania	Sep 00	-	-	-	-
Bosnia and Herzegovina	-	-	-	-	-
Croatia	Nov 00	May 95	-	Oct 01	-
FR Yugoslavia	-	-	-	-	-
FYR Macedonia	-	Jun 98	-	Apr 01	-
CIS					
Armenia	-	May 97	-	-	Apr 96
Azerbaijan	-	-	-	-	Apr 96
Belarus	-	-	-	-	Mar 95
Georgia	Jun 00	Dec 96	-	-	Apr 96
Kazakhstan	-	Jul 96	-	-	Jan 95
Kyrgyzstan	Dec 98	Mar 95	-	-	Feb 95
Moldova	Jul 01	Jun 95	-	-	Nov 94
Russia	-	Jun 96	-	-	Jun 94
Tajikistan	-	-	-	-	-
Turkmenistan	-	-	-	-	May 98
Ukraine	-	Sep 96	-	-	Jun 94
Uzbekistan	-	-	-	-	Jun 96

Sources: WTO, IMF and EU.
Note: EU Association Agreement, Stabilisation and Association Agreement and EU Partnership and Cooperation Agreement dates are given for when the agreements were signed. The agreements came into force at a later date.

way to allow partially for the influence of other factors on the reform process is to examine progress in transition by comparing three groups of countries with the first-wave accession candidates. These three groups are the second-wave accession candidates, the non-accession CEE countries and CIS countries.

Chart 2.6a shows the differences in transition indicator scores for large-scale privatisation and institutional development (excluding infrastructure). It supports the view that decisions by the EU regarding accession are associated with significant acceleration in reforms.

The chart shows three markedly different trends in the progress in transition by the second-wave accession countries, other CEE countries and CIS countries. The second-wave accession countries begin to converge with the first-wave countries during the period 2000-01 following the decision at the Helsinki European Council in late 1999. In contrast, the non-accession CEE countries show relatively constant progress throughout the period while the CIS countries diverge increasingly from the first-wave accession candidates. These different patterns in transition progress suggest that the decision of the Helsinki European Council to enhance accession prospects for the second-wave countries helped to strengthen their reform momentum. However, it must also be recognised that the decision not to invite countries into accession negotiations may reflect other factors that are likely to inhibit progress in transition.

Chart 2.6b shows that the pace of large-scale privatisation and institutional development in the first-wave countries accelerated significantly between 1997 and 2001 compared with 1995-96. While this may be due to a natural shift from the initial reforms of liberalisation and small-scale privatisation towards second phase reforms, it also supports the view that the decision of the Luxembourg European Council to formally open accession negotiations was a spur to reform. The acceleration in large-scale privatisation and institutional development occurred in the period immediately before and after the decision was taken in 1997.

The EU was unwilling to open up prospects of EU accession negotiations with five countries in 1997: Albania, Bosnia and Herzegovina, Croatia, FR Yugoslavia and FYR Macedonia. As far as Croatia is concerned, there were concerns about the lack of political pluralism under the regime of former President Tudjman and the failure to comply with the international war crimes tribunal. FR Yugoslavia was still under the Milosevic regime and was facing increasing isolation, with international sanctions tightened in 1998-99. For Albania, Bosnia and Herzegovina and FYR Macedonia, it was clear that the institutional structures in each country were too weak for the EU accession process. An alternative had to be considered.

The Stabilisation and Association Process (SAP) was seen as a way forward for those countries not yet in a position to move towards accession negotiations. The European Commission (EC) formally proposed the SAP for the five CEE countries in May 1999. From the outset, the EC was explicit in linking international integration with fulfilling economic and political conditions. The EC offered the prospect of economic integration to the five countries in return for progress in democracy, respect for human rights and a market economy. The EC also stipulated that each agreement would be “tailor-made” to the circumstances of each country and acknowledged that some countries would move faster towards an agreement than others.

The first country to sign a Stabilisation and Association Agreement (SAA) was FYR Macedonia in April 2001. Over

Box 2.2

Progress in EU accession

At the June 1993 Copenhagen European Council, the EU member states agreed that certain countries in CEB and SEE could become members of the EU. Accession would take place as soon as each country was able to satisfy the necessary conditions. These economic and political conditions include:

- stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities;
- the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the EU; and
- the ability to accept the obligations of membership, including adherence to the aims of political, economic and monetary union.

Membership in particular requires that the candidate countries incorporate EU legislation (*the acquis communautaire*) into national legislation and implement this effectively through appropriate administrative and judicial structures. The EU also must have the ability to integrate new member states without endangering the momentum of European integration.

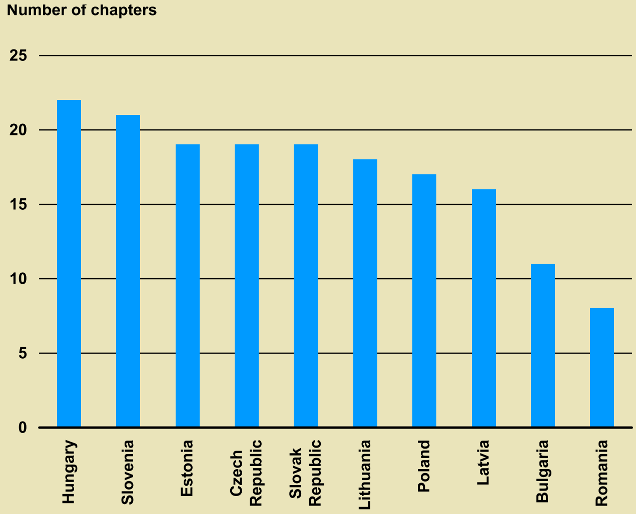
Accession negotiations with the EU candidate member countries are conducted individually and the pace of negotiation depends on the degree of preparation by the country and the EU and on the complexity of the issues involved. The negotiations cover both the political and economic aspects of the Copenhagen criteria. They also focus on the incorporation of EU legislation, which is divided into 31 chapters, with each covering a certain area of the economy, such as free movement of capital, labour, services and products. The actual negotiations take the form of a series of bilateral inter-governmental conferences between the EU member states and each of the candidate countries.

Responsibility for assessing the extent to which EU candidate member countries fulfil the Copenhagen criteria rests with the European Commission and these assessments are made in the context of the annual progress report prepared by the Commission. The 2001 report is due to be adopted in November. The Commission has recently provided the European Parliament with a preliminary assessment of this ongoing work.[1] According to this assessment, all negotiating candidate countries continue to meet the political criteria, recognising that the position of Russian minorities in the Baltic region continues to improve and that the situation of orphans in Romania has started to change. However, serious issues must still be addressed. The position of the Romany people and the cultural discrimination they face also remains a difficult issue.

On the economic criteria, the Commission observed that the competitive market had made its mark in all the EU candidate countries. It noted that the competitiveness in the single European market had largely been achieved since trade in goods and services between the EU and the applicant countries had already been widely liberalised. It is also recognised that the Maastricht criteria for the euro will have to be met in full once the Copenhagen criteria for accession have been met.

Regarding the incorporation of EU legislation, negotiations have been opened for eight of the ten candidate countries of CEB and SEE (all except Bulgaria and Romania) on all 31 chapters except for the one dealing with the budget and institutional issues. The chart shows the number of chapters that have been provisionally closed by each of the ten candidate countries. Hungary leads the way with 22 chapters provisionally closed, followed closely by Slovenia with 21 and the Czech Republic, Estonia and the Slovak Republic on 19. However, the number of chapters provisionally closed is not a complete measure of progress because it does not take account of the varying complexities and difficulties among the chapters or the progress that has been achieved in

Number of *acquis communautaire* chapters provisionally closed



Source: European Commission.

chapters that have not yet been closed. In addition, it must be recognised that many of the more controversial issues are yet to be addressed in each of the countries, such as justice and home affairs, competition, taxation, transport, budget for regional policy and agriculture. A compromise was recently reached on the chapter on the free movement of people, which balances the objectives of free movement and security as much as possible.

While significant progress has been achieved in meeting the political and economic criteria for EU accession in the ten candidate countries of CEB and SEE, these efforts have had significant costs and strained the scarce administrative capacities of the countries. To help meet these costs and to support local administrative capacity, the EU adopted budget provisions to make pre-accession financing available for all membership candidates in the areas of technical assistance and training (through the Phare instrument), infrastructure and environment (through the ISPA instrument) and agriculture (through the SAPARD instrument). Total potential financial support through these instruments for the period 2000-06 is €3.1 billion. The Phare and ISPA programmes are on track but the SAPARD programme has had to overcome substantial start-up problems.

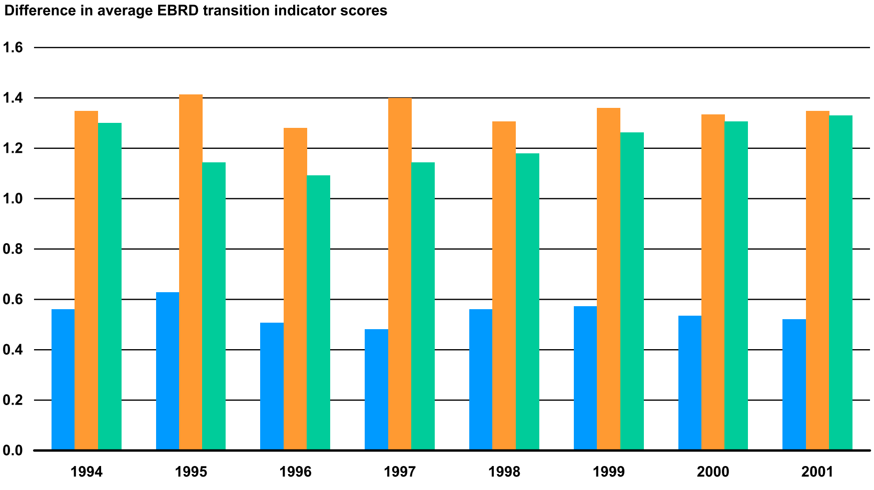
As the candidate member countries prepare for accession with EU financial support, the institutions of the EU also have to be adjusted. An important step in the process was the Treaty of Nice, which was agreed in December 2000. The purpose of the treaty was to remove obstacles to EU enlargement and to adopt reforms that would ensure EU institutions function efficiently after its membership expands. At the same time, the EU heads of state and government approved a plan for completing the accession negotiations. However, there are doubts about how successful the treaty has been in preparing the EU institutions for the expansion in membership.[2] In addition, the Nice Treaty must be ratified by each member state. It already failed to clear its first hurdle when the Irish Republic rejected the treaty in a referendum. It is crucial to the credibility of the accession process and to the reform momentum in the candidate countries to ensure that EU institutions are successfully adjusted.

1 See Verheugen (2001).

2 Baldwin, Berglöf, Giavazzi and Widgrén (2001) provide an assessment of the treaty.

Chart 2.6a

Progress in reform relative to first-wave EU candidate members

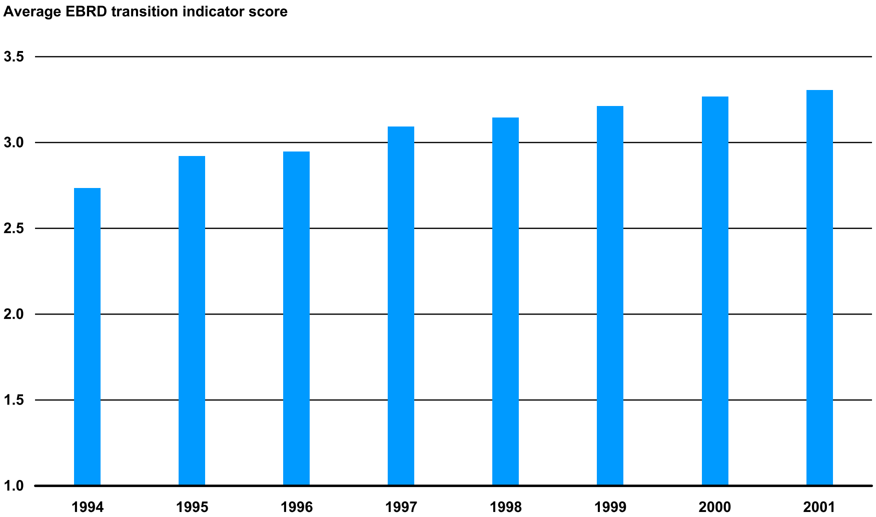


Source: EBRD.

Note: Each bar represents the difference in reform progress between the first-wave EU accession countries and the country groupings listed above.

Chart 2.6b

EBRD transition indicators for first five EU candidate members



Source: EBRD.

the past two years it has been one of the fastest reforming countries, with significant progress being made on privatisation, banking reform and institutional reform, including competition laws. At the time of signing, the EC noted the political significance of the agreement, which conferred on the country the status of “potential candidate” for future accession to the EU. The way forward for FYR Macedonia is now uncertain because of the recent conflict with ethnic Albanian guerrillas. The increased uncertainty has led to a slowdown in reform. An effective resolution to this problem is essential if the country is to take the next crucial step towards formal entry to the accession process.

Croatia and Albania are following closely in the SAA process. Croatia was already relatively advanced in reform and therefore was able to move quickly after the political changes in January 2000. It signed the agreement in October 2001 and is well-positioned, compared with the four SEE countries, to enter into accession negotiation. Albania has made substantial gains in institutional strengthening since 1999, as shown by two peaceful nation-wide elections (local and parliamentary) in the past year. It is now formally negotiating an SAA. Bosnia and Herzegovina and FR Yugoslavia are further behind but the latter is making more rapid progress than the former. The EC has presented Bosnia and Herzegovina with a “road-map” of 18 key steps to be taken before negotiations can start but by mid-2001 only six of these had been implemented.

International integration and the CIS

For Russia and the other CIS countries, the approach to international integration has differed significantly from the route taken by CEB and SEE countries, notwithstanding the Partnership and Cooperation Agreements that most CIS countries have signed with the European Union. For example, only four CIS countries have acceded to the WTO compared with all CEB and SEE countries except Bosnia and Herzegovina, FR Yugoslavia and FYR Macedonia. Moreover, regional trade within the CIS remains significant, particularly between Russia and the other CIS countries (see Chapter 3) while most CEB and SEE countries have reoriented their trade towards western Europe and other industrialised market economies.

The lack of a strong outward-looking orientation for the CIS, apart from the natural resources sector (see Chapter 4), and the central position of the Russian economy within the CIS highlight the crucial role of Russia in the international integration of all the CIS countries. If Russia implements an economic strategy focused on timely accession to the WTO and on deeper international economic integration, this would have a significant influence both on the reform agenda within Russia and on the other CIS countries due to the greater openness and competitiveness in the Russian economy. However, in pursuing an agenda of greater trade liberalisation, the Russian government faces challenges as great as those confronted by developing countries that were forced to deal with strong vested interests against liberalisation after decades of focusing on import substitution.

One middle-income developing country that has successfully confronted these challenges is Mexico, which embarked on a wide-ranging trade liberalisation programme following the 1982 debt crisis.

This programme followed four decades of trade policy based on import substitution and culminated in the implementation of a free trade agreement with the United States and Canada in 1994. As an interim step, Mexico joined the General Agreement on Tariffs and Trade (GATT) in 1986.

The initial trade liberalisation reforms in Mexico were advanced by a reform-oriented government in the wake of a serious economic crisis and were supported by the IMF and the World Bank. The programme was sustained by building a broad base of private sector support for free trade.[14] The government sought to bring selected private sector groups into the policy-making process at a time when the balance of power within the corporate sector was shifting towards exporters and away from companies that focused solely on the domestic market. As business preferences began to shift in favour of free trade after the initial liberalisation measures, elements within the private sector gained a stronger voice in the policy-making process, particularly those from the internationally active companies.

While international integration based on free trade can provide significant potential for catch-up growth, it also exposes previously sheltered economies to new types of risk that must be effectively managed. These risks arise from cyclical variations in external demand and private capital flows (see Chapter 1). Mexico confronted these types of risks in 1995 shortly after entering into the free trade agreement with Canada and the United States. However, sustained progress in structural reform and institutional development has helped it to withstand the recent emerging markets pressures more effectively than other Latin American countries.

President Putin of Russia has recently made WTO accession a top priority and the government has approved a plan to bring legislation into line with WTO requirements. The new legislation will focus on a new customs code and measures dealing with import and export licensing, anti-dumping and other trade remedies. However, new legislation needs to go well beyond these issues and there are concerns about how effectively these new laws would be enforced, particularly at the regional and local levels. There is also significant resistance to further trade liberalisation from many domestic manufacturers and service companies that primarily serve the domestic market.

As in Mexico, the challenge in advancing the trade liberalisation programme will be to foster domestic support for this agenda. This could be achieved in part through the creation of organisations of exporters and consumer groups and by granting these groups access to the trade policy-making process. One way to complement and reinforce such domestic initiatives would be for the European Union and the United States to embark on a process of negotiating free trade agreements with Russia. This would help to increase the benefits of liberalisation to Russian producers and consumers.

Within the CIS as a whole, economic and political relations between member states have generally been established on a bilateral or multilateral rather than a CIS-wide basis. Many CIS states have been unwilling to strengthen their links with post-Soviet Russia. Consequently, the CIS has never evolved into a free trade area and some nations have formed alliances without Russia, such as GUUAM – the political, economic and security alliance of Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova. In contrast, Belarus, Kazakhstan, Kyrgyzstan and Tajikistan have strengthened relations, forming a customs union with Russia, and signing a treaty for the formation of a Eurasian Economic Community in October 2000. Belarus has intensified relations by signing a Union Treaty with Russia, which details plans for economic integration with Russia, including full monetary union in 2005.

Recent evidence suggests that cooperation between CIS countries may have been beneficial to the former Soviet republics in the aftermath of central planning. While the collapse of supply relationships that existed under central planning contributed to the sharp output declines in the CIS, evidence suggests that CIS trade relations may have helped to alleviate the disruption. The emergence of barter trade between CIS states in the face of tight liquidity constraints may also have limited the effects of disorganisation in CIS trade.[15]

It is possible that the CIS, and in particular relations with Russia, may prove to be an important source of economic security in the region in the future. However, the risks involved in relying on integration with Russia were apparent in the wake of the fallout from the August 1998 crisis, which led to severe macroeconomic disturbances throughout the region. The subsequent revival of Russian economic growth following the rouble devaluation and high oil prices has stimulated a period of economic recovery throughout the CIS (see Chapter 3).

The best strategy for the economic integration of the CIS is to adopt an approach that neither favours nor discriminates against Russian trade and that supports the diversification of export markets. However, the existing customs union between Russia and Belarus, Kazakhstan, Kyrgyzstan and Tajikistan extends Russia's external tariff to the other custom union countries. This serves to make these markets more favourable for privileged Russian producers. The accession to the WTO by Russia would help to reduce the extent of this tariff protection in the customs union and create more open and competitive markets.

2.8 Conclusion

The past year has seen sustained progress in reform and a significant improvement in the EBRD's transition indicator scores for many transition economies and across most areas of transition. A number of countries that have been lagging behind have made significant advances over the past year, including Bosnia and Herzegovina, FR Yugoslavia and Romania. These countries have benefited from favourable political and economic developments in SEE.

Supported by a strong CIS recovery, a number of CIS countries achieved significant reform gains, particularly Russia but also Azerbaijan, Belarus and Uzbekistan. At the same time, many countries

[14] See Thacker (2000a and 2000b).

[15] See Bevan, Estrin, Hare and Stern (2001).

that are candidates for EU accession continued to make steady progress in strengthening the performance of their market-supporting institutions. Only in Turkmenistan, where the political commitment to reform has been weak, was there backtracking in reform.

These recent reform developments largely conform with well-established patterns of transition. In most countries of the region, this includes liberalisation and small-scale privatisation ahead of large-scale privatisation and the development of market-supporting institutions. Moreover, the foundations for sustained progress in market-oriented reform appear to have been laid in countries where liberalisation has taken root and where a private sector has begun to develop through small-scale privatisation and the elimination of market entry barriers. Well-functioning democratic political systems also point towards sustained progress. This process is not guaranteed, however. Factors such as undue private influence over government policies and judicial decisions can have an adverse effect on reform progress. Policy-making based on political expediency can also slow down or divert the course of reform.

The process of international integration can complement domestic factors that help to sustain reform progress. The prospect of EU accession has had a significant influence on the extent of reforms in many CEB and SEE countries. To sustain this positive influence for change, the credibility of the accession process must be maintained through the effective reform of EU institutions and measures to help meet the costs of accession in the candidate countries. Initiatives are under way to address both issues and their effective implementation is central to the success of the process.

In contrast with the countries of CEB and SEE which are steadily integrating their economies into the international economy, the CIS economies remain relatively isolated. A significant share of their trade has remained within the CIS, with the exception of the export of natural resources to international markets. The priority for the CIS is to promote greater international trade and investment through accession to the WTO, particularly by Russia, but also by Ukraine and Kazakhstan. The adoption of more liberal and open trade regimes in these countries would generate significant benefits for the smaller CIS economies, some of which have already acceded to the WTO. As a longer-term objective, the European Union and the United States could consider the prospect of entering into free trade agreements with Russia to help in bolstering domestic support within these countries for greater economic openness.

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Annex 2.1: Legal transition indicators

The EBRD conducted a Legal Indicator Survey (LIS) for the seventh consecutive year in 2001 to measure progress in legal reform in central and eastern Europe, the Baltic states and the Commonwealth of Independent States, as viewed by local lawyers and academics. The EBRD's Office of the General Counsel has developed measures to assess both the extent to which key commercial and financial laws have reached internationally acceptable standards (extensiveness) and the degree to which these laws are implemented and enforced (effectiveness). The survey can also be used to analyse the role of legal reform in promoting investment and growth in the region.

The results of this year's LIS reflect how lawyers and other experts familiar with the region perceive the state of legal reform in 2001.[1] These perceptions do not always correspond directly with the written legislation or regulations that exist in the various jurisdictions. Table 2.1.1 provides an assessment of commercial laws, including pledge, bankruptcy and company law. Table 2.1.2 provides an assessment of banking and capital markets laws.

The LIS results presented in the tables assess perceptions of legal reform in terms of both the extensiveness of legal reform and its effectiveness.[2] For commercial law, extensiveness measures the impact of the jurisdiction's pledge, bankruptcy and company law on commercial transactions.[3] For financial markets, extensiveness assesses whether banking and capital market legal rules approach minimum international standards, such as the Basel Committee on Banking Supervision's Core Principles or the Objectives and Principles of Securities Regulation developed by the International Organisation of Securities Commissions (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 legal reform appears to be progressing in any jurisdiction. Countries that exhibit a high extensiveness score in conjunction with low effectiveness indicate that the relevant legislation may be broadly in line with international standards but poor implementation may have prevented proper utilisation of the legislation. For example, Azerbaijan and FYR Macedonia have a significant gap between extensiveness and effectiveness for their commercial laws while Tajikistan has an even larger gap in its financial laws. These gaps indicate that relatively extensive laws are not being properly implemented.

The legal indicators reflect the subjective assessments of survey respondents as well as the views of EBRD lawyers with experience in working on commercial and financial transactions in the region. For a few countries the LIS respondents provided a wide range of assessments. In these cases or where there were significant gaps between the extensiveness and effectiveness indicators the EBRD's in-house knowledge of that country's legal system was utilised to take an overall assessment of the differing views. The LIS should not be considered a stand-alone tool for measuring legal reform. It is intended to supplement other forms of data. 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.[4]

Results of the LIS 2001

This is the first year that there was an increase in the effectiveness scores for the majority of survey countries. Effectiveness scores have increased for 20 countries in commercial law and for 16 in financial markets. In addition, effectiveness scores remained constant (i.e. within less than 1 point difference) for two countries in commercial law and four countries for financial markets.

One notable exception is Poland, which experienced a downturn in effectiveness scores for both financial markets and commercial law. This decrease occurred despite revisions to the Commercial Companies Code and amendments to the securities laws to bring them in line with EU standards. Poland did not, however, receive lower extensiveness scores, indicating that respondents were aware of the legislative changes and their substantive implications. The effectiveness drop may, therefore, reflect a view that these changes were either vague, contradictory or inconsistent. This is reflected, for example, by Poland's very low effectiveness scores for company law for 2001.[5]

1 The survey was made available to respondents in both English and Russian.

2 The scores for commercial law and financial markets are aggregate indicators that do not segregate the individual subject areas surveyed (e.g. commercial law results are not further broken down into pledge, company, bankruptcy, etc.). More in-depth analysis of the LIS sector scores and data is presented in the EBRD's publication *Law in transition*, published by the EBRD's Office of the General Counsel.

3 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.

4 The EBRD endeavours each year to achieve as broad a response as possible for each country. In certain circumstances, the political situation in a country or a lack of available practitioners with the requisite qualifications has created a lower response rate. Those countries with less than four responses to the 2001 LIS were Armenia, Belarus, Bosnia and Herzegovina, FYR Macedonia, Moldova, Slovenia, Tajikistan, Turkmenistan and Uzbekistan. Results for these countries should be interpreted with extra caution. Insufficient data were received for Kyrgyzstan.

5 Poland's 2001 effectiveness score for company law was 34.7 as compared with 44.6 in 2000.

In addition, respondents may be revealing some scepticism as to whether all the legislative changes required by the EU can be effectively implemented.

Conversely, while Russia's extensiveness scores dropped, its effectiveness scores improved, most significantly in the commercial law area. While respondents indicated that there are problems with the existing legislative framework, perceptions of how Russia has implemented or utilised existing laws have improved. The World Bank cited Russia's improvement in July 2001, stating that progress had been made in Russia's reform of the legal and judicial system, including more transparent procedures for the appointment of judges and a reform of Russia's civil and criminal codes. Russia's Arbitration Courts issued a circular in January 2001, which contained a Survey on the Practice of Arbitration Courts in Dealing with Disputes relating to the Protection of Foreign Investors. This is an example of efforts to provide greater certainty to foreign investors with respect to the Russian court system.

Although effectiveness increased for both commercial and financial legal sectors, for approximately one-quarter to one-third of the survey countries, the extensiveness scores decreased (sometimes alongside an increase in effectiveness). This in turn often led to a decrease in the overall score. This may reflect negative perceptions of the substantive content of existing laws. Alternatively, this decrease may reflect the fact that lawyers are gaining a better understanding of substantive laws. These perceptions may be the result of more frequent use and application of commercial and financial laws as economies continue to develop.

The Slovak Republic showed a marked and steady improvement in all of the legal sectors covered by the LIS, exhibiting gradual but perceptible shifts in each sector. Belarus showed an increase in both commercial and financial market scores for 2001. For commercial law, the increase corresponds to respondents' perceptions of legislative changes in company, pledge and bankruptcy laws. The improvement in financial market scores corresponds with a series of resolutions passed by the National Bank of Belarus in 2001 that addressed issues such as a guarantee fund for depositors and foreign currency bank transfers. However, given the limited response to the 2001 LIS for Belarus, these results should be interpreted cautiously.

This is the first year that the EBRD has included the Federal Republic of Yugoslavia in the LIS results. Reflecting the relatively Western orientation and, by transition standards, the advanced commercial system in the Socialist Federal Republic of Yugoslavia before its break-up, FR Yugoslavia's 2001 commercial and financial scores generally fall in the middle for all transition countries and are slightly lower than many of its Balkan neighbours. Since late 2000 the new FR Yugoslavian, Serbian and Montenegrin governments have made legal reform a key priority. The LIS scores reflect recent efforts to develop modern commercial and financial legislation and improve the court system. However, both FR Yugoslavia's commercial and financial sector scores are characterised by significant gaps between extensiveness and effectiveness, which reflect the need for longer-term legal institution-building.

Legislative changes that have an impact on the overall effectiveness of the court and legislative system are less frequent, and they have a more indirect impact on perceptions of the effectiveness of legal reform. This year many countries have enacted legislation or promulgated government decrees aimed at reforming their judicial and administrative practices. Albania, Kazakhstan and Uzbekistan adopted plans, a law and a decree respectively, which are designed to promote and improve the judicial system. Several countries have reformed laws that deal with certain sectors or professions that serve as supporting institutions to the court system, including court executors, accountants, notaries and auditors.[6] These systemic reforms may have an impact on the perceptions of lawyers throughout the survey countries with respect to the effectiveness of specific legal reforms. Moreover, as noted in the 2000 *Transition Report*, several countries continue to improve regulatory structures in the financial services sector with the creation of consolidated regulators. These reforms may also lead to improved perceptions of the efficacy of the financial regulatory system in these countries.

LIS commercial law results

Bankruptcy scores (for both extensiveness and effectiveness) remain lower than pledge or company law scores, which are the highest of the commercial law scores. Perhaps the most interesting change to note is that 15 out of 25 survey countries have lower scores for the extensiveness of pledge laws whereas the effectiveness for pledge laws has improved for the majority of countries. This may be explained by the fact that while pledge registries came into effect in a few countries over the past year, increasing effectiveness perceptions, greater use of the pledge laws simultaneously revealed shortcomings in the coverage of the laws themselves.

While Poland experienced a downturn in its effectiveness scores overall, the Czech Republic suffered a decrease in effectiveness for its commercial law scores. This score reflects perceptions of commercial law as well as of the general effectiveness of the court system and legislative process. The EU has repeatedly criticised the Czech Republic for its failure to reform its judiciary, and the Governor of the Czech National Bank has publicly noted this was one of the key deficiencies in the Czech transition process. This may feed into the lower effectiveness score that the Czech Republic received for company law as well as the lower scores for the overall effectiveness of its commercial legal systems.

Company law

This year company law was the sector that experienced the greatest change in the broad area of commercial law. Many countries have amended or replaced existing company laws as well as civil and commercial codes. Some changes, such as an increase in minimum share capital and more detailed procedures regarding the filing of company information, reflect harmonisation with EU requirements. Other changes reflect

6 For example, the new Czech Execution Code which came into effect on 1 May 2001 seeks to address well-known problems with the execution of court judgements by increasing the qualifications for court executors and providing a quicker and less formal execution procedure.

Table 2.1.1

Legal transition indicators: commercial law

	2001			2000		
Country	Overall	Extensiveness	Effectiveness	Overall	Extensiveness	Effectiveness
Albania	2+	2+	2	2+	3+	2-
Armenia	2+	3-	2	3	4-	2
Azerbaijan	2+	3	2	3-	3	2
Belarus	3	3	3	1+	1	2+
Bosnia and Herzegovina	2-	1+	2	2+	3	1
Bulgaria	4-	4	4-	4-	4	4-
Croatia	4-	4-	4-	4-	4	3+
Czech Republic	3	3	3	3+	3	3+
Estonia	4-	3+	4	4-	4-	3+
FR Yugoslavia	3+	3+	3	na	na	na
FYR Macedonia	4-	3+	4-	3	3+	2+
Georgia	3	3	3	2	3	2
Hungary	4-	4-	4-	4-	4	4-
Kazakhstan	4	4	4	4-	4	4-
Kyrgyzstan	na	na	na	3	3+	3
Latvia	4-	4-	4	4-	4	4-
Lithuania	4-	4-	4-	4-	4	3+
Moldova	4-	3+	4-	3	3	2
Poland	3+	4-	3	4-	4-	4
Romania	4	4	4	4-	3+	4-
Russia	3+	3	4-	3+	4-	3
Slovak Republic	3+	3+	3+	3	3	3
Slovenia	4-	4-	4	4-	4	4-
Tajikistan	2	2	2	2-	2	2-
Turkmenistan	2+	2	3	na	na	na
Ukraine	3	3+	3	3	3+	2
Uzbekistan	3	3	3	3-	3	2+

Source: EBRD.

an increased focus on the protection of minority shareholders, which may be a result of increased litigation by minority shareholders and increased merger and take-over activity. Over the past two years there have also been important legal challenges brought by foreign minority shareholders in countries such as the Czech Republic and Russia.

There is a notable decrease in Russia's commercial law scores this year. Russia's company law score for extensiveness dipped dramatically. This may in part be due to the government's failure to thoroughly revise its joint-stock company law.[7] Russia's Federal Commission for the Securities Market is, however, working with the EBRD to develop a comprehensive Corporate Governance Code, the first draft of which was presented for discussion and consultations in late September 2001.

The increase in the Czech commercial law score probably reflects new amendments to the Czech Commercial Code, which entered into force in January 2001. The amendments strengthened rules on mandatory offers and notification requirements when shareholders reach certain thresholds. A person acquiring control of 40, 66 and 75 per cent of the voting rights in a publicly traded company will be required to adhere to the mandatory offer provisions. Additional minority protections in the revised Czech Commercial Code require significant corporate actions (such as mergers and restructurings) to be approved at the annual shareholders' meeting, and pre-emptive rights to be given to shareholders so that they may participate in any new share issuance. In addition, an entity (or entities acting together) is now required to report any acquisition or disposition of shares representing between 5 per cent and 95 per cent of the voting rights in a publicly traded Czech company.

7 Amendments to the Joint Stock Company Law were adopted in the middle of the year but they do not take effect until 1 January 2002. They are a watered down version of those originally proposed.

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 can 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 have not been amended to approximate those of more developed countries or those 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. 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 commercial legal sectors that were the focus of the survey. However, the legislation 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 security interests 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 commercial legal sectors that were the focus of the Survey. Pledge law appears to allow 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 commercial legal sectors that were the subject of the Survey. 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 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 the 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 is the average of the scores given for the two indicators, rounded up where the average did not fall exactly into the existing categories. 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.

Hungary has also refined its minority shareholder protections in response to controversial transactions involving two of its largest chemical companies, BorsodChem and Tisza Chemical Works Rt. In 2001 the Council of the Budapest Stock Exchange adopted amendments to its regulations and the Hungarian government approved amendments to the rules governing take-overs in order to increase protection for minority shareholders. Under these changes shareholders with up to a 50 per cent stake in a public company would be required to report to the State Financial Institutions Supervision Authority within two days of increasing or decreasing their holdings by 5 per cent or more. Shareholders have to make similar declarations when their holdings surpass 75 per cent and 90 per cent ownership thresholds. On reaching a 33 per cent ownership level, shareholders have to make a public offer for all outstanding shares. This is a change from the previous requirement that the controlling shareholder(s) must make an offer for only 50 per cent of the outstanding shares. The Hungarian amendments also expand the definition of indirect ownership to include situations where formal and/or informal agreements of shareholders lead to the parties acting together and provide for tougher fines for violation of the take-over rules.

Lithuania's extensiveness and effectiveness scores for company law have increased this year. Lithuania enacted a new Company Law in July 2000, which became effective at the start of the year. The minimum authorised capital for a public company has been increased from LTL 100,000 (approximately US$ 25,000) to LTL 150,000 (approximately US$ 37,500). The new law requires a qualified two-thirds majority of shareholder votes at the annual meeting in order to pass significant resolutions related to the company's activities, and provides for better transparency and disclosure for shareholder meetings.

Latvia enacted a new Law on Commerce this year but its effective date is not until January 2002. Notwithstanding this delay, Latvia's extensiveness scores for company law increased significantly. The new law (and its constituent parts) is meant to replace various laws including parts of the previous Joint Stock Companies Act. As with the Lithuanian law, Latvian companies will have two years to amend their by-laws and to re-register with the government (or face liquidation). The new law reduces the number of permitted types of commercial entities to five, with limited liability companies and joint-stock companies being the most prevalent. All Latvian joint-stock companies will now be required to select supervisory boards. Other changes relate to the publication of corporate records, filing and notification procedures and corporate decision-making procedures.

Bankruptcy law

Bankruptcy scores remain the lowest in terms of both extensiveness and effectiveness in the commercial law section of the LIS. The effectiveness scores in particular remain low, indicating a sense that insolvency proceedings take too long and are not effective. In addition, respondents appear to be uncertain as to the powers and qualifications of bankruptcy trustees and liquidators. Large-scale insolvency reform, which took place in 2000, has not led to a perceived improvement in the effectiveness of bankruptcy practice in the EBRD's countries of operations. Two notable exceptions in this field are FYR Macedonia and the Slovak Republic. FYR Macedonia amended its bankruptcy law in July 2000 so it is unclear whether respondents took account of this change when they completed the LIS last year. FYR Macedonia's effectiveness scores for bankruptcy increased this year, which may be attributable to the implementation of last summer's amendments.

Extensiveness and effectiveness scores for bankruptcy increased significantly in the Slovak Republic. This may reflect recent legislative developments that came into effect in August 2000 and February 2001. These amendments are aimed at improving the effectiveness of bankruptcy procedures. Recent changes stipulate that bankruptcy property may be sold without a public auction and authorise bankruptcy creditors to approve the appointment of a bankruptcy administrator. Chapter IV of the Bulgarian Commercial Act, which regulates insolvency proceedings, was amended in October 2000. The amendments aim to speed up bankruptcy proceedings and to bring the process into line with a three-stage process of judicial review set forth in the Bulgarian Civil Procedure Code.

The amendments include an improved process for preparing lists of claims, time restrictions for creditors to raise claims and an amended time frame for the repeal of claims. These changes mark an attempt to address the criticisms made by Bulgarian banks and others concerning delays in insolvency proceedings that have prevented banks from receiving compensation. Bulgaria's bankruptcy scores were lower for 2001 and may reflect perceptions of problems with early efforts to implement these new procedures.

Despite efforts to clarify and interpret existing bankruptcy laws through government directives, Russia's extensiveness and effectiveness scores for bankruptcy have decreased quite significantly. Since the middle of 2000, the Federal Service on Insolvency and the Russian Central Bank have issued a number of directives and regulations to explain existing bankruptcy rules and practices. Unfortunately, it appears that LIS respondents have not found these efforts to be effective. It is also likely that all this regulatory activity has increased uncertainty among bankruptcy practitioners.

Pledge law

While there was very little legislative activity on pledge laws throughout the region during the past year, pledge extensiveness scores generally decreased and effectiveness scores increased. The decrease in extensiveness scores may reflect an increased use and understanding of new pledge legislation in more complex transactions, which reveal shortcomings in the new laws. In contrast, the increased effectiveness results may reflect the implementation of new procedures to make effective the registration of pledges in movable property. Moldova's pledge law scores increased significantly for 2001. This might reflect lawyers' raised expectations in light of the enactment of a new pledge law in July 2001. In 2001 Romania and Albania joined a small but growing number of countries that have created a centralised and unified registry for non-possessory pledges in movable property.

Albania adopted a new Law on Securing Charges in October 1999, which required the registration of charges in an electronic registry. However, the registry did not commence operations until February 2001. Parties that had previously concluded secured transactions before the commencement of the registry had 90 days to register them in the new registry. As a result, Albania's effectiveness scores increased significantly this year.

Romania received high scores for the extensiveness and effectiveness of pledge law for 2001. In late 2000 Romania began to operate a new Electronic Archive of Secured Transactions. The archive implements provisions of the 1999 Law on the Legal Treatment of Security Interest in Personal Property, which allows for non-possessory charges to be taken in a wide range of assets. The archive provides a centralised mechanism for publicising the existence of such pledges (previously, there were several registries for charges over movable property). Registration can take place at locations throughout Romania at a minimal cost.

Azerbaijan also received a high extensiveness score for pledge law and received an improved effectiveness score. This probably reflects the effects of the new Civil Code that took effect on 1 September 2000. The new Civil Code includes provisions that deal with pledges in both tangible and intangible property, including bank accounts and licence fees. To be valid and enforceable, a pledge must be executed in writing and filed with the appropriate registering authorities. Certain types of security interests must also be notarised to be effective. The Code establishes detailed requirements for enterprise pledges.

While the provisions on pledges in the Czech Commercial and Civil Code have been amended, the Czech Republic's pledge law scores remain lower than in many EU accession countries. In September 2000 the Civil Code pledge provisions were revised to allow parties to create non-possessory pledges in movable property. These pledges can be noted on the ownership certificate where transfer of title requires such a certificate, or the charged assets can be labelled with the name of the creditor and kept on the debtor's premises. The amendments did not, however, represent a wholesale reform to allow for simple registration of non-possessory pledges in movable property in a centralised registry.

While Hungary's pledge scores were unchanged, changes to the Hungarian Civil Code, effective in September 2001, expanded the scope of collateral that can be pledged, clarified the priority of enterprise charges and provided for out-of-court enforcement measures. The EBRD is assisting the Hungarian government with the implementation of these changes, and their effect is likely to be registered in the 2002 LIS.

Financial markets

The improvement in financial market scores, especially effectiveness scores, primarily reflects improvements in the capital markets sector. Extensiveness scores and effectiveness scores for banking have declined, which may reflect a growing sense that banking supervision and regulation have not been conducted in an effective manner.

In contrast, a majority of the LIS survey countries have increased their capital market extensiveness scores. This may reflect changes to company law and to various capital market regulations, which improve minority shareholder protection and provide for greater transparency with respect to the listing of publicly traded securities.

Banking

Poland's effectiveness scores have decreased in all categories, including banking. The decline in banking scores may reflect the failure of the Polish parliament (Sejm) to pass amendments to the Banking Act and the Central Bank Act. The banking law amendments included changes to the Banking Supervisory Commission's supervision of changes to bank ownership, the activities of foreign branches in Poland and the activities of Polish banks abroad. However, Poland passed amendments in June 2001 aimed at aligning Polish legislation with EU law. The amendments broaden the list of permissible banking activities to include the issuance of electronic money, consumer loans and credits and letters of credit. It is likely that these recent amendments are probably too new to be reflected in responses to this year's survey.

Russia has also experienced a large decrease in its banking scores. Commentators have noted that the banking industry has not been restructured since the 1998 crisis and continues to be one of the weakest sectors in the Russian economy. Banks continue to carry a higher degree of credit risk than they do in many other countries, and uncertainty remains regarding unsettled claims on forward foreign exchange and option contracts written before the 1998 crisis.

Russia began to address some of these issues in June with new laws on the Insolvency of Credit Institutions, on the Central Bank and on commercial banks. The role of the Russian Central Bank has been strengthened with respect to monitoring the banking sector and insolvent banks. The new legislation gives banks a period of temporary administration of 12 months to achieve financial recovery compared with a previous 18 month period. The law also increases the liability of bank managers for allowing banks to become insolvent and sets new criteria for declaring a bank insolvent. The laws also permit the Central Bank to revoke a banking licence if the capital adequacy ratio falls below 2 per cent.

Armenia received strong scores for the extensiveness of its banking laws. In June 2001 the Armenian government approved a Law on the Insolvency and Bankruptcy of Banks. The new law provides criteria for determining when a bank is insolvent and also procedures for the liquidation of banks. Other amendments have been made to the Laws on Banking and Bank Activity and the Law on the Central Bank.

The Slovak Republic amended its central bank law and its commercial banking law in January 2001. The revisions to the banking law expanded the National Bank's supervisory powers. They also required it to impose administration on those banks whose capital adequacy ratio falls below 4 per cent or whose credit exposure to non-performing loans exceeds 30 per cent of share capital and capital reserves. The National Bank is required to revoke the licence of those banks whose capital adequacy ratio falls below 2 per cent. These amendments correspond with an increase in the Slovak Republic's banking effectiveness score.

Hungary's banking law scores have also declined considerably for 2001. This may reflect uncertainty as to the delegation of supervisory responsibilities for financial institutions. In June 2001 the Hungarian parliament passed a new law on the National Bank of Hungary that dissolved the National Bank's supervisory board and transferred the control function to the State Accounting Office. A new Monetary Council took over the tasks of the National Bank Council from July 2001.

Several jurisdictions have adopted new anti-money-laundering legislation or have amended existing laws. In the Czech Republic amendments were made to the Anti-Money-Laundering Act, which came into force in August 2000. The amendment redefines what constitutes a questionable transaction. In the Slovak Republic the Act on the Protection from Legalising Income from Criminal Activities came into force in January 2001. This obligates certain entities (banks, insurance companies, auditors and tax advisers) to identify any natural or legal person that undertakes a business transaction for over SKK 100,000 (approximately US$ 2,000).

In late 2000 Albania enacted a new law on the prevention of money laundering. The new law sets forth the obligations of

Table 2.1.2

Legal transition indicators: financial regulations

	2001			2000		
Country	Overall	Extensiveness	Effectiveness	Overall	Extensiveness	Effectiveness
Albania	2-	2	2-	2-	2	1
Armenia	3	3+	3	2+	2	3
Azerbaijan	2	2+	2	2	2	2-
Belarus	3-	3-	2+	2+	2+	2
Bosnia and Herzegovina	1+	1+	1	1	1	1
Bulgaria	3	3	3	3-	3	2+
Croatia	3	3	3	3	3+	3-
Czech Republic	3	3+	3	3+	4	3-
Estonia	4-	4	3+	3+	4	3-
FR Yugoslavia	3	3+	2	na	na	na
FYR Macedonia	3	3+	2	2+	3	2-
Georgia	3-	3	2+	3-	3+	2
Hungary	4-	4-	4-	4	4	4
Kazakhstan	3+	4	3	3	3	3-
Kyrgyzstan	na	na	na	3	3+	3-
Latvia	3	3	3	3	3	3
Lithuania	3+	3+	4-	4-	4	4-
Moldova	3+	4	3	2	3-	2-
Poland	3+	4	3	4	4	4
Romania	3+	4	3	3+	4	3
Russia	3-	3-	2+	3	3	3-
Slovak Republic	3	3	3	3	3	3-
Slovenia	4-	4	4-	4	4	4
Tajikistan	2	2	2-	2	2	1
Turkmenistan	1	1	1	na	na	na
Ukraine	2+	2+	2+	3-	3	2+
Uzbekistan	2+	3-	2	2	2	2-

Source: EBRD.

banks, currency exchangers, insurance companies, privatisation offices and other similar entities with respect to identifying clients that may be engaged in unusual or suspicious activities. Poland and Russia also passed laws to counteract money laundering during 2001.

Capital markets

In November 2000 the Estonian Ministry of Finance approved a new draft Securities Law that took effect in July 2001 and aligns Estonia's capital markets system more closely with EU requirements for public offerings. As a result, Estonia's capital market effectiveness scores continued to rise. Estonia also adopted a regulation that outlines new procedures for the registration and announcement of the public offering of securities. A new Central Register for Securities was created, which will contain all registered shares by 1 January 2003.

At the beginning of 2001 the Czech capital market laws changed substantially. Despite these changes, the Czech Republic's extensiveness score in capital markets decreased while the effectiveness score increased slightly. Amendments were made to the Commercial Code, Securities Act and Bonds Act. These amendments introduced new principles relating to the public trading of securities through the introduction of listing requirements mandated by legislation. Other changes expanded and clarified the authority of the Czech Securities Commission (CSC) and are reflected in the stronger effectiveness score. Previously only securities designated by the CSC could be traded on the Prague Stock Exchange and the RM-System.

The Slovak Republic's extensiveness scores increased in 2001. The Slovak government established a new Office for Financial Markets, which will supervise and regulate both the capital and insurance markets. A new Act on Stock Exchanges came into force in November 2000 that allows for a stock exchange to be formed with at least ten founders. The Act also sets out rules for stock exchanges and for the offering of securities. These legislative changes appear to correspond with the improved perceptions of survey respondents. The basic Slovak Securities Act was also amended to clarify that a security is publicly traded

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 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 limited in scope. Although regulations in banking may have been amended to accord with international principles, at least one important area of regulation is perceived as deficient – for example, capital adequacy, use of international accounting standards or use of consolidated comprehensive supervision. Supervision 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 Basel Committee's Core Principles, although regulations concerning bank insolvency and deposit protection may not have been adopted. Further refinement to regulation of securities intermediaries and/or investment funds and creation of shareholder depositories and registers seems 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 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 regulators may have engaged in corrective actions against failing banks and securities market practices, enforcement problems still 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 appear 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 seems 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 is the average of the scores given for the two indicators rounded up where the average did not fall exactly into the existing categories. 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.

when it is introduced onto the capital market, as opposed to the date when permission to issue the share is granted.

Bulgaria received a large increase in its capital market effectiveness score in 2001. This may reflect a delayed reaction to the enactment of new securities legislation in the second half of 2000. In 2000 the Bulgarian Council of Ministers adopted an Ordinance, containing a detailed list of requirements for initial and secondary public offerings of securities, which applies international standards regarding the contents of such documents. The same ordinance also contains requirements concerning periodic disclosure of information by public companies. The rules are applicable to Bulgarian and foreign companies that are listed or are seeking listing on Bulgarian stock exchange markets. The Ordinance follows the enactment of a new Bulgarian Securities Law in 2000.

Annex 2.2: Public participation in environmental decision-making

People's right to express their views on activities affecting their quality of life is increasingly recognised as a critical element of sustainable development.[1] Public participation in environmental decision-making is an important aspect of Agenda 21, the global agreement on sustainable development signed in Rio de Janeiro in 1992. Environmental non-governmental organisations (NGOs) and the public are recognised as watchdogs of governments and corporations, and as a source of critical information. Moreover, public participation in environmental decision-making can advance effective participatory processes more generally and promote the democratic process.

There is evidence to suggest that the public is gaining more influence over environmental decisions in transition countries although the extent of that influence varies from country to country. The newly acquired right of NGOs and individuals to voice their views on policies, plans and development proposals has an important impact on the quality of environmental decisions. It represents a profound change from the non-participatory structures of central planning.

Public participation in environmental decision-making is supported by domestic legislation – for example, through the provisions on public participation in Environmental Impact Assessments (EIAs) – and by the commitment of countries to international treaties such as the Aarhus Convention. The public's legal right to access environmental information is an important element of meaningful public participation. The degree to which environmental information and data are collected and organised for public access and use is a significant indicator of the public's ability to have input into environmental decisions. Measuring the actual degree of public participation, on the other hand, is often problematic. Indicators of the effectiveness of EIA provisions on public involvement can offer some insight into this area.

Aarhus Convention

The key international treaty governing public participation in environmental decision-making is the Convention on Access to Information, Public Participation in Decision Making and Access to Justice in Environmental Matters – the Aarhus Convention. This regional convention is open to the member countries of the UN Economic Commission for Europe, including all transition countries. It was adopted in Aarhus, Denmark, in June 1998 and came into force in October 2001. The convention acknowledges that sustainable development can be achieved only through the involvement of all stakeholders and is based on three principles: (1) individuals and organisations should be able to demand environmental information; (2) the public should be involved early in decisions that could have an impact on the environment; and (3) persons who have been denied environmental information should have the right of appeal.[2]

The Aarhus Convention is expected to play an important role in promoting public participation in environmental decision-making in the region over the coming years. In the meantime, progress on ratification can give an indication of the region's willingness to endorse the principles of the convention. Of the 45 countries that have so far signed or have directly ratified or acceded to the convention, 22 are transition countries, leaving only five transition countries that are yet to sign (see Table 2.2.1). The region has also been relatively fast in ratifying the convention. Fifteen of the 17 countries that have ratified or acceded to the convention are transition countries, including all the countries of the Commonwealth of Independent States (CIS) apart from Russia and Uzbekistan.[3] While this is a positive sign, it leaves open the question of how effectively the convention will affect relevant domestic legislation and improve public participation in a real sense. All ratifications are recent and countries are yet to start the process of harmonising relevant domestic laws.

Environmental data and information

The first vital step to public involvement in environmental decision-making is the provision of and public access to good-quality environmental information. Experience from both developed and developing countries indicates that giving the public access to company-level data can help to promote more environmentally responsible behaviour by industry, for example in terms of waste management or the use of toxic materials.

Disclosing company-specific pollution data and information helps the public to scrutinise companies' environmental behaviour, and the resulting public pressure can complement government regulation. Furthermore, the need to collect environmental data often helps companies to identify wasteful processes, the elimination of which yields both environmental and financial benefits.[4]

Recognising this, the Aarhus Convention includes provisions about the consistent collection, analysis and reporting of environmental data, and calls for the creation of nationwide pollution inventories or registers, accessible to the public in a structured and standardised form. The Pollution Release and Transfer (PRTR) system promoted by the Organisation for Economic Co-operation and Development (OECD) provides a good example of how environmental information can be made available to the public. A PRTR system is a database or inventory of potentially

1 For a more comprehensive set of indicators of sustainable development, see the 2000 *Transition Report*, Annex 2.4.

2 See United Nations (1998).

3 Progress on ratification is slower outside the region because in most Western countries ratification is not possible until all national legislation is in compliance with the convention.

4 See World Bank (2000).

Table 2.2.1

Participation in the Aarhus Convention

Country	Signature	Ratification
Albania	S	R
Armenia	S	R
Azerbaijan	-	A
Belarus	S	AA
Bosnia and Herzegovina	-	-
Bulgaria	S	-
Croatia	S	-
Czech Republic	S	-
Estonia	S	R
FR Yugoslavia	-	-
FYR Macedonia	-	A
Georgia	S	R
Hungary	S	R
Kazakhstan	S	R
Kyrgyzstan	-	A
Moldova	S	R
Latvia	S	-
Lithuania	S	-
Poland	S	-
Russia	-	-
Romania	S	R
Slovak Republic	-	-
Slovenia	S	-
Tajikistan	-	A
Turkmenistan	-	A
Ukraine	S	R
Uzbekistan	-	-

Source: UNECE (http://www.unece.org/env/pp/ctreAty.htm).
Note: S - Signature, R - Ratification, A - Accession, AA - Approval.

harmful releases to the environment, covering air, water and soil as well as wastes transported off site for treatment and disposal.[5] Unlike other environmental databases, a PRTR system provides individual facility-level pollutant data, which can be periodically produced and made publicly available in an easily accessible way.

Many transition countries have begun to establish PRTR systems, often with the help of international organisations. Legal frameworks for PRTR systems have been established in Albania, Croatia, the Czech Republic, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia. Some of these countries plan to disclose environmental information to the public beginning in 2002 while EU accession countries are expected to start filing registers under the European Pollutant Emission Register (EPER) by mid-2003.

Some countries already disseminate aggregate environmental information although company or facility-specific data are not usually disclosed to the public. Poland, for example, has had for many years mandatory self-reporting requirements linked to its pollution charges, including quarterly or annual reports to the regional authorities on the emission of regulated pollutants. The pollution information collected in this way is currently only partially released to the public but the Polish authorities intend to make it fully available soon. Russia publishes annual environmental status reports providing information on large polluters by industrial sector as well as by the amount of pollution they produce. In the Czech Republic, electronic reporting and the dissemination of pollution data via the Internet have been tested. Advances in information technology have important implications for the dissemination of information, and increased access to the Internet will facilitate the flow of environmental information in the region, particularly from NGOs.

Legal provisions for public participation in EIAs[6]

One of the most common ways in which the public can express their views on developments and influence decision-making is through participation in the preparation and review of EIAs.[7] A legal framework for EIAs is often the first procedural law in transition countries to incorporate public participation in environmental decision-making.

The region has its own history of developing environmental appraisal systems, dating back to the 1970s. In 1985 the Soviet Union introduced the State Environmental Review system (SER), which aimed to assess and set permissible levels for the environmental impact of projects and regional development schemes. The process included environmental appraisal reports, which are similar in many ways to EIA reports.

However, the appraisals were carried out by committees of experts and consequently lacked transparency and opportunities for public participation. A more Western approach was introduced to the region in the 1990s with the adoption of EIAs. Most advanced transition countries made a full switch to Western procedures. Bulgaria, Croatia, the Czech Republic, Hungary, Poland, the Slovak Republic, Slovenia and Romania have adopted systems that correspond to EU norms.[8] The Baltic states are in the process of changing their EIA legislation and are still largely guided by SER-type provisions.[9] The CIS countries have typically incorporated EIA procedures, including public participation provisions, into their existing

5 Aarhus PRTR Task Force, http://www.ecn.cz/PRTR-TF/article59.htm.

6 This section is based on a review of local environmental legislation and information from local sources.

7 See OECD (1999).

8 See Lee (2000).

9 See Cherp (2001).

Table 2.2.2

EIA provisions for public involvement in decision-making

Country	Public disclosure of EIAs	Provision on public comment / discussions / hearings: EIA system[1]	SER system[2]	Right to appeal	Obligation to consider alternatives	Share of rejected or modified projects
Albania	Yes	Right to evaluate; no provision for procedures	-	na	na	na
Armenia	Yes	Public hearings at all three stages	-	Yes	Yes	0%
Azerbaijan	Yes	Public comment on EIA report	Public comments must be seriously considered	Yes	na	na
Belarus	No	Optional, no provision for procedures	Optional. Public represented in expert committee	No	na	na
Bosnia and Herzegovina	No	None	na	No	No	na
Bulgaria	Yes	Public comment / discussion on preliminary and final report	-	Yes	Yes	5%
Croatia	Yes	Public hearing for preliminary and final EIA report	-	na	Yes	20%
Czech Republic	Yes	Public comment / meeting on final EIA report	-	Yes	Yes	About 5%
Estonia	Yes	Public comment on preliminary and final EIA report	-	Yes	Yes	Rejected: na Modified: 40%
FR Yugoslavia	No	Optional public hearing	-	na	na	na
FYR Macedonia	To be introduced in new law	na	na	na	na	na
Georgia	Yes	Detailed provisions under preparation	Obligatory public discussion	Yes	na	na
Hungary	Yes	Public comment on preliminary and final EIA report	-	Yes	Optional	5%
Kazakhstan	No	None	Optional public environmental review	na	Yes	17-20%
Kyrgyzstan	Yes	Public comment on EIA review	Optional public environmental review	Yes	na	na
Moldova	Yes	Public comment on EIA	Optional public environmental review	No	na	na
Latvia	Yes	Public comment on all three stages	Provided for. In practice only experts are heard	Yes	Yes	Rejected: < 5% Modified: 50%
Lithuania	Yes	Public comment on preliminary and discussion of final EIA	-	Yes	Yes	Small
Poland	Yes	At preliminary and final stage	-	Yes	Yes	Rejected: small Modified: na
Romania	Yes	Public hearing on EIA report	-	Yes	na	Rejected: na Modified: high
Russia	Yes	Public comment/ discussion at all three stages	Public comments are considered at final SER	Yes	Yes	30%
Slovak Republic	Yes	Public comment at all three stages	-	na	Yes	More than 20%
Slovenia	Yes	Comment on final report. Optional public debate	-	Yes	Yes	na
Tajikistan	na	na	na	na	na	na
Turkmenistan	na	na	na	na	na	na
Ukraine	No	Optional review of EIA report	Optional public review	na	na	30%
Uzbekistan	Yes	Optional review of EIA report	Optional public review	Yes	Yes	na

Sources: Compiled from a review of national legislation and information from local sources (1990-2000). Data on the share of rejected and modified projects are from Kobus et al (2000).

1 Participation is possible at three stages of the Environmental Impact Assessment (EIA) system: preliminary (scoping), draft and final stage.

2 SER = State Environmental Review.

SER system. Table 2.2.2 documents the legal provisions on public participation in EIAs and their application. The table distinguishes five elements:

- provisions for the public disclosure of EIAs – a vital first step for public participation in the EIA process;
- provisions for public hearings and discussion to provide opportunities for the public or public representatives to voice their concerns;
- the right to appeal either against decisions based on an EIA or the way in which an EIA was conducted;
- the obligation to consider alternatives in an EIA report – this is embodied either as an obligation to developers to study alternatives (other than the "no project" case) or the public's right to propose alternatives for consideration by the developers;
- the share of projects that were rejected or significantly modified because of EIA results, as a measure of the public's influence over the decision-making process.

The table shows broad differences in the way that public participation is provided in the region. Albania, Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania, Poland and Russia have quite extensive public participation provisions in their EIA procedures. In most of these countries, public discussions are held as part of the EIA process, most commonly at its preliminary and final stages. Public comments on EIAs are often released together with a statement on how they were (or were not) taken into account. In the case of Romania, a public participation procedure exists only in the EIA law. Outside the CIS, only four countries (Albania, Bosnia and Herzegovina, FYR Macedonia and FR Yugoslavia) do not have procedural laws for EIAs. Albania and FYR Macedonia have, however, prepared draft laws and have submitted them to parliament for approval.

In the CIS, all countries have enacted new legislation for EIAs or SERs since 1995. Although most of them include a legal clause for "optional" public inputs to be integrated into the EIA discussion process, full public participation procedures have not usually been established. Azerbaijan and Kyrgyzstan have recently introduced detailed provisions for public participation in the EIA/SER processes. Georgia's framework law on EIAs also provides for public participation, including public discussions, and the procedural law is under preparation. Armenia has established extensive public participation provisions, including hearings at the community and regional level, involving the public, NGOs and experts.

Russia's EIA regulation of 2000 contains detailed provisions on the format and timeline for public participation at all stages of the EIA process. As in other SER-based systems, the Russian SER committee, which consists of independent environmental experts, has to take into account the recommendations of an independent public review of the EIA report. As environmental NGOs become more active in the CIS, it is expected that they and the public will increasingly use these opportunities.

Implementation of public participation

Setting up a procedural law for public participation does not guarantee that environmental decisions will be made through participatory processes. Authorities do not always welcome public participation, which is seen as curbing their decision-making powers. Developers often perceive it as costly in terms of both time and money without seeing the benefits public consultation can provide in terms of access to local knowledge. Overall, the implementation of new EIA requirements is slow and as a result there is a disparity between law and practice.

The cases of Bulgaria and the Czech Republic are instructive in this respect. The Bulgarian EIA procedures are relatively advanced in terms of public participation but their application is still uneven. Public discussions are often carried out too late, sometimes even after project completion.[10] While there are cases where pressure from NGOs has brought about changes to development proposals, more experience with public participation is needed to make the EIA procedures more effective. The Czech provisions on public participation in EIAs are less comprehensive. Inadequate public notification, poor access to documentation and insufficient opportunities for appeal are among the main shortcomings. In practice, however, the EIA procedures are utilised extensively by environmental NGOs to put pressure on developers. Czech legislation also gives NGOs the right to be involved in the siting and permitting process that follows the EIA.

The Baltic states provide another notable example. Estonia, Latvia and Lithuania have all established public participation provisions for EIAs, including procedures for notification, consulting and consideration of alternative plans. In practice, however, there is still much room for improvement. A study for Estonia showed that 70 per cent of EIAs are conducted without public participation.[11] This should change following the recent establishment of procedural laws and regulations in all three countries. The Estonian Law on EIAs and Environmental Auditing, which contains an extensive participation procedure, came into force in 2001 after lengthy discussions within government over public participation. Lithuania and Latvia have also approved detailed regulations for EIAs.

In Armenia the implementation of extensive public participation provisions has proven difficult as clear implementation mechanisms are lacking and the institutional capacity to undertake public participation is insufficient.[12]

In this situation the information disclosure policies and public participation requirements of international financial institutions (IFIs) can have an important demonstration effect.[13] The disclosure and consultation requirements of IFIs

10 See Veleva and Anachkova (2000).

11 See REC (1998).

12 See Ter-Nikoghsyan (2000).

13 For a discussion of the EIA practices of IFIs, see Kennedy (1999).

show how the public can be informed and participate in environmental decision-making. This demonstration role is important, particularly in countries where public participation is "declaratory" rather than operational.[14] Projects financed by IFIs tend to attract the attention of international and local NGOs. As a result, IFI projects receive much wider public scrutiny and attention than projects that are financed locally. However, while the involvement of international partners may empower local NGOs with additional resources and know-how, they may also dominate local voices.

Conclusion

A legal framework for public participation in environmental decision-making is evolving across the region through the adoption of EIA laws and procedures. Countries are making progress in collecting and making environmental information publicly available, often adopting the PRTR system.

The emerging legal frameworks provide the public with access to environmental decision-making instruments and encourage them to participate in the process. The public rights and obligations embodied in the provisions help to institutionalise public participation in environmental decisions and reinforce the concept of public participation in environmental decision-making. These are important steps but on their own they cannot ensure meaningful public participation. Now that the laws are in place, the challenge facing the region is to ensure that they are effectively implemented.

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[14] See Cherp (2001).

Macroeconomic performance and prospects

3

Conditions in the global economy have changed dramatically over the past year. In 2000, when growth in the world economy was rapid and investor confidence was strong, the transition economies of central and eastern Europe, the Baltic states and the Commonwealth of Independent States (CIS) experienced their highest average growth rate since reforms began. Since the second half of 2000, however, performance of the world economy has progressively weakened and this has affected the transition countries through a slowdown in exports.

In September 2001 the terrorist attacks in the United States and the anticipated response to those attacks significantly heightened uncertainty regarding the outlook for the already weakened global economy and for the transition economies. These developments are likely to prolong the slowdown in the United States and further dampen growth in western Europe in the remainder of 2001 and early 2002. Despite the increased global uncertainty, the region as a whole is expected to record its third successive year of positive growth in 2001 at 4.3 per cent,[1] following the 5.5 per cent growth achieved in 2000. The outlook for 2002 is less positive, with growth likely to slow down to around 3.4 per cent for the region as a whole. While the region is not immune to the global slowdown, compared with other emerging markets, most transition economies are relatively well-positioned for further growth.

Nonetheless, there are significant differences in the degree to which various parts of the region have been, and are likely to be, influenced by the world economy and by unfolding political developments. Having redirected economic activity towards Western markets and investors – in particular those in the European Union – central eastern Europe and the Baltic states (CEB) is most exposed to a global slowdown and international investors' diminished appetite for risk. However, as the process of economic integration continued in the first half of 2001, export performance and foreign direct investment (FDI) remained relatively strong while rising domestic demand further contributed to robust macroeconomic performance. Nevertheless, CEB would be affected by a protracted slowdown in EU growth, in particular through greater external imbalances and heavier external and fiscal financing requirements.

Growth in south-eastern Europe (SEE) has been sustained by a recovery from economic and regional political crises. However, its pace is likely to slow down as policy will need to adjust to a much weaker outlook for exports as well as for private capital inflows. The CIS currently seems least exposed to the worldwide economic downturn. High oil prices have supported strong growth in Russia and this has benefited the rest of the CIS through trade linkages.

Following significant volatility in the aftermath of the terrorist attacks, future markets point towards a weakening of prices for Brent crude to the bottom of the US$ 22-28 range by year-end. This could negatively affect demand in Russia although oil prices would need to fall well below US$ 18 per barrel to fundamentally alter the outlook for Russia. Several Central Asian countries, particularly Tajikistan and Uzbekistan, may experience heightened political tensions. Moreover, the potential influx of refugees into Uzbekistan, Tajikistan and Turkmenistan, which border Afghanistan, may increase domestic tensions and impose a financial burden. Against these risks stand the benefits of increased Western financial support in exchange for military cooperation.

The ability of policy to respond to these challenges varies by sub-region. Structural fiscal deficits in CEB and a more challenging international investment climate limit the potential for fiscal policy to sustain domestic demand in the face of a prolonged global slowdown. Instead, fiscal policy may need to be tightened to maintain sustainable fiscal and external balances and investor confidence. While FDI inflows remain high, greenfield investments have been slow to replace earlier privatisation-related inflows, with a resulting shift in the composition of external financing towards potentially more volatile debt and portfolio flows. At the same time, monetary policy in the advanced EU accession countries is constrained by the aim of bringing inflation towards EU levels in preparation for membership of the exchange rate mechanism (ERM). However, the analysis in this chapter suggests that monetary policy should not aim for a rapid disinflation.

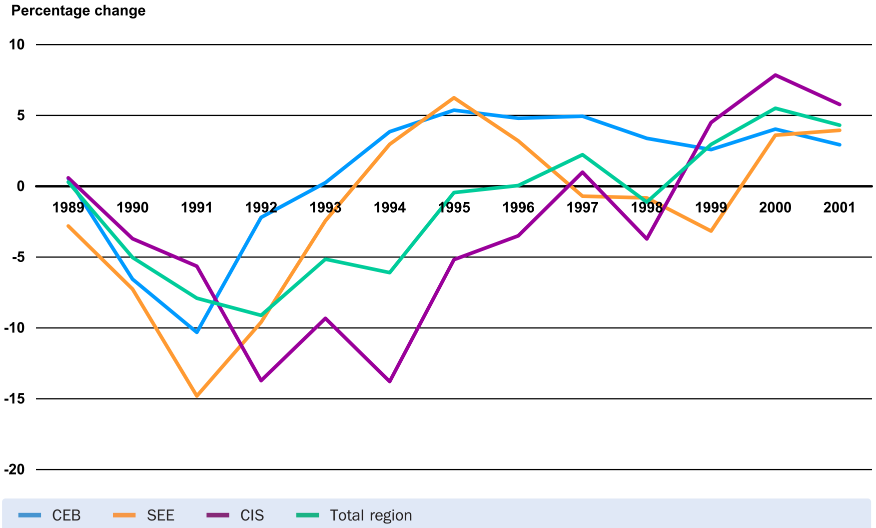
The constraints on macroeconomic policy in SEE are even tighter than those in CEB following years of instability, including high structural fiscal and external imbalances. The adoption of fixed exchange rates or currency boards in several countries has restrained these imbalances by firmly tying the hands of policy makers. In the face of weaker external demand, fiscal policy will need to be adjusted to limit external imbalances. However, SEE has significant scope for supporting growth and increasing private foreign financing of external imbalances through further progress in structural reform, as the recent success of Bulgaria demonstrates.

The CIS contains two groups of countries with differing policy responses. In energy-rich Russia and the Caspian countries the main challenge is to deal effectively with trade surpluses and capital inflows associated with the booming resource sectors. This requires above all further strengthening of fiscal policy and the adoption of a medium-term fiscal framework. The other CIS countries should capitalise on the recent upswing to boost reform efforts and raise competitiveness on international markets to be able to reduce their dependence on Russia if its growth slows. In those states likely to be most affected by regional instability caused by military

1 All regional average GDP measures are weighted by EBRD estimates of nominal GDP in US dollars for each country of the corresponding region in the previous period.

Chart 3.1

Growth in real GDP



Source: EBRD.

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

conflict in Afghanistan, immediate policy concerns will focus on raising revenues to finance security measures and handling the possible inflow of refugees. Support from the international financial community is therefore likely to assume increasing importance.

The chapter looks at the implications of a downturn in the global economy for transition countries. Section 3.1 outlines recent economic developments in the region and analyses the reasons for the relative resilience of growth. Section 3.2 considers the likely impact of a continued slowdown in the global economy and heightened uncertainty surrounding the outlook for the remainder of 2001 and 2002. It also evaluates the major risks to the general outlook. Section 3.3 discusses some of the key policy challenges for the region, focusing both on short-term adjustment and medium-term policies to support growth. It considers the appropriate fiscal and monetary policy response in CEB and SEE in the short run, the importance of attracting and maintaining high FDI inflows to support growth in the future, the impact of the resource boom in Russia and the Caspian region, and the long-term consequences of the recent increase in trade between CIS countries.

The chapter is based on the analysis of macroeconomic data for all 27 of the EBRD's countries of operations over the last 12 years, presented in Annex 3.1.

Additional macroeconomic indicators for individual countries are reported in the country assessments at the back of this Report. These indicators are primarily based on official statistics. While the quality of macroeconomic statistics in transition countries has improved, imperfections remain in some of the data. Given the difficulty of accounting for the large unofficial economies in some countries, the variation of country-specific definitions and the different composition of price baskets, cross-country comparisons should be interpreted with appropriate caution. Where official data are unavailable or unreliable, the analysis is based on EBRD staff estimates using secondary information from a wide range of sources.

3.1 Recent economic developments

In 2000 record growth was recorded for the region (see Chart 3.1 and Table A.3.1). The most impressive gains were recorded in the CIS, which grew by 7.9 per cent on the basis of high commodity prices and competitive devaluations of CIS currencies following the Russian crisis of 1998. Growth in the CIS is likely to level out in 2001 but it is expected to remain above 5 per cent. Despite a slight slowdown in Poland and Slovenia, stronger growth in Croatia and the Czech Republic helped CEB to grow by 4 per cent in 2000, exceeding the EU average growth rate of 3.3 per cent. Output performance in CEB is likely to remain positive in 2001 and, at around 3 per cent, will again exceed EU growth. SEE recovered in 2000 to register a 3.6 per cent increase in real GDP, with turnarounds in Romania and FR Yugoslavia, and this rate is expected to increase to 4 per cent in 2001.

In 2001 SEE and the CIS are likely to record on average higher growth than CEB for the first time. This is an encouraging development that reflects recent efforts to promote macroeconomic stability and to advance structural and institutional reforms (see Chapter 2 and the 2000 *Transition Report*). However, the disparity in cumulative macroeconomic performance remains wide. By the end of 2000, the majority of countries in CEB had exceeded their official 1989 levels of GDP. In SEE the average ratio is around 70 per cent while in the CIS it is only 60 per cent. The challenge to sustain high growth rates is particularly urgent in many CIS states as well as in the southern Balkan countries, where poverty rates are high and the costs of transition have been absorbed disproportionately by the poor.

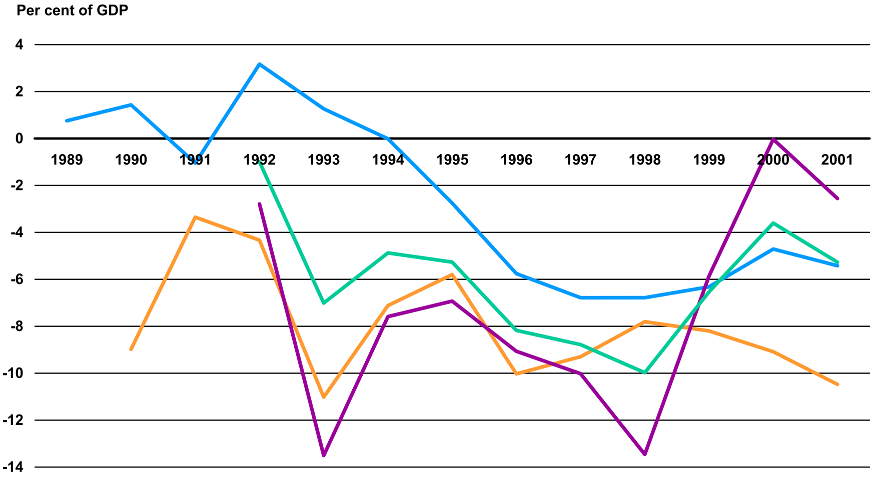
Central eastern Europe and the Baltic states: sustained growth

The strong average growth performance of the CEB region illustrated in Chart 3.1 masks significant variation between individual countries. Croatia and the Czech Republic returned to growth in 2000, assisted by the recovery of tourism and strong investment performance respectively. The Baltic states benefited significantly from stronger growth in both the EU and the CIS. Only Poland and Slovenia experienced slightly lower growth in 2000 compared with the previous year and are likely to slow down further this year. Most other CEB economies are also likely to experience lower GDP growth rates, with the exceptions of the Czech Republic, Lithuania and the Slovak Republic.

Exports were central to the favourable growth performance in 2000, with all CEB economies benefiting from exceptionally strong growth in export volumes – in the range of 10 to 30 per cent – due primarily to the strength of the EU economy. Export growth remained relatively firm in the early months of 2001 despite the EU slowdown. However, from April 2001 CEB export growth to the EU began to slow down, pointing to a delayed response

Chart 3.2

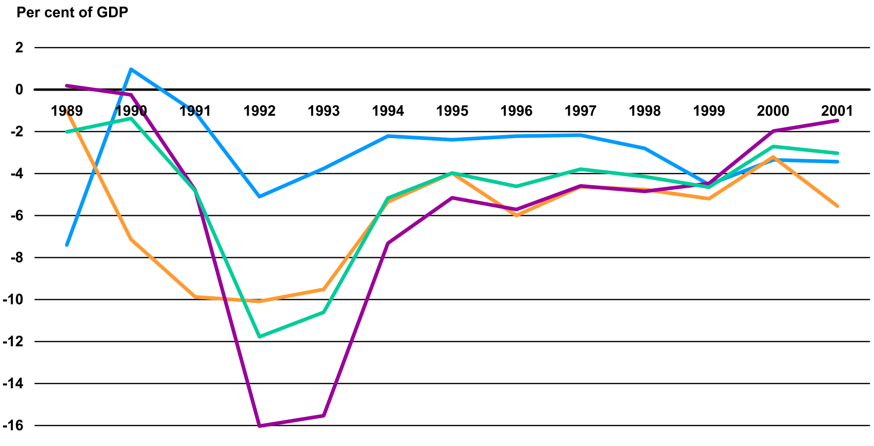
Current account balance



Source: EBRD.
Note: Balance of payments data are not available for most CIS countries until 1992.

Chart 3.3

General government balances



Source: EBRD.

to changes in external demand. This trend is likely to continue for the remainder of the year and therefore the growth of CEB countries will become increasingly dependent on developments in domestic demand (see Table A.3.2). In the Czech Republic a cyclical upswing in investment is supporting the present recovery while in Hungary a fiscal package equivalent to about 2 per cent of GDP should help to sustain growth at about 4.5 per cent this year. In Poland, however, domestic demand has been restrained by tight monetary policy since the second half of 2000 and growth is therefore forecast to decline to 2 per cent in 2001 from 4 per cent in 2000.

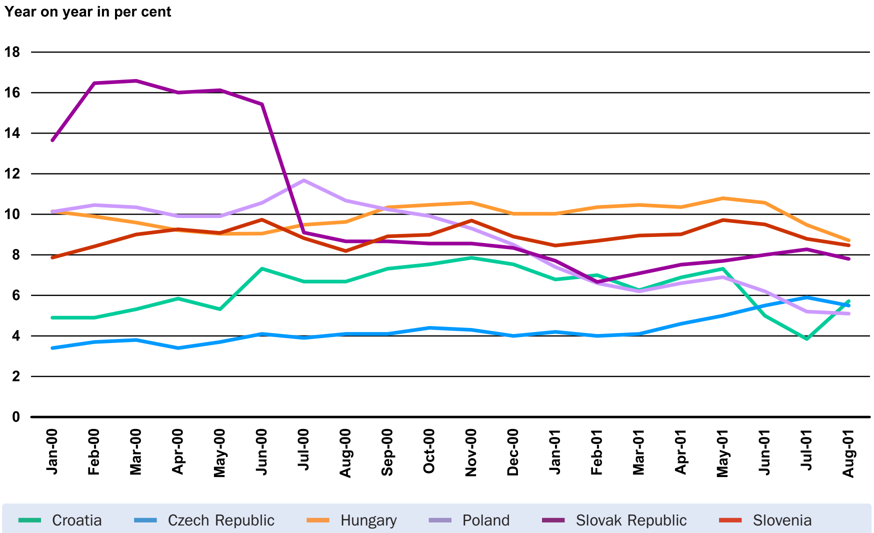
Reflecting the shifting balance between external and domestic demand, there is expected to be a significant change in the external balances of CEB between 2000 and 2001 (see Chart 3.2 and Table A.3.7). Strong export growth in 2000 brought improvements in current account performance in all countries, except the Czech Republic and Estonia where strong cyclical upturns in domestic demand led to a deterioration in the trade balance and the service account respectively. By contrast, for 2001 it is expected that the current account balances of most CEB countries will weaken with the slowdown in external demand and the continued strength of domestic demand. Poland and Slovenia are exceptions to this trend mainly due to subdued domestic demand limiting import growth. These external deficits are financed largely by FDI, which is likely to become more scarce as investor caution remains high. This highlights the importance of maintaining an attractive investment climate for FDI as well as controlling external balances through domestic policy.

Strong GDP growth in 2000 helped the CEB countries to improve their fiscal performance (see Chart 3.3 and Table A.3.4). However, with external demand slowing, pressure on fiscal balances is expected to increase again, while approaching elections in the Czech Republic, Hungary and the Slovak Republic may make governments hesitant about expenditure cuts. This political budget cycle was evident in Poland in the run-up to the September 2001 elections. While the structural causes of these fiscal deficits must be addressed over the medium term (see Chapter 3 of the 2000 *Transition Report*), the widening fiscal and external imbalances in the context of already significant fiscal deficits limits the ability of fiscal policy to assume a stabilising role. In these circumstances, the balance between monetary and fiscal policy becomes particularly important, as highlighted in Section 3.3.

Inflation performance has differed quite markedly across countries in CEB (see Table A.3.3). In Hungary and Slovenia year-on-year inflation increased slightly during 2000 and stayed relatively high until the second quarter of 2001, when the headline rate started falling (see Chart 3.4). The sharp rise in energy prices and the fall in the euro against the US dollar accounts for much of the persistence of inflation in these countries in the recent past. Both the euro-dollar rate and crude oil prices are more likely to move in the opposite direction from now on. In Poland the high interest rate policy of the central bank was successful in reducing domestic demand in the face of a high external deficit, with inflation falling sharply since mid-2000 but with unemployment accelerating. In contrast, inflation has risen in recent months in the Baltic states, the Czech Republic and the Slovak Republic as economic growth has accelerated. With these

Chart 3.4

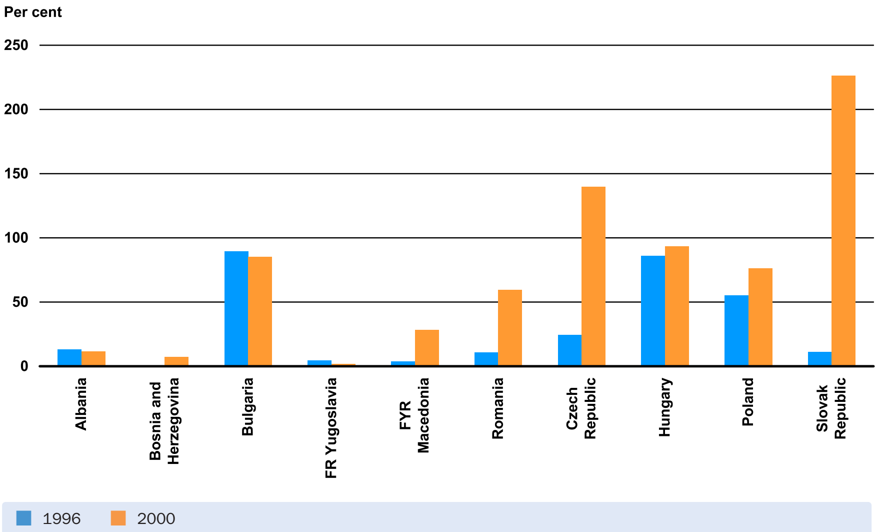
Headline inflation in selected countries of central and eastern Europe



Source: EBRD.

Chart 3.5

FDI inflows as a percentage of trade deficit, selected years



Sources: EBRD and UNCTAD.

developments, inflation across CEB is showing a tendency to converge around 5 to 6 per cent per annum.

South-eastern Europe: strong recovery at last

Following three years of recession, recovery in south-eastern Europe was achieved in 2000, prompted by upturns in FR Yugoslavia and Romania and higher growth in Bulgaria. As in CEB countries, exports contributed strongly to this growth in addition to the cyclical recovery of domestic demand. In 2001, growth is expected to strengthen based on further increases in fixed investment and consumption. For example, there was a 7.6 per cent surge in household consumption during the first quarter of 2001 in Romania. Similar patterns are evident in Bulgaria, where the 4.5 per cent increase in real GDP growth in the first quarter of 2001 was supported by a 12 per cent increase in fixed investment. However, the contribution to growth from exports is likely to weaken.

In the southern Balkans the degree of political stability and the confidence of investors and consumers are likely to remain the key influences on economic growth. FR Yugoslavia received important support when international donors agreed to a US$ 1.2 billion financing package for reconstruction in June 2001. This should underpin the stabilisation programme and help to sustain recovery, with growth expected at about 5 per cent for this year. The impact of the ethnic conflict in FYR Macedonia is likely to lead to a sharp fall in GDP this year, making it the only case of negative growth in 2001.

Chart 3.2 illustrates that current account deficits in SEE remain high (see also Table A.3.7). The deterioration in 2000 was the result of several adverse developments, particularly the increase in oil prices and the severe drought that hit all the countries of the region. Balance of payments data point to a further deterioration of the trade accounts in SEE during the first half of 2001 as import growth has remained high and exports to the EU have started to slow down. In contrast to CEB, external deficits are largely financed by official sources of finance rather than FDI.

Chart 3.5 shows that, with the exception of Bulgaria, FDI inflows have covered a far smaller percentage of the trade deficit than they have in CEB. There is little access by SEE countries to other sources of private finance (see Chapter 2 of the 2001 *Transition Report Update*), and as a result the region remains reliant on official sources of financing. This commits these countries to the conditionality of donor assistance but makes the southern Balkan countries in particular vulnerable to a possible decline in official finance as political attention shifts elsewhere. The challenge of increasing private external financing is discussed in Section 3.3.

Fiscal deficits have been high in SEE, largely as a result of falling revenues and high government expenditures associated with oversized public sectors (see Chart 3.3 and Table A.3.4). More recently, the Kosovo war and the ongoing conflict in FYR Macedonia have imposed further strains on the already weak public finances of these countries. High structural deficits and the dependence on multilateral finance will continue to require fiscal austerity in all countries of SEE over the medium term, with growth depending largely on accelerated structural reforms.

Inflationary trends in the region have been broadly downward (see Table A.3.3) although inflation in FR Yugoslavia increased significantly in 2000 due to energy price liberalisation and tax increases in Serbia. All countries are expected to record reduced inflation rates in 2001. Nevertheless, in 2001 inflation remains high in FR Yugoslavia and Romania and is forecast to reach 45 per cent and 40 per cent respectively at the end of the year. Bulgaria experienced a temporary rise in inflation during 2000 as a result of rising food and energy prices but inflation has subsequently declined rapidly.

Commonwealth of Independent States: the Russian growth dividend

The CIS has grown strongly since the Russian crisis of 1998, reaching 7.9 per cent growth in 2000. Growth is expected to slow down in 2001 but will remain high compared with past CIS performance and earlier forecasts. In the first half of 2001 the largest CIS economies continued to grow strongly, with Russia achieving 5.4 per cent growth, Kazakhstan 14 per cent and Ukraine 10.5 per cent. As a non-oil-exporting country, the strength of the recovery in Ukraine is particularly noteworthy and this partly reflects growth in industrial production and exports to Russia and Turkmenistan.

This development is consistent with the view that recovery in the region is not solely tied to high oil prices (see Chapter 3 of the 2000 *Transition Report* and Chapter 1 of the 2001 *Transition Report Update*). While the rise in commodity prices has aided the oil-exporting countries, the competitive devaluation of CIS currencies after the Russian crisis of 1998 has also stimulated, at least temporarily, the growth in manufacturing.

The competitive edge of Russian producers, however, has declined due to a significant real appreciation of the exchange rate against the euro since August 1998, which has brought Russia's real exchange rate to around 80 per cent of its pre-crisis level. Production costs in Russia have also risen due to sharp increases in real wages. However, while these factors have depressed net export growth in Russia, they have boosted domestic demand, which grew at around 11 per cent during the first half of 2001. The growth in demand in Russia has also boosted the market for CIS exporters, which is reflected in the general upturn in the region.

The recent pattern of current account balances in the region also confirms this assessment. The oil-exporting CIS countries saw their external balances turn sharply positive last year, with the average current account moving from a 5.9 per cent deficit in 1999 to a 9 per cent surplus in 2000. In 2001, however, there has been a reversal of this pattern, with the average current account surplus falling to 1.6 per cent of GDP in the oil-exporting countries. By contrast, the current account of non-oil-exporting countries has strengthened, with the average deficit falling from 5.6 per cent of GDP in 1999 to an expected 3.7 per cent of GDP this year. This partly reflects growing trade between CIS countries, which has provided some insulation against the world economy slowdown (see Section 3.3).

Many of the CIS governments have recently implemented fiscal reforms. The failure to implement these in previous years is regarded as one of the main causes of the Russian crisis. Economic growth together with improved revenues enabled Russia to attain a fiscal surplus in 2000 although tax cuts and slowing growth are likely to erode the surplus in 2001. Ukraine has seen its fiscal balance improve from a deficit of 5.4 per cent in 1997 prior to the Russian crisis to a deficit of 1.3 per cent last year. Kazakhstan reduced its deficit to 0.8 per cent in 2000 from 7 per cent in 1997 and the Kyrgyz government has significantly improved its management of borrowing and debt.

The public finances of several countries in the CIS, however, remain precariously weak. Countries that are highly indebted tend to continue to have the highest fiscal deficits. This is due to the interest burdens on these countries that add pressure to expenditures and to other structural imbalances in their public finances. All CIS countries started with about the same share of public expenditures in GDP. However, due to differences in tax reform and in the efficiency of revenue collection, the variation in revenues has proven far greater than differences in expenditures. Among the countries most exposed to regional tensions resulting from military conflict in Afghanistan are some of the Central Asian states with the weakest public finances (Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan). In these countries, maintaining fiscal stability in the face of increasing security outlays will be a considerable challenge and is likely to require additional foreign assistance.

Inflation was subdued in most CIS countries in 2000. Average inflation declined from 27.2 per cent in 1999 to 20.6 per cent last year and is expected to fall further this year. The only countries that continue to report inflation higher than 20 per cent are Belarus, Uzbekistan, Tajikistan and Russia. While in the first three countries, the imbalances that fuel inflation are largely the consequence of delayed reforms, in Russia inflation is being propelled by a large current account surplus and capital inflows in the face of limited sterilisation possibilities. The challenge to contain inflation in the face of commodity-induced macroeconomic volatility is examined in more detail in Section 3.3 below.

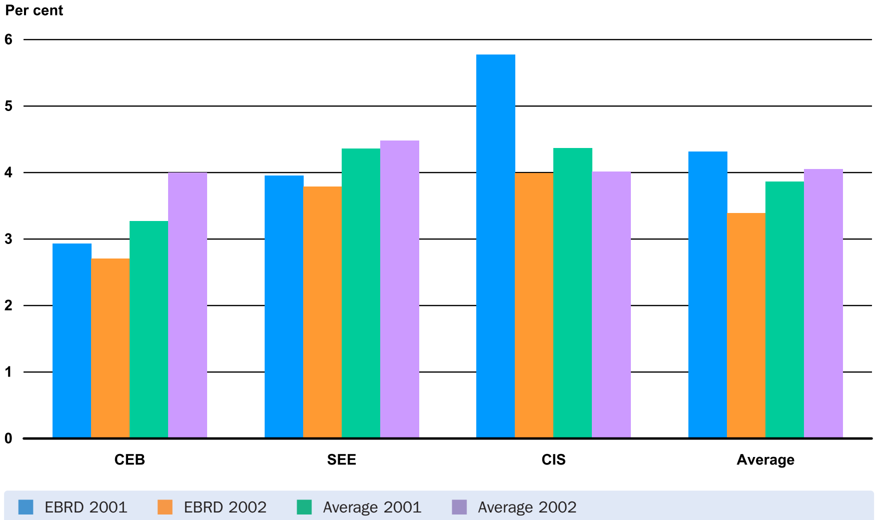
3.2 Outlook for the region amid global uncertainties

The degree of uncertainty concerning the economic outlook for the region increased significantly as a result of the terrorist attacks in the United States and the anticipated response to those attacks. The US economy, already weakened by a sharp decline in domestic investment, faces the possibility of a significant deterioration in consumer confidence and persistent weakness in business confidence. As developments in the first half of 2001 have shown, the EU economy is susceptible to a slowdown in the United States and it is also potentially vulnerable to the same factors that may prolong the period of slow growth or recession in the United States.

The central banks of the United States and western Europe have moved to underpin confidence by making ample liquidity available in the immediate aftermath of the attack. They have also taken measures to support domestic demand by reducing interest rates. However, the effectiveness of these and other potential measures, such as increased fiscal

Chart 3.6

EBRD and baseline GDP growth forecasts, 2001–02



Source: EBRD.

Note: Average forecast of surveyed institutions excludes the EBRD. See Table A.3.10 for a list of surveyed forecasting institutions.

expenditures or tax cuts, remain uncertain. This increase in uncertainty has contributed to a general shift in investor preferences towards perceived safe assets and away from relatively risky investments, particularly in US markets but also in international markets. The yield spreads faced by some emerging market borrowers, including Argentina and Brazil, have widened by more than 1 per cent. Crude oil prices initially exhibited considerable volatility but are now well below the level of early September, reflecting weaker prospects for global energy demand. There is also the potential for heightened political tensions and increased security risks in several countries in Central Asia.

Prior to these events, the EBRD undertook a survey of private forecasters and other international financial institutions (IFIs) to gauge the outlook for the region. Tables A.3.10 and A.3.11 present the results of this survey of forecasts for 2001 and 2002 respectively. With the exception of those made by the EBRD, all the reported forecasts were prepared before 11 September 2001. The EBRD's forecasts prior to their recent revision were mostly in line with those of other forecasters, with the exception of Poland and some CIS countries. In broad terms, the consensus outlook was for a moderate pick-up in growth in CEB and SEE in 2002 and for a further slowdown in growth in Russia and most other CIS countries.

The consensus forecast for the region by private forecasters and other IFIs may therefore be interpreted as the baseline expectation of developments in the region prior to 11 September. Chart 3.6 presents a comparison of the EBRD's revised forecasts with the baseline, indicating the EBRD's preliminary assessment of the likely impact of the terrorist attack in the United States and the response. The chart shows that relative to the baseline, the EBRD has lowered its forecast for average GDP growth in CEB by more than 1 percentage point and in SEE by around 0.5 points. However, it should be noted that the lower EBRD forecast for CEB reflects in part its less positive assessment of Polish growth prospects even before 11 September (see Table A.3.11). In the CIS the EBRD forecast for 2002 remains in line with the consensus, supported by a positive outlook for Russia, although this is subject to more than the usual level of uncertainty due to volatile oil prices.

The main impact on CEB countries is expected to result from weaker global and west European economies, which are likely to dampen both prospects for exports and FDI. The anticipated EU slowdown is also expected to have a negative impact in south-eastern Europe, particularly on Bulgarian and Romanian exports. In the CIS, Russia and the oil-exporting countries are vulnerable to a sharp fall in oil prices although few observers currently expect this to happen. The EBRD's baseline forecast is for a moderate weakening of oil prices in 2002. The CIS countries bordering Afghanistan are likely to experience heightened political risk and reduced access to private finance. This might be offset, however, by additional official assistance to compensate for costs associated with a NATO-led military campaign.

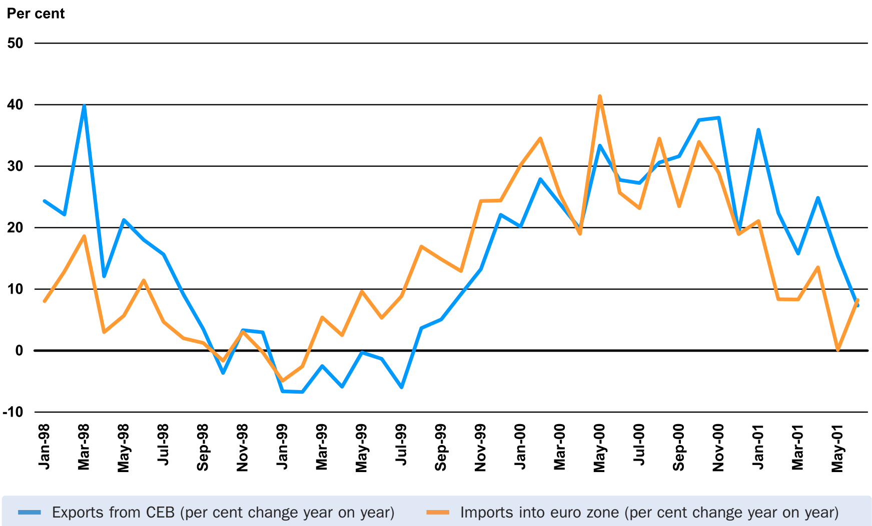
The relatively favourable outlook of forecasts for CEB prior to mid-September – 4.0 per cent for CEB as a whole in 2002 – was influenced significantly by assessments of the extent and duration of an EU slowdown and its impact on CEB export growth. As shown in Chart 3.7, CEB exports have tended to reflect total imports into the eurozone, albeit with a delay of three to six months. The possibility of a further weakening of consumer and business confidence in the EU has increased with recent events. If this occurs, it is likely to reduce exports from the region to the EU more markedly than has happened so far. This will consequently weaken both growth and the fiscal position of CEB.

The Baltic states experienced the strongest growth performance in CEB in the first half of 2001 and forecasters on average expected that this pattern would continue in 2002. The important role of the Baltic states as a transit point for trade in the Baltic Sea region and for Russian oil exports has supported growth in 2000 and 2001. The Baltic states would therefore be more affected than any other CEB countries by developments in Russia and other CIS countries.

Prior to 11 September 2001, forecasters expected on balance a further improvement in SEE growth, with a consensus outlook of 4.5 per cent for output growth in 2002. This forecast is largely shaped by expectations for the three largest economies in SEE: Bulgaria, FR Yugoslavia and Romania. In the first two countries, growth prospects for next year have considerably weakened since 11 September. In Bulgaria, declining net exports and the need to tighten fiscal policy will probably constrain growth to 3.5 per cent, against a pre-crisis consensus of around 4.5 per cent. In Romania, the range of growth forecasts is particularly wide. The EBRD's forecast of 3.5 per

Chart 3.7

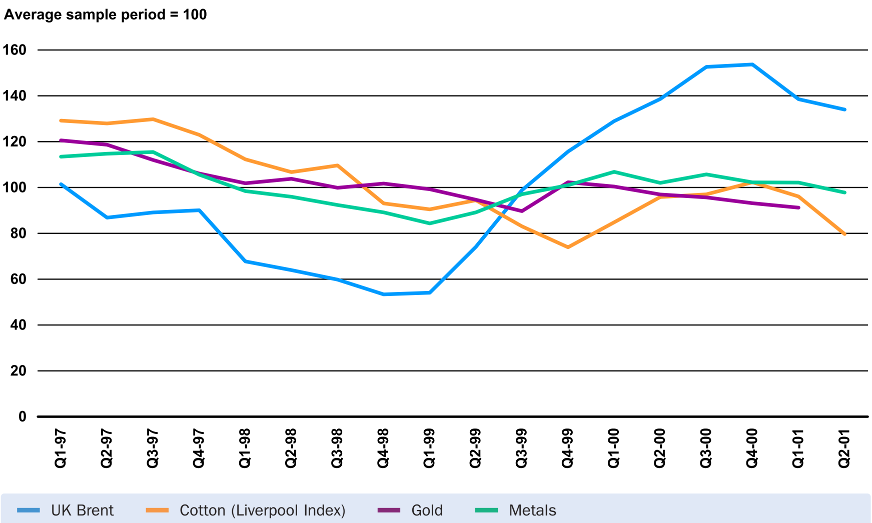
Impact of the EU slowdown on exports in CEB



Sources: European Central Bank and Bloomberg.

Chart 3.8

Commodity price developments, 1997–2001, quarterly



Source: IMF, *International Financial Statistics.*

cent growth in 2002 reflects caution over the likely development of external demand and the implications of a potential flight to quality among emerging market investors for external financing. Weaker FDI prospects and tighter monetary conditions will also lower investment growth. In FR Yugoslavia, inadequate statistics and political uncertainty make it difficult to make an assessment of future growth prospects. However, the consensus view among the majority of forecasters is that growth will stay around the range of 5 to 6 per cent both this year and next. This is of course from a very low base.

The consensus forecast for the CIS prior to 11 September was for output growth to slow down to 4 per cent in 2002 from 4.5 per cent in 2001. The EBRD's forecasts do not deviate from this baseline (although the EBRD expects much higher growth in 2001), assuming that oil prices can be maintained in the US$ 18-22 per barrel range. Should oil prices fall below this range, growth would undoubtedly fall – maybe to 2-3 per cent in Russia. However, a much stronger fiscal position and much greater political stability make a repeat of the 1998 crisis unlikely even with much lower oil prices.

All three large CIS economies – Russia, Ukraine and Kazakhstan – are expected to slow down in 2002 as net exports decline. For the non-energy-rich Central Asian states, regional instability would be in addition to the risk to commodity prices, in particular cotton, from the world economic slowdown. As Chart 3.8 reveals, cotton prices were already significantly lower during the first half of 2001 and this will affect economic prospects, particularly in Tajikistan and Uzbekistan, where cotton accounts for one-fifth and one-third of export revenues respectively.

The uncertainty in the global economy is likely to have less impact on inflation than on growth. Indeed, the outlook for inflation remains to a large extent continued stabilisation, with average inflation rates declining in all three sub-regions (see Tables A.3.12 and A.3.13). However, for some of the countries most exposed to possible military conflict in Afghanistan and already burdened with large macroeconomic imbalances, the possibility of increased price volatility has to be recognised.

For CEB the trend of cross-regional convergence in inflation rates observable in 2001 is expected to continue into next year. The EBRD expects inflation in Hungary, the Slovak Republic and Slovenia to come down to below 7 per cent, while inflation in the Baltic states is expected to increase to 4 to 5 per cent and to remain at similar levels for the Czech Republic and Croatia. In SEE the greatest reductions are expected in Romania and FR Yugoslavia, with the forecast for both countries for 2002 averaging at around 25 per cent. However, there is significant uncertainty surrounding these average forecasts.

In the CIS, Russian inflation is expected to level out as monetary pressures from the balance of payments abate (see below). Declines are also forecast for Kazakhstan and Ukraine. However, considerable uncertainty persists regarding inflation forecasts for several countries, including Belarus, Tajikistan, Turkmenistan and Uzbekistan. Two of these (Turkmenistan and Uzbekistan) have multiple exchange rates and all three have extensive price controls. Tajikistan has had volatile inflation in the recent past and the range of forecasts reflects ongoing concerns over stability.

3.3 Policy challenges

The more difficult external environment and heightened global uncertainty pose significant macroeconomic policy challenges. In CEB the need to adopt the appropriate fiscal and monetary policies to maintain external and internal balance is becoming increasingly urgent, particularly in view of the projected fall in external demand in 2001 and next year and the potential postponement of FDI decisions. Over the medium term, a major aim should be to maintain presently high levels of FDI once privatisation is completed, to strengthen competitiveness, lower unemployment and ensure a stable source of foreign financing of structural external deficits. In SEE, flexibility in fiscal and monetary policy is limited as a result of recent instability. The need to tighten fiscal policy may therefore dampen growth next year. The structural external imbalances would be dealt with most effectively through reforms that improve the investment climate and attract levels of FDI comparable to those in CEB.

In the CIS most countries must continue to improve fiscal revenue performance to reduce structural fiscal deficits and to move towards sustainability on their domestic and external debt.[2] In addition, the resource-rich CIS countries, such as Russia, must adapt financial policies to reduce the impact of commodity price cycles on domestic stability. Furthermore, all CIS countries should aim to reduce barriers to intra-regional trade in order to support the positive trend of growing trade between CIS countries, which has underpinned the recent recovery.

Response to an EU slowdown and the macroeconomic policy mix

One of the most persistent issues in macroeconomic management in the transition economies has been to deal with the large government sector imbalances characteristic of most countries in the region. Although fiscal adjustments were part of the early stabilisation programmes (with or without IMF support), fiscal deficits have remained stubbornly high. This reflects the difficulty of reforming an extensive array of public services and, in some cases, the transfer of implicit liabilities (such as the costs of bank restructuring) onto the budget. In the following, the discussion concentrates on CEB, not because the fiscal policy challenges are less in SEE and the CIS, but because of the saliency of the question about the appropriate fiscal and monetary policy mix in CEB.

Most CEB governments in the region defend their fiscal stance by pointing to the fact that fiscal deficits have been close to or even below the 3 per cent of GDP threshold set by the Maastricht Treaty criteria. However, there are two main reasons to believe that this threshold is not the most suitable benchmark in the present circumstances. First, in the context of future expenditure commitments to meet the EU's *acquis communautaire*, fiscal corrections will be necessary to continue to attract private investment. Second, governments should typically aim to achieve fiscal balance over the economic cycle if they do not want future generations to pay for high public consumption at present.[3] This suggests that budgets should have been balanced or even in surplus in recent years when growth was buoyant. Even if a moderate increase in public debt levels is deemed acceptable, governments may find it difficult to finance fiscal deficits above a certain level. If the budget is already in deficit during an economic upswing, this will greatly reduce the scope for expansion when growth slows.

Consequently, the fiscal performance of most countries in CEB has been disappointing. While the average fiscal deficit in 2000 declined by 1.2 per cent of GDP, this was largely driven by drastic adjustments in the Baltic states. Hungary's budget outturn has also been less expansionary than suggested by the official deficit of 3.5 per cent of GDP and deferred expenditures are now providing a war chest to the government to stimulate the economy in advance of the election in 2002. However, the timing and scale of this expansion and its link to the political cycle may be questioned. The case of Poland during 1999-2000 exemplifies the risks of a political business cycle. Inadequate fiscal stabilisation when growth is high increases the costs of adjustment at a later stage. As growth has slowed down, the estimate for Poland's fiscal deficit in 2001 has increased from 1.8 per cent in the budget to 4 per cent as of September 2001. The need for further fiscal tightening will certainly slow down the pace of recovery in Poland during 2002.

Assuming that fiscal policy is tightened, what scope would there be for monetary policy to support both external adjustment and domestic demand? In principle, through lowering interest rates, the monetary authorities should be able to reduce nominal exchange rates, support net exports and encourage domestic investment. Where consumer credit is important, there may also be a direct impact on domestic consumption but this is likely to be of secondary importance in much of the region. Yet, the evidence from the transition economies so far is relatively limited.

First, several CEB countries have until recently used an explicit or implicit exchange rate target as the main goal of monetary policy. This naturally limits the extent to which governments can influence external adjustment through movements in the exchange rate. Moreover, evidence suggests that the real exchange rate movements that have occurred have been of limited importance in explaining export performance in CEB.[4] Second, investment has been influenced strongly by FDI and there does not appear to be a tight relationship between real interest rates and domestic investment in most countries.

Nonetheless, the experience of Poland suggests that monetary policy can be quite effective at influencing domestic demand in the transition economies even though their financial sectors remain small compared with market economies. Between August 1999 and August 2000 the National Bank of Poland (NBP) increased interest rates by 600 basis

2 See 2000 *Transition Report* and 2001 *Transition Report Update*.

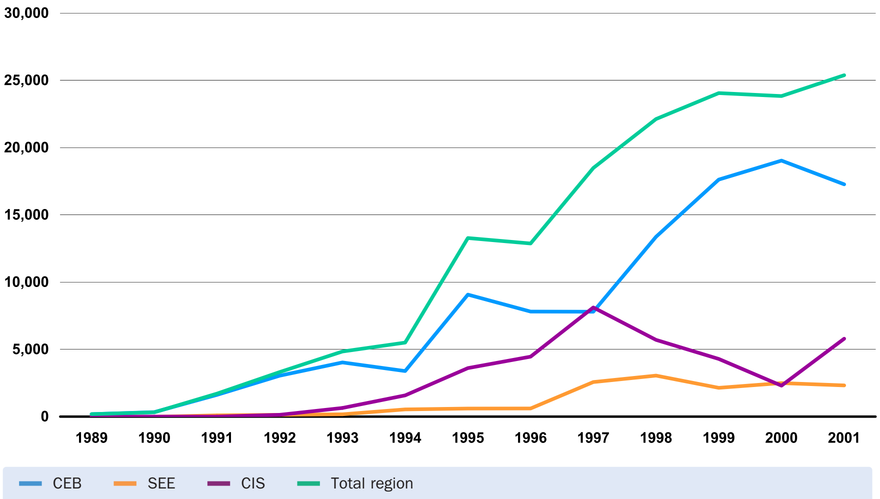
3 This point is reinforced if implicit pension liabilities are considered as part of current government debt (on which no interest is paid). On the other hand, it might be argued that the present generation had to bear the costs of transition while future generations will reap most of the benefits. This could justify some increase in public debt levels.

4 See PlanEcon (2001) 27 July.

Chart 3.9

Foreign direct investment, net inflows

Millions of US dollars



Source: EBRD.

points. The ensuing increase in real interest rates to above 10 per cent by end-2000 managed to bring growth in domestic demand down from 4.9 per cent in 1998 to 2.6 per cent last year. However, investment growth declined from over 14 per cent to 3 per cent during the same period. High interest rates on the other hand supported a stable zloty despite inflation averaging 8 per cent and this may have slowed down the external adjustment.

A more flexible monetary policy would be supported by the recent adoption of inflation targeting in a number of countries. The Czech and Slovak Republics and Poland adopted inflation targeting several years ago while Hungary abandoned its crawling peg regime in favour of inflation targeting within a system of wide exchange rate bands in April 2001. This creates room for some nominal exchange rate appreciation as the process of catch-up with the EU continues over the medium term and should help to reduce inflation.

In the short term, however, governments should not be too concerned if the exchange rate weakens as a result of a protracted flight to quality by international investors (so far there is little indication of weakened currencies in CEB). Instead, governments should adopt fairly generous inflation targets, thereby allowing monetary policy to support growth. The fact that inflation remains difficult to predict and manage accurately in transition economies underscores the need for targets that are not too ambitious.

Attracting and maintaining FDI

A key challenge for all transition economies over the medium term will be to maintain a steady inflow of FDI, both in order to cover external deficits with a stable source of private financing and to enhance competitiveness. This will enhance the ability of these countries to close such financing gaps in the future. The world economic slowdown may negatively affect the expansion of multinationals as previous capacity shortages are disappearing but the transition countries have an opportunity to attract projects involving the relocation of facilities within Europe as a means of lowering costs of production.

There has been a continuous increase in FDI inflows to CEB over the last few years, driven mainly by the low costs of production, proximity to the European Union and improvements in the business climate (see Chart 3.9).[5] Initially, FDI inflows were often associated with large-scale privatisation, particularly in the banking and telecommunications sectors. However, the privatisation process is close to completion in a number of advanced transition countries. It is therefore becoming increasingly important to attract greenfield investment and to encourage cross-border mergers and acquisitions in the private sector.

The case of Hungary illustrates the challenge of maintaining FDI once privatisation has largely been completed. In 1995-96, Hungary attracted US$ 6.7 billion in net FDI inflows but inflows have declined to less than US$ 1.5 billion per annum since then. This still covers most of the current account deficit, which has also declined in recent years as a result of a very strong trade performance. However, there has been a gradual shift in financing sources for Hungary towards commercial debt and some short-term portfolio investment in the Treasury bills market. The diversification of financing sources is not unwelcome but it does expose Hungary to a greater risk of volatility in the future.[6] A similar pattern can be observed in Poland although FDI inflows were still increasing last year. For example, in May 2001 it was estimated that around US$ 2 billion of foreign funds were invested in short-term Polish Treasury bills and might be withdrawn if the weakness of the zloty that began around that time was sustained.

As well as contributing to a stable source of external financing, FDI contributes to ongoing improvements in external competitiveness (see Table A.3.8), as shown by Hungary's enormous export expansion in recent years. The potential role of FDI in transferring technology and skills to the host country has led several countries to try to attract FDI through special investment incentives. Such policies can be very effective in bringing in additional FDI, as illustrated by the experience of the Czech and Slovak Republics, and, outside the region, Ireland. The former two countries introduced relatively generous investment incentives in 1997 and 1998 respectively and have since more than doubled non-privatisation-related FDI (see Chart 3.10). However, as with any

5 See Bevan and Estrin (2000) for an econometric panel data analysis of the determinants of FDI in selected transition economies. Motives for relocation are also reported in Chapter 6 of the 2000 *Transition Report*, using survey data.

6 In principle, with an open capital account the type of foreign financing hardly matters for current account sustainability as even domestic savers could easily withdraw savings in case of crisis. The advantage of FDI nonetheless is that fixed assets may be the least liquid precisely when investors might want to get out. This provides an advantage over short-term portfolio flows as demonstrated by experience in the aftermath of the Asian and Russian crises.

Box 3.1

Role of investment incentives in transition countries

A wide array of fiscal instruments has been applied in the region to attract foreign investment, including tax incentives, employment subsidies and support relating to infrastructure and the project site. The tax incentives range from deep across-the-board corporate tax cuts (Estonia) to general tax discounts for investment projects exceeding certain thresholds (Czech Republic, Romania and the Slovak Republic), discretionary tax breaks and customs duties exemptions for specific projects negotiated with the government (Bulgaria and Romania) and the establishment of special economic zones in pre-selected regions (Poland and Hungary). Employment subsidies focus mainly on paying for retraining costs while site and infrastructure support is often dependent on local municipalities and includes provision of cheap public land and state aid for infrastructure development.

The main advantage of investment incentives is the effectiveness with which they can be targeted at specific areas of need. In cases where large-scale investments are expected to lead to technological benefits or a boost for suppliers, investment incentives for commitments above a certain size could help to raise investment to a significantly higher level. In areas where benefits are expected from the cumulative effect of a number of projects, special economic zones may provide an effective way of attracting investment to a specific area. Targeted tax incentives also have a clear advantage of lowering taxes uniformly as the fiscal impact is limited. This is an important consideration when fiscal deficits are large, as in much of the region. Moreover, because investment incentives can be tied directly to the accumulation of capital, they can to some extent limit the leakage into domestic consumption and may pay for themselves through future increased tax revenues. Given that many transition economies have in the past used fiscal resources to rescue loss-making enterprises, a case could be made that this money would be far better spent on supporting the creation of new jobs.

Against the advantages of investment incentives stand the risks of distorting the allocation of resources and therefore financing the wrong types of projects. As with any subsidy, corruption can severely distort the competitive environment. This in turn may discourage the entry of new companies, reduce innovation and lead to lower growth over the long term. As with other forms of industrial policy, there is no reason to believe that the government would be better than the market at “picking winners”. To minimise these disadvantages, governments should adopt investment incentives that support private decisions rather than try to influence capital allocation directly. For this reason, governments should resist the temptation to use investment incentives as a tool for regional policies or for supporting specific industries, and choose relatively broad selection criteria. Most importantly, governments should use investment incentives only as a measure to accompany structural reforms aimed at strengthening the business climate and the competitive environment.

A prime example of a non-transition country that has been successful in attracting substantial export-oriented foreign investment inflows through tax incentives is Ireland,[1] which embarked on significant fiscal reforms in the 1980s. These were aimed at reducing fiscal deficits and lowering public debt, which stood at over 12 and 70 per cent of GDP respectively at the start of the decade. While fiscal consolidation focused on cutting budget expenditures, marginal tax rates were continuously lowered as the tax base widened. The main investment incentive was a dual corporate income tax introduced in 1980, providing a 10 per cent rate for manufacturing and certain internationally traded services, compared with a standard rate of over 35 per cent. The latter was gradually lowered to 20 per cent by 1998 while the lower special rate is due to be phased out by 2003 and replaced by a 12.5 per cent rate for all sectors of the economy. In addition, the Investment and Development Agency in Ireland has provided grants for employment, training and research and development.

1 See Cunningham (1996) and Foley and Griffith (1992).

public subsidy, investment incentives should be carefully designed to address specific market failures rather than be misused for political purposes as a favour to special industrial or regional interest groups (see Box 3.1).

Compared with CEB, the countries of SEE and the CIS have been less successful in attracting FDI, reflecting a slower pace of reform, the late start of privatisation and in SEE less market confidence about EU accession prospects, at least until recently. Cumulative FDI inflows per capita at US$ 215 and US$ 167 respectively have been around 15-20 per cent of those achieved in CEB. However, as EU accession prospects improved and structural reforms accelerated, FDI increased in Bulgaria and Romania in recent years. In common with CEB, privatisation programmes have been the main source of FDI inflows in SEE. Bulgaria increased per capita FDI inflows to US$ 123 in 2000, on a par with Hungary or Lithuania last year. Privatisation of large public enterprises and of the major banks were the key sources of inflows in Bulgaria since a reformist government came to power in 1997. With privatisation nearing completion, Bulgaria increasingly faces the same challenge as CEB countries in trying to maintain FDI. In Romania the privatisation of large-scale state-owned enterprises is still under way and FDI inflows have so far failed to regain their peak level of over US$ 2 billion in 1998. If strong structural reforms and adherence to macroeconomic austerity can be maintained, FDI inflows could double over the medium term.

In contrast to Bulgaria and Romania, the other SEE countries have lagged a long way behind in terms of FDI, mainly because of the high level of political instability that has prevailed in the region and the slower pace of reforms. As a result, they have been far more dependent on official financial flows, which have typically covered around one-third of their current account deficits. Replacing official flows with private financing will be a key challenge to prevent costly external adjustment once donor resources diminish. The case of FR Yugoslavia will be particularly instructive in this regard, given the country’s size and previous business links with enterprises in Slovenia and Croatia. The large Yugoslav diaspora is also likely to encourage higher levels of FDI.

In the CIS, FDI inflows have been concentrated in the energy-rich Caspian countries, with capital inflows increasingly causing problems of macroeconomic management. In the remainder of the CIS, low FDI inflows continue to reflect the serious flaws in the investment climate (see Chapter 2).

Managing natural resources

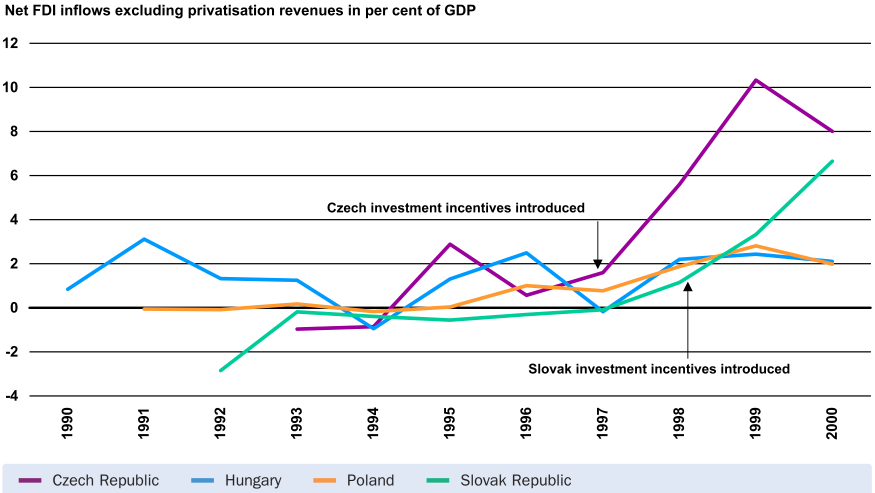
Russia and the countries surrounding the Caspian Sea have abundant resources of natural wealth. If properly managed, ownership of natural resources should be beneficial, but the experience of many countries has shown that there are associated risks and challenges that need to be addressed. The risks fall roughly into two categories. First, prices for commodities are highly volatile and if the associated volatility in national income is not properly managed, this may lead to domestic and external imbalances and increased price instability. Second, aside from the negative impact of high macroeconomic volatility on investment and growth, the abundance of natural resources might also reduce incentives to invest in technology and education, thereby lowering long-term growth prospects.[7] Finally, natural resource wealth tends to be associated with corruption, as productive entrepreneurship may offer fewer rewards than the pursuit of political influence to appropriate resource rents (see Chapter 4).

The best macroeconomic policy solution to address these risks is prudent fiscal and financial management. Governments need to soften the impact of commodity prices on trade balance inflows by investing external and fiscal surpluses during times of exceptionally high export earnings and by drawing on these savings in downturns. This form of macro-management obviously requires far-sighted, highly capable governments and careful medium-term fiscal planning.

Until recently the governments in the region were ill-prepared to address this issue but some of them have made substantial progress over the last year, with the establishment of explicit stabilisation funds in Azerbaijan and Kazakhstan and implicit fiscal stabilisation through reserve accounts in Russia. Looking at their budgetary accounts, the extent to which they have succeeded in reducing the impact of high oil prices is striking. As a result of fiscal prudence over the last year, budget deficits have improved between 1999 and 2000 by more than 5 per cent of GDP in Russia and Azerbaijan and only slightly less in Kazakhstan. In terms of expenditures, Russia and Azerbaijan even managed to reduce their budgetary outlays last year compared with 1999 by 2.6 and 2.9 per cent of GDP respectively. Governments in these countries have

Chart 3.10

Impact of investment incentives on FDI inflows for selected countries



Source: EBRD.

Note: Privatisation revenues include non-FDI-related sales e.g. to domestic investors. In some cases privatisation-related FDI is not reflected in privatisation revenues if, for example, inflows are used in a capital increase and do not accrue to the government.

therefore been able to use fiscal means to counteract the short-term influence of high oil prices.

Fiscal policy is best suited to deal with the risks associated with volatile export earnings but monetary policy can play a secondary role in dealing with the short-term impact of capital inflows. This is because, unlike in OECD countries, central banks in the CIS appear to have some short-term control over the exchange rate through foreign exchange rate interventions, as capital mobility is limited. Central banks in Azerbaijan, Kazakhstan and Russia have utilised this power extensively and have intervened heavily in foreign exchange markets. Gross reserves in Russia almost tripled to US$ 36 billion between the end of 1999 and July 2001. In Kazakhstan they grew from US$ 1.5 billion to US$ 2.6 billion by the end of April 2001.[8] The rise in Azerbaijan has been much smaller.

As Chart 3.11 illustrates, this smaller increase in reserves in Azerbaijan probably stems from the fact that their oil fund absorbed 55 per cent of the trade balance surplus in 2000, and this was invested abroad. The impact of the increase in reserves on monetary aggregates differs between Kazakhstan and Russia. In Kazakhstan the monetary base grew by only 6 per cent as much of the increased inflow through the trade balance was offset by capital flight (large errors and omissions), outflows on the service account, debt-repayments to the IMF and income repatriation of foreign investors (limited net FDI inflows). The rest of the increase was successfully sterilised by the Kazakh central bank. By contrast, the monetary base in Russia grew by 75 per cent in 2000.

Consequently, the impact on inflation in the three countries has differed considerably. While inflation in Russia remains above 20 per cent, Kazakhstan's year-on-year inflation rate was 8.6 per cent in August and in Azerbaijan it stood at below 2 per cent. However, with the trade surplus narrowing, inflation has started to fall in Russia, and this trend is likely to continue as oil prices weaken in 2002.

In short, even though all three countries have been successful over the last 18 months in dealing with the increased export earnings as a result of high commodity prices, there is no reason to be complacent. Continued improvements in fiscal management, including medium-term planning of expenditures and prudent investment of public surpluses, are key to the success of these countries in the long term. In the short term, contin-

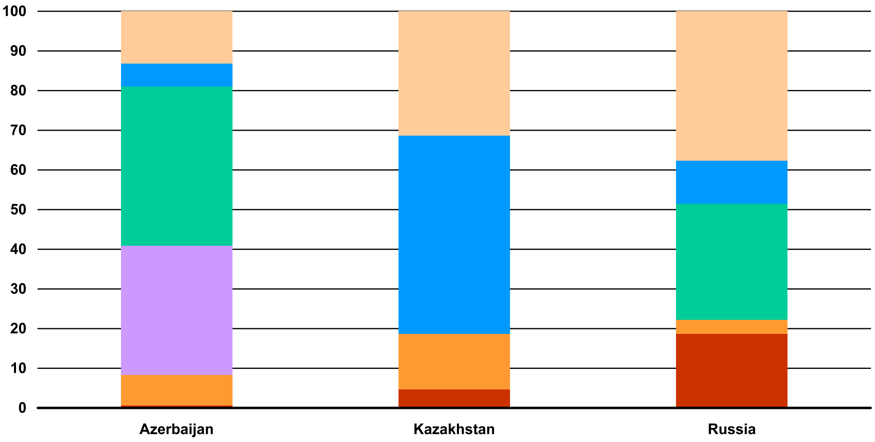
7 Some reduction in investment rates may be warranted if natural wealth is large as long as the overall capital stock is not depleted. See Chapter 4 for a discussion of genuine savings rates and sustainable resource management.

8 From May 2001, Kazakhstan started to place government revenues from the oil sector in excess of expectations in a newly created National Fund.

Chart 3.11

Decomposition of the trade surplus in 2000

Per cent



Change in reserves · IMF repayments · Oil fund · Budget surplus (if any)
Capital flight · Other

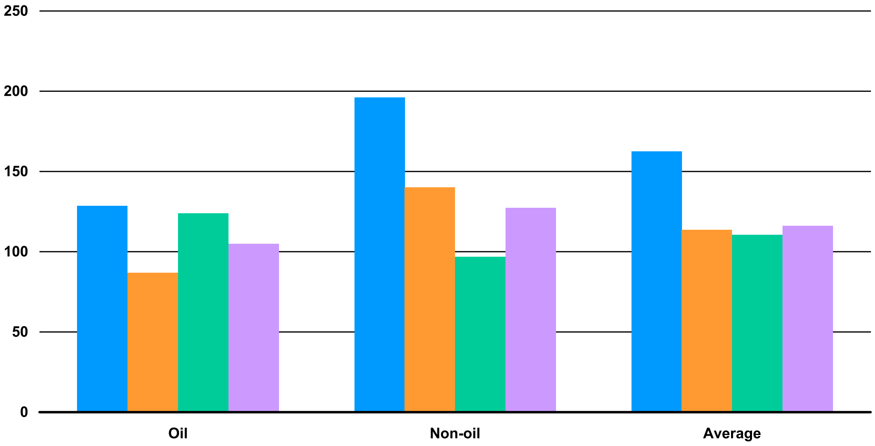
Source: IMF.

Note: Capital flight is calculated as net errors and omissions from the balance of payment. Other includes the service and income balance, the change in arrears and the capital account net of the budget surplus.

Chart 3.12

Trade expansion with CIS and non-CIS markets

Median change in trade volumes, Q1 2001, in per cent of Q1 2000



CIS exports · Non-CIS exports · CIS imports · Non-CIS imports

Source: Interfax.

Note: Oil-exporting countries include Azerbaijan, Kazakhstan and Russia. Non-oil include Belarus, Kyrgyzstan and Moldova.

ued foreign exchange interventions may be warranted to soften the impact of large oil price volatility but the monetary authorities should not retain the existing exchange rate for too long if oil prices move significantly in a particular direction.

Regional integration in the CIS

The dissolution of the Soviet Union in 1989 was followed by a rapid decline in trade relations between the independent republics and Russia. The disorganisation that followed the collapse of the complex supply relationships that existed under central planning contributed to the severe output declines experienced in the CIS states.[9] Moreover, evidence suggests that the imposition of trade barriers between CIS countries led the Russian regions to trade more with each other than with the independent republics between 1994 and 1996. The exceptions to this were Belarus and Kazakhstan, which continue to have trade agreements with Russia.[10] Some decline in trade between CIS countries was unavoidable and necessary to correct the inefficient patterns of specialisation imposed by central planning but the collapse of trade between CIS countries was probably too extreme.

The subsequent Russian crisis of 1998 appears to have severed many of the links between countries in CEB and SEE on the one side and the CIS on the other but the recent picture in the CIS is quite different. Trade between CIS countries has intensified over the last two years and is one of the driving forces behind growth in the region, particularly for the non-oil exporters of the CIS. However, evidence for the re-emergence of trade ties in the CIS is difficult to identify as structural changes in volumes of trade are overshadowed by large relative price movements after the Russian crisis.[11] As a result, trade volume data provide a different picture to data calculated in US dollars.

Chart 3.12 illustrates that the volume of exports between CIS countries in the first quarter of this year increased at a significantly higher rate than exports to the rest of the world.[12] This increase was highest for the non-oil-exporting CIS countries, where CIS exports almost doubled compared with the same period in 2000. The pattern is supported by import statistics, which show that imports from other CIS countries have on average grown significantly in the oil-exporting CIS countries but have fallen in the other CIS countries. In Ukraine, the biggest non-oil-exporting republic in the CIS, customs data show a 40 per cent increase in

9 See Blanchard and Kremer (1997). See Bevan *et al*. (2001) for an application to intra-CIS supply chains in Kazakhstan and Ukraine.

10 See Djankov and Freund (2000).

11 Broadly speaking, commodity exports outside the CIS have increased in US dollar value as world prices have risen, while trade between CIS states, which is largely in manufactured goods, has declined in value as CIS currencies have generally appreciated in real terms.

12 Export growth is measured as the median volume growth rate for the most important export goods of each country. The sample includes oil-exporting countries (Azerbaijan, Kazakhstan and Russia) and non-oil-exporting countries (Belarus, Kyrgyzstan and Moldova).

exports to Russia in the first half of 2001, against a 30 per cent increase to Europe and a 22 per cent increase to other CIS countries.

These findings support the view that non-oil-exporting countries have shared to a large extent in the gains from the boom in the large oil-exporting economies. The positive development in their external balances is partially due to an increase in their trade surplus in trade between CIS countries.

This reintegration has clearly been beneficial in the short term but it is unclear whether it will be beneficial for the smaller CIS economies in the long term. There is concern that these economies might "import" the volatility of oil prices through volatility in the demand for their exports and that trade between CIS states might be achieved at the expense of integration in the world economy.

The importance of concerns over importing instability largely depends on how successful the oil-exporting countries will be in dealing with their resource wealth. Integration into the world economy could be put at risk for two reasons. First, CIS countries may be forced to raise barriers to the rest of the world as part of the CIS integration process. There is little sign of this so far but the concerns remain (e.g. for WTO members such as Kyrgyzstan) if trade integration within the CIS were to be formalised to a greater degree. Second, it is possible that increased trade between CIS countries will lead the CIS to become locked into inferior technological standards, which make trade with the rest of the world difficult. This might apply in particular to manufacturing, which accounts for about one-third of intra-CIS exports by non-oil-exporting countries.

Many of these goods are manufactured according to Soviet standards, which makes it difficult to market them outside of the CIS. The fear is that enterprises will be less inclined to strive for world standards if they can sell within the CIS. Consequently, trade integration within the CIS should not be based on preferential trade arrangements. A process of gradual reduction in trade barriers with neighbouring countries and with the rest of the world would offer the best prospect for sustained benefits from international trade.

3.4 Conclusion

While the global slowdown will lower growth in the transition countries this year, the region has so far shown itself to be relatively resilient. However, as the slowdown in the world economy seems to be more protracted than had been anticipated earlier in the year, the region is unlikely to escape unscathed. While the repercussions of recent events in the United States are extremely difficult to predict, it seems likely that they will intensify and prolong the global slowdown. It also seems likely that the impact of such a slowdown will differ by region, creating different policy challenges.

CEB is particularly exposed to a slowdown in export trade with the European Union and a reduced supply of FDI and other risk capital. While exports remained resilient until April this year, growth has increasingly relied on buoyant domestic demand. As net exports fall, the baseline forecast is for growth in the region to decline moderately to below 3 per cent both this year and next. The main policy challenge will arise from the need to support growth without exacerbating already high fiscal and external deficits. In these circumstances, a combination of fiscal tightening and a flexible monetary policy stance offers the best chance of supporting balanced growth. This will require particular political determination as elections are approaching in most of the major economies of the region.

Growth in SEE is likely to remain strong this year, as a result of continued recovery in Romania and FR Yugoslavia, while prospects for 2002 are more uncertain. Large structural fiscal and external imbalances throughout the region suggest that fiscal policy does not have the scope to offset the likely fall in external demand and will have to be tightened. However, monetary policy is also less flexible as inflation remains high in some countries while others – such as Bulgaria – have exchange rate regimes (currency boards), which do not permit monetary or fiscal flexibility. In view of this, the region should focus efforts on encouraging foreign investment inflows through improvements in the investment climate, continued privatisation and perhaps through well-targeted investment incentives, which seem to have been successfully applied in the Czech and Slovak Republics in recent years.

The CIS will record high but decelerating growth in 2001-02, largely as a result of reductions in the pace of expansion in Russia, Ukraine and Kazakhstan. Russian growth is likely to slow down over the next few months, with negative repercussions for trading partners in the region. As the outlook for oil prices remains uncertain, the forecast deceleration in Russian growth might be more pronounced than presently foreseen, with knock-on effects for the remainder of the CIS. Russia can help to mitigate the impact of oil price volatility through careful fiscal and financial management, and some progress has already been made in this regard. For the remainder of the CIS, the primary challenge is to accelerate structural reform to lay the foundations for sustained recovery. Countries that are exposed to possible security threats from ongoing military interventions in Afghanistan are likely to require assistance from Western governments and IFIs. This assistance will be most effective if coupled with a renewed emphasis on structural reforms.

As the international financial environment deteriorates, policy makers across the region will be required to exercise extreme vigilance over possible external and fiscal imbalances. Experience from earlier crises clearly indicates that markets differentiate between the countries of the region in relation to the strength of their economies and the quality of macroeconomic management. In the present uncertain environment, the need for prudent macroeconomic management is likely to be greater than ever.

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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	2001	Estimated level of real GDP in 2000
						(in per cent)								*(1989=100)*
Croatia	-1.6	-7.1	-21.1	-11.7	-8.0	5.9	6.8	6.0	6.5	2.5	-0.4	3.7	3.8	**80**
Czech Republic	1.4	-1.2	-11.6	-0.5	0.1	2.2	5.9	4.8	-1.0	-2.2	-0.8	3.1	3.5	**98**
Estonia	8.1	-6.5	-13.6	-14.2	-8.8	-2.0	4.6	4.0	10.4	5.0	-0.7	6.9	4.5	**83**
Hungary	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	4.5	**104**
Latvia	6.8	2.9	-10.4	-34.9	-14.9	0.6	-0.8	3.3	8.6	3.9	1.1	6.6	6.5	**64**
Lithuania	1.5	-5.0	-5.7	-21.3	-16.2	-9.8	3.3	4.7	7.3	5.1	-3.9	3.9	4.0	**65**
Poland	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	6.0	6.8	4.8	4.1	4.0	2.0	**127**
Slovak Republic	1.4	-2.5	-14.6	-6.5	-3.7	4.9	6.7	6.2	6.2	4.1	1.9	2.2	3.0	**103**
Slovenia	-1.8	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.5	4.6	3.8	5.2	4.6	2.2	**114**
Central eastern Europe and the Baltic states	*0.6*	*-6.6*	*-10.3*	*-2.2*	*0.3*	*3.9*	*5.4*	*4.8*	*4.9*	*3.4*	*2.6*	*4.0*	*2.9*	***107***
Albania	9.8	-10.0	-28.0	-7.2	9.6	8.3	13.3	9.1	-7.0	8.0	7.3	7.8	7.0	**103**
Bosnia and Herzegovina	na	-23.2	-12.1	-30.0	-40.0	-40.0	20.8	86.0	37.0	10.0	10.0	5.0	5.0	**na**
Bulgaria	0.5	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-6.9	3.5	2.4	5.8	4.0	**71**
FR Yugoslavia	1.3	-7.9	-11.6	-27.9	-30.8	2.5	6.1	7.8	10.1	1.9	-15.7	5.0	5.0	**47**
FYR Macedonia	0.9	-9.9	-7.0	-8.0	-9.1	-1.8	-1.2	1.2	1.4	2.9	2.7	5.1	-4.0	**77**
Romania	-5.8	-5.6	-12.9	-8.8	1.5	3.9	7.1	3.9	-6.1	-5.4	-3.2	1.6	4.0	**77**
South-eastern Europe	*-2.8*	*-7.3*	*-14.8*	*-9.6*	*-2.4*	*3.0*	*6.2*	*3.2*	*-0.7*	*-0.8*	*-3.2*	*3.6*	*4.0*	***73***
Armenia	14.2	-7.4	-11.7	-41.8	-8.8	5.4	6.9	5.9	3.3	7.2	3.3	6.0	6.0	**63**
Azerbaijan	-4.4	-11.7	-0.7	-22.6	-23.1	-19.7	-11.8	1.3	5.8	10.0	7.4	11.1	8.0	**52**
Belarus	8.0	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.8	11.4	8.4	3.4	5.8	2.5	**85**
Georgia	-4.8	-12.4	-20.6	-44.8	-25.4	-11.4	2.4	10.5	10.8	2.9	3.0	1.9	3.0	**34**
Kazakhstan	-0.4	-0.4	-13.0	-2.9	-9.2	-12.6	-8.2	0.5	1.7	-1.9	2.7	9.6	10.0	**69**
Kyrgyzstan	8.0	3.0	-5.0	-19.0	-16.0	-20.1	-5.4	7.1	9.9	2.1	3.7	5.1	5.0	**66**
Moldova	8.5	-2.4	-17.5	-29.1	-1.2	-31.2	-1.4	-7.8	1.3	-6.5	-4.4	1.9	5.0	**33**
Russia	0.0	-4.0	-5.0	-14.5	-8.7	-12.7	-4.1	-3.5	0.9	-4.9	5.4	8.3	5.5	**63**
Tajikistan	-2.9	-1.6	-7.1	-29.0	-11.0	-18.9	-12.5	-4.4	1.7	5.3	3.7	8.3	6.0	**47**
Turkmenistan	-6.9	2.0	-4.7	-5.3	-10.0	-17.3	-7.2	-6.7	-11.3	5.0	16.0	17.6	10.0	**75**
Ukraine	4.0	-3.4	-8.7	-9.9	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2	5.8	7.0	**42**
Uzbekistan	3.7	1.6	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	2.5	4.4	4.1	4.0	3.0	**98**
Commonwealth of Independent States	*0.6*	*-3.7*	*-5.6*	*-13.7*	*-9.3*	*-13.8*	*-5.2*	*-3.5*	*1.0*	*-3.7*	*4.5*	*7.9*	*5.8*	***61***
Central and eastern Europe, the Baltic states and the CIS[1]	**0.3**	**-5.0**	**-7.9**	**-9.1**	**-5.1**	**-6.1**	**-0.4**	**0.1**	**2.2**	**-1.1**	**3.0**	**5.5**	**4.3**	**72**

Note: Data for 1989-99 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 2000 are preliminary actuals, mostly official government estimates. Data for 2001 represent EBRD projections.

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

Table A.3.2

GDP growth by components

(real change in per cent)

	1997	1998	1999	2000
Bulgaria				
Real GDP growth	-6.9	3.5	2.4	5.8
Private consumption	-15.7	8.1	5.2	2.1
Public consumption	-11.5	4.1	-0.4	19.1
Gross fixed investment	-23.9	16.4	25.3	9.8
Exports of goods and services	3.1	-15.6	-5.2	20.0
Imports of goods and services	-2.7	-2.8	5.1	17.6
Croatia				
Real GDP growth	6.5	2.5	-0.4	3.7
Private consumption	na	-0.6	-2.7	4.1
Public consumption	na	2.3	0.8	-0.7
Gross fixed investment	na	2.5	-1.1	-3.5
Exports of goods and services	na	3.9	0.7	8.7
Imports of goods and services	na	-4.9	-2.7	4.2
Czech Republic				
Real GDP growth	-1.0	-2.2	-0.8	3.1
Private consumption	1.8	-2.9	1.4	1.4
Public consumption	0.8	-0.9	-0.1	-0.2
Gross fixed investment	-2.9	-3.9	-5.5	5.2
Exports of goods and services	8.1	10.7	6.6	18.8
Imports of goods and services	7.2	7.9	5.8	18.7
Estonia				
Real GDP growth	10.4	5.0	-0.7	6.9
Private consumption	8.9	5.4	-0.6	9.0
Public consumption	1.8	4.5	3.8	1.0
Gross fixed investment	17.5	11.3	-14.6	12.0
Exports of goods and services	30.3	12.6	-0.6	27.6
Imports of goods and services	29.7	12.6	-5.8	27.0
Hungary				
Real GDP growth	4.6	4.9	4.2	5.2
Private consumption	1.7	4.9	4.6	3.3
Public consumption	5.7	-0.3	1.8	1.6
Gross fixed investment	9.2	13.3	5.9	6.6
Exports of goods and services	26.4	16.7	13.1	21.8
Imports of goods and services	24.6	22.8	12.3	21.1
Latvia				
Real GDP growth	8.6	3.9	1.1	6.6
Private consumption	5.0	6.2	5.1	5.6
Public consumption	0.3	6.1	0.0	-2.2
Gross fixed investment	20.7	44.0	-4.0	10.8
Exports of goods and services	13.1	4.9	-6.4	12.8
Imports of goods and services	6.8	19.0	-5.2	5.1

	1997	1998	1999	2000
Poland				
Real GDP growth	6.8	4.8	4.1	4.0
Private consumption	6.9	4.9	5.4	2.6
Public consumption	3.1	1.4	1.0	1.1
Gross fixed investment	21.7	14.2	6.5	3.1
Exports of goods and services	9.9	11.0	1.0	17.5
Imports of goods and services	16.7	14.0	6.0	12.0
Romania				
Real GDP growth	-6.1	-5.4	-3.2	1.6
Private consumption	-3.1	-4.6	-4.9	-1.2
Public consumption	-11.6	14.1	-2.5	4.2
Gross fixed investment	-3.0	-18.1	-5.1	5.5
Exports of goods and services	11.4	na	9.7	23.9
Imports of goods and services	7.5	na	-5.1	29.1
Russia				
Real GDP growth	0.9	-4.9	5.4	8.3
Private consumption	5.4	-3.6	-3.4	8.0
Public consumption	-2.4	0.6	9.5	2.0
Gross fixed investment	-5.7	-11.2	2.4	18.0
Exports of goods and services	4.2	2.7	-4.5	6.0
Imports of goods and services	10.6	-14.1	-21.7	16.0
Slovak Republic				
Real GDP growth	6.2	4.1	1.9	2.2
Private consumption	5.6	5.3	0.1	-3.4
Public consumption	4.0	4.0	-6.9	-0.9
Gross fixed investment	12.0	11.1	-18.8	-0.7
Exports of goods and services	17.6	12.2	3.6	15.9
Imports of goods and services	13.1	19.9	-6.1	10.2
Slovenia				
Real GDP growth	4.6	3.8	5.2	4.6
Private consumption	2.8	3.3	6.0	0.8
Public consumption	4.3	5.8	4.6	3.1
Gross fixed investment	11.6	11.3	19.1	0.2
Exports of goods and services	11.6	6.7	1.7	12.7
Imports of goods and services	11.9	10.4	8.2	6.1

Source: EBRD.

Note: Data for 1997-99 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 2000 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	2001
Central eastern Europe and the Baltic states													
Croatia	na	609.5	123.0	665.5	1,517.5	97.6	2.0	3.5	3.6	5.7	4.2	6.2	5.7
Czech Republic	1.4	9.7	52.0	11.1	20.8	9.9	9.1	8.8	8.5	10.7	2.1	3.9	4.9
Estonia	6.1	23.1	210.5	1,076.0	89.8	47.7	29.0	23.1	11.2	8.2	3.3	4.0	6.1
Hungary	17.0	28.9	35.0	23.0	22.5	18.8	28.2	23.6	18.3	14.3	10.0	9.8	9.1
Latvia	4.7	10.5	172.2	951.2	109.2	35.9	25.0	17.6	8.4	4.7	2.4	2.8	2.4
Lithuania	2.1	8.4	224.7	1,020.5	410.4	72.1	39.6	24.6	8.9	5.1	0.8	1.0	1.5
Poland	251.1	585.8	70.3	43.0	35.3	32.2	27.8	19.9	14.9	11.8	7.3	10.1	5.6
Slovak Republic	2.3	10.8	61.2	10.0	23.2	13.4	9.9	5.8	6.1	6.7	10.6	12.0	7.4
Slovenia	1,306.0	549.7	117.7	207.3	32.9	21.0	13.5	9.9	8.4	8.0	6.1	8.9	8.6
Median [1]	*5.4*	*23.1*	*117.7*	*207.3*	*35.3*	*32.2*	*25.0*	*17.6*	*8.5*	*8.0*	*4.2*	*6.2*	*5.7*
Mean [1]	*198.8*	*204.0*	*118.5*	*445.3*	*251.3*	*38.7*	*20.5*	*15.2*	*9.8*	*8.4*	*5.2*	*6.5*	*5.7*
South-eastern Europe													
Albania	0.0	0.0	35.5	226.0	85.0	22.6	7.8	12.7	33.2	20.6	0.4	0.1	3.5
Bulgaria	6.4	26.3	333.5	82.0	73.0	96.3	62.0	123.0	1,082.0	22.2	0.7	9.9	8.0
FR Yugoslavia	1,269.0	593.0	121.0	9,237.0	116.5×10^{12}	3.3	78.6	94.3	21.3	29.5	37.1	60.4	93.6
FYR Macedonia	1,246.0	608.4	114.9	1,664.4	338.4	126.5	16.4	2.5	1.5	0.6	-1.3	9.2	6.2
Romania	1.1	5.1	170.2	210.4	256.1	136.7	32.3	38.8	154.8	59.1	45.8	45.7	34.2
Median [1]	*6.4*	*26.3*	*121.0*	*226.0*	*170.6*	*96.3*	*32.3*	*38.8*	*33.2*	*22.2*	*0.7*	*9.9*	*8.0*
Mean [1]	*504.5*	*246.6*	*155.0*	*2,284.0*	*188.1*	*77.1*	*39.4*	*54.3*	*258.5*	*26.4*	*16.5*	*25.1*	*29.1*
Commonwealth of Independent States													
Armenia	4.8	10.3	274.0	1,346.0	3,731.8	5,273.4	176.7	18.8	13.8	8.7	0.7	-0.8	3.1
Azerbaijan	na	7.8	107.0	912.0	1,129.0	1,664.0	412.0	19.7	3.5	-0.8	-8.5	1.8	2.0
Belarus	1.7	4.7	94.1	970.8	1,190.2	2,221.0	709.3	52.7	63.8	73.2	293.8	168.9	59.8
Georgia	na	3.3	79.0	887.4	3,125.4	15,606.5	162.7	39.4	7.1	3.6	19.2	4.1	5.6
Kazakhstan	na	na	78.8	1,381.0	1,662.3	1,892.0	176.3	39.1	17.4	7.3	8.3	13.2	8.6
Kyrgyzstan	na	na	85.0	855.0	772.4	228.7	40.7	31.3	25.5	12.0	35.8	18.7	7.6
Moldova	na	4.2	98.0	1,276.4	788.5	329.7	30.2	23.5	11.8	7.7	39.3	31.3	11.1
Russia	2.0	5.6	92.7	1,526.0	875.0	311.4	197.7	47.8	14.7	27.6	86.1	20.8	21.4
Tajikistan	na	4.0	112.0	1,157.0	2,195.0	350.0	609.0	418.0	88.0	43.2	27.6	32.9	39.4
Turkmenistan	2.1	4.6	103.0	493.0	3,102.0	1,748.0	1,005.3	992.4	83.7	16.8	24.2	8.3	11.2
Ukraine	2.2	4.2	91.0	1,210.0	4,743.0	891.0	377.0	80.0	15.9	10.5	22.7	28.2	12.5
Uzbekistan	0.7	3.1	82.2	645.0	534.0	1,568.0	304.6	54.0	58.9	17.8	29.1	24.2	25.9
Median [1]	*na*	*na*	*93.4*	*1,064*	*1,426*	*1,616*	*251*	*44*	*17*	*11*	*26*	*20*	*11*
Mean [1]	*na*	*na*	*108.1*	*1,055*	*1,987*	*2,674*	*350*	*151*	*34*	*19*	*48*	*29*	*17*
Central and eastern Europe, the Baltic states and the CIS													
Median [1]	*6.1*	*24.7*	*100.5*	*899.7*	*534.0*	*131.6*	*40.2*	*24.1*	*14.8*	*10.6*	*9.2*	*9.9*	*7.8*
Mean [1]	*316.4*	*219.2*	*120.7*	*1,080.3*	*1,074.5*	*1,262.2*	*176.3*	*85.6*	*68.7*	*16.7*	*27.2*	*20.6*	*15.6*

Note: Data for 1989-99 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 2000 are preliminary actuals, mostly official government estimates. Data for 2001 represent EBRD projections.

The figure for Albania for 1997 is based on the information of the country where data collection was possible. Estimates of inflation from parts of Bosnia and Herzegovina (for the Federation and Republika Srpska separately) are provided in the selected economic indicators at the back of this Report.

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

Table A.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	2001	Change	Change
												Estimate	Projection	1999-00	2000-01
								(in per cent of GDP)						(in percentage points)	
Croatia	na	na	na	-3.9	-0.8	1.2	-1.4	-1.0	-1.9	-1.0	-6.5	-6.9	-5.3	-0.4	1.6
Czech Republic	na	-0.2	-1.9	-3.1	0.5	-1.1	-1.4	-0.9	-1.7	-2.0	-3.3	-4.9	-9.2	-1.6	-4.3
Estonia	na	na	na	na	-10.0	1.4	-0.6	-1.9	2.2	-0.3	-4.6	-0.7	-0.5	3.9	0.2
Hungary	na	0.0	-3.0	-7.2	-6.6	-8.4	-6.7	-5.0	-6.6	-5.6	-5.7	-3.5	-3.0	2.2	0.5
Latvia	na	na	na	na	na	-4.4	-3.9	-1.8	0.3	-0.8	-3.9	-3.3	-2.0	0.6	1.3
Lithuania	na	na	na	na	-5.3	-4.8	-4.5	-4.5	-1.8	-5.9	-8.5	-2.8	-1.4	5.8	1.3
Poland	-7.4	3.1	-2.1	-4.9	-2.4	-2.2	-3.1	-3.3	-3.1	-3.2	-3.7	-3.2	-4.0	0.5	-0.8
Slovak Republic	na	na	na	-11.9	-6.0	-1.5	0.4	-1.3	-5.2	-5.0	-3.6	-3.6	-4.1	0.0	-0.5
Slovenia	na	na	2.6	0.3	0.6	-0.2	-0.3	-0.2	-1.7	-1.4	-0.9	-1.3	-1.5	-0.4	-0.2
Central eastern Europe and the Baltic states [1]	*-7.4*	*1.0*	*-1.1*	*-5.1*	*-3.8*	*-2.2*	*-2.4*	*-2.2*	*-2.2*	*-2.8*	*-4.5*	*-3.3*	*-3.4*	*1.2*	*-0.1*
Albania	na	-6.1	-20.7	-23.1	-15.5	-12.6	-10.1	-12.1	-12.6	-10.4	-11.4	-9.1	-9.2	2.4	-0.1
Bosnia and Herzegovina	na	na	na	na	na	na	-0.3	-4.4	-0.5	-6.9	-7.0	-5.5	-5.0	1.5	0.5
Bulgaria	-1.0	-8.1	-4.5	-2.9	-8.7	-3.9	-5.7	-10.4	-2.1	0.9	-0.9	-1.1	-1.5	-0.1	-0.4
FR Yugoslavia	na	na	na	na	na	na	-4.3	-3.8	-7.6	-5.4	-8.3	-1.0	-5.9	7.3	-4.9
FYR Macedonia	na	na	-4.5	-9.8	-13.4	-2.7	-1.0	-1.4	-0.4	-1.8	0.0	1.0	-8.0	1.0	-9.0
Romania	na	na	na	-4.6	-0.4	-2.2	-2.5	-3.9	-4.6	-5.0	-3.5	-3.7	-3.7	-0.2	0.0
South-eastern Europe [1]	*-1.0*	*-7.1*	*-9.9*	*-10.1*	*-9.5*	*-5.3*	*-4.0*	*-6.0*	*-4.6*	*-4.8*	*-5.2*	*-3.2*	*-5.5*	*2.0*	*-2.3*
Armenia	na	na	-1.9	-13.9	-54.7	-16.5	-11.0	-9.3	-4.6	-3.7	-5.2	-4.9	-4.8	0.3	0.2
Azerbaijan	na	na	na	2.7	-15.3	-12.1	-4.9	-2.8	-1.6	-4.2	-4.8	0.4	-0.5	5.2	-0.9
Belarus	na	na	na	-3.3	-5.2	-1.3	-1.9	-1.6	-0.7	-0.3	-2.2	-0.6	-1.5	1.6	-0.9
Georgia	na	na	-3.0	-25.4	-26.2	-7.4	-5.3	-7.3	-6.7	-5.4	-6.7	-4.6	-3.5	2.1	1.1
Kazakhstan	na	1.4	-7.9	-7.3	-4.1	-7.7	-3.4	-5.3	-7.0	-7.7	-5.0	-0.8	2.5	4.2	3.3
Kyrgyzstan	na	na	na	na	-14.4	-5.7	-8.4	-8.8	-8.8	-11.2	-12.8	-9.6	-5.9	3.2	3.7
Moldova	na	na	0.0	-26.6	-7.5	-5.9	-5.0	-8.5	-6.6	-5.7	-5.4	-4.0	-3.8	1.5	0.1
Russia	na	na	na	-18.9	-7.3	-10.4	-6.0	-8.9	-7.9	-8.0	-3.3	3.0	3.0	6.3	0.0
Tajikistan	1.3	-3.0	-20.2	-30.5	-20.9	-4.6	-3.3	-5.8	-3.3	-3.8	-3.1	-0.6	-0.5	2.5	0.2
Turkmenistan	na	1.7	3.0	-9.4	-4.1	-2.3	-2.6	0.3	0.0	-2.6	0.0	0.4	0.0	0.4	-0.4
Ukraine	na	na	na	-25.4	-16.2	-7.7	-6.1	-3.2	-5.4	-2.8	-2.4	-1.3	-1.7	1.1	-0.4
Uzbekistan	-0.9	-1.1	-3.6	-18.3	-10.4	-6.1	-4.1	-7.3	-2.4	-3.0	-2.8	-1.2	-1.0	1.5	0.2
Commonwealth of Independent States [1]	*0.2*	*-0.2*	*-4.8*	*-16.0*	*-15.5*	*-7.3*	*-5.2*	*-5.7*	*-4.6*	*-4.8*	*-4.5*	*-2.0*	*-1.5*	*2.5*	*0.5*

Note: Data for 1989-99 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 2000 are preliminary actuals, mostly official government estimates. Data for 2001 represent EBRD projections.

[1] Unweighted average for the region.

Table A.3.5

General government revenue

(in per cent of GDP)

	1994	1995	1996	1997	1998	1999	2000
Croatia	41.8	43.5	44.3	42.5	45.6	42.8	40.4
Czech Republic	42.6	41.9	40.3	39.7	39.3	41.4	40.3
Estonia	35.4	36.1	38.8	40.6	38.3	36.5	36.0
Hungary	50.3	45.9	45.3	44.3	43.8	42.3	40.6
Latvia	na	37.2	37.4	41.3	42.6	40.0	37.4
Lithuania	32.6	32.3	29.6	32.6	32.6	32.1	30.2
Poland	48.3	47.4	43.1	42.7	41.4	40.2	39.4
Slovak Republic	44.0	47.0	45.6	41.1	38.3	39.7	41.8
Slovenia	43.4	43.1	42.7	42.1	43.0	43.6	42.8
Central eastern Europe and the Baltic states [1]	*42.3*	*41.6*	*40.8*	*40.8*	*40.5*	*39.9*	*38.8*
Albania	23.8	23.4	18.3	16.9	20.3	21.3	22.4
Bosnia and Herzegovina	na	39.0	0.5	39.2	42.9	47.9	47.2
Bulgaria	41.8	35.7	31.9	31.4	36.8	39.8	43.5
FR Yugoslavia	na	na	na	na	na	29.7	42.8
FYR Macedonia	43.1	37.9	35.7	34.9	34.0	38.0	40.1
Romania	31.7	31.4	28.9	27.3	31.0	32.1	31.5
South-eastern Europe [1]	*35.1*	*33.5*	*23.1*	*29.9*	*33.0*	*34.8*	*37.9*
Armenia	27.7	17.8	15.1	16.5	18.5	20.3	16.7
Azerbaijan	33.8	17.6	17.6	19.1	17.0	18.6	21.2
Belarus	46.0	36.1	40.8	44.9	45.9	46.1	32.1
Georgia	na	7.1	13.8	14.3	13.7	15.4	14.7
Kazakhstan	18.5	16.9	13.2	13.5	18.2	17.4	21.7
Kyrgyzstan	26.8	24.8	23.9	23.9	24.4	24.0	25.7
Moldova	30.4	26.5	23.5	29.1	33.1	27.3	26.6
Russia	34.6	33.1	33.5	36.5	33.4	35.1	38.8
Tajikistan	47.6	17.5	13.2	13.7	12.0	13.5	13.6
Turkmenistan	16.9	20.5	16.6	25.4	22.0	19.4	25.8
Ukraine	43.7	39.1	36.7	38.8	36.0	33.8	34.5
Uzbekistan	29.2	34.6	34.3	30.1	32.4	30.5	31.1
Commonwealth of Independent States [1]	*32.3*	*24.3*	*23.5*	*25.5*	*25.6*	*25.1*	*25.2*
Memorandum:							
Germany	43.5	43.1	43.9	43.7	43.8	44.6	na
Greece	35.5	36.4	36.9	38.9	40.1	41.9	na
Japan	32.1	32.0	31.7	31.6	31.6	31.1	na
Portugal	37.8	38.8	40.1	41.0	41.3	42.8	na
United States	29.4	29.8	30.2	30.5	30.9	31.1	na

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

Note: Data for 1994-99 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 2000 are preliminary actuals, mostly official government estimates.

[1] Unweighted average for the region.

Table A.3.6

General government expenditure

(in per cent of GDP)

	1994	1995	1996	1997	1998	1999	2000
Croatia	40.6	44.9	45.3	44.4	46.7	49.3	47.3
Czech Republic	41.8	41.5	40.6	40.9	40.8	42.0	44.5
Estonia	40.5	41.5	40.7	38.4	38.6	41.0	36.7
Hungary	58.7	52.2	48.2	50.9	49.4	44.8	45.1
Latvia	40.5	41.2	39.2	41.0	43.4	44.0	42.0
Lithuania	37.4	36.8	34.2	33.7	38.1	40.2	33.2
Poland	50.5	49.2	46.4	45.8	44.6	43.9	42.6
Slovak Republic	45.5	45.2	47.0	45.5	42.9	43.3	45.4
Slovenia	43.6	43.4	42.9	43.8	44.4	44.5	44.1
Central eastern Europe and the Baltic states [1]	*44.3*	*44.0*	*42.7*	*42.7*	*43.2*	*43.7*	*42.3*
Albania	36.4	33.4	30.3	29.4	30.7	32.7	31.4
Bosnia and Herzegovina	na	39.3	52.7	39.7	49.9	54.9	52.7
Bulgaria	45.7	41.3	42.3	33.5	35.8	40.7	44.5
FR Yugoslavia	na	na	na	na	na	38.0	39.7
FYR Macedonia	45.8	39.0	37.1	35.3	35.8	38.0	37.8
Romania	33.9	34.7	33.8	34.3	38.4	36.8	35.1
South-eastern Europe [1]	*40.5*	*37.6*	*39.3*	*34.5*	*38.1*	*40.2*	*40.2*
Armenia	44.1	28.8	24.4	21.1	22.2	25.5	21.6
Azerbaijan	45.9	22.5	20.3	20.8	21.2	23.7	20.8
Belarus	47.3	43.0	42.7	46.1	46.4	47.9	na
Georgia	23.5	12.3	21.1	21.0	19.1	22.1	17.9
Kazakhstan	18.4	20.8	18.6	20.4	25.8	22.4	22.5
Kyrgyzstan	32.4	33.2	32.7	32.7	35.6	36.8	32.9
Moldova	36.3	31.5	32.0	35.7	38.7	32.8	30.6
Russia	45.1	39.1	42.4	44.4	41.4	38.4	35.8
Tajikistan	52.2	20.8	19.0	17.0	15.8	16.6	14.2
Turkmenistan	19.2	23.1	16.3	25.3	24.6	19.4	25.3
Ukraine	51.4	33.0	39.9	44.2	38.7	36.1	35.8
Uzbekistan	35.3	38.7	41.6	32.5	34.5	33.2	31.8
Commonwealth of Independent States [1]	*37.6*	*28.9*	*29.2*	*30.1*	*30.3*	*29.6*	*26.3*
Memorandum:							
Germany	43.5	43.1	43.9	43.7	43.8	44.6	na
Greece	35.5	36.4	36.9	38.9	40.1	41.9	na
Japan	32.1	32.0	31.7	31.6	31.6	31.1	na
Portugal	37.8	38.8	40.1	41.0	41.3	42.8	na
United States	29.4	29.8	30.2	30.5	30.9	31.1	na

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

Note: Data for 1994-99 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 2000 are preliminary actuals, mostly official government estimates. General government expenditure includes net lending.

[1] Unweighted average for the 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	2001	Change 1999-2000	Change 2000-01
							(in per cent of GDP)							*(in percentage points)*	
Croatia	na	na	-3.4	3.2	5.7	5.9	-7.7	-5.5	-11.6	-7.1	-6.9	-2.1	-4.1	4.8	-2.1
Czech Republic	na	na	na	na	1.3	-1.9	-2.6	-7.4	-6.1	-2.4	-3.0	-4.6	-6.8	-1.6	-2.2
Estonia	na	na	na	3.3	1.3	-7.2	-4.4	-9.1	-12.2	-9.1	-4.8	-6.3	-7.5	-1.5	-1.3
Hungary	-4.6	0.4	0.8	0.9	-9.0	-9.4	-5.6	-3.7	-2.1	-4.9	-4.3	-3.3	-3.1	1.0	0.2
Latvia	na	na	na	na	19.1	5.5	-0.4	-5.4	-6.1	-10.7	-9.8	-6.9	-7.4	2.9	-0.5
Lithuania	na	na	na	na	-3.2	-2.2	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-6.6	5.2	-0.6
Poland	-2.2	1.0	-2.6	1.1	-0.7	0.7	4.5	-1.0	-3.2	-4.4	-7.5	-6.2	-5.0	1.3	1.2
Slovak Republic	na	na	na	na	-4.7	4.6	2.1	-10.6	-9.6	-9.7	-5.5	-3.7	-6.4	1.8	-2.7
Slovenia	9.0	3.0	1.0	7.4	1.5	4.0	-0.5	0.2	0.1	-0.8	-3.9	-3.4	-1.8	0.5	1.6
Central eastern Europe and the Baltic states [1]	*0.8*	*1.4*	*-1.0*	*3.2*	*1.3*	*0.0*	*-2.8*	*-5.8*	*-6.8*	*-6.8*	*-6.3*	*-4.7*	*-5.4*	*1.6*	*-0.7*
Albania	na	na	na	na	-30.1	-14.4	-7.2	-9.1	-12.1	-6.1	-7.2	-6.9	-7.5	0.3	-0.6
Bosnia and Herzegovina	na	na	na	na	na	-14.1	-10.3	-27.3	-31.0	-18.9	-21.4	-21.2	-20.4	0.2	0.8
Bulgaria	-1.6	-8.2	-1.0	-4.2	-10.1	-0.3	-1.5	1.7	10.3	-0.5	-5.3	-5.8	-5.8	-0.6	0.1
FR Yugoslavia	na	na	na	na	na	na	na	-11.6	-9.4	-4.8	-7.5	-8.3	-9.6	-4.3	-1.4
FYR Macedonia	na	-9.1	-5.5	-0.8	0.6	-5.3	-5.0	-6.5	-7.5	-8.8	-4.0	-8.4	-13.7	-0.9	-5.3
Romania	na	-9.6	-3.5	-8.0	-4.5	-1.4	-5.0	-7.3	-6.1	-7.7	-3.8	-3.8	-5.8	0.0	-2.0
South-eastern Europe [1]	*na*	*-9.0*	*-3.4*	*-4.3*	*-11.0*	*-7.1*	*-5.8*	*-10.0*	*-9.3*	*-7.8*	*-8.2*	*-9.1*	*-10.5*	*-0.9*	*-1.4*
Armenia	na	na	na	na	-14.3	-16.0	-17.0	-18.2	-18.7	-21.3	-16.6	-14.5	-14.3	2.1	0.2
Azerbaijan	na	na	19.3	-12.2	-12.2	-9.4	-13.2	-25.8	-23.1	-32.6	-13.2	-2.7	-6.1	10.5	-3.4
Belarus	na	na	na	na	-11.9	-9.1	-4.4	-3.7	-6.3	-7.1	-1.7	-1.3	-0.9	0.4	0.3
Georgia	na	na	na	-33.5	-40.2	-22.3	-7.5	-9.1	-10.6	-9.4	-7.8	-6.1	-6.1	1.7	0.1
Kazakhstan	-75.4	-85.9	-50.0	-24.5	-7.9	-7.8	-1.3	-3.6	-3.6	-5.6	-1.4	5.9	2.2	7.3	-3.7
Kyrgyzstan	na	na	na	na	na	-7.6	-15.7	-23.3	-7.9	-20.0	-15.3	-7.9	-6.1	7.4	1.8
Moldova	na	na	na	-3.0	-11.9	-7.0	-5.8	-10.5	-12.6	-16.7	-2.7	-7.8	-7.6	-5.2	0.3
Russia	na	na	na	na	na	2.9	2.3	3.0	0.5	0.4	13.5	18.8	11.6	5.3	-7.2
Tajikistan	na	na	na	na	-28.8	-17.8	-16.0	-7.1	-5.4	-9.1	-3.4	-6.3	-7.2	-2.9	-0.9
Turkmenistan	na	na	88.6	68.5	14.1	4.0	0.9	0.1	-24.2	-36.8	-22.4	13.9	-1.5	36.3	-15.4
Ukraine	na	na	na	na	na	-3.1	-5.2	-2.7	-3.0	-3.1	2.6	4.7	2.6	2.1	-2.1
Uzbekistan	na	na	395.6	-12.0	-8.4	2.1	-0.2	-7.8	-5.4	-0.4	-2.0	2.9	2.7	5.0	-0.3
Commonwealth of Independent States [1]	*na*	*na*	*na*	*-2.8*	*-13.5*	*-7.6*	*-6.9*	*-9.1*	*-10.0*	*-13.5*	*-5.9*	*0.0*	*-2.6*	*5.8*	*-2.5*
Central and eastern Europe, the Baltic states and the CIS [1]	**na**	**na**	**na**	**-1.0**	**-7.0**	**-4.9**	**-5.3**	**-8.2**	**-8.8**	**-10.0**	**-6.5**	**-3.6**	**-5.3**	**2.9**	**-1.7**

Note: Data for 1989-99 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 2000 are preliminary actuals, mostly official government estimates. Data for 2001 represent EBRD projections.

[1] Unweighted average for the region.

Table A.3.8

Indicators of competitiveness

(change as a percentage, unless indicated)

	1996	1997	1998	1999	2000	1996-2000
Bulgaria[1]						
Industrial gross output	-11.8	-11.3	4.3	-12.5	12.0	-20.0
Productivity in industry	-10.1	-4.3	12.3	-2.8	na	na
Real wage in industry (PPI-based)	-21.4	16.2	14.1	na	na	na
D-Mark unit labour costs	-20.2	24.4	14.6	na	na	na
Real D-Mark exchange rate index (1995=100)	87.2	123.9	144.7	144.9	156.2	-
Wage share	0.39	0.42	0.41	na	na	-
Croatia[2]						
Industrial gross output	3.1	6.8	3.7	-1.4	1.7	14.5
Productivity in industry	12.6	6.6	7.4	1.7	4.3	36.7
Real wage in industry (PPI-based)	11.0	8.2	11.4	2.8	-1.6	35.2
D-Mark unit labour costs	1.0	2.0	0.3	-2.6	-0.5	0.1
Real D-Mark exchange rate index (1995=100)	103.2	106.7	109.6	106.0	109.7	-
Wage share	0.56	0.50	0.53	0.51	na	-
Czech Republic						
Manufacturing gross output	5.5	6.4	2.5	-2.7	4.8	17.3
Productivity in manufacturing	9.6	11.1	5.6	2.2	5.8	38.9
Real wage in manufacturing (PPI-based)	11.9	8.4	5.6	6.3	0.7	37.1
D-Mark unit labour costs	9.9	0.9	4.3	1.3	4.1	21.9
Real D-Mark exchange rate index (1995=100)	110.0	115.5	126.3	124.8	131.7	-
Wage share	0.27	0.25	0.25	0.25	na	-
Estonia						
Manufacturing gross output	2.2	18.5	5.6	-2.4	na	na
Productivity in manufacturing	7.8	27.4	9.4	4.6	na	na
Real wage in manufacturing (PPI-based)	7.7	11.5	10.7	3.5	na	na
D-Mark unit labour costs	14.6	-6.2	4.4	-3.7	na	na
Real D-Mark exchange rate index (1995=100)	121.5	132.4	142.1	145.7	148.7	-
Wage share	0.57	0.52	0.51	0.50	na	-
Hungary						
Manufacturing gross output	3.4	14.8	16.2	12.5	na	na
Productivity in manufacturing	3.3	13.0	10.1	0.2	na	na
Real earnings in manufacturing (PPI-based)	-0.6	3.6	7.4	8.5	3.4	24.1
D-Mark unit labour costs	1.8	1.7	-8.2	9.0	na	na
Real D-Mark exchange rate index (1995=100)	105.4	115.2	115.3	118.8	124.5	-
Wage share	0.29	0.27	0.27	0.29	na	-
Latvia						
Manufacturing gross output	7.3	17.1	3.7	-5.7	4.7	414.6
Productivity in manufacturing	15.4	12.7	12.9	-1.4	2.3	492.4
Real wage in manufacturing (PPI-based)	0.8	17.8	4.8	7.7	na	na
D-Mark unit labour costs	-0.9	18.4	-6.8	8.9	11.8	432.9
Real D-Mark exchange rate index (1995=100)	116.7	135.7	140.6	150.6	169.4	-
Wage share	0.38	0.39	0.43	0.45	0.45	-
Lithuania[3]						
Manufacturing gross output	3.5	8.0	9.3	-9.6	10.7	22.2
Productivity in manufacturing	8.5	5.7	8.0	-6.1	13.3	31.8
Real wage in manufacturing (PPI-based)	14.9	18.1	28.6	-10.4	-16.3	30.9
D-Mark unit labour costs	30.3	34.1	12.8	2.6	-2.1	98.0
Real D-Mark exchange rate index (1995=100)	129.0	158.9	167.8	175.4	201.0	-
Wage share	0.32	0.33	0.36	0.33	na	-

Table A.3.8 (continued)

Indicators of competitiveness

(change as a percentage, unless indicated)

	1996	1997	1998	1999	2000	1996-2000
Poland						
Manufacturing gross output	9.8	12.8	5.1	5.3	7.3	47.1
Productivity in manufacturing	10.0	12.1	4.7	9.5	8.3	53.0
Real wage in manufacturing (PPI-based)	14.5	12.1	8.4	5.8	8.1	59.2
D-Mark unit labour costs	8.9	3.0	5.0	-7.1	12.8	23.3
Real D-Mark exchange rate index (1995=100)	111.6	119.3	125.7	123.3	140.6	-
Wage share	0.33	0.34	0.34	0.34	na	-
Romania						
Manufacturing gross output	12.5	-6.8	-18.1	-6.1	8.9	-12.1
Productivity in manufacturing	14.8	-1.4	-15.9	6.6	na	na
Real wage in manufacturing (PPI-based)	4.4	-23.7	10.7	1.9	-14.2	-22.9
D-Mark unit labour costs	-4.7	-3.8	47.1	-16.8	na	na
Real D-Mark exchange rate index (1995=100)	94.8	117.5	151.7	132.8	155.1	-
Wage share	0.33	0.29	0.34	0.29	0.00	-
Russia[4]						
Manufacturing gross output	-6.8	1.9	-5.2	8.1	na	na
Productivity in manufacturing	0.2	12.0	19.1	7.3	na	na
Real wage in manufacturing (PPI-based)	9.6	-13.7	7.7	-9.2	na	na
D-Mark unit labour costs	76.2	-5.9	-43.0	-43.2	na	na
Real D-Mark exchange rate index (1995=100)	136.2	156.4	116.5	91.1	109.1	-
Wage share	na	na	na	na	na	-
Slovak Republic						
Manufacturing gross output	2.4	1.6	6.5	-3.0	10.0	18.2
Productivity in manufacturing	2.5	4.1	11.5	2.0	7.8	30.7
Real wage in manufacturing (PPI-based)	9.8	7.5	6.1	-3.9	1.9	22.7
D-Mark unit labour costs	15.3	12.2	-5.8	-6.5	5.7	20.6
Real D-Mark exchange rate index (1995=100)	106.3	116.3	119.0	116.3	132.3	-
Wage share	0.30	0.30	0.29	0.29	na	-
Slovenia						
Manufacturing gross output	0.9	0.2	3.9	0.0	7.0	12.4
Productivity in manufacturing	6.7	4.5	5.4	1.8	7.3	28.3
Real wage in manufacturing (PPI-based)	7.3	6.2	5.0	6.3	3.3	31.3
D-Mark unit labour costs	-1.6	4.8	2.7	2.2	-1.5	6.7
Real D-Mark exchange rate index (1995=100)	99.6	103.5	108.0	108.6	109.6	-
Wage share	0.39	0.37	0.36	0.35	na	-

Sources: Production, employment and wages figures are taken from various issues of monthly, quarterly and annual publications from national authorities, the IMF, the OECD, the ILO and the Vienna Institute for International Economic Studies.

Note: Data for 1996-99 represent the percentage change of annual averages based on actual data. Figures for 2000 represent preliminary official estimates.

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

Data on the exchange rate to the D-Mark, on CPI and PPI are based on national authorities, the IMF and EBRD estimates.

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.

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] Before 1997 average gross monthly wages in industry refers only to state sector, thereafter to total industry.

[2] Figures for 1996-97 refer to industry and thereafter to manufacturing. PPI refers to industry between 1996-97 and to manufacturing thereafter.

[3] Output and PPI refers 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 (estimate)	2001 (projection)	Cumulative FDI-inflows 1989-2000	Cumulative FDI-inflows per capita 1989-2000	FDI-inflows per capita 1999	FDI-inflows per capita 2000	FDI-inflows 1999	FDI-inflows 2000
	(in millions of US dollars)													(in mln US$)	(US$)	(US$)		(in percent of GDP)	
Croatia	na	na	na	13	102	110	109	486	347	835	1,445	827	470	4,274	938	321	182	7.2	4.3
Czech Republic	na	na	na	983	563	749	2,526	1,276	1,275	3,591	6,234	4,477	5,000	21,673	2,102	605	434	11.7	9.1
Estonia	na	na	na	80	156	212	199	111	130	574	222	324	350	2,008	1,400	154	226	4.3	6.4
Hungary	187	311	1,459	1,471	2,328	1,097	4,410	2,279	1,741	1,555	1,720	1,167	1,314	19,725	1,964	170	116	3.6	2.6
Latvia	na	na	na	na	50	279	245	379	515	303	331	398	300	2,498	1,056	139	168	5.0	5.6
Lithuania	na	na	na	na	30	31	72	152	328	921	478	375	450	2,387	646	129	102	4.5	3.3
Poland	na	0	117	284	580	542	1,134	2,741	3,041	4,966	6,348	9,299	7,000	29,052	751	164	240	4.1	5.9
Slovak Republic	10	24	82	100	107	236	194	199	84	374	701	2,058	2,000	4,169	772	130	381	3.6	10.7
Slovenia	-14	-2	-41	113	111	131	183	188	340	250	144	110	385	1,510	756	72	55	0.7	0.6
Central eastern Europe and the Baltic states	*183*	*333*	*1,617*	*3,044*	*4,027*	*3,388*	*9,070*	*7,810*	*7,800*	*13,368*	*17,622*	*19,035*	*17,269*	*83,022*	*1,154*	*209*	*212*	*5.0*	*5.4*
Albania	na	na	na	20	45	65	89	97	42	45	51	141	207	595	174	15	41	1.4	3.8
Bulgaria	na	4	56	41	40	105	82	81	503	537	836	1,000	500	3,286	404	102	123	6.7	8.3
Bosnia and Herzegovina	na	na	na	na	na	0	0	0	0	100	90	150	164	340	79	21	35	2.0	3.5
FR Yugoslavia	na	na	na	na	na	na	na	0	740	113	112	25	200	990	116	13	3	1.1	0.3
FYR Macedonia	na	0	0	0	0	24	12	12	18	175	27	169	350	437	219	14	85	0.8	5.0
Romania	na	-18	37	73	87	341	417	415	1,267	2,079	1,025	1,009	900	6,732	301	46	45	3.0	2.7
South-eastern Europe	*na*	*-14*	*93*	*134*	*172*	*535*	*600*	*605*	*2,570*	*3,049*	*2,141*	*2,494*	*2,321*	*12,380*	*215*	*35*	*55*	*2.5*	*3.9*
Armenia	na	na	na	0	1	8	25	18	52	221	122	104	140	550	145	32	27	6.6	5.4
Azerbaijan	na	na	na	na	0	22	282	661	1,093	1,024	550	117	314	3,749	464	69	14	12.1	2.2
Belarus	na	na	na	na	18	11	15	105	350	201	443	90	100	1,231	123	44	9	3.8	0.7
Georgia	na	na	na	na	0	8	6	54	236	221	60	152	100	738	138	11	28	2.1	5.1
Kazakhstan	na	na	na	100	473	635	964	1,137	1,320	1,136	1,584	1,244	2,000	8,593	577	106	84	9.4	6.8
Kyrgyzstan	na	na	na	na	na	38	96	47	83	109	38	29	40	440	93	8	6	3.0	2.2
Moldova	na	na	na	17	14	18	73	23	71	88	34	100	60	438	102	8	23	2.6	7.1
Russia	na	na	na	na	na	500	1,663	1,665	4,036	1,734	746	-346	2,000	9,998	69	5	-2	0.4	-0.1
Tajikistan	na	na	na	9	9	12	10	18	18	25	21	22	22	144	23	3	4	1.9	2.2
Turkmenistan	na	na	na	na	79	103	233	108	108	62	89	131	150	913	171	17	24	3.8	4.4
Ukraine	na	na	na	na	na	151	263	531	581	744	479	587	795	3,336	68	10	12	1.5	1.8
Uzbekistan	na	na	na	9	48	73	-24	90	167	140	121	73	71	697	28	5	3	1.5	1.2
Commonwealth of Independent States	*0*	*0*	*0*	*135*	*642*	*1,579*	*3,606*	*4,456*	*8,115*	*5,705*	*4,288*	*2,302*	*5,792*	*30,827*	*167*	*27*	*19*	*4.1*	*3.3*
Total	**183**	**319**	**1,710**	**3,314**	**4,840**	**5,502**	**13,277**	**12,871**	**18,484**	**22,122**	**24,051**	**23,831**	**25,382**	**126,229**	**498**	**82**	**90**	**3.9**	**4.2**

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.

For those countries (e.g. Azerbaijan, Estonia, Kazakhstan and Slovak Republic) where net investment into equity capital was not easily available, more recent data include reinvested earnings as well as inter-company debt transactions.

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

Table A.3.10

GDP growth forecasts for 2001 (in per cent)

	Average[1]	Range[2]	EBRD (Oct 2001)	European Union (Aug 2001)	OECD (June 2001)	IMF (Sept 2001)	United Nations DESA[4] (Aug 2001)	Economist Intelligence Unit (Aug 2001)	PlanEcon (Aug 2001)	IWH[5] (Aug 2001)	Kopint-Datorg[6] (Aug 2001)	Vienna Institute (July 2001)	CSFB[7] (Aug 2001)	JP Morgan (July 2001)	Dun & Bradstreet (Aug 2001)
Central eastern Europe and the Baltic states															
Croatia	3.4	1.2	3.8	na	na	4.0	2.8	3.2	3.9	na	3.0	3.0	4.0	na	3.0
Czech Republic	3.5	1.7	3.5	3.5	3.0	3.3	3.0	3.4	4.4	2.7	3.5	3.5	4.2	3.5	3.4
Estonia	5.2	1.8	4.5	5.9	na	4.5	5.5	5.1	6.3	4.5	5.3	5.5	na	na	5.0
Hungary	4.5	1.3	4.5	4.6	5.1	4.5	4.2	4.3	4.7	3.8	4.8	4.8	4.0	4.0	4.8
Latvia	5.8	2.2	6.5	5.5	na	6.0	5.5	4.9	6.9	4.7	5.8	6.0	na	na	6.0
Lithuania	3.8	2.1	4.0	3.5	na	3.6	3.7	3.0	5.1	4.2	4.2	3.5	na	na	3.2
Poland	2.6	2.8	2.0	4.3	3.8	2.5	2.3	2.5	2.6	2.2	2.5	2.0	2.0	1.5	3.0
Slovak Republic	3.0	2.0	3.0	3.0	2.8	3.0	3.0	3.3	4.2	2.2	3.2	3.0	2.8	2.5	2.9
Slovenia	3.8	2.3	2.2	4.3	na	4.5	3.7	3.7	4.3	3.8	4.0	4.0	na	na	4.0
Average	*3.9*	*1.9*	*3.8*	*4.3*	*3.7*	*4.0*	*3.7*	*3.7*	*4.7*	*3.5*	*4.0*	*3.9*	*3.4*	*2.9*	*3.9*
Weighted average[3]	*3.2*	*2.2*	*2.9*	*na*	*na*	*3.3*	*3.0*	*3.1*	*3.6*	*na*	*3.3*	*3.0*	*na*	*na*	*3.5*
South-eastern Europe															
Albania	7.3	1.0	7.0	na	na	7.3	7.0	7.0	8.0	na	na	na	na	na	7.7
Bosnia and Herzegovina	6.8	3.5	5.0	na	na	na	6.8	7.0	8.5	na	na	na	na	na	na
Bulgaria	4.2	2.0	4.0	5.2	na	4.5	3.8	4.0	5.1	3.2	4.0	4.0	3.5	na	4.5
FR Yugoslavia	6.3	7.4	5.0	na	na	na	4.6	5.0	5.4	na	7.0	5.0	na	na	12.0
FYR Macedonia	0.8	8.0	-4.0	na	na	2.5	2.0	2.0	-0.8	na	na	0.0	na	na	4.0
Romania	3.6	4.7	4.0	1.8	na	4.1	3.8	3.9	5.7	1.0	3.5	4.0	4.0	na	3.5
Average	*4.8*	*4.4*	*3.5*	*3.5*	*na*	*4.6*	*4.7*	*4.8*	*5.3*	*2.1*	*4.8*	*3.3*	*3.8*	*na*	*6.3*
Weighted average[3]	*4.3*	*4.4*	*4.0*	*na*	*na*	*na*	*4.2*	*4.3*	*5.5*	*na*	*na*	*na*	*na*	*na*	*na*
Commonwealth of Independent States															
Armenia	5.4	3.5	6.0	na	na	6.5	5.5	5.0	6.5	na	na	3.0	na	na	na
Azerbaijan	7.9	2.0	8.0	na	na	8.5	8.5	8.0	6.5	na	na	8.0	na	na	8.0
Belarus	3.0	1.5	2.5	na	na	2.5	2.5	2.5	4.0	na	na	3.0	na	na	4.0
Georgia	3.8	5.3	3.0	na	na	3.5	4.0	3.5	7.3	na	na	2.0	na	na	3.0
Kazakhstan	7.5	4.0	10.0	na	na	6.0	6.5	8.0	9.7	na	na	6.0	na	na	6.0
Kyrgyzstan	4.6	1.0	5.0	na	na	5.0	5.0	4.0	4.4	na	na	4.0	na	na	4.5
Moldova	4.0	3.0	5.0	na	na	5.0	4.0	3.2	4.6	na	na	2.0	na	na	na
Russia	4.1	3.0	5.5	na	3.0	4.0	3.5	4.5	4.1	4.0	4.0	5.0	5.0	2.5	4.0
Tajikistan	5.4	3.0	6.0	na	na	5.0	5.0	4.5	6.1	na	na	4.0	na	na	7.0
Turkmenistan	11.5	9.3	10.0	na	na	10.0	16.0	16.0	6.7	na	na	na	na	na	10.0
Ukraine	5.6	4.0	7.0	na	na	6.2	5.0	7.0	7.0	na	6.0	4.0	3.0	na	5.5
Uzbekistan	2.2	2.0	3.0	na	na	3.0	1.0	1.0	2.4	na	na	2.0	na	na	3.0
Average	*5.4*	*3.5*	*5.9*	*na*	*3.0*	*5.4*	*5.5*	*5.6*	*5.8*	*4.0*	*5.0*	*3.9*	*4.0*	*2.5*	*5.5*
Weighted average[3]	*4.5*	*3.1*	*5.8*	*na*	*na*	*4.4*	*3.9*	*4.9*	*4.8*	*na*	*na*	*na*	*na*	*na*	*na*
Central and eastern Europe, the Baltic states and the CIS															
Average	*4.8*	*3.2*	*4.7*	*4.2*	*3.5*	*4.8*	*4.7*	*4.8*	*5.3*	*3.3*	*4.3*	*3.8*	*3.6*	*2.8*	*5.1*
Weighted average[3]	*3.9*	*2.8*	*4.3*	*na*	*na*	*na*	*3.5*	*4.1*	*4.3*	*na*	*na*	*na*	*na*	*na*	*na*

Note: All forecasts quoted here were published or reported to the EBRD between March and October 2001. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial delays between preparation and publication of forecasts.

1 The number at the bottom of this column 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 2000.

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

5 Institute for Economic Research, Halle, Germany.

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

7 Credit Suisse First Boston.

Table A.3.11

GDP growth forecasts for 2002 (in per cent)

	Average[1]	Range[2]	EBRD (Oct 2001)	European Union (Aug 2001)	OECD (June 2001)	IMF (Sept 2001)	United Nations DESA[4] (Aug 2001)	Economist Intelligence Unit (Aug 2001)	PlanEcon (Aug 2001)	IWH[5] (Aug 2001)	Kopint-Datorg[6] (Aug 2001)	Vienna Institute (July 2001)	CSFB[7] (Aug 2001)	JP Morgan (July 2001)	Dun & Bradstreet (Aug 2001)
Central eastern Europe and the Baltic states															
Croatia	3.5	1.6	3.0	na	na	4.2	3.0	3.0	4.6	na	3.0	3.0	4.0	na	4.0
Czech Republic	3.9	2.1	3.0	4.0	3.5	3.9	3.6	3.7	5.1	3.6	na	3.5	5.0	4.0	3.5
Estonia	5.1	2.0	4.0	5.7	na	5.0	na	5.0	6.0	4.7	5.5	5.5	na	na	4.7
Hungary	4.5	1.0	4.0	5.0	4.7	4.5	4.5	4.5	4.6	4.3	4.5	5.0	4.5	4.5	4.2
Latvia	5.2	2.1	5.0	5.5	na	6.0	na	5.1	6.1	5.0	5.5	4.0	na	na	5.0
Lithuania	4.2	3.2	3.2	4.0	na	4.7	na	3.5	6.2	4.5	5.2	3.5	na	na	3.0
Poland	3.6	2.6	2.0	4.6	3.9	3.7	3.8	3.8	3.8	3.5	na	4.0	4.0	3.7	2.7
Slovak Republic	3.7	2.8	3.0	3.8	3.6	4.4	3.8	3.8	5.3	2.5	na	4.0	3.2	3.5	3.2
Slovenia	4.1	2.4	2.6	4.3	na	4.0	3.9	4.0	4.4	4.3	4.0	4.5	na	na	5.0
Average	*4.2*	*2.2*	*3.3*	*4.6*	*3.9*	*4.5*	*3.8*	*4.0*	*5.1*	*4.1*	*4.6*	*4.1*	*4.1*	*3.9*	*3.9*
Weighted average[3]	*3.9*	*2.3*	*2.7*	*na*	*na*	*4.0*	*na*	*3.9*	*4.4*	*na*	*na*	*4.0*	*na*	*na*	*3.3*
South-eastern Europe															
Albania	7.1	2.0	6.0	na	na	7.0	7.0	7.0	7.3	na	na	na	na	na	8.0
Bosnia and Herzegovina	6.4	2.2	5.0	na	na	na	6.8	6.5	7.2	na	na	na	na	na	na
Bulgaria	4.4	1.7	3.5	4.9	na	5.0	4.3	4.4	5.2	3.8	4.0	4.0	4.5	na	5.0
FR Yugoslavia	5.9	2.0	5.0	na	na	na	6.0	6.0	6.2	na	na	5.0	na	na	7.0
FYR Macedonia	3.7	4.1	1.0	na	na	4.0	2.6	3.0	5.1	na	na	5.0	na	na	5.0
Romania	3.6	4.2	3.5	2.3	na	4.5	3.8	3.7	5.9	1.7	na	2.0	4.5	na	4.0
Average	*5.2*	*2.7*	*4.0*	*3.6*	*na*	*5.1*	*5.1*	*5.1*	*6.2*	*2.8*	*4.0*	*4.0*	*4.5*	*na*	*5.8*
Weighted average[3]	*4.4*	*3.2*	*3.8*	*na*	*na*	*na*	*4.5*	*4.4*	*5.9*	*na*	*na*	*na*	*na*	*na*	*na*
Commonwealth of Independent States															
Armenia	5.3	2.0	5.5	na	na	6.0	na	5.5	5.4	na	na	4.0	na	na	na
Azerbaijan	7.5	2.5	7.0	na	na	8.5	na	8.5	8.2	na	na	6.0	na	na	6.5
Belarus	2.5	1.0	2.0	na	na	2.2	na	2.0	3.0	na	na	3.0	na	na	2.7
Georgia	4.0	2.9	3.0	na	na	3.8	na	5.5	5.9	na	na	3.0	na	na	3.0
Kazakhstan	5.8	2.8	6.0	na	na	5.0	na	7.0	7.3	na	na	5.0	na	na	4.5
Kyrgyzstan	4.4	1.0	4.0	na	na	4.5	na	5.0	4.9	na	na	4.0	na	na	4.0
Moldova	3.6	2.1	3.5	na	na	5.0	na	3.5	2.9	na	na	3.0	na	na	na
Russia	3.8	1.5	4.0	na	4.0	4.0	na	3.8	3.7	3.0	4.0	4.0	4.0	4.5	3.0
Tajikistan	4.8	3.0	3.0	na	na	5.0	na	5.5	6.0	na	na	4.0	na	na	5.0
Turkmenistan	6.1	9.0	3.0	na	na	6.0	na	12.0	4.5	na	na	na	na	na	5.0
Ukraine	4.3	3.0	3.5	na	na	4.0	na	4.0	5.0	na	na	6.0	3.0	na	4.8
Uzbekistan	2.2	2.0	2.0	na	na	2.0	na	2.0	1.0	na	na	3.0	na	na	3.0
Average	*4.5*	*2.7*	*3.9*	*na*	*4.0*	*4.7*	*na*	*5.4*	*4.8*	*3.0*	*4.0*	*4.1*	*3.5*	*4.5*	*4.2*
Weighted average[3]	*4.0*	*1.8*	*4.0*	*na*	*na*	*4.1*	*na*	*4.1*	*4.1*	*na*	*na*	*na*	*na*	*na*	*na*
Central and eastern Europe, the Baltic states and the CIS															
Average	*4.6*	*2.6*	*3.7*	*4.4*	*3.9*	*4.7*	*4.4*	*4.9*	*5.2*	*3.7*	*4.5*	*4.1*	*4.1*	*4.0*	*4.4*
Weighted average[3]	*4.0*	*2.2*	*3.4*	*na*	*na*	*na*	*na*	*4.0*	*4.4*	*na*	*na*	*na*	*na*	*na*	*na*

Note: All forecasts quoted here were published or reported to the EBRD between March and October 2001. The dates in brackets indicate the months in which the forecasts were reported or published by each institution.There may in some instances be substantial delays between preparation and publication of forecasts.

[1] The number at the bottom of this column 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 2000.

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

[5] Institute for Economic Research, Halle, Germany.

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

[7] Credit Suisse First Boston.

Table A.3.12

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

	Average[1]	Range[2]	EBRD (Oct 2001)	European Union (Aug 2001)	OECD[3] (June 2001)	IMF (Sept 2001)	United Nations ECE[3] (Aug 2001)	Economist Intelligence Unit (Aug 2001)	PlanEcon (Aug 2001)	IWH[4] (Aug 2001)	Kopint-Datorg[5] (Aug 2001)	Vienna Institute (July 2001)	CSFB[6] (Aug 2001)	JP Morgan (July 2001)	Dun & Bradstreet (Aug 2001)
Central eastern Europe and the Baltic states															
Croatia	5.7	0.7	5.7	na	na	5.8	5.9	5.3	5.7	na	6.0	6.0	5.5	na	na
Czech Republic	4.5	1.1	4.9	4.3	4.2	3.9	4.3	4.7	4.7	5.0	4.2	4.4	4.8	4.6	na
Estonia	5.7	1.8	6.1	4.7	na	5.7	5.0	6.5	6.4	6.0	5.3	na	na	na	na
Hungary	8.9	5.1	9.1	9.0	9.4	4.5	9.3	9.3	9.6	9.0	9.5	9.0	9.6	9.4	na
Latvia	2.5	1.6	2.4	1.8	na	2.3	2.8	3.4	2.8	2.0	2.8	na	na	na	na
Lithuania	1.4	1.7	1.5	1.5	na	0.6	0.5	2.1	2.0	1.0	2.2	na	na	na	na
Poland	6.3	2.4	5.6	6.8	6.5	5.7	6.1	6.3	6.0	6.0	6.6	8.0	5.8	5.7	na
Slovak Republic	7.6	1.8	7.4	7.5	7.5	7.2	7.4	7.7	7.4	7.4	7.7	8.0	7.6	7.6	9.0
Slovenia	8.2	1.8	8.6	8.0	na	7.0	8.7	8.8	8.6	8.5	8.0	8.0	na	na	na
Average	*5.7*	*2.0*	*5.7*	*5.5*	*6.9*	*4.7*	*5.6*	*6.0*	*5.9*	*5.6*	*5.8*	*7.2*	*6.7*	*6.8*	*9.0*
South-eastern Europe															
Albania	3.1	1.0	3.5	na	na	2.5	3.5	3.5	2.8	na	na	na	na	na	na
Bosnia and Herzegovina	3.8	1.1	4.0	na	na	na	4.0	3.0	4.1	na	na	na	na	na	na
Bulgaria	7.2	3.5	8.0	8.5	na	6.8	7.6	7.5	8.5	7.0	7.0	5.0	7.3	na	6.0
FR Yugoslavia	77.6	58.9	93.6	na	na	na	86.0	85.0	93.9	na	80.0	70.0	na	na	35.0
FYR Macedonia	5.4	5.2	6.2	na	na	4.0	6.0	6.6	2.8	na	na	8.0	na	na	4.0
Romania	35.2	6.2	34.2	36.7	na	33.8	34.0	34.0	34.7	35.0	35.0	40.0	35.0	na	na
Average	*22.1*	*12.7*	*24.9*	*22.6*	*na*	*11.8*	*23.5*	*23.3*	*24.5*	*21.0*	*40.7*	*30.8*	*21.2*	*na*	*15.0*
Commonwealth of Independent States															
Armenia	4.2	2.1	3.1	na	na	4.5	3.5	4.5	5.2	na	na	na	na	na	na
Azerbaijan	2.5	1.0	2.0	na	na	2.5	3.0	2.0	2.8	na	na	na	na	na	na
Belarus	73.9	40.2	59.8	na	na	69.0	100.0	75.0	65.5	na	na	na	na	na	na
Georgia	5.6	0.9	5.6	na	na	5.9	6.0	5.5	5.1	na	na	na	na	na	na
Kazakhstan	8.5	2.4	8.6	na	na	9.4	7.0	8.8	8.7	na	na	na	na	na	na
Kyrgyzstan	9.5	3.4	7.6	na	na	9.1	11.0	11.0	8.9	na	na	na	na	na	na
Moldova	13.4	8.9	11.1	na	na	12.8	20.0	12.0	11.3	na	na	na	na	na	na
Russia	21.4	2.6	21.4	na	20.0	22.1	20.0	22.2	22.6	20.0	22.5	20.0	21.9	22.5	na
Tajikistan	40.7	21.7	39.4	na	na	39.9	30.0	42.0	51.7	na	na	na	na	na	41.0
Turkmenistan	15.9	14.4	11.2	na	na	15.0	11.0	11.0	25.4	na	na	na	na	na	22.0
Ukraine	15.2	7.5	12.5	na	na	14.9	15.0	14.0	14.3	na	17.0	20.0	13.5	na	na
Uzbekistan	28.7	4.3	25.9	na	na	26.1	30.0	30.0	30.2	na	na	na	na	na	30.0
Average	*20.0*	*9.1*	*17.4*	*na*	*20.0*	*19.3*	*21.4*	*19.8*	*21.0*	*20.0*	*19.8*	*20.0*	*17.7*	*22.5*	*31.0*
Central and eastern Europe, the Baltic states and the CIS															
Average	*15.7*	*7.5*	*15.1*	*8.9*	*9.5*	*12.8*	*16.6*	*16.0*	*16.7*	*9.7*	*15.3*	*17.2*	*12.3*	*10.0*	*21.0*

Note: All forecasts quoted here were published or reported to the EBRD between March and October 2001. The dates in brackets indicate the months in which the forecasts were reported or published by each institution.There may in some instances be substantial delays between preparation and each institution.

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

Table A.3.13

Inflation forecasts for 2002 (change in the average consumer price level, in per cent)

	Average[1]	Range[2]	EBRD (Oct 2001)	European Union (Aug 2001)	OECD[3] (June 2001)	IMF (Sept 2001)	United Nations ECE[3] (Aug 2001)	Economist Intelligence Unit (Aug 2001)	PlanEcon (Aug 2001)	IWH[4] (Aug 2001)	Kopint-Datorg[5] (Aug 2001)	Vienna Institute (July 2001)	CSFB[6] (Aug 2001)	JP Morgan (July 2001)	Dun & Bradstreet (Aug 2001)
Central eastern Europe and the Baltic states															
Croatia	4.9	1.5	4.9	na	na	4.0	5.4	5.0	4.7	na	5.2	5.5	4.6	na	na
Czech Republic	4.4	2.0	4.7	4.4	4.8	3.8	4.0	4.3	5.5	4.5	na	3.5	5.3	3.8	na
Estonia	4.6	2.6	4.7	3.5	na	3.8	na	5.5	6.1	5.0	3.8	na	na	na	na
Hungary	6.6	4.0	5.5	6.8	8.0	4.0	8.0	7.0	7.0	7.0	6.0	6.5	7.0	6.3	na
Latvia	3.3	3.2	4.0	3.2	na	3.0	na	3.8	4.7	1.5	3.0	na	na	na	na
Lithuania	2.8	3.5	2.6	2.5	na	2.8	na	2.2	5.0	1.5	2.7	na	na	na	na
Poland	5.3	2.2	3.8	5.5	5.0	5.7	6.0	6.0	4.8	5.0	na	6.0	5.0	5.6	na
Slovak Republic	6.3	3.0	7.0	5.3	7.5	6.0	6.2	6.8	5.9	6.5	na	6.0	5.1	5.0	8.0
Slovenia	6.2	2.5	6.6	5.0	na	5.0	6.2	6.3	7.3	7.5	6.2	6.0	na	na	na
Average	*4.9*	*2.7*	*4.9*	*4.5*	*6.3*	*4.2*	*6.0*	*5.2*	*5.7*	*4.8*	*4.5*	*5.6*	*5.4*	*5.2*	*8.0*
South-eastern Europe															
Albania	3.9	2.0	3.5	na	na	3.0	4.0	4.0	5.0	na	na	na	na	na	na
Bosnia and Herzegovina	3.9	2.1	na	na	na	na	4.0	2.8	4.8	na	na	na	na	na	na
Bulgaria	4.9	5.4	5.0	6.0	na	3.2	4.3	4.3	8.6	4.5	4.0	4.0	5.0	na	5.5
FR Yugoslavia	25.3	15.0	28.9	na	na	na	26.0	26.0	26.0	na	na	30.0	na	na	15.0
FYR Macedonia	5.0	4.5	6.8	na	na	2.5	6.2	7.0	2.5	na	na	6.0	na	na	4.0
Romania	26.5	12.0	25.0	23.7	na	26.0	24.0	23.0	25.3	30.0	na	35.0	26.7	na	na
Average	*11.6*	*6.8*	*13.8*	*14.9*	*na*	*8.7*	*11.4*	*11.2*	*12.0*	*17.3*	*4.0*	*18.8*	*15.9*	*na*	*8.2*
Commonwealth of Independent States															
Armenia	3.0	0.0	3.0	na	na	3.0	na	3.0	na	na	na	na	na	na	na
Azerbaijan	2.3	0.3	2.2	na	na	2.5	na	2.3	na	na	na	na	na	na	na
Belarus	57.8	86.3	39.8	na	na	23.7	na	110.0	na	na	na	na	na	na	na
Georgia	5.0	0.8	5.3	na	na	5.2	na	4.5	na	na	na	na	na	na	na
Kazakhstan	7.1	1.3	6.3	na	na	7.5	na	7.6	na	na	na	na	na	na	na
Kyrgyzstan	8.9	2.2	8.9	na	na	7.8	na	10.0	na	na	na	na	na	na	na
Moldova	12.7	8.0	10.0	na	na	10.0	na	18.0	na	na	na	na	na	na	na
Russia	15.8	7.5	12.5	na	15.0	12.9	na	17.0	na	15.0	20.0	15.0	15.1	19.6	na
Tajikistan	23.5	34.3	26.5	na	na	10.7	na	12.0	na	na	na	na	na	na	45.0
Turkmenistan	18.3	17.7	12.3	na	na	15.0	na	16.0	na	na	na	na	na	na	30.0
Ukraine	14.7	9.0	11.0	na	na	12.3	na	12.0	na	na	na	20.0	18.0	na	na
Uzbekistan	29.3	17.8	29.9	na	na	22.2	na	25.0	na	na	na	na	na	na	40.0
Average	*16.5*	*15.4*	*14.0*	*na*	*15.0*	*11.1*	*na*	*19.8*	*na*	*15.0*	*20.0*	*17.5*	*16.6*	*19.6*	*38.3*
Central and eastern Europe, the Baltic states and the CIS															
Average	*11.6*	*9.3*	*10.8*	*6.6*	*8.1*	*8.2*	*8.7*	*13.0*	*8.2*	*8.0*	*6.4*	*12.0*	*10.2*	*8*	*21*

Note: All forecasts quoted here were published or reported to the EBRD between March and October 2001. The dates in brackets indicate the months in which the forecasts were reported or published by each institution.There may in some instances be substantial delays between preparation and publication of forecasts.

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

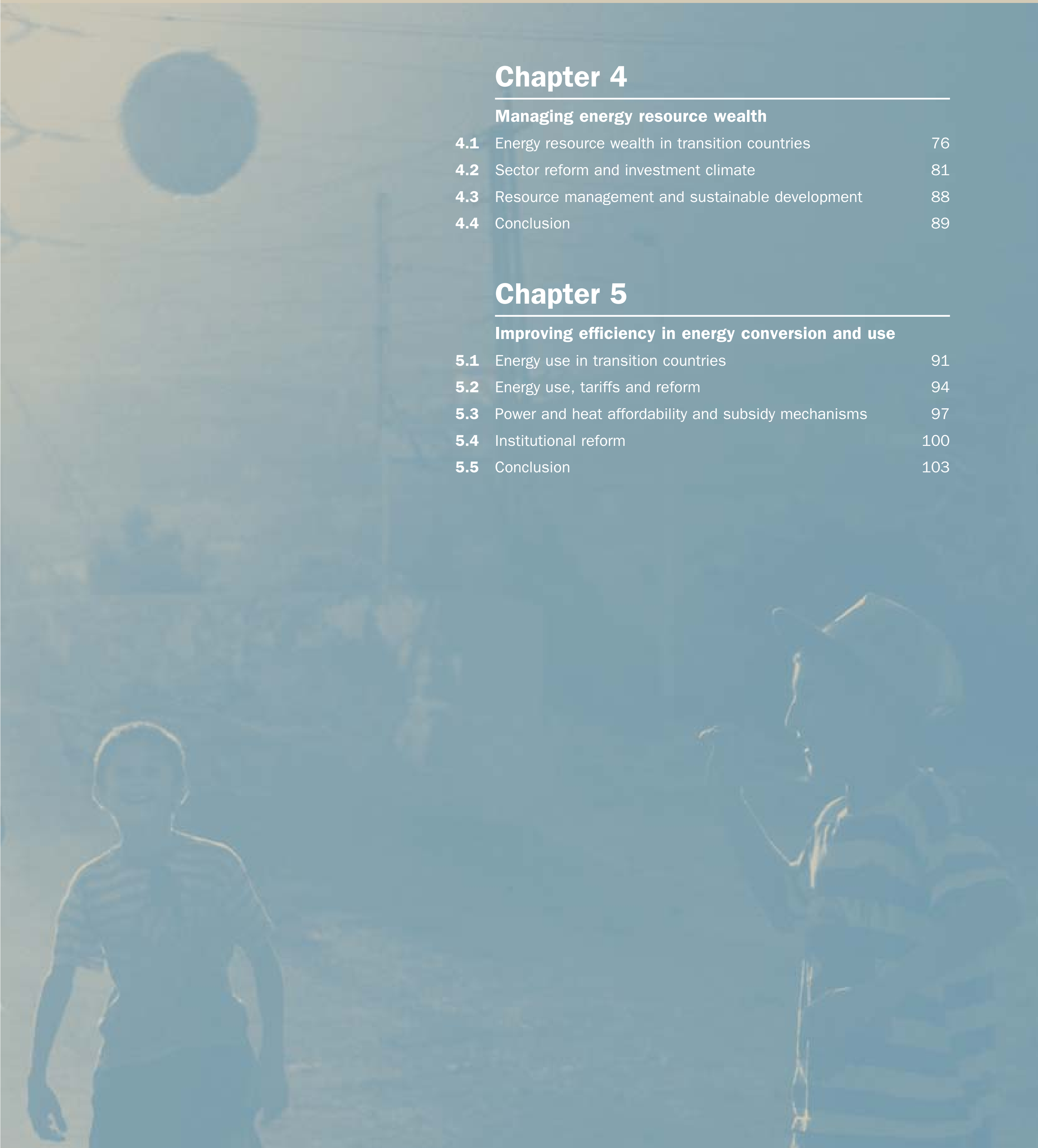
6 Credit Suisse First Boston.

Part II

Energy in transition

Chapter 4

Chapter 5



Managing energy resource wealth

4

Energy has always played an important role in central and eastern Europe and the former Soviet Union. During the 1970s the availability of vast energy resources in the former Soviet Union allowed the communist bloc to continue its policy of heavy industrialisation with scant attention given to energy and resource efficiency. Consequently the centrally planned economies forfeited important technological gains and were faced with the double disadvantage of a distorted structure of production and outdated equipment. It is only now, as energy prices are gradually adjusted to international levels, that the countries of the region are beginning to be exposed to the kind of price pressure experienced by Western firms.

The extent to which the transition economies are adjusting to these price changes is the subject of this and the following chapter. From the outset, a crucial distinction needs to be made between the energy-rich economies of Russia and the Caspian basin, and the resource-poor economies in much of the rest of the region. For the former, the move towards world market prices in the international trade of energy resources represents a significant gain in their current terms of trade or in anticipated future wealth, which could be used to cushion adjustment costs at home. For the latter, pressures to seek out the cheapest and most reliable sources of energy have intensified – a process that has, among other things, led to a move from coal towards natural gas. This has a number of implications for energy producers and for the environment. Chapter 5 examines the policies designed to increase energy efficiency in transition and looks at the generation of secondary energy.

This chapter focuses on the energy-rich countries of the region and the challenges they face in developing and managing their energy wealth. The evidence on the performance of resource-rich economies around the world is sobering. On average, growth has been slower in resource-rich countries. Macroeconomic volatility has been higher and corruption has often been more prevalent.[1]

How can transition countries take advantage of their energy wealth without falling victim to the “resource curse” evident in many resource-rich countries? This chapter explores the extent to which the availability of actual or potential income (or rents)[2] from energy production has helped reforms in the energy-rich transition countries in the past, and the extent to which this income has been used to delay critical adjustments. It highlights the policy challenges arising from the need to develop energy resources efficiently and in an environmentally responsible manner.

In exploring the link between energy resource wealth and transition, this chapter broadly covers quite varied experiences across the group of energy-rich countries. For example, Russia’s oil production is relatively mature, investment needs in exploration are not large over the short to medium term and current energy income is significant. In contrast, Azerbaijan and Kazakhstan have great energy potential but this lies in the future and is dependent on considerable investment being made. The political conditions in each of the Caspian economies (Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan) vary and this variation has been reflected in different reform paths. The resulting policy challenges are diverse,[3] but the parallels are striking nonetheless and lead to the following general conclusions:

- Investment in energy resource development is hampered by continued state control over much of the sector and, in the case of Russia, weak governance structures and misguided privatisation, which created incentives for asset stripping instead of business development.

- To attract new investment, governments need to insist on better corporate governance and create a stable and predictable investment environment. One solution, which seems to work effectively in the context of relatively weak institutional capacity, is a system of production sharing arrangements (PSAs), which insulate foreign investors to some extent from the risks of frequent discretionary policy changes.

- A key constraint on effective sector development is market access. While the state has relinquished control over production in many instances, it still extends large influence through its control of the major transport routes. Creating a regulatory framework that provides reliable market access while encouraging the development of alternative transport options is therefore a key challenge for the future.

- The “resource curse” can be avoided through careful resource management. In this respect, governments need to adopt a long-term planning strategy and be guided by concern for sustainable development. They also need to put in place institutional mechanisms to deal with the macroeconomic risks of resource wealth, such as resource price volatility and exchange rate appreciation.[4]

The following section provides an overview of the size and significance of the region’s energy resource wealth and the impact resource rents have had on output and reform. It includes a review of the

1 See, for example, Auty and Mikesell (1998); Sachs and Warner (1995); and Stijns (2001). Note that the negative impact of resource wealth is similar, whether this wealth is in the form of fossil fuels, metals or agricultural products.

2 Rents are the surplus income earned on the use of a resource (in this case, energy) above the long-run marginal costs of production.

3 See Kalyuzhnova (2001) for a detailed discussion of the challenges facing the Caspian region.

4 On the management of such effects, see Chapter 3.

significance of coal and non-fossil fuels in primary energy production in the region, and outlines trends in demand for various primary energy sources. Section 4.2 addresses the major impediments to the development of, and increased investment in, the primary energy sector, focusing on the region's significant oil and gas resources, which are of major global significance. Section 4.3 examines the issue of sustainable resource management and the policies required to avoid the "resource curse".

4.1 Energy resource wealth in transition countries

Production levels and reserves

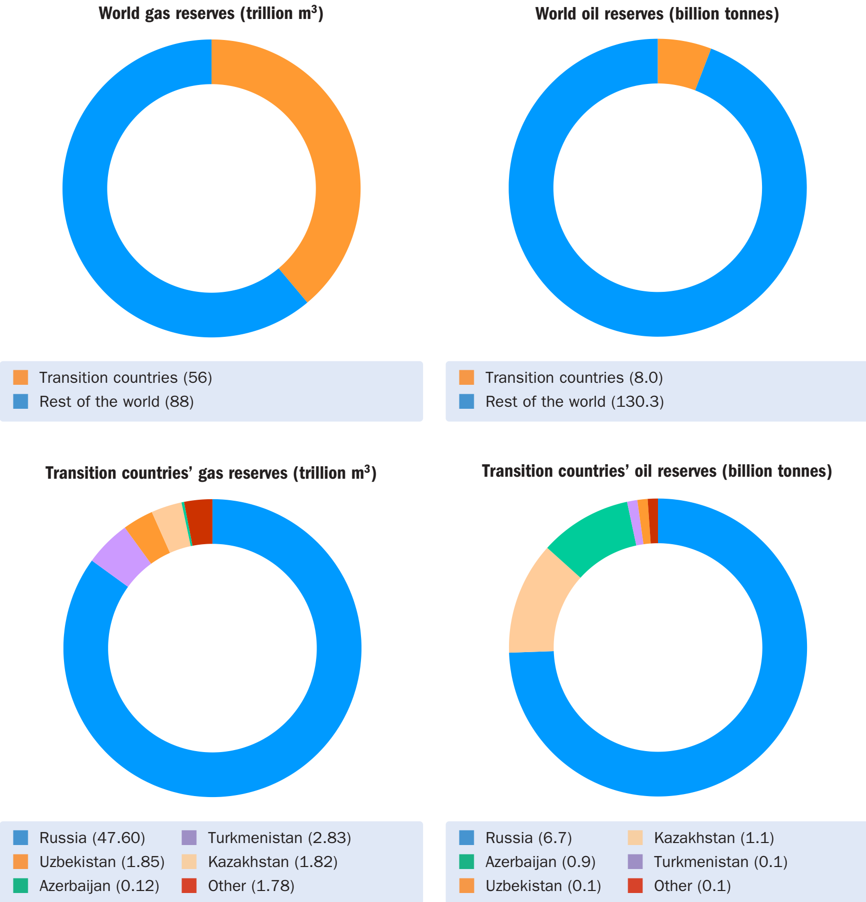
Several transition countries, particularly in the CIS, have abundant reserves of both traditional and renewable energy, and they account for a significant share of global hydrocarbon reserves (see Chart 4.1). This is especially true for gas; Russia alone holds one-third of proven global reserves. Oil reserves in Russia and the Caspian region are estimated at around 7 billion and at least 2 billion tonnes respectively, putting the Caspian region roughly on a par with the North Sea.[5]

In the remainder of the chapter, Russia and the four Caspian states are referred to as "energy-rich", largely on account of their considerable oil and gas reserves. This categorisation is useful for analysis, as it points to shared policy challenges. It is important to note, however, that the region – Russia, Kazakhstan, Ukraine and Poland in particular – also holds significant deposits of coal, and that several countries have major hydro-energetic potential. Kyrgyzstan, Tajikistan, Georgia and Latvia derive between 25 and 50 per cent of their primary energy needs from hydroelectric power. Other forms of renewable energy are not exploited on a large scale although there is considerable potential to do so (see Box 4.1).

Like output in general, energy production in the region fell dramatically at the beginning of transition, particularly in Russia. In 1989 the Soviet Union was the world's largest oil producer, ahead of Saudi

Chart 4.1

Global and regional hydrocarbon reserves



Source: BP Global.
Note: Figures show proven reserves (reserves which are virtually certain to be technically and economically producible).

Arabia, with an annual output of about 600 million tonnes.[6] At its lowest point, in 1996, the production of the Soviet successor states had fallen to some 350 million tonnes. In 2000 it was 395 million tonnes. Output of natural gas has performed better, but still declined by about 9 per cent, or almost 70 billion cubic metres, between 1989 and 2000. About three-quarters of the fall occurred in Turkmenistan, where gas output collapsed when the country was barred from exporting to the European market, and demand from traditional CIS trading partners fell. Coal output in the CIS also declined, from 525 million tonnes in 1989 to less than 300 million tonnes in 2000. In Poland, the other main coal producer of the region, output fell from about 168 to 102 million tonnes between 1989 and 2000 (see Chart 4.2).

The fall in energy production went hand in hand with a change in the fuel mix, with coal losing market share to cleaner and often cheaper natural gas (see Chart 4.3). The market share of nuclear power also rose. This was due partly to the completion of reactors in the Czech Republic, Romania and the Slovak Republic, and partly to the relatively limited scope for changing the load of a nuclear power station once it has been commissioned. However, given the need to shut down several unsafe reactors, and the high cost of new nuclear capacity, the trend is likely to be a reduction in the share of nuclear power in the future. The production of coal should fall further also, as the region's coal sector is restructured and unprofitable mines are closed.

5 The figures are for proven reserves, but estimates vary widely. In the Caspian region reserves could be much higher. In Russia, where the government does not publish data on the size and location of reserves, they may be lower.

6 Fifty (metric) tonnes per year equal about one barrel per day.

Box 4.1

Renewable energy resources in transition countries

In 1999 the region met 6 per cent of its total energy consumption from renewable sources. The overwhelming majority of this was hydro-electricity, and a small fraction was geothermal energy. The "new" renewables – biomass, wind and solar energy – still play only a negligible role, and most applications have a pilot character. Many of them were financed by multilateral agencies or bilateral donors.

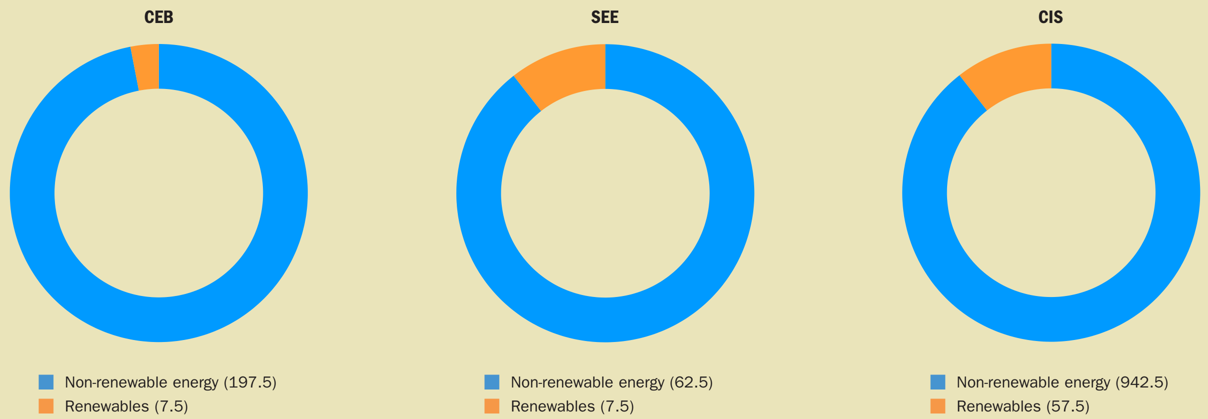
There are, however, good long-term prospects for renewable energy in transition countries. Wind speeds in many areas of Russia, Central Asia and elsewhere are suitable for wind power generation. Large forest reserves suggest there is potential for biomass-based heat generation.

The region's geothermal potential has not yet been fully exploited, while waste-to-energy and mini-hydro schemes lend themselves to small-scale generation. Stand-alone renewable or hybrid (for example, wind-diesel) systems are often the cheapest way of supplying energy to remote areas.

The US Energy Information Administration forecasts that the consumption of renewable energy in central and eastern Europe will grow by 5 per cent per year over the next 20 years – 2.7 times faster than its total energy demand. In the CIS, however, the development of renewable energy could trail demand growth. The difference can be explained by a number of constraints that currently hamper the development of renewables in the entire region and that are likely to prevail for a longer period in less advanced transition countries:

- There is little demand for "greenfield" generation projects, as many countries already have excess capacity. While this is likely to change over the medium term (particularly if unsafe nuclear capacity is decommissioned), the least-cost option to meet demand for the foreseeable future will be the rehabilitation of existing plants, combined with energy efficiency improvements to slow demand growth.
- The abundant availability of relatively cheap hydrocarbon, particularly natural gas in the CIS, further lowers the attractiveness of renewable energy solutions.
- Low energy tariffs and collection rates discriminate particularly heavily against renewable energy schemes, which, as high cost options, need cost-covering prices more urgently than existing generators (whose investment costs are often sunk).
- Insufficient policies to deal with the environmental impact of traditional energy mean that renewables cannot turn their benign environmental characteristics into a cost advantage.
- Delays in power sector reform prevent small-scale and other independent renewable producers from selling power to the grid.

Total energy consumption in 1999 (million tonnes of oil equivalent)



Source: US Energy Information Administration.
Note: SEE excludes FR Yugoslavia.

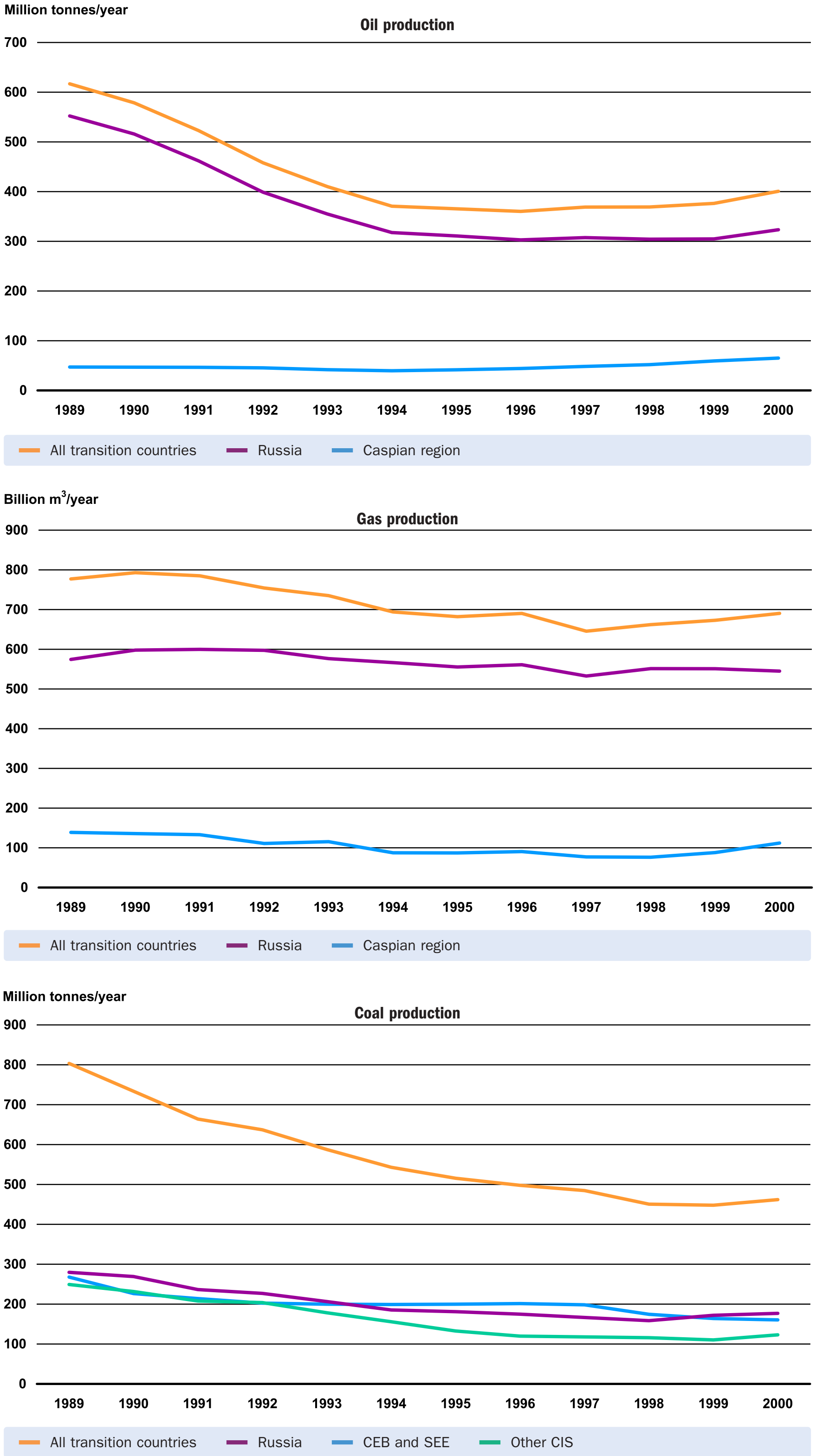
Hydrocarbon output, on the other hand, is expected to accelerate significantly. By some estimates, crude oil production in the Caspian region could reach 200 million tonnes per year by 2015, up from 65 million tonnes in 2000. Russia's crude production is expected to rise more gradually to around 375 million tonnes a year, up from 325 million tonnes. The major source of this projected increase will be new fields, which are still far from reaching peak production levels, such as Azeri-Chirag-Guneshli in Azerbaijan, Tengiz and Kashegan in Kazakhstan and Sakhalin in Russia.

The increased production is predominantly intended for export. In contrast to domestic energy consumption, export demand has increased significantly since 1989. Crude oil exports from Russia and the Caspian region to non-CIS countries have increased by over 50 per cent since their trough in 1993 while gas exports rose almost continuously from below 90 billion cubic metres in 1990 to over 130 billion cubic metres in 2000. This trend is likely to continue as the region develops into an important global supplier of energy, particularly for the European market. Faced with declining production from the large North Sea oil and gas fields, and a structural shift in demand towards natural gas, western Europe is looking increasingly to the transition countries to cover its energy needs. The East Asian market, in particular China and Japan, represents the other main source of growth in demand for the region.

Growing exports have focused attention on the need for additional transport capacity. Transneft and Gazprom of Russia continue to control the vast majority of export outlets from the region. Since both their systems were originally designed to serve the Soviet market, there are more and more bottlenecks at the main export points to Europe, such as on the Slovak-

Chart 4.2

Total energy production, 1989-2000



Source: BP Global, *Statistical Review for World Energy*, 2001.

Ukrainian border, in the Baltic states and on the Romanian-Ukrainian border (see Chart 4.4). Moreover, oil exporters are also dependent on the cooperation of a few transit countries and face the risk of delays as a result.[7] These constraints have given rise to a number of planned investments by Gazprom and Transneft as well as alternative pipeline proposals sponsored by international companies.

Energy rents, output growth and reform

Despite the fact that peak production levels may still be a distant prospect, by most measures, Russia and the Caspian countries are already highly energy-dependent economies, and they stand apart from the rest of the region in terms of their reliance on energy resource wealth.[8] Their share of energy in exports is similar to that of the other leading energy-based economies, and the importance of energy revenues as a source of government income is growing (see Table 4.1). Tax and royalty incomes from oil and gas production now make up between 15 and 42 per cent of government revenues in the five most important energy-producing countries. For Kazakhstan, for instance, it was calculated that the rise in oil prices in 2000 buoyed government revenues by as much as 6 per cent of GDP.

The region's energy-rich countries also earn sizeable resource rents from the extraction and sale of energy resources. Rents accrue on both exports and domestic sales, and are shared between producers, the owners of transport infrastructure, governments and energy consumers. Chart 4.5 shows that average export rents over the past decade have ranged from 5 per cent of GDP for Uzbekistan to 25 per cent of GDP for Turkmenistan.[9] Export rents are significant income sources for these economies, but the scope to increase exports, and thus boost revenue, is limited by constraints on export capacity. At the same time, a significant part of the potential export rent tends to be seized by the owners of the pipeline network. Much of the domestic rent, on the other hand,

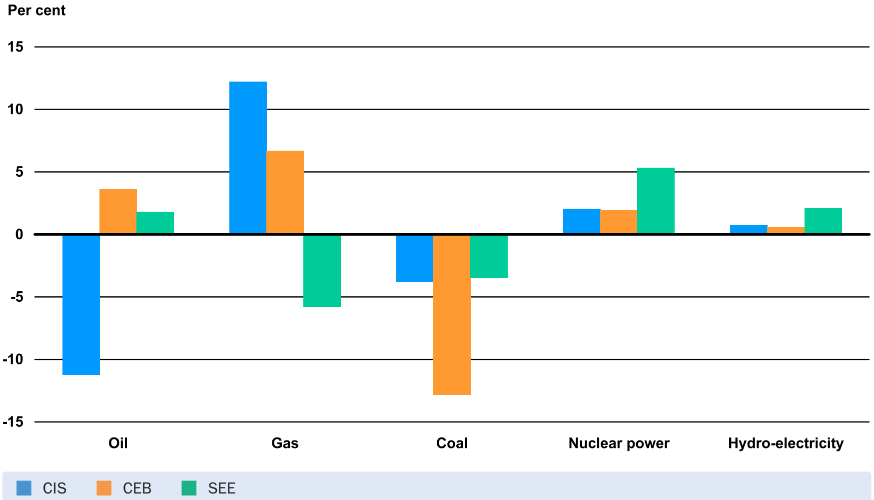
7 Transit revenues are particularly significant for Ukraine and the Czech and Slovak Republics, which may earn some US$ 1.5 billion and US$ 700 million respectively each year on gas transit to western Europe alone. Oil transit revenues are also important for the Baltic states and will become crucial for Georgia. These countries are very much part of the evolving picture of energy trade from the region.

8 Romania, Ukraine, Georgia, Hungary and FR Yugoslavia presently produce sizeable oil and gas volumes. In none of these countries, however, are production levels sufficient to cover domestic demand, let alone allow exports. In terms of government revenues, primary energy production in all these countries is insignificant.

9 Estimates of rents are based on valuing exports per year at the net-back of received export prices less transport costs from the border to the average wellhead less average lifting costs (development and production). Rents are sensitive to volatile oil prices. They also critically depend on the costs of extraction and transport to market.

Chart 4.3

Changes in consumption shares of major primary energy sources, 1989-2000



Source: BP Global, *Statistical Review for World Energy*, 2001.

is passed on to industrial and residential consumers in the form of subsidies, to an extent that the rent earned by producers on domestic sales is sometimes negative (see Chart 4.5). The indiscriminate provision of cheap energy (mostly gas, power and heat) to consumers is not exclusive to the energy-producing countries, though, as outlined in Chapter 5. There are often political constraints on raising energy prices in transition countries, despite the efficiency losses associated with current pricing policies.

Given the size of energy rents over the past decade in the five major producing economies of the region, it is pertinent to ask whether they have benefited, relative to non-energy-rich transition economies, from the gradual real increase in energy prices since the start of transition. Energy rents and the ability to use energy wealth to borrow from abroad might have provided governments in these countries with a cushion to soften the impact of economic reforms and restructuring, through public investments and more generous social safety nets, for instance. This in turn might have given them flexibility to accelerate and deepen critical reforms, generating a cycle of better performance and more reforms.[10]

This has not happened, however. The energy-rich countries have actually lagged behind both central eastern Europe and the Baltic states (CEB), south-eastern Europe (SEE), and the non-energy-rich CIS economies in some key reform dimensions. Energy-rich countries have on the whole made less progress on domestic and foreign market liberalisation, indicating a worrying parallel with failed protectionist policies in other resource-dependent countries.[11] Having followed comparable positive reform movements until 1994, most energy-rich

Table 4.1

Resource dependence, selected transition economies and comparison countries

	Azerbaijan [1]		Kazakhstan [2]		Russia [3]		Turkmenistan [4]		Uzbekistan [5]		Mexico [6]	Iran [7]	Norway [8]
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000	1999	1999	1999
	(in per cent unless otherwise indicated)												
Oil and gas export in per cent of total exports	78.2	85.2	34.1	46.8	60.2	50.4	62.6	81.0	13.3	12.3	7.3	69.4	0.3
Oil and gas export in per cent of GDP	17.6	30.5	12.1	24.7	16.3	21.5	31.6	68.7	3.6	4.3	0.5	14.7	0.1
Oil and gas revenues in per cent of total government revenues	22.1	36.2	5.0	27.5	24.2	30.1	na	42.0	15.4	14.8	29.8	45.9	0.2
FDI in oil and gas sector in per cent of total FDI	71.0	80.5	83.3	69.7	10.7	na	na	na	na	na	na	na	na
Memo:													
Oil production, million tonnes	13.8	14.9	30.1	35.3	304.8	323.3	7.1	7.4	8.1	7.5	166.1	175.2	149.4
Gas production, billion m^3	5.6	5.3	9.3	10.7	551.0	545.0	21.3	43.8	51.9	52.2	37.1	53.0	51.0

Sources: For transition economies, oil and gas production is from BP Global: *Statistical Review for World Energy*, 2001. Other sources as indicated.

1 Data are from the IMF. Figures for the share of the oil and gas sector in FDI were calculated from gross inflow data.

2 Figures for oil and gas exports and government revenues are from the IMF. Exports are not corrected for under-invoicing. Figures for FDI from *Kazakhstan Economic Trends* are based on net flows.

3 The share of oil and gas in FDI is from UNCTAD *World Investment Report 2000*. For oil and gas exports, figures are from *Russian Economic Trends*. For oil and gas revenues, figures are from the *IMF Staff Report* and refer to the federal government only. For 2000, revenues are for the first quarter only.

4 Figures for oil and gas exports are from Interfax. Turkmenistan's US dollar GDP is an EBRD staff estimate based on a weighted exchange rate taking into account the existence of a large parallel market premium. Data for the share of oil and gas in government revenues are based on oral communications from the Ministry of Finance.

5 All data are from the *IMF Staff Report*, January 2001. Data for oil and gas sector revenues refer to oil only. A breakdown of FDI is unavailable, although there has been no foreign investment in the energy sector to date.

6 All data are from the Mexican statistical office.

7 Data are from the IMF.

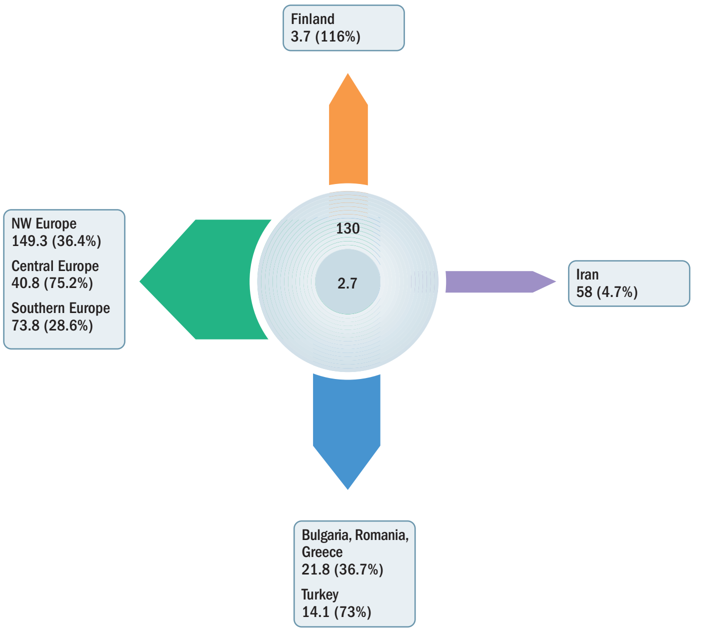
8 Data for exports are from the Norway statistical office. The share of oil and gas in government revenues is for 1998 and from the EU (www.eubusiness.com).

10 For evidence on the mutually reinforcing relationship between growth and reforms, see Falcetti *et al*. (2001).

11 In terms of both domestic and foreign market liberalisation indicators, the resource-rich economies are among the ten poorest performing countries, based on country averages, over the 1989-2000 period. The average of the “trade and foreign exchange system” and “price liberalisation” indicators is statistically significantly lower in 2000 for the energy-rich than the non-energy-rich CIS countries at the 5 per cent confidence level.

Chart 4.4a

Major gas export routes in 2000 to non-CIS countries



	Throughput in 2000	Capacity utilisation
Transgas Pipeline	105.8 billion m^3	~100%
Gastransit	18.3 billion m^3	~ 83%
Turkmenistan to Iran	2.7 billion m^3	~34%
Russia to Finland	4.3 billion m^3	na

Total gas exports from Russia in billion m^3

Total gas exports from Turkmenistan in billion m^3

Pipeline throughput

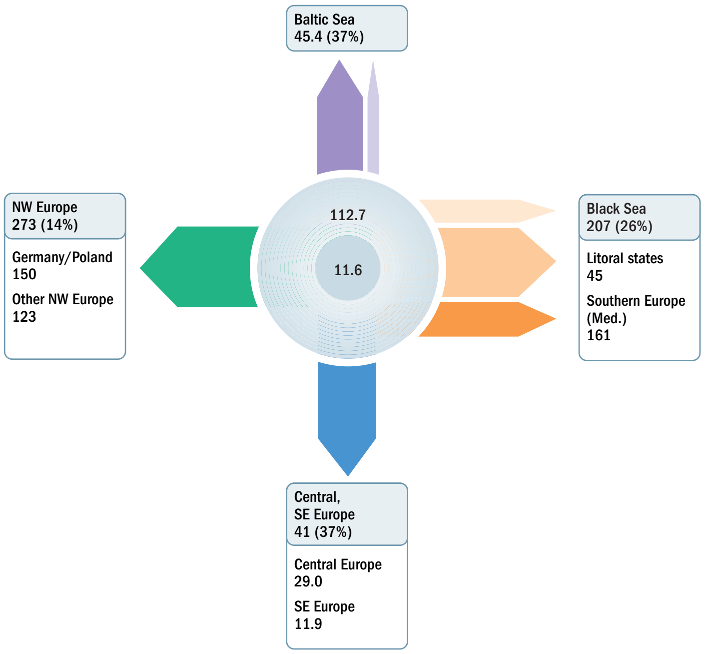
Major market: total consumption in billion m^3 p.a. (% supplied by CIS)

Source: PlanEcon, World Bank.

Note: NW Europe = France, Germany and Poland; Central Europe = Austria, Croatia, Czech Republic, Hungary, Slovak Republic, Slovenia and Switzerland; Southern Europe = Italy.

Chart 4.4b

Major oil export routes in 2000 to non-CIS countries



	Throughput in 2000	Capacity utilisation
North Druzhba	38.6 million tonnes	110%
South Druzhba	15.3 million tonnes	61%
Odessa Port	10.7 million tonnes	107%
Novorossiysk Port	37.4 million tonnes	96%
Tuapse Port	5.7 million tonnes	114%
Butinge Port	3.1 million tonnes	38%
Ventspils Port	13.6 million tonnes	76%

Total oil exports from Russia in million tonnes

Total oil exports from Caspian region in million tonnes

Pipeline throughput

Major market: total consumption in million tonnes p.a. (% supplied by CIS)

Source: PlanEcon, World Bank.

Note: Baltic Sea = Denmark, Finland, Norway and Sweden; NW Europe = Benelux, half of France, Germany and Poland; Central Europe = Austria, Czech Republic, Hungary and Slovak Republic; SE Europe = Bosnia and Herzegovina, Croatia, Slovenia and FR Yugoslavia; Black Sea Litoral states = Bulgaria, Romania and Turkey; Southern Europe (Med.) = Albania, half of France, Greece, Italy and FYR Macedonia.

Capacity utilisation can exceed 100 per cent if throughput is above nameplate loading capacity. However, persistent operation at this level leads to more rapid depreciation of the equipment.

countries slowed in their reforms as awareness of natural resource wealth increased while the non-energy-rich CIS economies pressed on with liberalisation (see Chart 4.6). Similar differences are not observed with respect to other reform dimensions, however.

Moreover, there are important differences within the energy-rich countries. On the one hand, Kazakhstan and Russia are among the most advanced reformers in the CIS, despite having backtracked temporarily on external liberalisation after the Russian crisis in 1998. Since then, governments in both countries seem to have adopted a cautious yet positive approach to liberalisation. Azerbaijan, in spite of shortcomings in institutional reforms and governance, has maintained a liberal external trade regime and used oil revenues carefully for budget and current account financing. Turkmenistan and Uzbekistan, on the other hand, have failed to make or maintain reform progress. Both Turkmenistan and Uzbekistan had access to early income from gas, cotton and gold exports, whereas in Azerbaijan and Kazakhstan potential energy rents had to be unlocked by attracting foreign investment. This might explain the different paths of reform in these countries. It also highlights the potential risks to future reform in Azerbaijan and Kazakhstan once energy rents fully materialise.[12]

While the energy-rich countries have not used energy income to accelerate structural reform, they have nonetheless recorded a shallower initial contraction of output followed by more rapid, though less broad-based, growth. Chart 4.7 shows that Russia and the Caspian countries have, on average, recorded a smaller cumulative decline in output than energy-poor CIS countries. The difference is small though, and compared with CEB and SEE countries, recovery has come much more slowly and growth has been less robust. The upturn in growth over 1999 and 2000 appears to be driven by strong positive terms of trade effects in response to higher oil prices – to some extent at least (see 2001 *Transition Report Update*).

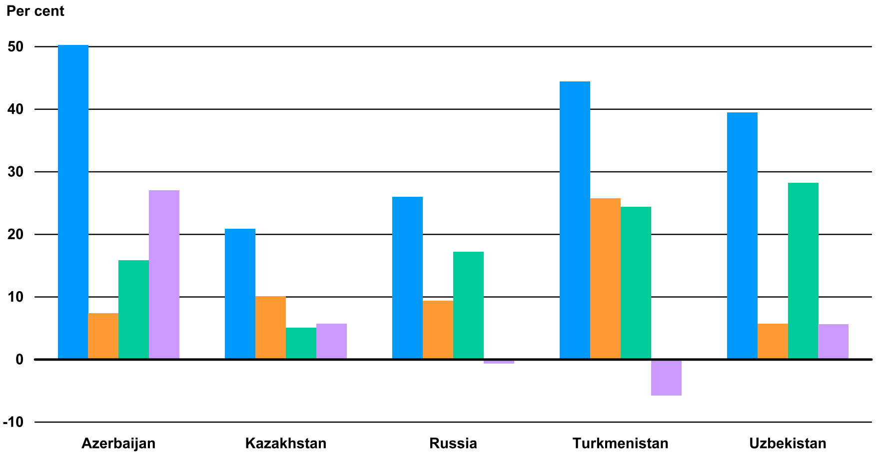
4.2 Sector reform and investment climate

Despite the recent boost to production from the increase in energy prices, there remains a need in all energy-rich countries for major investment to enhance productivity, increase pipeline capacity and develop new fields. The total investment requirements are difficult to estimate but are likely to exceed US$ 300 billion over the next decade, with perhaps three-quarters of this amount to be spent in Russia. The cash flow in Russia's hydrocarbon sector should be sufficient to finance modest production growth over the next few years but as the need to develop new fields increases, Russian energy producers will increasingly have to raise external capital. In the Caspian region the investment needs are higher relative to oil sector cash flows, and sector development already depends on external capital injections.

For these investments to materialise, major improvements are needed in terms of industry structure, governance and the investment climate. At the same time, governments need to ensure that companies abide by the rules of good environmental practice (see Box 4.2). Changes are required along the following lines:

Chart 4.5

Resource rents as a percentage of GDP for the major oil and gas producers (average 1992-2000)



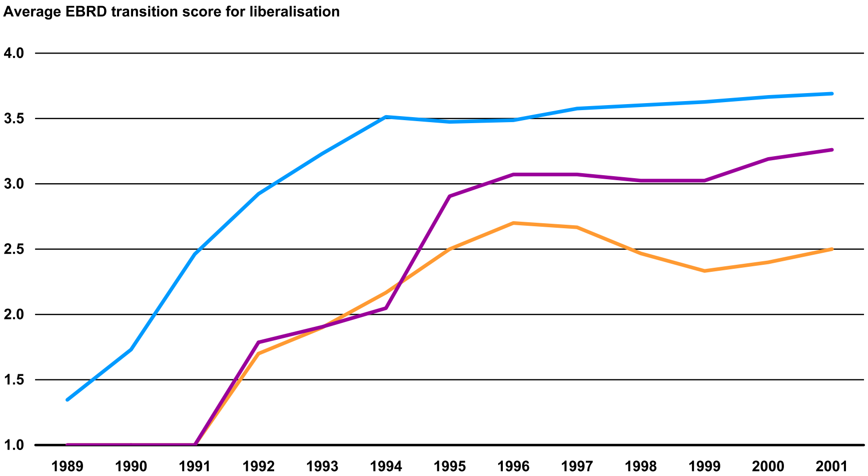
Total rent · Export rent · Domestic consumer subsidies · Domestic producer rent

Source: EBRD.

Note: Estimates for Turkmenistan are for 1993-2000. Rents are the surplus income earned on resource use, above the long-run costs of production.

Chart 4.6

Progress in liberalisation in energy-rich and non-energy-rich countries



CEB and SEE · CIS energy-rich · Other CIS

Source: EBRD.

Note: CIS energy-rich countries include Azerbaijan, Kazakhstan, Russia, Turkmenistan and Uzbekistan. The transition score is the average of the EBRD transition indicators for "trade and foreign exchange system" and "price liberalisation".

- the introduction of an equitable, efficient and transparent tax system to encourage investment and secure government revenues;

- the creation of a stable legal and regulatory regime supportive of good corporate governance and environmental compliance; and

- changes to industry structure and market access to foster competition and induce efficiency improvements.

There also remains a need for broader policy and institutional reforms to mitigate political risk. This includes a reformed energy retail sector, as distribution problems may have a direct bearing on production risk.[13] Reforms of gas-based heating systems, for instance, are an

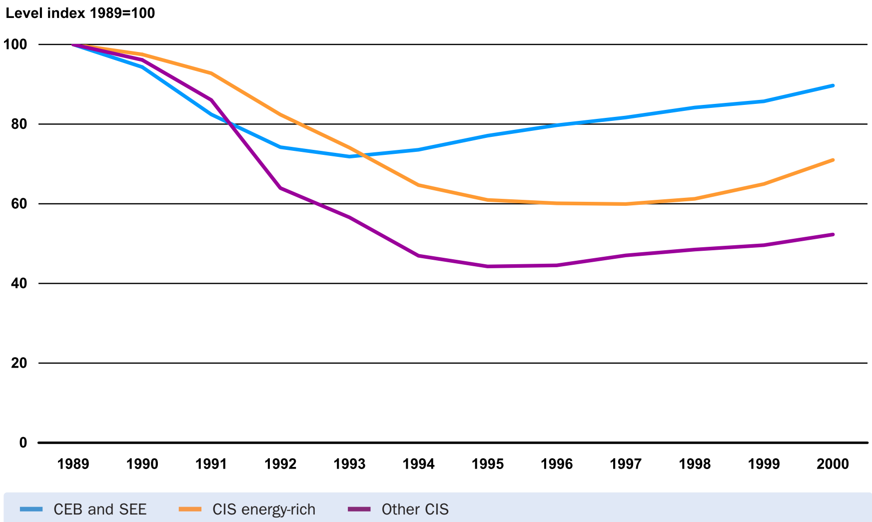
12 Turkmenistan exported around US$ 2 billion worth of natural gas to western Europe during 1992-93 while Uzbekistan was among the countries which most rapidly reoriented its exports to the West, given ready world markets for cotton and gold (see Esanov *et al*. 2001).

13 See Walters (2000).

essential prerequisite to avoid the political backlash that might be triggered by the concurrent occurrence of substantial gas exports and severe domestic heat shortages.

Chart 4.7

GDP in energy-rich and non-energy-rich countries



Source: EBRD.

Note: CIS energy-rich countries are Azerbaijan, Kazakhstan, Russia, Turkmenistan and Uzbekistan.

Fiscal arrangements

In designing the fiscal regime for energy projects, countries must balance the twin objectives of maintaining their share of resource rents and offering competitive tax terms to investors, so as to attract long-term development funds. International best practice suggests that where implementation capacity allows it, multiple fiscal instruments should be used to cause as few distortions as possible as risks and returns change over time. These include a percentage royalty fee on volume recovered as compensation for depleting the nation's resources, a corporate profit tax with deduction of reasonable business expenses as well as taxes to capture resource rents above defined thresholds.[14]

Over the past years, Russia in particular has deviated substantially from this type of practice. The heavy reliance on multiple revenue and production-based levies has led to a complex and inflexible fiscal regime, providing a disincentive for investment in higher-cost or new oil fields with more exploration risk. Another tax-related problem that has stifled investment in the Russian context has been uncertainty in federal-regional fiscal relations, with many regions and local governments introducing taxes not anticipated in the federal legislation, combined with arbitrary implementation.

The tax arrangements for Caspian energy producers vary in terms of their adherence to international best practice. Azerbaijan and Kazakhstan provide simple

Box 4.2

Environmental good practice in oil and gas development

Hydrocarbon production and transport are known to pose considerable environmental risk and can cause extensive environmental disruption. To reduce the environmental impact of hydrocarbon projects, developers need to adhere to the rules of good environmental practice and address the following specific issues:

- The environmental "footprint" from the construction of sites, access roads, and pipeline corridors.
- Possible disturbances to wildlife, fisheries and ecosystems. Arctic ecosystems and the Caspian Sea, a closed water body which is home to some 400 unique species, are vulnerable to pollution and human interference.
- Emissions effecting water, soil and air, and the discharges of waste such as drilling fluids, solids and produced water. Owing predominantly to industrial pollution, the Caspian Sea is one of the most polluted water bodies in the world. However, oil fields and refining complexes are increasingly replacing industry as the main source of pollution.
- Any disturbance to historic sites and cultural resources.
- Conflicting interests with, and disturbance to, local populations.
- The risk of pollution incidents, such as oil spills from developments, production sites or pipeline transportation. Environmental non-governmental organisations (NGOs) estimate that Russia may lose as much as 15 million tonnes of oil and 30 billion cubic metres of gas annually to leakage. The Black Sea, a major transport route, is also vulnerable to accidents and spills.

Beyond the narrow objective of impact mitigation, the strategies of progressive companies are increasingly based on the integration of economic, environmental and social considerations into development strategies – "the triple bottom line". In the case of the region's hydrocarbon producers, this would include concerns about:

- Climate change issues associated not least with the widespread venting and flaring of associated gas, the reduction of gas leakage, the development of the region's renewable energy potential and the promotion of energy efficiency technology.
- Historical pollution and remediation issues arising from redundant, Soviet-era fields and contaminated sites.
- A potential loss of biodiversity through the opening up of frontier areas, through pollution and other adverse impacts.
- The socio-economic implications of business decisions, including the distribution and management of oil revenues; the formulation and enforcement of regulations in view of economic incentives for exploiting natural resources; and an increased transparency of information provided to NGOs and public groups.
- The integration of new and improved technologies into developments, with respect to drilling in the delicate Arctic environment for example.
- The maintenance of good corporate standards and policies and best industry practice unilaterally, even in the absence of local requirements.

[14] Gray (1998).

Table 4.2

Hydrocarbon tax structure in transition countries and comparison countries

	Royalty	Corporate profits tax	Excess profits tax	Excise levy	Other production-based levies
Azerbaijan	26% (oil) 20% (gas)	27%	none	none	none
Kazakhstan	1 to 20% depending on project economics	30%	4 to 30% depending on IRR of contract area	none	none
Russia	6 to 16%	30%	none	66 RUB/metric tonne (oil) 30% (non-CIS gas exports)	Mineral replacement tax, 10% Export duty, € 20/tonne (oil)[1]
Turkmenistan	10%	25%	none	none	VAT on export within CIS, 20% Export duty, 10%
Uzbekistan	na	26%	none	50% (oil) 48% (gas)	Sub-surface user tax, 12.3% (oil) 18.5% (gas)
United Kingdom[2]	12.5%	30%	50%	none	none
Venezuela	16.6% (oil) 20% (gas)	67.7%	none	none	none

Sources: Report by the International Tax and Investment Centre in conjunction with Ernst & Young and PricewaterhouseCoopers, July 2001; Oil and gas tax guide (various countries), Arthur Andersen, 2001.

[1] The export duty has been adjusted in the past depending on the oil price. From January 2002 a fixed (35%) percentage levy will be raised for oil prices above US$ 15 per barrel (rising to 40% at prices above US$ 25 per barrel).

[2] For UK fields given development consent after March 1993, the only relevant tax is corporation profits tax; royalty and the additional petroleum revenue tax (PRT) are not applicable. The UKPRT is a windfall tax on profits, with fields generally not becoming PRT-paying until 'payback' is reached, and with PRT deductible from corporation tax.

profits-based systems. The current tax regime in Turkmenistan is heavily weighted towards the use of revenue taxes, including the application of value added tax (VAT) on oil and gas exports. Uzbekistan also makes use of substantial excise levies and additional contributions for the replacement of the mineral raw material base. While the reliance on direct taxes may be a reasonable second-best solution in the presence of tax enforcement problems, Turkmenistan, Uzbekistan and Russia all present investors with a regressive structure where the government's percentage share of the profits increases as prices and profitability decline (see Table 4.2).

Apart from the level of taxes and their incidence, the stability of the tax regime is a key concern for investors, particularly when the strength of the state is weak. To mitigate this problem, a growing number of countries have adopted PSA legislation. PSAs are contractual agreements between investors and governments, covering all key rights to execute a project, including production, import, ownership, export, currency and fiscal rights. They provide an agreed structure and level of taxation and in doing so help to create the legal stability missing under a licensing system.[15] The PSAs reached with international oil companies have been particularly successful in attracting foreign investment and expertise in Azerbaijan, where contracts have to be passed by parliament, with the status of laws unto themselves.

As PSAs typically allow investors to offset most or all production costs against the cash flow of a project, governments need to be able to verify such costs if they are to ensure that the PSA is not abused by investors. The schedule for cost recovery and the share of "profit oil" going to the government are key factors determining the attractiveness of fiscal provisions under PSAs. PSAs tend to vary depending on field characteristics and distance to market, and also on the negotiating power and skills of the government involved (see Table 4.3).

In Russia, domestic companies are used to operating under a licensing regime, and the need for PSAs is limited to fields that are to be developed with the help of international companies. However, as noted above, considerable improvements need to be made to the tax provisions under the current licensing regime. Moreover, the Russian approach to PSAs has been less than satisfactory. Although Russia passed its PSA law in 1996, with amendments in 1999, necessary implementing regulations remain incomplete. As the reliance on foreign investment for new field development increases, strengthening the PSA framework is a key aspect of creating a more attractive investment

15 Most PSAs share the same basic structure. Tax payments are commonly made in kind. A share of production is used to pay royalties, with the remaining production split between the cost of oil (to investors for expenditures) and the profit from oil, split between investors and government (and potentially structured as equivalent to an excess profit tax).

Table 4.3

Comparison of signed PSAs and fiscal provisions (in per cent)

Wellhead price	US$ 12/barrel (US$ 88/tonne)	US$ 16/barrel (US$ 117/tonne)	US$ 20/barrel (US$ 147/tonne)
Kazakhstan - Oryx PSA	46	49	50
Azerbaijan - AIOC PSA	33	37	35
Turkmenistan - Model PSA	24	32	34
Azerbaijan - General "R" Factor PSA	21	24	23
Kazakhstan - Elf-Temir PSA	21	34	38
Nigeria - Offshore PSA	21	26	28
Colombia - Model PSA	10	15	17
Angola - Shallow Water PSA	5	11	13
Nigeria - Niger Delta PSA (Onshore)	0	6	9
Russia - General Model PSC	-6	0	3
Russia - Sakhalin II PSA	-11	5	8
Venezuela - Guanare PSA	-11	-3	1

Source: World Bank, based on analysis by Petrocash.

Note: The table shows the contractor's share of the projected net present value of each PSA for different oil prices, but otherwise consistent assumptions (100 million barrel oil field, no gas, 15% discount factor). The higher the contractor's share, the more attractive the fiscal provisions to the investor.

climate, and the development of several projects depends on establishing a workable PSA framework.

Corporate governance

The hydrocarbon sectors in the CIS have become renowned for their lack of transparency in financial management and decision-making. Poor governance is now a major impediment for their development. This is true as much for the state-controlled firms that dominate in the Caspian region as it is for the privatised firms that dominate in Russia. A principal consideration across the region therefore has to be improvement to the quality of corporate governance. The challenge is not uniform, however, because of the different policy choices taken by governments since the start of transition, particularly with respect to ownership.

In Russia, the major oil producers have been privatised (see Table 4.4) although transport pipelines have remained state owned, and continue to provide a source of revenue for the state. The nature of privatisation in the oil sector is at the root of present governance problems. Some key assets were transferred into private hands at very low prices under the loans-for-shares scheme implemented in 1995. While there are clear differences in ownership structure, the power of incumbent management remains a common feature of Russian oil companies. Subsequently, these inside owners often diluted minority shareholders through transfer pricing and capital transfers between related companies, thereby discouraging new outside investment.[16]

Yet, the state has retained considerable influence over the energy sector as a whole. This is clearly evident in the gas sector, where the old state monopoly Gazprom remains an integrated producer and supplier, and the government retains a substantial minority stake in the company. While recent reforms have given Gazprom a stronger commercial focus and sounder corporate governance, it has been used as a quasi-fiscal institution, providing subsidies to both failing domestic firms and to neighbouring countries, such as Belarus, Moldova and Ukraine. Ukraine's natural gas debts now exceed US$ 1.5 billion and other CIS states also have substantial arrears, although at lower levels. As a result, both performance and investment levels in the gas sector have suffered (see Box 4.3).

Russia therefore suffers from two types of governance problems in the energy sector. On the one hand, the institutional framework is still too weak to constrain effectively the ability of incumbents to disregard the rights of creditors and minority shareholders and to take money out of the companies. On the other hand, the state retains considerable direct influence over the sector through its control over the transport system and through its continuing large stake in Gazprom. While there has been progress, the transition to a private energy sector that adheres to sound corporate governance and business practices and that is regulated effectively by the state remains incomplete.

There are, however, signs that changes to firm governance, including measures designed to safeguard creditors and minority shareholders, are being implemented in Russia. The move is paralleled by a more forward-looking business strategy. The need for capital is a key driver of corporate governance improvements, with companies adopting Western accounting practices and other standards to gain access to international financial markets.

It is striking, though, that it is largely the principal shareholders and incumbent management that have begun to take greater account of shareholder rights. Management of the major Russian oil companies remains subject to relatively little effective supervision and for that reason is open to significant risks of opportunistic

16 Corporate governance scandals were widely reported after 1998, a period of ownership redistribution and consolidation in the oil sector. Well-known cases include the alleged crowding-out of minority shareholders in Yukos, and the suspected use of bankruptcy procedures by TNK in its hostile take-over of Sidanco/Chernogorneft. In many cases, firms were in formal compliance with the (often inadequate) Russian laws. For a discussion, see for example Black *et al*. (1999).

Table 4.4

Industry structure in the Russian oil and gas market

	Reserves 2000	Production 2000	Ownership (% rounded) Government	Management	Minority
Gazprom, *million tonnes of oil equivalent*	29,427.7	474.4	40	25	35
Oil, *million tonnes*	627.7	9.8			
Gas, *billion m*^{3}	32,000.0	516.2			
TNK, *million tonnes of oil equivalent*	na	38.5	0	100	0
Oil, *million tonnes*	2,631.9	36.1			
Gas, *billion m*^{3}	na	2.6			
LUKoil, *million tonnes of oil equivalent*	1,934.3	70.0	17	23	60
Oil, *million tonnes*	1,836.0	67.5			
Gas, *billion m*^{3}	109.2	2.8			
Yukos, *million tonnes of oil equivalent*	na	53.7	0	84	16
Oil, *million tonnes*	1,520.9	52.1			
Gas, *billion m*^{3}	na	1.8			
Surgut, *million tonnes of oil equivalent*	1,108.1	50.5	0	60	40
Oil, *million tonnes*	784.2	40.1			
Gas, *billion m*^{3}	359.9	11.5			
Tatneft, *million tonnes of oil equivalent*	na	25.0	33	32	35
Oil, *million tonnes*	864.0	24.4			
Gas, *billion m*^{3}	na	0.7			
Sidanco, *million tonnes of oil equivalent*	na	10.2	0	94	6
Oil, *million tonnes*	718.2	9.3			
Gas, *billion m*^{3}	na	1.0			
Sibneft, *million tonnes of oil equivalent*	717.3	17.4	0	88	12
Oil, *million tonnes*	671.6	17.0			
Gas, *billion m*^{3}	50.8	0.5			
Itera, *million tonnes of oil equivalent*	na	16.2	0	100	0
Oil, *million tonnes*	na	0.3			
Gas, *billion m*^{3}	226.3	17.7			
Rosneft, *million tonnes of oil equivalent*	na	17.2	96	0	4
Oil, *million tonnes*	na	13.0			
Gas, *billion m*^{3}	na	4.7			
Slavneft, *million tonnes of oil equivalent*	na	12.6	87	0	13
Oil, *million tonnes*	na	12.0			
Gas, *billion m*^{3}	na	0.6			
Bashkir Fuel Co, *million tonnes of oil equivalent*	na	12.1	65	0	35
Oil, *million tonnes*	na	11.8			
Gas, *billion m*^{3}	na	0.3			

Sources: United Financial Group and EBRD.

Note: One billion m^3 of natural gas equals 0.9 million tonnes of oil equivalent.

behaviour by controlling shareholders. This in turn remains one of the key obstacles to outside investment in Russian oil companies. The way forward clearly involves bringing in more market-based checks on firms as well as consolidating the rights of minority shareholders in such firms.

In contrast to developments in Russia, state control over the oil and gas sector in the Caspian countries has been maintained, albeit to varying degrees (highest in Turkmenistan, lowest in Kazakhstan). Despite the widespread use of PSAs, the state often retains important equity stakes in production, and all Caspian countries have consolidated state-owned assets in the energy sector under the roof of one or two national companies. Part of this can be attributed to the way in which political power has remained more concentrated in the Caspian states, facilitating greater direct state control over resource rents. Moreover, given the smaller size of these economies, a centralised approach to managing state assets in the energy sector was more feasible than it was in Russia, where regional interests were strong.

State ownership may facilitate the direct collection of resource rents, particularly in a context of weak tax administration, but at the cost of considerable lack of transparency of resource flows within the public sector. This is most evident in Turkmenistan, where sector reforms have progressed the least. However, the ability of the state energy companies to attract outside investments or meet the cash calls under existing joint-venture and PSA contracts is limited. As a result, there is an inherent conflict between the need to attract more outside investment and the desire to keep close state control over the energy sector. This is now leading to a gradual restructuring of the state energy companies in a number of Caspian

Box 4.3

Corporate governance: the case of Gazprom

Gazprom is the largest energy company in the region, and one of the largest in the world. Currently the state controls nearly 40 per cent of Gazprom's equity, with the remainder being held by dispersed investors. Gazprom is controlled by a management team that is, in principle, sanctioned by the government with the approval of the Duma. In June 2001 the management team was changed. The change was prompted by increasing pressure from shareholders and the public, who were dissatisfied with the shareholding structure, poor performance, the abuse of managerial discretion and the lack of transparency in commercial transactions (see, for example, Browder 2001 and Fedorov 2001). Gazprom's public accounts point to falling investment, rising debt and a generally negative trend for all leading financial indicators of performance. Sales declined substantially in both 1998 and 1999, with negative net income in both years.

The deteriorating performance of Gazprom is also related to the strong influence still exerted by the state and the political motivation for many business decisions.[1] Perhaps the most significant decision has been the cross-subsidisation of other sectors through the supply of energy to effectively insolvent customers. As a consequence, the company has had difficulty securing prompt cash payment from domestic consumers. By 1998, Gazprom's share of cash collection amounted to no more than 15 per cent of its sales. Using a large firm data set, a recent study (Commander *et al*, 2001) found that Gazprom and other utilities, as well as local government, systematically used offsets (zachety) to transfer liquidity to the enterprise sector, primarily to large loss-makers. Since 1998, the share of cash collections has increased in step with the decline in non-monetary transactions and a declining willingness of government to subsidise the enterprise sector.

Gazprom's new management has publicly stated its commitment to openness and transparency, and its intention to introduce Western corporate governance principles. Company accounts are kept and audited in accordance with international standards. However, the accounts are not fully consolidated and transactions with related parties are not fully disclosed. At the same time, the government has announced tentative plans to restructure the company. However, the reforms put forward so far, for example with respect to liberalising the dealing in Gazprom shares, have generally been described as cautious (Oxford Analytica 2001). This suggests that Gazprom's travails are not simply a function of its ownership and control regime. De-politicising the gas sector does not only require changes to management, but also to industry structure and market access.

1 For further discussion, see Aghion and Commander (2000).

countries. For example, in Kazakhstan, Kaztransoil (recently merged with Kaztransgas into a single transport operator) is planning to undergo a restructuring programme, which would separate its multiple business interests into independent commercial entities. These moves are paralleled by efforts to access international capital markets. Kaztransoil issued a US$ 150 million seven-year Eurobond in June 2001, priced at about 300 basis points over US treasuries.

The widespread use of PSAs in the Caspian region will ultimately lead to a further dilution of state control as investment needs rise and pressure from foreign partners for more transparency increases. The key question will be how greater private sector involvement in production can be combined with policies that promote market liberalisation in transport and distribution. Particularly in the case of gas, there is a clear need to unbundle production, transport and distribution, encourage market entry and, where appropriate, strengthen regulatory supervision.

The need for regulation is not limited to ensuring competition. Strong regulatory control is also required, both in Russia and the Caspian region, with respect to environmental compliance. The production and the transport of hydrocarbon involves substantial environmental risks for the sensitive ecosystems found in energy-rich transition countries, especially in extreme climates (see Box 4.2). These risks are not always properly managed although collaboration with international developers has brought improvements. Older installations in particular often violate good environmental practice, and governments are lax in monitoring performance. Leakage from pipelines and the flaring of associated gas, for instance, remain widespread problems despite the high environmental as well as economic costs. Azerbaijan, which is flaring substantial amounts of domestic gas while simultaneously importing gas from Russia, is a case in point.

Competition and market access

Strengthening competition, particularly for the transport and distribution of energy, is a common requirement throughout the region. The challenge is not only to restrict the incumbent firm's market power but also to limit the scope for political interference. Changes to industry structure that facilitate the entry of new companies and, where feasible, multiple providers can help address these dual problems. Without such change, the opportunity for corruption will remain, at the expense of long-term sector development.

Introducing competition into network utilities poses particular problems (as discussed in more detail in Chapter 5) because of natural monopoly features as well as the way in which both regulatory authority and competition have to be established simultaneously. Transition countries have no tradition of independent regulatory authority and this suggests that the inefficiencies of regulation in countries with well-functioning institutions, such as those in western Europe, are likely to be magnified in the transition context. This implies that, wherever technically feasible, measures that emphasise competition should be considered as complementary to regulatory solutions.

In contrast, there are no inherent monopolistic properties at either the production or supplier ends, and these areas can be opened up for competition. In Russia, for example, liberalisation of the gas market could clearly lead to significant entry by the major oil companies on the production side, raising competitive pressure. Competition could be further encouraged by selective disposal of part of Gazprom's existing portfolio of gas reserves.

A crucial precondition for market entry and competition is more open and non-discriminatory access to transportation capacity. This is not just an issue for energy-rich countries, but for all countries in the region. Thus, being almost exclusively dependent on Gazprom as a source of supplies, much of eastern Europe would not currently benefit much from opening its pipeline network to third parties. However, once east European countries gain access to gas supplies from the North Sea and other sources connected to the west European gas grid, they will be able to obtain significant benefits from introducing third-party access to their pipeline network.

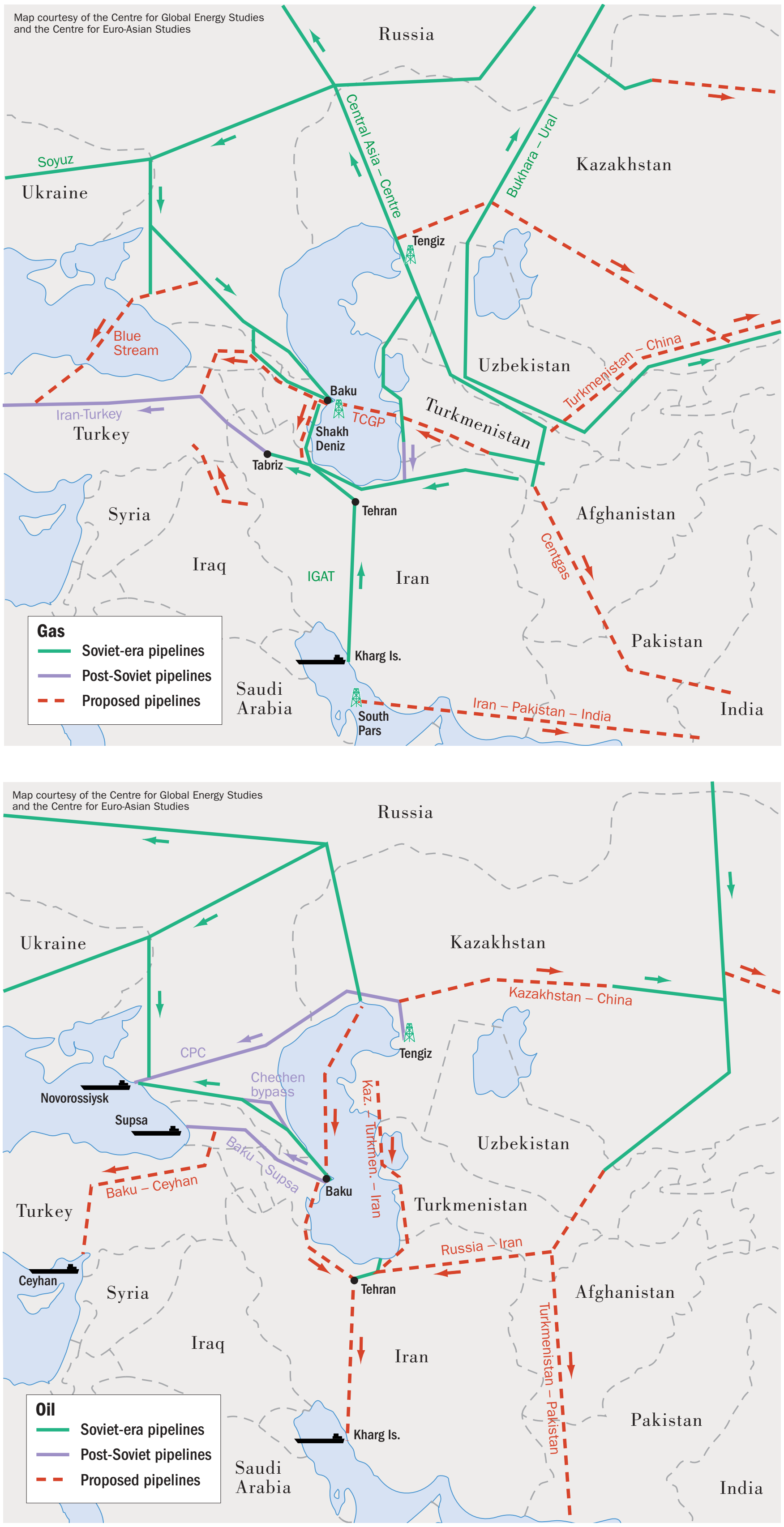
In Russia the oil sector is already populated by a multiplicity of firms operating under a reasonable degree of competition but equitable and cost-effective access to pipelines remains a major issue. The state-owned transportation monopoly, Transneft, controls over 97 per cent of crude oil transportation in the country, and export capacity in particular has often been allocated arbitrarily. Given the distances involved, the returns from production also remain very sensitive to transportation costs. At present, Transneft's tariffs are relatively high, with a large wedge between domestic and export tariffs. The absence of a proper regulatory framework for Transneft, including price setting, therefore remains a major drawback. Market entry in the Russian gas sector is similarly constrained by Gazprom's control over the transport infrastructure.

In this situation, part of the response may be for rival companies to make their own investments in pipelines, thereby creating a system of competing networks. While this approach is partly pursued by LUKoil and Rosneft, competition for the Transneft and Gazprom transport networks is more likely to arise from new transport capacity for Caspian hydrocarbon (see Chart 4.8).

Plans to increase transport capacity have strong political overtones. While Russia faces some important transport bottlenecks, it has so far been able to increase exports to the West by securing spare capacity at the expense of Caspian producers. This is most clearly the case for gas. For example, in 1993 Turkmenistan was practically shut out from the European gas market, and in 1997 the transit of Turkmen gas was stopped completely after Turkmenistan halted deliveries to the Russian company Itera due to payment arrears. Faced with declining domestic output, Gazprom has recently

Chart 4.8

Existing and potential oil and gas export routes from the Caspian basin



begun to market Turkmen gas but the price paid to Turkmenistan is considerably less than the Western market price, netted back to the Turkmen border, so that most of the rents accrue to Russia. Numerous proposals are on the table to break Russia's monopoly over energy transit from the region. However, Russia is likely to retain a key role because of geographical reasons, and because most alternative routes face political and security problems of their own.

Improving market access in this way involves major economic, environmental and political hurdles. The costs of building new pipelines are significant, requiring large annual throughput commitments to make projects financially viable and attract commercial funding. There are also environmental constraints related to the siting of pipelines through sensitive areas. To minimise the risk of negative environmental impacts, pipeline projects must meet stringent environmental standards.

Lastly, most pipeline proposals from the region involve transit through third-party countries (see Chart 4.8). This complicates the political negotiations necessary for reducing the risk of delays by transit countries. As such, pipeline projects from the region will need to be based on complex intergovernmental agreements and will progressively require better mechanisms of regional cooperation and contract enforcement.

However, while the costs of building new pipelines and mitigating their environmental impact are high, their existence, or even just their potential construction, increases competitive pressure and can have a dramatic effect on transit. For instance, since construction of the competing CPC pipeline began, Kazakhstan's transit quota through the Transneft system has increased by a factor of four. The possibility of a Trans-Caspian gas pipeline shipping Turkmen gas to Turkey was arguably one of the factors motivating Gazprom to resume gas transit from Turkmenistan to Ukraine.

4.3 Resource management and sustainable development

As constraints on investment are overcome and hydrocarbon production grows, Russia and the Caspian countries will increasingly face the problem of how to manage energy revenues and avoid the danger of a "resource curse". This curse is the consequence of poor economic management and a political culture of corruption, bred by the availability of windfalls and unchecked by effective institutions. The example of countries such as Norway shows that, if managed properly, resource wealth can bring benefits to a country.

Good resource management is particularly challenging in transition countries, where state institutions remain inherently weak. Yet, to date, there is little evidence that governance has been systematically worse in energy-rich CIS countries compared with their regional neighbours, as theories about the "resource curse" would suggest.[17] Although energy sector-specific data are lacking, the problems of governance and corruption do not appear to be higher in Russia and the Caspian region than in the less energy-rich CIS countries. For example, according to the 1999 *Transition Report*, Chapter 6, the share of bribes in enterprise revenues in 1999 was 5.3 per cent on average in the former, against 6.0 per cent in the latter. However, both are well above the levels found in central and eastern Europe.[18]

Encouragingly, some countries are beginning to put in place the institutional mechanisms needed for sound resource management but progress has so far been uneven. Kazakhstan and, more recently, Azerbaijan have created national oil funds that are intended to serve the role of asset diversification and fiscal stabilisation for the government. Such funds are not without problems and need to be carefully managed but their creation signals a growing awareness about the importance of good resource management.[19] Turkmenistan and Uzbekistan, in contrast, still use much of their resource revenues to operate multiple exchange rate regimes and subsidise selected domestic industries.

As noted previously, the share of resource revenue used to subsidise domestic energy consumers remains considerable in all countries. Significant improvements in resource management are still required if the energy-producing countries of the region are to benefit fully from their energy resource wealth. The challenges include issues of macroeconomic management arising from large resource-based capital inflows and the question of long-term sustainable development. The former are discussed in more detail in Chapter 3, and the discussion below focuses on sustainable resource management.

Resource-based growth is in essence the result of gradually liquidating that part of a country's capital stock represented by its natural resource endowment. Long-term sustainability demands that this reduction in natural capital be compensated by the accumulation of other forms of assets, such as physical capital (for example, new infrastructure or machinery) or human capital (for example, a better-trained workforce).[20] In other words, a part (or all) of the resource rents have to be re-invested productively. Ensuring that this rule is obeyed is the long-term objective of resource management.

Sustainable development has many facets and is difficult to monitor. One simple measure of sustainability is "genuine saving". This indicator, originally developed by the World Bank, is based on the recognition that a key condition for sustainable development is a constant capital stock, and it traces changes in the total capital stock.[21] The starting point is a country's net savings rate, which is a measure of investment in physical capital, net of depreciation and foreign investment. The depletion of the resource stock, a form of depreciation not included in the conventional measures, must then be deducted from this, while education expenditures (investment in human capital) are added. Broader

17 See, for example, the arguments of Auty (2001).

18 The survey did not cover Turkmenistan and Tajikistan.

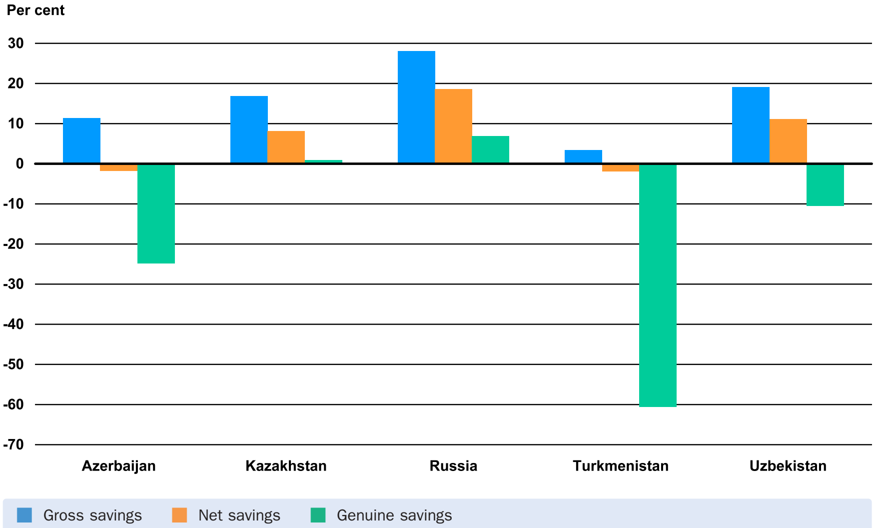
19 For a critical assessment of savings and stabilisation funds, see IMF (2000).

20 This "weak" interpretation of sustainability assumes that different forms of capital are substitutes. "Strong" sustainability rules would emphasise the irreplaceable quality of certain assets.

21 See World Bank (1997).

Chart 4.9

Gross, net and genuine savings as a percentage of GDP, 1992-99 average



Sources: EBRD and World Bank.

definitions also include the depletion of environmental assets, and sometimes technical progress is factored in. A negative genuine savings rate indicates an unsustainable growth path but a positive rate does not necessarily imply sustainability.

Chart 4.9 shows estimates of genuine savings for the five energy-rich transition countries between 1992 and 1999. In Azerbaijan, Turkmenistan and Uzbekistan genuine savings rates were negative throughout this period, as depressed net savings, a drop in education expenditures and increased reliance on oil and gas rents took their toll on the total capital stock. In Kazakhstan genuine savings were barely above zero, suggesting that overall the Caspian hydrocarbon countries have followed an unsustainable path since the beginning of transition.[22] Only in Russia were genuine savings rates positive although it is unclear whether Russia has indeed used its resources sustainably by investing in true savings productively. Yet, the hydrocarbon-rich countries of the region had higher net savings rates than their resource-poor neighbours, which suggests that oil wealth did increase overall savings, although insufficiently so.

The picture is less bleak according to another measure of sustainability – the "user cost approach". This asks what proportion of rents needs to be reinvested to ensure a revenue stream – returns on investment plus resource rents – that remains constant over time. Generally, the longer the remaining lifetime of the resource (and the higher the return on investment), the higher the fraction of rents available for immediate consumption.[23] At least in the short term, transition countries fare better under the user cost approach. The slow development of reserves and substantial recent discoveries mean that the remaining lifetime of the reserves is still relatively long. According to the logic of the user cost approach, this means that at least initially a higher proportion of current rents may be available for consumption.

The long-term sustainability of the region's energy-based economies nevertheless remains a concern, and with production expected to grow over the next few years, the need to increase savings rates will also become greater. Institutionally, the reinvestment of resource rents can usefully be combined with the responsibility of running the stabilisation fund, and energy-rich countries such as Norway and Kuwait have specific "reserve funds for future generations". In addition, the private sector should be encouraged to increase savings – for example, through pension legislation. In most successful resource-based economies, revenue management is complemented by improvements in natural resource accounting to allow decision-makers to keep track of changes in the total capital stock.

4.4 Conclusion

The economies of central and eastern Europe and the CIS continue to be highly dependent on fossil fuels as a source of energy. The substantial availability of hydrocarbon reserves in Russia and the Caspian basin makes it unlikely that oil and gas will lose its predominant position in the region's energy markets. Moreover, Russia and the Caspian region are likely to become increasingly important suppliers of energy, particularly gas, to the west European market. This chapter has explored what these developments mean for the hydrocarbon-rich countries of the region and what policies are needed to unlock this potential.

The first challenge is promoting investment. Over the next decade Russia and the Caspian countries will face huge investment needs for the development of their hydrocarbon sectors. Much of this money will have to be raised from external sources. However, foreign investment will begin to flow only if the countries can offer a stable, predictable business environment and competitive tax arrangements. The region has had some successes with PSAs but tax rules vary widely and doubts remain over the rule of law. Equally, for the incumbent domestic producers to become attractive to outside investors, they need to dramatically improve their corporate governance, become more transparent financially and respect the rights of creditors and minority shareholders.

The second challenge is redefining the role of the state. To increase the efficiency of the sector and attract investment, the role of the state needs to change from owner and director to regulator. Despite the drive for privatisation in 1994, the state still wields considerable

22 This is consistent with the genuine savings estimates of the World Bank. Their estimates differ because the World Bank applies a less detailed, summary method to calculate resource rents and uses a broader concept of genuine savings that also includes the depletion of other natural resources and the environmental costs of climate change.

23 See El Serafy (1989).

direct influence over the Russian hydrocarbon sector, although it is beginning to take a more commercial approach to the sector. The dominant Caspian companies have remained firmly under state control, but government influence in the Caspian region is slowly eroded through the signing of PSAs and joint ventures with private operators. At the same time, governments need to improve regulatory supervision to reign in the widespread violation of corporate governance standards, and ensure environmental compliance in a sector where environmental risks can be extremely high.

The third challenge is introducing competition. State control over the sector must not be replaced by private market power. A key condition for competition is open and non-discriminatory access to pipelines. At present, most of the region's pipeline network is controlled by two companies, Transneft and Gazprom, which are themselves under the strong influence of the Russian government. As a result, pipeline access and transit fees often reflect political as well as economic concerns, and market power is used to transfer rents from producers to pipeline owners. Remedying this situation requires root and branch reform in both Transneft and Gazprom, and a clear regulatory framework governing market access. In parallel, competition may be strengthened through independent pipeline projects, where these can be justified on economic and environmental grounds.

The final challenge is the better management of resource rents. Resource wealth has been a mixed blessing for many countries. So far, the energy-rich transition countries have avoided this "resource curse" but they have not taken advantage of the benefits that resource wealth can bring. A large fraction of generated income has been dissipated unproductively, usually in the form of energy subsidies for domestic consumers. To maximise the benefits of energy wealth and ensure long-term sustainable development, countries need to put in place the foundations for effective resource management. Not least, this means the better use of resource rents – that is, the phasing out, or at least the reform, of energy subsidisation. This issue is further developed in Chapter 5.

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Improving efficiency in energy conversion and use

5

One of the legacies of central planning is the inefficient use of energy in the transition countries. This chapter examines the reasons for this and looks at ways to address the problem. It concentrates, in particular, on the generation and supply of heat and power for households and industry.

At the start of transition, the power industries were monolithic enterprises operating according to objectives set by central government. This resulted in a variety of undesirable features. In the first place, there were high levels of energy consumption compared with industrialised market economies alongside low operational efficiency in generation and large losses in transmission and distribution. Second, tariffs were set well below supply costs while there was also persistently low revenue collection. There was substantial *de facto* subsidisation from large users to residential customers and small businesses. In addition, none of the regulatory or institutional arrangements necessary for operation along commercial lines were in place. The energy sector had a history of poor environmental, health and safety standards. Unsafe and ageing Soviet-designed nuclear power plants have continued to operate throughout the region.

Since the start of transition energy consumption has fallen, largely as a result of the severe decline in output in the early 1990s. However, energy intensity – energy use relative to GDP – remains high by OECD standards. Some piecemeal changes have been made, but there remains an urgent need for further institutional reforms as well as price adjustments, improvements in payments collection and direct measures to improve efficiency and safety. Many countries have passed legislation facilitating industry restructuring, and a small number of countries have privatised power companies. However, there has been considerable variation across countries in the extent of reform. Furthermore, the performance of ageing plants has generally declined following the failure to invest in new equipment. The result has been deteriorating efficiency and system security.

A combination of price reform, measures to raise collection rates and the introduction of new institutions designed to provide appropriate regulatory supervision is crucial if the secondary energy sector is to advance. However, the introduction of price reform must be accompanied by measures that provide social protection for the vulnerable. Tariff reform will need to occur in tandem with the introduction of new subsidy mechanisms. A second requirement is that price reform needs to be complemented by institutional reform. Privatisation of power and heat distribution is required if the problem of low collection is to be successfully tackled. More generally, private sector participation – within a framework of effective regulation and liberalisation – can bring substantial efficiency gains.

The chapter is organised into four sections. Section 5.1 outlines recent findings on energy intensity. Section 5.2 examines the link between high energy intensity and low prices, and argues that price increases would yield substantial economic benefits. The potentially adverse consequences of price increases for poorer groups within the population are covered in Section 5.3, which assesses the magnitude of the power and heat affordability problem and proposes appropriate subsidy mechanisms. Section 5.4 argues that institutional reform is essential and discusses the best arrangements for increasing private participation in the sector.

5.1. Energy use in transition countries

Energy intensity

Centrally planned economies paid little attention to energy and resource efficiency and consequently consumed a substantial amount of energy. However, over the first decade of transition total primary energy consumption fell from 1,925 million tonnes of oil equivalent (mtoe) in 1989 to 1,250 mtoe in 1999. This decline is mainly due to the sharp reduction in output which the region experienced at the beginning of transition. The change in GDP accounts for 86 per cent of the decrease in energy consumption, with only 14 per cent of the reduction due to efficiency gains. Relative to GDP, energy consumption has remained high, primarily because energy prices and collection rates have been too low to provide sufficient incentives for greater efficiency in energy conversion and consumption.

The ratio of energy consumption to output or GDP gives a measure of energy intensity. Overall, the region's energy intensity has come down by 11 per cent between 1992 and 1998 but the picture is not uniform (see Chart 5.1). Central eastern Europe and the Baltic states (CEB) recorded a continuous drop, and by 1998 used 21 per cent less energy per unit of output than in 1992. South-eastern Europe (SEE) saw energy intensity fall by 16 per cent, despite a temporary reversal in the mid-1990s when reforms in Bulgaria and Romania stalled.

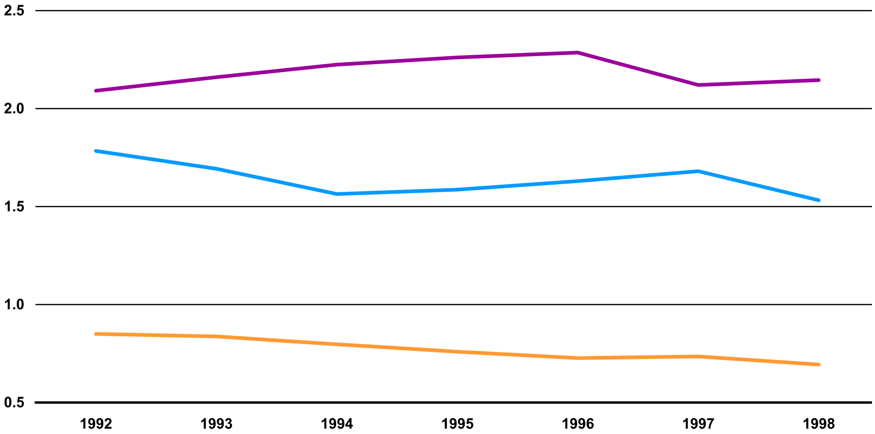
In contrast, energy intensity in the Commonwealth of Independent States (CIS) increased during most of the transition period, peaking in 1996. By 1998, the CIS still used 5 per cent more energy per unit of output than it did in 1992 – 40 per cent more in the case of Ukraine, 11 per cent in Uzbekistan and 4 per cent in Russia. Part of this can be explained by data inaccuracies and the marked shift of activity from the official to the shadow economy experienced in the CIS. Part can also be explained by the lack of measures to improve efficiency.

Despite the reduction in energy intensity in much of the region, transition countries still lag behind OECD nations. In 1998 the CEB countries used about four times as much energy per unit of output as western Europe. In SEE, energy use relative to GDP was about nine times higher than in western Europe, and in the CIS it was almost 13 times higher (see Chart 5.2). The figures appear less excessive

Chart 5.1

Energy intensity, 1992-98

Tonnes of oil equivalent per US$ 1,000 of GDP

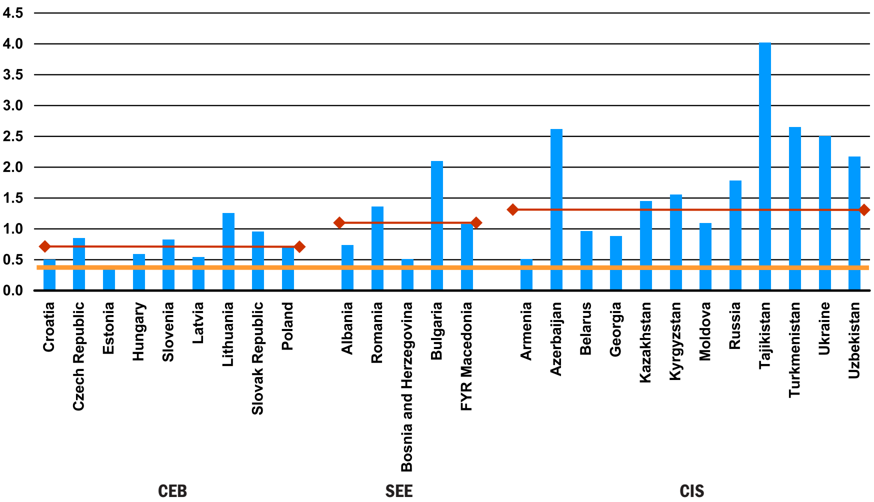


Sources: EBRD calculations based on data from the International Energy Agency and the World Bank.

Chart 5.2

Energy intensity in 1999

Tonnes of oil equivalent/US$ 1,000



Sources: EBRD calculations based on data from the International Energy Agency, the World Bank and the US Department of Energy.

if the United States, the most intensive energy user in the West, is used as the benchmark. Even then only Estonia, the region's least energy-intensive country, reaches a comparable standard. Croatia and Latvia, second and third in rank, still had energy intensities almost twice as high as that of the United States in 1998.

To identify the main factors that have driven adjustments in energy intensity, the data have to be separated into different components. Three factors are of particular interest: (i) the efficiency of the industrial sector – that is, energy use per unit of output by industry; (ii) energy use per unit of output in the rest of the economy (including residential consumption); and (iii) the growth in low-energy sectors at the expense of energy-intensive sectors (or vice versa).

In CEB the main factor behind the energy savings that occurred between 1992 and 1998 was reduced consumption in the non-industrial sector (see Chart 5.3). Energy intensity in industry also dropped as companies began to restructure, replaced their capital stock and closed inefficient production facilities. The structural shift away from the industrial sector was slow, however, with the share of industry in GDP falling from 29 per cent in 1992 to 26 per cent in 1998. Consequently, structural change contributed only about 1 per cent to the overall reduction in energy intensity.

Lower consumption in the non-industrial sector was also the main factor in lowering the energy intensity of SEE countries. Energy intensity in the industrial sector, in contrast, increased, mainly as a result of patchy restructuring. At the same time, the industrial share in GDP fell from 30 per cent in 1992 to 22 per cent in 1998, causing a 7 per cent decrease in energy intensity.

In the CIS, energy intensity increased both in the industrial and non-industrial sectors. Structural change partially offset this trend and accounted for a 5 per cent decrease in energy intensity as the industrial share of GDP fell from 36 per cent in 1992 to 24 per cent in 1998.

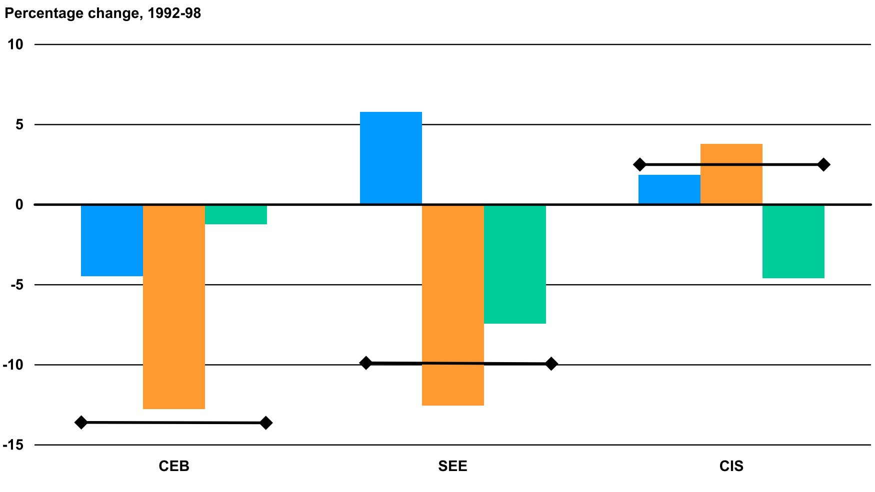
The efficiency with which primary energy is converted into heat and power has a significant impact on energy intensity. About 60 per cent of all energy is consumed in these forms. A comparison of performance reveals high inefficiencies in both the power and heat sectors in most transition countries. Transmission and distribution losses in the power sector, for instance, are as high as 27 per cent in some countries, compared with an industry standard of about 4-5 per cent in western Europe. Despite these shortcomings, transition countries have been slow in improving their heat and power sectors. In the CIS a deterioration in power sector performance, particularly in Russia and Ukraine, even led to a 6 per cent increase in energy intensity. Slow progress in energy sector reform and flawed tariff policies have been the main factors that have delayed improvements in efficiency.

Energy use and the environment

High energy use tends to result in high levels of energy-related pollution. Unsurprisingly, transition countries therefore have significant problems in this area and fail to meet Western standards of energy-related pollution control.
In 1998, the latest year for which

Chart 5.3

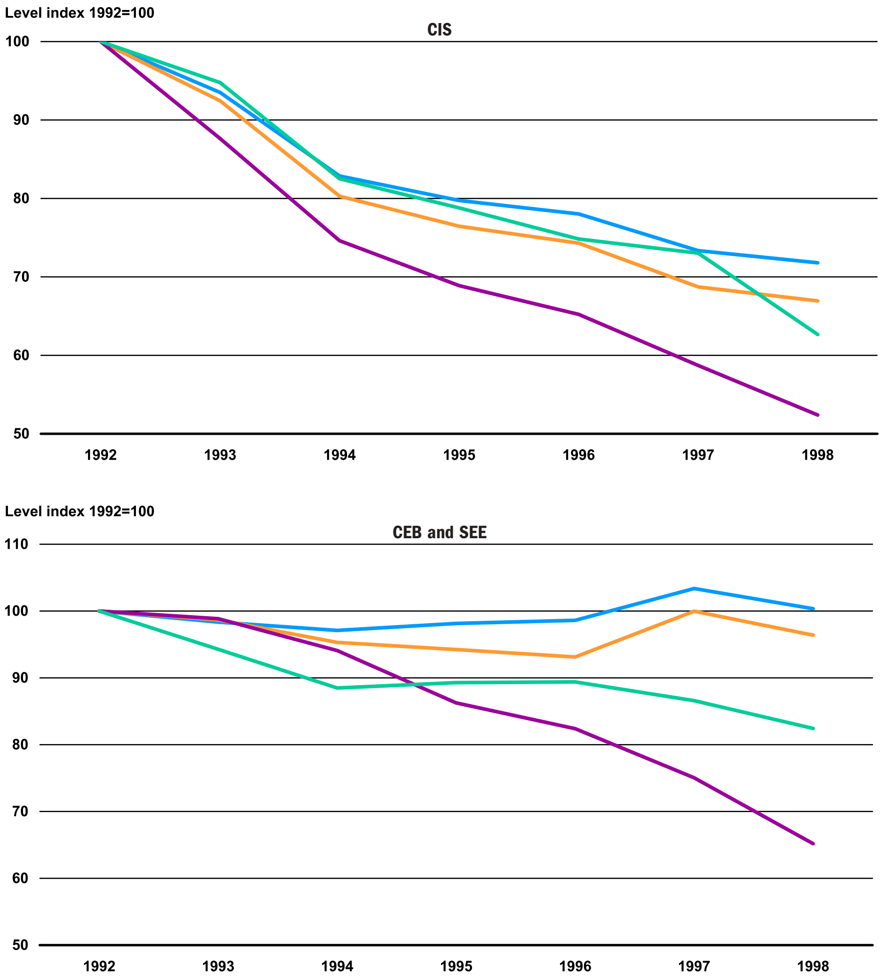
Change in energy intensity



Sources: EBRD calculations based on data from the International Energy Agency and the World Bank.
Note: Bosnia and Herzegovina and FR Yugoslavia are not included.

Chart 5.4

Energy use and air emissions, 1992-98



Sources: EBRD, US Energy Information Administration and UN Economic Commission for Europe.
Note: Armenia, Georgia, Moldova and Russia are the only CIS countries included. Sufficient SEE data were not available.

emissions data are available, transition countries emitted collectively 18-19 per cent more air pollutants (SO_2 and NO_X) per unit of output than the countries of the European Union. Relative to output, the region also emits more greenhouse gases than EU countries do. In 1998 the CIS produced almost nine times as much CO_2 relative to GDP as the EU, and SEE and CEB emitted six and three times as much respectively.[1]

Although emissions and energy use are closely linked, air emissions have tended to drop more steeply than energy consumption, particularly in CEB. Carbon dioxide emissions in CEB fell by about 8 per cent between 1993 and 1998, compared with only a 3 per cent drop in energy use. The decrease in the emission of air pollutants was even more pronounced (see Chart 5.4) and unlike carbon emissions, air pollution did not rebound when the region returned to growth. SEE countries saw the emission of greenhouse gases and various air pollutants fall by between 24 and 63 per cent while energy consumption decreased by 19 per cent. Only in the CIS did emissions fall on a par with energy consumption.

Overall, changes in energy use accounted for between 70 and 90 per cent of the change in air emissions observed between 1992 and 1998. The balance is due to a change in fuel mix and, in the case of local pollutants, the installation of technology for reducing pollution. Improvements in energy efficiency will remain the main reason for further emission reductions although specific environmental measures will become increasingly important as the region tries to improve its environmental record.

Many countries in the region – including Armenia, Bulgaria, the Czech Republic, Lithuania, Russia, the Slovak Republic and Ukraine – continue to have significant nuclear capacity. These countries have had lower air pollution and greenhouse gas emissions and, as they started from a lower level of emissions, have experienced a less pronounced reduction. However, lower air emissions are traded against an increased accident risk, possible exposure to radiation and protracted waste storage problems. Most

1 On the other hand, greenhouse gas emissions have fallen in absolute terms. As a result, transition countries, unlike other industrialised countries, are set to meet their obligations under the Kyoto Protocol.

of the region's nuclear power countries are faced with systems that have serious deficiencies in terms of nuclear safety and need massive investment to improve safety measures and decommission obsolete reactors. While the need to upgrade is urgent, the costs are greater than most countries can afford.

Over the last ten years, central and east European countries have spent around US$ 1 billion on nuclear safety, and Western donors have contributed another US$ 2 billion across the region. Half of this amount was channelled through two dedicated funds, the Nuclear Safety Account (NSA) and the Chernobyl Shelter Fund (CSF), which are managed by the EBRD. The NSA has financed urgent near-term technical safety improvements, including regulatory reforms in Bulgaria, Lithuania, Russia and Ukraine as well as measures for decommissioning the remaining Chernobyl reactor. The CSF aims to create an environmentally safe containment area following the 1986 accident.

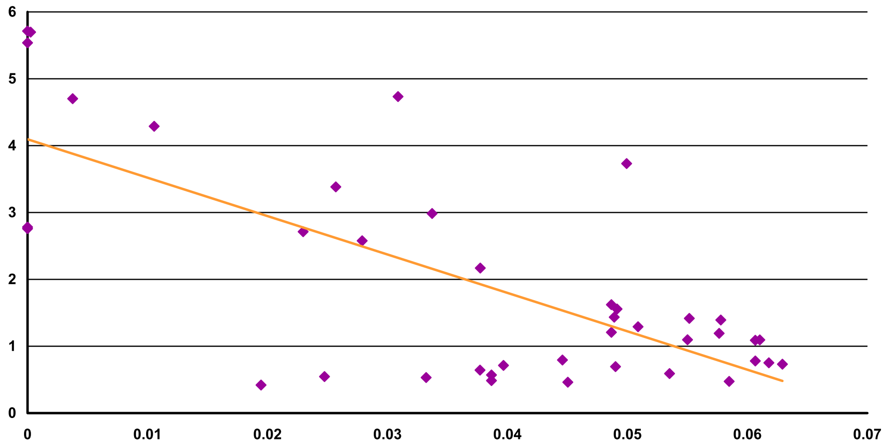
The cost of decommissioning a first wave of reactors in EU accession countries will amount to about US$ 600 million in the short term, and several times more than this over a longer period of time. Most of these funds are provided by Western donors, which set up dedicated Nuclear Decommissioning Funds for Bulgaria, Lithuania and the Slovak Republic in 2000.

The region has made considerable progress in upgrading nuclear safety, and countries such as the Czech Republic, Hungary and Slovenia have reached safety standards comparable to those in the West. Others such as Bulgaria, Lithuania, the Slovak Republic and to a lesser extent Ukraine have agreed on action plans (including decommissioning) that, if implemented as planned, will see safety levels approach Western standards. Nevertheless, nuclear safety remains a key challenge for much of the region.

Chart 5.5a

Industrial energy intensity and energy prices

Tonnes of oil equivalent per US$ 1,000 of value added in industry

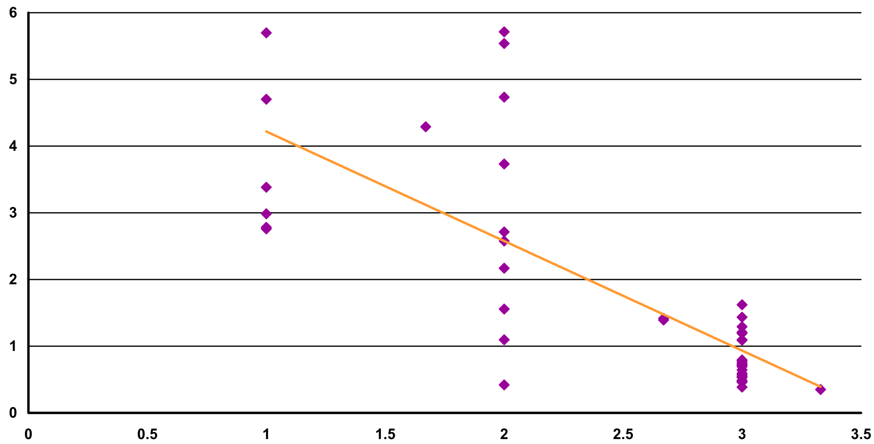


Electricity prices for industrial consumers (in US $/kWh)

Chart 5.5b

Industrial energy intensity and governance and enterprise restructuring

Tonnes of oil equivalent per US$ 1,000 of value added in industry



EBRD transition indicator score for governance and enterprise restructuring

Sources: EBRD and International Energy Agency.

Note: The analysis used pooled data for six countries (Czech Republic, Hungary, Kazakhstan, Poland, Russia and Slovak Republic) over seven years (1992-98). Data points represent the values for a particular country in a particular year (e.g. Czech Republic 1998). Data on energy consumption and energy prices are from the International Energy Agency.

5.2 Energy use, tariffs and reform

High energy intensity and correspondingly high emissions are not necessarily signs of inefficient energy use. Some countries may need more energy than others due to factors such as the severity of the climate, the need for extensive long-distance transport or their reliance on heavy industry. Many of the transition countries share some of these features and this may, in principle, justify above-average energy intensities. However, available evidence strongly suggests that the transition countries do not use energy as efficiently as they could, and that there are opportunities to reduce consumption without incurring high costs.

Many of the prevailing inefficiencies are caused by lack of progress in transition, particularly the slow restructuring of energy-intensive industries and inadequate reform of the power and heat sectors. An analysis of six transition countries shows that high energy intensity in the industial sector is linked to a low score for governance and enterprise restructuring in the EBRD's transition indicators (see Chart 5.5).[2] Energy intensity is also linked with a lack of progress in privatisation but the link is less evident statistically, suggesting that privatisation

[2] The countries covered are the Czech Republic, Hungary, Kazakhstan, Poland, Russia and the Slovak Republic. Sufficient data were not available for other countries. The results reported are based on a multivariate panel data analysis.

Table 5.1

Power prices in EBRD transition countries in 2000

Country	Residential price (USc/kWh)	Industrial price (USc/kWh)	Industrial / residential price ratio	Residential price / LRMC ratio
Albania	2.8	2.6	0.9	0.3
Armenia	4.6	3.2	0.7	0.6
Azerbaijan	1.3	3.7	2.8	0.2
Belarus	1.4	5.2	3.7	0.2
Bosnia and Herzegovina	4.3	6.4	1.5	0.5
Bulgaria	3.4	3.9	1.1	0.4
Croatia	7.3	6.7	0.9	0.9
Czech Republic	4.5	4.3	1.0	0.6
Estonia	6.7	5.7	0.9	0.8
FYR Macedonia	5.3	5.3	1.0	0.7
Georgia	4.4	4.3	1.0	0.5
Hungary	5.9	4.5	0.8	0.7
Kazakhstan	2.7	2.8	1.1	0.3
Kyrgyzstan	0.4	1.3	3.5	0.0
Latvia	6.4	5.3	0.8	0.8
Lithuania	6.1	4.7	0.8	0.8
Moldova	4.0	na	na	0.5
Poland	8.4	3.1	0.4	1.1
Romania	4.9	3.9	0.8	0.6
Russia	0.9	1.6	1.8	0.1
Slovak Republic	5.9	4.6	0.8	0.7
Slovenia	7.6	7.0	0.9	1.0
Tajikistan	0.0	0.1	6.3	0.0
Turkmenistan	0.5	0.5	1.1	0.1
Ukraine	2.0	2.3	1.1	0.2
Uzbekistan	0.7	0.7	1.0	0.1

Sources: EBRD survey of national energy authorities.
Note: Prices are country-wide averages.

on its own does not necessarily lead to the restructuring needed to secure lasting energy efficiency gains.

Notwithstanding the importance of enterprise reform, the most significant factor influencing energy intensity appears to be the level of energy tariffs. In most transition countries energy consumption is still subsidised, as end-user prices are kept below cost-recovery levels for some consumer groups and non-payment is tolerated from others. As Chart 5.5 shows, there is a strong link between low energy prices and high energy intensity in the industrial sector. Price increases can explain 50 per cent of the drop in energy intensity observed in the countries covered by the analysis. If prices were to be raised towards cost-recovery levels, there would be an increase in efficiency as a result of reduced consumption. This would occur both in the residential sector and in industry, where investments aimed at energy efficiency would be undertaken. In addition, raising prices would increase power sector cash flows, which in turn would support investments to reduce system losses.

The extent of under-pricing in the power sector is illustrated in Table 5.1. The optimal pricing rule applied to transition economies – where demand is stagnant and excess capacity often exists – would set the price somewhere between marginal operating cost and long-run marginal cost (LRMC).[3] The price could be expected to rise above marginal operating cost and towards LRMC as demand picks up and investments are undertaken. Taking the LRMC as being equal to 8 US cents/kiloWatt hour (kWh),[4] the mean ratio of residential tariffs to LRMC across the region is 0.5, a low figure by Western standards. Residential tariffs tend to be lowest in the CIS and SEE. The lowest prices are in Central Asia, where the ratio of residential tariffs to LRMC is around 0.1.

In addition to the widespread problem of under-pricing, the difference in prices between consumer groups can also be problematic. Typically residential power tariffs are lower than those for industry. On average, industrial tariffs are almost one and a half times higher than residential tariffs across all transition countries. This sharply contrasts with western Europe, where industrial tariffs are on average two-thirds of the price charged to households, reflecting the relative costs of supplying these two customer categories. Looking across the region, the price differential for industrial customers has tended to be highest in Central Asia (on average 2.6 times higher) and in the other CIS countries, where the ratio is around 1.9. In SEE and CEB the ratio ranges from slightly above 1.0 to 0.8.

A further distortion relates to price differentials according to time of day and time of year. In general, LRMC will be specific to times of day and year, given that electricity demand will fluctuate substantially. Consequently, demand during a peak period will generally incur operating costs plus capital costs while off-peak demand will only generally incur marginal operating costs.[5] Time-of-day pricing has been introduced in 11 transition countries, resulting in pricing that more closely reflects actual costs.[6] However, prices tend to be uniform across time of year, and typically charges for large customers are small relative to the underlying cost. Exceptions are Bosnia and Herzegovina, Bulgaria, FYR Macedonia and Slovenia, where time-of-year pricing has been introduced. In addition, Bosnia and Herzegovina, Poland, Romania, the Slovak Republic and Tajikistan have introduced significant capacity charges for industrial

3 Marginal operating cost is defined as the cost of producing an extra unit of output using the existing capital stock. Long-run marginal cost is marginal operating cost plus the cost of additional capacity required to increase output. See Turvey and Andersen (1977) for discussion of LRMC pricing in the power sector.

4 EBRD (1996) and Stern and Davies (1998) argue that the US LRMC, approximately 8 cents per kWh for residential consumers, is an appropriate yardstick for the transition economies.

5 This is because capacity exists for peak demand. Additional demand in peak periods therefore requires additional capacity. Additional off-peak demand can be satisfied using existing capacity.

6 Armenia, Bulgaria, Croatia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, Slovenia and Ukraine.

Box 5.1

Energy pricing and industrial restructuring

In Russia, industrial firms accounted for around one-third of total debts (receivables) owed to the power sector by the end of 2000. Aside from the problems that this causes for the power sector, firms have little incentive to restructure. Industry has in effect been the recipient of major subsidies from the power sector. These subsidies have limited the pressures for restructuring or closure, not least by providing a lifeline to failing firms.

This problem has spread widely throughout the region. Indeed, an EBRD survey of over 900 firms in Hungary, Romania and Russia in 2000 found that barely one-third of firms in Romania and Russia had begun to implement explicit energy-saving measures. By contrast, this share was closer to 50 per cent in Hungary.

Power subsidies have generally been delivered in the CIS through a combination of non-payments or payment using non-monetary means. Indeed, most of the barter has been based on the granting of energy-based subsidies to industrial consumers. In Russia there was a strong link between the use of such non-monetary transactions and the lack of restructuring.[1] Clearly, there are complex questions of cause and effect involved but the energy component in non-monetary transactions has been large (though declining after 1999). Moreover, the presence of these transactions has tended to be associated with weak restructuring. In many cases, access to non-monetary transactions has also been associated with firms that are performing poorly, highlighting the subsidy nature of these transactions.

In short, the power sector has played a critical role in much of the CIS in maintaining lax budgetary practices in industrial firms. As such, it has held back adjustments in terms of energy intensity and has limited the pressure to restructure.

1 See Commander, Dolinskaya and Mumssen (2001).

consumers.[7] Clearly there is significant scope for further reforms to pricing arrangements throughout the region.

Table 5.2

Cash collection and commercial loss rates for selected countries in 2000

Country	Cash collection (per cent)	Commercial losses (per cent)
Albania	60	30
Armenia	80	30
Azerbaijan	15	na
Belarus	50	na
Bosnia and Herzegovina	75	25
Bulgaria	85	10
FYR Macedonia	60	na
Georgia	35	na
Kazakhstan	na	25
Kyrgyzstan	45	10
Moldova	55	35
Romania	45	5
Russia	85	na
Tajikistan	na	na
Turkmenistan	30	na
Ukraine	55	5
Uzbekistan	25	na

Sources: EBRD survey of national energy authorities.

Note: Cash collection is defined as cash revenues over total billings.
Commercial losses are defined as non-billed consumption, i.e. consumption against which there exists no outstanding financial claims.

The collection of payments plays a critical role in power pricing in the transition economies. Cash collection (the percentage of total cash collected) and revenue collection (cash collection plus barter payment) are typically far below 100 per cent, and commercial losses (defined as non-billed consumption) are substantially above OECD levels (see Table 5.2). In western Europe and the United States, cash collection is generally close to 100 per cent, and commercial losses close to zero. In the CIS, cash collection averages only 50 per cent and commercial losses 20 per cent. Cash collection is particularly low for industrial consumers and consequently incentives for industrial restructuring are limited (see Box 5.1). Cash collection averages 65 per cent in SEE and commercial losses average 20 per cent. Low cash collection and high commercial losses are far less of a problem in CEB.

The same issues that have applied to power tariffs – low prices, price variation between consumer groups, and low collection rates – are also present in the district heating sector. Heat prices range from zero in Azerbaijan to about 3 US cents/kWh in Latvia (see Table 5.3). This can be compared with the LRMC of a free standing boiler – the closest alternative to district heat – of around 3 US cents/kWh in CEB and SEE, and 2 US cents/kWh in the CIS, where gas is available more cheaply.[8] As in the case of power, industry tends to be charged higher rates than residential consumers, despite the higher cost of serving the latter. Anecdotal evidence suggests that collection is also problematic, particularly from public sector consumers, but no systematic data are available. The analysis highlights a number of key policy challenges. They include the need to increase prices, to reduce the cross-subsidy between customer categories and to improve payments discipline. Raising prices and reducing cross-subsidies is reasonably straightforward from a technical viewpoint but may be politically difficult. The introduction of time-of-day pricing is also technically feasible for large consumers. However, improving payments discipline typically requires the introduction of the private sector, which in turn will require far-reaching

7 Large customers pay a capacity charge plus a charge for each unit consumed. Depending on the structure of the charge, this can approximate LRMC time-of-day pricing – see Turvey and Andersen (1977).

8 An LRMC benchmark for district heat is difficult to establish because systems differ widely and there are few comparable networks outside the region.

Box 5.2

Energy conservation and energy service companies

Studies often find that even in well-functioning market economies there is a discrepancy between actual energy savings and what would be possible under best practice. In other words, even if tariffs are set at an adequate level, energy consumers may not adopt the most efficient energy solutions available. A number of "barriers" have been identified that can explain this efficiency gap. For example:

- consumers may be unaware of the available energy conservation opportunities;
- the costs of developing expertise and installing energy conservation equipment are too high, relative to consumers' energy bills;
- in countries with less developed financial markets, consumers may not be able to borrow for energy conservation measures;
- landlords may be unable to recover the cost of energy efficiency investments because of rent controls.

While the removal of market imperfections requires state intervention, innovative private sector solutions can help to overcome many of these barriers. One solution is the creation of energy service companies (ESCOs). These are businesses that specialise in the development, financing and implementation of energy conservation solutions for their customers. Energy audits, design, installation, financing, operation and maintenance are all provided and financed by the ESCO, and its repayment is tied to the achieved savings through an energy performance contract.

Energy service industries first emerged in North America in the late 1970s in response to high oil and electricity prices and the introduction of tax incentives for energy conservation. By 1999 the US ESCO industry had installed assets worth US$ 2.3 billion.[1] In transition countries the development of an energy service industry has been slow for several reasons. Chief among them are:

- Inadequate tariff levels. Low energy tariffs reduce the financial viability of energy conservation investments and makes it difficult for ESCOs to retain benefits.
- Shortcomings in energy sector reform. Regulatory impediments often discriminate against ESCOs, and delays in sector reform deter international providers from entering this difficult market.
- Customer reluctance. Potential customers remain sceptical about the scope for low-cost energy savings. In the public sector, customers are hesitant to relinquish control over energy management, or have unrealistic expectations about how energy conservation benefits should be shared.

Hungary is one country in the region where a small energy service industry has developed, while pioneer firms (many supported by the EBRD) are active in countries such as Armenia, Bulgaria, Poland, Romania and the Slovak Republic. The vast CIS market will remain unsuitable for ESCO development, however, until tariff and energy sector reform has progressed further.

1 See World Bank (1999).

Table 5.3

Heat prices in selected countries in 2000

Country	Residential price (USc/kWh)	Industrial price (USc/kWh)
Azerbaijan	0.0	0.0
Belarus	0.1	1.4
Bulgaria	1.7	2.0
Croatia	1.6	2.7
Czech Republic	2.8	na
Kazakhstan	1.0	1.3
Latvia	3.0	3.0
Moldova	1.6	1.6
Poland	2.8	2.8
Romania	1.6	1.6
Russia	0.2	0.4
Ukraine	0.5	0.8

Sources: EBRD survey of national energy authorities.
Note: Prices are country-wide averages.

institutional reform (see Section 5.4). Meeting these challenges will make investments more economically viable. Finance will become available for new power and heat generating stations and the upgrading of transmission and distribution networks, resulting in declining losses and improvements in system security. Residents will have incentives to regulate heat and power consumption. Industry will have incentives to improve energy efficiency and to move away from energy-intensive production methods. This can be further helped by an emerging energy service industry (see Box 5.2).

5.3 Power and heat affordability and subsidy mechanisms

Price reform does not come without costs. The impact on poorer groups in particular is likely to be significant. Electric power and heat are important basic services. People without access to power may suffer genuine hardship. In the climate of much of eastern Europe and the CIS, people without access to heat would have their health put at significant risk during the winter. Household incomes have already fallen in many transition economies, particularly in the CIS, and there is widespread poverty. This has important implications for how price adjustments can be introduced and highlights the importance of effective compensation mechanisms.

How much does affordability constrain reform?

Affordability of price increases is a concern for all those households living at or below subsistence level. A significant share of the population in most CIS countries would have difficulty in affording large price increases for energy. The poor typically comprise between 25 and 50 per cent of households.[9] While many of these households lack connections to utilities, a minority in urban areas would be adversely affected by any price increases. In addition to welfare concerns, the political viability of price reform remains a key issue. Attention needs to be paid therefore

9 See World Bank (2000).

to the level of poverty in the population and to the burden of utility payments in current household budgets.

Evidence from Russia provides some insight into the scale and development of the problem. In 1992 the share of Russian household expenditure allocated to utility payments averaged only 1.5 per cent. At the same time, Russian firms commonly faced utility prices that were roughly twice as high as household tariffs. Just over 50 per cent of households fell below the poverty line as measured by expenditure.[10]

How have conditions changed over the course of the transition period? The Russia Longitudinal Monitoring Survey reveals a number of features that are relevant for policy. First, an average 1.5 per cent expenditure share on utilities reported for 1992 camouflages enormous variation across expenditure groups. The poorest households spent over 15 per cent of their expenditure on utilities. The expenditure share for all households classified as poor approached 2.5 per cent compared with 0.6 per cent for all non-poor households. While many poor households – particularly in rural areas – are not yet connected to utilities, there is a significant group of poor urban households that would struggle to afford utility payments. For these households, subsidies will be required if hardship is to be avoided.[11]

Second, the increase in the share of expenditure devoted to utilities has generally been small over the past decade. In 1995 and 1999 the share of utility payments by the poor was still only 2.5 per cent compared with 0.8 per cent for the non-poor. This suggests that price increases would not have a dramatic effect on the budgets of most poor households in percentage terms. While the incidence of poverty has declined from its peak in 1992, over 35 per cent of households fell below the poverty line in both 1995 and 1999.[12] For the poorest 10 per cent of the population in Russia, average per capita expenditure was less than half of the subsistence level. While there is clearly scope for price increases for the higher income groups, poverty in Russia is sufficiently severe to make it difficult for poor households to withstand even the relatively small impact of energy price increases.

Third, non-payment remains a problem across all income categories. For instance, in 1999 around 45 per cent of the poorer households had unpaid utility and rental bills amounting to around half of what they notionally owed. Around one-third of the top 20 per cent in terms of expenditure also had unpaid bills. These unpaid bills amounted to over 25 per cent of their total utility and rental bills. In short, there continues to be a major problem across all income groups with partial or non-payment of utility bills. Better payments discipline would put significant pressure on the household budget of poorer groups.

The findings highlighted by the Russian survey are common to a large number of countries in the region. Evidence confirms that utility and rental payments have remained generally low as a share of total household expenditure, suggesting that governments and utilities have continued to operate “subsidy” schemes for households. Based on household survey data, the affordability ratios – defined as energy expenditure divided by income – for the poorest income groups in Georgia and Ukraine remain as low as 2 per cent and 5 per cent respectively.

A more comprehensive picture encompassing the whole region, based on affordability ratios for the population as a whole (rather than for low income groups), suggests that affordability would not be a problem for higher income groups, even if collections were 100 per cent (see Table 5.4). Georgia is the only country in which energy payments would exceed 10 per cent of average household expenditure if there were 100 per cent collection at current prices.

Table 5.4 also illustrates the average share of expenditure that would be required if electricity prices were brought closer to long-run marginal cost (here assumed to be about 8 US cents/kWh, see Section 5.2 above). The impact of full price adjustment on household budgets is greatest in the CIS. In Azerbaijan, for instance, electricity spending would rise to almost 10 per cent of total expenditure from less than 4 per cent today. In Kyrgyzstan the increase would be from 2 per cent to 9 per cent. Even at these levels, power would be affordable for higher income groups in most countries.

How should subsidies be provided?

How is it possible to make sure that all those eligible to receive energy subsidies really benefit while minimising the subsidy to those who could afford to pay cost-recovery prices? And what are the implications for public finances and the financial performance of the utility?

Broadly speaking, there are four types of subsidies that could be used in the transition economies: (i) continued supply to non-paying customers or across-the-board subsidies; (ii) lifeline tariffs, where consumers receive an initial block of energy for free or at a low price, with consumption of additional blocks charged at higher prices; (iii) targeted subsidies; and (iv) non-targeted subsidies or general income support.[13] In evaluating the benefits of these approaches, it is important to consider certain conflicting aims. On the one hand, the effectiveness of the subsidy scheme depends on the extent to which it covers all potentially eligible poor people. On the other hand, its efficiency depends on the subsidy reaching only those consumers who need it. Additional objectives are to minimise the scheme’s costs for the government or the utility; to make it fair and cost-efficient to administer; and to minimise

10 See Commander, Tolstopiatenko and Yemtsov (1999).

11 This is also true for other countries. Lovei *et al.* (2000) report figures for Moldova, indicating district heating alone, without any subsidy, would have consumed around 60 per cent of the household income of a family in the lowest 20 per cent of the population in terms of income as of 1997-98.

12 The poverty gap also declined by more than the decline in the headcount, indicating that the poor were on average closer to the poverty line than they were at the start of the transition process.

13 This list is a summary from a more extensive classification in Lovei *et al.* (2000). This study divides subsidy mechanisms into ten categories, with different types of across-the-board subsidies, lifeline tariffs and targeted subsidies considered separately.

distortions arising from the scheme. Clearly a country must also have the institutional capacity to operate the chosen scheme.

A policy of across-the-board price subsidies or the failure to disconnect non-paying customers would not achieve most of these aims. While such a scheme typically covers all poor people with utility connections (which may in some cases be a minority of the poor), it lacks targeting. As a result, the costs are high, either for the government or for the utilities. Incentives to economise on energy consumption are also absent under this scheme.

The benefits of the other subsidy mechanisms are more difficult to evaluate and to a large extent depend on the level of poverty, its frequency and its severity. Lifeline tariffs are most appropriate when the number of people who would have difficulty in paying is relatively large. However, lifeline tariffs can be implemented only when consumption can be adequately metered, which applies to electricity, but not necessarily to heating services.[14] Moreover, the costs of lifeline tariffs could be quite substantial compared with more directly targeted subsidies.

Targeted subsidies can be more efficient if the subsidy is directly related to household income. They are appropriate for situations where there is no metering, and are a possible means therefore of subsidising heat consumption. Russia and Ukraine have at various times used a form of targeted subsidy known as a burden limit. This is defined as a percentage of expenditure on utilities above which a household would receive a subsidy.[15] However, such burden limits often fail to reach a significant proportion of the poor who may be forced to forego energy consumption in order to pay for food and shelter. Furthermore, measurement of household incomes is particularly difficult in many transition countries where a large informal economy exists. The introduction of targeted subsidies has to take into account the state's administrative capacity. It will typically work best when combined with an already existing system of income support, as is the case in many central European countries. For instance, targeted subsidies were adopted in conjunction with a recent EBRD investment in the power sector in Georgia since the poor could be relatively easily identified. However, in many transition economies the coverage of targeted subsidies is often less than perfect, leading to a trade-off between the higher coverage achieved by a lifeline tariff and the better targeting and potential cost saving of a targeted scheme.

In short, efficiently targeting the poor is difficult to achieve in any country. In most transition economies, these problems are magnified since incomes are not perfectly measured, metering is often absent or easily manipulated and incentives for misreporting are large. However, there is an urgent need to move away as soon as possible from blanket subsidies in the form of low prices and from poor enforcement of payments discipline.
To the extent that private sector involvement is desirable (see Section 5.4 below) before better information is available about incomes and before meters are in place, there may be a case for maintaining blanket subsidies for an interim period. As institutional capacity improves and metering becomes more common, subsidy schemes – either lifeline tariffs or targeted subsidies – can be implemented efficiently and help to reduce poverty.

Table 5.4

Average affordability ratios in transition countries in 2000 (in per cent)

Country	Current prices: Affordability of electricity	Current prices: Affordability total (including heat)	Estimated at LRMC prices: Affordability of electricity	Estimated at LRMC prices: Affordability total (including heat)
Albania	2.1	na	3.5	na
Armenia	8.4	na	11.1	na
Azerbaijan	3.8	na	9.3	na
Belarus	2.1	2.7	5.0	7.5
Bosnia and Herzegovina	0.8	na	1.1	na
Bulgaria	7.9	10.3	12.2	15.2
Croatia	3.3	3.5	3.4	3.7
Czech Republic	4.3	5.9	5.7	7.4 [1]
Estonia	3.2	7.0	3.5	8.4 [1]
FYR Macedonia	8.6	na	10.6	na
Georgia	12.4	na	16.7	na
Hungary	3.9	na	4.5	na
Kazakhstan	1.9	1.9	3.4	3.4
Kyrgyzstan	1.9	na	9.1	na
Latvia	2.0	7.0	2.3	7.2 [1]
Lithuania	1.6	na	1.9	na
Moldova	5.2	16.4	7.3	19.9 [1]
Poland	2.5	3.0	2.8	0.0
Romania	1.9	4.3	2.5	5.7
Russia	0.2	0.2	0.5	0.7
Slovak Republic	3.5	na	4.0	na
Slovenia	0.7	na	0.7	na
Tajikistan	0.2	na	6.6	na
Turkmenistan	0.3	na	1.1	na
Ukraine	2.9	3.5	5.8	6.9
Uzbekistan	1.1	na	3.5	na

Sources: EBRD survey of national energy authorities, EBRD calculations and International Energy Agency (IEA).
Note: The price elasticity of demand for both heat and electricity is assumed to be -0.5. For the CIS countries the long-run marginal cost (LRMC) of heat is assumed to be 2 USc. In the Baltic states, central and southern Europe the long-run marginal cost of heat is taken to be 3 USc. Long-run marginal cost of electricity is 8 USc for all countries of operations. The affordability ratio is defined as energy expenditure per capita divided by average income per capita.
[1] Based on IEA 1998 consumption figures.

14 Apartment size is sometimes used as a proxy for heat consumption.

15 The burden was set at 10 per cent of total utility expenses in Russia in 1995 and later raised to 15 per cent. In Ukraine, burden limits have co-existed with price discounts to specific groups of consumers, low collection rates and across-the-board price subsidies (Lovei *et al.*, 2000).

5.4 Institutional reform

Institutional reform – alongside required price adjustments – is essential. This can also help to promote investments in rehabilitation, efficiency and supply. Furthermore, privatisation can raise significant budgetary resources in countries with good physical assets, tariffs above costs, and a strong regulatory environment. The prospect of EU accession has also promoted reforms required to meet the 1996 Power Directive and conditions relating to the environment and nuclear safety.

The introduction of the private sector in a well-regulated and competitive environment can lead to substantial efficiency gains. Improvements in efficiency resulting from private participation may also reduce the price increases necessary to ensure the viability of the power sector. Furthermore, the introduction of the private sector should help to mobilise finance and increase the possibility of further investments in the sector.

Apart from improving payments discipline, there is only limited evidence from transition economies to suggest that private sector participation has improved operational performance. However, experience in infrastructure reform in the United Kingdom, as well as private participation in infrastructure around the world, suggests that the introduction of the private sector in a well-regulated and liberalised environment can result over time in improvements to performance.[16]

There are also powerful reasons for accelerating private sector involvement when payments discipline is low. A private firm owned by a foreign strategic investor will have a stronger incentive to enforce payments discipline. It will also have the technical knowledge and finance required for essential re-metering programmes,[17] computerisation of billing and other measures that can help improve payments performance. Experience to date suggests that in cases where the private sector has entered power distribution, payments collection has gone up. Table 5.5 outlines developments in Kazakhstan (Almaty and Karaganda), Georgia (Telasi) and Moldova where there have indeed been major improvements in payments discipline.

Table 5.5

Cash collection rates pre- and post-privatisation (in per cent)

	Pre-privatisation	Year 1	Year 2	Year 3
Almaty, Kazakhstan	1	51	70	80
Karaganda, Kazakhstan	10	25	35	46
Telasi, Georgia	8	14	29	55
Moldova	26	58	na	na

Source: EBRD.
Note: The cash collection rate is the ratio of cash revenue to total billings.

Sequence of reform

Introducing the private sector into a well-regulated and, where possible, liberalised environment is an important objective but the order in which reform is implemented is also critically important.

There are no formulaic solutions and the appropriate reforms will tend to vary from country to country. For example, an institutionally more advanced country may adopt more sophisticated trading arrangements, while recourse for investors in the event of a regulatory dispute may differ according to the level of independence and integrity of the local judiciary. The following steps, based on the successful experience in England and Wales and lessons from transition countries where restructuring and privatisation has been undertaken (see discussion below on progress in reform), provide some broad parameters for power and heat reform.

- Corporatisation and commercialisation of the industry: The first step is to set up a joint-stock company wholly owned by the state, with the separation of accounts for different parts of the business. The next step is to unbundle the company into subsidiaries into which private activity can be introduced and, ultimately, provide the basis on which market liberalisation can occur.

- Regulatory authority: A regulatory authority, which is free from day-to-day political interference, needs to be established. This agency should set tariffs for those parts of the industry that remain a monopoly. This is likely to include retail tariffs as well as access charges. The agency should also develop and implement rules for network access. There will also be a need to enforce environmental, health and safety standards.

- Entry of the private sector: Before a full framework for private participation is in place (for example, regulatory and market rules are not fully developed), a limited number of concessions can be granted where there is an urgent need for rehabilitation of generation assets.[18] Once the institutional framework is in place, assets may be sold outright, and free entry of private companies into the generation sector may be permitted.

- Tariff reform: Tariffs should be raised to cover long-term costs and to reduce any cross-subsidy element, while taking care to ensure that customers can afford to pay.

- Market liberalisation: This can typically be achieved by allowing third-party access to energy networks. Generators would compete with each other to secure bilateral contracts with large consumers for the supply of power. In countries with strong institutional capacity it may also be feasible to introduce power pools. Such pools normally

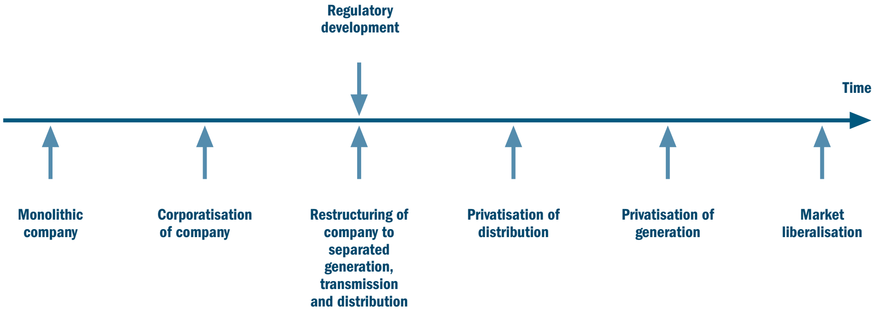
[16] For evidence on UK power sector reform, see Newbury and Pollitt (1997). Elsewhere in the world, there were over 900 private infrastructure projects worth US$ 300 billion of investment in Africa, Latin America, Asia and the transition economies between 1985 and 1995. For more information, see the World Bank Private Infrastructure Database. For evidence on restructuring in transition economies, a summary is provided in Commander, Dutz and Stern (2000). Evidence suggests that privatisation and liberalisation give the greatest impetus to industry restructuring and productivity increase. Such reform helps to eradicate corruption within the company and introduces new (commercial) skills.

[17] Effective metering is necessary for improved collection. Experience shows that people are prepared to pay for what they can be seen to consume. Furthermore, effective metering is required in order to reduce commercial losses. For example, there is evidence to demonstrate that commercial losses fall after Soviet-style meters are replaced with modern tamper-proof meters.

[18] This is with a view to limiting the amount of capacity tied up under long-term contracts at the outset of market liberalisation. See Kennedy (1999) for a discussion.

Chart 5.6

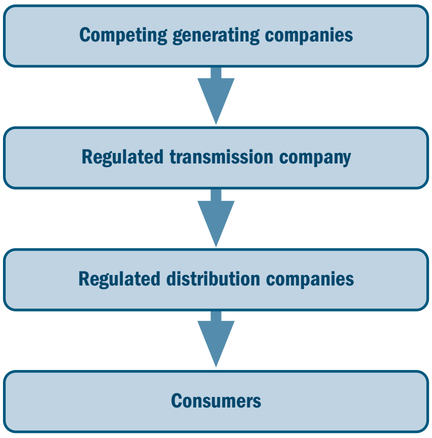
Timeline of reform in power sector



Source: EBRD.

Chart 5.7

Reformed structure for electricity market



Source: EBRD.

involve a central body taking bids for supply from generators and determining the cheapest supplier that can meet the demand for power. The central body would subsequently request the winning plant to supply the network, collect revenues from distribution companies and large consumers and make payments to generators accordingly. However, there are substantial and often prohibitive technical (for example, data, communications and software equipment) and institutional requirements to operate a pool successfully.[19] This suggests that such solutions are unlikely to be feasible in the near term in most transition countries.

With respect to the best order for these measures, it is crucial that a sound regulatory framework is in place prior to privatisation (see Chart 5.6). Furthermore, when privatisation occurs, it should involve strategic investors in order to maximise privatisation revenues, to secure finance for necessary investments and to strengthen incentives for improved efficiency. Privatisation of distribution should occur prior to privatisation of generation when payments discipline is a problem. This is because privatisation of generation when there is low cash collection is likely to attract low sale revenues and may not support necessary investments. This could in turn lead to increasing political objections to such changes.

Moreover, when cash collection remains a problem, liberalisation of markets should generally be on the basis of bilateral contracts rather than by resort to a power pool. Indeed, this is likely to be the case when institutional capacity is limited, as in the majority of transition economies. More sophisticated market mechanisms will have to be introduced only as institutional capacity improves; an aspect that is discussed with more country detail in the next section. The industry structure at the end of the reform progress is represented in Chart 5.7.

Progress in reform

An overview of the actual experience with reform in the transition countries is provided below. In particular, it highlights the pitfalls that can result from an inappropriate sequence of reform or choice of policy instruments. It focuses on three key reform areas: regulation, privatisation and the creation of energy markets.

All transition countries except Tajikistan and Turkmenistan have embarked on power sector reform through corporatisation of the industry but many countries have gone further. A notable example is Russia, which has recently adopted a power sector reform plan (see Box 5.3). Draft legislation for comprehensive sector reform is presently being finalised in Lithuania, and far-reaching reform legislation has recently been adopted in Croatia and Slovenia.

In Bulgaria and Romania, independent regulators have been established and industry restructuring is under way. In Bulgaria, industry components have been divided into separate legal entities, whereas in Romania a holding company structure has been adopted with different industry components as subsidiaries. In other countries privatisation plans are moving forward – for example, in the Czech Republic and Poland. In most countries liberalisation is also on the reform agenda although there has been little in terms of implementation, possibly due to fears that incumbent firms may fail if liberalisation proceeds.

Experience has shown that implementation is key. While many countries have drafted and adopted legislation, in few countries has this begun to function well. The lack of implementation reflects the complexities associated with institution-building. Experience in the power sector over the past decade provides some important insights into how to implement change.

In Kazakhstan and Moldova, where privatisation of the power sector has been undertaken, there are lessons to be drawn about regulation. In Hungary and Georgia there are lessons to be learned about the sequence of events leading to privatisation. And in Ukraine and Kazakhstan there are lessons to be drawn about liberalisation.

Need for regulation: lessons from Kazakhstan and Moldova

Kazakhstan moved forward with radical power sector reform through the sale of some integrated power and heat generation and distribution companies in 1996. In Moldova the main distribution company and two smaller companies were sold to a Spanish strategic investor in February 2000.

[19] See Kennedy (2001) for a discussion of alternative market rules and their suitability in a transition context.

Box 5.3

Power sector reform in Russia

The starting point for Russian power sector reform is RAO UES – a majority state-owned power company with commercial minority shareholders. The company owns the national grid, three large national generating companies and equity stakes in 33 large national generating companies. RAO UES also has majority stakes in regional energy companies (energos), which in turn own local (power and heat) generation and distribution assets. Payments discipline remains a major problem. Prices charged for energy have remained too low to support investment. Indeed, one of the main reasons for reform has been the need to secure commercial finance for required investments (estimated to be US$ 50 billion over the next ten years).

Following discussion of alternative plans, the Russian prime minister agreed to a sector reform plan in July 2001. The plan envisages that RAO UES will focus on running the national grid, with energos owning local generation and distribution companies. Separate privately owned large generators will compete in a national market for supply to regions where demand exceeds local generating capacity. The reform will involve moving RAO UES generating assets into a separate company, with a *pro rata* issue of shares to RAO UES shareholders. This will be followed by share swaps between RAO UES and minority shareholders, the former consolidating ownership in transmission and the latter in generation. The intention is that regulation will be strengthened and tariffs rebalanced (to reduce the cross-subsidy between industrial and residential consumers) and increased to cover investment costs.

The crucial factor, if sustained progress is to be achieved, will be the development of regulatory and market arrangements. Although the intention is to strengthen regulation, the reform plan is vague on how this will be achieved. The extent of the regulator's independence is not yet clear and a decision as to whether the regulator will focus only on power or on other industries as well is yet to be made. It is also unclear what form the regulatory rules (for example, the tariff-setting mechanism) and market rules will take. Although a wholesale power pool involving both generation and distribution companies is envisaged, the details of how this would function have not yet been decided. These implementation details will make the difference between success or failure in introducing competition and effective regulation.

The results of privatisation in Kazakhstan have been mixed. On the payments side, collection of payments improved substantially in each of the three privatised companies. However, tariffs have remained below cost-recovery levels throughout the country. As a result, one strategic investor made a high-profile exit from the country, a second investor has cut its investment programme, and a third investor has not been able to secure adequate finance. In the absence of further investments, it is likely that power supply interruptions will become more frequent.

Moldova has a more risky investment climate than Kazakhstan in a number of respects. Specifically, spreads on Moldovan government bonds are high relative to those in Kazakhstan, foreign direct investment is relatively low, and the track record with large-scale privatisation has been troubled. Yet Moldova was successful in the privatisation of its power company to a strategic investor that has subsequently secured finance for investment projects. In a difficult macroeconomic and political environment, power sector risk was sufficiently mitigated through institutional design to attract finance.

The difference between Moldova and Kazakhstan can be explained to a significant extent by differences in the regulatory frameworks that were adopted and implemented. The regulatory framework in Kazakhstan is weak. The regulator is not independent by any of the standard criteria. For example, the head of the office has often been replaced during cabinet reshuffles, the budget for the regulator is fixed by the government, and these factors provide scope for political influence in decision-making. Moreover, the regulator is under-resourced, with insufficient staff to carry out price reviews and investment appraisals. By contrast, in Moldova the regulator is funded by the power industry through licence fees and is appointed for a fixed term of five years.

There have also been strategic differences in the ways that prices have been regulated. In Kazakhstan a cost-plus mechanism, whereby tariffs are set to cover operating costs plus a return on capital, has been adopted. In theory this should provide adequate return for investors. In practice, the vagueness in the primary legislation governing regulation of the power sector has resulted in a set of rules under which tariffs are insufficient to support investment. This is because certain operating costs are excluded in the regulators' calculations and because permitted returns are too low.

In Moldova a price cap regulation system was adopted, under which tariffs have been set on a seven-year basis so that revenues will cover costs – including investment costs – subject to improvements in performance (for example, collection improvements and cost reductions). The mechanism specifies a power price schedule from 2000 to 2007 that is updated according to movements in inflation and the nominal exchange rate. It also takes into account differences between forecast and actual demand. Incentives to perform well are strong under this mechanism because any improvement in performance results in increased profits since prices are fixed. At a later date they may be passed on to consumers in the form of lower tariffs. Risks under the mechanism are limited and investors have a degree of certainty upon which to make investment decisions. This is particularly important in transition economies.

In recognition of the weaknesses in the Kazakhstan regulatory framework, the regulator, together with the EBRD, has worked on developing a new long-term tariff methodology. In determining the way forward, the original use of cost-plus regulation has been rejected. Instead, the regulator has endorsed a price-cap tariff mechanism on the grounds that it would provide security to investors, improve incentives for cost containment and involve relatively low resources on the part of the regulator.

In addition, the strengthening of the independence of the regulator in Kazakhstan would help to ensure that the mechanism will be implemented free from political interference. This would require fixed-term appointments for key regulatory staff, expanding the budget of the regulator, providing better justification for decisions relating to tariff-setting and investment appraisal, and allowing investors to undertake judicial process outside Kazakhstan (for example, international arbitration).[20] Although governments may be reluctant to allow international judicial recourse, failure to do this provides a negative signal to investors, and may undermine privatisation efforts.

Process of privatisation: lessons from Georgia, Hungary and Ukraine

In both Georgia and Ukraine, privatisation of generation took place either simultaneously or prior to the privatisation of distribution to strategic investors. In Ukraine a concession for a thermal power generating plant was awarded to a foreign strategic investor at a time when there had been no privatisation of the distribution companies. In the case of Georgia a large thermal generating plant was sold to a foreign strategic investor shortly after the main distribution company in the country had been privatised.

In both cases, cash collections remained a problem following privatisation. In Ukraine attempts to increase cash collections within a framework of state-owned distribution companies failed. In Georgia, although the privatised distribution company was successful in increasing cash collections, these remained low for the sector as a whole due to poor enforcement of payments discipline in the remaining state-owned distribution companies. As a result, cash flows to generating companies have been insufficient to cover costs so that investments under the concession have not gone ahead, leading to fuel shortages.

A contrasting example is Hungary, where comprehensive power sector reform began in 1994. Cash collection in the power sector has not been a problem, either before or after privatisation. Following division of the industry into generating and distribution companies and a transmission company, seven generation companies and all the distribution companies were privatised in 1997, with these privatisations involving strategic investors. As such, they were successful to the extent that they raised substantial revenue for the government, mobilised investment finance and led to improved performance of the sector.

One of the main lessons from these experiences is that when collection of payments is a problem, it is crucial to privatise distribution companies prior to moving ahead with other reforms. When there is limited cash flow, there is little to be gained from only privatising generation. In fact, failure to privatise distribution may undermine other reforms, not least by unleashing a political backlash. However, when collection is not a problem, there is no reason to delay the privatisation of generation until privatisation of distribution companies has been completed.

Establishing a market in electricity: lessons from Kazakhstan and Ukraine

Kazakhstan and Ukraine have chosen different paths for power market liberalisation against a background of poor payments discipline. In Ukraine a power pool was introduced that was not only expensive to set up but was also very institutionally demanding for the market operator. For the market to function, it would have been necessary for generators to be paid revenue to cover their costs. This did not happen because of limited cash flows in the power sector and the non-transparent manner in which these cash flows were allocated by the market operator.

At present, the market has been abandoned and supply is presently organised by the regulator, which orders generators to supply on a quota basis. The expense of setting up the market does not appear to be justified. The technical and institutional arrangements required were too demanding for Ukraine. By contrast, following the liberalisation of the power market in Kazakhstan, large customers and generators are allowed to enter into bilateral supply contracts. Market participants in Kazakhstan are paid according to their costs as specified in three-month supply contracts and these are not renewed if payments are not forthcoming.

This mechanism appears to function well by matching suppliers with paying customers. In addition, the mechanism is decentralised, and limited institutional capacity is required for it to function properly. In both these respects, the bilateral contracting model may be the most appropriate market mechanism for countries where collection of payments remains a problem and institutional capacity is limited. To the extent that customers do not contract for the whole of their consumption, arrangements to cater for residual demand are required. In this respect, a pool for residual demand – a so-called "balancing pool" – may be appropriate. A balancing pool is reasonably straightforward to set up and operate, and is currently being considered by both Kazakhstan and Ukraine.

5.5 Conclusion

Many transition countries have begun to undertake power sector reform but experience to date has been patchy. Enforcement of payments discipline has improved when the private sector has participated in distribution. However, there have been only limited improvements in performance on the cost side. Moreover, tariffs remain low, resulting in weak incentives for reducing energy consumption on the part of both households and firms. Without tariff reform, efficiency gains on the consumption side will be limited.

By lowering incentives for entry by private companies and investment, the private and environmental gains from efficiency in generation and distribution are reduced. It is clear that price reforms are essential but this can only be accomplished alongside the establishment of appropriate subsidy mechanisms for vulnerable households. Rather than rely on untargeted subsidies, a mix of lifeline tariffs and targeted cash subsidies are needed.

Price reforms will in turn require institutional changes to facilitate private sector involvement in the sector. The order in which such reforms are carried out is critical. As this chapter has shown, in countries where radical power sector reform has been undertaken, there are a number of important lessons to be learned. Experience suggests that independent regulatory authority is essential if the private sector is to be introduced successfully. Another crucial point is that

[20] See Kennedy (2001) for a discussion of regulatory reform in Kazakhstan.

distribution should be privatised first if cash collection is a problem. Other reforms, such as privatisation of generation and the introduction of sophisticated trading arrangements, are more likely to be successful once the problem of payments discipline has been addressed.

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Key reform challenges

- **Improvement of public infrastructure, including energy, water supply and transport, remains a crucial part of the government's efforts to remove obstacles to private sector development.**
- **The government must intensify efforts to fight against corruption, improve the legal framework for credit provisioning, and reduce bureaucratic hurdles in order to foster further domestic and foreign investment.**
- **Successful privatisation of strategic utilities in the telecommunications and energy sectors and of the state savings bank would strengthen competition and boost performance in these sectors.**

Liberalisation

Albania recommended for Stabilisation and Association Agreement negotiations. In June 2001 the European Commission (EC) recommended that negotiations begin with Albania on a Stabilisation and Association Agreement (SAA). In addition to general political and economic criteria, an SAA would contain obligations on sector and policy-specific issues such as political dialogue, regional cooperation, free movement of goods and labour, approximation and enforcement of legislation, justice and home affairs and cooperation policies. These negotiations should help the country to consolidate recent political and economic reforms. The European Council invited the Commission to present the draft negotiating directives for the negotiation of an SAA with Albania. The EC is expected to present such a mandate for negotiations before the end of the year and, following its approval by the Council, the negotiations may start in spring 2002.

Foreign trade has been further liberalised. Significant improvements in tax collection and efficiency of customs administration in 2000 allowed for further liberalisation of the foreign trade regime. As of January 2001, the maximum and minimum tariff rates on goods were reduced from 18 to 15 per cent and from 5 to 2 per cent respectively. These reductions have decreased the average duty paid during the first half of 2001 to 7.7 per cent from 10.6 per cent in the same period of 2000.

Stabilisation

Tax revenues and customs administration have improved. The government has strengthened its efforts to enhance valuation procedures and to combat smuggling, corruption and evasion. As a result, tax revenue collection in 2000 was about 25 per cent higher than in 1999, reaching 19.3 per cent of GDP. This is the highest ratio of government revenue to GDP achieved since 1994. At the same time, the profit tax rate was reduced to 25 per cent at the beginning of 2001 from 30 per cent. The tax base for payers of corporate tax is expected to rise from 42,000 to 50,000 entities in 2001.

Privatisation

Large-scale privatisation gathers momentum. The privatisation of five medium-sized state-owned companies (a brewery, winery, dairy factory, pharmaceutical factory and cement factory) was successfully concluded in the first half of 2001 through tender sales, mostly to foreign investors. The government is now concentrating on larger enterprises and utilities. In preparation for its privatisation, the state oil company, Albpetrol, has been split into three companies: Albanian Petroleum Company (oil and natural gas extraction), Albanian Refining and Marketing Oil (ARMO, refining) and Servcom (petroleum distribution). Servcom was offered for sale in September 2001 and the privatisation of those parts that operate service stations is nearly complete. Progress is also being made with privatisation of ARMO. The company is being restructured by removing some non-strategic parts of refining, sales and distribution, which are separately being sold or given on lease. Its privatisation is expected to begin by the end of 2001. INSIG, the state-owned insurance company, is scheduled to be privatised in 2002.

Land registration slows, but a land market is developing. The official registration of private agricultural land, begun in 1998, is taking longer than expected. The pace of progress in land registration has slowed as the more remote areas are tackled. Completion is now expected in 2002, after which land tax will be collected from the country's 400,000 farmers. In addition, the distribution of ownership and issue of titles with respect to agricultural land is almost complete. By the start of 2001, 98.4 per cent (579,250 hectares) of agricultural land had been distributed to private ownership and titles issued with respect to 564,000 hectares. As a consequence, a market in land is developing, with more than 40,000 transactions in the period 1998 to 2000 for the sale or lease of agricultural property.

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 — Large influx of refugees from Kosovo

2000
- Sep — Accession to WTO
- Sep — Indirect monetary policy instruments adopted

Enterprise reform

Obstacles to private sector development are gradually removed. The investment climate and enterprise performance have improved steadily since the crisis of 1997. In 2000, FDI inflows increased threefold from that in 1999, reaching US$ 143 million. These inflows have been attracted by opportunities presented by the privatisation of medium-sized enterprises, banks and telecommunications companies. Nevertheless, private enterprises

Enterprises, infrastructure, finance and social reforms

1992
Apr Two-tier 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 Pyramids placed under international administration

1998
Mar State-owned Rural Commercial Bank closed
Jul Banking law amended

1999
May Capital adequacy ratio raised to 12 per cent
Nov Credit ceilings lifted for private banks

2000
Jan Secured transaction law enacted
Jun National Commercial Bank sold to foreign investor
Jul Mobile telecommunications company sold to foreign investor

2001
Feb Second mobile licence awarded to foreign investor

still encounter many obstacles to their development, including corruption, inadequacies in the legal framework, the cost of protecting private property and poor quality infrastructure. Further progress is being made to improve the legal framework and to stimulate domestic and foreign investments. A collateral registry for movable property started operating in January 2001. An agency that will provide "one-stop" facilities for investors and a credit information bureau are intended to be launched in 2001 and 2002, respectively. The law on offices for the execution of court decisions was approved in January 2001 and laws on bankruptcy and mediation of business disputes are also expected to be approved before the end of the year.

Infrastructure

Efforts to restructure the energy sector have intensified.
The government has intensified its efforts to restructure the state-owned energy company, KESH, with management assistance from the Italian company ENEL. In December 2000 an agreement was reached with the World Bank on a strategy for the electricity sector that includes specific quantitative targets for improving the main indicators of KESH's performance. As part of the effort to reduce electricity shortages, a two-tier tariff structure will be adopted in October 2001 in order to reduce excessive demand for electricity for heating purposes and still protect the most vulnerable. As a result of strong actions against electricity theft and assisted by increased penalties for non-payment, the company is gradually being brought back to profitability. However, the privatisation of KESH, originally intended for 2001, has been postponed.

A second mobile telephone licence has been awarded ...
Vodafone-Panafon won the tender for a second GSM licence with US$ 38 million in February 2001 and began operations in August. This has led to increased competition in the sector. In June 2001 the Albanian Mobile Communications (AMC), the existing GSM operator owned by a consortium of Telenor of Norway and Cosmote of Greece, lowered its subscription rates and call charges by 20 per cent, while the fixed-line monopoly, Albtelecom, lowered phone calls and internet use tariffs by 30 per cent in September 2001.

... and the fixed-line telecommunications monopoly is to be privatised.
The privatisation of the fixed-line state telecommunications monopoly, Albtelecom, is under way and is expected to be completed by the end of 2001. According to the amended law on its privatisation adopted in May 2001, a strategic investor will be sought for a controlling share of between 51 and 76 per cent. Albtelecom's monopoly of fixed-line services is to end in January 2003, in line with WTO requirements.

Transport infrastructure is being improved.
In June 2001 the construction of the four-lane, 29 kilometre Tirana-Durres highway, which was begun eight years ago as part of the EU-sponsored east-west transport corridor, was completed. Seven transport infrastructure projects funded under the Stability Pact for South-Eastern Europe had been delayed due to property expropriation issues, but work on most of these projects started by March 2001.

Financial institutions

Privatisation of the last state-owned bank advances.
The opening of an international tender for the privatisation of the largest bank in the country, the Savings Bank, was announced at the end of June 2001. A privatisation advisor was appointed last year and the bank was fully recapitalised by the government through treasury bills (estimated at Lek 17.4 billion, about 5 per cent of GDP) at the end of 2000. The bank's bad loan portfolio was transferred to the bad loan agency in March 2001. It is expected that a share of between 35 and 49 per cent will be sold to a foreign bank or consortium of banks and that a 24 per cent share will be sold to local investors. The winner of the tender is expected to be selected by the middle of 2002.

Bank intermediation is increasing.
The central bank eased monetary policy by removing the minimum interest rate on three-month deposits in September 2000 and by extending direct credit to the budget and purchasing foreign currency privatisation receipts. The subsequent decrease in the treasury bill rate and other interest rates as well as improvements in the investment climate have contributed to higher private sector credit growth during 2000, especially in the construction and housing sectors. Total credit to the private sector increased by 32 per cent relative to 1999, albeit from a low level. The central bank has also drafted a law on deposit insurance which is expected to be approved soon by parliament.

Social reform

Health and education are government priorities ...
The government's Medium Term Expenditure Framework, prepared with assistance from the World Bank, places a strong emphasis on health care and education. Key priorities include better access to primary health care and family doctors, construction of new schools and more training for teachers. Spending on education is expected to reach 3.2 per cent of GDP, and on health 2.7 per cent of GDP, in 2001. A poverty assessment and rural development strategy is also being prepared in cooperation with the World Bank.

... and pensions have increased.
As of July 2001, the pensions of over 500,000 Albanian pensioners were increased by 8 per cent for those who live in towns and by 30 per cent for those in rural areas. The strategy to increase pensions in rural areas aims to equalise them with those in the cities within a few years. Measures to narrow the gap for rural inhabitants between contributions and benefits are also envisaged; the gap should diminish as farm incomes improve.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **19.3 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **vouchers**
Tradability of land – **limited de facto**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes** [1]
Separation of railway accounts – **no**
Independent electricity regulator – **yes** [1]

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **no**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **58.6 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
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	10.0	10.0	10.0	10.0	10.0	10.0	10.0	na
Share of trade with non-transition countries (in per cent)	na	na	na	na	na	na	95.6	96.3	95.2
Share of trade in GDP (in per cent)	95.3	60.1	38.4	35.8	42.9	37.3	33.8	38.1	35.3
Tariff revenues (in per cent of imports)	3.5	5.7	10.9	9.9	8.0	8.7	10.1	7.4	9.1
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	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	1.1	1.8	3.0	3.1	3.3	3.6	3.6	3.9	7.0
Private sector share in GDP (in per cent)	10.0	40.0	50.0	60.0	75.0	75.0	75.0	75.0	75.0
Private sector share in employment (in per cent)	3.8	58.5	69.8	74.1	78.6	79.6	80.4	81.1	82.2
EBRD index of small-scale privatisation	2.0	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	1.0	2.0	2.0	2.0	2.0	2.0	2.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	8.0	1.9	1.2	0.6	0.4	0.5	0.5	0.5	0.5
Effective statutory social security tax (in per cent)	na	na	na	na	na	37.3	na	na	32.5
Share of industry in total employment (in per cent)	na	na	10.2	8.3	7.6	8.0	7.8	5.7	5.5
Change in labour productivity in industry (in per cent)	na	na	na	23.8	26.5	-8.8	9.0	na	9.7
Investment rate/GDP (in per cent)	5.2	13.2	17.9	18.0	15.5	16.0	16.0	16.8	19.0
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	1.7	1.7	1.7	1.7	1.7
Infrastructure									
Main telephone lines per 100 inhabitants	1.3	1.3	1.4	1.3	1.9	2.3	3.1	3.7	5.1
Railway labour productivity (1989=100)	34.0	33.7	33.6	33.3	37.6	21.4	28.5	32.1	34.9
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	na	4.8 (91)	4.3 (84)	3.0 (72)	3.2 (70)	3.5 (58)	na
Electricity consumption/GDP (1989=100)	120.9	131.9	79.7	78.5	96.6	86.1	78.8	85.4	78.1
EBRD index of infrastructure reform	na	na	na	na	na	na	1.8	1.8	2.5
Financial institutions									
Number of banks (of which foreign owned) [2]	na	na	6 (3)	6 (3)	8 (3)	9 (3)	10 (8)	13 (11)	13 (12)
Asset share of state-owned banks (in per cent)	na	na	97.8	94.5	93.7	89.9	85.6	81.1	64.8
Non-performing loans (in per cent of total loans) [3]	na	na	na	34.9	40.1	91.3	35.4	32.7	42.6
Domestic credit to private sector (in per cent of GDP)	na	na	3.9	3.6	3.9	3.8	0.6	2.0	3.0
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	1.3	2.0	2.0	2.0	2.0	2.0	2.0	2.3
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.7	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	2.0	2.0	2.0	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	2.0	2.0	1.7	1.7
Social sector									
Expenditures on health and education (in per cent of GDP)	na	na	na	na	na	na	na	5.1	6.1
Life expectancy at birth, total (years)	71.3	71.3	72.5	71.3	71.7	71.7	71.9	72.0	72.1
Basic school enrolment ratio (in per cent)	85.9	86.6	87.6	na	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] Includes branches of foreign banks.

[3] Includes loans of banks under forced administration.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	9.6	8.3	13.3	9.1	-7.0	8.0	7.3	7.8	7.0
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed investment	na	na	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	-10.0	-2.0	6.0	13.6	-5.6	4.1	6.4	5.0	na
Agricultural gross output	10.4	8.3	13.2	3.0	1.0	5.0	3.7	4.5	na
Employment				(Percentage change)					
Labour force (annual average)	0.4	1.3	1.8	1.8	-23.6	1.5	-1.1	-1.8	na
Employment (annual average)	-3.2	9.7	5.7	-2.5	-0.8	-2.0	-0.4	-1.3	na
				(In per cent of labour force)					
Unemployment (annual average) [1]	24.8	16.1	13.9	9.3	14.9	17.8	18.0	16.8	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	85.0	22.6	7.8	12.7	33.2	20.6	0.4	0.1	3.5
Consumer prices (end-year)	30.9	15.8	6.0	17.4	42.1	8.7	-1.0	4.2	3.8
Producer prices (annual average)	na	na	na	na	na	na	na	na	na
Producer prices (end-year)	na	na	na	na	na	na	na	na	na
Gross average monthly earnings in economy (annual average)	64.6	46.9	25.6	20.0	0.0	26.1	-0.3	14.3	na
Government sector [2]				(In per cent of GDP)					
General government balance	-15.5	-12.6	-10.1	-12.1	-12.6	-10.4	-11.4	-9.1	-9.2
General government expenditure	40.4	36.4	33.4	30.3	29.4	30.7	32.7	31.4	na
General government debt	na	na	na	na	68.9	60.1	62.2	71.5	72.6
Monetary sector				(Percentage change)					
Broad money (M3, end-year)	75.0	40.6	51.8	43.8	28.5	20.6	22.3	12.1	na
Domestic credit (end-year)	152.6	17.8	-10.0	48.1	43.0	13.2	12.3	39.0	na
				(In per cent of GDP)					
Broad money (M3, end-year)	40.2	38.4	46.8	55.0	58.1	52.0	57.9	60.9	na
Interest and exchange rates				(In per cent per annum, end-year)					
Refinancing rate	34.0	25.0	20.5	24.0	32.0	22.9	17.8	10.8	na
Treasury bill rate (3-month maturity)	na	10.0	14.7	21.1	35.3	19.9	14.8	7.8	na
Deposit rate (1 year) [3]	23.0	16.5	13.7	19.1	28.5	16.5	9.1	7.7	na
Lending rate (1 year) [4]	30.0	20.0	21.0	28.8	43.0	25.0	25.8	23.7	na
				(Leks per US dollar)					
Exchange rate (end-year)	100.9	95.0	94.5	103.7	149.8	141.4	135.2	142.6	na
Exchange rate (annual average)	105.6	95.4	93.0	104.8	149.6	151.2	138.1	143.7	na
External sector				(In millions of US dollars)					
Current account	-357	-279	-177	-245	-276	-186	-265	-260	-308
Trade balance	-490	-460	-475	-692	-518	-621	-846	-814	-912
Merchandise exports	112	141	205	229	167	205	275	256	276
Merchandise imports	602	601	680	921	685	826	1,121	1,070	1,188
Foreign direct investment, net	45	65	89	97	42	45	51	141	207
Gross reserves (end-year), excluding gold	147	204	240	275	306	384	485	608	na
External debt stock	936	1,012	683	732	757	874	975	1,033	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	2.3	2.9	2.7	4.0	3.8	4.2	4.9	4.4	na
				(In per cent of exports of goods and services)					
Debt service	16.9	19.7	2.5	6.0	6.1	6.2	2.8	3.3	na
Memorandum items				(Denominations as indicated)					
Population (annual average, millions)	3.2	3.2	3.2	3.3	3.4	3.4	3.4	3.4	na
GDP (in millions of lek)	125,334	184,393	229,793	280,998	341,716	460,631	506,200	539,210	597,018
GDP per capita (in US dollars)	375	604	761	817	681	903	1,078	1,094	na
Share of industry in GDP (in per cent)	13.9	12.5	11.7	12.2	12.4	11.9	11.9	11.5	na
Share of agriculture in GDP (in per cent)	54.6	54.6	54.6	51.5	56.0	54.4	52.6	51.0	na
Current account/GDP (in per cent)	-30.1	-14.4	-7.2	-9.1	-12.1	-6.1	-7.2	-6.9	-7.5
External debt - reserves, in US$ millions	789	808	443	457	451	490	490	425	na
External debt/GDP (in per cent)	78.9	52.4	27.6	27.3	33.1	28.7	26.6	27.5	na
External debt/exports of goods (in per cent)	838.7	459.2	224.9	204.4	328.0	299.8	179.1	146.7	na

[1] Figures do not account for emigrant workers abroad who accounted for an estimated 18 per cent of the total labour force in 1995.

[2] General government includes the state, municipalities and extra-budgetary 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 one-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 one-year loans by commercial banks.

Armenia

Key reform challenges

- **A difficult investment climate and poor integration in regional markets remain the main obstacles to sustained, private sector-led growth; lower administrative barriers and consistent application of rules and regulations are needed to boost investor confidence.**
- **Recent improvements in tax collection must be sustained to lower the fiscal deficit, which together with increased private saving and improved export competitiveness are key to reducing external imbalances.**
- **The effort to reform the state-owned utilities should continue, including a renewed attempt to privatise electricity distribution.**

Liberalisation

Council of Europe membership is gained, but WTO accession is delayed.
In January 2001 Armenia became a member of the Council of Europe. Membership should strengthen Armenia's integration with Europe and help to strengthen its democratic and human rights record. Armenia was admitted to the Council at the same time as Azerbaijan, with the expectation that membership of the Council can help both countries to find a peaceful solution to the Nagorno-Karabakh conflict. The resolution of this issue is crucial for Armenia if it is to overcome its regional isolation and re-establish regional trade links. The long-awaited accession to the WTO, however, has been delayed as discussions on domestic support for agriculture continue.

Stabilisation

Fiscal management improves ...
In the first five months of 2001 state budget revenues were up 20 per cent compared with the same period in 2000, and for the first time in recent years revenue collection was on target at mid-year. Changes to the tax code and to the administration of tax policy are thought to lie behind the marked improvement. Maintaining this progress would allow the government to reduce its borrowing requirement, ease the budget constraint on some core government programmes and reduce the backlog of arrears without jeopardising fiscal stability. The central bank continues to pursue a cautious monetary policy, which has created a low-inflation environment and has kept the exchange rate relatively stable.

... but the current account deficit remains high.
For many years Armenia has recorded one of the highest current account deficits in the region. Efforts to reduce external imbalances are only slowly bearing fruit. In 2000 the deficit amounted to 14.5 per cent of GDP and official projections forecast a similar result for 2001. A large part of the deficit is financed by transfers and remittances from the Armenian diaspora, but the country also depends on other sources of finance, in particular the IMF and the World Bank. In mid-2001 Armenia's external debt stood at US$ 860 million, similar to the level a year earlier. In net present value terms, it was close to the threshold of 150 per cent of exports used by the IMF and the World Bank to assess debt sustainability. To reduce external imbalances, Armenia needs to increase domestic saving and improve export competitiveness. The country has a relatively open trade regime, but poor transport links, high transaction costs and the lack of trade relations with Turkey and Azerbaijan because of the Nagorno-Karabakh conflict all hamper exports. In 2000 exports amounted to only 15.5 per cent of GDP, but they increased significantly in the first half of 2001.

Privatisation

Privatisation advances despite political divisions and reluctant investors.
Since 1995 Armenia has privatised almost 7,000 small companies and over 1,500 medium-sized and large enterprises, most of them during the early period of mass privatisation. In a push to conclude the privatisation programme, parliament recently approved a final list of over 900 enterprises to be privatised over the next three years. The list includes strategic mining, metallurgical and energy assets. However, domestic political divisions over privatisation have widened and this has dampened the interest of foreign investors, many of whom were already concerned about Armenia's poor investment climate. Nevertheless, seven of the 14 larger companies included in the 2001 programme have been sold, including the Yerevan Jewellery Factory and the Hrazdan cement plant. Bidding or negotiations with strategic investors are ongoing for most others, including the Ararat cement plant, the electronics company Mars and gold producer Armgold.

Enterprise reform

A simplified tax code helps, but the investment climate remains difficult.
The government has stepped up its effort to reduce tax evasion and stimulate growth by streamlining the tax system and reducing the overall tax burden. In December 2000 parliament approved a new tax code, which replaced corporate taxation on a progressive scale with a 20 per cent flat rate for larger businesses. Measures to simplify the tax code for small enterprises had already come into force in July 2000. To combat corruption, which is seen as endemic by many investors, the government has formed a high-level commission, chaired by the prime minister, to tackle bribery and corruption, reform the civil service and increase the transparency of administrative procedures. A new financial disclosure law has recently been enacted and the government has agreed to a comprehensive plan to improve the overall investment climate. Implementation has, however, been slow

Liberalisation, stabilisation, privatisation

1991
- Jan — Land reform begins
- May — Small-scale privatisation begins
- Sep — Independence from Soviet Union

1992
- Jan — VAT introduced
- Jan — Foreign trade registration abolished
- Aug — Privatisation law adopted

1993
- Nov — New currency (dram) introduced

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
- Dec — New law on simplified tax

2001
- Jan — New customs code in force
- Jan — Council of Europe membership
- Jul — New privatisation programme approved

Enterprises, infrastructure, finance and social reforms

1992

Dec Central bank law adopted

1993

May Stock exchange established

1995

May Bankruptcy law adopted
Jun Foreign bank ownership allowed
Sep Banking crisis peaked

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 Yerevan water utility transferred to private management
Dec New competition law adopted

2001

Jul Bank capital requirements raised

with respect to both initiatives, and entrepreneurs continue to complain about the lack of transparency in the regulatory system, cumbersome administrative procedures and uneven application of the rule of law.

Restructuring of the industrial sector remains slow.
Over the first seven months of 2001 industrial output grew by 8.7 per cent compared with the same period in 2000. Growth in the first quarter was partly due to a base effect – the political uncertainty associated with the October 1999 assassinations had the strongest impact on output in early 2000 – and an increase in production in a small number of large companies. In the second quarter, output was affected by a reduction in gas supplies because of payment arrears. The episode is symptomatic of an industrial sector that remains slow to restructure. Many enterprises, in particular larger firms, owe their continued survival to tax and energy arrears and ineffective bankruptcy enforcement.

A new law to improve competition.
After two years of preparation, a new law on competition policy came into force in December 2000. Prepared with technical assistance from the EU, the law seeks to bring Armenian competition policy in line with EU rules. It covers all aspects of competition policy, including unfair competition, abuse of market power, anti-competitive behaviour, and rules on mergers and acquisitions. The cornerstone of the law is the establishment of an independent, seven-member Competition Commission. Secondary legislation, including the statute of the Competition Commission, is currently under preparation.

Infrastructure

Renewed efforts to privatise electricity distribution follow a failed tender.
Armenia's attempt to privatise its four electricity distribution companies foundered in April 2001 when an international tender failed to attract bids. The privatisation, which took two years to prepare and was the subject of a fierce internal debate, had repeatedly been delayed. In the event, international investors shied away from a deal they increasingly saw as risky and unattractive as terms had to be amended to appease critics. The need for reform in the energy sector remains urgent and the authorities are committed to the privatisation of the distribution companies. The law governing a renewed privatisation attempt under revised terms was ratified in August 2001 and, assuming there is sufficient private sector interest, the sale of the four companies is expected by March 2002. Preparations for the privatisation of some of the power generation assets also continue.

Controversy continues in the telecommunications sector.
The decision by Armentel, the national telecommunications operator controlled by the Greek company OTE, to raise telephone charges and abandon flat tariffs for local calls, has sparked renewed controversy. The authorities have made their assent contingent on a renewed commitment by OTE to invest US$ 300 million into the system by 2006. Disagreements over the level of investment undertaken by OTE have marred the relationship between the company and the government ever since OTE took over Armentel in December 1997. The 15-year exclusivity enjoyed by Armentel is also still the subject of negotiations. Armentel's profits dropped by almost 50 per cent in 2000 and in May 2001 its senior management was changed for the fifth time in four years.

Financial institutions

Savings Bank has been sold.
Following a long debate about the best strategic direction for the Armenian Savings Bank, the last fully state-owned bank, it was finally put up for sale at the end of 2000. It has the largest customer base and branch network of all Armenian banks but, as the privatisation advisors have attested, is in urgent need of restructuring. An initial request for expressions of interest showed only limited appetite from strategic investors, and instead of a tender the government decided on a direct sale to a group of Armenian investors with only limited banking experience. The banking sector remains small. At the beginning of 2001 the total capitalisation of the Armenian banking system was US$ 61 million and it has since fallen significantly. To increase financial stability and accelerate consolidation in the fragmented sector, minimum capital requirements were increased to US$ 1.3 million in July 2001, and will be further increased to US$ 1.7 million in July 2002.

Social reform

New strategy for poverty reduction adopted.
In the context of negotiations with the World Bank and the IMF, the government has developed a new strategy to reduce poverty. An estimated 55 per cent of the population currently live below the national poverty line, with an estimated 23 per cent in extreme poverty. In addition to measures to boost growth and improve state governance, the programme includes targets for social protection. A first stage of pension reform, including the introduction of an identification code system, is to be completed this year. The system of mandatory social security payments was simplified in the context of income tax reform so that personal income tax and social security contributions are now paid at a combined flat rate of 28 per cent. The restructuring of the State Fund for Social Insurance is also expected this year and should increase the timelines of pension payments. The authorities are also stepping up efforts to improve the targeting of state assistance programmes and to reform health care financing; the latter includes steps towards the introduction of a viable health insurance system.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **17.7 per cent**
Exchange rate regime – **floating** [1]

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **MEBO**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty [2] – **86.2 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	na	8.9	12.8	6.2	7.7	7.0	7.0	9.3	na
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	2.0	2.0	1.0	1.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	na	na	34.3	52.4	55.5	55.4	60.0	62.0	78.4
Share of trade in GDP (in per cent)	97.0	87.7	94.0	73.4	65.8	62.7	54.7	52.5	56.5
Tariff revenues (in per cent of imports)	0.2	6.1	0.7	1.0	1.9	2.7	2.8	2.1	2.1
EBRD index of price liberalisation	2.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of forex and trade liberalisation	2.0	2.0	2.0	3.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	na	3.3	3.4	3.4	3.4	3.4	5.6	6.7	8.8
Private sector share in GDP (in per cent)	35.0	40.0	40.0	45.0	50.0	55.0	60.0	60.0	60.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	2.0	2.0	2.3	2.7	3.0	3.0	3.3	3.3	3.3
EBRD index of large-scale privatisation	1.0	1.0	1.0	2.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	12.8	0.9	0.1	0.6	0.1	na	na
Effective statutory social security tax (in per cent)	74.4	na	12.9	19.1	19.3	na	na	na	na
Share of industry in total employment (in per cent)	25.7	23.5	23.9	20.5	17.8	16.7	15.7	15.0	14.3
Change in labour productivity in industry (in per cent)	-41.4	0.3	7.5	19.0	20.4	12.4	6.6	12.9	13.2
Investment rate/GDP (in per cent)	17.1	12.5	20.2	16.2	17.9	16.2	17.2	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	1.0	1.0	1.0	1.0
Infrastructure									
Main telephone lines per 100 inhabitants	15.7	15.6	15.6	15.5	15.4	15.0	15.7	15.7	na
Railway labour productivity (1989=100)	42.7	28.8	26.3	20.3	16.9	19.9	19.0	14.0	16.1
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	0.4 (na)	1.5 (na)	2.2 (76)	3.3 (80)	4.9 (87)	4.7 (88)	na
Electricity consumption/GDP (1989=100)	142.1	92.6	75.0	69.1	74.6	89.1	77.2	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.1	2.3	2.5
Financial institutions									
Number of banks (of which foreign owned)	na	na	41 (1)	35 (3)	33 (4)	30 (4)	31 (10)	32 (11)	31 (11)
Asset share of state-owned banks (in per cent)	na	na	1.9	2.4	3.2	3.4	3.7	2.4	2.6
Non-performing loans (in per cent of total loans)	na	na	34.0	36.1	22.6	7.9	10.4	4.3	6.2
Domestic credit to private sector (in per cent of GDP)	na	na	na	na	na	na	na	5.9	7.5
Stock market capitalisation (in per cent of GDP)	na	na	na	na	0.2	1.0	1.0	1.3	0.8
EBRD index of banking sector reform	1.0	1.0	1.0	2.0	2.0	2.3	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	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	3.0	4.0	3.7	3.7
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	3.0	3.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	11.7	7.8	3.4	4.4	3.4	3.1	3.5	3.6	3.7
Life expectancy at birth, total (years)	71.5	71.1	71.4	72.3	72.7	73.7	74.4	74.5	74.5
Basic school enrolment ratio (in per cent)	88.7	84.6	81.3	81.1	82.4	82.4	83.2	na	na
Earnings inequality (GINI-coefficient)	35.5	36.6	32.1	38.1	na	na	na	na	na

[1] Rare interventions but no explicit exchange rate target.

[2] Based on an international poverty line. The poverty rate based on the national poverty line is 55 per cent.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	-8.8	5.4	6.9	5.9	3.3	7.2	3.3	6.0	6.0
Private consumption	-26.3	5.2	9.0	3.8	7.3	5.3	0.4	na	na
Public consumption	2.2	-3.2	0.2	-2.4	-2.3	-2.2	-0.6	na	na
Gross fixed investment	-7.8	44.9	-17.3	10.3	2.1	12.0	0.5	na	na
Exports of goods and services	na	na	-7.8	-9.7	28.9	-34.0	5.9	na	na
Imports of good and services	na	na	-10.3	-5.5	24.4	-6.7	-11.2	na	na
Industrial gross output	-10.3	5.3	1.5	1.4	0.9	-2.5	5.2	6.4	na
Agricultural gross output	-18.5	3.2	4.7	1.8	-5.9	13.1	1.3	-2.3	na
Employment				(Percentage change)					
Labour force (annual average)	1.4	-2.2	-0.7	-0.9	-2.5	-2.4	0.6	-4.2	na
Employment (annual average)	-2.2	-3.6	-0.8	-2.8	-4.4	-3.7	-2.9	-1.2	na
				(In per cent of labour force)					
Unemployment (end-year) [1]	6.3	5.8	8.3	10.1	11.2	8.9	11.6	10.9	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	3,731.8	5,273.4	176.7	18.8	13.8	8.7	0.7	-0.8	3.1
Consumer prices (end-year)	10,896.0	1,884.5	31.9	5.8	21.8	-1.3	2.1	0.4	2.6
Producer prices (annual average)	na	na	na	17.8	19.2	15.0	2.9	-1.8	na
Producer prices (end-year)	na	na	228.6	30.3	22.1	14.7	5.9	-0.4	na
Gross average monthly earnings in economy (annual average)	751.0	2,726.9	243.6	45.7	37.8	30.3	21.8	12.0	na
Government sector [2]				(In per cent of GDP)					
General government balance	-54.7	-16.5	-11.0	-9.3	-4.6	-3.7	-5.2	-4.9	-4.8
General government expenditure	82.9	44.1	28.8	24.4	21.1	22.2	25.5	21.6	na
General government debt	na	na	na	na	na	na	na	na	na
Monetary sector				(Percentage change)					
Broad money (M3, end-year)	1,072.2	737.1	68.9	32.8	28.7	36.0	13.6	38.7	12.9
Domestic credit (end-year)	910.5	1,510.6	68.0	27.8	6.3	62.4	4.2	na	na
				(In per cent of GDP)					
Broad money (M3, end-year)	68.2	13.0	7.9	8.3	8.7	10.0	11.0	14.6	na
Interest and exchange rates				(In per cent per annum, end-year)					
Refinancing rate	210.0	210.0	52.0	60.0	60.5	50.3	47.0	19.0	na
Money market rate [3]	na	na	38.8	41.4	54.5	45.3	52.0	23.6	na
Deposit rate [4]	na	na	63.2	32.2	30.0	25.9	23.8	16.4	na
Lending rate [4]	na	na	77.3	59.1	62.3	54.1	44.0	29.5	na
				(Drams per US dollar)					
Exchange rate (end-year)	75.0	405.5	402.0	435.1	495.0	522.0	523.8	552.2	na
Exchange rate (annual average)	9.1	288.7	405.9	414.0	490.8	504.9	535.1	539.5	na
External sector				(In millions of US dollars)					
Current account	-67	-104	-218	-291	-307	-403	-307	-278	-294
Trade balance	-98	-178	-403	-469	-559	-578	-474	-467	-492
Merchandise exports	156	215	271	290	234	229	247	307	356
Merchandise imports	254	394	674	760	793	806	721	774	848
Foreign direct investment, net	1	8	25	18	52	221	122	104	na
Gross reserves (end-year), excluding gold	14	32	100	156	229	315	319	305	na
External debt stock	121	200	382	584	757	787	855	862	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	0.6	0.9	1.6	2.1	2.9	3.8	4.2	3.8	3.6
				(In per cent of export of goods and services)					
Debt service	na	3.4	20.9	20.3	14.2	19.0	14.3	10.6	na
Memorandum items				(Denominations as indicated)					
Population (end-year, millions) [5]	3.7	3.8	3.8	3.8	3.8	3.8	3.8	3.8	na
GDP (in billions of drams)	4.3	187.1	522.3	661.2	804.3	955.4	987.1	1,032.5	1,128.8
GDP per capita (in US dollars)	125.2	172.7	341.6	422.4	432.2	498.2	485.5	503.6	na
Share of industry in GDP (in per cent)	30.7	25.6	24.3	23.4	22.5	19.9	21.0	22.0	na
Share of agriculture in GDP (in per cent)	46.3	37.0	38.7	34.8	29.4	30.8	26.2	22.5	na
Current account/GDP (in per cent)	-14.3	-16.0	-17.0	-18.2	-18.7	-21.3	-16.6	-14.5	-14.3
External debt - reserves, in US$ millions	107.4	167.9	282.2	428.2	528.0	471.7	536.4	557.4	na
External debt/GDP (in per cent)	25.8	30.9	29.7	36.6	46.2	41.6	46.3	45.0	na
External debt/exports of goods and services (in per cent)	69.8	87.4	127.5	158.6	229.1	218.8	223.1	194.4	na

[1] Registered unemployment. Unofficial estimates indicate substantially higher unemployment.
[2] Consolidated accounts of the Republican government and the local authorities.
[3] Average of one-three month Treasury bills.
[4] Weighted average rate for maturities of 15 days to less than one year.
[5] Official (*de jure*) population. Actual population may be significantly lower, as official emigration data are incomplete.

Azerbaijan

Key reform challenges

- **A record of prudent management of Oil Fund resources, combined with an improved investment climate and supported by increased financial intermediation, will be necessary for a more balanced development of the non-oil and gas sectors of the economy.**
- **More effective implementation of the second privatisation programme should be a priority to support private sector development.**
- **Tackling the problem of the quasi-fiscal deficit in the energy sector will require commitment to the adoption of a new regulatory framework, including tariff and subsidy changes, and to the restructuring and privatisation of key enterprises.**

Liberalisation

Commitment is made to a more liberal trade and foreign exchange regime.
The new customs tariff code, introduced in early 2001, maintains the 15 per cent maximum tariff for most products, but includes a 0.5 per cent tariff rate for previously zero-rated goods. All *ad hoc* tariff exemptions have been eliminated and specific tariffs have replaced *ad valorem* tariffs on selected goods to address under-invoicing. The authorities are committed to reducing the weighted-average tariff from the current 7.9 per cent to 6.5 per cent over the next three years, with a uniform rate applicable to all goods subject to non-zero tariffs. The government is also engaged in intensive preparatory work for accession to the WTO. Azerbaijan's exchange system is liberal, and the authorities are expected to accept the obligations of Article VIII of the IMF's Articles of Agreement before the end of 2001.

Stabilisation

Guidelines for the management of Oil Fund assets are established.
A presidential decree has been issued on policy guidelines to ensure that Oil Fund assets are managed prudently, that they will not be used for loans or loan guarantees, and that information about investments based on annual audits will be made public. The Oil Fund will invest mainly in overseas assets to preserve mineral wealth for future generations, with only interest earnings being made available to support government expenditures. Although the Oil Fund and state budgets are not formally integrated, the authorities have agreed that both will be prepared in close coordination in future, and expenditures of the Oil Fund will be executed through the Treasury. These decisions on the Oil Fund were an important element underpinning the recent approval of a new three-year IMF programme and an upgrade of Azerbaijan's long-term foreign debt rating.

Structural weaknesses within public finances are being addressed slowly.
The ratio of tax revenues to GDP is low by regional standards and total tax arrears, excluding penalties, amount to 20 per cent of GDP. Tax and fiscal administration reform should help bolster public revenues through improved transparency and clarity, notwithstanding the fact that the 2001 tax code reduces the VAT rate from 20 to 18 per cent. The practice of setting targets for tax and social protection fund payments by large state enterprises has been replaced with the requirement that all taxpayers pay taxes based on their legal obligations. At the same time, management of fiscal expenditures has been improved, with progress in implementing a single treasury account and in developing a new expenditure monitoring system. To address the problem of tax arrears, the authorities will oversee the cash flow of the largest taxpaying state-owned enterprises. SOCAR, the state-owned oil company responsible for most of the tax arrears, will be given a tax credit for quasi-fiscal activities undertaken for the government, which will be offset against SOCAR's pre-2001 tax arrears. From 2002 any such subsidies must be explicitly included in the state budget.

Privatisation

Privatisation of medium-sized and large enterprises is relaunched ...
While small-scale privatisation is nearly complete, privatisation of larger enterprises has lagged behind. Following the adoption of the second privatisation programme in August 2000, 39 cash and 12 voucher auctions had been held by the first quarter of 2001, with 127 state enterprises being offered for sale for the first time. In addition, since case-by-case privatisation began in late 1998, 10 companies have been privatised through competitive tenders. Receipts from privatisation have been modest, amounting to US$ 118 million from 1996 until the first quarter of 2001 (about 2 per cent of GDP). Importantly, an official list of some 450 larger enterprises open for privatisation to both foreign and domestic investors was published in March 2001, including enterprises belonging to the telecommunications, fuel and energy, mechanical engineering, chemical and fishery industries as well as the state-owned airline Azal.

... but additional preparation of major projects is required to ensure success.
Tender results were announced for a long-term management contract for BAGES, the Baku electricity distribution network, in March 2001. However, the absence of an adequate regulatory framework, the poor quality of available information and vaguely formulated

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

2001
Jan	New customs tariff codes adopted
Jan	Council of Europe membership
Apr	Ministries of Economic Development and Energy created
Jul	New IMF programme approved

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

Oct	Water law enacted
Dec	Decree on Oil Fund issued

2000

Mar	Baku-Ceyhan pipeline agreement ratified

2001

Mar	Shakh Deniz gas purchase agreed with Turkey
May	Revocation of banking licence of Agroprom

tender documents have complicated completion of the transaction with the tender winner. At the same time, though, the tender for a 25-year management contract for Azerbaijan Aluminium was awarded successfully to a Dutch company, Fondel Metal, in March 2001. The foreign company has committed to invest US$ 500 million over five years while the government has granted concessions on supplies of electricity and natural gas and on the transport of raw materials and equipment until 2005.

Enterprise reform

A series of measures are being taken to improve governance.
Private investors remain highly concerned about the absence of a level playing field for all enterprises and the sometimes arbitrary implementation of taxation and regulation. As part of government efforts to enhance governance, a commitment has been made to develop a comprehensive anti-corruption campaign. A Chamber of Accounts has been established and will be given the authority to audit all government agencies, including all extra-budgetary funds, and will also be obliged to publish its findings. In addition, the authorities have begun to implement administrative reforms, including the merging of some key ministries, the transfer of policy-making and regulatory functions from state-owned enterprises to the relevant government ministries, and the introduction of measures to streamline and improve the effectiveness of the civil service.

Infrastructure

Reform of power and gas is to be initiated …
The large quasi-fiscal deficit in the energy sector was estimated at 13 per cent of GDP in 1999, roughly half from electricity and half from gas. The deficit originates from several sources. They include: revenue losses by SOCAR from below-cost prices for fuel, oil and gas supplied to Azerenergy and Azerigaz; low collection rates – only 44 per cent of gas and 41 per cent of electric power supply billings were collected in 1999 – while several groups of the population are exempt; and technical losses. The accumulation of this deficit has many adverse implications, including the loss of fiscal revenues, distortions at the enterprise level as a result of implicit subsidies and excessive energy consumption from distorted tariffs. The authorities are developing a comprehensive programme to resolve these problems, including tighter budgetary control of utilities, a schedule for the eventual unification of domestic and exported oil prices, and privatisation of all distribution networks.

… but reform of all infrastructure sectors is still pending.
Azerbaijan still lacks an adequate legal and regulatory framework to protect the public interest and to encourage private investment in key infrastructure sectors. First steps in this direction have been a decree establishing the Ministry of Fuel and Energy in April 2001 and the planned creation of a Ministry of Transport. In these and other infrastructure sectors, development of appropriate legal and regulatory frameworks is proceeding alongside privatisation plans. The government is expected over the next year to begin privatisation of Aztelecom and the Baku City Telephone Network and to start a programme for private participation in the provision of water and waste-water services in Greater Baku.

Financial institutions

Bank restructuring and privatisation is urgently needed …
The banking system has undergone further consolidation over the past year, with the number of banks down to 53 from 68. However, it remains "overbanked" and undercapitalised, with total manat deposits equivalent to 1.3 per cent of GDP. The privatisation of the International Bank of Azerbaijan (IBA, the country's largest bank) has been delayed repeatedly and will now most likely take place in the coming 12 months. The other three state-owned banks have been restructured by merging the viable parts into a single bank – the United Universal Bank – and by transferring non-performing assets to an asset collection agency. An important step in that process was the recent revocation of the licence of Agroprom Bank.

… but there have been some improvements in commercial banking supervision.
Minimum capital requirements are US$ 5 million for new banks and US$ 2 million for existing banks. A gradual increase of the latter and the enforcement of this requirement will be essential in the central bank's efforts to strengthen the banking sector. Moreover, to help level the playing field, the central bank has reduced the balances it holds with IBA to zero by the end of September 2001, recognising that there is a conflict in maintaining deposits in the commercial banks that it supervises. The central bank is also working to improve its internal audit capacity as well as its accounting policies and procedures.

Social reform

Social spending is low and inadequately targeted.
The proportion of the population living below the poverty line increased between 1995 and 1999 (by between 2.5 and 5 per cent), irrespective of the particular poverty threshold used as a measure. To address poverty reduction objectives in a comprehensive fashion, the government has begun to formulate a national programme for poverty reduction through a participatory process. In March 2001 a presidential decree requested a revision of various social assistance benefits by the end of 2001, acknowledging existing targeting problems. The government plans include improving access to health care and education for the most vulnerable and replacing untargeted subsidies for energy with direct cash transfers. In addition, the government is considering pension reform, including the introduction of individual contribution records and strengthened links between contributions and benefits.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **14.5 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **64.2 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	8.0	8.0	8.0	6.0	6.0	na	na
Number of goods with administered prices in EBRD-15 basket	na	na	12.0	12.0	4.0	3.0	3.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	na	na	58.4	58.3	53.1	43.8	43.7	59.2	78.2
Share of trade in GDP (in per cent)	164.6	115.8	116.8	67.7	66.9	55.1	57.4	54.0	65.0
Tariff revenues (in per cent of imports)	0.1	1.2	1.1	1.6	1.9	4.3	4.4	5.4	na
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	1.0	1.0	2.0	2.0	2.3	3.0	3.3	3.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	na	0.0	0.0	0.0	0.1	1.1	1.9	2.6	2.7
Private sector share in GDP (in per cent)	10.0	10.0	20.0	25.0	25.0	40.0	45.0	45.0	45.0
Private sector share in employment (in per cent)	35.6	35.5	37.6	42.8	48.5	53.6	57.9	63.7	na
EBRD index of small-scale privatisation	1.0	1.0	1.0	1.0	2.0	3.0	3.3	3.3	3.3
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	1.0	2.0	2.0	1.7	1.7
Enterprises									
Budgetary subsidies (in per cent of GDP)	11.2	4.6	5.4	2.2	2.1	0.7	0.1	0.1	0.2
Effective statutory social security tax (in per cent)	na	62.7	54.7	33.9	62.1	63.0	76.3	82.0	na
Share of industry in total employment (in per cent)	11.5	10.5	10.3	9.7	7.7	6.6	6.8	7.0	7.0
Change in labour productivity in industry (in per cent)	-25.6	-12.0	-21.0	-16.6	-66.2	17.3	-1.0	0.4	10.4
Investment rate/GDP (in per cent)	na	19.0	26.3	15.6	29.1	38.0	40.6	na	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.7	1.7	1.7	1.7	1.7	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	9.0	8.8	8.5	8.3	8.5	8.7	8.9	9.5	na
Railway labour productivity (1989=100)	37.1	28.3	15.3	8.6	9.2	11.7	15.9	17.5	23.4
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	0.67 (na)	1.98 (39)	2.48 (41)	2.7 (56)	na	na	na
Electricity consumption/GDP (1989=100)	92.7	113.4	142.3	152.4	151.9	137.3	135.0	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	1.8	1.8	1.9
Financial institutions									
Number of banks (of which foreign owned)	120 (na)	164 (1)	210 (2)	180 (5)	136 (6)	99 (6)	79 (4)	70 (5)	59 (5)
Asset share of state-owned banks (in per cent)	88.7	80.4	77.6	80.5	77.6	80.9	65.5	82.5	60.4
Non-performing loans (in per cent of total loans)	6.7	26.6	15.7	22.3	20.2	19.9	19.6	37.2	na
Domestic credit to private sector (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	1.0	1.0	1.0	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	1.0	1.7	1.7	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	2.3	3.0	3.3	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	1.0	2.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	9.4	10.9	6.8	4.9	5.2	4.8	4.6	5.2	4.7
Life expectancy at birth, total (years)	69.5	69.4	69.4	69.0	70.0	70.9	71.4	71.5	na
Basic school enrolment ratio (in per cent)	88.5	89.2	90.4	90.3	90.4	91.4	91.6	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	45.8	na	na	na	na

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	*Projection*
Output and expenditure					*(Percentage change in real terms)*				
GDP	-23.1	-19.7	-11.8	1.3	5.8	10.0	7.4	11.1	8.0
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed investment	na	na	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output [1]	-19.7	-24.7	-21.4	-6.7	0.3	2.7	3.6	10.4	na
Agricultural gross output	-15.4	-13.0	-6.8	3.0	-6.9	3.9	7.1	12.1	na
Employment [2]					*(Percentage change)*				
Labour force (end-year)	-0.6	-1.4	1.0	2.5	0.9	0.4	7.0	na	na
Employment (end year)	-0.2	-2.3	-0.5	2.0	0.2	0.2	0.0	0.0	na
					(In per cent of labour force)				
Unemployment (end-year)	9.6	10.4	11.7	12.1	12.7	12.9	13.2	13.4	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	1,129.0	1,664.0	412.0	19.7	3.5	-0.8	-8.5	1.8	2.0
Consumer prices (end-year)	1,294.0	1,788.0	85.0	6.5	0.4	-7.6	-0.5	2.2	2.2
Producer prices (annual average)	na	na	1,734.0	122.7	29.8	0.0	-6.1	27.4	na
Producer prices (end-year)	na	na	na	87.2	2.2	-21.5	17.9	16.3	na
Gross average monthly earnings in economy (annual average)	708.3	601.5	307.6	43.1	58.5	18.9	9.5	11.3	na
Government sector					*(In per cent of GDP)*				
General government balance [3]	-15.3	-12.1	-4.9	-2.8	-1.6	-4.2	-4.8	0.4	-0.5
General government expenditure [3]	55.9	45.9	22.5	20.3	20.8	21.2	23.7	20.8	na
General government debt	na	25.7	19.6	14.1	13.5	15.8	24.2	25.7	na
Monetary sector					*(Percentage change)*				
Broad money (M3, end-year)	818.0	1,114.6	24.0	18.9	33.6	-17.0	16.2	37.2	na
Domestic credit (end-year)	480.0	841.0	61.0	33.2	11.1	11.4	-14.4	-46.2	na
					(In per cent of GDP)				
Broad money (M3, end-year)	54.9	55.9	12.2	11.3	13.1	10.6	10.6	11.6	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Refinance rate (6 months)	na	na	80.0	20.0	12.0	14.0	10.0	10.0	na
Interbank interest rate (3 months) [4]	na	na	na	36.0	22.9	23.2	20.5	22.5	na
Deposit rate [5]	34.0	406.0	90.0	13.0	11.5	10.9	9.9	12.2	na
Lending rate [5]	257.0	406.0	107.0	33.0	21.5	27.7	27.5	27.2	na
					(Manats per US dollar)				
Exchange rate (end-year)	256.0	4,330.0	4,440.0	4,098.0	3,888.0	3,890.0	4,378.0	4,565.0	na
Exchange rate (annual average)	120.0	1,433.0	4,417.0	4,300.0	3,983.0	3,869.0	4,120.0	4,472.0	na
External sector					*(In millions of US dollars)*				
Current account	-160	-123	-318	-821	-914	-1,363	-601	-141	-348
Trade balance	-122	-163	-275	-549	-567	-1,046	-406	347	na
Merchandise exports	697	682	680	789	808	678	1,027	1,886	na
Merchandise imports	819	845	955	1,338	1,375	1,724	1,433	1,539	na
Foreign direct investment, net	0	22	282	661	1,093	1,024	550	117	na
Gross reserves (end-year), excluding gold [6]	0	2	119	214	467	449	676	680	na
External debt stock	52	239	425	521	602	717	1,034	1,259	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold [6]	na	0.0	1.1	1.5	2.7	2.2	4.2	4.0	na
					(In per cent of exports of goods and services)				
Debt service	na	0.4	5.2	7.4	7.3	4.7	4.8	4.5	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	7.5	7.6	7.7	7.8	7.9	8.0	8.0	8.1	na
GDP (in millions of manats)	157,082	1,873,400	10,669,000	13,663,200	15,791,400	16,177,000	18,771,000	23,565,000	26,457,000
GDP per capita (in US dollars) [7]	173	171	313	407	503	526	568	652	na
Share of industry in GDP (in per cent)	24.9	20.4	27.3	25.9	25.3	25.1	23.6	na	na
Share of agriculture in GDP (in per cent)	26.9	32.2	25.1	24.7	20.0	19.7	21.7	na	na
Current account/GDP (in per cent)	-12.2	-9.4	-13.2	-25.8	-23.1	-32.6	-13.2	-2.7	-6.1
External debt - reserves, in US$ millions	52	237	306	307	135	268	358	579	na
External debt/GDP (in per cent)	4.0	18.3	17.6	16.4	15.2	17.1	22.7	23.9	na
External debt/exports of goods and services (in per cent)	6.3	29.2	49.9	55.5	52.3	71.0	80.6	58.4	na

[1] Industrial output excludes crude oil production.

[2] Employment and labour force estimates differ from official statistics. Labour force data are corrected for the working age population outside the labour force. Unemployment is based on survey data. Less than 5 per cent of all unemployed are registered.

[3] General government consolidates all levels of government except for municipalities and SOEs, and includes the Oil Fund and other extra-budgetary 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, three month deposit and lending rates to "bank-clients".

[6] At end-2000, there were additional foreign exchange assets of US$ 270.96 million in the account of the State Oil Fund.

[7] GDP per capita figures for 1992-93 are estimated from the IMF. The manat became official legal tender in January 1994. An improved method of calculating value-added in the oil sector has led to a sharp upward revision in nominal GDP and related variables for 2000 and beyond relative to previous estimates.

Belarus

Key reform challenges

- **Following the presidential election, comprehensive liberalisation of markets and trade should now be implemented, building on the partial liberalisation measures introduced under the Staff-Monitored Programme with the IMF.**
- **Sharply reducing still pervasive bureaucratic controls, creating competitive markets and freeing up the private sector remain key to establishing conditions for economic development.**
- **Compliance with the policy requirements of the Union Treaty with Russia calls for increasing alignment with Russian market regulations, which may give a boost to reforms.**

Liberalisation

The foreign exchange market has been further liberalised.
Following liberalisation of the foreign exchange market in late 1999 and early 2000 and unification of the exchange rates in September 2000, the National Bank further liberalised the market by July 2001. The new measures include ending both a ban on foreigners taking part in interbank trade and a US$ 200,000 per month limit on the amount of hard currency that market participants can buy. The export revenue surrender regime (which does not apply to all exports) remains at 30 per cent, although the effective rate is lower owing to numerous exemptions.

Price controls have been reduced, but state controls remain pervasive.
The scope of administrative price controls was reduced in early 2001 and again under the terms of the IMF Staff-Monitored Programme (SMP) which began in April 2001. Overall, by April 2001 the government had reduced the number of "socially important" goods subject to price control from 48 to 28 and had removed 80 per cent of monthly price-increase ceilings. The remaining 20 per cent of price ceilings were also to be eliminated by the end of September. However, other administrative control mechanisms continue to be widespread in the areas of wage and trade regulations as well as in business licensing, registration and certification. *Ad hoc* pressures by state agencies on enterprises, discretionary regulatory exemptions and unpredictable presidential decrees also remain key instruments of state control.

Stabilisation

Economic growth slows and investment declines.
GDP grew by about 3 per cent in the first half of 2001, down from 5.9 per cent in 2000. The slowdown is due to several factors, in particular a 3.2 per cent decline in fixed investment. The government's Social and Development Programme for the period 2001-05 adopted in May 2001 projects cumulative GDP growth of 35-40 per cent over the period. However, the populist policy measures proposed in the programme – such as significant new public sector wage increases and adherence to the full employment target – fail to address key investment climate issues that would help to reverse the economy's declining competitiveness and boost quality investment and growth.

Progress in stabilisation is overshadowed by key vulnerabilities.
Through substantial tightening of financial policies since late 2000, the government managed to bring down inflation to a monthly average of 3.4 per cent in the first half of 2001, far lower than the monthly rate of 7.5 per cent recorded over the same period in 2000. However, this is still the highest inflation rate in the CIS, and the economy remains vulnerable to renewed macroeconomic instability in several areas. The sharp increases in real wages above productivity growth have squeezed enterprise profits and budgetary resources and have undermined the competitiveness of the enterprise sector. There are also large fiscal pressures associated with increased subsidies to agriculture and the authorities' commitment to increasing public sector wages to US$ 100 a month by the end of the year. However, severe cuts in non-wage current and capital expenditures, together with increased expenditure arrears, limited the increase in the budget deficit from 0.6 per cent of GDP in 2000 to 1 per cent of GDP in the first half of 2001.

A rate regime is introduced.
In early 2001 the National Bank introduced a crawling peg exchange rate regime, linking the Belarussian rouble to the Russian rouble. Under this arrangement, the national currency will be permitted to depreciate by 2.5-3.0 per cent per month against the Russian rouble. The band may be adjusted and is reviewed frequently by the central bank. Under the terms of the Union Treaty, the Russian rouble is to be used as the common currency from the beginning of 2005 and is to be replaced by a new common currency in 2008.

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
Sep Unification of exchange rate

2001
Jan Crawling peg to Russian rouble introduced
Jan Some prices liberalised
Apr Staff-Monitored Programme with IMF agreed

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
Jan New land code adopted
Mar New (unfavourable) business registration procedures adopted

2000
Jul New bankruptcy law adopted

2001
Apr Directed lending halted
Jun New investment code adopted

Privatisation

Privatisation remains stalled.
According to the five-year economic development programme adopted in May, the state will continue to play a dominant role in the economy. Reflecting this approach, progress in privatisation remains stalled and there have been no true privatisations this year. Since the start of transition, few companies have been truly privatised (defined as a reduction in the state share to less than 50 per cent), with the majority having been sold from one state entity to another. Only about 10 per cent of republican enterprises and about 40 per cent of communal enterprises have been genuinely privatised so far. In line with SMP commitments to the IMF, the government has recently announced its intention to re-start the privatisation process for small and medium-sized enterprises. However, the government also believes that large-scale enterprise privatisation would be premature in the present environment, given depressed asset prices and lack of interest from foreign investors.

Enterprise reform

There is little progress in industrial and agricultural restructuring.
Persistent soft budget constraints for privileged enterprises, little genuine privatisation and stifling government controls impede new investment and the restructuring of industry and agriculture. The policy commitments of the authorities under the SMP are not ambitious enough to lead to significant changes in this area and some important commitments have not been fulfilled. In particular, the presidential decree that provides discretionary powers to the president to confiscate the property of individuals or enterprises remains in force. This type of policy discretion has a strong impact on the behaviour of enterprises, which tend to compete for subsidies and regulatory privileges, resort to barter and accumulate arrears rather than respond to market demands.

A new investment code has been adopted.
In June 2001 the Belarussian parliament adopted a new investment code, which is intended to increase domestic and foreign investment by providing government support and guarantees for investors. The law entered into force in September. Among other measures, the code details conditions under which foreign investment projects will receive government guarantees. In contrast to the spirit of the code, a recent presidential decree obliges foreign investors to pay extra taxes until the end of 2001 to help finance priority sectors.

Infrastructure

Energy debt has been reduced, but gas subsidies continue.
Last year Belarus paid almost US$ 130 million in hard currency to reduce the accumulated payment arrears on gas supplies from Gazprom, the Russian gas company. In addition, US$ 64 million was paid mainly in the form of barter arrangements. As a result, Belarus's debt had come down from US$ 250 million in early 2000 to US$ 77 million by the second quarter of 2001. The principal debt for gas accounts for US$ 40 million of this sum, while the remaining US$ 37 million consists of penalties. According to a recent agreement, Gazprom will allow Belarus to defer its remaining US$ 77 million of debt on the condition that Beltransgaz pays off the debt in three years by supplying Belarussian tractors and Beltransgaz bills of exchange. However, Russia continues to provide sizeable subsidies by charging Belarus only around one-third of the average Russian export price for natural gas.

World Bank approves loan for infrastructure development.
To help Belarus improve the efficiency of its infrastructure, the World Bank in June 2001 approved a US$ 22.6 million loan for social infrastructure rehabilitation to finance work on heating systems, thermal insulation and lighting. The loan is designed to improve the environment in schools and hospitals and is the first World Bank loan to Belarus since 1994. The loan follows a US$ 1 million pilot project in Minsk that demonstrated the potential for supply improvements and energy saving in heating and lighting of these public institutions.

Financial institutions

Private sector access to credit remains limited.
The phasing out of the system of directed credits as a condition before the SMP could be initiated has been a notable positive development. Other important policy steps include the maintenance of positive real interest rates since February 2000 and the introduction of a new Banking Code that tightens the framework of prudential regulations. However, the general characteristics of the economy largely inhibit the development of a market-oriented financial system. The slow pace of both privatisation and growth of the new private sector limit lending to the private sector. The stock of credit to the private sector is well below 10 per cent of GDP. Foreign capital is present in 20 of the 24 banks, mainly from Russian sources, but these banks hold a relatively small share of total bank capital. The dominant banks are state-owned.

Social reform

Untargeted support is of doubtful sustainability.
Preliminary statistics show substantial growth in both real average monthly wages and pensions, which increased by about 20 per cent in the first half of 2001, largely as a result of pre-election considerations. However, part of the wage and pension increases were designed to offset reductions in consumer subsidies. A presidential pre-election promise to introduce a substantial increase in the average monthly wage in the public sector by the end of the year is likely to induce fiscal difficulties, as is a continued commitment to full employment targets. While registered unemployment rose slightly in the first half of 2001 to 2.2 per cent of the workforce, an estimated 7-8 per cent of the workforce was either working reduced hours or on mandatory leave while officially registered as employed. The government has engaged with the World Bank in a policy dialogue on targeting the social safety net.

Liberalisation
Current account convertibility – **limited**
Interest rate liberalisation – **limited de facto**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenue in GDP – **43.9 per cent**
Exchange rate regime – **crawling peg**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **vouchers**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **no**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **10 per cent**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **no**

Social reform
Share of the population in poverty – **10.4 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	80.0	70.0	60.0	45.0	30.0	27.0	na	na	na
Number of goods with administered prices in EBRD-15 basket [1]	5.0	5.0	5.0	5.0	5.0	5.0	na	na	na
Share of trade with non-transition countries (in per cent)	na	na	28.5	20.5	19.0	19.3	17.3	22.6	22.9
Share of trade in GDP (in per cent)	na	121.9	113.4	98.8	91.9	112.1	96.9	102.6	116.2
Tariff revenues (in per cent of imports) [2]	na	3.7	5.4	3.2	4.3	4.1	4.3	3.7	na
EBRD index of price liberalisation	2.0	2.0	2.0	3.0	3.0	3.0	2.0	1.7	1.7
EBRD index of forex and trade liberalisation	1.0	1.0	1.0	2.0	2.0	1.0	1.0	1.0	1.7
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.1	0.4	0.5	0.7	0.9	1.0	1.1	na
Private sector share in GDP (in per cent)	10.0	10.0	15.0	15.0	15.0	20.0	20.0	20.0	20.0
Private sector share in employment (in per cent)	na	na	na	6.8	9.3	12.0	16.4	18.6	na
EBRD index of small-scale privatisation	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of large-scale privatisation	1.0	1.7	1.7	1.7	1.0	1.0	1.0	1.0	1.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	8.7	15.8	4.4	1.9	4.2	4.7	5.6	6.7	na
Effective statutory social security tax (in per cent)	80.1	65.2	67.5	80.4	82.1	86.8	81.9	84.9	na
Share of industry in total employment (in per cent)	30.4	29.6	29.0	27.6	27.5	27.6	27.6	27.6	na
Change in labour productivity in industry (in per cent)	-4.7	-5.7	-10.7	-0.9	29.4	18.6	10.9	9.0	na
Investment rate/GDP (in per cent)	25.4	33.9	33.2	25.0	22.0	24.7	26.0	na	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.7	1.7	1.0	1.0	1.0	1.0
EBRD index of competition policy	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	17.1	17.8	18.6	19.0	20.8	22.6	24.3	26.1	na
Railway labour productivity (1989=100)	52.6	46.5	33.6	29.9	28.8	32.6	32.2	35.9	37.5
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	na	na	1.5 (80)	1.1 (87)	na	na	na
Electricity consumption/GDP (1989=100)	104.6	100.0	101.7	102.8	100.3	94.3	90.2	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	1.1	1.3	1.3
Financial institutions									
Number of banks (of which foreign owned)	na	na	48 (na)	42 (1)	38 (1)	38 (2)	37 (3)	36 (4)	31 (6)
Asset share of state-owned banks (in per cent)	na	na	69.2	62.3	54.1	55.2	59.4	66.6	66.0
Non-performing loans (in per cent of total loans)	na	na	8.4	11.8	14.2	12.7	16.5	13.1	15.2
Domestic credit to private sector (in per cent of GDP)	na	na	17.6	6.2	6.7	8.5	17.1	9.7	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na	na	4.1
EBRD index of banking sector reform	1.0	1.0	1.0	2.0	1.0	1.0	1.0	1.0	1.0
EBRD index of reform of non-banking financial institutions	2.0	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	2.0	2.0	2.0	1.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	2.0	2.0	2.0	2.3
Social sector									
Expenditures on health and education (in per cent of GDP)	8.7	15.1	12.9	10.4	11.2	13.0	12.1	11.4	na
Life expectancy at birth, total (years)	70.0	69.0	68.8	68.5	68.6	68.5	68.4	68.4	na
Basic school enrolment ratio (in per cent)	93.8	93.3	93.2	93.7	93.4	93.8	96.5	na	na
Earnings inequality (GINI-coefficient)	34.1	39.9	na	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 9.

[2] Refers to taxes on international trade.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
									Estimate
Output and expenditure				*(Percentage change in real terms)*					
GDP	-7.6	-12.6	-10.4	2.8	11.4	8.4	3.4	5.8	2.5
Private consumption	-1.5	-14.5	-12.3	4.5	10.0	8.7	5.0	na	na
Public consumption	-10.5	-3.0	-2.9	-0.2	8.4	5.8	2.1	na	na
Gross fixed investment	-15.4	-17.2	-28.7	7.2	21.4	11.8	-5.4	na	na
Exports	na	28.1	90.8	27.1	23.9	-3.4	-2.3	na	na
Imports	na	21.4	79.8	26.5	24.9	-1.2	-8.6	na	na
Industrial gross output	-9.4	-14.8	-11.7	3.5	18.8	12.4	10.3	8.0	na
Agricultural gross output	3.7	-14.4	-4.7	2.4	-4.9	-0.7	-8.3	9.3	na
Employment				*(Percentage change)*					
Labour force (annaual average)	-0.6	-2.4	-5.7	0.1	-2.5	-1.1	-0.4	-0.1	na
Employment (annual average)	-1.3	-2.6	-6.2	-1.0	0.1	1.1	1.2	-1.6	na
				(In per cent of labour force)					
Unemployment (end-year) [1]	1.4	2.1	2.7	3.9	2.8	2.3	2.2	2.1	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	1,190.2	2,221.0	709.3	52.7	63.8	73.2	293.8	168.9	59.8
Consumer prices (end-year)	1,996.0	1,959.9	244.0	39.3	63.4	181.7	251.3	107.5	40.3
Producer prices (annual average)	1,536.3	2,171.0	462.0	33.6	88.0	72.0	355.0	185.6	na
Producer prices (end-year)	2,320.0	1,866.7	122.0	31.0	89.0	200.1	245.1	168.0	na
Gross average monthly earnings in economy (annual average)	1,106.8	60.4	668.9	60.5	87.3	104.2	322.4	na	na
Government sector [2]				*(In per cent of GDP)*					
General government balance	-5.2	-1.3	-1.9	-1.6	-0.7	-0.3	-2.2	-0.6	-1.5
General government expenditure	57.8	47.3	43.0	42.7	46.1	46.4	47.9	na	na
General government debt	na	na	na	4.0	4.1	5.1	na	na	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	na	1,368.4	310.9	66.7	102.8	129.6	195.1	na	na
Domestic credit (end-year)	na	2,030.9	226.5	58.8	115.1	300.5	141.3	na	na
				(In per cent of GDP)					
Broad money (M2, end-year)	20.9	17.0	10.4	11.3	11.8	14.6	9.9	na	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinancing rate	210.0	300.0	66.0	35.0	40.0	48.0	120.0	90.0	na
Treasury bill rate (3-month maturity)	na	320.0	70.0	37.0	38.4	43.2	80.0	na	na
Deposit rate (1 year)	65.1	89.6	100.8	32.3	15.6	14.3	23.8	37.6	na
Lending rate (1 year)	71.6	148.5	175.0	62.3	31.8	27.0	51.0	68.0	na
				(Belorussian roubles per US dollar)					
Official exchange rate (end-year) [3]	0.698	10.6	11.5	15.5	30.7	107.0	320.0	1,180.0	na
Official exchange rate (annual average) [3]	0.269	3.7	11.5	13.3	26.2	46.4	250.0	717.0	na
External sector				*(In millions of US dollars)*					
Current account	-435	-444	-458	-516	-859	-1,017	-194	-162	-100
Trade balance	-528	-490	-666	-1,149	-1,407	-1,501	-570	-838	-646
Merchandise exports	1,970	2,510	4,803	5,790	6,919	6,172	5,646	6,987	7,335
Merchandise imports	2,498	3,000	5,469	6,939	8,326	7,673	6,216	7,825	7,981
Foreign direct investment, net	18	11	15	105	350	201	443	90	100
Gross reserves (end-year), excluding gold	37	101	377	369	394	345	309	357	na
External debt stock [4]	1,014	1,251	1,527	950	976	1,011	886	829	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	0.2	0.4	0.8	0.6	0.5	0.5	0.6	0.5	na
				(In per cent of export of goods and services)					
Debt service [5]	0.4	4.3	2.9	2.3	2.0	1.8	3.1	2.9	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, millions)	10.3	10.3	10.3	10.3	10.2	10.2	10.0	10.0	na
GDP (in millions of Belorussian roubles)	986	17,815	119,813	184,174	356,079	662,370	2,890,320	9,136,014	14,967,084
GDP per capita (in US dollars)	356	471	1,009	1,350	1,328	1,400	1,151	1,275	na
Share of industry in GDP (in per cent) [6]	30.9	30.8	31.4	34.6	35.8	34.4	34.3	na	na
Share of agriculture in GDP (in per cent) [6]	18.3	15.0	17.7	16.0	14.7	12.7	12.9	12.7	na
Current account/GDP (in per cent)	-11.9	-9.1	-4.4	-3.7	-6.3	-7.1	-1.7	-1.3	-0.9
External debt - reserves, in US$ millions	977	1,150	1,150	481	582	666	577	473	na
External debt/GDP (in per cent)	27.7	25.7	14.7	6.9	7.2	7.1	7.7	10.5	na
External debt/exports of goods and services (in per cent)	47.1	45.3	29.0	14.2	12.5	14.2	13.8	11.7	na

[1] Officially registered unemployment.

[2] General government includes the state budget, social funds, and extra-budgetary funds, excluding inter-budgetary transfers.

[3] A significant parallel market premium, peaking at around 300 per cent in December 1999, existed until unification of the exchange rate in September 2000. Hence there was no end-of-period premium in 2000 although the annual average premium was around 140 per cent.

[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

- **More than five years after the Dayton Peace agreement, a single economic space is not yet in place; harmonised tax laws between the two Entities would encourage greater integration and competition.**
- **With privatisation proceeding slowly and most economic activity remaining in the state sector, the pace of privatisation should accelerate while ensuring high standards of transparency and governance.**
- **Initiatives to raise minimum capital requirements and to privatise state banks are attracting much-needed strategic investment to the banking sector but a stronger commitment to reform is required, especially in Republika Srpska (RS), to boost confidence.**

Liberalisation

Development of a single economic space is proceeding gradually.
Since the Dayton Peace Accords were signed in November 1995, progress towards creating a single economic space between the two Entities has been slow. The authorities have taken steps recently towards this goal, including the decisions by both Entity parliaments in May 2001 to equalise the sales tax rate. It has also been agreed that collection should be at the retail level, except for cigarettes of which taxation will be at the wholesale level. Other areas that create divisions between the two Entities are direct taxes, which tend to be lower in RS, valuation of goods for customs purposes and different foreign investment laws. Preparations are advanced for the introduction of a harmonised income tax law in January 2002.

Preparations are being made for accession to the WTO.
The State government is proceeding with negotiating entry to the WTO and accession to the organisation is likely to take place during 2002. The government is changing legislation on imports to conform with WTO rules, with surcharges on imports to be subsumed under the Customs Tariff Law as compound tariffs. In June 2001 Bosnia and Herzegovina was one of seven signatories in the south-east European region to sign a memorandum of understanding on free trade, thereby committing to free trade within the region by 2006. Formal negotiations on a Stabilisation and Association Agreement with the EU have not yet begun, although the authorities are working on a plan of reforms towards negotiations.

Stabilisation

Macroeconomic stability has been maintained but significant imbalances persist.
While inflation remains low in the Federation and has fallen to single-digit levels in RS, the authorities in both Entities and at state level face serious fiscal and external imbalances. Expenditure in both Entities in 2000 exceeded the budgeted amount, especially in RS where public sector wage arrears are a significant problem. The Federation government allowed several months of pension arrears to build up from the previous year. The IMF and the World Bank are providing technical assistance to both governments for the design and implementation of modern treasury systems. On the external account, the current account deficit remains above 20 per cent of GDP, and international donor support will continue to be necessary for financing large external gaps.

Privatisation

Small-scale privatisation is under way.
In RS the government is auctioning enterprises where the value of state capital is less than KM 300,000. By July 2001 108 out of 276 small enterprises still in state hands had been sold. Citizens are using frozen foreign exchange coupons to purchase these enterprises. In the Federation the process is approximately half-complete, with about 160 out of 320 state-owned enterprises of less than KM 0.5 million sold by mid-2001, mainly to management-employee groups and privatisation funds. In both Entities the intention is to finish the process by the end of 2002.

Large-scale privatisation has made some progress but governance problems remain.
The privatisation of medium-sized and large enterprises has encountered numerous delays, and several transactions that have been completed were marred by a lack of transparency. In the Federation over 1,029 enterprises are being sold through auctions and tenders over the next two to three years. By the end of June 2001 about 530 had been sold either directly to individuals or to privatisation funds nominally controlled by private investors. A total of 260 large enterprises will be sold through tender, 86 of which with the technical assistance of the international community. In RS 830 large enterprises were registered for sale. In 650 cases at least 55 per cent of the enterprise is now privately owned, and new directors and managing boards are being appointed. Most of these enterprises, however, still lack strategic owners and working capital. The remaining 180 companies are identified as strategic, and will be privatised through tenders, 52 of which with the help of the international community. Little progress has been made on this front so far. In both Entities, privatisation has so far left governance issues unresolved in many cases due to the difficulty of dislodging incumbents.

Enterprise reform

Labour laws in both Entities have been revised.
After long delays, due in part to the November 2000 elections, the Office of the High Representative (OHR) imposed amendments to the labour laws of both Entities in late 2000. In the Federation the new Law on Job Placement and Social Security of the Unemployed helps to bring legislation in line with EU standards by reducing high unemployment benefit entitlements and enabling employers to lay off excess labour. In RS in November 2000 the OHR amended the existing labour law, reducing compensation payments to employees on "wait lists". These measures were

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 — Currency board established
Aug — Central bank of BH 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 FR Yugoslavia abolished
Jun — Small-scale privatisation begins

2000
Mar — Excise taxes harmonised between Entities
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
Apr	Banking law adopted in RS

2001

Jan	Closure of payments bureaux
Feb	Deposit insurance introduced in the Federation
Jun	Further rise in bank minimum capital requirements

essential to unlock further assistance and investment from the international community and will help to increase the attractiveness to investors of enterprises undergoing privatisation. However, contractual obligations will remain on investors to maintain certain levels of employment.

Infrastructure

Railway reform has advanced.
The railway system was severely damaged during the war and is in urgent need of rehabilitation. In June 2001 the EBRD and the EIB jointly signed a €52 million loan to the state for repairs and new investment, for assistance with labour restructuring and for strengthening institutional structures. The Bosnia and Herzegovina Public Railway Corporation (BHPRC) will be the executing agency for the project, thereby strengthening its role, and therefore the role of state-wide institutions in the industry. In addition, key covenants for the project include the consolidation of the two railway companies currently operating in the Federation into one company and the preparation by each railway company (in the Federation and in RS) of a business plan and a labour restructuring plan.

The regulatory framework for telecommunications has improved.
In March 2001 a new Communications Regulatory Agency (CRA) was formed, combining the functions of the Telecommunications Regulatory Agency and the Independent Media Commission. The new agency is charged with implementing market reforms, in particular the liberalisation of the market to allow greater competition and lower charges for users. It is envisaged that the sector will be fully liberalised and privatised by 2005. A key requirement, the separation of post and telecommunications in the Federation, has been overdue for nearly two years. In April 2001 the CRA granted national GSM licences to the two state-owned mobile telephone operators, PTT BiH Sarajevo and Mobilna Srpska Banja Luka. However, the launch of a third GSM operator, scheduled for summer 2001, has been delayed.

Financial institutions

Bank privatisation is proceeding very slowly.
Bosnia and Herzegovina continues to face serious difficulties in divesting state shares in banks although some progress has been made in the past year in attracting strategic investors, including Raiffeisen, Volksbank and Hypo-Alpe Adria (all Austrian banks) and Croatia's Zagrebacka banka, to the sector. At the end of 2000 there were 56 banks in operation (37 in the Federation and 19 in RS). The sector remains concentrated around a small core of state banks. The privatisation of five banks of the Privredna banka Sarajevo (PBS) group in the Federation continues to be held up by failure to attract strategic investors, although a group of Western cooperative banks are currently negotiating a purchase. The end of June deadline for privatisation has been extended until the end of 2001. In RS, tenders were issued for most state-owned banks but only one bank was sold by mid-2001; other tenders failed to attract much interest. At the end of June 2001 five banks in RS were under provisional administration and urgent reforms in the sector are required.

The payments bureaux have been closed.
The dismantling of the payments bureaux was successfully completed in January 2001. Commercial banks encountered some early difficulties with the new clearing systems but the process now appears to be running smoothly. As of July 2001, 43 banks were licensed to carry out payments operations, with about two-thirds of transactions being carried out by 10 banks. Bank supervision and regulation procedures have been strengthened.

Bank capital requirements have been increased.
Stronger monitoring of banks and an increase in minimum capital requirements in both Entities should help to bring about a much-needed consolidation of the sector. In the Federation, minimum capital requirements were raised from KM 7.5 million to KM 10 million by June 2001, with a further increase to KM 15 million due to take place by the end of 2002. Competition in the sector will be helped by the decision of the Entity governments to allow banks from one Entity to open branches in the other. Several banks are now operating in both Entities. Confidence in the Federation banking sector has also been helped by the introduction in February 2001 of deposit insurance. Four banks are currently registered in the scheme and deposits of up to KM 5,000 are insured in these banks. A similar law has been passed in RS but not yet implemented. The international community also favours merging the two insurance agencies.

Social reform

Pension reforms are finally being enacted.
After long delays, the authorities are implementing measures to ensure that no new pension arrears will be incurred. The process involves linking pension entitlements each month to pension contributions received that month, plus transfers from the budget. However, implementation of these new measures has been inconsistent. It is intended that existing arrears will be cleared over time through privatisation receipts.

1 The territorial constitutional entities distinguished in this assessment include the State of Bosnia and Herzegovina (BH), the Federation of Bosnia and Herzegovina (FBH), Republika Srpska (RS) and the cantons of the Federation. The 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 revenue in GDP – **53 per cent** [1]
Exchange rate regime – **currency board**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **no**

Infrastructure
Independent telecoms regulator – **na**
Separation of railway accounts – **na**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes in the Federation**
Secured transactions law – **restricted**
Securities commission – **yes in the Federation**

Social reform
Share of the population in poverty – **na**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
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 trade with non-transition countries (in per cent)	na	na	58.3	67.3	57.2	53.9	59.0	67.4	75.5
Share of trade in GDP (in per cent)	67.1	na	78.5	66.1	80.9	85.0	80.4	69.5	71.9
Tariff revenues (in per cent of imports)	na	na	na	na	10.5	7.6	9.2	11.4	na
EBRD index of price liberalisation	1.0	1.0	1.0	1.0	2.0	2.0	3.0	3.0	3.0
EBRD index of forex and trade liberalisation	2.0	2.0	1.0	1.0	1.0	3.0	3.0	3.0	3.0
Privatisation									
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	35.0	35.0	35.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.3
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	1.0	1.0	2.0	2.0	2.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	na	na	1.1	0.1	0.3	0.3	na
Effective statutory social security tax (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/GDP (in per cent)	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	14.2	14.6	7.1	5.4	9.0	8.4	9.1	9.6	na
Railway labour productivity (1996=100)	na	na	na	na	100.0	85.5	88.7	97.5	196.9
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	na	na	4.4 (60)	3.6 (60)	3.5 (86)	5.1 (94)	na
Electricity consumption/GDP (1989=100)	188.9	302.0	77.1	71.7	39.8	29.8	28.0	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	na	1.7	2.4
Financial institutions									
Number of banks (of which foreign owned)	na	na	na	na	na	na	na	na	56 (14)
Asset share of state-owned banks (in per cent)	na	na	na	na	na	na	na	na	55.4
Non-performing loans (in per cent of total loans)	na	na	na	na	na	na	na	na	15.7
Domestic credit to private sector (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	1.0	1.0	1.0	1.0	1.0	1.0	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	2.0	2.0	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	1.0	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
Life expectancy at birth, total (years)	72.2	na	na	na	na	73.1	73.3	73.0	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] Estimate of general government revenue as per cent of Bosnia and Herzegovina GDP in 1999.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure					*(Percentage change in real terms)*				
GDP	-40.0	-40.0	20.8	86.0	37.0	10.0	10.0	5.0	5.0
Total consumption	na	na	4.8	52.5	15.0	7.6	na	na	na
Gross fixed investment	na	na	67.1	175.1	61.3	5.2	na	na	na
Industrial gross output	na	na	33.0	38.1	51.4	18.5	10.5	9.5	na
Agricultural gross output	na	na	-9.7	28.4	22.8	8.6	na	na	na
Employment					*(Percentage change)*				
Labour force (end-year)	-10.5	-12.5	-12.5	-12.5	4.1	-2.7	1.3	na	na
Employment (end-year) [1]	na	11.2	67.8	69.4	0.1	16.9	2.5	na	na
					(In per cent of labour force)				
Unemployment (end-year)	na	na	na	na	37.0	38.0	40.0	40.1	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average) [2]									
Federation (KM based)	na	780.0	-4.4	-24.5	14.0	5.1	-0.3	1.9	3.3
Republika Srpska (KM based)	na	1,061.0	12.9	16.9	-7.3	2.0	14.0	14.7	11.0
Consumer prices (end-year)									
Federation (KM based)	na	na	na	7.7	13.6	1.8	-1.0	4.0	2.4
Republika Srpska (KM based)	na	na	na	-17.7	-10.0	5.6	14.0	16.1	6.2
Gross average monthly earnings in economy (annual average)									
Federation	na	na	na	289.5	66.6	6.3	17.2	8.3	na
Republika Srpska	na	na	na	41.7	62.4	52.2	60.0	39.9	na
Government sector					*(In per cent of GDP)*				
General government balance	na	na	-0.3	-4.4	-0.5	-6.9	-7.0	-5.5	-5.0
General government expenditure	na	na	39.3	52.7	39.7	49.9	54.9	52.7	na
Monetary sector					*(Percentage change)*				
Broad money (M2, end-year) [3]	na	na	8.5	96.2	52.0	31.3	39.9	16.1	na
Domestic credit (end-year)	na	na	-9.0	4.3	17.6	10.9	-1.3	3.4	na
					(In per cent of GDP)				
Broad money (M2, end-year) [3]	na	17.9	14.8	18.8	19.3	22.6	26.0	27.6	na
Exchange rates					*(Dinar/KM per DM)*				
Exchange rate (annual average) [4]	na	na	1.0	1.0	1.0	1.0	1.0	1.0	na
External sector					*(In millions of US dollars)*				
Current account	na	-177	-193	-748	-1,060	-790	-971	-909	-992
Trade balance	-53	-803	-930	-1,546	-1,758	-1,959	-1,852	-1,616	-1,608
Merchandise exports [5]	7	91	152	336	575	697	649	732	877
Merchandise imports [5]	60	894	1,082	1,882	2,333	2,656	2,502	2,348	2,485
Foreign direct investment, net [6]	na	0	0	0	0	100	90	150	164
Gross reserves (end-year), excluding gold	na	na	na	235	80	175	455	499	na
External debt stock [7]	na	na	3,361	3,620	4,076	2,985	3,095	2,584	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	0.6	0.6	1.2	0.4	0.7	2.0	2.4	na
					(In per cent of exports of goods and services)				
Debt service [7]	na	na	134.6	87.1	38.4	10.4	13.2	13.0	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions) [7]	4.1	4.2	4.2	4.1	4.2	4.2	4.3	4.3	na
GDP (in millions of markas)	na	2,035	2,676	4,125	6,116	7,336	8,323	9,115	10,350
GDP per capita (in US dollars)	297	299	445	669	815	993	1,054	996	na
Share of industry in GDP (in per cent)	na	na	23.9	21.4	22.6	22.5	na	na	na
Share of agriculture in GDP (in per cent)	na	na	24.6	20.5	17.5	16.0	na	na	na
Current account/GDP (in per cent)	na	-14.1	-10.3	-27.3	-31.0	-18.9	-21.4	-21.2	-20.4
External debt - reserves, in US$ millions	na	na	3,154	3,162	3,996	2,810	2,640	2,085	na
External debt/GDP (in per cent)	na	na	180.0	132.1	119.1	71.6	68.3	60.3	na
External debt/exports of goods and services (in per cent)	na	na	882.2	550.2	406.8	236.9	257.7	216.8	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 central 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] Includes refugees abroad.

Bulgaria

Key reform challenges

- **The new government faces the challenge of fulfilling its electoral promises to improve living standards through a mix of liberal economic policies, increased social expenditures and tax cuts.**
- **Implementation of proposed changes to the Energy Act should speed up liberalisation of the sector; privatisation of the dominant telecommunications operator should also be relaunched.**
- **With privatisation of the banking sector nearing an end, increasing attention should be paid to the development of the non-bank financial sector, including full implementation of pension reforms.**

Liberalisation

EU accession remains a top priority.
Bulgaria was invited to start EU accession negotiations in December 1999. As of July 2001, 11 chapters of the *acquis communautaire* (the legal and regulatory framework for the single European market) have been provisionally closed (out of the 21 that have been opened and the 31 in total). Despite the progress made so far, the future pace of EU negotiations may slow down, as Bulgaria moves to the more complex chapters, such as those on agriculture and environment.

Stabilisation

Fiscal stability is needed to secure sustainability of the currency board.
Since introduction of the currency board in July 1997, the range of options available for deficit financing has been reduced, leaving only limited scope for fiscal expansion or accommodation of external shocks. The 2001 Budget Law reduced substantially the tax burden in order to support job creation and the development of the private sector. The tax cuts include a reduction of 2 percentage points in all personal income tax rates and 5 percentage points in the corporate profit tax rates (from 25 to 20 per cent). The tax rate on social contributions was also lowered by 3 percentage points. As a result of these measures, tax revenues for 2001 are expected to decline by one and a half percentage points of GDP. To close this gap, the authorities agreed to take legislative measures to improve collection and at the same time increase the tax base by reducing the size of the black economy. Since these measures are unlikely to yield significant near-term results, the government may also need to reduce spending to meet the 2001 fiscal target.

Privatisation

Completion of privatisation has been delayed because of the elections.
Enterprise privatisation was nearing completion at the end of 2000, with almost 78 per cent of state-owned assets (excluding infrastructure) sold to the public. About 400 enterprises with state shares remain to be sold and are included in the 2001 privatisation programme. A series of amendments to the Privatisation Act were approved in November 2000 with the aim of streamlining privatisation procedures, improving transparency and curbing the privileges of management-employee teams. However, in the first half of 2001 all the major privatisation deals were delayed due to the general elections in June. The new government recently sold Hemus Air and pledged to move ahead swiftly with the privatisation of the remaining state-owned enterprises.

The land market is still underdeveloped.
Land restitution was largely complete by the end of 2000 but a large proportion of arable land is not used and the land market is still underdeveloped. The market is constrained by the small size of the plots that are in supply, the lack of access to credit resources and low rents. A recent World Bank initiative to develop and implement a land cadastre should clear the perennial question of identifying the actual owner of agricultural land. Foreign ownership of land remains prohibited.

Enterprise reform

The regulatory and administrative framework needs to be further streamlined.
Despite significant progress in building the legislative and regulatory framework to support private sector activity, there is significant scope to improve the effectiveness of its application and implementation. Administrative procedures need to become more business friendly and business establishment and registration procedures need be further streamlined. The previous government undertook a Licensing Reform Programme to review the existing licensing and permit requirements in order to reduce administrative barriers to enterprise growth and introduced a one-stop-shop programme for business regulation. However, excessive government control through audits, inspections and approval procedures, together with an unclear interpretation and weak enforcement of existing laws, remain among the major obstacles faced by investors in Bulgaria. The newly elected government has the opportunity now to improve the investment climate by capitalising on the relatively good macroeconomic standing and political stability of the country compared with its neighbours.

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 Extra-budgetary funds closed
Jan Export tax abolished
Mar EU accession negotiations begin

Infrastructure

Important energy deals signed just ahead of elections.
A week before the June 2001 elections, the government signed two deals totalling US$ 1.4 billion with two American companies, AES and Entergy, for the modernisation of the

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
Jul Health care reform initiated

2001
Mar Labour code amended
Apr Cadastre and Property Register Act passed

electricity production in the coal-basin of Maritza-Iztok. The deals would involve the establishment of a US$ 1 billion greenfield power plant at Maritza East I and approximately US$ 400 million for the renovation of an existing power plant at Maritza East III. Closing of both projects is forecast to take place in 2002, with investment inflows concentrated in 2002-05, when construction will be completed. Electricity would be sold to the National Energy Corporation (NEK) at fixed prices by AES and Entergy, and the ownership of the plan would be transferred in 15 and 18 years respectively to NEK.

Draft changes to the energy law would foster liberalisation in the sector …
The changes to the Energy Act, presented to parliament in March 2001 and agreed with the World Bank and the IMF, are expected to lead gradually to increased competition in the industry. According to the draft, producers of electricity would be allowed from January 2002 to contract prices directly with large industrial consumers. These, in turn, would be able to negotiate gas supplies directly with foreign companies, using the distribution network of the state gas monopoly, Bulgargas. Responsibilities for regulation and licensing would be transferred to the State Commission for Energy Regulation (SCER). Finally, households that have switched off their heating would be charged fees for the heating supply to the building areas that are shared among neighbours. Individual meters to measure heating consumption by each household would also be installed.

… and the privatisation in the telecommunications sector is expected to be relaunched.
After the failure of a first attempt to privatise the Bulgarian Telecommunications Company (BTC), a new privatisation strategy for the company is being prepared by the economic team of Simeon II. The decision to grant BTC the third GSM licence was nullified by the new government because it was taken without an international tender.

Financial institutions

Bank and insurance privatisation nearing completion.
The privatisation of Biochim Bank, one of the three remaining state-owned banks in Bulgaria, has been postponed. Hebrosbank had offered to pay €26 million for the 99.6 per cent share held by the Bank Consolidation Company (BCC) in Biochim. However, the bid was rejected because it was considered too low. More recently, a decision by shareholders of the Central Cooperative Bank (CCB) paved the way for the sale of a majority stake in the bank held by BCC (32.8 per cent) and Corporate Bank (24 per cent). Talks with several banks are under way to finalise this privatisation. Two other key privatisation deals in the financial sector involve the National Insurance Company DZI, whose privatisation was put on hold after reaching an advanced stage, and the State Saving Bank (DSK Bank), whose privatisation is expected to take place in 2002.

Credit to the private sector remains low.
Despite some progress in bank lending to SMEs, intermediation remains low and credit to the private sector was only 12 per cent of GDP at the end of 2000. Banks continue to focus their activity on intermediating short-term deposits into low-risk assets rather than extending commercial loans. The government has undertaken several initiatives to facilitate an expansion of private sector credit, including the decision to streamline insolvency procedures and the submission to parliament of amendments to the Civil Procedure Code to strengthen creditors' rights and simplify the collection of collateral.

Activity on the securities market remains limited.
Trade volumes have been extremely low in the Bulgarian Stock Exchange (BSE) despite the considerable number of large companies that are quoted. To develop the domestic security market, the new government has confirmed its intention to offer and sell on the stock exchange significant packages of state shares in companies still to be privatised.

Social reform

Changes to the labour code aim to increase labour market flexibility.
In March 2001 parliament approved amendments to the labour code to make it easier for firms to adjust their workforce to changes in the economy. To alleviate the costs of labour market adjustments, the government is committed to implementing several labour market policies, including budget financing of special programmes targeted at regions with high unemployment. One of the major challenges facing the new government is to reduce unemployment from the 18 per cent peak reached at the end of 2000.

Pension and health reform advance.
Implementation of a three-pillar pension reform is under way. The first pay-as-you-go pillar has been created and a fully funded privately managed second pillar is under preparation. So far the government has licensed a dozen mandatory pension funds and most of the necessary regulations were approved in August 2000. However, before the beginning of 2002, when the second pillar is expected to become operative, further regulations must be issued to define the contribution rates and a scheme of financing transition costs from the old system to the new one should be approved. Social pensions were increased by 10 per cent at the beginning of June 2001. Health care reform is also entering its second stage after the introduction of out-patient care reform. The next step would concern hospital care reform, with the transformation of hospitals from budget units to commercial enterprises.

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 – **18 per cent**
Private pension funds – **yes**

Stabilisation
Share of general government tax revenue in GDP – **43.2 per cent**
Exchange rate regime – **currency board**

Enterprises and markets
Competition Office – **yes**

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	16.0	26.0	43.0	46.0	52.0	14.4	15.8	17.2	na
Number of goods with administered prices in EBRD-15 basket	2.0	3.0	3.0	3.0	3.0	2.0	1.0	1.0	na
Share of trade with non-transition countries (in per cent)	85.1	84.2	76.1	65.4	66.2	72.0	76.9	80.4	76.0
Share of trade in GDP (in per cent)	94.4	77.0	81.2	75.5	94.2	91.3	71.5	73.3	90.1
Tariff revenues (in per cent of imports)	4.5	7.2	7.6	7.7	4.7	4.8	5.5	2.8	1.8
EBRD index of price liberalisation	3.0	3.0	3.0	2.0	2.0	3.0	3.0	3.0	3.0
EBRD index of forex and trade liberalisation	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.0	0.2	0.7	1.5	4.7	6.4	8.7	10.0
Private sector share in GDP (in per cent)	25.0	35.0	40.0	50.0	55.0	60.0	65.0	70.0	70.0
Private sector share in employment (in per cent)	18.0	28.0	36.0	41.0	47.0	55.0	61.0	65.0	na
EBRD index of small-scale privatisation	1.0	1.7	2.0	3.0	3.0	3.0	3.0	3.3	3.7
EBRD index of large-scale privatisation	1.7	2.0	2.0	2.0	2.0	3.0	3.0	3.0	3.7
Enterprises									
Budgetary subsidies (in per cent of GDP)	1.4	1.9	1.4	1.1	0.8	0.7	2.1	1.5	na
Effective statutory social security tax (in per cent)	66.4	63.1	64.2	61.8	61.3	61.1	65.3	65.8	na
Share of industry in total employment (in per cent)	32.6	30.4	29.1	28.1	27.5	26.6	24.7	23.9	na
Change in labour productivity in industry (in per cent)	7.9	2.3	9.9	-3.3	-10.1	-4.3	12.3	-2.8	na
Investment rate/GDP (in per cent)	16.2	13.0	13.8	15.7	8.4	11.4	14.7	16.4	18.0
EBRD index of enterprise reform	1.0	1.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	26.3	27.2	33.5	30.6	31.3	32.3	32.9	34.2	na
Railway labour productivity (1989=100)	62.9	70.0	69.9	76.9	74.0	80.7	73.4	65.3	71.2
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	1.42 (82)	2.18 (85)	3.5 (85)	1.9 (89)	2.4 (110)	2.8 (112)	na
Electricity consumption/GDP (1989=100)	101.8	103.2	101.4	107.9	122.7	118.5	112.7	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.7	3.0	3.1
Financial institutions									
Number of banks (of which foreign owned)	79 (0)	41 (0)	40 (1)	41 (3)	42 (3)	28 (7)	34 (17)	34 (22)	35 (25)
Asset share of state-owned banks (in per cent)	na	na	na	na	82.2	66.0	56.4	50.5	19.8
Non-performing loans (in per cent of total loans) [1]	na	6.7	6.8	12.5	15.2	13.0	11.8	17.5	10.9
Domestic credit to private sector (in per cent of GDP) [2]	5.8	3.7	3.8	21.1	35.6	12.6	12.7	14.6	12.2
Stock market capitalisation (in per cent of GDP)	na	na	na	0.5	0.2	0.0	7.7	6.0	5.1
EBRD index of banking sector reform	1.7	2.0	2.0	2.0	2.0	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	2.0	2.0	2.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	3.0	4.0	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	3.0	4.0	3.7	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	12.6	10.4	8.6	7.7	6.5	7.4	7.4	na	na
Life expectancy at birth, total (years)	71.2	71.1	71.0	70.9	70.8	70.7	70.9	71.1	na
Basic school enrolment ratio (in per cent)	95.1	94.0	94.3	93.7	93.6	94.0	94.3	na	na
Earnings inequality (GINI-coefficient)	na	25.1	na	na	29.1	na	na	na	na

[1] Changes in non-performing loans data compared with previous Transition Reports are due to the change of loan categories included in non-performing loans (see definitions).

[2] Credit expansion in 1995 and 1996 was followed by a banking crisis in 1997, greatly reducing the stock of credit to the enterprise sector.

	1993	1994	1995	1996	1997	1998	1999	2000 Estimate	2001 Projection
Output and expenditure					(Percentage change in real terms)				
GDP	-1.5	1.8	2.1	-10.9	-6.9	3.5	2.4	5.8	4.0
Private consumption	-0.7	-2.6	-1.8	-2.1	-15.7	8.1	5.2	2.1	na
Public consumption	-12.6	-11.5	-7.4	28.7	-11.5	4.1	-0.4	19.1	na
Gross fixed investment	-17.5	1.1	8.8	-52.8	-23.9	16.4	25.3	9.8	na
Exports of goods and services	na	na	na	na	3.1	-15.6	-5.2	20.0	na
Imports of goods and services	na	na	na	na	-2.7	-2.8	5.1	17.6	na
Industrial gross output	-6.2	5.9	-5.4	-11.8	-11.3	4.3	-12.5	12.0	na
Agricultural gross output	-30.2	9.4	14.5	-7.4	32.9	1.4	0.6	-15.5	na
Employment					(Percentage change)				
Labour force (annual average)	-0.1	-3.1	-0.6	1.6	-2.2	-1.7	-5.8	-4.0	na
Employment (annual average)	-1.6	0.6	1.3	0.1	-3.9	-0.1	-6.9	-6.8	na
					(In per cent of labour force)				
Unemployment (end-year)	16.4	12.8	11.1	12.5	13.7	12.2	16.0	17.9	na
Prices and wages					(Percentage change)				
Consumer prices (annual average)	73.0	96.3	62.0	123.0	1,082.0	22.2	0.7	9.9	8.0
Consumer prices (end-year)	63.9	121.9	32.9	310.8	578.6	0.9	6.2	11.4	2.8
Producer prices (annual average)	26.9	75.0	52.7	126.9	901.8	17.1	4.4	17.3	na
Producer prices (end-year)	24.9	105.3	38.9	356.7	472.6	0.5	14.0	14.7	na
Gross average monthly earnings in economy (annual average)	57.8	53.5	53.2	89.4	815.9	46.5	5.1	16.3	na
Government sector [1]					(In per cent of GDP)				
General government balance	-8.7	-3.9	-5.7	-10.4	-2.1	0.9	-0.9	-1.1	-1.5
General government expenditure	48.1	45.7	41.3	42.3	33.5	35.8	40.7	44.5	na
General government debt	150.9	159.6	111.1	152.5	116.6	100.7	96.6	94.1	na
Monetary sector					(Percentage change)				
Broad money (M3, end-year)	47.6	78.6	39.6	124.5	359.3	9.6	11.4	26.4	na
Domestic credit (end-year)	56.0	37.1	16.8	216.8	155.5	-17.7	0.2	9.9	na
					(In per cent of GDP)				
Broad money (M3, end-year)	78.3	79.5	66.3	74.9	35.3	30.6	32.3	36.5	na
Interest and exchange rates					(In per cent per annum, end-year)				
Base interest rate	52.0	72.0	34.0	180.0	6.7	5.1	4.5	4.6	na
Interbank interest rate (up to 1 month)	68.3	108.0	44.2	448.8	1.6	2.9	2.6	2.6	na
Deposit rate (1 month)	53.6	72.3	25.3	211.8	3.0	3.3	3.3	3.1	na
Lending rate (less than 1 year)	83.7	117.8	51.4	480.8	13.9	13.3	14.1	11.5	na
					(Leva per US dollar)				
Exchange rate (end-year)	0.033	0.066	0.071	0.487	1.777	1.675	1.947	2.100	na
Exchange rate (annual average)	0.028	0.054	0.067	0.178	1.674	1.760	1.836	2.123	na
External sector					(In millions of US dollars)				
Current account	-1,099	-31	-198	164	1,048	-62	-652	-701	-770
Trade balance	-885	-17	37	122	321	-381	-1,081	-1,175	-1,700
Merchandise exports	3,727	3,935	4,967	4,689	4,809	4,193	4,006	4,812	5,100
Merchandise imports	4,612	3,952	4,930	4,568	4,488	4,574	5,087	5,988	6,800
Foreign direct investment, net	40	105	82	81	503	537	836	1,000	500
Gross reserves (end-year), excluding gold	655	1,002	1,236	518	2,121	2,679	2,900	3,460	na
External debt stock	13,836	11,338	10,148	9,602	9,760	10,260	9,984	10,364	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	1.3	2.3	2.2	1.0	4.4	5.4	5.3	5.4	na
					(In per cent of export of goods and services)				
Debt service	8.6	27.4	13.6	15.9	12.4	19.0	16.9	16.5	na
Memorandum items					(Denominations as indicated)				
Population (end-year, millions)	8.5	8.4	8.4	8.3	8.3	8.2	8.2	8.1	na
GDP (in millions of levas)	299	526	880	1,749	17,055	21,577	22,776	25,454	28,589
GDP per capita (in US dollars)	1,281	1,152	1,563	1,179	1,230	1,490	1,513	1,476	na
Share of industry in GDP (in per cent) [2]	32.7	29.9	31.0	28.5	25.3	25.5	24.6	25.1	na
Share of agriculture in GDP (in per cent) [2]	9.9	11.5	12.7	14.5	23.8	18.8	15.9	13.4	na
Current account/GDP (in per cent)	-10.1	-0.3	-1.5	1.7	10.3	-0.5	-5.3	-5.8	-5.8
External debt - reserves, in US$ millions	13,181	10,337	8,912	9,084	7,639	7,581	7,084	6,904	na
External debt/GDP (in per cent)	127.7	116.8	77.4	97.7	95.8	83.7	80.5	86.4	na
External debt/exports of goods and services (in per cent)	282.5	218.4	150.6	145.3	139.2	171.5	172.3	148.3	na

[1] General government includes the state, municipalities and extra-budgetary funds.

[2] From 1995, the industrial classification changed. Using the old classification, industry as a share of GDP was 32.4 per cent in 1996 and the share of agriculture in GDP was 12.8 per cent.

Croatia

Key reform challenges

- **While strong efforts are being made to reduce the fiscal deficit, the government should address structural weaknesses in government finances, especially in the area of social welfare expenditures.**
- **Despite recent improvements, inter-enterprise arrears remain high and the number of bankrupt enterprises is rising; bankruptcy administration procedures should be strengthened to promote enterprise restructuring.**
- **Recent delays in the liberalisation of fixed-line telecommunications services should not divert the focus away from creating a sound regulatory framework and competitive environment.**

Liberalisation

Restrictions on capital account transactions have been eased.
The foreign exchange law has been amended, with effect from June 2001. Under the amended law, individuals will be able to open foreign exchange accounts abroad and banks will be able to offer foreign currency denominated loans, in addition to foreign exchange indexed loans. In preparation for the expected increase in capital account transactions, the central bank has adapted its monetary policy. In July 2001 reserve requirements were reduced from 23.5 per cent to 22 per cent and the base for the calculation of reserve requirements was extended to include foreign currency.

Stabilisation

Structural deficits are gradually being addressed.
In March 2001 the government signed a Stand-By Arrangement with the IMF for SDR 200 million (US$ 256 million). A key objective under this arrangement is the reduction of the consolidated central government deficit. On an accrual basis, the deficit was 5.7 per cent of GDP in 2000; the target is to reduce it to 5.3 per cent of GDP in 2001 and 4.3 per cent in 2002. The key to achieving these targets is a 9 per cent reduction of the total wage bill of the consolidated central government and rationalisation of social transfers. The government introduced a new framework for public sector wages in June 2001 and is set to reduce the number of government employees by 10,000 by the end of the year. The parliament is also considering legislation to align benefits of privileged groups with those of the general population and to better target social benefits.

Privatisation

Privatisation of remaining state-held shares is moving forward.
By mid-2000 there were 1,852 enterprises in the portfolio of the Croatian Privatisation Fund (CPF) worth HRK 24 billion (€314 million) in nominal value terms. These enterprises were recording daily losses of HRK 7.5 million (€1 million). The state held a majority stake in 307 enterprises. By September 2001 the CPF had reduced the number of companies in its portfolio to 1,598 through liquidation, sales of minority stakes and management changes, and daily losses had been reduced to HRK 3.4 million (€454,000). It was planned that shares (mainly minority) in around 1,000 enterprises would be divested during 2001 through various methods including public sector arrears-to-equity swaps, the exchange of shares for privatisation vouchers, and the sale of shares through public tenders and auctions.

Enterprise reform

Total arrears have fallen but the number of troubled enterprises continues to rise …
Total arrears in the economy declined from 19 per cent of GDP at the end of 1999 to 13 per cent by the end of 2000 and 11 per cent by June 2001. This largely reflected the partial clearance of government arrears and increased liquidity in the banking system. Total loans to enterprises remained largely flat during 2000 but are now increasing. However, the number of enterprises in arrears increased from 30,278 at the end of 1999 to 33,076 by June 2001, and the number with arrears in excess of three months, and hence technically bankrupt, is also rising.

… and enterprise restructuring is hampered by a weak judicial system.
While the scope of the new bankruptcy law of March 1999 is extensive, its effectiveness has been hampered by the inefficiency of the court system. The number of bankruptcies filed at regional commercial courts increased from 887 during 1999 to 1,422 in 2000. However, the judiciary could not deal effectively with the rising number of bankruptcy filings and at the end of 2000 there were 1,454 pending bankruptcy cases, an increase from 929 cases at the end of 1999. In July 2001 the government launched a US$ 7 million project, funded by the World Bank and jointly implemented by USAID, to improve the efficiency of the judiciary in the bankruptcy process. The programme focuses on strengthening the capacity of the court and extra-court systems through the training of professionals and the creation of a legal information system for bankruptcy administration.

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
2001	
Mar	IMF stand-by arrangement agreed
Jun	Capital accounts restrictions eased

Infrastructure

Croatia Telecoms continues to be privatised but its monopoly period is extended.
In 2001 the privatisation of further stakes in Croatia Telecoms (HT) became a high priority in order to help finance the budget deficit. The government had planned to privatise a further 21 per cent stake in HT through domestic and international public offerings. However, the public offerings became increasingly unattractive due to the weak performance of telecommunications shares in global equity markets. Therefore, in July 2001 the government agreed instead to privatise a 16 per cent stake to Deutsche Telekom (DT) for €500 million. The deal is to be signed later this year and will give DT, which already owns 35 per cent, a controlling stake in the company. The agreement is

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	Dubrovcka 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

2001

Apr	New central bank law enacted
May	Establishment of independent pensions regulator
Jul	New energy laws adopted

controversial as the price was subject to the government meeting certain requirements, including a change in the law on telecommunications, in order to extend the exclusivity period of HT by two years. The extension is in breach of Croatia's commitment to the WTO to liberalise fixed-line infrastructure from 2003.

New energy laws will provide the basis for liberalisation and privatisation.
Five new laws governing the energy sector – on energy, the electricity market, regulation of energy activities, the gas market and the oil and oil derivatives markets – were adopted in July 2001. The laws set out the framework for regulation and market liberalisation in the electricity, gas, oil and other energy sectors. Large-user electricity and gas markets will be opened from January 2002. An independent energy sector regulator will be established shortly with the mandate of overseeing the operation of competitive energy markets and of proposing tariffs for monopoly industry components (for example, power transmission and distribution). The laws present models for restructuring INA (a company with a monopoly in gas distribution and which also engages in oil exploration, refining and distribution) and Croatian Energy (HEP – an integrated electric power monopoly). However, privatisation of these companies, planned for 2002, will be the subject of separate legislation to be adopted by the end of 2001.

Financial institutions

The banking system gradually becomes stronger …
Following a series of sales during 1998-2000 of rehabilitated banks to foreign strategic investors, foreign-controlled banks now account for over 80 per cent of banking assets. The capital adequacy of the system, measured according to Basel criteria, was 21 per cent at the end of 2000. Financial performance, measured both by return over assets (ROA) and by return over equity (ROE), improved from 0.7 per cent and 8.3 per cent respectively in 1999 to 1.9 per cent and 24.6 per cent in 2000. Total non-performing loans at the end of 2000 were still high at 9.3 per cent of total assets but had declined from 10.3 per cent in 1999. The consolidation of the banking sector is taking place through mergers and acquisitions. At the end of 2000 the four largest banks accounted for 61 per cent of the total assets of the banking system. A bid for the take-over of Zagrebacka Banka, launched by UniCredito (Italy) and Allianz (Germany) in May 2001, would have led to a further consolidation of the system as UniCredito also controls Splitska Banka. However, UniCredito withdrew its application when it became clear that the central bank would not approve the take-over because the combined market share of Zagrebacka Banka Group and Splitska Banka would total almost 40 per cent.

… and the government aims to complete the privatisation of the financial sector.
Two rehabilitated banks, Dubrovacka Banka and Croatia Banka, remain 100 per cent state-owned. Public tenders for the sales of 75 per cent minus two shares of these banks closed in June 2001, with the goal of finalising the privatisation by the end of the year. In August 2001 a privatisation advisor for the Croatian Insurance Group (COG) was selected for the privatisation of the state's 77.5 per cent shareholding in the first half of 2002. A subsidiary of COG, Croatian Insurance, controls 50 per cent of the insurance market. Privatisation is likely to enhance further competition in the sector.

Social reform

A privately managed second-pillar pension system will be launched in January 2002.
While a law establishing a "three-pillar" pension system was approved by parliament in 1998, implementation has been greatly delayed both by fears of the short-term fiscal impact and by lack of preparation to establish the necessary technical and regulatory infrastructure. A central register, REGOS, and a new regulator, the Agency for Supervision of Pension Funds and Pension Insurance (HAGENA), were established in October 2000 and May 2001 respectively in order to put the privately managed second pillar into operation in January 2002. HAGENA is scheduled to provide licences to private fund management companies in autumn 2001. It is estimated by the regulator that there will be inflows of HRK 2.5 billion (US$ 300 million) into the second pillar in 2002. Up to 30 per cent of the assets of the pension funds may be allocated to listed equities and it is expected that the launch of the second pillar will boost both market capitalisation and turnover of the local stock exchange.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of central government tax revenue in GDP – **40.6 per cent** [1]
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **voucher**
Tradability of land – **full except foreigners** [2]

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **10 per cent**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **4 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
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	4.0	4.0	2.0	2.0	1.0
Share of trade with non-transition countries (in per cent)	na	72.3	69.1	68.9	65.1	61.3	64.9	69.8	68.9
Share of trade in GDP (in per cent)	64.0	78.2	66.2	66.6	64.0	67.7	61.8	60.2	64.8
Tariff revenues (in per cent of imports) [3]	10.9	7.4	10.8	9.5	8.9	8.1	7.6	8.1	6.1
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	4.0	4.0	4.0	4.0	4.0	4.0	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP) [4]	na	na	0.4	0.9	1.4	2.0	3.6	8.1	10.1
Private sector share in GDP (in per cent)	25.0	30.0	35.0	40.0	50.0	55.0	55.0	60.0	60.0
Private sector share in employment (in per cent)	26.0	36.0	45.0	48.0	53.0	54.0	54.0	58.0	56.0
EBRD index of small-scale privatisation	3.0	4.0	4.0	4.0	4.3	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	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	3.8	3.6	2.0	1.8	1.9	1.9	2.4	2.4	2.4
Effective statutory social security tax (in per cent)	na	na	na	na	na	na	na	na	na
Share of industry in total employment (in per cent) [5]	35.4	35.1	35.1	34.4	31.5	32.1	28.8	28.3	27.7
Change in labour productivity in industry (in per cent) [5]	-0.8	-2.7	1.7	5.7	12.6	6.6	7.4	1.7	4.3
Investment rate/GDP (in per cent)	13.8	14.4	13.6	15.7	20.5	24.2	23.7	23.4	22.0
EBRD index of enterprise reform	1.0	1.0	2.0	2.0	2.7	2.7	2.7	2.7	2.7
EBRD index of competition policy	1.0	1.0	1.0	1.0	2.0	2.3	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	20.0	21.5	25.2	27.2	30.9	33.5	34.8	36.5	na
Railway labour productivity (1989=100)	35.6	40.9	42.4	49.4	44.1	46.0	52.1	52.9	58.2
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	7.3 (na)	8.2 (na)	7.9 (na)	7.0 (na)	7.0 (na)	6.8 (na)	na
Electricity consumption/GDP (1989=100)	102.2	111.2	105.5	103.0	99.7	100.9	99.3	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.3	2.3	2.6
Financial institutions									
Number of banks (of which foreign owned)	na	43 (na)	50 (na)	54 (1)	58 (4)	61 (7)	60 (10)	53 (13)	44 (20)
Asset share of state-owned banks (in per cent)	na	58.9	55.5	51.9	36.2	32.6	37.5	39.6	5.7
Non-performing loans (in per cent of total loans) [6]	na	na	12.2	12.9	11.2	8.2	12.6	20.6	19.7
Domestic credit to private sector (in per cent of GDP)	na	37.7	21.2	22.9	21.4	25.3	26.6	22.0	na
Stock market capitalisation (in per cent of GDP)	na	na	3.3	3.1	15.3	21.6	14.5	13.9	14.1
EBRD index of banking sector reform	1.0	2.0	2.7	2.7	2.7	2.7	2.7	3.0	3.3
EBRD index of reform of non-banking financial institutions	1.0	1.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	4.0	4.0	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	4.0	3.0	2.7	3.3
Social sector									
Expenditures on health and education (in per cent of GDP) [7]	na	na	12.2	12.5	11.2	10.4	11.2	12.4	13.5
Life expectancy at birth, total (years)	71.2	na	na	72.1	72.4	72.5	72.8	73.0	na
Basic school enrolment ratio (in per cent)	85.0	89.0	88.0	89.0	94.4	94.3	na	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

[1] Includes tax revenues of extra-budgetary 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 currency deposits.

[5] Based on Employment Service and enterprise data. Until 1996, data are according to UCEA classification standards. From 1997, data are according to NCEA classification standards.

[6] Changes in non-performing loans data compared with previous Transition Reports are due to the change of loan categories included in non-performing loans (see definitions).

[7] Refers to expenditures by the central government on education and expenditures by the health insurance fund.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	*Projection*
Output and expenditure				*(Percentage change in real terms)*					
GDP	-8.0	5.9	6.8	6.0	6.5	2.5	-0.4	3.7	3.8
Private consumption	na	na	na	na	na	-0.6	-2.7	4.1	na
Public consumption	na	na	na	na	na	2.3	0.8	-0.7	na
Gross fixed investment	na	na	na	na	na	2.5	-1.1	-3.5	na
Exports of goods and services	na	na	na	na	na	3.9	0.7	8.7	na
Imports of goods and services	na	na	na	na	na	-4.9	-2.7	4.2	na
Industrial gross output	-6.0	-2.7	0.3	3.1	6.8	3.7	-1.4	1.7	na
Agricultural gross output	na	-0.3	0.7	1.3	4.0	10.2	-3.5	2.8	na
Employment [1]				*(Percentage change)*					
Labour force (annual average)	na	-1.0	-1.3	0.9	3.4	-1.5	-1.0	7.2	na
Employment (annual average) [1]	-2.6	-4.2	-3.3	-1.4	3.4	-3.1	-3.4	4.1	na
				(In per cent of labour force)					
Unemployment (annual average)	14.8	14.5	14.5	10.0	9.9	11.4	13.6	16.1	na
Prices and wages				*(Percentage change)*					
Retail prices (annual average)	1,517.5	97.6	2.0	3.5	3.6	5.7	4.2	6.2	5.7
Retail prices (end-year)	1,149.0	-3.0	3.8	3.4	3.8	5.4	4.4	7.4	6.4
Producer prices (annual average)	1,512.4	77.6	0.7	1.4	2.3	-1.2	2.6	9.7	na
Producer prices (end-year)	1,075.6	-5.5	1.6	1.5	1.6	-2.1	5.9	11.2	na
Gross average monthly earnings in economy (annual average) [2]	na	na	34.0	12.3	13.1	12.6	10.2	7.0	na
Government sector [3]				*(In per cent of GDP)*					
General government balance	-0.8	1.2	-1.4	-1.0	-1.9	-1.0	-6.5	-6.9	-5.3
General government expenditure	35.0	40.6	44.9	45.3	44.4	46.7	49.3	47.3	na
General government debt	na	22.2	19.3	28.5	27.3	26.2	32.8	34.6	na
Monetary sector				*(Percentage change)*					
Broad money (M4, end-year)	na	75.7	39.3	49.1	38.3	13.0	-1.1	29.3	na
Domestic credit (end-year)	na	36.3	18.6	3.1	44.4	22.4	-6.6	8.9	na
				(In per cent of GDP)					
Broad money (M4, end-year)	25.8	20.2	25.0	34.0	41.0	41.7	39.7	46.6	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinancing rate (3 months)	97.4	14.0	27.0	9.5	9.0	10.5	11.6	7.0	na
Interbank interest rate (daily)	86.9	17.8	27.2	10.4	9.4	15.8	12.7	4.5	na
Deposit rate [4]	27.4	5.0	6.1	4.2	4.4	4.1	4.3	3.4	na
Lending rate [4]	59.0	15.4	22.3	18.5	14.1	16.1	13.5	10.5	na
				(Kuna per US dollar)					
Exchange rate (end-year)	6.6	5.6	5.3	5.5	6.3	6.2	7.6	8.8	na
Exchange rate (annual average)	3.6	6.0	5.2	5.4	6.2	6.4	7.1	8.3	na
External sector				*(In millions of US dollars)*					
Current account	623	854	-1,442	-1,091	-2,325	-1,530	-1,391	-399	-839
Trade balance	-723	-1,142	-3,259	-3,624	-5,196	-4,147	-3,299	-3,204	-3,364
Merchandise exports	3,904	4,260	4,633	4,546	4,210	4,605	4,395	4,567	4,795
Merchandise imports	4,627	5,402	7,892	8,169	9,407	8,752	7,693	7,771	8,159
Foreign direct investment, net	102	110	109	486	347	835	1,445	827	470
Gross reserves (end-year), excluding gold	616	1,405	1,895	2,314	2,539	2,816	3,025	3,525	na
External debt stock	2,638	3,020	3,809	5,308	7,452	9,586	9,872	10,876	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	1.3	2.5	2.4	2.8	2.7	3.2	3.7	4.4	na
				(In per cent of export of goods and services)					
Debt service	9.7	8.9	9.6	8.9	10.4	11.8	20.2	17.6	na
Memorandum items				*(Denominations as indicated)*					
Population (mid-year, millions)	4.6	4.6	4.7	4.5	4.6	4.5	4.5	4.6	na
GDP (in millions of kuna)	39,003	87,441	98,382	107,981	123,812	137,604	142,700	157,511	172,802
GDP per capita (in US dollars)	2,349	3,137	4,029	4,422	4,398	4,805	4,458	4,179	na
Share of industry in GDP (in per cent)	na	na	22.8	21.6	21.9	21.1	21.6	22.3	na
Share of agriculture, in GDP (in per cent) [5]	na	na	8.6	8.4	7.8	7.9	8.0	8.1	na
Current account/GDP (in per cent)	5.7	5.9	-7.7	-5.5	-11.6	-7.1	-6.9	-2.1	-4.1
External debt - reserves, in US$ millions	2,022	1,615	1,914	2,994	4,913	6,771	6,848	7,351	na
External debt/GDP (in per cent)	24.2	20.7	20.2	26.7	37.1	44.3	49.2	57.2	na
External debt/exports of goods and services (in per cent)	42.6	42.4	53.7	67.7	90.7	111.9	121.6	125.7	na

[1] Employment Service and enterprise data until 1996. From 1997, based on labour force surveys.
[2] Until 1994 net wages, gross wages thereafter.
[3] Consolidated central government. Government expenditures include net lending.
[4] Weighted average over all maturities.
[5] Including hunting, forestry and fishing.

Czech Republic

Key reform challenges

- **Further progress in enterprise reform requires strengthening of the legal framework for enterprises, effective enforcement of creditor rights, and the workout of bad loans transferred to the former Consolidation Bank.**
- **Fiscal policy reform, particularly to address increasingly generous social payments and enterprise subsidies, is necessary to lower the budget deficit.**
- **Completion of energy sector reform is needed to provide effective regulation in a liberalised sector and to facilitate privatisation and the entry of new competitors.**

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

Apr	Austerity package announced
May	Currency crisis
May	Managed float exchange rate regime adopted
May	Second austerity package announced

1998

Mar	EU accession negotiations started
Apr	Investment incentives adopted

Stabilisation

The budget deficit has increased significantly.
The general government deficit, excluding privatisation revenues, reached 4.9 per cent of GDP in 2000 and is expected to almost double in 2001 to more than 9 per cent of GDP. A large part of the increase in the deficit is related to the cost of restructuring the banking sector, which reached CZK 106 billion in 2000, equivalent to about 5 per cent of GDP, and will total about CZK 191 billion over the 2001-04 period, (almost 10 per cent of current GDP). Social welfare expenditures have also been rising, to about 53 per cent of total state budget expenditures in 2000, compared with 43 per cent in 1995. In addition, the stock of state loan guarantees had reached CZK 135 billion (CZK 104 billion on a risk adjusted basis) by the end of 2000, equivalent to almost 7 per cent of GDP. Since January 2001, parliament has tightened the rules on extension of new state guarantees, requiring each guarantee to be approved as a separate law.

Enterprise reform

Commercial legislation has been amended but implementation is lacking.
In January 2001 a number of commercial law amendments were enacted. They include: strengthening of minority shareholder rights during take-overs, tightening disclosure requirements for publicly listed companies, increasing the supervisory powers of the Securities Commission, and streamlining the approval process for issuing commercial bonds and enhancing disclosure requirements. However, the judicial system remains weak with an inadequate number of judges and slow legal procedures, particularly in relation to bankruptcy. Many enterprises are allowed to operate despite being technically bankrupt as only 14 per cent of outstanding bankruptcy cases in 2000 were resolved.

Foreign direct investment remains strong.
The Czech Republic has attracted about US$ 14 billion in foreign direct investment over the last three years. This has resulted in the highest cumulative flows of FDI per capita in the region, strong investment-led growth and declining unemployment. Foreign-owned enterprises now account for about 40 per cent of industrial output, up from about 15 per cent in 1997, and about two-thirds of pre-tax profits. This increase in FDI follows the introduction of a generous package of investment incentives adopted in 1998, adding to rather than replacing existing subsidies to ailing enterprises. These investment incentives include up to 10 years of corporate tax holidays, duty-free imports and financial support by the government for training and creation of new jobs. However, investment incentives are typically not available for small and medium-sized enterprises.

A new growth strategy has been approved.
In July 2001 the government approved a strategy for increasing economic growth in the short term, mostly consolidating existing initiatives and focusing on housing and infrastructure projects, industrial zones, support for SMEs and restructuring of ailing industrial conglomerates, primarily in the mining and steel sectors. The plan assumes total investment of CZK 166.4 billion (about US$ 4 billion), financed by the budget, privatisation revenues, transfers from the EU and loans from commercial banks. A new steel restructuring plan approved by the government assumes the merger of existing independent steel producers, three state-owned and one private, the transfer of their debts to the state, and the eventual privatisation of the state's share in the new entity.

Infrastructure

Energy sector reform has moved forward …
A new Energy Act was adopted in November 2000. It envisages liberalisation of 30 per cent of the electricity market in 2002, increasing the share of the market open to competition to 50 per cent by 2005 and moving to full liberalisation in 2006. The gas market will be more restricted, with a minimum of 28 per cent of the market liberalised by 2005 and 33 per cent by 2008. An independent Energy Regulatory Office for both the gas and the electricity sectors was established in January 2001, taking over responsibility for connection charges from the Ministry of Finance and assuming the regulatory functions of the Ministry of Industry and Trade. Household gas prices increased by 40 per cent in July 2001 to move further towards the goals of cost recovery and the elimination of cross-subsidies by the end of 2002.

… but little progress has been achieved in utility privatisation.
The state still owns majority stakes in large energy companies, including the dominant power generating company CEZ, the regional power and gas distribution companies, and the gas transmission company, Transgas. In

Enterprises, infrastructure, finance and social reforms

1990
Jan Two-tier 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
Nov New energy law adopted

2001
Jan New capital market laws enacted
Jun Bank privatisation completed

addition, the state owns majority stakes in the dominant telecommunications operator, Czech Telecom, and another large telecommunications company, Ceske Radiokomunikace (CR). Although the government planned to make rapid progress with the privatisation of the telecommunications companies and utilities, adverse market conditions have deterred it from selling its stakes in these firms. The government agreed on the sale of CR to Tele Danmark Communication and Deutsche Bank for US$ 177 million in early September but the achieved price was about two-thirds of the original expectations. The energy sector companies are to be sold in two packages. One combines gas transmission and distribution companies and the other consists of power generation and distribution companies. However, disagreements within the government have led to delays in the privatisation process.

The first privately financed motorway construction contract has been awarded.
The government decided to speed up its motorway construction programme and agreed in March 2001 to private financing worth US$ 1.4 billion for a section of the D47 motorway in northern Moravia to be constructed by Israeli company Housing & Construction. The government did not award the contract as the result of an open international tender but instead negotiated directly with the pre-selected private investor. The work is expected to start in spring 2002 and should take about five years to complete. The private company will fund the construction and maintenance of the motorway for 30 years and will then hand the road over to the state.

Financial institutions

Bank privatisation has been completed …
The government sold a 60 per cent stake in the last state-owned bank, Komercni Banka, to Société Générale (France) for US$ 1 billion in June 2001. This completes bank privatisation and leaves the sector dominated by a small number of foreign-owned banks that account for over 90 per cent of banking assets. Investors in privatised banks face the problem of bad loans, which still comprise almost 20 per cent of total loans despite significant pre-privatisation bank restructuring. Corporate governance and management quality in the banking sector need improvement, including tighter risk management.

… although bad asset workouts have only made a start.
The Consolidation Bank, transformed into the Consolidation Agency in September 2001, was established as a state agency for managing non-performing assets transferred from the banking sector. Over the past few years the bad assets transferred to the Consolidation Bank have reached CZK 230 billion (US$ 6 billion), more than 10 per cent of GDP. Moreover, privatised banks have the option to transfer additional non-performing assets to the Consolidation Agency, including bad assets of the failed IPB bank, which was taken over by CSOB in June 2000. It is therefore expected that the bad assets managed by the agency will increase by a further CZK 180 billion (7.8 per cent of GDP) in 2001. Following the first sell-off of a package of bad assets worth CZK 19 billion (US$ 0.5 billion) for 7 per cent of its nominal value in February 2001, the Consolidation Agency deferred further sell-offs to concentrate on a new workout strategy. Consolidation Agency losses are expected to reach up to 2.5 per cent of GDP this year.

Commercial laws have been improved but the capital market remains illiquid.
While amendments to commercial laws were enacted in January 2001 (see above), the local stock market still suffers from low liquidity and a lack of investor confidence and does not serve as a source of capital for enterprises. There have been no initial public offerings (IPOs) since the stock market was established in November 1992. A metal processing company attempted to enter the stock market through an IPO in early 2001 but the deal was postponed for lack of investor interest. A number of brokerage firms withdrew or scaled down their operations in the first half of 2001 due to low activity on the stock market, while several share trading firms became bankrupt. There is only a handful of liquid stocks, including two large banks, two telecoms companies, the dominant power generating company and an oil refinery.

Social reform

Pension eligibility rules are tightened.
The pension system is a combination of a basic pay-as-you-go system, financed by a 26 per cent payroll tax, and tax-exempt voluntary pension funds. The pension system deficit reached CZK 20 billion in 2000, equivalent to about 1 per cent of GDP, up from 0.7 per cent of GDP a year earlier. The impact of population ageing has been accentuated by the generous early retirement option, leading the government to tighten conditions for early retirement in July 2001. There are currently 17 pension funds, down from 44 in 1997, managing the voluntary supplementary pension contributions of 2.4 million private pension plan holders, about 40 per cent of the working age population. The assets administered by pension funds amount to more than CZK 40 billion, equivalent to about 2 per cent of GDP. The 10 largest funds account for almost 95 per cent of all assets.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **37.1 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **0.8 per cent**
Private pension funds – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	18.3	17.9	18.1	17.4	17.4	13.3	13.3	13.3	13.3
Number of goods with administered prices in EBRD-15 basket	5.0	5.0	4.0	2.0	2.0	2.0	2.0	2.0	2.0
Share of trade with non-transition countries (in per cent)	na	na	68.6	68.1	71.3	72.1	74.3	73.9	76.8
Share of trade in GDP (in per cent)	63.1	82.8	80.9	89.4	85.0	95.2	99.1	102.6	123.8
Tariff revenues (in per cent of imports)	na	3.5	3.5	2.6	2.6	1.7	1.5	1.2	0.9
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	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	na	na	2.7	4.6	6.3	7.1	7.9	9.4	10.4
Private sector share in GDP (in per cent)	30.0	45.0	65.0	70.0	75.0	75.0	75.0	80.0	80.0
Private sector share in employment (in per cent)	31.1	47.1	53.0	57.2	58.9	59.7	60.6	65.0	65.0
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies (in per cent of GDP) [1]	na	6.4	7.1	8.3	8.0	7.8	7.8	7.7	10.2
Effective statutory social security tax (in per cent)	na	88.2	91.9	91.7	90.8	93.7	93.2	92.5	na
Share of industry in total employment (in per cent)	35.6	33.5	32.2	32.1	31.6	32.9	33.4	34.7	33.5
Change in labour productivity in industry (in per cent)	26.3	-1.0	8.7	11.2	12.0	0.7	3.4	-2.5	8.0
Investment rate/GDP (in per cent)	28.5	26.6	29.5	34.0	36.6	35.1	33.6	32.6	33.6
EBRD index of enterprise reform	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3
EBRD index of competition policy	2.0	2.7	2.7	2.7	3.0	3.0	3.0	3.0	3.0
Infrastructure									
Main telephone lines per 100 inhabitants	17.7	19.0	20.9	23.2	27.3	31.8	36.4	37.1	na
Railway labour productivity (1989=100)	91.8	76.8	80.0	84.0	83.2	80.2	73.0	69.2	74.1
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	3.23 (95)	3.73 (95)	3.83 (95)	3.69 (95)	4.96 (na)	5.12 (na)	na
Electricity consumption/GDP (1989=100)	86.0	85.2	85.9	85.5	85.4	85.1	86.1	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.8	2.8	2.8
Financial institutions									
Number of banks (of which foreign owned)	na	52 (12)	55 (13)	55 (13)	53 (14)	50 (15)	45 (15)	42 (17)	40 (16)
Asset share of state-owned banks (in per cent) [2]	na	11.9	17.9	17.6	16.6	17.5	18.6	23.1	28.2
Non-performing loans (in per cent of total loans) [3]	na	na	na	26.6	21.8	19.9	20.3	21.5	19.3
Domestic credit to private sector (in per cent of GDP)	na	51.0	50.3	46.7	47.1	54.7	48.0	43.8	na
Stock market capitalisation (in per cent of GDP)	na	na	14.2	30.2	31.3	26.6	20.1	23.1	23.2
EBRD index of banking sector reform	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3
EBRD index of reform of non-banking financial institutions	1.0	2.0	2.7	2.7	2.7	2.7	3.0	3.0	3.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	4.0	4.0	3.3	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	4.0	4.0	2.7	2.7
Social sector									
Expenditures on health and education (in per cent of GDP)	10.1	12.6	11.9	11.8	11.7	11.2	10.8	na	na
Life expectancy at birth, total (years)	72.2	72.7	73.0	73.4	73.8	73.9	74.5	74.6	na
Basic school enrolment ratio (in per cent)	99.2	99.1	99.5	99.4	99.2	99.1	97.6	na	na
Earnings inequality (GINI-coefficient)	21.4	25.8	26.0	28.2	25.4	25.9	na	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. Changes in non-performing loans compared with previous Transition Reports are due to the change of loan categories included in non-performing loans (see definitions).

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	*Projection*
Output and expenditure				*(Percentage change in real terms)*					
GDP [1]	0.1	2.2	5.9	4.8	-1.0	-2.2	-0.8	3.1	3.5
Private consumption	1.2	5.6	5.8	6.9	1.8	-2.9	1.4	1.4	na
Public consumption	3.6	3.1	-4.2	3.5	0.8	-0.9	-0.1	-0.2	na
Gross fixed investment	0.2	9.1	19.8	8.2	-2.9	-3.9	-5.5	5.2	na
Exports of goods and services	15.8	1.7	16.7	9.2	8.1	10.7	6.6	18.8	na
Imports of goods and services	23.7	14.7	21.2	14.3	7.2	7.9	5.8	18.7	na
Industrial gross output	-5.8	2.9	11.8	11.1	0.1	2.8	-0.4	5.1	na
Agricultural gross output	-3.8	-6.6	3.2	2.5	-1.5	-1.8	2.3	-2.0	na
Employment				*(Percentage change)*					
Labour force (end-year)	0.4	-1.1	0.8	0.7	0.1	0.5	0.4	0.2	na
Employment (end-year)	0.2	0.7	2.8	1.2	-1.7	-2.5	-1.7	0.9	na
				(In per cent of labour force)					
Unemployment (end-year)	3.5	3.2	2.9	3.5	5.2	7.5	9.4	8.8	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	20.8	9.9	9.1	8.8	8.5	10.7	2.1	3.9	4.9
Consumer prices (end-year)	18.2	9.7	7.9	8.6	10.0	6.8	2.5	4.0	4.8
Producer prices (annual average)	9.2	5.3	7.6	4.8	4.9	4.9	1.0	4.9	na
Producer prices (end-year)	11.4	5.6	7.2	4.4	5.7	2.2	3.4	5.0	na
Gross average monthly earnings in economy (annual average)	25.3	18.5	18.5	18.4	10.5	9.4	8.2	7.0	na
Government sector				*(In per cent of GDP)*					
General government balance [2]	0.5	-1.1	-1.4	-0.9	-1.7	-2.0	-3.3	-4.9	-9.2
General government expenditure [2]	41.2	41.8	41.5	40.6	40.9	40.8	42.0	44.5	na
General government debt [3]	18.8	17.6	15.3	13.1	13.0	13.4	15.0	17.5	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	22.5	20.8	19.4	7.8	8.7	5.2	8.1	6.8	na
Domestic credit (end-year)	19.2	16.0	12.2	12.0	8.6	3.4	0.9	-2.6	na
				(In per cent of GDP)					
Broad money (M2, end-year)	70.6	73.6	75.3	71.3	73.0	71.2	75.4	77.4	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
2-week repo rate	na	na	11.3	12.4	14.8	9.5	5.3	5.3	na
3-months PRIBOR	8.0	12.7	10.9	12.7	17.5	10.1	5.6	5.4	na
Deposit rate [4]	7.0	6.9	6.9	6.7	8.0	6.7	4.0	4.5	na
Lending rate [4]	14.1	12.8	12.7	12.5	13.9	10.5	8.0	8.1	na
				(Koruna per US dollar)					
Exchange rate (end-year)	29.8	28.2	26.7	27.3	34.7	30.0	35.7	38.8	na
Exchange rate (annual average)	29.2	28.8	26.5	27.1	31.7	32.3	34.6	38.6	na
External sector				*(In millions of US dollars)*					
Current account	456	-787	-1,369	-4,292	-3,211	-1,336	-1,567	-2,273	-3,700
Trade balance [5]	-525	-1,381	-3,678	-5,877	-4,540	-2,554	-1,903	-3,131	-5,000
Merchandise exports [5]	14,229	15,929	21,463	21,691	22,777	26,351	26,265	29,052	33,000
Merchandise imports [5]	14,754	17,310	25,140	27,568	27,317	28,905	28,167	32,183	38,000
Foreign direct investment, net	563	749	2,526	1,276	1,275	3,591	6,234	4,477	5,000
Gross reserves (end-year), excluding gold	3,872	6,243	14,023	12,435	9,800	12,623	12,894	14,078	na
External debt stock	8,496	10,694	16,549	20,845	21,352	24,047	22,615	21,149	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	2.5	3.4	5.6	4.4	3.6	4.4	4.6	4.5	na
				(In per cent of current account revenues, excluding transfers)					
Debt service	5.9	11.3	8.9	10.5	15.0	14.5	14.4	9.7	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 millions of koruna)	1,020,300	1,182,800	1,381,100	1,572,300	1,668,800	1,798,300	1,836,300	1,910,600	2,072,518
GDP per capita (in US dollars)	3,386	3,977	5,049	5,620	5,109	5,412	5,148	4,797	na
Share of industry in GDP (in per cent)	33.3	33.6	33.3	33.8	35.9	36.9	35.5	36.0	na
Share of agriculture in GDP (in per cent)	5.3	4.9	4.7	4.9	5.0	4.8	3.9	3.9	na
Current account/GDP (in per cent)	1.3	-1.9	-2.6	-7.4	-6.1	-2.4	-3.0	-4.6	-6.8
External debt - reserves, in US$ millions	4,624	4,451	2,526	8,409	11,552	11,424	9,721	7,071	na
External debt/GDP (in per cent)	24.3	26.0	31.8	36.0	40.6	43.1	42.6	42.8	na
External debt/current acc. revenues, excl. transfers (in per cent)	43.6	48.9	56.3	67.2	68.1	68.2	64.9	56.2	na

[1] GDP and GDP component data in 1995 constant prices.

[2] General government excludes privatisation revenues.

[3] Consolidated outstanding debt including state budget, health insurance, extra-budgetary funds and local governments, but excluding the indirect debt of special state financial institutions, including Konsolidacni Banka.

[4] Weighted average over all maturities.

[5] Break in series in 1995 due to a change in the reporting system.

Estonia

Key reform challenges

- **With the privatisation of the major electric power generator close to completion, the government should focus on liberalising access to the network and further tariff adjustments.**
- **Consolidation of the Tallinn and Helsinki stock exchanges, new securities legislation and development of domestic pension funds should spur the expansion of securities activities.**
- **Implementation of the fully funded second pillar for pensions to address the demographic shift should help to ensure the sustainability of the pension system.**

Liberalisation

Estonia has almost fully eliminated capital controls.
As EU accession is approaching, Estonia has cleared out all the remaining minor restrictions on capital movements. The country has had practically no restrictions on capital movements after regaining its independence, which resulted in an early closure of the respective chapter at the EU accession negotiations in summer 2000. In May 2001 parliament passed an amendment to the Law on Coast and Shore Protection to grant equal opportunities to foreigners in the purchase and sale of land near water. The amendment replaces an article that had granted the state pre-emptive rights to any piece of property fully or partly within a no-building zone and close to the sea or other water areas if it was sold to a person who did not hold Estonian citizenship.

Stabilisation

The government has implemented an impressive fiscal adjustment.
Thanks to strong economic growth and strict containment of expenditures, the authorities succeeded in reducing the fiscal deficit of the general government from 4.6 per cent of GDP in 1999 to 0.7 per cent in 2000. In December 2000 parliament approved a balanced budget for 2001. On the revenue side the 2001 budget anticipated a significant reduction in the ratio of direct taxes to GDP (given the increase in tax-free income for individuals and the continued impact of the corporate income tax abolition on investments in 2000) but an increase in excise taxes and VAT rates on central heating. On the expenditure side the budget called for a continued freeze on nominal pensions and government wages. However, in early 2001 parliament postponed the increase in VAT on central heating and approved a 3 per cent increase in pensions, which was possible because of the smaller than expected number of pensioners.

The government plans to issue its first eurobond.
Parliament has approved the government's proposal to issue, for the first time, a five-year fixed-interest eurobond in the international market, in the amount of €100 million before 31 December 2001. The bond issue is expected in late October or early November, depending on market conditions. In July 2001 the Ministry of Finance selected Credit Suisse First Boston to manage the issue. The government plans to use the funds to refinance loans, including two from the World Bank, and to finance the purchase of airspace monitoring radar equipment for €15.3 million.

Enterprise reform

Estonia ranks well in terms of competitiveness.
A recent survey of competitiveness by the Switzerland-based Institute for Management Development placed Estonia twenty-second out of 49 countries, the best among transition countries. The country scored well in criteria such as the lack of government interference in business negotiations and the low level of employees' social security contributions. However, this is partially offset by the high level of employers' contributions.

New commercial legislation compatible with EU law has been passed.
In June 2001 parliament passed amendments to the commercial and bankruptcy laws to bring legislation into line with EU commercial law. In September 2001, parliament also passed the Contracts and Non-contractual Obligations Act, which introduces clearer rules for contract enforcement and consumer protection. The law is to enter into force in July 2002.

Infrastructure

The privatisation of the main electric power generator is closer to completion.
In August 2000 the Estonian state energy firm, Eesti Energia, signed a preliminary contract with the US company NRG Energy for the sale of a 49 per cent stake in AS Narva Elektrijaamad (which owns two power stations and a 51 per cent interest in the state-owned oil shale company) for US$ 70.5 million. Under the deal, NRG Energy undertook to invest approximately US$ 360 million over five years in the renovation of the power-generating unit of AS Narva Elektrijaamad and about US$ 80 million in the oil shale company. At the end of June 2001 the two firms moved another step

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 EU accession negotiations begin

1999
Nov WTO membership

2000
Jan Corporate income tax on reinvested profits abolished

2001
May Capital account fully liberalised

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 Uhispank
Feb Eesti Telekom floated
Feb Telcommunications law amended
Feb Banking law amended

2000
Jun Last state-owned bank privatised

2001
Jan Telecommunications market liberalised
May Law on unified financial sector supervisory agency passed
Aug Railways privatised

towards finalising the deal by agreeing on a power purchase agreement (PPA), the conditions of shareholders' contracts and an extensive information memorandum. In September 2001 three international banks agreed a 14-year loan to finance the plants' renovation costing approximately €285 million (about EEK 4.5 million). The 15-year PPA is largely unchanged from the basic terms signed in August 2000, under which the plants were to sell electricity to Eesti Energia at an average price of EEK 0.4779 per kilowatt hour (KWh) (US$ 0.0266 per KWh). Further reform efforts need to focus on ensuring third-party access to networks, removing price distortions, and defining the role of the regulator in the future EU internal energy market.

Privatisation of the railways has been completed.
In April 2001 the government signed an agreement to sell 66 per cent of Eesti Raudtee (Estonian Railways), the main freight operator and owner of track infrastructure, to BRS, an international consortium including the US company Rail World, the UK company Jarvis International, and the Estonian company Ganiger Invest OÜ. BRS paid the EEK 1 billion (US$ 56.8 million) purchase price for the shares and thus completed the transaction in August 2001. Besides the purchase price, the company also submitted an EEK 50 million completion guarantee for investments, which was underwritten by Hansapank. BRS has pledged to invest EEK 4.7 billion by 2010.

The telephone market has been liberalised.
In January 2001 the fixed-line telephone market was opened to competition, ending the eight-year monopoly of Eesti Telefon. In April 2001 the Competition Board made a decision stating that Eesti Telefon violated the law when it unified the tariffs for former local calls and national long-distance calls, essentially simultaneously increasing the average level of tariffs. The decision requires Eesti Telefon to apply fair pricing and to justify price increases in excess of inflation, and to earn an acceptable acceptable rate of return on equity. Eesti Telefon has denied any wrongdoing and contested the Competition Board's decision in court, claiming that the prices are cost-based. If the court upholds the Competition Board's decision, it may fine Eesti Telefon.

Financial institutions

Supervision of financial institutions has been strengthened.
Non-bank financial sector supervision has been strengthened by the 2000 Insurance Activities Act and will be boosted further by the securities market law, submitted to parliament in April 2001 and expected to be passed after the summer recess. The new Act regulates in detail public offers, activities of investment companies (including cross-border services), clearing and settlement activities, and includes more extensive regulation of insider dealing and takeovers. A law on the establishment of a unified financial supervisory agency for banking, insurance and securities was passed by parliament in May 2001. The agency will begin operations by the end of 2001. It will have operational and budgetary independence and licensing powers and will be financed mainly by contributions from market participants, in line with international best practice.

Stock exchange consolidation with the Helsinki exchange is progressing.
In May 2001 the owner of the Helsinki stock exchange, HEX Group, acquired a majority holding in the Tallinn stock exchange. At the end of 2000 the Tallinn exchange had a market capitalisation of €1.9 billion, compared with the €318 billion capitalisation of the Helsinki exchange and €32.87 billion on the Warsaw exchange. The priority now is to build a well-functioning securities market in Estonia, to enhance the visibility of Estonian companies and to increase the liquidity in the trading of their shares.

Social reform

Legislation has been passed to establish the second pension pillar.
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 reformed first tier became operational in January 1999 and is financed by 20 percentage points of the 33 per cent social tax (13 per cent is 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, which was approved by the parliament in September 2001, will offer additional pension coverage financed by mandatory individual contributions. Participation will be mandatory for new entrants to the labour market (born in or after 1983 after turning 18) but voluntary (although irreversible) for existing workers. Employers will pay 16 per cent of the social security tax to finance the first pillar and 4 per cent towards the second pillar. The employee will pay an additional 2 per cent of gross wages towards the second pillar.

A new unemployment insurance scheme is under discussion.
In June 2001 parliament adopted an unemployment insurance law, under which insurance is paid in the case of redundancy, termination of collective agreements and employer insolvency. Under the law, employees are required to pay contributions of 1 per cent and employers of 0.5 per cent into an unemployment insurance fund. The scheme, together with the 2 per cent contribution of wage income to the planned second pension pillar (see above), would substantially increase the already high level of payroll taxation. The unemployment insurance law will take effect from 1 January 2002.

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**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Social reform
Share of the population in poverty – **19.3 per cent**
Private pension funds – **yes**

Stabilisation
Share of general government tax revenue in GDP – **38.3 per cent**
Exchange rate regime – **currency board**

Enterprises and markets
Competition Office – **yes**

Financial sector
Capital adequacy ratio – **10 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	21.1	18.0	24.0	24.0	25.6	25.6	na
Number of goods with administered prices in EBRD-15 basket	na	na	3.0	3.0	3.0	3.0	3.0	3.0	na
Share of trade with non-transition countries (in per cent)	na	54.8	54.5	61.6	59.5	73.1	64.3	76.3	84.7
Share of trade in GDP (in per cent)	93.1	107.2	122.0	113.8	106.6	123.8	124.2	112.7	146.4
Tariff revenues (in per cent of imports) [1]	na	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.1
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	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	na	1.0	2.6	4.1	5.3	6.3	7.1	8.2	8.8
Private sector share in GDP (in per cent)	25.0	40.0	55.0	65.0	70.0	70.0	70.0	75.0	75.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	2.0	3.0	4.0	4.0	4.3	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)	na	1.5	1.4	1.9	0.9	0.3	0.9	0.9	0.8
Effective statutory social security tax (in per cent)	73.3	84.3	81.2	76.6	81.6	82.9	85.6	76.4	na
Share of industry in total employment (in per cent)	27.6	25.6	25.1	28.6	27.8	26.3	26.0	25.5	26.7
Change in labour productivity in industry (in per cent)	-30.3	-5.2	1.0	-5.6	7.5	22.0	6.6	2.6	na
Investment rate/GDP (in per cent)	21.0	24.4	27.0	26.0	27.8	30.9	29.4	24.5	24.1
EBRD index of enterprise reform	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3
EBRD index of competition policy	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.7	2.7
Infrastructure									
Main telephone lines per 100 inhabitants	21.5	23.1	24.5	27.7	29.9	32.1	34.4	35.3	na
Railway labour productivity (1989=100)	53.1	55.0	47.7	50.8	55.0	74.2	98.6	124.6	148.7
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	1.6 (99)	3.0 (100)	3.2 (98)	3.4 (97)	4.1 (99)	4.1 (na)	na
Electricity consumption/GDP (1989=100)	121.4	106.5	114.4	104.7	106.5	100.7	93.4	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	3.3	3.7	4.0
Financial institutions									
Number of banks (of which foreign owned) [2]	na	21 (1)	22 (1)	18 (4)	15 (3)	12 (3)	6 (2)	7 (2)	7 (4)
Asset share of state-owned banks (in per cent) [3]	na	25.7	28.1	9.7	6.6	0.0	7.8	7.9	0.0
Non-performing loans (in per cent of total loans) [4]	na	na	3.5	2.4	2.0	2.1	4.0	2.9	1.5
Domestic credit to private sector (in per cent of GDP)	7.6	11.1	13.4	14.7	19.2	26.4	25.2	25.9	25.9
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	24.7	9.4	36.6	35.2
EBRD index of banking sector reform	2.0	3.0	3.0	3.0	3.0	3.3	3.3	3.7	3.7
EBRD index of reform of non-banking financial institutions	1.0	1.7	1.7	1.7	2.0	3.0	3.0	3.0	3.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	4.0	3.0	3.3	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	4.0	4.0	3.7	4.0
Social sector									
Expenditures on health and education (in per cent of GDP)	na	12.0	12.1	9.6	13.4	12.2	12.2	13.1	12.0
Life expectancy at birth, total (years)	69.0	68.0	67.0	67.8	69.8	70.1	69.8	70.6	na
Basic school enrolment ratio (in per cent)	91.1	91.4	91.5	92.3	92.6	93.5	95.0	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

[1] Excludes differential excise taxes on imports.
[2] Includes Merita-Nordbanken branch and investment banks.
[3] Increase in 1998 is due to renationalisation of Optiva bank, following its insolvency in late 1998.
[4] Changes in non-performing loans data compared with previous Transition Reports are due to the change in the definition of non-performing loans (see definitions).

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	-8.8	-2.0	4.6	4.0	10.4	5.0	-0.7	6.9	4.5
Private consumption	na	0.8	5.4	8.1	8.9	5.4	-0.6	9.0	na
Public consumption	na	5.5	16.3	-1.0	1.8	4.5	3.8	1.0	na
Gross fixed investment	na	6.2	4.0	11.4	17.5	11.3	-14.6	12.0	na
Exports of goods and services	na	3.8	5.5	2.2	30.3	12.6	-0.6	27.6	na
Imports of goods and services	na	12.5	5.4	7.5	29.7	12.6	-5.8	27.0	na
Industrial gross output	-18.7	-3.0	1.9	2.9	14.6	4.1	-3.4	na	na
Agricultural gross output	na	na	0.2	-6.3	-1.5	-5.0	-8.2	-1.7	na
Employment				(Percentage change)					
Labour force (annual average) [1]	-4.7	-1.1	-3.0	-1.3	-0.6	-1.0	-1.4	0.7	na
Employment (annual average) [1]	-7.5	-2.2	-5.3	-1.6	-0.2	-1.2	-4.1	-0.9	na
				(In per cent of labour force)					
Unemployment (annual average) [1]	6.5	7.6	9.8	10.0	9.7	9.9	12.4	13.8	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	89.8	47.7	29.0	23.1	11.2	8.2	3.3	4.0	6.1
Consumer prices (end-year)	35.6	41.7	28.9	14.8	12.5	6.5	3.9	5.0	5.6
Producer prices (annual average)	75.2	36.3	25.6	14.8	8.8	4.2	-1.2	4.9	na
Producer prices (end-year)	na	32.8	21.8	9.9	7.7	0.1	2.2	6.1	na
Gross average monthly earnings in economy (annual average) [2]	94.2	62.7	37.0	25.7	19.7	15.4	7.6	10.5	na
Government sector [3]				(In per cent of GDP)					
General government balance	-10.0	1.4	-0.6	-1.9	2.2	-0.3	-4.6	-0.7	-0.5
General government expenditure	40.1	40.5	41.5	40.7	38.4	38.6	41.0	36.7	na
General government debt	na	na	na	na	7.6	5.8	6.5	5.9	na
Monetary sector				(Percentage change)					
Broad money (M2, end-year)	na	40.1	34.5	34.5	43.4	0.1	23.6	27.5	na
Domestic credit (end-year)	na	na	59.0	92.5	78.3	16.5	9.6	27.2	na
				(In per cent of GDP)					
Broad money (M2, end-year)	32.8	33.5	32.9	34.6	40.6	35.4	42.1	48.0	na
Interest and exchange rates				(In per cent per annum, end-year)					
Interbank interest rate (up to 30 days maturity)	na	na	na	7.9	15.8	18.5	5.1	6.1	na
Deposit rate (over 12 months) [4]	na	8.8	8.7	10.5	10.8	8.9	8.9	6.8	na
Lending rate (over 12 months) [5]	na	17.5	15.8	13.9	11.2	16.3	8.6	8.9	na
				(Kroons per US dollar)					
Exchange rate (end-year)	13.9	12.4	11.5	12.4	14.3	13.4	15.6	16.8	na
Exchange rate (annual average)	13.2	13.0	11.5	12.0	13.9	14.1	14.7	17.0	na
External sector				(In millions of US dollars)					
Current account	22	-167	-158	-398	-563	-478	-247	-315	-417
Trade balance	-145	-357	-666	-1,019	-1,125	-1,115	-822	-788	-907
Merchandise exports	812	1,226	1,697	1,813	2,294	2,690	2,515	3,289	3,782
Merchandise imports	957	1,583	2,363	2,832	3,419	3,806	3,337	4,077	4,689
Foreign direct investment, net	156	212	199	111	130	574	222	324	350
Gross reserves (end-year), excluding gold	388	511	650	703	821	876	944	1,006	na
External debt stock [6]	228	381	626	1,534	2,562	2,924	2,879	3,092	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	3.8	3.1	2.7	2.5	2.4	2.2	2.7	2.4	na
				(In per cent of export of goods and services)					
Debt service	2.0	1.6	1.7	2.6	3.7	5.1	6.0	5.9	na
Memorandum items				(Denominations as indicated)					
Population (end-year, millions)	1.5	1.5	1.5	1.5	1.5	1.4	1.4	1.4	na
GDP (in millions of kroons)	21,826	29,867	40,897	52,423	64,045	73,538	76,327	85,436	94,747
GDP per capita (in US dollars)	1,094	1,544	2,417	2,980	3,174	3,617	3,609	3,508	na
Share of industry in gross value added (in per cent)	na	na	na	19.0	17.9	15.8	14.6	na	na
Share of agriculture in gross value added (in per cent)	na	na	na	6.2	5.3	4.5	4.2	na	na
Current account/GDP (in per cent)	1.3	-7.2	-4.4	-9.1	-12.2	-9.1	-4.8	-6.3	-7.5
External debt - reserves, in US$ millions	-160	-130	-24	831	1,742	2,048	1,935	2,085	na
External debt/GDP (in per cent)	13.8	16.5	17.5	35.2	55.5	55.9	55.4	61.4	na
External debt/exports of goods and services (in per cent)	19.9	21.9	24.3	52.5	70.9	70.1	71.9	64.6	na

[1] New series based on ILO methodology. Population aged 15-69.

[2] Starting in 1998 the data on average monthly gross wages do not include compensations from Health Insurance Fund.

[3] General government includes the state, municipalities and extra-budgetary funds. General government expenditure includes net lending.

[4] Weighted average annual interest rate of time deposits.

[5] Weighted average annual interest on kroon loans.

[6] The debt data from 1996 onwards are from the Bank of Estonia. The data include non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

FR Yugoslavia[1]

Key reform challenges

- **Private sector development has been severely constrained over the past 10 years. New privatisation programmes in both Serbia and Montenegro must be pursued vigorously and transparently.**
- **The banking sector is in crisis and fails to meet the needs of the real economy. A major consolidation and restructuring of the sector, with the selective participation of foreign banks, are required.**
- **Poverty and unemployment are widespread. Necessary and long-delayed reform measures should be combined with carefully targeted social support for vulnerable sections of the population.**

Liberalisation, stabilisation, privatisation

1991
Jun Disintegration of Socialist Federal Republic of Yugoslavia begins

1992
Apr Sovereignty proclaimed
May Economic sanctions introduced by UN

1993
Dec Hyperinflation reaches peak

1994
Jan Widespread price controls introduced
Jan Stabilisation programme introduced

1997
Oct Privatisation law enacted in Serbia

1998
Jun Economic sanctions tightened
Dec Privatisation council established in Montenegro

1999
Mar Kosovo conflict begins
Jun Kosovo placed under UN administration
Nov DM becomes legal tender in Montenegro

2000
Oct Milosevic rule ends
Oct Most price controls relaxed
Nov Montenegro adopts DM as sole currency

2001
Jan Export surrender requirement abolished
Jan Exchange rate unified and managed float introduced
Jan Current account convertibility introduced
Jan Economic sanctions lifted
May Most non-tariff import restrictions abolished
Jun IMF standby arrangement approved
Jun Comprehensive tax reform implemented in Serbia
Jun Privatisation law adopted in Serbia

Liberalisation

Major price liberalisation has occurred in Serbia …
While the prices of 60 per cent of weighted goods in the consumer price index basket were formerly administratively controlled, the Serbian government abandoned price controls and subsidies in late 2000, except for those applied to public utilities and bread. However, a key challenge remains the price of electricity, which at the end of 2000 was less than US¢ 1 per kilowatt hour (KWh), much cheaper than in neighbouring countries and well below cost-recovery levels. The average price of electricity was raised by 60 per cent in April 2001 and by a further 40 per cent in June. A further 15 per cent increase is planned for October 2001.

… and in Montenegro.
The prices of staple consumer goods, i.e. bread and milk, were partially liberalised in Montenegro over the past year. Both bread and milk increased in price by nearly 60 per cent in January and a further 100 per cent in August. Post and telecommunications charges were raised by nearly 100 per cent in June 2001. Further liberalisation is planned for 2001 on controlled prices of items such as transportation, telecommunications and municipal services.

The exchange rate regime has been unified.
Until last year, a multiple-exchange rate system was in operation, with access to foreign currency at the "official" rate (YUD 6 = DM 1) restricted to favoured associates of the old regime. At the end of 2000 the National Bank of Yugoslavia (NBY) unified the rates at a level of around YUD 30 = DM 1, close to the previous black market rate. Montenegro abolished the dinar as legal tender in November 2000, leaving the Deutschmark as the sole currency in use.

The Federal authorities have greatly liberalised the trade regime.
During the first half of 2001 the Federal authorities abolished almost all non-tariff import restrictions and introduced a new tariff schedule for imports, greatly simplifying the previous regime. The unweighted average tariff is now 9.4 per cent. However, quantitative export restrictions have been maintained for some agricultural goods. FR Yugoslavia began negotiations in February 2001 for accession to the WTO and started preliminary discussions with the EU on a Stabilisation and Association Agreement.

Stabilisation

The central bank is operating a managed float.
Since the unification of the exchange rates, the NBY has operated a managed float exchange rate regime, with frequent interventions in the currency market. Concerns have been raised about real appreciation of the dinar, given the high rate of inflation in Serbia, but so far monthly export levels are stable, and by August 2001 foreign exchange reserves at the NBY had risen by nearly US$ 400 million since the start of the year, covering more than two months of imports.

Major tax reforms have been implemented in Serbia.
The Serbian government introduced wide-ranging reforms to the tax system in April 2001. The government greatly reduced the number of taxes, lowered the tax rate on various goods and services and widened the tax base through the elimination of exemptions. The sales tax rate was unified at a rate of 17 per cent and preparations were begun for the introduction of VAT in 2003. The Montenegrin government has prepared a Tax Action Plan with a view to broadening the effective tax base and lowering tax rates. Initial implementation of this plan will focus on amendments to turnover tax legislation. However, reducing the high level of tax evasion is also a key challenge.

Privatisation

New laws have been passed to accelerate privatisation in Serbia …
Social ownership remains the dominant form of ownership in the enterprise sector, with several attempts in the 1990s at comprehensive privatisation having failed. At the end of June 2001 the Serbian parliament adopted a new law on privatisation. The law specifies that at least 70 per cent of shares in state and socially owned assets will be sold to private investors. Employees and other eligible citizens can retain up to 30 per cent of the shares, depending on how quickly the enterprise is sold. Any enterprise not sold within four years will be taken over by the Privatisation Agency and sold or liquidated. The new Privatisation Agency has selected 38 enterprises for early privatisation through tenders and auctions. In August 2001 the Agency selected privatisation consultants for three cement factories, and invited expressions of interest for buyers of all 38 enterprises.

Enterprises, infrastructure, finance and social reforms

1993

Jan Montenegro stock exchange established

1997

Jun Sale of 49 per cent of fixed-line telecommunications operator in Serbia

Oct Banking code adopted

2000

Dec Montenegro central bank established

Dec New telecommunications law enacted in Montenegro

2001

Mar First foreign bank granted licence

Apr Major increase in electricity price in Serbia

Jun Further large energy price increase

... while Montenegro plans to accelerate sales.

Privatisation in Montenegro has been more advanced than that in Serbia although progress has slowed down in recent years. The government plans to accelerate the process via tender privatisation of 15-20 large enterprises (with about 25,000 employees in total), a Mass Voucher Privatisation Programme for 240 medium-sized companies, a batch sale privatisation of 33 companies and liquidation of about 30 companies.

Enterprise reform

Profound corporate governance problems are starting to be addressed.

State and socially owned enterprises in FR Yugoslavia are plagued by a range of problems, including unclear ownership, lack of capital, large and persistent losses and soft budget constraints. A number of new laws are being prepared, both at Federal and Republic level, that would help to improve corporate governance and enterprise performance. In Serbia, drafts of a new enterprise law, a foreign investment law and an anti-trust law are advancing. The enactment and implementation of these laws would greatly improve the attractiveness of Serbia for foreign investors. Montenegro approved a new foreign investment law in 2000 in an effort to boost foreign investment from very low levels. Among other provisions, the law guarantees the right to repatriate profits.

Infrastructure

Telecommunications services need to be liberalised.

The only large-scale privatisation in the country to date was the sale in 1997 of 49 per cent of the fixed-line telecommunications company, Telekom Srbija, to STET of Italy (29 per cent) and OTE of Greece (20 per cent) for approximately US$ 900 million. The contract gave long exclusive monopoly rights (until June 2005) to the buyers, contrary to established best practice. A liberalisation of the sector in line with WTO rules would enhance competition and carry substantial benefits for the rest of the economy. Tariffs for fixed-line and local calls are generally below cost-recovery levels while international charges are high and a new regulatory environment with tariff re-balancing is urgently needed. In the mobile sector, there are two competing companies in both Serbia and Montenegro. Both Republic governments hold large stakes in each mobile company.

The energy sector faces urgent reconstruction needs.

Energy was one of the sectors worst affected by the Kosovo conflict in 1999. Since then, blackouts have been frequent and widespread, especially during the winter months, and the country has had to import electricity. Price increases announced (and already partly implemented) for 2001 should enable supply companies to cover operating expenses. Power facilities that were damaged by the war need urgent repairs, to be financed from emergency grant funds, if further blackouts are to be avoided in the coming winter.

Financial institutions

The banking sector needs a comprehensive overhaul.

A two-tier banking sector has been in place since the late 1980s but subsequent events have left the sector in deep crisis. At the end of June 2001 there were 81 banks in Serbia and 11 in Montenegro. However, many banks are insolvent. Most assets are concentrated in six large, state-owned banks, five of which were found to be insolvent in central bank audits. Confidence in the sector is low, reflected in a low savings rate and a minimal degree of financial intermediation, and consequently lending to enterprises is almost non-existent. The authorities are preparing a rehabilitation strategy for the sector. It is likely that each insolvent bank will be closed unless there are clear signs that a strategic investor would be willing to take it over. In Montenegro the largest bank, state-owned Montenegro Bank, is under administration. However, in both republics several smaller, private banks are operating profitably.

Social reform

Poverty and inequality are widespread.

According to World Bank estimates, absolute poverty in FR Yugoslavia is currently twice as high as it was in 1990. In April 2000 about 12 per cent of the population were living in absolute poverty, defined as at or below the income necessary to purchase the World Food Programme's minimum subsistence basket. A further 20 per cent were defined as "near-poor". Levels of inequality are comparable to neighbouring countries but are likely to rise in the short term as the economy is liberalised. Given the fiscal constraints, the governments of both republics are drawing up plans to target the provision of social benefits more effectively.

Pension and unemployment benefit systems need urgent reform.

The rate of unemployment is estimated at around 30 per cent of the labour force although many of those classified as unemployed work in the informal economy. The present system of unemployment benefit contains both generous replacement rates and lengthy eligibility periods for those who have contributed to social insurance for a minimum period. This system creates rigidities in the labour market and needs to be reformed. Pension payments under the present pay-as-you-go system are also relatively generous and are not sustainable in the long run. In the short run, the challenges are to implement unpopular measures, such as raising the retirement age and lowering the minimum pension provision.

1 The Federal Republic of Yugoslavia consists of two republics, Serbia and Montenegro. Kosovo, a province of Serbia, has been under UN administration since June 1999. Key reform challenges and progress in transition in Kosovo are discussed in Chapter 2.

Liberalisation

Current account convertibility – **full**
Interest rate liberalisation – **limited de jure**
Wage regulation – **no**

Privatisation

Primary privatisation method – **na**
Secondary privatisation method – **na**
Tradability of land – **limited de jure**

Infrastructure

Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Social reform

Share of the population in poverty – **na**
Private pension funds – **no**

Stabilisation

Share of general government tax revenue in GDP – **38.8 per cent (Serbia); 37.2 per cent (Montenegro)**
Exchange rate regime – **managed float**

Enterprises and markets

Competition Office – **no**

Financial sector

Capital adequacy ratio – **8 per cent**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
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 trade with non-transition countries (in per cent)	na	na	na	na	na	na	na	na	88.7
Share of trade in GDP (in per cent)	na	na	na	na	41.1	43.8	56.7	49.0	70.6
Tariff revenues (in per cent of imports)	na	na	na	na	na	na	na	na	88.7
EBRD index of price liberalisation	3.0	3.0	2.0	2.0	2.0	2.0	1.7	1.7	1.7
EBRD index of forex and trade liberalisation	2.0	2.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Privatisation									
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	na	40.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	na	na	na	na	na	na	na
Effective statutory social security tax (in per cent)	na	na	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	37.1	37.1	37.0	36.6	36.0	35.2	36.5	33.6	na
Change in labour productivity in industry (in per cent)	-26.8	-36.5	3.7	6.7	-3.7	13.8	1.6	-14.3	na
Investment rate/GDP (in per cent)	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	1.0	1.0	1.0
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	na	na	na	na	na	na	na	na	na
Railway labour productivity (1990=100)	56.6	40.0	34.7	36.6	38.3	43.2	43.2	23.1	35.8
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	na	na	na	na	na	na	na
Electricity consumption/GDP (1989=100)	na	na	na	na	na	na	na	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	na	na	na
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	94.1	94.7	92.0	89.8	90.0	89.0	90.9
Non-performing loans (in per cent of total loans)	na	na	10.3	12.0	12.3	15.1	13.1	10.2	27.8
Domestic credit to private sector (in per cent of GDP)	na	na	na	na	8.2	9.7	9.9	9.8	9.0
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	3.0	3.0	na	na
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	4.0	3.0	na	na
Social sector									
Expenditures on health and education (in per cent of GDP)	na	na	na	na	na	na	10.2	9.5	na
Life expectancy at birth, total (years)	na	na	na	na	na	na	na	72.3	na
Basic school enrolment ratio (in per cent)	74.3	72.5	71.6	72.7	71.8	70.8	69.2	na	na
Earnings inequality (GINI-coefficient)	28.8	33.4	32.1	31.9	33.8	na	na	na	na

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	*Projection*
Output and expenditure				*(Percentage change in real terms)*					
GDP	-30.8	2.5	6.1	7.8	10.1	1.9	-15.7	5.0	5.0
Exports of goods and services	na	na	na	na	32.7	6.8	-46.9	15.3	na
Imports of goods and services	na	na	na	na	17.2	0.7	-30.4	12.2	na
Industrial gross output	-38.2	1.3	3.8	7.6	9.5	3.6	-22.5	10.9	na
Agricultural gross output	-3.2	6.0	4.1	1.5	7.3	-3.2	2.7	-19.7	na
Employment				*(Percentage change)*					
Labour force (end-year) [1]	1.9	-2.0	0.5	1.0	4.2	0.6	-0.1	10.8	na
Employment (end year)	2.8	-2.0	-1.4	-0.5	5.9	-0.1	-10.1	-2.2	na
				(In per cent of labour force)					
Unemployment (end-year)	23.1	23.1	24.6	25.8	25.8	25.1	26.5	27.3	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	na	3.3	78.6	94.3	21.3	29.5	37.1	60.4	93.6
Consumer prices (end-year)	na	na	120.4	58.6	9.5	44.5	36.5	113.5	45.2
Producer prices (annual average)	na	8.0	57.7	90.1	19.5	25.5	44.2	44.5	na
Gross average monthly earnings in economy (annual average) [2]	na	na	na	na	48.2	33.3	23.1	96.8	na
Government sector				*(In per cent of GDP)*					
General government balance	na	na	-4.3	-3.8	-7.6	-5.4	-8.3	-1.0	-5.9
General government expenditure	na	na	na	na	na	na	38.0	39.7	na
Monetary sector [3]				*(Percentage change)*					
Broad money (M3, end-year)	na	na	na	na	na	na	15.1	166.2	na
Domestic credit (end-year)	na	na	na	na	na	na	20.5	276.1	na
				(In per cent of GDP)					
Broad money (M3, end-year)	na	na	na	na	na	na	12.8	20.3	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Discount rate	80,000	9.0	90.2	68.2	33.7	34.5	35.0	26.6	na
Commercial banks' money market rate	na	na	1,145.9	456.7	211.7	123.5	69.4	92.1	na
Deposit rate	na	na	na	34.3	19.1	16.2	13.1	34.6	na
Lending rate (long-term)	na	na	na	196.7	71.8	60.3	45.4	77.9	na
				(Dinars per US dollar)					
Exchange rate (official, end-year) [4]	na	1.6	4.7	5.1	5.9	10.0	11.7	63.2	na
Exchange rate (official, annual average)	na	1.6	1.8	5.0	5.7	9.3	11.1	33.0	na
External sector				*(In millions of US dollars)*					
Current account	na	na	na	-1,670	-1,564	-660	-764	-680	-1,400
Trade balance	-112	-413	-1,135	-2,260	-2,352	-1,816	-1,619	-1,849	-2,442
Merchandise exports	2,921	1,482	1,531	1,842	2,447	3,033	1,677	1,923	2,064
Merchandise imports	3,033	1,895	2,666	4,102	4,799	4,849	3,296	3,772	4,506
Foreign direct investment, net	na	na	na	0	740	113	112	25	200
Gross reserves (end-year), excluding gold	na	na	na	na	na	na	na	392	na
External debt stock	10,265	10,619	11,058	11,477	11,783	12,152	12,588	11,725	na
				(In months of current account expenditures, excluding transfers)					
Gross reserves (end-year), excluding gold	na	na	na	na	na	na	na	1.1	na
				(In per cent of current account revenues, excluding transfers)					
Debt service [5]	na	na	na	0.7	3.2	1.8	4.6	2.2	na
Memorandum items				*(Denominations as indicated)*					
Population (mid-year, millions) [6]	10.5	10.5	10.5	10.6	10.6	10.6	8.4	8.6	na
GDP (in millions of dinars)	na	na	na	94,080	125,602	165,796	191,587	322,705	656,068
GDP per capita (in US dollars)	na	na	na	1,367	1,562	1,308	1,213	942	na
Share of industry in GDP (in per cent)	43.1	41.0	40.1	38.6	39.3	39.7	38.2	na	na
Share of agriculture in GDP (in per cent)	32.3	31.4	31.1	29.4	29.4	19.0	25.1	na	na
Current account/GDP (in per cent)	na	na	na	-11.6	-9.4	-4.8	-7.5	-8.4	-13.7
External debt - reserves, in US$ millions	na	na	na	na	na	na	na	11,333	na
External debt/GDP (in per cent)	na	na	na	79.4	71.2	87.5	124.0	145.3	na
External debt/exports of goods and services (in per cent)	na	na	na	453.6	360.9	307.9	586.0	460.3	na

Note: Data from 1999 onwards exclude Kosovo.

[1] Sharp increase in the labour force in 2000 is the result of including unregistered unemployed in the total.

[2] Data from 1999 refer to net wages.

[3] Data refer to Serbia only.

[4] Exchange rate was re-denominated to 1Din:1DM on 24 January 1994. Multiple exchange rate regime was in place until late 2000. The unofficial rate in October 2000 was 30 Din:1DM, compared with an official rate of 6 Din:1DM.

[5] FR Yugoslavia has been in default on virtually all of its external debt since 1992.

[6] Population decrease in 1999 is the result of excluding Kosovo population from the total.

Georgia

Key reform challenges

- **To lower the budget deficit to a more sustainable level and to strengthen debt repayment capacity, the government must improve the administration and collection of taxes.**
- **Strengthening the frameworks for taxation, licensing and law enforcement would greatly improve the investment climate for private business.**
- **To ensure a sustainable and reliable power supply at affordable tariff levels, the government should consolidate power sector reform through further privatisation.**

Liberalisation

WTO commitments have been fulfilled but exports are restricted.
When Georgia became a member of the WTO in June 2000, it made certain undertakings, including acceptance of the Government Procurement Agreement. To implement this, the government has issued regulations for the 1998 procurement law and adopted an institutional strengthening plan for carrying out state procurement. However, restrictions on the export of timber were adopted recently in order to increase supply to the domestic market and to respond to concerns over environmental issues and that timber was being stolen for the lucrative export market. Proposed restrictions on exports of scrap metal (presently Georgia's largest export) would have a strong effect on the balance of payments if implemented.

Stabilisation

Paris Club debt has been rescheduled.
By the start of 2001 Georgia had accumulated external debt equal to 54 per cent of GDP. Much of this debt was incurred as a result of the increased price of energy imports in the years immediately after independence, when the adverse shift in the terms of trade was not reflected in higher domestic energy prices. In 2000 the principal and interest due on external debt equalled 28 per cent of exports. Georgia could not meet this requirement, and accumulated arrears on principal repayments to Turkmenistan that reached about US$ 180 million by end-2001. In March this year Georgia successfully rescheduled its bilateral debt to Paris Club creditors and principal repayments due in 2001 and 2002 were rescheduled over 20 years with three years' grace.

Tax collections remain low ...
Disbursements under IMF and World Bank loan facilities have been delayed following poor fiscal revenue performance in the first quarter of 2001. There are several main reasons for this. In particular, customs duties (accounting for 5 per cent of government revenues, but potentially twice this level) are low because of unsecured borders and areas of conflict. Efforts have been made to deal with corruption among customs officials by sub-contracting their work to an international operator. However, this attempt failed as some incumbent officials were still able to undermine the work of the international operator.

... but new revenue measures have been introduced.
Several steps have been or are being taken to improve revenue collections: a new head of customs has been appointed, tests for tax officials are nearing completion, changes to the tax code are pending (including the introduction of streamlined procedures for the taxation of SMEs) and new procedures for monitoring tax officers have been put in place. However, the fundamental problem is that wages for officials remain low.

Privatisation

Large-scale privatisation has advanced.
Small and medium-scale privatisation was largely completed by the end of 1998. As a condition of a World Bank Structural Adjustment Loan, 29 large industrial companies were to be privatised by early 2001. By September 2001, 12 industrial enterprises had been successfully privatised, including two sold to foreign investors. However, it is unclear whether the remaining large state-owned enterprises can be successfully privatised under current conditions. There is a lack of foreign investor interest, both because of social obligations that are written into privatisation contracts and because of doubts over the potential commercial viability of many of the remaining companies, even if they were to be restructured. Given these factors, the State Property Ministry is currently focusing on privatisation of the main utilities, including power and telecommunications, rather than large industrial enterprises.

Enterprise reform

Arbitrary tax enforcement remains a problem for investors.
The inadequacies of the fiscal system have had a negative impact on the investment climate. One of the main problems for foreign investors is arbitrary tax enforcement. Within the tax code, the process for refunding VAT is unreliable. Tax payments on exports to Russia are made at the border rather than the point of sale, which can cause cash flow problems when goods are sold on credit.

The courts have not always proved reliable for foreign investors seeking judgements on taxation and labour restructuring (e.g. workers who have been laid off are often reinstated by the courts). Licensing requirements are onerous, and regulatory interference in day-to-day company operations is high. Nevertheless, companies with strong management and good products have

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

2001
- Mar External debt rescheduling

Enterprises, infrastructure, finance and social reforms

1994

Jan First foreign-owned bank opened

1995

Jun Two-tier banking system established

1996

Jun Competition law enacted

Jul Basel 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

Dec Law on securities market adopted

Nov Major electricity utility privatised

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

2001

Feb IAS accounts introduced for all banks

succeeded in this difficult environment – for example, a French-owned bottling factory and a locally owned manganese factory.

An anti-corruption strategy has been adopted.
An Anti-Corruption Committee was set up in June 2000 and a medium-term anti-corruption strategy was subsequently published in November 2000. The strategy outlines proposals to improve the business environment by establishing fair and transparent tax rules, raising the salaries of government workers and introducing a code of ethics for them, and strengthening the judiciary through the introduction of more stringent selection and testing criteria. A presidential decree issued in March 2001 contained detailed proposals to implement the anti-corruption strategy. They focused on measures to increase transparency through a broadening of financial disclosure, clarifying the role of government regulatory agencies, carrying out internal audits of government agencies, and publication of their expenditures. It remains to be seen, however, to what extent the strategy will be effectively implemented.

Infrastructure

Power sector privatisation moves forward.
In the power sector the Telasi power distribution company (serving Tbilisi) has been privatised through sale to AES (a US power company) along with one thermal power plant. There are plans to introduce private participation in the areas of transmission and dispatch and the wholesale market (a revenue allocation mechanism) under management contracts. If successful, this could lead to a more rigorous approach to the disconnection of large customers for non-payment (under the transmission contract) as well as a fairer system of allocating sector revenues to the generating companies (under the wholesale market contract). The IFC has been appointed advisor for the letting of contracts, bidders have been short-listed, financial proposals have been submitted and a preferred bidder chosen. The remaining state-owned distribution companies need to be transferred to private management in order to raise total collection rates. The IFC has been appointed as privatisation advisor for these companies. Most probably, they will be packaged together and offered for sale under management contracts before the end of 2001.

The telecommunications sector is being prepared for privatisation.
An industry regulator is in place and has in the last year acted to consolidate licences through a process of re-registration (previously there were too many licences in existence). The local operator has been offered for privatisation, with bids for a 75 per cent stake to be submitted by the end of October 2001. However, the financial viability of the company is unclear, and investor interest appears to be limited. The more lucrative national operator is scheduled for privatisation by the end of 2001 through the proposed sale of a 51 per cent stake.

A detailed oil pipeline study is under way.
Following intergovernmental agreements between Georgia, Azerbaijan, Turkey and Turkmenistan, a preliminary study for the Baku-Ceyhan pipeline (linking the Caspian Sea with Europe) has been completed and a more detailed study is now under way (at a cost of around US$ 100 million). Questions remain over the commercial viability of the proposed pipeline. In March 2001 Kazakhstan signed a memorandum of understanding with the other countries involved in the pipeline, although this does not amount to a legal commitment regarding the oil transport volumes which would be required for construction to go ahead.

Financial institutions

The banking sector regulatory framework has been strengthened …
Banking sector reform in Georgia has progressed following the increase of minimum capital requirements from GEL 2 million (US$ 1 million) to GEL 5 million (US$ 2.4 million) in January 2001. In addition, a new asset classification system was introduced early in 2001, together with international accounting standards for most of the banks in the sector. Legislative amendments designed to ensure that the banking law takes precedence over other legislation are also due to be submitted to parliament.

… but more progress is required to win the confidence of depositors.
Despite these regulatory reforms, there are too many banks – 26 in total – in relation to banking sector assets. Financial intermediation remains limited (only 3 per cent of the population have a bank account), and spreads between deposit and lending rates are high (between 10 and 20 per cent). In the second half of 2000 it emerged that a number of banks were in financial distress due to management and corporate governance problems, and earlier this year six failing banks were closed. The IFIs are currently supporting the National Bank of Georgia in its efforts to strengthen regulation, particularly regarding banks in financial distress.

Social reform

A targeted power subsidy is in place.
Georgia has one of the lowest per capita incomes in the region. Furthermore, unemployment is high and rising, and over 50 per cent of the population live below the official poverty line. The government is due to complete a poverty reduction strategy no later than November 2001. In the meantime, the social safety net includes minimal pensions, unemployment benefit and a family allowance. As a contribution to alleviating the impact of the higher power sector tariffs necessary to improve the enforcement of payment discipline, USAID is funding a US$ 5 million programme this winter to provide subsidies to the poor for their heating and electric power.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **14 per cent**
Exchange rate regime – **floating**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **limited for foreigners**

Enterprises and markets
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 per cent**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **54.2 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	na	na	13.4	13.0	13.0	8.3	3.0	3.0	na
Number of goods with administered prices in EBRD-15 basket	5.0	5.0	5.0	4.0	3.0	3.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	na	na	33.3	33.1	27.6	35.7	58.7	70.0	72.4
Share of trade in GDP (in per cent)	123.2	154.8	90.2	37.0	39.1	43.8	39.6	53.1	55.4
Tariff revenues (in per cent of imports)	na	na	0.3	0.5	2.0	4.4	4.2	1.7	na
EBRD index of price liberalisation	2.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3
EBRD index of forex and trade liberalisation	1.0	1.0	1.0	2.0	3.0	4.0	4.0	4.0	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	na	10.4	14.6	19.1	19.8	20.5	21.8	22.7	23.0
Private sector share in GDP (in per cent)	15.0	20.0	20.0	30.0	50.0	55.0	60.0	60.0	60.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	1.0	2.0	2.0	3.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	1.0	1.0	1.0	2.0	3.0	3.3	3.3	3.3	3.3
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	13.8	1.1	1.5	2.2	2.1	2.0	na
Effective statutory social security tax (in per cent)	8.6	7.6	9.1	12.8	26.1	38.2	39.8	64.3	na
Share of industry in total employment (in per cent)	17.9	16.9	15.8	14.5	10.4	5.1	6.9	na	na
Change in labour productivity in industry (in per cent)	-20.5	-7.7	-34.4	-0.6	49.9	2.8	-7.3	na	na
Investment rate/GDP (in per cent)	16.4	3.1	1.6	4.0	6.0	7.2	7.8	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	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	10.5	10.5	9.6	10.3	10.5	11.4	11.6	11.6	na
Railway labour productivity (1989=100)	37.4	22.0	22.6	18.9	18.1	28.4	38.9	47.7	59.5
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	1.6 (20)	3.5 (35)	2.8 (55)	3.1 (68)	3.5 (51)	3.0 (32)	na
Electricity consumption/GDP (1989=100)	165.5	189.4	151.8	147.4	141.8	127.2	136.3	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.4	2.7	2.9
Financial institutions									
Number of banks (of which foreign owned)	75 (na)	179 (na)	226 (1)	101 (3)	61 (6)	53 (8)	43 (9)	34 (9)	30 (8)
Asset share of state-owned banks (in per cent)	77.6	66.7	68.2	45.9	0.0	0.0	0.0	0.0	0.0
Non-performing loans (in per cent of total loans) [1]	12.9	10.3	24.3	40.3	6.3	6.8	6.5	4.9	5.6
Domestic credit to private sector (in per cent of GDP)	na	na	6.1	3.4	3.8	5.0	na	5.8	6.1
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	2.0	2.0	2.3	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	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	3.0	3.0	2.0	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	2.0	3.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	6.7	9.7	8.3	1.7	2.8	4.1	4.0	na	na
Life expectancy at birth, total (years)	69.0	69.0	69.4	69.8	70.3	72.5	72.7	72.9	na
Basic school enrolment ratio (in per cent)	91.2	82.3	82.0	80.4	79.4	80.0	81.8	na	na
Earnings inequality (GINI-coefficient)	36.9	40.0	na	na	na	49.8	na	na	na

[1] Changes in non-performing loans data compared with previous Transition Reports are due to the change of loan categories included in non-performing loans (see definitions).

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	-25.4	-11.4	2.4	10.5	10.8	2.9	3.0	1.9	3.0
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed investment	na	na	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	-21.0	-40.0	-10.0	7.7	8.1	-2.7	7.4	na	na
Agricultural gross output	-42.0	11.6	19.9	5.1	7.1	na	8.0	na	na
Employment [1]				(Percentage change)					
Labour force (annual average)	-6.0	-8.0	9.9	5.0	13.5	-18.3	3.1	na	na
Employment (annual average)	-9.7	-2.4	-1.1	0.6	28.3	-22.5	3.5	na	na
				(In per cent of labour force)					
Unemployment (end-year) [2]	9.1	3.6	3.1	2.8	7.7	12.3	12.7	10.3	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	3,125.4	15,606.5	162.7	39.4	7.1	3.6	19.2	4.1	5.6
Consumer prices (end-year)	7,487.9	6,473.9	57.4	13.7	7.3	7.2	10.9	7.0	5.5
Producer prices (annual average)	649.7	211.6	36.8	32.4	29.0	2.3	na	na	na
Producer prices (end-year)	na	na	na	na	na	3.7	15.7	na	na
Gross average monthly earnings in economy (annual average)	1,300.0	22,042.9	122.6	110.1	89.3	19.8	14.4	9.8	na
Government sector [3]				(In per cent of GDP)					
General government balance	-26.2	-7.4	-5.3	-7.3	-6.7	-5.4	-6.7	-4.6	-3.5
General government expenditure	35.9	23.5	12.3	21.1	21.0	19.1	22.1	17.9	na
General government debt	na	na	na	na	na	na	na	na	na
Monetary sector				(Percentage change)					
Broad money (M3, end-year)	4,319.0	2,229.0	135.1	41.9	45.6	-1.2	17.4	na	na
Domestic credit (end-year)	2,048.0	3,448.3	80.7	59.6	56.1	28.9	19.4	na	na
				(In per cent of GDP)					
Broad money (M3, end-year)	20.1	5.6	4.9	6.7	8.0	6.4	7.6	na	na
Interest and exchange rates				(In per cent per annum, end-year)					
Interbank credit rate (3 month) [4]	na	na	na	27.0	31.0	40.0	na	20.0	na
Treasury bill rate (3 month maturity) [5]	na	na	na	na	44.0	39.1	na	29.0	na
Deposit rate (3 month)	na	na	17.9	16.1	12.6	10.0	12.0	na	na
Lending rate (3 month)	na	na	69.8	53.2	45.0	38.0	35.0	na	na
				(Laris per US dollar)					
Exchange rate (end-year)	0.1	1.3	1.2	1.3	1.3	1.7	1.9	na	na
Exchange rate (annual average)	0.0	1.1	1.3	1.3	1.3	1.4	2.0	2.0	na
External sector				(In millions of US dollars)					
Current account	-354	-278	-216	-275	-375	-389	-219	-182	-188
Trade balance	-448	-365	-338	-351	-559	-685	-541	-361	-379
Merchandise exports	457	381	363	417	494	478	477	645	671
Merchandise imports	905	746	700	768	1,052	1,164	1,018	1,006	1,050
Foreign direct investment, net	0	8	6	54	236	221	60	152	100
Gross reserves (end-year), excluding gold	1	41	157	158	173	118	132	110	na
External debt stock	597	1,004	1,217	1,357	1,508	1,652	1,700	1,623	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	0.0	0.6	2.3	2.2	1.5	1.0	1.3	na	na
				(In per cent of current account revenues, excluding transfers)					
Debt service	na	na	7.2	9.2	4.7	13.4	17.4	na	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)	16	1,373	3,694	3,847	4,679	5,741	5,665	5,955	6,525
GDP per capita (in US dollars)	163	232	535	563	657	771	524	556	na
Share of industry in GDP (in per cent)	6.7	25.4	14.0	11.4	12.5	11.9	13.0	na	na
Share of agriculture in GDP (in per cent)	71.8	34.2	29.8	27.0	35.5	30.9	28.0	na	na
Current account/GDP (in per cent)	-40.2	-22.3	-7.5	-9.1	-10.6	-9.4	-7.8	-6.1	-6.1
External debt - reserves, in US$ millions	596	963	1,060	1,199	1,334	1,534	1,568	1,513	na
External debt/GDP (in per cent)	67.8	80.4	63.7	44.9	42.8	39.8	60.3	54.5	na
External debt/exports of goods and services (in per cent)	112.7	208.0	251.2	265.7	228.0	229.3	229.6	na	na

[1] Figures from 1997 onwards are from the SDS Household Survey.

[2] Based on registered unemployment. This series closely matches data based on the ILO methodology.

[3] General government includes the state, municipalities and extra-budgetary funds.

[4] Determined at credit auctions at which central bank and commercial banks participate. The three-month credit auction was suspended from September 1998 to November 2000. Figure for 1998 relates to August. Figure for 2000 relates to December.

[5] Treasury bills were introduced in August 1997. Market was suspended Sept 1998-Aug 1999. 1998 data relate to August. 2000 data relate to December.

Hungary

Key reform challenges

- **Prospects for lower inflation have improved with the changes to the exchange rate system and the introduction of inflation targeting. However, the government will need to show commitment to its inflation target in 2002 by adhering to a tighter fiscal policy than currently planned.**
- **Enforcement of the new take-over rules will be crucial to improving the protection of minority shareholders and restoring investor confidence.**
- **Social reforms, particularly in the health sector, should be accelerated both to improve services and to reduce underlying fiscal imbalances.**

Stabilisation

Stabilisation prospects improve with the introduction of full currency convertibility and inflation targeting.
Over the past year the government's economic policy has continued to be based on the stimulation of domestic investment through the Szechenyi Plan (subsidies to mortgage loans and SME loans and substantial investment in infrastructure) and the maintenance of external competitiveness. Until recently, the government and the central bank used a combination of short-term capital account controls and financial market interventions to avert pressure on the currency in the presence of the former narrow exchange rate band. However, this policy limited the central bank's capacity to bring down inflation. Following the widening of the forint fluctuation band from +/– 2.25 per cent to +/– 15 per cent in May 2001, the government and the central bank announced that all remaining restrictions on the capital account would be lifted. In June 2001, the central bank announced its shift from exchange rate control to inflation targeting and the forint was made fully convertible. In October 2001, the crawling peg was abandoned and the central parity rate was fixed. These changes will allow the monetary authorities more room for manoeuvre in their anti-inflationary policies.

Full independence of the central bank has been established.
Full independence of the central bank was established with the adoption of the new Act on the National Bank of Hungary, which entered into force in July 2001, and represents a substantial step towards harmonisation with EU laws. The Act stipulates that the primary objective of the central bank will be to achieve and maintain price stability. In order to strengthen the institutional and personal independence of the bank, the law stipulates that the bank and the members of its decision-making bodies shall not seek or take instructions from the government or any other body. In contrast to previous legislation, the new Act stipulates that the bank will not participate in the development of the government's economic policy programme. The central bank's body for the implementation of monetary policy is the Monetary Council, which has been operating with the statutory minimum of seven participants.

Privatisation

Privatisation is nearly complete.
During the period 1990-2000, Hungary attracted US$ 11.9 billion in privatisation revenue, equivalent to over 27 per cent of GDP in this period. However, as virtually all state assets have now been sold, in 2000 the country recorded its lowest level of privatisation revenues since 1990, a sum of only US$ 66 million.

Enterprise reform

Improved legal framework for minority shareholder protection.
In July 2001 new regulations on take-overs were introduced, following events during 2000 surrounding chemical companies BorsodChem and TVK, which revealed weaknesses in the former legislation and inadequacies in the powers of the regulators. The most significant changes include new rules on the acquisition of interest rather than voting rights, with a more comprehensive definition of connected persons and interests including concerted behaviour, and on assessing the aggregated interest that triggers the obligation to make an offer. The mandatory key threshold bid has been lowered to 25 per cent from 33 per cent where no shareholder holds more than 10 per cent of shares. Limitations on the conditions to which an offer can be subject have been increased and the bidder is now required to demonstrate the availability of resources needed to fund the offer. The powers of the State Financial Supervisory Authority have also been increased. The new legislation represents a significant improvement compared with the former legal framework by removing some uncertainties. However, a large degree of discretion has now been given to the supervisory authority, in particular regarding the loose definition of interest and connected persons.

The Competition Office rules on agreements restricting competition.
During 2000 the Economic Competition Office (GVH) made 18 decisions on agreements restricting competition. The most significant cases were the price cartel decision against pharmaceutical producers and distributors – over their announcement to carry out uniform price increases – and the price fixing agreement of certain meat producers and retail chains. Fifty-six cases were investigated in 2000 on the grounds of abuse of dominant position, the most serious of which was against the telecommunications service provider, Matav. The investigation into the pricing policies of MOL (the national oil and gas company)

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

2001
May	Forint fluctuation band widened
Jun	Inflation targeting introduced
Jun	Full convertibility of the forint introduced
Oct	Forint in fixed band with euro peg

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
Dec Amendments to competition act

2001
Jan Capital gains tax introduced
Jun New telecommunications law approved
Jul New central banking act adopted
Jul Take-over law amended

also focused on whether MOL is abusing its dominant market position. In most of the 71 merger and acquisition investigations (of which 17 were in the telecommunications sector) the GVH ruled that the Competition Act had not been violated.

Infrastructure

A new telecommunications law further liberalises the sector.
In June 2001 parliament passed a new telecommunications law ending the monopoly of Matav, which is 60 per cent owned by Deutsche Telekom AG, on fixed-line telephony in 70 per cent of the country. In the rest of Hungary, other companies including Vivendi SA of France and Hungarian Telephone & Cable Corp. of the United States hold concessions to local fixed-line telephony services. Under the new law, the government will maintain control over the price of basic fixed-line services. Several aspects of the law aim at curbing the dominance of Matav. Most importantly, local loop unbundling regulation is asymmetrical: it bars Matav from expanding in the concession areas of other long-term operators until 2004. Meanwhile, Matav will have to unbundle its local loops to admit smaller players immediately after the opening up of the market. The law will start to enter into force in January 2002.

International open tenders have not been applied in new motorway developments.
The government has selected a number of domestic companies to build new motorways. The priority projects are the building of the M3 motorway, the reconstruction and extension of the M7 and the extension of the M0 around Budapest. The government carried out the selections without undertaking a public procurement process. This departs from the previous government practice of holding open international tenders. The legal framework allows both the Hungarian Development Bank Rt (MFB), which is in charge of financing the motorway programme, and the privatisation agency to bypass competitive bidding on grounds of bank confidentiality.

Financial institutions

Competitive pressures spur banking development.
Bank competition for the custom of blue-chip firms is at a peak and interest margins have been worn down to levels lower than in some west European countries. An increasing number of banks have been turning to retail banking and to financing of medium-sized firms in particular. Loans to households and SME lending have been growing fast, albeit from a very low base. Retail lending amounts to only about 10 per cent of total loans, well below Western levels, while SME loans account for only about 30 per cent of total private sector credit. A subsidised programme to kick-start the development of the mortgage market, introduced in early 2000, was extended in February 2001 to all banks that wish to engage in mortgage lending. Formerly, only the state-owned mortgage bank, FHB, was able to benefit from the subsidy, which has now been increased.

Postabank shares are to be transferred to the Post Office.
Under a decree that came into force in August 2001 the privatisation agency, APV Rt., and the finance ministry transferred their shares in Postabank free of charge to the state-run Hungarian Post Office, Magyar Posta, in September. Magyar Posta's auditor, PricewaterhouseCoopers, has been selected to evaluate the Postabank shares transferred to Magyar Posta. At its height, Postabank was Hungary's second-largest bank by assets, although it has slipped to seventh place because of poor management. Nevertheless, it has one of the largest branch networks in the country. Magyar Posta is likely to remain a state-owned company. A bid to acquire Postabank earlier in 2001 by OTP, Hungary's largest commercial bank, was rejected by the government.

The Budapest stock exchange records poor performance.
A punitive capital gains tax introduced in January 2001, consisting of a flat rate of 20 per cent, with no off-set possibility against losses and no adjustment for inflation, is a key factor that has dampened trading on the Budapest stock exchange (BSE). Ineffective protection of minority shareholders (as shown in the take-over of BorsodChem), the slow progress in pension reform, poor liquidity and no initial public offerings (IPOs) are other contributing factors. Following recent government intervention in the gas and pharmaceutical companies, even the blue chips on the BSE have failed to attract foreign portfolio investors, resulting in a heavy outflow of portfolio equity.

Social reform

Health care finances are under growing pressure.
The OECD estimates that the deficit of the health care system could rise from the current 0.8 per cent of GDP to 5.7 per cent in the long term if major reforms are not implemented. The government has not yet been able to contain expenditure on subsidies to pharmaceuticals, hospitals are running large debts, doctors rely on "informal donations" made by patients, and a nursing shortage is imminent because of low pay. Although the government acknowledges the need to reform, it is unlikely that any significant step will be taken in the near future. Public spending on health care amounted to 7.7 per cent of GDP in 1999.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **42 per cent**
Exchange rate regime – **fixed with band to euro**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **MEBOs**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **15.4 per cent**
Private pension funds – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	10.9	10.8	11.8	12.9	12.8	15.9	na	na	na
Number of goods with administered prices in EBRD-15 basket	4.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Share of trade with non-transition countries (in per cent)	80.6	78.2	79.1	77.7	77.0	81.2	84.3	87.9	87.2
Share of trade in GDP (in per cent)	54.0	50.4	45.4	62.8	68.6	90.2	93.2	95.2	115.5
Tariff revenues (in per cent of imports)	11.8	12.0	12.6	12.9	9.6	4.0	2.6	2.4	na
EBRD index of price liberalisation	3.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3	3.3
EBRD index of forex and trade liberalisation	4.0	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	3.9	8.7	12.3	20.8	23.4	27.4	28.5	29.6	30.1
Private sector share in GDP (in per cent)	40.0	50.0	55.0	60.0	70.0	75.0	80.0	80.0	80.0
Private sector share in employment (in per cent)	na	na	na	71.0	76.8	83.3	81.4	na	na
EBRD index of small-scale privatisation	2.0	3.0	3.7	3.7	4.0	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	2.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	5.4	5.2	5.9	4.9	5.6	4.9	5.2	4.8	na
Effective statutory social security tax (in per cent)	79.9	76.6	78.3	76.2	78.4	80.1	84.3	79.1	na
Share of industry in total employment (in per cent)	28.0	28.4	27.6	26.7	26.7	26.7	27.8	27.4	na
Change in labour productivity in industry (in per cent)	3.9	16.4	14.8	10.5	4.3	9.3	7.4	9.5	na
Investment rate/GDP (in per cent)	19.9	18.9	20.1	20.0	21.4	22.2	23.2	28.1	30.3
EBRD index of enterprise reform	3.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3
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	12.6	14.6	16.9	18.5	26.1	30.4	33.6	40.2	na
Railway labour productivity (1989=100)	80.8	72.9	85.6	92.6	93.2	108.4	112.9	117.0	128.7
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	3.99 (90)	5.85 (90)	5.96 (90)	6.75 (90)	6.97 (na)	7.26 (na)	na
Electricity consumption/GDP (1989=100)	107.4	103.8	101.7	101.4	103.1	99.1	95.1	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	3.8	3.8	3.8
Financial institutions									
Number of banks (of which foreign owned)	35 (12)	40 (15)	43 (17)	42 (21)	41 (25)	41 (30)	40 (27)	39 (27)	38 (30)
Asset share of state-owned banks (in per cent)	74.4	74.9	62.8	52.0	16.3	10.8	11.8	9.1	8.6
Non-performing loans (in per cent of total loans) [1]	na	29.6	20.2	12.1	9.0	5.3	6.8	4.4	3.1
Domestic credit to private sector (in per cent of GDP)	23.4	20.7	21.4	18.6	18.7	20.4	20.0	20.7	23.6
Stock market capitalisation (in per cent of GDP)	1.6	2.3	4.2	5.8	12.4	35.2	29.9	36.2	26.3
EBRD index of banking sector reform	2.0	3.0	3.0	3.0	3.0	4.0	4.0	4.0	4.0
EBRD index of reform of non-banking financial institutions	2.0	2.0	2.0	3.0	3.0	3.3	3.3	3.3	3.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	4.0	4.0	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	4.0	4.0	3.7	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	14.0	13.5	13.9	12.4	11.4	na	na	na	na
Life expectancy at birth, total (years)	69.0	69.0	69.4	69.8	70.3	70.6	70.6	71.0	70.6
Basic school enrolment ratio (in per cent)	99.2	99.1	99.1	99.1	99.2	99.2	99.2	na	na
Earnings inequality (GINI-coefficient)	30.5	32.0	32.4	na	na	34.8	na	na	na

[1] Changes in non-performing loans data compared with previous Transition Reports are due to the change of loan categories included in non-performing loans (see definitions).

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure					(Percentage change in real terms)				
GDP	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	4.5
Private consumption	1.9	-0.2	-7.1	-3.4	1.7	4.9	4.6	3.3	na
Public consumption [1]	27.5	-12.7	-4.1	-4.2	5.7	-0.3	1.8	1.6	na
Gross fixed investment	2.0	12.5	-4.3	6.7	9.2	13.3	5.9	6.6	na
Exports of goods and services	-10.1	13.7	13.4	8.4	26.4	16.7	13.1	21.8	na
Imports of goods and services	20.2	8.8	-0.7	6.6	24.6	22.8	12.3	21.1	na
Industrial gross output	4.0	9.6	4.6	3.4	11.1	12.4	10.4	18.3	na
Agricultural gross output	-9.7	3.2	2.6	6.3	-1.8	-0.3	0.1	na	na
Employment					(Percentage change)				
Labour force (annual average) [2]	-9.0	-3.3	-2.6	-1.2	-1.3	0.4	2.1	0.4	na
Employment (annual average) [2]	-11.7	-2.0	-1.9	-0.8	0.0	1.4	3.1	1.0	na
					(In per cent of labour force)				
Unemployment (end-year) [3]	14.5	12.4	12.1	11.8	11.6	10.1	9.9	9.0	na
Prices and wages					(Percentage change)				
Consumer prices (annual average)	22.5	18.8	28.2	23.6	18.3	14.3	10.0	9.8	9.1
Consumer prices (end-year)	21.1	21.2	28.3	19.8	18.4	10.3	11.2	10.1	6.9
Producer prices (annual average)	10.8	11.3	28.9	21.8	20.4	11.3	5.1	11.7	na
Producer prices (end-year)	9.5	14.8	30.2	20.1	19.5	7.1	8.2	12.4	na
Gross average monthly earnings in economy (annual average)	21.9	22.6	16.8	20.4	22.3	18.3	13.9	13.5	na
Government sector [4]					(In per cent of GDP)				
General government balance	-6.6	-8.4	-6.7	-5.0	-6.6	-5.6	-5.7	-3.5	-3.0
General government expenditure	57.5	58.7	52.2	48.2	50.9	49.4	44.8	45.1	na
General government debt	90.4	88.2	86.4	72.8	63.9	62.3	60.7	57.6	na
Monetary sector					(Percentage change)				
Broad money (M3, end-year)	15.3	13.0	20.1	22.5	20.3	15.2	16.0	12.6	na
Domestic credit (end-year) [5]	20.8	18.1	13.7	7.6	12.0	13.2	-6.4	14.8	na
					(In per cent of GDP)				
Broad money (M3, end-year)	56.8	52.2	48.7	48.6	46.9	45.8	46.9	46.8	na
Interest and exchange rates					(In per cent per annum, end-year)				
Refinance rate	na	25.0	28.0	23.0	20.5	17.0	14.5	11.0	na
Interbank interest rate (up to 30-day maturity)	21.8	31.3	27.8	23.2	19.7	17.3	14.5	12.1	na
Deposit rate weighted average (fixed for less than 1 year)	16.6	22.9	24.4	18.6	16.3	14.4	11.9	9.5	na
Lending rate weighted average (maturing within 1 year)	25.6	29.7	32.2	24.0	20.8	18.8	19.4	12.8	na
					(Forints per US dollar)				
Exchange rate (end-year)	100.7	110.7	139.5	164.9	203.5	219.0	252.5	284.7	na
Exchange rate (annual average)	92.0	105.1	125.7	152.6	186.8	214.5	237.3	282.2	na
External sector					(In millions of US dollars)				
Current account [6]	-3,453	-3,912	-2,480	-1,678	-981	-2,298	-2,081	-1,495	-1,576
Trade balance [6]	-3,246	-3,635	-2,442	-2,645	-1,963	-2,353	-2,176	-2,119	-3,227
Merchandise exports [6]	8,094	7,613	12,810	14,183	19,637	20,749	21,844	25,346	28,451
Merchandise imports [6]	11,340	11,248	15,252	16,828	21,600	23,102	24,020	27,466	31,678
Foreign direct investment, net	2,328	1,097	4,410	2,279	1,741	1,555	1,720	1,167	1,314
Gross reserves (end-year), excluding gold	6,691	8,727	11,967	9,681	8,400	9,312	10,948	11,202	na
External debt stock	24,566	28,521	31,655	27,956	24,395	27,280	29,336	30,757	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	5.8	7.5	7.6	5.7	4.0	4.1	4.6	4.2	na
					(In per cent of export of goods and services)				
Debt service	45.0	58.2	45.7	47.2	37.5	29.1	18.4	16.8	na
Memorandum items					(Denominations as indicated)				
Population (end-year, millions)	10.3	10.2	10.2	10.2	10.2	10.1	10.0	10.0	na
GDP (in millions of forints)	3,548,300	4,364,800	5,614,000	6,893,900	8,540,669	10,087,434	11,436,500	12,900,000	14,709,686
GDP per capita (in US dollars)	3,752	4,052	4,359	4,425	4,495	4,641	4,775	4,552	na
Share of industry in GDP (in per cent)	21.3	21.9	23.1	23.5	25.0	25.9	26.9	na	na
Share of agriculture in GDP (in per cent)	6.1	5.9	5.9	6.1	5.8	5.4	5.3	na	na
Current account/GDP (in per cent)	-9.0	-9.4	-5.6	-3.7	-2.1	-4.9	-4.3	-3.3	-3.1
External debt - reserves, in US$ millions	17,875	19,794	19,688	18,275	15,995	17,968	16,332	19,555	na
External debt/GDP (in per cent)	63.7	68.7	70.9	61.9	53.3	58.0	56.6	67.3	na
External debt/exports of goods and services (in per cent)	225.4	267.2	176.3	138.6	96.2	102.3	106.7	97.3	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 Survey.

[3] Registered unemployed. Data from the Labour Force Survey for 1992 to 2000 indicate lower rates of respectively 11.9, 10.7, 10.2, 9.9, 8.7, 7.8, 7 and 6.4 per cent.

[4] Government sector data before 1996 are official fiscal balance data. For the following years data are adjusted towards balances on a national accounts basis (SNA).

[5] Changes in domestic credit adjusted to account for bank recapitalisation in 1993-95.

[6] Data from balance of payments.

Kazakhstan

Key reform challenges

- **The reduction of entry barriers by eliminating "red tape", improving the judiciary and strengthening local government administration would be a better way to promote economic diversification than the current import substitution policy.**

- **In the energy sector the strategy of renegotiating existing contracts and extracting payments through control of transportation routes risks discouraging investment; the focus should be on transfer pricing legislation and transport tariff methodology.**

- **The domestic equity market needs to be boosted – initial public offerings of residual government stakes in large companies and the mandatory introduction of international accounting standards for large corporates would be key first steps.**

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 issued

1999
Jan Temporary trade restrictions on neighbours introduced
Jan Major budgetary reforms introduced
Apr Export surrender requirement re-introduced temporarily
Sep Sovereign eurobond issued (first in CIS after Russian crisis)

2000
Jan Oil export quota introduced temporarily
Jul Lifelong privileges granted to president
Aug Minority stake in TC Oil sold to Chevron
Aug National Fund established

2001
Jul Capital amnesty decreed
Jul New tax code enacted (effective from January 2001)

Liberalisation

Negotiations with the WTO are moving forward.
Negotiations on entry to the WTO had stalled since October 1998 but have recently regained some momentum as bilateral negotiations on market access and legislative reforms resumed. The fourth working party meeting on accession was held in July 2001. Kazakhstan will be required to improve its tariff offers on industrial goods, reduce the number of tariff peaks, improve market access in services, including in the financial and telecommunications sectors, and abolish restrictions on employment of foreign labour. In a positive recent development, exit visa requirements for Kazakh citizens were abolished in July 2001.

Stabilisation

A National Fund has been set up.
In August 2000 the government established a National Fund to be used for fiscal stabilisation, and to safeguard national wealth for future generations. The fund received its first transfers in May 2001 and stood at US$ 1.2 billion in October. Although the rules governing contributions to and investments by the fund broadly follow good international practice, an urgent priority remains the adoption of a medium-term fiscal framework, explicitly limiting the extent to which the government could draw on the fund for budgetary purposes.

A capital amnesty has attracted significant repatriated funds.
From 14 June to 14 July 2001 Kazakh residents could repatriate capital into special accounts at 20 qualified domestic banks without fear of legal reprisal or investigation of the source of this money. The scheme resulted in about US$ 480 million in capital repatriations. Proponents of the scheme said it had reversed earlier capital flight and had drawn money from "under the mattresses" into the banking system. Opponents pointed out that the absorptive capacity of the real economy is limited and funds would therefore be likely to leave the country again once they had been "legalised". To date, US$ 265 million has remained in the banking system. Critics also viewed the measure as self-serving for senior officials.

New tax code brings tax reductions.
From 1 July 2001 employers' social contributions were reduced from 26 per cent to 21 per cent and VAT lowered from 20 per cent to 16 per cent. From July 2001, the destination principle has been applied to all VAT payments, and exports to the CIS (with the exception of oil and gas) will thus be VAT-free. The social tax reduction should provide a boost to domestic employment and may lure some companies into the formal economy. The reduction in VAT is more controversial as it could increase tax dependence on the energy sector. The oil and mining sectors are excluded from the lower taxes unless they agree to negotiate compensatory measures in their Production Sharing Agreements and other contracts.

Slow progress in privatisation.
In January to August 2001, Kazakhstan raised only KZT 11 billion (US$ 76 million) in privatisation revenues, excluding the US$ 660 million transferred to the government for the sale of a 5 per cent stake in the Tengiz Chevron joint venture. Blue Chip privatisation – the sale of residual government stakes in several large domestic enterprises through the stock market – has failed to accelerate. The government now appears to favour direct sales of its residual stakes to strategic investors, missing the opportunity to boost the share market. The government retains control over key assets, such as oil and gas transportation, telecommunications and the railways.

Enterprise reform

Investment and restructuring increase significantly.
In 2000 aggregate investment rose by 30 per cent compared with 1999. While FDI in the oil sector still accounted for the bulk of investment activity, there are encouraging signs of recovery in the non-energy sectors. Rising exports and a competitive exchange rate have boosted enterprise cash flows, while the lack of debt in the corporate sector has provided significant scope for increased debt finance. The government is preparing a revised joint-stock company law and the introduction of mandatory international accounting standards in an attempt to increase disclosure among the largest domestic corporates.

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
Jan New civil service law adopted
Jun Tractebel leaves Kazakhstani energy sector
Jul Wholesale power trading company (KOREM) established

2001
May National Development Bank set up
May Gas and oil transport companies merged (Kaztransneftegas)

The government persists with its import substitution policy.
The government's efforts to support economic diversification centre on local content requirements for foreign investors and support for domestic companies through the National Development Bank founded in May 2001 as well as selective trade measures. Local content is not mandatory under existing contracts but is strongly encouraged. So far, contracts worth some US$ 350 million have been concluded between foreign and domestic companies. The National Development Bank, capitalised with US$ 200 million from the budget, may finance a mixture of public and social infrastructure projects and support for domestic businesses. The government's activist stance raises concerns over potential market distortions.

Infrastructure

Merger of Kaztransoil and Kaztransgas creates a powerful domestic monopoly.
In April 2001 the oil and gas transportation networks were combined under a single state-owned holding, Kaztransneftegas. The new company also holds stakes in the national shipping fleet, the Atyrau airport, the Pavlodar refinery and the Almangeldy gas deposit. Despite a successful debut eurobond issue in June by its subsidiary Kaztransoil, corporate restructuring of Kaztransneftegas to separate non-core assets is crucial to allow the company to attract the large amount of financing required for modernisation. Oil producers are concerned that the government may be using its control over most energy transport routes to extract additional payments from the sector. These concerns reflect action taken last year, when transit tariffs to Russia almost doubled.

Railway restructuring programme is launched.
The state-owned railway, Kazakhstan Temir Zholy (KTZ), is to be split into several commercial joint-stock companies responsible for passenger traffic, freight, repair and maintenance services. In a separate move the government is considering the final draft of a plan to liberalise the fixed line telecommunications sector and introduce independent regulation.

Financial institutions

The banking sector continues its rapid expansion.
Banking sector assets grew by 60 per cent during the first half of 2001. Over the same period bank loans grew 88 per cent to US$ 2.7 billion (around 13 per cent of GDP) while equity in the banking sector rose 25 per cent to reach US$ 678 million. The banking sector is benefiting from continued high liquidity. Against the background of a buoyant economy, non-performing loans fell from 5.5 per cent of assets in 1999 to 2 per cent in 2000, although rapid credit expansion may cause a deteriorating portfolio in the future. In May 2001 the government announced a tender for its remaining 33 per cent stake in the Savings Bank (Halyk), which was expected to be bought by the biggest private bank, KKB. However, a rival domestic consortium appeared at a late stage, leading the government to postpone the tender and raise the minimum price. The possibility of a Halyk-KKB merger raised suspicions of political patronage and concerns over excessive market power.

Pension assets top US$ 1 billion but asset diversification is still problematic.
The funded pension system passed a landmark in mid-July 2001, with assets topping US$ 1 billion. The growth of pension assets has provided a captive market to issuers of domestic securities, including the government and, increasingly, corporate bond issuers. Interest rates on three-month treasury bills had fallen to record levels of 4.9 per cent by mid-2001, while three-to-five-year corporate bonds of domestic blue-chip companies indexed to US dollars were issued at coupons of around 8-9 per cent during the first half of the year. Pension funds are allowed to invest 25 per cent of their assets abroad, 15 per cent in corporate equities and bonds of AA listed companies and 10 per cent in issues of IFIs. However, this leeway has not been fully used in the past, partly because of lack of experience, and partly because in the present favourable economic environment the risk-return profile of domestic paper has appeared more attractive. In contrast to the bond market, the equity market remains lack-lustre. Companies fear the loss of control associated with issuing equity and shun tough disclosure requirements.

Social reform

The government is focusing its attention on improved public services.
The government's budget for 2001 included a 30 per cent salary increase for all public officials as well as increased outlays on health, education and social security. In June 2001 legislation was passed moving social assistance towards income targeting and abolishing privileges for specific groups. Public service delivery has been hampered by two main factors in the past. First, low wages have led to the loss of the best and most motivated staff and led to unequal access because of unofficial payments to supplement low salaries. Second, local governments are largely responsible for the delivery of social services but have highly unequal revenues, leading to great regional variation in per capita social spending.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **16.1 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **30.9 per cent**
Private pension funds – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	2.5	2.5	2.5	0.0	0.0	0.0	0.0	0.0	na
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	3.0	0.0	0.0	0.0	0.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	na	na	33.2	39.9	41.7	52.4	47.3	58.7	64.2
Share of trade in GDP (in per cent)	136.7	179.6	64.4	64.9	61.8	63.6	56.9	69.3	90.2
Tariff revenues (in per cent of imports) [1]	17.3	0.5	5.6	3.9	2.0	1.5	1.9	1.6	na
EBRD index of price liberalisation	2.0	2.0	2.0	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	3.0	3.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP) [2]	3.4	6.1	6.4	6.7	8.9	12.3	16.2	17.9	18.7
Private sector share in GDP (in per cent)	10.0	10.0	20.0	25.0	40.0	55.0	55.0	60.0	60.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	2.0	2.0	2.3	3.0	3.3	4.0	4.0	4.0	4.0
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]	na	na	3.2	3.6	2.6	1.8	0.7	0.7	na
Effective statutory social security tax (in per cent)	37.7	na	39.8	55.3	56.3	51.5	na	na	na
Share of industry in total employment (in per cent)	na	21.2	20.7	20.5	20.9	22.2	24.6	26.8	29.3
Change in labour productivity in industry (in per cent)	-10.7	-1.0	-22.7	-0.1	12.3	18.6	3.8	15.7	15.8
Investment rate/GDP (in per cent)	30.4	27.9	22.6	20.5	11.8	15.6	17.3	14.6	13.8
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	8.8	11.7	11.7	11.8	11.6	10.8	10.9	10.8	na
Railway labour productivity (1989=100)	69.5	51.4	37.6	32.6	30.4	30.0	31.2	27.6	42.5
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	4.2 (73)	3.2 (75)	3.0 (70)	3.8 (50)	4.7 (na)	3.2 (na)	na
Electricity consumption/GDP (1989=100)	110.3	102.4	110.4	110.0	97.0	81.9	76.3	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.4	2.4	2.5
Financial institutions									
Number of banks (of which foreign owned)	155 (1)	204 (5)	184 (8)	130 (8)	101 (9)	81 (22)	71 (20)	55 (18)	48 (16)
Asset share of state-owned banks (in per cent) [4]	4.6	na	na	24.3	28.4	44.8	23.0	19.9	1.9
Non-performing loans (in per cent of total loans) [5]	na	na	na	14.9	19.9	6.0	4.7	5.5	2.1
Domestic credit to private sector (in per cent of GDP)	na	49.3	26.6	7.1	6.3	4.3	5.4	7.4	10.6
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	6.1	8.2	15.5	7.5
EBRD index of banking sector reform	1.0	1.0	1.0	2.0	2.0	2.3	2.3	2.3	2.3
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.7	1.7	1.7	1.7	2.0	2.0	2.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	2.0	2.3	3.3	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	2.0	2.0	3.3	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	6.1	6.5	5.3	7.5	7.2	7.1	6.2	6.1	na
Life expectancy at birth, total (years)	67.7	66.7	65.7	64.9	64.1	64.5	64.6	64.8	na
Basic school enrolment ratio (in per cent)	94.2	94.0	93.6	94.3	94.6	93.7	93.2	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

[1] Refers to taxes on international trade.
[2] Excludes sale of 5 per cent stake in TCO for US$ 660 million in January 2001.
[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 a state-owned institution. In 1998 the merger bank was reprivatised. In December 2000 the state reduced its stake in the Savings Bank to less than 50 per cent.
[5] Changes in non-performing loans data compared with previous Transition Reports are due to the change of loan categories included in non-performing loans (see definitions).

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure					(Percentage change in real terms)				
GDP	-9.2	-12.6	-8.2	0.5	1.7	-1.9	2.7	9.6	10.0
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed investment	na	na	-16.7	-42.2	11.2	-12.5	na	na	na
Exports of goods and services	na	na	na	-16.7	-1.7	-55.3	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	-14.0	-27.5	-8.6	0.3	4.1	-2.4	2.2	14.6	na
Agricultural gross output	-6.9	-21.0	-24.4	-5.0	-0.8	-18.9	21.6	-3.3	na
Employment					(Percentage change)				
Labour force (annual average)	-7.7	1.6	3.4	14.6	0.4	1.8	-6.1	na	na
Employment (annual average)	na	-3.8	-7.8	-12.3	-17.1	-15.4	-19.0	-9.2	na
					(In per cent of labour force)				
Unemployment (annual average)	0.6	8.1	13.0	8.6	7.3	6.6	6.3	6.0	na
Prices and wages					(Percentage change)				
Consumer prices (annual average)	1,662.3	1,892.0	176.3	39.1	17.4	7.3	8.3	13.2	8.6
Consumer prices (end-year)	2,169.0	1,158.3	60.4	28.6	11.2	1.9	17.8	9.6	7.0
Producer prices (annual average)	na	2,920.4	231.2	24.3	15.6	0.8	18.8	38.0	na
Producer prices (end-year)	na	1,923.8	40.2	18.5	11.7	-5.5	57.2	19.4	na
Gross average monthly earnings in economy (annual average)	2,566.7	1,248.2	177.3	42.9	24.9	13.4	13.4	20.2	na
Government sector [1]					(In per cent of GDP)				
General government balance [2]	-4.1	-7.7	-3.4	-5.3	-7.0	-7.7	-5.0	-0.8	2.5
General government expenditure [3]	25.2	18.4	20.8	18.6	20.4	25.8	22.4	22.5	na
General government debt	na	na	na	na	na	na	na	na	na
Monetary sector					(Percentage change)				
Broad money (M3, end-year)	692.0	576.1	109.0	16.6	28.2	-14.1	84.4	45.0	na
Domestic credit (end-year) [4]	653.0	745.3	-21.5	15.6	-2.8	40.5	40.6	70.6	na
					(In per cent of GDP)				
Broad money (M3, end-year)	27.9	13.1	11.4	9.5	10.3	8.6	13.6	15.3	na
Interest and exchange rates					(In per cent per annum, end-year)				
Refinancing rate	240.0	230.0	52.5	35.0	18.5	25.0	18.0	14.0	na
Treasury bill rate (3-month maturity)	na	456.4	58.7	32.2	16.0	25.8	16.6	6.8	na
Deposit rate [5]	na	na	44.4	29.3	12.0	14.5	13.5	15.6	na
Lending rate [5]	na	na	58.3	53.6	22.8	18.4	21.3	19.9	na
					(Tenge per US dollar)				
Exchange rate (end-year)	6.3	54.3	64.0	73.8	75.9	84.0	138.3	145.4	na
Exchange rate (annual average)	5.3	36.4	61.1	67.8	75.6	78.6	120.1	142.3	na
External sector					(In millions of US dollars)				
Current account	-438	-904	-213	-750	-802	-1,236	-233	1,073	460
Trade balance [6]	-414	-929	114	-335	-276	-801	344	2,765	2,300
Merchandise exports	4,769	3,285	5,440	6,292	6,899	5,871	5,989	9,615	10,500
Merchandise imports	5,183	4,214	5,326	6,627	7,176	6,672	5,645	6,850	8,200
Foreign direct investment, net	473	635	964	1,137	1,320	1,136	1,584	1,244	2,000
Gross reserves (end-year), excluding gold	487	838	1,136	1,295	1,697	1,461	1,479	1,594	na
External debt stock [7]	2,902	4,474	4,765	5,807	7,750	9,932	12,051	12,525	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold [8]	1.1	2.1	2.2	2.1	2.5	2.2	2.6	2.2	na
					(In per cent of exports of goods and services)				
Debt service [9]	1.4	4.2	7.9	15.9	24.5	22.4	27.3	49.9	na
Memorandum items					(Denominations as indicated)				
Population (end-year, millions)	16.9	16.2	16.0	15.7	15.5	15.2	15.0	14.9	na
GDP (in millions of Tenge)	29,423	423,469	1,014,281	1,415,750	1,672,143	1,733,264	2,016,456	2,596,000	3,101,853
GDP per capita (in US dollars)	328	721	1,040	1,333	1,429	1,452	1,123	1,225	na
Share of industry in GDP (in per cent)	28.5	23.6	23.5	23.5	24.0	23.9	23.9	na	na
Share of agriculture in GDP (in per cent)	16.6	15.0	12.3	11.7	11.4	9.4	11.2	na	na
Current account/GDP (in per cent)	-7.9	-7.8	-1.3	-3.6	-3.6	-5.6	-1.4	5.9	2.2
External debt - reserves, in US$ millions	2,415	3,637	3,630	4,512	6,052	8,471	10,572	10,931	na
External debt/GDP (in per cent)	52.4	38.4	28.7	27.8	35.0	45.0	71.8	68.6	na
External debt/exports of goods and services (in per cent)	56.3	120.2	79.8	83.4	100.1	146.6	174.1	116.5	na

[1] General government includes the state, municipalities and extra-budgetary funds.

[2] Government balance includes quasi-fiscal operations (zero after 1995). Balance excludes privatisation revenues and includes quasi-fiscal operations. The deficit gross of privatisation revenues (as presented by the government) was -3.7 per cent in 1998, -3.5 per cent of GDP in 1999 and 0.4 (surplus) in 2000.

[3] Expenditures include extra-budgetary funds after 1998, leading to a break in the series. Following the old series, expenditures increased by only 1.4 per cent of GDP in 1998.

[4] Domestic credit from International Financial Statistics. Break in series in 1996-97.

[5] 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.

[6] Exports are at declared customs prices and are not corrected for under-invoicing of oil and gas exports, estimated at some US$ 400 million for 2000 by the IMF.

[7] Includes inter-company debt by branches of non-resident foreign enterprises. Public debt was around US$ 3.9 billion in 2000.

[8] The figure for 1993 is in months of merchandise imports only.

[9] Debt service in 2000 includes amortisation and interest on inter-company loans as reported by the NBK. Without these, debt service would be US$ 1,760 million (16.4 per cent of total exports).

Kyrgyzstan

Key reform challenges

- **Economic and financial integration with neighbouring countries should be fostered, as the attraction of FDI from them would help to increase much-needed investment in the private sector.**
- **The reduction in the public investment programme and the debt restructuring with Russia have improved the sustainability of public finances but the government must adhere to its strict budgetary targets.**
- **Reform of the civil service remains a priority to improve the investment climate and achieve a better targeting of scarce public resources.**

Liberalisation

Trade integration remains hampered by regional constraints.
The extent of liberalisation of prices, trade and capital account transactions in Kyrgyzstan continues to exceed that of its neighbours. For example, the country is still the only WTO member in Central Asia. However, the country has not been able to exploit fully the benefits of these policies. Corruption and bureaucracy in the customs service continue to hamper imports while Kyrgyzstan's neighbours in the region maintain protective barriers against Kyrgyz goods. Trade disputes are further aggravated by the fact that much of the trade between the regions is in goods such as water, electricity and gas, for which prices are set through bilateral bargaining. No market reference prices are available for these goods.

Stabilisation

The trade balance continues to strengthen ...
Following a nominal fall of 100 per cent against the US dollar since the middle of 1998, the som has stabilised over the last year. Inflation has fallen to 10 per cent year-on-year and gold exports have soared despite low gold prices. As a result, the trade balance was in surplus for the first quarter of this year. The recent agreement to reduce the foreign-financed public investment programme should help to improve the trade balance further over the medium term.

... and some progress has been made towards debt sustainability.
In May 2001 Kyrgyzstan agreed on a rescheduling of its debt payments to Russia, which formed a significant share of its external obligations. Most other external debts are on highly concessional terms. As a result, debt service payments as a percentage of revenues and exports are expected to decrease after 2003. The size of the public investment programme will also be reduced from 7.1 per cent of GDP in 2000 to 3 per cent by 2005, which will help to stabilise the debt level further. The current government strategy anticipates that a balanced primary budget will be achieved by 2004, at which stage interest payments should account for about 2 per cent of GDP. The authorities are putting greater emphasis on the budgetary process by introducing a medium-term budgetary framework, strengthening treasury controls and prioritising public investment projects, all with the aim of reducing the budget deficit.

Privatisation

A new privatisation strategy has been announced.
The government has divested most of its company holdings. The state still holds stakes in some 350 companies. State companies are concentrated in the construction sector (40 per cent of the total number), transportation (45 per cent) and in the energy and telecommunication sectors. In February 2001 the government approved a new state property privatisation strategy for 2001-03. The main objectives are to privatise stakes in KyrgyzTelekom, Kyrgyzenergo, KyrgyzGas and Kyrgyz Airlines. However, there have been no significant privatisation transactions over the past year.

Enterprise reform

Renewed drive for civil service reform.
Public sector reform is high on the agenda in the country's Poverty Reduction Strategy. Reform proposals would involve the liquidation of parallel and duplicated functions and a reduction in the number of employees as well as the introduction of performance-based assessment of public employees. These reforms will be coupled with a wage structure designed to attract talented people into the public service. Another important element of the reform will be decentralisation, with financial authority being passed down to local governments, and closure of local offices of federal agencies. The new focus on public sector reforms reflects the ongoing concerns of investors about weaknesses in the investment climate, linked to the lack of transparency and significant corruption in the government sector.

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 convertiblitiy 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

2001
Jun Interim poverty reduction strategy adopted

Despite growth in the agricultural sector, income has been falling.
Structural reforms in the agricultural sector have progressed well, contributing to the growth of private farms and a 5 per cent real increase in agricultural value added in 2000. Yields of newly established private farms are 20-30 per cent higher on average than those of state farms. Despite the increased output, however, income levels in the sector have fallen. The reasons are twofold. First, the sector has absorbed large numbers of workers made redundant in the industrial sector. Second, a limited market coupled

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

with increased output has depressed prices. Trade restrictions imposed by neighbouring countries have contributed to this decline.

Infrastructure

Privatisation of the main telecommunications provider has been delayed.
The national telecommunications company, JSC KyrgyzTelekom, returned to profit in 2000 after a loss of KGS 1 billion (US$ 20 million) in 1999, due both to tariff increases and to a stronger economy. An attempt to privatise 40 per cent of the company by international tender failed last year. The appointed consultant for the tender blamed the government for insisting on unrealistic valuation expectations and reducing the value of KyrgyzTelekom by depriving it of the chance to bid for a GSM licence. The government has re-stated its intention to privatise the company and it is included in the list of firms to be privatised by 2003.

Reforms in the energy sector are under way.
With World Bank support, the state-owned energy company Kyrgyzenergo has been divided into generation, distribution and transmission units. The reform programme also involves the rise of electricity and heating tariffs to cost recovery levels, which will be a precondition for any successful privatisation in the sector. The government is to submit to parliament by October 2001 a bill to reduce the number of energy users eligible for special privileges under the existing electricity tariff structure. To mitigate the impact of price increases on the poor, the bill allows for a lifeline tariff for a basic level of electricity consumption. Significant investments in new hydroelectric power stations continue. Electricity output rose last year by 13 per cent and exports of electricity in US dollar terms grew by 53 per cent to the main markets, Uzbekistan and Kazakhstan. However, the recent move towards substituting electricity for gas in heating to avoid imports from Uzbekistan has strained relations with that country. Increased hydropower generation deprives Uzbekistan of downstream water supplies, essential for its large irrigated agricultural sector.

Financial institutions

The banking sector is slowly recovering from the recent crisis.
The assets of the banking sector fell from US$ 160 million (10 per cent of GDP) before the banking crisis in 1998-99 to US$ 90 million (7 per cent of GDP) at the end of 2000. The small increase in assets in the first half of 2001 was supported by higher capital requirements – KGS 100 million (US$ 2 million) effective from July 2001. There has also been new entry into the sector, partly from abroad. The National Bank of Pakistan and the Kyrgyz Industrial Credit Bank (set up with IFI equity investments) each obtained a banking licence in 2000. As a result, about one-half of the capital in the banking sector is now foreign-owned.

The central bank retains ownership of key banks.
While the Debt Recovery Agency (DBRA) will be given the mandate to be the sole liquidator of failed banks, the central bank continues to control much of the household deposit base in the Savings and Settlement Corporation (SSC), which it took over in 1998 following its insolvency. The privatisation of SSC is complicated by the fact that the government wants the bank to provide financial services nation-wide. Kairat Bank, which was founded in 1998 by the central bank to take over the assets from bankrupt banks, has been transferred to the government for its future privatisation. In 2000 the central bank also established the Kyrgyz Agricultural Financial Corporation, which is supposed to provide credits to the agricultural sector. This further increases the ownership role of the central bank in the banking sector, for which it is also the regulator.

Social reform

Social expenditures are set to increase.
The share of the population considered poor rose to 55 per cent by 1998, according to the World Bank, and has fallen only slightly over the last two years. Poverty is concentrated in rural areas and among families with many children. Sixty-one per cent of children are estimated to be living in poor families. According to the same survey data, income inequality is also relatively high, with the top fifth of the income distribution consuming about seven times as much as the poorest fifth. This year the government has completed its Poverty Reduction Strategy Paper and has targeted a doubling of expenditure on education, health care and social protection in the period 2003-05.

Liberalisation
Current account convertibility – **yes**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **17.6 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **MEBOs**
Tradability of land – **limited de facto**

Enterprises and markets
Competition Office – **no**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **no**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **55 per cent**
Private pension funds – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	40.0	na	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket	4.0	4.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Share of trade with non-transition countries (in per cent)	na	na	40.2	17.6	19.4	33.5	57.7	55.7	56.9
Share of trade in GDP (in per cent)	na	na	69.1	63.0	72.1	72.2	81.4	79.3	77.8
Tariff revenues (in per cent of imports)	na	na	1.0	2.3	2.0	2.2	2.4	1.4	na
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	2.0	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.2	0.6	0.9	1.3	1.4	1.6	1.9	2.4
Private sector share in GDP (in per cent)	20.0	25.0	30.0	40.0	50.0	60.0	60.0	60.0	60.0
Private sector share in employment (in per cent)	39.8	52.4	41.7	68.5	72.5	74.2	76.3	77.3	na
EBRD index of small-scale privatisation	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP) [1]	na	na	2.1	2.3	1.8	2.2	2.5	2.2	na
Effective statutory social security tax (in per cent)	na	na	53.0	67.5	60.5	67.7	66.5	60.3	na
Share of industry in total employment (in per cent)	16.3	16.0	14.7	12.5	11.1	10.2	8.9	9.2	na
Change in labour productivity in industry (in per cent) [2]	-23.7	-17.0	-14.5	-11.4	16.5	48.8	18.8	-7.9	na
Investment rate/GDP (in per cent)	14.6	13.4	5.6	20.7	22.6	12.6	12.2	18.0	16.0
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	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	7.5	8.0	7.3	7.7	7.5	7.6	7.6	7.6	na
Railway labour productivity (1990=100)	73.5	54.3	39.7	34.4	32.1	31.7	33.0	30.1	44.9
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	0.74 (65)	1.00 (70)	2.25 (75)	2.00 (80)	0.48 (90)	0.37 (93)	na
Electricity consumption/GDP (1989=100)	127.7	149.4	180.9	175.7	155.4	135.3	139.7	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	1.9	1.9	2.0
Financial institutions									
Number of banks (of which foreign owned)	15 (1)	20 (1)	18 (3)	18 (3)	18 (3)	20 (3)	23 (6)	23 (5)	22 (6)
Asset share of state-owned banks (in per cent)	na	na	77.3	69.7	5.0	8.0	7.1	21.4	na
Non-performing loans (in per cent of total loans) [3]	na	na	92.2	72.0	26.1	7.6	0.2	6.4	16.4
Domestic credit to private sector (in per cent of GDP)	na	na	na	12.5	8.7	3.5	5.3	5.0	na
Stock market capitalisation (in per cent of GDP) [4]	na	na	na	na	3.0	3.2	23.7	na	0.3
EBRD index of banking sector reform	1.0	1.0	2.0	2.0	2.0	2.7	2.7	2.3	2.3
EBRD index of reform of non-banking financial institutions	1.0	1.0	1.0	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	3.0	3.0	3.3	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	2.0	2.0	3.0	3.0
Social sector									
Expenditures on health and education (in per cent of GDP)	na	6.8	9.6	10.5	8.4	8.1	7.7	6.3	5.8
Life expectancy at birth, total (years)	68.1	67.2	66.0	65.8	66.5	66.9	67.1	67.3	na
Basic school enrolment ratio (in per cent)	90.3	89.7	89.0	89.2	89.4	89.4	89.7	na	na
Earnings inequality (GINI-coefficient)	30.0	44.5	44.3	39.5	42.8	43.1	na	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] 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.
[4] The listing of the state energy company, Kyrgyzenergo, accounts for the large increase in capitalisation in 1998.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	-16.0	-20.1	-5.4	7.1	9.9	2.1	3.7	5.1	5.0
Private consumption	na	-20.9	-17.8	3.6	-10.8	15.1	1.8	na	na
Public consumption	na	-14.4	-8.7	16.4	4.0	15.1	-1.7	na	na
Gross fixed investment	na	-30.2	55.4	-14.2	-30.3	-3.4	25.4	na	na
Exports of goods and services	na	-19.0	-17.4	6.7	21.1	-8.7	-10.4	na	na
Imports of goods and services	na	-22.2	-18.4	6.9	-20.2	1.5	-4.9	na	na
Industrial gross output	-25.3	-23.5	-24.7	3.9	39.7	5.3	-4.3	6.0	na
Agricultural gross output	-10.0	-15.0	-2.0	15.2	12.3	2.9	8.2	3.9	na
Employment				*(Percentage change)*					
Labour force (annual average)	-0.4	0.2	1.4	2.6	1.9	4.1	1.9	1.7	na
Employment (annual average) [1]	-8.5	-2.1	-0.2	0.6	2.3	0.9	0.8	2.9	na
				(In per cent of labour force)					
Unemployment (end-year) [2]	na	3.1	4.4	6.0	4.3	4.3	5.4	5.6	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	772.4	228.7	40.7	31.3	25.5	12.0	35.8	18.7	7.6
Consumer prices (end-year)	1,363.0	95.7	32.3	34.9	14.7	18.4	39.9	9.5	5.9
Producer prices (annual average)	649.7	196.7	37.6	26.1	29.0	4.8	14.9	5.0	na
Producer prices (end-year)	224.6	96.7	17.0	23.0	26.0	8.0	53.0	na	na
Gross average monthly earnings in economy (annual average)	628.7	178.5	57.8	33.3	38.6	16.0	34.0	21.6	na
Government sector [3]				*(In per cent of GDP)*					
General government balance [3]	-14.4	-5.7	-8.4	-8.8	-8.8	-11.2	-12.8	-9.6	-5.9
General government expenditure [3]	39.0	32.4	33.2	32.7	32.7	35.6	36.8	32.9	na
General government debt	na	37.0	40.0	44.2	54.0	76.3	98.7	119.0	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	na	na	80.1	21.3	25.4	17.2	33.9	12.1	na
Domestic credit (end-year)	na	na	71.0	20.9	4.1	32.2	7.2	na	na
				(In per cent of GDP)					
Broad money (M2, end-year)	na	12.7	17.1	14.3	13.6	14.4	13.3	11.8	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinancing rate [4]	276.8	89.5	45.8	45.9	23.5	32.9	49.0	na	na
Treasury bill rate (3-month maturity)	na	73.0	44.0	52.3	23.5	32.9	65.5	32.0	na
Deposit rate [5]	na	na	na	24.8	32.0	29.5	na	na	na
Lending rate [5]	na	na	na	58.3	50.1	42.5	na	na	na
				(Soms per US dollar)					
Exchange rate (end-year)	8.0	10.7	11.2	16.7	17.4	29.4	45.5	48.4	na
Exchange rate (annual average)	6.1	10.8	10.8	12.8	17.4	20.8	39.0	47.8	na
External sector				*(In millions of US dollars)*					
Current account	na	-84.3	-234.8	-424.8	-139.2	-328.4	-194.8	-103.2	-89.5
Trade balance	na	-86.1	-122.0	-251.7	-16.0	-170.0	-84.0	8.8	-1.9
Merchandise exports	na	340.0	408.9	531.2	630.0	585.0	462.0	510.9	482.0
Merchandise imports	na	426.1	530.9	782.9	646.0	755.0	546.0	502.1	483.9
Foreign direct investment, net	na	38.2	96.1	46.8	83.0	108.6	38.4	28.5	39.8
Gross reserves (end-year), including gold	na	67.3	114.5	110.4	141.8	123.1	184.3	205.5	na
External debt stock	291.7	413.8	763.9	1,151.2	1,356.1	1,472.6	1,682.2	1,738.5	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	na	1.6	1.8	1.2	1.9	1.4	2.8	3.3	na
				(In per cent of export of goods and services)					
Debt service	na	4.8	22.3	15.5	12.1	20.1	24.3	25.3	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, millions)	4.5	4.5	4.5	4.6	4.6	4.7	4.7	4.7	na
GDP (in millions of soms)	5,355	12,019	16,145	23,399	30,686	34,181	49,572	62,196	70,900
GDP per capita (in US dollars)	195.1	249.1	330.7	398.4	382.1	350.2	270.7	275.2	na
Share of industry in GDP (in per cent)	25.1	20.5	12.0	11.1	16.5	16.3	21.3	21.5	na
Share of agriculture in GDP (in per cent)	39.2	38.4	40.7	46.3	41.2	36.1	34.3	36.7	na
Current account/GDP (in per cent)	na	-7.6	-15.7	-23.3	-7.9	-20.0	-15.3	-7.9	-6.1
External debt - reserves, in US$ millions	na	347	649	1,041	1,214	1,350	1,498	1,533	na
External debt/GDP (in per cent)	33.2	37.3	51.2	63.2	76.8	89.5	132.3	133.5	na
External debt/exports of goods and services (in per cent)	na	111.0	170.5	204.6	200.9	227.3	319.2	302.6	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 per cent.

[3] General government includes the state, municipalities and extra-budgetary funds. It also includes 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 three-month Treasury bill rate has become the official reference rate.

[5] Weighted average over all maturities.

Latvia

Key reform challenges

- **The main priorities are to continue prudent macroeconomic policies, to complete large-scale privatisation and to develop an appropriate regulatory framework to foster competition in the infrastructure sector.**
- **Further improvements in the legal framework are needed to reduce the potential for corruption, to promote investment and to facilitate the creation and development of new companies.**
- **The sustainability of public finances should be accelerated through the implementation and further reform of private pensions legislation.**

Liberalisation

EU accession negotiations have proceeded at a fast pace.
Although Latvia started EU accession negotiations only in March 2000, by June 2001 it had opened all chapters for negotiation and had provisionally closed 16, including the chapter on the free movement of persons. Trade policy remains liberal. The authorities intend to keep their tariffs at or below EU levels and to refrain from increasing any *ad valorem* tariffs or introducing any specific new tariffs or export subsidies until accession.

Stabilisation

A new agreement has been reached with the IMF.
In April 2001 the IMF approved a memorandum on economic cooperation and a 20-month precautionary stand-by credit for Latvia in the amount of US$ 42 million to support the government's economic programme for 2001-02. The authorities regard the stand-by agreement as precautionary and do not intend to draw on it. Under the agreement, real GDP is expected to grow by 6 per cent in 2001, the general government deficit is targeted at 1.7 per cent of GDP, annual average inflation is expected to remain below 3 per cent and the current account deficit should fall to 6.3 per cent of GDP. Despite the adoption in June 2001 of a supplementary budget with a deficit of 1.8 per cent of GDP, the target under the IMF programme remains 1.7 per cent. The government is also committed to selling state holdings in the Latvian Shipping Company (LASCO), the Ventspils Nafta oil terminal and the Latvijas Gaze gas company, and to building a competitive system in the energy and telecommunications sectors. However, in May 2001 the World Bank postponed a second US$ 40 million tranche under its Programmatic Structural Adjustment Loan (PSAL) because of the slow pace of social reforms, particularly in the area of pensions, and the government's continued poor record on privatisation.

Privatisation

The privatisation of the Latvian Shipping Company has again been delayed.
In May 2001 the privatisation of LASCO failed for the fourth time when neither of the two competing bidders transferred the required bid bond of US$ 5 million. One of them, the Italian firm d'Amico, has subsequently indicated that it would be willing to continue negotiations. The government may abandon the requirement that the stake be sold to a strategic investor. A working group of government officials was set up in July 2001 to develop an acceptable privatisation model and to assess the potential involvement of the EBRD in the process.

Plans to privatise part of Ventspils Nafta are only progressing slowly.
After the failure to sell a 5 per cent stake of the Ventspils Nafta oil terminal through the stock market in April 2000, the government has decided to sell its remaining 38.6 per cent stake to a foreign investor, while an additional 5 per cent is being reserved until July 2003 for sale to the company's largest private shareholder, Latvijas Naftas Tranzits (Latvian Oil Transit), which already holds a 47 per cent share. A consortium headed by Austrian investment bank Raiffeisen Investment AG was selected in 2000 as advisor for the privatisation but prolonged negotiations over the conditions of the consortium's contract have delayed the sale, which is now planned for early 2002.

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

Enterprise reform

Enactment of an EU-compatible commercial law has been delayed.
The enactment of an EU-compatible commercial law, which was to have come into effect in April 2001, has been delayed until 2002 because of opposition from one of the coalition parties. The law would streamline administrative procedures, enhance minority shareholder rights and further protect creditor interests. Although these simplifications may remove some of the shortcomings with regard to inconsistent interpretation of commercial laws, further efforts are needed to strengthen the ability of the courts to implement the new legislation.

Infrastructure

A further stake in the gas utility has been sold.
In July 2001 the government auctioned a 2 per cent stake in Latvijas Gaze (Latvian Gas) on the Riga stock exchange for US$ 15.8 million, at a 249 per cent premium over the initial price set by the privatisation agency. In August 2001, the government auctioned a further 3 per cent share, raising US$ 11.8 million. Following these sales, Hera Latvija increased its stake to 25 per cent. The German consortium of Ruhrgas and E.ON Energie increased its stake to around 44 per cent. The other main shareholder is Gazprom, the company's main supplier of

Enterprises, infrastructure, finance and social reforms

1991
Dec Competition law enacted

1992
May Two-tier banking system established
May Banking law enacted
Oct IAS accounting introduced

1993
May Company law enacted
Dec Stock exchange established

1994
Jan BIS capital adequacy requirement introduced

1995
May Banking crisis
Jul Stock exchange begins trading
Oct New banking law enacted
Oct IAS accounting for banks introduced
Oct First state-owned bank privatised

1996
Jun Energy Regulation Council established
Sep Bankruptcy law enacted

1997
Jun New competition law enacted
Aug First corporate eurobond
Nov Major adjustments of electricity tariffs
Dec First corporate GDR issue

1998
Jan Anti-monopoly office established
Jul Private pension law enacted
Sep New energy law adopted
Sep New insurance law enacted
Nov Railway law adopted

1999
Aug PAYG pension system reformed

2000
Feb Law on second pension pillar passed
May Law on unified financial sector supervision adopted

2001
Jul Financial and Capital Markets Commission established
Jul First contributions to second pensions pillar
Jul European Social Charter adopted

natural gas, with a 25 per cent stake. The government is now left with only a 3 per cent share in the company.

The restructuring of Latvenergo is progressing.
Despite parliamentary resistance to privatisation of parts of energy firm Latvenergo, the Cabinet of Ministers has approved a restructuring programme for the company which they hope to complete by December 2002. The restructuring plan envisages the establishment of separate units and accounting systems for distribution, transmission and power generation. In addition, work has begun to establish a new grid code that provides third-party access to energy transmission and distribution and establishes separate prices for transmission and distribution services. In July 2001 the three Baltic states also adopted a plan for the formation of a joint Baltic power market in the context of sector liberalisation within the EU.

Negotiations to shorten the fixed-line monopoly of Lattelekom continue.
The sale of the government's residual majority stake in the telecommunications company, Lattelekom, depends on the government 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 per cent of Lattelekom and the remaining shares belong to Tilts Communications, which in turn is owned 90 per cent by Sonera of Finland and 10 per cent 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. In turn, the government 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 promised.

Financial institutions

The banking sector is continuing to consolidate.
The failure of two smaller banks and mergers among others in 1999 and 2000 reduced the number of licensed banks to 21 at the end of 2000. Further consolidation is under way, with Rietumu Banka (the fourth-largest bank in terms of assets) and Saules Banka (the thirteenth-largest bank) merging in July 2001. Icelandic bank Islandsbanki-FBA was planning to become a strategic investor in the bank, but pulled out of the deal in September 2001. Furthermore, the Riga Regional Court ruled Bank Paritate (ranked seventeenth) to be insolvent in July 2001 and a rehabilitation plan for the bank was approved in August.

The unified financial sector authority begins operations.
The unified Financial and Capital Markets Commission (FCMC) started operations in July 2001 for the supervision of banks, brokerages, insurers, credit institutions, investment funds, private pension funds and other financial market participants. In addition, the authorities aim to submit to parliament by the end of 2001 amendments to the Law on Credit Institutions. These would enable the FCMC to prohibit the establishment or continuation of close links with domestic and overseas affiliated third-party enterprises as well as transactions with these enterprises if these transactions hinder the adequate supervision of the FCMC or adversely affect the soundness of banks. An IMF assessment in 2000 concluded that prudential regulations are close to full compliance with the Basel core principles.

Social reform

Contributions to the second pension pillar have started.
Contributions to the second pillar of the pension system started in July 2001 and are expected to rise gradually from 2 per cent of income to 10 per cent 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 first 18 months the State Treasury will manage the accumulated capital but from 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 is committed to submitting additional amendments to the law. These would 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. Delays in these reforms have led the World Bank to postpone the disbursement of the second tranche of the PSAL (see above).

The European Social Charter is adopted.
In July 2001 the government adopted the European Social Charter, which includes rights to: fair conditions of work; freedom of association; vocational training; health; social and medical assistance; social security; and appropriate economic protection. While the charter does not necessarily imply social security payments will rise across the board, rights such as vocational training, medical assistance and mothers' and children's rights to economic protection will inevitably add to the burden of an already overstretched budget.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **31.4 per cent**
Exchange rate regime – **fixed**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **10 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **34.8 per cent**
Private pension funds – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	6.1	6.1	16.6	16.6	17.8	19.6	20.4	na	na
Number of goods with administered prices in EBRD-15 basket	2.0	2.0	2.0	2.0	2.0	2.0	2.0	na	na
Share of trade with non-transition countries (in per cent)	46.8	43.6	46.4	49.5	50.0	56.7	66.4	72.9	79.8
Share of trade in GDP (in per cent)	na	96.7	64.3	74.5	73.5	80.2	84.7	72.1	72.4
Tariff revenues (in per cent of imports)	na	2.9	3.2	1.8	1.5	1.4	1.1	0.9	0.8
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	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	na	na	0.3	0.7	0.8	2.2	3.3	3.5	4.1
Private sector share in GDP (in per cent)	25.0	30.0	40.0	55.0	60.0	60.0	65.0	65.0	65.0
Private sector share in employment (in per cent)	na	na	58.0	60.0	63.0	66.0	68.0	70.0	na
EBRD index of small-scale privatisation	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.3
EBRD index of large-scale privatisation	2.0	2.0	2.0	2.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	0.2	0.4	0.8	5.2	4.7	5.2	5.0
Effective statutory social security tax (in per cent)	na	na	70.0	73.9	68.3	76.4	79.0	81.7	na
Share of industry in total employment (in per cent)	28.8	23.1	21.0	20.4	19.8	20.2	18.4	17.8	18.1
Change in labour productivity in industry (in per cent)	-34.7	-9.2	10.3	2.5	11.6	9.9	12.1	-1.4	1.4
Investment rate/GDP (in per cent) [1]	41.2	9.2	19.1	17.6	18.8	22.8	27.6	26.3	na
EBRD index of enterprise reform	2.0	2.0	2.0	2.0	3.0	2.7	2.7	2.7	2.7
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	24.9	26.6	25.8	28.0	29.8	30.2	30.2	30.0	na
Railway labour productivity (1989=100)	58.5	54.0	48.8	50.2	65.6	75.4	72.0	73.6	84.5
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	2.7 (85)	4.7 (85)	5.6 (94)	6.4 (98)	6.6 (99)	6.7 (na)	na
Electricity consumption/GDP (1989=100)	126.0	112.7	106.1	106.7	101.8	95.8	94.2	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.9	3.1	3.1
Financial institutions									
Number of banks (of which foreign owned)	50 (na)	62 (na)	56 (na)	42 (11)	35 (14)	32 (15)	27 (15)	23 (12)	21 (12)
Asset share of state-owned banks (in per cent)	na	na	7.2	9.9	6.9	6.8	8.5	2.6	2.9
Non-performing loans (in per cent of total loans)	na	na	11.0	19.0	20.0	10.0	6.8	6.8	5.0
Domestic credit to private sector (in per cent of GDP)	na	na	15.9	7.4	6.8	10.5	15.2	16.0	19.6
Stock market capitalisation (in per cent of GDP)	na	na	na	0.2	3.0	6.1	6.1	5.9	8.3
EBRD index of banking sector reform	2.0	2.0	3.0	3.0	3.0	3.0	2.7	3.0	3.0
EBRD index of reform of non-banking financial institutions	1.0	1.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	3.3	3.3	3.7	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	3.0	2.0	3.0	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	7.4	10.1	10.0	10.6	9.6	9.5	10.5	na	na
Life expectancy at birth, total (years)	68.9	67.6	66.7	66.8	69.3	69.9	69.7	69.8	na
Basic school enrolment ratio (in per cent)	91.1	89.1	88.6	89.1	90.7	91.3	90.9	na	na
Earnings inequality (GINI-coefficient)	33.3	28.3	32.5	34.6	34.9	33.6	na	na	na

[1] Source: World Bank Development Indicators. Gross capital formation.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	-14.9	0.6	-0.8	3.3	8.6	3.9	1.1	6.6	6.5
Private consumption	na	3.2	0.6	10.3	5.0	6.2	5.1	5.6	na
Public consumption	na	-0.9	7.7	1.8	0.3	6.1	0.0	-2.2	na
Gross fixed investment	na	0.8	8.7	22.3	20.7	44.0	-4.0	10.8	na
Exports of goods and services	na	-8.4	3.3	20.2	13.1	4.9	-6.4	12.8	na
Imports of goods and services	na	-0.7	1.3	28.5	6.8	19.0	-5.2	5.1	na
Industrial gross output	-32.1	-9.9	-3.7	5.5	13.8	3.1	-5.4	3.2	na
Agricultural gross output	-22.2	-20.5	-6.6	-5.7	2.0	-9.9	-9.5	3.9	na
Employment				(Percentage change)					
Labour force (annual average)	-2.0	-1.5	-1.9	-1.0	-3.6	-0.4	-1.0	-0.3	na
Employment (annual average)	-6.9	-10.1	-3.5	-2.7	1.9	0.6	-0.5	0.0	na
				(In per cent of labour force)					
Unemployment (annual average)	8.7	16.7	18.1	19.4	14.8	14.0	13.5	13.2	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	109.2	35.9	25.0	17.6	8.4	4.7	2.4	2.8	2.4
Consumer prices (end-year)	34.9	26.3	23.1	13.1	7.0	2.8	3.2	1.8	3.3
Producer prices (annual average)	117.1	16.9	11.9	13.7	4.1	1.9	-4.0	0.6	na
Producer prices (end-year)	36.3	10.7	15.9	7.7	3.6	-1.9	-1.1	1.0	na
Gross average monthly earnings in economy (annual average)	119.7	52.2	24.5	10.3	21.6	11.1	5.8	6.1	na
Government sector [1]				(In per cent of GDP)					
General government balance	na	-4.4	-3.9	-1.8	0.3	-0.8	-3.9	-3.3	-2.0
General government expenditure	na	40.5	41.2	39.2	41.0	43.4	44.0	42.0	na
General government debt	na	14.1	16.1	14.4	12.0	10.5	13.0	13.2	na
Monetary sector				(Percentage change)					
Broad money (M2, end-year)	na	47.4	-23.1	19.9	38.7	5.9	8.0	27.9	na
Domestic credit (end-year)	na	72.3	-28.2	6.0	39.3	30.6	15.2	43.6	na
				(In per cent of GDP)					
Broad money (M2, end-year)	31.5	33.4	22.3	22.2	26.6	25.7	25.6	29.4	na
Interest and exchange rates				(In per cent per annum, end-year)					
Refinancing rate	27.0	25.0	24.0	9.5	4.0	4.0	4.0	3.5	na
Interbank market rate [2]	56.6	37.8	21.1	9.7	3.9	7.0	2.7	3.3	na
Deposit rate (short-term, under 1 year)	28.4	18.8	15.0	10.0	5.3	6.5	4.2	4.2	na
Lending rate (short-term, under 1 year)	70.8	36.7	31.1	20.3	12.1	16.4	12.5	11.8	na
				(Lats per US dollar)					
Exchange rate (end-year)	0.60	0.55	0.54	0.56	0.59	0.57	0.58	0.61	na
Exchange rate (annual average)	0.67	0.56	0.53	0.55	0.58	0.59	0.59	0.61	na
External sector				(In millions of US dollars)					
Current account	417	201	-16	-279	-345	-650	-654	-493	-553
Trade balance	3	-301	-580	-798	-848	-1,130	-1,027	-1,058	-1,205
Merchandise exports	1,054	1,022	1,368	1,488	1,838	2,011	1,889	2,058	2,223
Merchandise imports	1,051	1,322	1,947	2,286	2,686	3,141	2,916	3,116	3,428
Foreign direct investment, net	50	279	245	379	515	303	331	398	300
Gross reserves (end-year), excluding gold	432	545	506	622	704	728	840	851	na
External debt stock [3]	355	825	1,538	2,091	2,756	3,098	3,821	4,711	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	4.1	4.0	2.8	2.5	2.5	2.2	2.8	2.6	na
				(In per cent of export of goods and services)					
Debt service	na	3.9	8.1	10.0	10.5	10.1	13.6	15.6	na
Memorandum items				(Denominations as indicated)					
Population (end-year, millions)	2.6	2.5	2.5	2.5	2.5	2.4	2.4	2.4	na
GDP (in millions of lats)	1,467	2,043	2,349	2,829	3,275	3,590	3,897	4,333	4,726
GDP per capita (in US dollars)	848	1,442	1,779	2,070	2,293	2,494	2,799	3,019	na
Share of industry in GDP (in per cent)	27.9	22.5	24.3	23.0	23.9	20.2	17.4	16.3	na
Share of agriculture in GDP (in per cent)	10.7	8.4	9.4	7.9	5.1	3.7	4.0	4.0	na
Current account/GDP (in per cent)	19.1	5.5	-0.4	-5.4	-6.1	-10.7	-9.8	-6.9	-7.4
External debt - reserves, in US$ millions	-77	280	1,032	1,469	2,052	2,370	2,981	3,860	na
External debt/GDP (in per cent)	16.3	22.6	34.6	40.7	48.9	50.9	57.4	65.9	na
External debt/exports of goods and services (in per cent)	22.4	49.1	73.7	80.0	96.0	99.3	131.1	144.0	na

[1] General government includes the state, municipalities and extra-budgetary funds. Privatisation revenues are not included in revenues. General government expenditure includes net lending.

[2] Weighted average interest rates in the interbank market.

[3] Includes non-resident currency and deposits, liabilities to affiliated enterprises and liabilities to direct investors.

Lithuania

Key reform challenges

- **Continued fiscal prudence would help to ensure macroeconomic stability and a smooth re-pegging of the exchange rate, while over the medium term the sustainability of the pension system must be addressed.**
- **The regulatory framework necessary for the introduction of competition and privatisation in the energy sector must be strengthened ahead of the proposed liberalisation timetable.**
- **Privatisation of the remaining state-owned bank would complete the process and enhance performance of the banking sector.**

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 arrangement reached
Dec	WTO membership

Liberalisation

Lithuania joins the WTO.
Lithuania joined the WTO in December 2000. This is likely to open new markets for the country’s exporters and strengthen domestic competition, especially in agribusiness. The government is committed to ending the exclusivity of Lithuanian Telecoms (LT) in the provision of fixed-line services by the start of 2003. It is also committed to reducing import tariffs for the most sensitive agricultural products, to reducing aggregate measurement of support (AMS) by 20 per cent during the transitional period of five years and to eliminating export subsidies. Tariff rates for most goods were set at between 0 and 25 per cent upon WTO accession.

Stabilisation

The currency will be re-pegged to the euro.
In June 2001 the central bank announced that it would re-peg the currency from the US dollar to the euro on 2 February 2002. The central bank intends to maintain the currency board arrangement until Lithuania accedes to the EU. The seven-month preparation time is intended to provide time for the population to adjust the currency composition of its assets and liabilities. Although the choice of the dollar as an anchor currency was reasonable when most trade was with the CIS, the share of trade with the EU and EU candidate members has steadily increased in recent years to almost 75 per cent of total exports.

Macroeconomic imbalances are set to narrow further.
Under the guidance of the IMF stand-by arrangement (SBA) approved in March 2000, key fiscal and current account imbalances have improved. The new government that came into power in June 2001 has concluded a memorandum of economic policy with the IMF for a new 19-month SBA for SDR 86.52 million (US$ 111 million), under which the government is committed to reducing the fiscal deficit to 1.4 per cent of GDP in 2001 and to 1.3 per cent in 2002. This will be achieved mainly by holding expenditure constant in real terms, including a freeze in public sector wages and a reduction in expenditures of the Social Security Fund (SoDra).

Privatisation

Minority shareholder rights in privatisation deals have been strengthened.
Large-scale privatisation is close to completion although the state continues to retain shares in some large, loss-making companies and in strategic enterprises such as Lithuanian Gas, Lithuanian Airlines, Lithuanian Energy, Lithuanian Railways and Agricultural Bank. These enterprises will be privatised during 2001 and 2002. In April 2001 parliament amended the Law on Public Trading to improve minority shareholder protection in the privatisation of state-owned companies. The amendment requires buyers of majority stakes to purchase shares from minority shareholders at the same price as from the state. The change in the law follows the sale in April 2001 of a 76 per cent state stake in the Lithuanian Shipping Company (LISCO) to a Danish strategic investor, DFS Thor Line, for US$ 47.6 million, about which concerns had been raised. The new rules will not apply to LISCO’s minority shareholders but will apply in the privatisation of remaining state-owned entities.

Enterprise reform

New bankruptcy and restructuring laws have been enacted.
In March 2001 parliament adopted two new laws, on bankruptcy and on enterprise restructuring. The laws are effective from July 2001 and are expected to enhance the effectiveness of bankruptcy procedures. Under the new law on bankruptcy, the insolvency of an enterprise can be established when the enterprise does not meet its obligations for more than three months and when overdue obligations and debts total more than half the value of the assets on the enterprise’s balance sheet. The previous law on bankruptcy had required arrears to be above the total value of assets. The bankruptcy procedure has also been streamlined to increase the efficiency of the process while protecting the rights of the bankrupt company. The new law on restructuring enables firms in financial distress to negotiate restructurings with their creditors.

The Competition Council assesses compliance of state aid with EU rules.
The Law on Monitoring of State Aid, adopted by parliament in May 2000, empowered the Competition Council to cancel state aid to enterprises if it does not comply with the provisions of the Europe Agreement and other legal acts. During 2000 the Council considered seven cases. Four cases were approved without conditions. In two cases, approval was subject to the state restricting the provision of subsidies. In the area

Enterprises, infrastructure, finance and social reforms

1992
- Sep Two-tier 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
- Oct New gas law adopted
- Dec New electricity law adopted

2001
- May Independent telecommunications regulator established
- Jul Bankruptcy and restructuring laws strengthened

of export credit, the state aid provider (the Ministry of Economy) was instructed to only provide subsidies to cover non-marketable risks. In one case – a scheme for partial compensation of certification expenses for exported products – the Council refused to authorise aid because it was targeted for export subsidies.

New investment in the Mazeikiu oil refinery will allow further restructuring.
The Mazeikiu oil refinery (MN), the largest enterprise in the country, continued to post net losses during 2000 despite the sale of a 33 per cent stake in late 1999 to the US company, Williams International (WI). The company's inability to secure a long-term crude oil supply contract from Russia's oil suppliers was the main cause. After extensive negotiations with various Russian oil companies, WI reached a preliminary agreement with Yukos in June 2001. Once the agreement is finalised, which is expected to happen in October 2001, Yukos will purchase US$ 75 million equivalent of new shares issued by MN, gaining a 27 per cent stake in the company. Yukos will also provide a US$ 75 million loan for the modernisation of the refinery and a long-term supply contract while WI will retain operational control of the company. In August 2001 parliament amended the law governing the privatisation of MN by allowing an increase in the company's share capital.

Infrastructure

Energy sector restructuring and liberalisation are progressing.
An electricity law that establishes the principles regulating the generation, transmission, distribution and supply of electricity was adopted in December 2000 and will come into force in January 2002. The new law provides for the gradual liberalisation of the electricity market, beginning with large customers. However, the necessary by-laws and the reorganisation of Lithuanian Energy, the integrated state-owned electricity monopoly, have yet to be implemented. The privatisation of the state-owned gas transmission and distribution monopoly, Lithuanian Gas, which was scheduled to take place by September 2001, has been delayed by disagreement among various political parties over the model and terms.

A new telecommunications regulator has been established.
The Communications Regulation Service (CRS), a new independent regulator for the telecommunications industry, was established in May 2001. Among its responsibilities, the CRS will oversee the fixed-line monopoly operator, Lithuanian Telecommunications (LT), to help ensure that it does not abuse its dominant position and does not discriminate in network terms of access. In 2000, before the CRS was established, the Competition Council ruled that LT was abusing its dominant position in fixed-line services and was restricting competition in the area of data transmission services. LT has also delayed the introduction of per-second billing for calls, introduced connection charges and changed the tariff structure. Following consultation with the government and the CRS, LT has decided to lower rates for certain services such as monthly connection charges for low-income users, off-peak calls, night calls and Internet connection charges as of September 2001.

Financial institutions

Significant progress has been made in bank privatisation.
In December 2000 the government sold its majority shareholding in the Lithuanian Development Bank to Sampo of Finland for about LTL 40 million (US$ 10 million). In May 2001 the 90 per cent state shareholding in the Savings Bank, the second-largest bank in terms of assets, was sold to Estonia's Hansapank for US$ 37.5 million. However, completion of the sale was put on hold when the proposed merger of Swedish banks Swedbank (a majority owner of Hansapank) and SEB (a majority owner of Vilniaus Bank, Lithuania's largest bank in terms of assets) raised concerns about market concentration. The combined share of the two banks would have exceeded 50 per cent. While both the central bank and the Competition Council approved the sale on condition that, if Swedbank and SEB merged, the new entity would have to dispose of some of its Lithuanian banking assets. The merger has recently been abandoned. The international tender for the privatisation of Agricultural Bank, the last bank to remain state-owned, was announced in August 2001.

Social reform

The need for pension reform has yet to be addressed.
The funding gap of the Social Security Fund, SoDra, has widened in recent years. In 2000, the deficit on a cash basis reached LTL 212 million (US$ 53 million). Successive governments have introduced short-term measures to relieve the pressures, including increasing the rate of social security tax and reducing the benefits to working pensioners. In order to achieve long-term sustainability, a draft law to introduce a mandatory privately managed pillar was to be discussed in parliament in June 2001. However, disagreements over the funding methods of the pay-as-you-go pillar during the transition period – whether to fund the gap from the privatisation fund and government borrowing, or to finance it entirely from borrowing – have prevented full discussions.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **29 per cent**
Exchange rate regime – **currency board**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **full** [1]

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **10 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **22.5 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
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	9.0	6.0	6.0	2.0	2.0	2.0	2.0	2.0	2.0
Share of trade with non-transition countries (in per cent)	na	75.0	35.0	43.0	38.8	54.6	46.6	50.9	65.9
Share of trade in GDP (in per cent)	na	157.7	100.3	101.4	97.8	99.4	87.8	72.2	81.4
Tariff revenues (in per cent of imports) [2]	na	1.1	3.2	1.4	1.2	1.3	1.1	1.1	na
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	2.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	na	0.9	1.3	1.4	1.4	1.6	6.9	8.0	9.8
Private sector share in GDP (in per cent)	20.0	35.0	60.0	65.0	70.0	70.0	70.0	70.0	70.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	2.7	3.3	4.0	4.0	4.0	4.0	4.0	4.3	4.3
EBRD index of large-scale privatisation	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	1.4	1.7	1.1	1.3	0.9	0.5	0.4	0.2
Effective statutory social security tax (in per cent)	87.2	65.8	81.5	70.3	73.0	70.8	78.8	78.3	na
Share of industry in total employment (in per cent)	28.9	25.7	22.5	21.4	20.6	21.6	21.2	20.7	20.5
Change in labour productivity in industry (in per cent)	na	-23.1	-11.1	14.1	9.6	1.8	8.0	-8.8	13.5
Investment rate/GDP (in per cent)	23.0	23.1	23.1	23.0	23.0	24.4	24.4	22.7	20.5
EBRD index of enterprise reform	1.0	2.0	2.0	2.0	3.0	2.7	2.7	2.7	2.7
EBRD index of competition policy	1.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.7
Infrastructure									
Main telephone lines per 100 inhabitants	22.5	23.1	24.1	25.4	26.8	28.3	30.0	31.4	na
Railway labour productivity (1989=100)	51.2	50.7	35.4	32.3	35.9	38.2	36.3	34.9	41.4
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	na	5.0 (85)	5.0 (85)	5.5 (85)	5.5 (90)	5.5 (90)	na
Electricity consumption/GDP (1989=100)	110.4	122.6	133.2	127.9	139.3	128.9	125.5	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.6	2.6	2.9
Financial institutions									
Number of banks (of which foreign owned)	na	26 (0)	22 (0)	15 (0)	12 (3)	12 (4)	12 (5)	13 (4)	13 (6)
Asset share of state-owned banks (in per cent)	na	53.6	48.0	61.8	54.0	48.8	44.4	41.9	38.9
Non-performing loans (in per cent of total loans)	na	na	27.0	17.3	32.2	28.3	12.5	11.9	10.8
Domestic credit to private sector (in per cent of GDP)	na	13.8	17.6	12.6	9.4	9.3	9.6	11.1	10.1
Stock market capitalisation (in per cent of GDP)	na	na	1.0	2.6	11.4	17.8	10.0	10.7	14.0
EBRD index of banking sector reform	1.0	2.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of reform of non-banking financial institutions	1.0	1.7	2.0	2.0	2.0	2.3	2.3	2.7	3.0
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	4.0	4.0	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	3.0	3.0	3.0	3.3
Social sector									
Expenditures on health and education (in per cent of GDP)	na	7.8	9.3	9.3	8.8	9.7	11.2	11.1	na
Life expectancy at birth, total (years)	70.3	69.0	68.7	69.3	70.4	71.2	71.6	72.1	na
Basic school enrolment ratio (in per cent)	92.5	91.6	92.1	93.2	93.3	95.1	96.1	na	na
Earnings inequality (GINI-coefficient)	37.2	na	34.9	34.1	35.0	34.5	na	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.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	-16.2	-9.8	3.3	4.7	7.3	5.1	-3.9	3.9	4.0
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed investment	na	na	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	-34.4	-26.5	5.3	5.0	3.3	8.2	-11.2	7.0	na
Agricultural gross output	-6.0	-20.0	11.0	12.6	8.6	-5.2	-14.5	5.4	na
Employment [1]				(Percentage change)					
Labour force (annual average)	-1.1	-6.4	0.7	-2.1	-5.7	0.8	1.0	-3.7	na
Employment (annual average)	-4.2	-5.8	-1.9	-0.7	-3.1	1.7	0.0	-5.0	na
				(In per cent of labour force)					
Unemployment (annual average)	4.4	3.8	17.5	16.4	14.1	13.3	14.1	15.4	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	410.4	72.1	39.6	24.6	8.9	5.1	0.8	1.0	1.5
Consumer prices (end-year)	188.8	45.0	35.7	13.1	8.4	2.4	0.3	1.4	2.1
Producer prices (annual average) [2]	392.0	44.8	28.3	16.5	6.0	-3.9	3.0	18.0	na
Producer prices (end-year) [2]	131.6	33.8	20.3	12.3	0.9	-8.3	23.3	2.6	na
Gross average monthly earnings in economy (annual average)	223.7	95.9	47.8	28.5	25.9	19.5	6.2	7.0	na
Government sector [3]				(In per cent of GDP)					
General government balance	-5.3	-4.8	-4.5	-4.5	-1.8	-5.9	-8.5	-2.8	-1.4
General government expenditure	35.4	37.4	36.8	34.2	33.7	38.1	40.2	33.2	na
General government debt	na	na	na	na	na	22.8	29.0	28.8	na
Monetary sector				(Percentage change)					
Broad money (M2, end-year)	100.2	63.0	28.9	-3.5	34.1	14.5	7.7	16.5	na
Domestic credit (end-year)	na	na	na	1.8	37.6	16.8	24.5	1.7	na
				(In per cent of GDP)					
Broad money (M2, end-year)	23.1	25.8	23.3	17.2	19.0	19.4	21.0	23.1	na
Interest and exchange rates				(In per cent per annum, end-year)					
Interbank interest rate	24.9	22.4	10.7	7.6	5.8	6.1	4.6	4.7	na
Treasury bill rate (3 month maturity)	na	20.6	22.4	10.6	9.1	11.5	12.3	5.7	na
Deposit rate [4]	19.7	7.6	7.4	4.3	1.9	2.4	1.6	1.0	na
Lending rate [5]	88.2	29.8	23.9	16.0	11.9	12.6	13.0	11.0	na
				(Litai per US dollar)					
Exchange rate (end-year)	3.9	4.0	4.0	4.0	4.0	4.0	4.0	4.0	na
Exchange rate (annual average)	4.3	4.0	4.0	4.0	4.0	4.0	4.0	4.0	na
External sector				(In millions of US dollars)					
Current account	-86	-94	-614	-723	-981	-1,298	-1,194	-675	-786
Trade balance	-155	-205	-698	-896	-1,147	-1,518	-1,405	-1,104	-1,203
Merchandise exports	2,026	2,029	2,706	3,413	4,192	3,962	3,147	4,050	4,415
Merchandise imports	2,181	2,234	3,404	4,309	5,340	5,480	4,551	5,154	5,618
Foreign direct investment, net [6]	30	31	72	152	328	921	478	375	450
Gross reserves (end-year), excluding gold	350	525	757	772	1,010	1,409	1,195	1,312	na
External debt stock [7]	na	529	1,374	2,081	3,146	3,577	4,528	4,857	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	1.7	2.4	2.3	1.9	1.9	2.7	2.7	2.7	na
				(In per cent of current account revenues, excluding transfers)					
Debt service	na	2.3	3.7	6.9	10.5	17.8	19.4	20.1	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)	11,590	16,904	24,103	31,569	38,340	42,990	42,655	45,254	47,752
GDP per capita (in US dollars)	716	1,143	1,623	2,129	2,588	2,904	2,882	3,064	na
Share of industry in GDP (in per cent)	33.4	25.5	23.6	23.3	22.1	20.6	19.7	22.8	na
Share of agriculture in GDP (in per cent)	13.9	10.1	10.7	11.2	10.5	9.1	7.5	6.9	na
Current account/GDP (in per cent)	-3.2	-2.2	-10.2	-9.2	-10.2	-12.1	-11.2	-6.0	-6.6
External debt - reserves, in US$ millions	na	4	617	1,309	2,136	2,168	3,333	3,545	na
External debt/GDP (in per cent)	na	12.4	22.8	26.4	32.8	33.3	42.5	42.9	na
External debt/exports of goods and services (in per cent)	na	22.5	43.1	49.4	60.2	70.5	106.8	95.1	na

1 Based on the 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 Covers only investment in equity capital for 1993 and 1994; equity capital and reinvested earnings for 1995 onwards.

7 Includes non-resident currency and deposits and loans to foreign subsidiaries.

FYR Macedonia

Key reform challenges

- **Conflict and violence during 2001 have threatened macroeconomic stability and prospects for growth; a lasting peace and resolution of differences are essential for building on the successes of recent years.**
- **The privatisation of large, loss-making enterprises has reached a crucial stage and successful completion of the programme would encourage much-needed investment, including foreign direct investment.**
- **Despite a new bankruptcy law, inter-enterprise arrears have continued to mount; the political will to see advances in restructuring and the enforcement of bankruptcy are crucial.**

Liberalisation

FYR Macedonia signs a Stabilisation and Association Agreement.
In April 2001 FYR Macedonia became the first country in south-eastern Europe to sign a Stabilisation and Association Agreement (SAA) with the European Union. The SAA is similar to the Europe Agreements signed in the 1990s between the EU and 10 central and east European countries but with an additional emphasis on regional cooperation. Under the agreement, FYR Macedonia has immediate free access to EU markets (except agriculture and fisheries) while it agrees to eliminate its own tariffs on EU goods over a maximum of 10 years. For textiles and steel, the country's biggest exports, the liberalisation timetable is less than 10 years. Import quotas on agricultural and fishery products were abolished on both sides when the agreement was signed but there is no timetable for further tariff liberalisation in these sectors. Oil and oil derivative imports were liberalised in July 2001, three years ahead of the date agreed between the government and Hellenic Petroleum (Greece) under an exclusivity agreement signed when the latter purchased the Okta oil refinery in 1999.

Prices of bread and flour have been liberalised.
After five years of government control, the prices of bread and flour were liberalised in October 2000. However, there has been little effect on the price of these goods so far, suggesting that the price caps that had been imposed were non-binding. The government continues to control the prices of most utilities and miscellaneous items such as oil, mail and motor insurance.

Stabilisation

A new temporary tax on transactions has been introduced.
Macroeconomic projections for growth and fiscal balance for 2001 have been revised downwards, and inflation and reserve loss projections revised upwards, because of the conflict between security forces and ethnic Albanian guerrillas. In order to finance increased military expenditure, in June 2001 the government introduced a tax on financial transactions. The tax will apply throughout the second half of 2001. Enterprises pay 0.5 per cent of the value of each non-cash transaction and 1 per cent of each cash transaction, including purchase of foreign exchange, cash withdrawal from giro accounts for material expenses and other similar transactions. In July 2001, the first month of operation, the tax yielded about US$ 7.7 million.

Privatisation

Privatisation of large loss-makers is proceeding.
By the end of June 2001, 1,646 companies had been privatised since the start of the programme in 1993, with about 70 sales taking place in the previous 12 months and a further 113 enterprises in the process. Sixty-five per cent of the privatised enterprises are small, 19 per cent are medium-sized and the remaining 16 per cent are large. Privatisation in the agricultural sector is nearly complete with 418 companies privatised. Attention is now focused on 40 large loss-making enterprises scheduled for privatisation or closure by the end of 2002 under an action plan designed by the government with the assistance of the World Bank. Independent external advisors are being employed in the due diligence process and are assisting in the search for strategic investors. The internal ethnic conflict has led to a delay in the programme. However, in June 2001 the government announced the liquidation of five of these enterprises (with 7,000 employees), which had posted a combined loss equivalent to nearly DM 600 million during 2000.

Enterprise reform

Corporate governance practices need to be improved.
In October 2000 the government strengthened the bankruptcy, collateral and executive procedures laws. Nevertheless, financial discipline and liquidity of enterprises have continued to deteriorate. By February 2001 enterprise arrears had risen by about 10 per cent relative to a year earlier, to about MKD 33 billion (approximately DM 1 billion). About 60 legal entities account for nearly half of these arrears. The government has tried to tackle the problem by freezing bank accounts. So far, this policy has had little success in improving payments discipline.

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
Oct Bread and flour prices liberalised

2001
Apr EU Stabilisation and Association Agreement signed
Jun Emergency tax on financial transactions introduced
Jul Oil imports liberalised

Enterprises, infrastructure, finance and social reforms

1992
Apr Two-tier 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 bank fully privatised
Jul New mortgage law enacted
Jul Law on banks adopted
Jul Law on securities enacted
Oct Bankruptcy law amended

2001
Apr Minimum bank capital requirements raised

Infrastructure

The government has sold a majority stake in Macedonian Telecoms.
In January 2001 the government sold 51 per cent of the fixed-line telecommunications company, Macedonian Telecoms (MT), to a consortium led by Matav of Hungary for US$ 320 million. MT has a monopoly on fixed-line services, currently due to expire in December 2004. In the mobile sector three companies have submitted bids for the second mobile licence. Negotiations with the highest bidder have begun and the government expects the second mobile operator to start operations in early 2002.

Privatisation plans for the energy sector are proceeding.
The state electricity company, Elektrostopanstvo na Makedonija (ESM), is being prepared for privatisation by the end of 2002. Fifty-one per cent of its shares will be sold in a three-stage process. During 2000 the government decided to grant 12-year concessions for seven small hydropower plants under ROT (Revitalisation, Operation and Transfer) projects. The tender has already been launched and the government is negotiating with one of the three short-listed companies. The same strategy may be used in the liberalisation of ESM's larger capacities.

Financial institutions

Foreign investments in banks and greater competition are leading to consolidation.
At the end of 2000 there were 23 commercial banks and 18 savings banks in the country. The share of privately owned bank capital had risen to 83.5 per cent, up 6 percentage points from the end of 1999, and six banks are 100 per cent private. Seventeen banks have a full licence for foreign payment operations. 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. Bad loans also remain high, with 34.8 per cent of loans classified as doubtful or non-performing. New minimum capital requirements came into force in April 2001 – €9 million for a full foreign operations licence and €3.5 million for domestic operations. Mergers between Prilep-based Pelagoniska Banka and Komercijalna Banka (Skopje), and between Teteks Banka (Tetovo) and Kreditna Banka (Bitola) were announced in July 2001. Consolidation is expected to continue as several other mergers and acquisitions are currently under negotiation.

Payments system has been reformed.
A new payments system has been in place since 1 July 2001. Under the new system, the Payments Settlement Institute (PSI) will be closed by the end of the year. Instead, all payments will be conducted through the commercial banks and the central bank. The two schemes will operate in parallel for the second half of 2001.

Activity on the stock market has expanded.
Total turnover on the Macedonian stock exchange (MSE) increased notably during 2000 to approximately DM 250 million, five times the level of 1999. The government accounted for more than half of the turnover through the sale of state-owned shares. However, the MSE failed to attract any companies to the official market, and at the end of June 2001 only one bank and one government bond were listed on this market. Ninety-six per cent of MSE activity takes place on the unofficial third market and market capitalisation remains small at well below 1 per cent of GDP.

Social reform

Pension reform is progressing.
A new stage in the reform of the pension system was reached in February 2001 with the preparation of the draft Law on Capital Financed Pension Insurance. The law is expected to be adopted by parliament before the end of the year. The law provides for the introduction of a multi-pillar pension scheme, with private pension funds to be managed by associations that are funded by foreign capital. The initial capital of these associations is expected to be about €1.5 million.

The government is preparing a Poverty Reduction Strategy.
According to a 1998 survey, more than 20 per cent of the population is living below the official poverty line of about US$ 75 per month (at 1996 prices) and the government is preparing a strategy to meet urgent social needs. Key elements of the strategy include macroeconomic reforms, universal financing for health care, targeted measures to increase educational enrolment, and an increase in labour market flexibility through lower dismissal costs and tighter eligibility requirements for unemployment benefit.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **36.2 per cent**
Exchange rate regime – **fixed**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **no**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **na**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **43.9 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	17.7	15.0	15.5	15.0	19.6	19.6	na	na	na
Number of goods with administered prices in EBRD-15 basket	4.0	3.0	2.0	2.0	2.0	2.0	na	na	na
Share of trade with non-transition countries (in per cent)	na	na	55.5	54.2	74.7	75.6	83.1	84.7	63.4
Share of trade in GDP (in per cent)	103.8	82.4	69.6	59.0	59.2	77.0	85.7	82.1	98.9
Tariff revenues (in per cent of imports)	6.0	8.5	10.5	12.6	11.4	6.8	7.3	9.1	na
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	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
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	35.0	35.0	40.0	50.0	50.0	55.0	55.0	55.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	3.0	3.0	4.0	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	3.0	3.0	3.0	3.0	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	5.2	5.1	2.9	2.4	0.7	0.3	0.1	0.1	na
Effective statutory social security tax (in per cent)	na	na	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	39.6	39.8	39.9	38.3	28.9	27.4	28.2	27.7	na
Change in labour productivity in industry (in per cent)	-10.1	-9.7	-4.1	5.2	-7.8	14.0	-0.2	-1.9	na
Investment rate/GDP (in per cent)	17.3	16.8	14.4	16.5	17.4	17.5	17.9	na	na
EBRD index of enterprise reform	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.3
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	15.2	15.6	16.1	16.5	17.0	19.9	22.0	23.4	na
Railway labour productivity (1989=100)	66.8	56.2	21.8	24.8	47.8	50.9	68.6	66.7	89.7
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	2.73 (90)	2.81 (90)	3.1 (90)	3.54 (90)	3.73 (88.8)	3.30 (86.5)	na
Electricity consumption/GDP (1989=100)	110.7	107.1	105.1	113.9	119.4	121.9	124.5	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.2	2.1	2.1
Financial institutions									
Number of banks (of which foreign owned)	na	na	6 (3)	6 (3)	22 (5)	22 (5)	24 (6)	23 (5)	22 (7)
Asset share of state-owned banks (in per cent) [1]	na	na	na	na	0.0	0.0	1.4	2.5	1.1
Non-performing loans (in per cent of total loans) [2]	na	na	na	na	21.7	21.1	7.8	9.4	26.9
Domestic credit to private sector (in per cent of GDP)	na	59.3	45.3	23.1	26.5	27.4	18.1	11.3	11.2
Stock market capitalisation (in per cent of GDP)	na	na	na	na	2.3	0.3	0.2	0.2	0.2
EBRD index of banking sector reform	1.0	1.3	2.0	3.0	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	1.7	1.7	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	2.0	3.0	3.7	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	2.0	4.0	3.7	2.3
Social sector									
Expenditures on health and education (in per cent of GDP)	15.0	14.3	14.4	13.8	10.9	na	na	na	na
Life expectancy at birth, total (years)	72.0	na	71.7	71.9	72.2	72.3	72.6	72.8	na
Basic school enrolment ratio (in per cent)	86.2	86.2	86.8	86.5	86.9	na	na	na	na
Earnings inequality (GINI-coefficient)	23.5	27.2	25.3	27.0	25.0	25.9	na	na	na

[1] Increase in 1998 is due to the establishment of the Macedonian Bank for Development Promotion.

[2] Includes loans of banks under forced administration.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	-9.1	-1.8	-1.2	1.2	1.4	2.9	2.7	5.1	-4.0
Industrial gross output	-14.3	-9.7	-8.9	5.0	2.9	4.5	-2.5	na	na
Agricultural gross output	-20.4	7.8	2.3	-2.9	0.0	3.9	0.3	na	na
Employment [1]				(Percentage change)					
Labour force (annual average)	-2.4	-2.4	-1.5	na	1.4	2.9	-2.1	-0.6	na
Employment (annual average)	-5.6	-6.0	-9.9	na	-4.7	5.4	1.0	na	na
				(In per cent of labour force)					
Unemployment (annual average) [2]	28.3	31.4	37.7	31.9	36.0	34.5	32.4	32.1	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	338.4	126.5	16.4	2.5	1.5	0.6	-1.3	9.2	6.2
Consumer prices (end-year)	241.8	55.0	9.0	-0.6	2.6	-2.4	2.3	8.7	6.3
Producer prices (annual average)	258.3	84.6	3.9	-0.2	4.5	3.4	na	na	na
Producer prices (end-year)	177.8	28.5	2.2	-0.6	8.6	-0.1	4.2	na	na
Gross average monthly earnings in economy (annual average)	498.9	103.8	10.4	2.7	2.8	3.7	2.9	13.6	na
Government sector [3]				(In per cent of GDP)					
General government balance	-13.4	-2.7	-1.0	-1.4	-0.4	-1.8	0.0	1.0	-8.0
General government expenditure	53.6	45.8	39.0	37.1	35.3	35.8	38.0	37.8	na
Monetary sector				(Percentage change)					
Broad money (M3, end-year)	na	8.9	-59.3	0.5	19.6	14.0	30.0	22.5	na
Domestic credit (end-year)	na	31.2	-48.8	-11.5	6.8	-31.7	12.8	11.6	na
				(In per cent of GDP)					
Broad money (M3, end-year)	89.1	39.2	13.8	13.3	15.2	16.8	21.5	23.0	na
Interest and exchange rates				(In per cent per annum, end-year)					
Basic rate of the NB [4]	848.0	66.0	16.0	11.0	15.2	18.3	11.8	8.9	na
Interbank interest rate	na	na	35.7	22.5	21.1	18.1	11.6	7.2	na
Deposit rate [5]	322.0	117.6	24.1	12.8	11.6	11.7	11.3	10.7	na
Lending rate [6]	367.0	159.8	46.0	21.6	21.4	21.0	20.0	19.0	na
				(Denars per US dollar)					
Exchange rate (end-year)	44.5	40.6	38.0	41.4	55.4	51.8	60.0	67.8	na
Exchange rate (annual average)	23.6	43.2	38.0	40.0	49.8	54.5	56.9	65.9	na
External sector				(In millions of US dollars)					
Current account	15	-180	-222	-289	-277	-309	-135	-279	-330
Trade balance	43	-186	-221	-317	-386	-419	-408	-601	-600
Merchandise exports	1,056	1,086	1,204	1,147	1,237	1,292	1,192	1,367	1,400
Merchandise imports	1,013	1,272	1,425	1,464	1,623	1,711	1,600	1,968	2,000
Foreign direct investment, net [7]	0	24	12	12	18	175	27	169	350
Gross reserves (end-year), excluding gold	105	165	257	240	256	304	480	600	na
External debt stock	818	844	1,062	1,118	1,139	1,437	1,484	1,550	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	1.0	1.2	1.7	1.6	1.6	1.8	3.0	3.1	na
				(In per cent of exports of goods and services)					
Debt service	13.1	15.8	10.4	11.1	8.7	10.1	12.7	11.5	na
Memorandum items				(Denominations as indicated)					
Population (mid-year, millions)	2.2	1.9	2.0	2.0	2.0	2.0	2.0	2.0	2.0
GDP (in millions of denars)	59,164	146,409	169,521	176,444	184,982	190,827	193,520	222,202	226,535
GDP per capita (in US dollars)	1,141	1,742	2,267	2,225	1,856	1,752	1,701	1,686	na
Share of industry in GDP (in per cent)	25.6	24.3	19.6	19.5	20.7	21.8	20.7	na	na
Share of agriculture in GDP (in per cent)	8.2	9.1	10.6	10.7	10.7	10.0	9.2	na	na
Current account/GDP (in per cent)	0.6	-5.3	-5.0	-6.5	-7.5	-8.8	-4.0	-8.3	-9.6
External debt - reserves, in US$ millions	713.4	678.6	805.0	878.5	882.8	1,133.1	1,004.0	950.0	na
External debt/GDP (in per cent)	32.6	24.9	23.8	25.3	30.7	41.0	43.6	46.0	na
External debt/exports of goods and services (in per cent)	71.8	67.1	76.5	85.9	83.4	101.0	103.1	99.0	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 figures provided in this table up to 1995 refer to officially registered unemployment. From 1996, they are based on a labour force survey.
[3] General government includes the state, municipalities and extra-budgetary funds.
[4] Refinancing rate until 1994. Weighted interest rate of deposits sold at auction (seven days maturity) thereafter. The figure for 2000 is from the October auction, the last one of the year.
[5] Minimum household deposit rate (three to six months) until 1993.
[6] Minimum lending rate offered to small enterprises until 1995, mid-point rates for short-term lending to all sectors thereafter.
[7] The large increase in projected FDI for 2001 is mainly due to the sale of a majority stake in the fixed line telephone company.

Moldova

Key reform challenges

- **While significant progress has been made in macroeconomic stabilisation, key structural reforms must be addressed in order to resume IFI lending and to continue to service external debt.**
- **A commitment by the new government to sustained liberalisation and restructuring of the key wineries and tobacco industry are essential for developing the private sector and for improving the competitiveness of the economy.**
- **Further privatisation, together with the implementation of effective regulatory frameworks, is needed to sustain progress in the reform of key infrastructure sectors, in particular telecommunications and electric power.**

Liberalisation

Moldova has joined the WTO.
After six years of negotiation, Moldova joined the WTO in June 2001. WTO membership should give a much needed boost to Moldova's export industry and may help to open up new trade opportunities, especially with the EU. Moldova has not yet re-oriented its trade towards Western countries – trade with CIS countries accounted for more than 40 per cent of total trade in the first half of 2001. According to the agreement, companies operating in Trans-Dniester will have to observe WTO rules and regulations, including the introduction of new customs rules common to the entire country.

Stabilisation

The new government faces serious external debt payment challenges ...
Following the general elections in February 2001 Moldova became the first former Soviet republic to elect a communist party back into power. The new government faces a serious external payments problem, especially with the repayment of the US$ 75 million eurobond due next June. There are concerns over the country's ability to meet this obligation, which accounts for much of the sharp rise in scheduled external debt repayments due next year, which amount to over US$ 200 million.

... while access to official funding has been suspended.
The IMF resumed its funding to Moldova under the Poverty Reduction and Growth Facility (PRGF) in December 2000 but suspended it in May 2001 pending a review of the new government's policies. The IMF recognised that some aspects of the new government's programme are positive, especially in the area of fiscal policy. However, there is concern that some recent proposals, including introduction of price controls for many products and services, trade restrictions to protect local producers and privileges in the energy sector, are inconsistent with the December 2000 programme. After a further mission in July, the IMF stated that resumption of funding is crucially dependent on implementing the terms of the December 2000 programme and the supplementary actions to which the government has committed itself. They include the adoption of a new law on bankruptcy and progress in privatisation.

Privatisation

A privatisation programme for wineries and tobacco has been adopted ...
In July 2001 the privatisation programme, including the sale of 13 wine and tobacco companies, was enacted. The tender for privatisation of the first two wineries has also been announced, with 80 per cent stakes in the enterprises being offered for sale.

... while privatisation and registration of land advance.
At the beginning of 2001 the number of private farmers who have received land plots reached 500,000, about 20 per cent more than at the beginning of 2000. About half of these farmers have registered an agricultural enterprise. Those farmers who have not registered their enterprise either cultivate the land themselves or have temporarily transferred their land plots to others. A serious problem that has yet to be resolved is the need to establish a means whereby farmers can mortgage their land with commercial banks in order to obtain longer-term sources of financing.

Enterprise reform

Financial restructuring among privatised companies is continuing ...
The Agency for Enterprise Restructuring (ARIA), funded by the World Bank, has continued to provide companies with technical assistance to support the implementation of rationalisation plans. A law was enacted in August 2001, according to which enterprises that pay their tax arrears in full are not required to pay penalties and receive a 50 per cent cut in sanctions. It is estimated that the past debts and penalties of 20 enterprises that have honoured their commitments towards their creditors in line with debt rescheduling agreements concluded with the Creditors' Council amount to US$ 1.95 million.

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 Parliamentary republic introduced
Dec PRGF programme agreed with IMF

2001
May IMF suspends PRGF programme
Jun WTO accession

... but a new bankruptcy law is still pending.
A controversial amendment to the bankruptcy law has not been approved despite having passed its first reading at the end of June 2001. Under the amendment, it was proposed that entities whose tax debts amounted to more than half the value of their assets could have their assets confiscated

Enterprises, infrastructure, finance and social reforms

1991
Jun Two-tier 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

by the state. A new law on bankruptcy is currently being drafted, the adoption of which represents one of the specific actions that the government should meet for the resumption of IMF funding.

SMEs still face a very difficult business environment.
The investment climate remains very unfavourable to the development of small and medium-sized enterprises (SMEs), mainly because of the arbitrary administration of taxes and regulations. A total of 1,472 SMEs, including 529 individual businesses, were registered during the first four months of 2001 although almost as many reported interruptions to their work or were closed over this period, mainly because of financial problems. By August 2001 the Micro Enterprise Credit (MEC) company, created at the end of 1999 by the EBRD, the IFC, the Western NIS Fund and other financial companies, had facilitated access to credit by granting over 581 loans (totalling nearly US$ 3.7 million). The MEC is expected to be transformed into a commercial bank by the end of 2002 although it will continue to service the needs of micro and small entrepreneurs.

Infrastructure

A tender commission for energy company privatisation has been established …
The government recently approved a new tender commission for the privatisation of energy companies. It plans to privatise the two remaining power distribution grids, three power stations and the hot water and heating supplier, Termocom. However, in August 2001 the government postponed its plan to privatise the power distribution companies due to a legal dispute with a Ukrainian power company and a lack of investor interest. Termocom is also facing a major challenge in paying debts of US$ 9 million to suppliers as customer arrears continue to increase. Consumers in Chisinau owe US$ 23.2 million to Termocom, according to data reported in June 2001. Individual consumers, who account for over 80 per cent of the total thermal energy supplied, represent the largest category of debtors (70 per cent of the total debt). To impose payment discipline and reduce arrears, Termocom is trying to enforce a system that would enable it to disconnect non-payers from the heating supply networks, and to restart services only upon payment of at least 60 per cent of the debt.

… while profitability in privatised energy strengthens with improved collections.
In July 2001 Union Fenosa (Spain), which has a majority share in three power distribution companies, introduced a new system of payment collection for electricity consumers, including the ability to cut off power supplies to non-payers. This move is aimed at reducing the extent of non-payment and theft of electricity. Total collection ratios have risen dramatically over the past year and are now close to 90 per cent but only 30 per cent is paid in cash. Technical losses and theft, however, remain significant problems.

A privatisation advisor for the sale of Moldtelecom has been selected.
In June 2001 the government selected an advisor for the privatisation of the fixed-line monopoly, Moldtelecom. An international tender to sell a 51 per cent stake in Moldtelecom is expected to be launched by the end of this year, a delay of more than one year compared with the original timetable. This delay arose from concerns over the extent of tariff adjustments before privatisation, the unfavourable investment climate and the lack of interest from potential investors.

Financial institutions

Bank restructuring and consolidation move ahead slowly.
Following the increase in minimum capital requirements at the beginning of 2001, the banking sector has undergone a process of strengthening and consolidation. In mid-2001 four of the existing 20 commercial banks had equity corresponding to the minimum required capital (US$ 2.5 million) and were entitled to perform domestic banking services. Nine banks (with capital twice the minimum required) were also allowed to engage in foreign exchange operations. Three more banks could also deal in trust services and trading in equities while the licences of the remaining banks have been suspended.

Social reform

High rates of poverty and inequality pose major reform challenges.
According to the July 2001 draft of the Poverty Reduction Strategy by the Ministry of Economy, at least 80 per cent of the population is living on less than US$ 1 per day. The distribution of income is highly unequal, with the bottom fifth earning 4.6 per cent of total income whereas the top fifth earns nearly half of total income. The average monthly salary covers less than 30 per cent of the minimal consumer basket. The average monthly pension in Moldova – equivalent to US$ 6 – covers less than 10 per cent of the minimal consumer basket. The government is considering an increase in the pension to up to half of the minimal consumer basket. However, it is estimated that at least US$ 5 million a year would be needed to increase pensions to this level. To alleviate poverty, social reforms should be coupled with further restructuring, which would result in higher average wages through gains in productivity.

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 – **84.6 per cent**
Private pension funds – no

Stabilisation
Share of general government tax revenue in GDP – **19.7 per cent**
Exchange rate regime – **independently floating**

Enterprises and markets
Competition Office – **no**

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
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	11.0	11.0	11.0	11.0	11.0	11.0	10.0	10.0	10.0
Share of trade with non-transition countries (in per cent)	na	na	8.9	16.5	15.4	19.4	29.2	40.3	44.0
Share of trade in GDP (in per cent)	138.6	88.7	110.6	92.1	99.3	97.1	86.8	81.8	89.7
Tariff revenues (in per cent of imports) [1]	0.8	2.1	1.1	1.4	1.9	2.2	2.0	3.4	na
EBRD index of price liberalisation	2.7	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3
EBRD index of forex and trade liberalisation	2.0	2.0	2.0	4.0	4.0	4.0	4.0	4.0	4.0
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	na	0.0	0.5	0.8	1.3	3.6	4.4	5.4	11.2
Private sector share in GDP (in per cent)	10.0	15.0	20.0	30.0	40.0	45.0	50.0	45.0	50.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	1.0	1.0	2.0	3.0	3.0	3.0	3.3	3.3	3.3
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)	na	na	na	na	na	na	na	na	na
Effective statutory social security tax (in per cent)	47.1	47.1	73.9	77.0	78.2	68.4	71.0	70.5	na
Share of industry in total employment (in per cent)	20.2	14.5	13.8	16.0	14.7	14.3	14.3	na	na
Change in labour productivity in industry (in per cent)	-20.0	7.3	-23.6	12.0	8.6	10.5	-3.2	na	na
Investment rate/GDP (in per cent)	16.2	15.5	19.3	16.0	19.4	19.9	21.9	na	na
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	1.7	1.7	1.7	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	11.6	11.9	12.3	13.0	14.0	14.6	15.0	12.7	na
Railway labour productivity (1989=100)	60.4	43.0	32.2	28.3	26.5	27.6	25.2	15.6	18.7
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	4.3 (64)	3.2 (92)	3.1 (87)	4.7 (92)	5.2 (na)	4.4 (na)	na
Electricity consumption/GDP (1989=100)	165.0	160.1	191.3	172.6	182.2	164.7	160.8	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.2	2.4	na
Financial institutions									
Number of banks (of which foreign owned)	16 (na)	16 (na)	21 (1)	22 (1)	21 (2)	22 (4)	23 (7)	20 (10)	20 (11)
Asset share of state-owned banks (in per cent)	na	na	na	na	na	na	0.3	7.9	9.8
Non-performing loans (in per cent of total loans) [2]	na	na	31.0	39.1	46.0	26.0	32.0	29.3	20.6
Domestic credit to private sector (in per cent of GDP) [3]	5.9	5.0	3.7	5.8	6.8	14.8	15.8	11.2	12.8
Stock market capitalisation (in per cent of GDP) [4]	na	na	na	na	na	0.1	0.1	0.1	0.1
EBRD index of banking sector reform	1.0	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3
EBRD index of reform of non-banking financial institutions	1.0	1.0	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	3.0	4.0	3.7	na
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	2.0	3.0	3.0	na
Social sector									
Expenditures on health and education (in per cent of GDP)	11.0	11.0	14.9	12.6	14.9	14.1	9.9	6.6	6.7
Life expectancy at birth, total (years)	67.8	67.4	66.0	65.7	66.6	66.5	66.5	66.6	na
Basic school enrolment ratio (in per cent)	79.9	79.1	78.8	79.4	79.2	92.5	92.5	na	na
Earnings inequality (GINI-coefficient)	41.1	43.7	37.9	39.0	na	na	na	na	na

[1] Refers to all taxes on foreign trade.
[2] Changes in non-performing loans data compared with previous Transition Reports are due to the change of loan categories included in non-performing loans (see definitions).
[3] Credits to individuals and enterprises excluding banks and government.
[4] Data from survey to Moldovan Stock Exchange, including government securities. Data from IFC give a figure of 4.56 per cent of GDP for listed companies in 1997.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	-1.2	-31.2	-1.4	-7.8	1.3	-6.5	-4.4	1.9	5.0
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed investment	na	na	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	0.3	-27.7	-3.9	-6.5	0.0	-11.0	-9.0	na	na
Agricultural gross output	9.9	-24.3	3.7	-11.9	11.4	-11.0	-8.0	na	na
Employment				(Percentage change)					
Labour force (annual average)	-1.0	0.0	-0.2	-0.8	-0.6	0.0	na	na	na
Employment (annual average) [1]	-17.7	-0.4	-0.5	-0.8	-0.8	-0.2	na	na	na
				(In per cent of labour force)					
Unemployment (end-year) [2]	0.7	1.1	1.4	1.8	1.5	1.9	2.0	2.2	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	788.5	329.7	30.2	23.5	11.8	7.7	39.3	31.3	11.1
Consumer prices (end-year)	837.0	116.1	23.8	15.1	11.1	18.2	43.8	18.5	9.0
Producer prices (annual average)	na	205.1	52.9	31.2	14.9	9.7	47.1	na	na
Producer prices (end-year)	6,947.0	214.5	46.6	20.4	13.6	13.6	58.6	na	na
Gross average monthly earnings in economy (annual average)	783.4	247.4	32.1	31.2	16.3	17.6	23.7	16.0	na
Government sector [3]				(In per cent of GDP)					
General government balance	-7.5	-5.9	-5.0	-8.5	-6.6	-5.7	-5.4	-4.0	-3.8
General government expenditure	28.0	36.3	31.5	32.0	35.7	38.7	32.8	30.6	na
General government debt	na	58.8	46.0	50.8	70.7	91.1	119.6	na	na
Monetary sector				(Percentage change)					
Broad money (M3, end-year)	309.7	115.8	65.2	15.3	34.0	-8.2	41.9	42.5	na
Domestic credit (end-year)	331.3	101.5	64.7	18.8	26.8	29.2	18.1	na	na
				(In per cent of GDP)					
Broad money (M3, end-year)	19.2	15.9	16.5	16.2	19.0	17.0	18.3	20.3	na
Interest and exchange rates				(In per cent per annum, end-year)					
Refinancing rate	na	na	21.0	19.5	16.0	28.4	na	31.0	na
Interbank interest rate (up to 30 days maturity)	na	na	na	31.2	24.5	30.9	na	32.6	na
Deposit rate (1 year)	na	na	32.5	25.4	23.5	21.7	na	27.5	na
Lending rate (1 year)	na	na	41.9	36.7	33.3	30.8	na	35.5	na
				(Lei per US dollar)					
Exchange rate (end-year)	3.6	4.3	4.5	4.7	4.7	8.3	11.6	12.4	na
Exchange rate (annual average)	1.5	4.1	4.5	4.6	4.6	5.4	10.5	na	na
External sector				(In millions of US dollars)					
Current account	-150	-82	-98	-202	-275	-322	-35	-110	-111
Trade balance	-148	-53	-70	-260	-347	-388	-128	-268	-251
Merchandise exports	483	619	739	823	890	644	469	495	571
Merchandise imports	631	672	809	1,083	1,237	1,032	597	763	822
Foreign direct investment, net	14	18	73	23	71	88	34	100	60
Gross reserves (end-year), excluding gold	77	179	257	315	366	140	181	206	na
External debt stock	256	620	668	815	1,335	1,466	1,457	1,421	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	1.5	2.9	3.0	3.0	3.1	1.4	2.9	2.6	na
				(In per cent of exports of goods and services)					
Debt service	na	2.3	8.2	5.7	13.8	27.9	37.4	22.1	na
Memorandum items				(Denominations as indicated)					
Population (end-year, millions)	4.3	4.4	4.3	4.3	4.3	4.3	4.3	4.3	na
GDP (in millions of leis)	1,821	4,737	7,550	8,830	10,120	10,370	13,710	17,530	21,052
GDP per capita (in US dollars)	289	268	387	443	507	449	304	326	na
Share of industry in GDP (in per cent)	38.9	31.4	25.0	23.1	20.2	16.7	16.2	na	na
Share of agriculture in GDP (in per cent)	31.2	27.3	29.3	27.5	26.0	25.8	22.3	na	na
Current account/GDP (in per cent)	-11.9	-7.0	-5.8	-10.5	-12.6	-16.7	-2.7	-7.8	-7.6
External debt - reserves, in US$ millions	179	441	412	500	969	1,326	855	1,215	na
External debt/GDP (in per cent)	20.4	53.1	39.7	42.5	60.9	75.9	105.7	101.3	na
External debt/exports of goods and services (in per cent) [4]	53.0	95.1	75.6	87.0	130.4	192.1	240.8	217.6	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 extra-budgetary funds.

[4] Figures for 1993 refer to exports of goods only.

Poland

Key reform challenges

- **Improvements in labour market regulations are necessary to return growth performance to its potential, to speed up enterprise restructuring and to address structural imbalances in the labour market.**
- **Further progress is needed in enterprise restructuring and reform of agriculture. Corporate governance and minority shareholder rights remain key issues in the enterprise sector while farms need to improve efficiency and increase productivity before EU accession.**
- **The implementation of recent social welfare reforms, particularly in the pension system, needs to be strengthened to improve fiscal performance.**

Stabilisation

Macroeconomic stability is weakened by loose fiscal policy.
The doubling by the government of its fiscal deficit target for 2001 from 1.8 per cent of GDP to 3.6 per cent and increasing policy uncertainty in the run-up to parliamentary elections, combined with the EU slowdown and contagion effects from Argentina and Turkey, led to a rapid fall of the zloty in early July 2001. While one-off measures, including some spending cuts, may allow successful implementation of the revised 2001 budget, lower spending on budget subsidies and social welfare is needed to deliver a sustainable fiscal deficit and ultimately to fulfil the Maastricht criteria. The challenge for the newly elected government will be to implement significant fiscal consolidation.

Privatisation

Privatisation has been negatively affected by market sentiment.
The government's privatisation plan for 2001 assumed PLN 18 billion (about US$ 4.5 billion) in privatisation receipts, mostly from sales of utility companies, but this was revised down to PLN 11.5 billion in mid-2001 due to adverse market conditions. The government planned to sell another stake in the monopoly telecommunications provider, TPSA, shares in energy generating and distributing companies, and a further stake in the dominant insurance provider, PZU. The government also aimed to start the privatisation of the copper and silver mining company, KGHM, continue the privatisation of the largest oil group, PKN Orlen, sell the Gdansk refinery, and privatise a number of chemical industry companies, spa resorts, and steel and mining companies. The privatisation programme focuses on direct sales to strategic investors through international tenders, although a substantial amount of privatisation income is expected to come from public offerings on the local stock exchange. However, the valuation of companies to be sold has declined as world stock markets have slumped since March 2000, contributing to delays in the privatisation process. The government sold a further 12.5 per cent in TPSA for US$ 875 million to a consortium led by France Telecom (which already owns a 35 per cent stake) in September 2001 and significant stakes in several energy sector companies.

Enterprise reform

The legal framework for enterprises has strengthened but further improvements are needed.
New commercial legislation was enacted in January 2001, including a new commercial code which reduces the number of economic activities requiring licences, a new register of insolvent debtors and a new national court register. However, the potential for disagreements between controlling and minority shareholders has remained and has been revealed in several high profile cases over the past few months. Examples include cases involving the dominant insurance company, PZU, a large tyre producer, Stomil Olsztyn, a regional financial institution, Bank Slaski, a manufacturing conglomerate, Elektrim, and a food processing firm, Agros. Shareholder conflicts have usually involved the Treasury and private foreign investors, highlighting the need for completion of privatisation in partly state-owned listed companies. Further changes in legislation and regulation should focus on increased transparency regarding management ownership stakes, better protection of minority shareholders against dilution of their stakes, and better enforcement of competition law.

Labour market pressures are growing.
The combination of slower domestic demand, expiration of employee-protection clauses in some privatisation contracts, and increases in working age population has led to a substantial increase in the registered unemployment rate, from 8.6 per cent in 1997 to 16 per cent of the labour force in the first half of 2001. While the legal framework for the labour market is relatively flexible, the minimum wage in certain regions is close to the average wage, which discourages job creation for less skilled workers and new entrants. There is also a need for better provision of training programmes, particularly in rural areas, relaxation of rules on temporary and short-term assignments and increased labour mobility through support for temporary housing.

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
- Mar EU accession negotiation 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
Jul Railway reform plan approved

2001
Jan New commercial legislation adopted

Restructuring in state-owned industrial companies remains slow.
The restructuring of the mining sector is continuing, in line with a World Bank supported plan that focuses on labour downsizing, closure of unprofitable mines and privatisation of potentially viable mines. However, the government failed in its attempt to privatise large loss-making steel companies at the end of 2000 when all the potential investors withdrew from negotiations. A new plan for restructuring the steel sector aims to merge the main steel producing companies, including Huta Sendzimira and Huta Katowice, and to scale down both the labour force and the level of production. State-owned companies, including steel producers, continue to benefit from state subsidies in the form of tax write-offs, debt cancellations and state loan guarantees.

Infrastructure

Energy sector privatisation proceeds.
The government amended its privatisation strategy for the energy sector in March 2001, moving the focus to the less attractive power generating firms which need large investments, particularly to improve environmental standards. In July 2001 the power-grid company, Polskie Sieci Elektroenergetyczne, initiated the operation of an hourly balancing market with the target of creating an operational wholesale power market. Long-term off-take contracts still account for about two-thirds of the existing power market although they are slowly being phased out.

Railway reform has progressed.
The state monopoly railway company, PKP, is continuing its restructuring programme by separating into a number of firms, including freight transport, energy, regional transport, telecommunications and rail infrastructure. The rail infrastructure firm is to remain under state control while the others will be sold to strategic investors. Local rail transport firms in Warsaw and the tri-city (Gdansk, Gdynia and Sopot) launched independent operations in July 2001 and their privatisation process has started. PKP plans to reduce its workforce further, from the current 166,000 employees to 145,000 by the end of 2002.

Financial institutions

Banking sector consolidates but further restructuring is needed.
The majority of assets in the banking sector are controlled by foreign-owned banks. However, a large majority-state-owned bank, PKO BP, still accounts for about 30 per cent of all deposits and remains the main supplier of funds for the interbank market. The state is also the sole shareholder in another major bank, BGZ, which focuses on the agricultural sector. The profitability of banks declined in 2000 relative to the previous year and the share of bad loans rose to almost 16 per cent of total loans in 2000. The impact of the economic slowdown in late 2000 and early 2001 as well as greater currency volatility may add to this financial pressure. Further consolidation in the banking sector, particularly among almost 800 cooperative banking institutions serving rural areas, is desirable.

Insurance company privatisation has been agreed after delays.
The government had planned to sell 50 per cent of the dominant insurance company PZU through a combination of a public offering and sale to a minority strategic investor earlier this year. The sale was expected to yield about PLN 7 billion (US$ 1.6 billion) in privatisation revenues. However, disagreements and lawsuits between the European insurance company Eureko (which bought a 20 per cent stake in 1999) and the Treasury on the validity of the 1999 sale and the composition of the management in early 2001, as well as the emergence of a major case of fraud in the life subsidiary, have delayed the completion of PZU's privatisation. However, the government agreed on the sale of a 21 per cent stake to Eureko for PLN 2.7 billion (US$ 0.7 billion) in early October.

Pension reform supports capital market development.
The Warsaw stock exchange is well developed by regional standards, with a number of new initial public offerings by private companies and listings of large state-owned companies. Market capitalisation reached 20 per cent of GDP in 2000, with market turnover at 50 per cent of market capitalisation. While foreign investors accounted for 28 per cent of turnover in 2000, local institutional investors, including 93 investment funds and 21 pension funds, increased their share in turnover to 22 per cent. The market is relatively concentrated, with the five largest companies accounting for approximately 50 per cent of both market capitalisation and turnover. Although there have been some disputes between shareholders in prominent companies (see above), the Warsaw stock exchange continues to be well regarded for its good legal framework and prudent supervision.

Social reform

Further reform of the Social Security Fund is necessary.
The implementation of pension reform, launched in 1999, is critically dependent on the performance of ZUS, the Social Security Fund, which handles social security payments including pension system contributions and their transfer to private pension funds. While initial technical problems with implementation of pension reform are close to being resolved, the relationship between the government, ZUS and ailing enterprises needs to be made more transparent to remove the scope for state support of non-viable enterprises via social contribution arrears. The Ministry of Finance and ZUS also need to solve the problem of impaired ZUS receivables, which are believed to be equivalent to several percentage points of GDP.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **34.7 per cent**
Exchange rate regime – **floating**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **MEBOs**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **18.4 per cent**
Private pension funds – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	14.0	16.0	17.0	17.0	15.0	12.0	10.0	9.0	9.0
Number of goods with administered prices in EBRD-15 basket	3.0	3.0	3.0	2.0	2.0	2.0	1.0	0.0	0.0
Share of trade with non-transition countries (in per cent)	84.4	87.7	86.3	82.3	79.3	75.5	77.4	79.3	81.1
Share of trade in GDP (in per cent)	32.6	34.5	37.7	40.0	42.4	48.5	47.0	43.5	43.9
Tariff revenues (in per cent of imports)	14.6	15.0	12.0	9.6	7.4	5.6	4.0	3.4	na
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	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.4	0.9	1.7	2.6	3.6	5.1	6.4	7.7	11.6
Private sector share in GDP (in per cent)	45.0	50.0	55.0	60.0	60.0	65.0	65.0	65.0	70.0
Private sector share in employment (in per cent)	54.0	57.0	59.0	61.4	63.0	66.7	69.2	70.9	72.0
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	2.0	2.0	3.0	3.0	3.0	3.3	3.3	3.3	3.3
Enterprises									
Budgetary subsidies (in per cent of GDP)	1.7	1.4	1.2	1.1	0.8	0.8	0.5	0.4	na
Effective statutory social security tax (in per cent)	na	na	71.7	76.1	77.7	76.4	72.7	78.8	na
Share of industry in total employment (in per cent)	25.9	24.6	22.5	23.1	22.2	21.9	21.7	21.1	21.1
Change in labour productivity in industry (in per cent)	12.5	13.8	13.0	6.5	9.1	11.6	4.3	9.1	10.4
Investment rate/GDP (in per cent)	15.8	14.9	18.0	18.7	20.9	23.6	25.3	26.4	26.3
EBRD index of enterprise reform	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of competition policy	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Infrastructure									
Main telephone lines per 100 inhabitants	10.3	11.5	13.1	14.8	16.9	19.4	22.8	26.0	na
Railway labour productivity (1989=100)	68.0	70.4	72.6	77.4	78.2	80.8	78.2	78.4	84.3
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	4.94 (90)	6.19 (95)	6.53 (97)	6.24 (97)	6.68 (na)	6.42 (na)	na
Electricity consumption/GDP (1989=100)	100.3	97.4	93.3	89.2	87.0	82.7	79.0	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	3.2	3.2	3.7
Financial institutions									
Number of banks (of which foreign owned) [1]	na	87 (10)	82 (11)	81 (18)	81 (25)	83 (29)	83 (31)	77 (39)	74 (47)
Asset share of state-owned banks (in per cent)	na	86.2	80.4	71.7	69.8	51.6	48.0	24.9	24.0
Non-performing loans (in per cent of total loans)	na	36.4	34.0	23.9	14.7	11.5	11.8	14.5	15.9
Domestic credit to private sector (in per cent of GDP)	11.4	12.2	12.0	12.7	15.9	17.1	17.6	18.8	18.8
Stock market capitalisation (in per cent of GDP)	0.3	3.7	3.5	3.9	6.6	9.6	13.1	20.0	18.8
EBRD index of banking sector reform	2.0	3.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3
EBRD index of reform of non-banking financial institutions	2.0	2.0	2.0	3.0	3.0	3.3	3.3	3.3	3.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	4.0	4.0	4.0	3.7
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	4.3	4.0	3.0	4.0
Social sector									
Expenditures on health and education (in per cent of GDP)	10.8	10.4	10.7	9.7	10.8	11.2	9.9	na	na
Life expectancy at birth, total (years)	71.1	71.6	71.7	71.9	72.2	72.6	73.0	73.2	na
Basic school enrolment ratio (in per cent)	97.1	97.2	97.1	97.2	97.4	98.0	98.1	na	na
Earnings inequality (GINI-coefficient)	24.7	25.6	28.1	29.0	30.2	30.0	na	na	na

[1] In 2000 including Slaski Bank Hipoteczny SA, a banking organisation that previously did not file reports on ownership.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure					*(Percentage change in real terms)*				
GDP	3.8	5.2	7.0	6.0	6.8	4.8	4.1	4.0	2.0
Private consumption	5.2	4.3	3.6	8.6	6.9	4.9	5.4	2.6	na
Public consumption	3.8	2.8	2.9	2.0	3.1	1.4	1.0	1.1	na
Gross fixed investment	2.9	9.2	16.9	19.7	21.7	14.2	6.5	3.1	na
Exports of goods and services	3.2	13.1	23.6	12.5	9.9	11.0	1.0	17.5	na
Imports of goods and services	13.2	11.3	24.3	28.0	16.7	14.0	6.0	12.0	na
Industrial gross output	6.4	12.0	9.6	8.3	11.5	4.8	4.4	7.1	na
Agricultural gross output	6.8	-9.3	10.7	0.7	1.0	1.0	-2.0	0.0	na
Employment					*(Percentage change)*				
Labour force (end-year)	0.7	0.6	-0.9	1.4	-2.7	-4.0	-1.0	1.8	na
Employment (end-year)	-1.7	1.1	0.3	3.5	1.3	1.4	-1.5	-3.3	na
					(In per cent of labour force)				
Unemployment (end-year)	16.4	16.0	14.9	13.2	8.6	10.4	13.0	15.0	na
Prices and wages					*(Percentage change)*				
Consumer prices (annual average)	35.3	32.2	27.8	19.9	14.9	11.8	7.3	10.1	5.6
Consumer prices (end-year)	37.6	29.5	21.6	18.5	13.2	8.6	9.8	8.5	4.2
Producer prices (annual average)	31.9	25.3	25.4	12.4	12.2	7.3	5.7	7.9	na
Producer prices (end-year)	37.0	27.9	18.9	11.2	11.5	4.9	8.1	5.7	na
Gross average monthly earnings in economy (annual average) [1]	na	34.6	31.6	26.5	21.5	16.7	10.6	11.4	na
Government sector [2]					*(In per cent of GDP)*				
General government balance	-2.4	-2.2	-3.1	-3.3	-3.1	-3.2	-3.7	-3.2	-4.0
General government expenditure	49.9	50.5	49.2	46.4	45.8	44.6	43.9	42.6	na
General government debt	88.7	72.4	57.9	51.2	49.8	43.2	44.5	42.5	na
Monetary sector					*(Percentage change)*				
Broad money (M2, end-year)	36.0	38.2	34.9	29.3	30.9	25.2	19.3	11.8	na
Domestic credit (end-year)	44.2	30.1	20.8	31.9	26.5	22.1	20.2	6.9	na
					(In per cent of GDP)				
Broad money (M2, end-year)	35.9	36.7	36.1	37.2	39.6	40.2	43.1	42.7	na
Interest and exchange rates					*(In per cent per annum, end-year)*				
Rate on 28-day open market operations [3]	35.0	33.0	29.0	26.0	28.0	15.5	16.5	18.0	na
3-months WIBOR [4]	33.7	27.0	24.2	21.7	25.4	15.2	17.9	19.0	na
Deposit rate [5]	25.0	26.0	19.5	17.0	18.0	12.8	12.9	14.3	na
Lending rate [6]	35.0	31.0	24.0	20.5	22.5	20.4	20.3	21.5	na
					(Zloty per US dollar)				
Exchange rate (end-year)	2.1	2.4	2.5	2.9	3.5	3.5	4.2	4.3	na
Exchange rate (annual average)	1.8	2.3	2.4	2.7	3.3	3.5	4.0	4.3	na
External sector					*(In millions of US dollars)*				
Current account	-600	677	5,310	-1,371	-4,312	-6,858	-11,569	-9,892	-9,000
Trade balance	-2,482	-895	-1,912	-8,179	-11,320	-13,720	-14,380	-13,145	-12,500
Merchandise exports	13,598	17,024	22,878	24,453	27,229	30,122	26,347	28,277	31,500
Merchandise imports	16,080	17,919	24,790	32,632	38,549	43,842	40,727	41,422	44,000
Foreign direct investment, net	580	542	1,134	2,741	3,041	4,966	6,348	9,299	7,000
Gross reserves (end-year), excluding gold	4,281	6,029	14,963	18,033	20,298	26,317	24,400	25,317	na
External debt stock	47,200	43,600	45,200	47,541	49,648	59,163	64,890	68,198	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	2.9	3.6	6.5	6.0	5.8	6.6	6.4	6.5	na
					(In per cent of current account revenues, excluding transfers)				
Debt service	na	18.8	11.8	7.5	7.4	6.9	9.5	8.8	na
Memorandum items					*(Denominations as indicated)*				
Population (end-year, millions)	38.5	38.6	38.6	38.6	38.7	38.7	38.7	38.7	na
GDP (in millions of zlotys)	155,780	210,400	288,700	362,800	445,100	549,500	611,600	690,400	743,429
GDP per capita (in US dollars)	2,234	2,399	3,085	3,483	3,511	4,066	3,987	4,108	na
Share of industry in GDP (in per cent)	32.9	32.2	29.2	27.1	28.1	28.1	28.2	29.0	na
Share of agriculture in GDP (in per cent)	6.6	6.2	6.4	6.0	5.7	5.5	5.2	5.0	na
Current account/GDP (in per cent)	-0.7	0.7	4.5	-1.0	-3.2	-4.4	-7.5	-6.2	-5.0
External debt - reserves, in US$ millions	42,919	37,572	30,237	29,508	29,350	32,846	40,490	42,881	na
External debt/GDP (in per cent)	54.9	47.1	38.0	35.3	36.6	37.6	42.1	42.9	na
External debt/exports of goods and services (in per cent)	305.4	228.0	173.4	170.8	160.4	175.0	218.8	214.5	na

[1] Gross wages are gross of income taxes.

[2] General government includes the state, municipalities and extra-budgetary funds. General government balance excludes privatisation receipts.

[3] Refinancing rate until 1997, rate on 28-day open market operations (reference rate) since 1998.

[4] Yield on 28-day Treasury bills until 1995, three-month WIBOR since 1996.

[5] The lowest rate offered on six-month time deposits.

[6] The lowest rate charged by commercial banks to prime borrowers.

Romania

Key reform challenges

- **Stabilisation measures are urgently needed to foster more investment and to generate sustainable economic growth and low inflation over the medium term.**
- **The new government must accelerate the pace of privatisation and financial restructuring of large state-owned enterprises to reduce the fiscal burden and to curb rising inter-enterprise arrears.**
- **A necessary condition to attract higher foreign direct investment is the improvement of the country's investment climate, providing a more transparent and predictable legal, regulatory and tax environment.**

Liberalisation

EU harmonisation is promoting further trade and capital account liberalisation.
Romania concluded a preferential trade agreement with the EU and free trade agreements with the countries of the European Free Trade Area (EFTA) and its central European neighbours (CEFTA). Under its preferential trade agreement with the EU, the government has agreed to cut average taxes on agricultural products from 38.2 per cent to 9.4 per cent and on industrial products from 15.6 per cent to 4.2 per cent. The remaining non-agricultural import tariffs should be eliminated by 2002. Steps are also expected towards further liberalisation of the capital account, with the lifting of existing restrictions on capital outflows expected later this year.

Romania is pressing ahead with EU accession negotiations.
Romania was invited to start EU accession negotiations in December 1999. As of July 2001, eight chapters (out of a total of 31) of the *acquis communautaire*, the legal and regulatory framework for the single European market, had been successfully closed and the new government is currently elaborating position papers on another seven chapters. By the end of 2002 the country will have received EU assistance for a cumulative amount of €650 million, distributed under several programmes, including the EU Phare programme, the Instrument for Structural Policies for Pre-Accession (ISPA) and the Special Programme for Agriculture and Rural Development (SAPARD).

Stabilisation

High inflation risks macroeconomic stability.
After three years of recession, real GDP growth resumed in 2000 but at the cost of higher than expected inflation, well above 40 per cent at the end of 2000. In June 2001 the finance ministry, together with the central bank, unveiled the government's anti-inflation plan aimed at reducing consumer price inflation from 30 per cent this year to 10 per cent by 2004-05. The programme envisages employment cuts in the public sector, a 30 per cent reduction in payment arrears to utilities and public enterprises and caps on real wage rises. However, the key will be effective implementation of these and other structural reforms.

The central bank is considering adoption of an inflation or exchange rate target.
The official exchange rate regime adopted by the Romanian National Bank is a managed float but, de facto, the monetary authorities are operating a crawling peg by steadily depreciating the national currency at a rate in line with the targeted rate of inflation. This policy faces two conflicting objectives: the reduction of inflationary expectations and the need to promote export competitiveness through a real exchange rate depreciation. Since last year, the second objective has prevailed, reflecting a widespread lack of financial discipline. The monetary authorities are now considering the adoption of an explicit inflation or exchange rate target. While this move could help in principle to curb inflation to single digit figures, it would not be sufficient unless structural reforms are successful in enhancing financial discipline.

Privatisation

The privatisation of Sidex is a key turnaround.
At the beginning of 2001 the Authority for Privatisation and Management of State Assets (APAPS) replaced the State Ownership Fund. The new body has a clear mandate to manage and sell state-owned assets and to monitor the implementation of privatisation undertakings and contracts. APAPS committed to selling 17 small and medium-sized enterprises (SMEs) under the first World Bank Public Sector Adjustment Loan (PSAL) programme and announced plans to privatise another 20 firms. The authorities are currently negotiating the second PSAL programme with the World Bank, with the aim of accelerating the privatisation of the remaining large-scale state-owned enterprises. More recently, the government successfully completed the sale of the country's largest steel company, Sidex, to the only bidder, the British-Indian company ISPAT.

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

2001
Jan New privatisation agency (APAPS) established
Jul Largest steel-maker privatised

Enterprise reform

The investment climate must be improved to attract more FDI.
Foreign direct investment in Romania has been low by international standards, even compared with other countries in central and south-eastern Europe. Taxes, regulations and policy instability are ranked by foreign investors as the most serious obstacles to their business, as reported in the last edition of the Foreign Investor Council white book. To improve the business environment,

Enterprises, infrastructure, finance and social reforms

1990
Dec Two-tier 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 pensions adopted

2001
Mar Second-largest state bank privatised
Apr Electricity prices increased
Jun New secondary market regulation issued
Jul Thermal power and electricity prices increased

the country's legal framework should be stabilised through less frequent changes to laws, and corruption should be tackled vigorously. This would require significant institution-building through extensive training of local officials and decentralisation of some public services to the regional level.

Enterprise restructuring remains a high priority …
Due to the failure of previous administrations to restructure and privatise the industrial sector, the new government has inherited an out-of-date and non-competitive industrial base, heavily burdened by a growing stock of inter-enterprise and tax arrears. According to recent IMF estimates, the total level of arrears reached about 45 per cent of Romanian GDP in 2000 and they will continue to undermine macroeconomic stability until the government takes concrete measures to eradicate them through the imposition of hard budget constraints on enterprises. The proposed reduction in arrears to utilities and public enterprises would be an important first step.

…together with promotion of SMEs and greenfield investments.
At the beginning of its term the new government passed an emergency ordinance aimed at encouraging development of SMEs. The most important facilities granted by the new regulations are custom duties exemptions on imported raw materials, equipment and know-how required for the manufacturing processes and income tax exemptions on reinvested profits. The ordinance also offers a 20 per cent cut in the profit tax applied to SMEs if their activity leads to an increase in employment at the firm of at least 10 per cent relative to the previous year. The government also introduced new legislation aimed at promoting larger investments. The law offers a series of tax facilities to both foreign and Romanian investors for greenfield projects that exceed US$ 1 million. Additional tax incentives will be granted to investments worth more than US$ 10 million.

Infrastructure

The government has approved a new railway strategy …
The new strategy for railways, promoted by the newly created Ministry of Public Works, Transport and Housing and the National Railway Company, envisages the integration into the European railway network of the 4th and 9th transport corridors that cross Romania, the commissioning of about 4,000 km of fibre optic rail lines, the computerisation of the railway system and the redevelopment of 13 railway stations. The project has to be completed by the end of 2010.

… but progress in energy sector reform has slowed.
While demonopolisation of the electric power, oil and gas sectors started in late 1999, progress has been slow and privatisation of the generation and distribution companies unbundled from the integrated state monopoly has not started yet. The government is working with the World Bank to develop a new framework for further liberalisation of the sector through elimination of energy subsidies and improvements in tariff collection. To raise energy prices to cost recovery levels, the government increased electricity prices by 15 per cent and thermal power prices by over 50 per cent in July following a 6.2 per cent average increase in electricity prices in April 2001.

Financial institutions

Following privatisation of Banca Agricola, only three banks remain state-owned.
With the privatisation of Banca Agricola in April 2001 to a consortium including Raiffeisen Bank and the Romanian American Enterprise Fund, more than two-thirds of total assets of the banking system are in private hands and about 55 per cent is foreign-owned. Of the three remaining state-owned banks, the most attractive to investors is Banca Comerciala Romana (BCR), which has 30 per cent shares of total assets of the banking system and total loans to customers. The process of privatisation of the bank started this year with the appointment of a privatisation commission, but the government does not plan to complete it before the end of 2002. The remaining two public banks are the former savings bank, CEC, and Eximbank. It is still unclear whether the first will act as a pure commercial bank in the future, while the latter needs restructuring before privatisation can start.

New regulations on money market operations have been approved.
At the beginning of June 2001 the National Bank issued new regulations governing the secondary treasury bill and money markets. According to the new norms, government securities with maturities higher than 12 months will be traded on both the Bucharest stock exchange and the interbank market while treasury bills with shorter maturities will continue to be traded only on the interbank market.

Social reform

Social protection measures are to be implemented.
The World Bank recently approved a Social Sector Development Project to support the process of accession to the European Union through the modernisation of the labour market, poverty reduction, the strengthening of social safety nets and micro-business development. The components of the project are key instruments in supporting the medium-term economic strategy approved by the government in 2000. The project is to be implemented between October 2001 and December 2005.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenue in GDP – **31.5 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de facto**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **12 per cent**
Deposit insurance system – **yes**
Secured transactions law – **yes**
Securities commission – **yes**

Social reform
Share of the population in poverty – **44.5 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	29.0	20.0	18.0	18.0	18.0	7.0	na	na	na
Number of goods with administered prices in EBRD-15 basket	13.0	7.0	5.0	5.0	5.0	2.0	na	na	na
Share of trade with non-transition countries (in per cent)	74.8	84.4	86.2	88.8	88.9	86.5	88.0	89.5	87.5
Share of trade in GDP (in per cent)	51.8	41.4	42.3	49.0	52.7	53.9	50.6	53.2	61.0
Tariff revenues (in per cent of imports)	4.9	6.6	6.0	6.2	5.1	4.5	5.9	5.5	3.3
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	3.0	3.0	4.0	4.0	3.0	4.0	4.0	4.0	4.0
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.1	0.4	1.2	2.2	4.6	6.6	7.9	8.9
Private sector share in GDP (in per cent)	25.0	35.0	40.0	45.0	55.0	60.0	60.0	60.0	60.0
Private sector share in employment (in per cent)	41.0	44.0	49.0	51.0	52.0	58.0	62.0	na	na
EBRD index of small-scale privatisation	2.0	2.0	2.3	2.7	3.0	3.3	3.3	3.7	3.7
EBRD index of large-scale privatisation	1.7	2.0	2.0	2.0	2.7	2.7	2.7	2.7	3.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	13.0	6.8	3.8	4.1	4.3	2.5	1.7	1.9	na
Effective statutory social security tax (in per cent)	77.5	81.6	77.2	69.5	65.9	61.9	na	na	na
Share of industry in total employment (in per cent)	31.6	30.1	28.8	28.6	29.2	27.2	27.0	24.4	na
Change in labour productivity in industry (in per cent)	-10.0	10.4	8.6	16.3	8.7	5.6	-14.9	5.7	na
Investment rate/GDP (in per cent)	19.2	17.9	20.3	24.3	24.7	21.5	21.4	20.2	21.6
EBRD index of enterprise reform	1.0	2.0	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	2.3	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	11.3	11.4	12.3	13.1	14.0	15.3	16.0	16.7	na
Railway labour productivity (1989=100)	47.5	42.8	44.2	53.2	74.7	51.5	54.2	46.0	48.9
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	2.2 (88)	2.1 (94)	1.9 (96)	2.3 (96)	3.4 (85)	4.7 (90)	na
Electricity consumption/GDP (1989=100)	89.2	86.0	81.3	78.9	79.0	77.7	76.8	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	3.1	3.3	3.3
Financial institutions									
Number of banks (of which foreign owned)	na	na	20 (3)	24 (6)	31 (8)	33 (13)	36 (16)	34 (19)	33 (21)
Asset share of state-owned banks (in per cent)	na	na	80.4	84.3	80.9	80.0	75.3	50.3	50.0
Non-performing loans (in per cent of total loans) [1]	na	na	18.5	37.9	48.0	56.5	58.5	35.4	3.8
Domestic credit to private sector (in per cent of GDP)	na	na	na	na	11.5	13.7	16.6	10.5	na
Stock market capitalisation (in per cent of GDP) [2]	na	na	0.0	0.4	0.2	2.0	3.3	3.1	3.8
EBRD index of banking sector reform	1.0	1.0	2.0	3.0	3.0	2.7	2.3	2.7	2.7
EBRD index of reform of non-banking financial institutions	1.0	1.0	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	3.0	4.0	3.3	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	3.0	4.0	3.7	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	6.9	5.9	6.2	6.3	6.3	5.9	na	na	na
Life expectancy at birth, total (years)	69.8	69.6	69.5	69.5	69.1	69.0	69.3	69.5	na
Basic school enrolment ratio (in per cent)	89.6	90.3	91.4	92.6	93.9	95.0	97.0	na	na
Earnings inequality (GINI-coefficient)	na	22.6	27.6	27.8	30.3	42.2	na	na	na

[1] Data for non-performing loans for Credit Bank between 1994 and 1996 and Dacia Felix Bank in 1997 are not included. The large decrease in 2000 is due to the imposition of NBR regulations on loan classification and transfer of non-performining loans of Bancorex and Banca Agricola to Banking Assets Recovering Agency. Changes in non-performing loans data compared with previous Transition Reports are due to the change of loan categories included in non-performing loans (see definitions).

[2] Includes listings on the Bucharest Stock Exchange and RASDAQ over-the-counter market.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	1.5	3.9	7.1	3.9	-6.1	-5.4	-3.2	1.6	4.0
Private consumption	0.9	2.6	13.1	8.0	-3.1	-4.6	-4.9	-1.2	na
Public consumption	2.7	11.0	1.0	1.5	-11.6	14.1	-2.5	4.2	na
Gross fixed investment	8.3	20.7	6.9	5.7	-3.0	-18.1	-5.1	5.5	na
Exports of goods and services	11.1	19.0	17.0	2.0	11.4	na	9.7	23.9	na
Imports of goods and services	4.4	2.8	16.3	8.7	7.5	na	-5.1	29.1	na
Industrial gross output, unadjusted series	1.3	3.3	9.5	9.8	-5.6	-17.3	-8.8	8.2	na
Agricultural gross output	12.9	0.2	4.5	1.3	3.4	-7.6	5.5	-14.1	na
Employment				(Percentage change)					
Labour force (end-year)	-1.4	0.1	-6.6	-4.3	-1.3	-0.7	-2.9	na	na
Employment (end year)	-3.8	-0.5	-5.2	-1.2	-3.8	-3.2	-4.5	na	na
				(In per cent of labour force)					
Unemployment (end-year) [1]	10.4	10.9	9.5	6.6	8.9	10.3	11.8	10.5	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	256.1	136.7	32.3	38.8	154.8	59.1	45.8	45.7	34.2
Consumer prices (end-year)	295.5	61.7	27.8	56.9	151.4	40.6	54.8	40.7	29.2
Producer prices (annual average)	165.0	140.5	35.1	49.9	156.6	33.2	42.2	51.5	na
Producer prices (end-year)	195.4	73.4	32.0	60.4	154.3	19.8	62.9	48.6	na
Gross average monthly earnings in economy (annual average)	196.5	135.6	50.5	54.2	98.2	60.3	44.3	46.9	na
Government sector				(In per cent of GDP)					
General government balance	-0.4	-2.2	-2.5	-3.9	-4.6	-5.0	-3.5	-3.7	-3.7
General government expenditure	34.2	33.9	34.7	33.8	34.3	38.4	36.8	35.1	na
General government debt	na	na	17.6	28.1	27.9	30.6	34.7	31.6	na
Monetary sector				(Percentage change)					
Broad money (M3, end-year)	141.0	138.1	71.6	66.0	104.9	48.9	45.0	38.0	na
Domestic credit (end-year)	110.4	109.2	123.6	82.1	82.1	95.2	26.8	7.5	na
				(In per cent of GDP)					
Broad money (M3, end-year)	22.3	21.4	25.3	27.9	24.8	27.5	25.7	23.2	na
Interest and exchange rates				(In per cent per annum, end-year)					
Discount rate	70.0	58.0	35.0	35.0	40.0	35.0	35.0	35.0	na
1-week BUBOR	na	na	na	51.7	102.4	159.0	68.9	49.0	na
Deposit rate (average)	42.5	49.5	32.4	38.9	34.1	42.3	41.3	27.0	na
Lending rate (average)	86.4	61.8	47.5	53.6	55.6	58.9	62.0	47.3	na
				(Lei per US dollar)					
Exchange rate (end-year)	1,276	1,767	2,578	4,035	8,023	10,951	18,255	25,926	na
Exchange rate (annual average)	760	1,655	2,033	3,083	7,168	8,875	15,333	21,693	na
External sector				(In millions of US dollars)					
Current account	-1,174	-428	-1,774	-2,584	-2,137	-2,917	-1,296	-1,400	-2,340
Trade balance	-1,128	-411	-1,577	-2,494	-1,980	-2,625	-1,092	-1,684	-2,890
Merchandise exports	4,892	6,151	7,910	8,061	8,431	8,302	8,503	10,366	11,560
Merchandise imports	6,020	6,562	9,487	10,555	10,411	10,927	9,595	12,050	14,450
Foreign direct investment, net	87	341	417	415	1,267	2,079	1,025	1,009	900
Gross reserves (end-year), excluding gold	40	536	278	547	2,090	1,374	1,526	2,497	na
External debt stock	4,249	5,509	6,484	8,345	9,502	9,886	9,063	9,901	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	0.1	0.8	0.3	0.5	2.0	1.3	1.6	2.1	na
				(In per cent of export of goods and services)					
Debt service [2]	na	na	10.5	13.5	20.4	23.3	28.5	25.4	na
Memorandum items				(Denominations as indicated)					
Population (mid-year, millions)	22.8	22.7	22.7	22.6	22.6	22.5	22.5	22.3	na
GDP (in billions of lei)	20,036	49,773	72,136	108,920	250,677	337,012	521,736	796,534	1,112,010
GDP per capita (in US dollars)	1,158	1,323	1,564	1,563	1,551	1,688	1,512	1,644	na
Share of industry in GDP (in per cent)	33.8	36.2	32.9	34.2	35.6	27.5	27.8	27.6	na
Share of agriculture in GDP (in per cent)	21.0	19.9	19.8	19.1	18.8	14.5	13.9	11.4	na
Current account/GDP (in per cent)	-4.5	-1.4	-5.0	-7.3	-6.1	-7.7	-3.8	-3.8	-5.8
External debt - reserves, in US$ millions	4,209	4,973	6,206	7,798	7,412	8,512	7,537	7,404	na
External debt/GDP (in per cent)	16.1	18.3	18.3	23.6	27.2	26.0	26.6	27.0	na
External debt/exports of goods and services (in per cent)	74.7	76.6	68.9	86.7	95.4	103.8	91.8	81.7	na

[1] Registered unemployment. Based on ILO methodology, unemployment was lower (8.0, 6.7, 6.0, 6.3, 6.8 for 1995, 1996, 1997, 1998 and 1999 respectively).

[2] Debt service payments on private and public external debt.

Russia

Key reform challenges

- **Reforming the country's bureaucracy and judiciary is necessary to strengthen the policy implementation capacity and credibility of state institutions.**
- **Reform of the natural monopolies has started with the proposed restructuring of UES and management changes at Gazprom but sustaining progress in these areas is a key challenge.**
- **Banking sector reform has been the weakest element in the reform programme and a credible reform process would require both more effective prudential supervision by the central bank and a strategy for the commercial operation of state banks.**

Liberalisation

Trade reform initiatives improve WTO membership prospects.
The chances of WTO entry have improved. The government has prepared concrete objectives for the next round of talks and the Ministry of the Economy has drafted a law on product standards intended to satisfy WTO requirements. At present, around 80 per cent of goods imported into Russia require certificates, compared with only 16 per cent in the EU. A new system of import tariffs was also introduced at the beginning of the year. The maximum tariff was reduced to 20 per cent from 30 per cent, the average tariff rate to about 11 per cent from 13 per cent and the main tariff categories were reduced to four from seven. At the same time, Russia switched to VAT collection based on the destination principle for trade inside the CIS (except for energy products), bringing it into line with imports from other regions. The foreign currency surrender requirement was reduced in August to 50 per cent from 75 per cent.

Stabilisation

Large external surpluses continue to test macroeconomic management.
Preliminary data show a modest decline in the current account surplus and continued capital inflows in the first half of 2001. The central bank used unsterilised interventions to help stabilise the exchange rate. The government also partially sterilised the currency inflows by producing a substantial fiscal surplus and using part of it to repay foreign debt. Nevertheless, by the end of August, gross foreign reserves including gold had risen by US$ 9.5 billion to reach US$ 37.5 billion. As a result, base money grew by 18 per cent in the first half of the year, following a sharp increase in late 2000, which is a key reason for the higher than expected inflation rate.

Privatisation

Privatisation has been slow but a new round is making progress.
Large-scale privatisation was suspended by the Duma in late 2000 pending the adoption of new enabling legislation. A new privatisation law, adopted this summer, changes the responsibilities of the state authorities for privatisation decisions. The government will no longer need to secure Duma approval for its annual privatisation programme. Instead, the list of companies to be privatised will be submitted as an annex to the annual budget law. The Duma retains its full rights, however, to make decisions on privatisation of the natural monopolies. Large-scale privatisation has recently been resumed, with Rosgosstrakh (the largest insurance company) and Norsi Oil as the first major targets. The privatisation list for 2002 contains over 350 enterprises while privatisation proceeds are planned at RUR 28 billion to RUR 34 billion (about US$ 0.9 billion to US$ 1.1 billion).

Enterprise reform

The tax revolution continues.
The new tax system implemented this year includes a flat 13 per cent personal income tax, unification and reduction of social security contributions, reduction of turnover taxes and elimination of a number of smaller taxes. The Duma recently voted to slash the corporate profit tax to 24 per cent from 35 per cent with effect from next year while abolishing most of the existing exemptions. In addition, accelerated depreciation will be allowed and the scope of legitimate business expenses deductible from the tax base widened.

A breakthrough has been achieved in land legislation.
After an eight-year delay, in July 2001 the Duma approved a new Land Code. The code, which has now passed its third reading by the Duma, allows both Russians and foreigners to purchase, trade and mortgage urban and industrial land. The code also specifies the approval process for land transactions. Agricultural land issues will be regulated by a separate law.

Corporate governance is improving but much remains to be done.
Many enterprises have voluntarily adopted public commitments related to corporate conduct. Other companies are seeking a formal or informal rating of their governance standards. A corporate governance code is under preparation and in August 2001

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 First shares-for-loans auctions conducted
Nov Currency corridor introduced

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

2000
Feb Agreement with the London Club on long-term debt restructuring
May Appointment of the new government
Jul Government reform programme adopted

2001
Jan Income and social tax regime liberalised
Jun Large-scale privatisation resumed
Jul Profit tax law adopted

Enterprises, infrastructure, finance and social reforms

1990
- Dec — Law on banks and banking activities enacted
- Dec — Law on central bank enacted

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
- Nov — Bankruptcy law enacted
- Nov — RAO UES, Gazprom transformed into joint-stock companies

1994
- Jan — 60 per cent 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 enacted
- 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 bank insolvency enacted
- Feb — Investor protection law adopted
- Jul — Law on bank restructuring enacted
- Jul — Law on foreign investment adopted
- Jul — Mortgage law introduced

2000
- Jun — Start of the anti-oligarch campaign
- Jul — Law on reforming the federal power structure

2001
- May — Banking laws amended
- Jun — Judiciary reform initiated
- Jul — Deregulation package adopted
- Sep — Agency for regulating natural monopoly tariffs established

amendments to the company law were enacted. The revised rules provide greater protection for minority shareholders, among others, by preventing share dilutions and restricting the power of managers over large-scale transactions. Major improvements are needed, however, in transparency and disclosure practices in much of the Russian corporate sector.

Major deregulation measures adopted.
Several new measures aimed at reducing bureaucratic "red tape" and corruption have been passed by the Duma. The licensing law provides for major reductions in the number of activities subject to licensing, currently 415 at the federal level and totalling almost 2,000 including the regional and local levels. Another bill aims to simplify business registration, including the creation of a one-stop business registration window. A third new law reduces the number of state agencies entitled to inspect businesses while the number of on-site inspections and other investigations and their duration is also to be curtailed.

Infrastructure

Railway reform programme has been approved.
In May 2001 the prime minister approved a three-stage plan for restructuring the railway system. In the first stage, during 2001-02, the commercial and regulatory functions of the Railway Ministry will be separated and the legal basis for the reform process will be drawn up. In the second stage, up to 2005, the commercially viable parts of the railway business will be separated from the non-profitable activities while in the next five years the competitive segments of the industry will be privatised.

A compromise has been reached on UES restructuring.
After months of debate, in July 2001 the prime minister signed a decree on the restructuring of energy monopoly UES. The key strategic directions of the programme are: separation of transmission and distribution from the competitive segments of the sector; provision of equal access to the grid for all power producers and consumers; independent sector regulation; gradual transition to market-based tariff setting and elimination of cross-subsidisation; and investor protection. The restructuring process will take 8 to 10 years and will encompass three stages, with the full-scale reform starting in 2004. During the first, preparatory stage a federal network company, a system operator and a number of regional generating companies will be created and the legal and regulatory framework for further reforms will be established.

Gazprom placed under more effective control.
The government has moved to strengthen the management and control of Gazprom, in which it holds a 38 per cent share, by replacing its chief executive officer and increasing the number of state representatives on the board of directors to six. At the same time, a special working group was established to consider ways to remove the restrictions on foreign purchases of the domestic shares and investigations into the relationship between Gazprom and Itera were initiated. A major sectoral reform plan is being prepared. This could involve separating the transportation network from gas extraction and allowing equal access to the pipelines for all gas companies. The Ministry of the Economy also wants to equalise transport tariffs for the supply of domestic and foreign markets and increase domestic tariffs to reduce energy subsidies to the domestic market.

Financial institutions

Banking regulations have been tightened but structural weaknesses remain.
A package of banking law amendments was signed in May 2001. The new provisions aim at increased transparency and better regulation of the sector, including consolidated accounting for bank groups, strengthening the responsibility of bank management and shareholders, and streamlining the bankruptcy process for banks. The minimum capital requirement for new banks has recently been raised fivefold to US$ 5 million and a 2 per cent capital adequacy ratio has been set as a solvency criterion for bankruptcy. The amendments also greatly increase the enforcement powers of the central bank. However, the key test will be how these powers are actually used. While the government approved a strategy for the banking sector in September 2001, a concrete implementation plan remains to be clarified. In July the government and the central bank agreed on deadlines for its disinvestment from the banking system. The central bank is expected to withdraw from Vneshtorgbank (VTB) next year but it plans to give up control of Sberbank only once its share in the retail deposit market has fallen below 50 per cent and a deposit insurance system has been introduced.

Social reform

Major pension reform adopted.
Pension reform will start from 1 January 2002. The current pay-as-you-go system will be complemented with a pillar financed through the unified "social tax". The new system will include three components: (i) a guaranteed minimum state pension for all; (ii) a second state-funded element that will depend on the length of employment; and (iii) a "saving component" including contributions both from the employee and the employer, with the entitlement under this part of the system depending on the return of the invested funds. Rules on the actual operation and management of the pension funds have yet to be clarified.

Liberallisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **22.4 per cent**
Exchange rate regime – **managed float**

Privatisation
Primary privatisation method – **vouchers**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **no** [1]
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **50.3 per cent**
Private pension funds – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
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	7.0	7.0	6.0	5.0	5.0	5.0	5.0	na	na
Share of trade with non-transition countries (in per cent)	na	na	66.6	68.2	67.0	65.4	66.9	70.5	68.5
Share of trade in GDP (in per cent)	115.0	61.7	42.6	41.8	37.8	36.9	49.1	62.1	61.0
Tariff revenues (in per cent of imports) [2]	3.8	12.0	15.0	10.8	7.9	7.3	7.2	8.9	18.5
EBRD index of price liberalisation	3.0	3.0	3.0	3.0	3.0	3.0	2.7	2.7	3.0
EBRD index of forex and trade liberalisation	3.0	3.0	3.0	3.0	4.0	4.0	2.3	2.3	2.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.8	1.1	1.3	1.5	1.7	2.7	3.3	3.4	3.8
Private sector share in GDP (in per cent)	25.0	40.0	50.0	55.0	60.0	70.0	70.0	70.0	70.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	2.0	3.0	3.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of large-scale privatisation	2.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3	3.3
Enterprises									
Budgetary subsidies (in per cent of GDP) [3]	na	na	na	na	8.1	8.5	5.9	5.3	na
Effective statutory social security tax (in per cent)	105.0	67.9	64.3	62.2	57.8	71.3	62.4	59.3	na
Share of industry in total employment (in per cent)	29.6	29.3	27.1	25.9	24.8	23.1	18.7	na	na
Change in labour productivity in industry (in per cent)	-13.9	-11.9	-11.4	4.5	0.8	12.0	19.1	7.3	na
Investment rate/GDP (in per cent)	23.9	20.4	21.8	20.9	21.0	19.1	17.5	na	na
EBRD index of enterprise reform	1.0	1.0	1.7	2.0	2.0	2.0	2.0	1.7	2.0
EBRD index of competition policy	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	15.5	15.8	16.2	17.0	17.5	18.3	19.7	19.7	na
Railway labour productivity (1989=100)	89.8	75.4	57.7	56.8	54.6	58.6	60.9	72.1	83.3
Electricity tariffs, USc kWh (collection rate in per cent) [4]	na	na	2.20 (50)	2.33 (50)	3.00 (50)	3.20 (50)	2.7 (87)	1.1 (100)	na
Electricity consumption/GDP (1989=100)	113.3	116.1	120.5	123.5	125.7	122.3	126.0	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.4	2.4	na
Financial institutions									
Number of banks (of which foreign owned)	1747.0	2009.0	2456.0	2,297 (21)	2,029 (22)	1697 (26)	1476 (30)	1349 (32)	1311 (33)
Asset share of state-owned banks (in per cent)	na	na	na	na	na	37.0	41.9	na	na
Bad loans (in per cent of total loans)	na	na	na	12.3	13.4	12.1	30.9	25.8	15.3
Domestic credit to enterprises (in per cent of GDP)	na	11.8	12.1	8.5	7.4	9.4	12.8	11.5	na
Stock market capitalisation (in per cent of GDP) [5]	0.5	0.0	0.1	4.6	9.7	30.5	16.5	43.8	16.1
EBRD index of banking sector reform	1.0	1.0	2.0	2.0	2.0	2.3	2.0	1.7	1.7
EBRD index of reform of non-banking financial institutions	1.0	1.7	1.7	2.0	3.0	3.0	1.7	1.7	1.7
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	3.3	3.7	3.7	na
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	3.0	2.0	2.3	na
Social sector									
Expenditures on health and education (in per cent of GDP)	6.0	7.2	7.7	6.1	7.4	8.7	7.4	6.6	5.9
Life expectancy at birth, total (years)	67.8	65.2	64.0	64.8	66.0	66.7	67.0	65.8	na
Basic school enrolment ratio (in per cent)	89.3	88.3	88.6	88.8	88.5	88.2	89.1	na	na
Earnings inequality (GINI-coefficient)	37.1	46.1	44.6	47.1	48.3	na	na	na	na

[1] Although there is no general deposit insurance, deposits in Sberbank are covered by a formal deposit insurance scheme.
[2] Refers to all taxes on international trade.
[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] Includes listings on the Moscow Interbank Currency Exchange, Moscow Stock Exchange and RTS Stock Exchange.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	-8.7	-12.7	-4.1	-3.5	0.9	-4.9	5.4	8.3	5.5
Private consumption	1.2	1.2	-2.8	-4.7	5.4	-3.6	-3.4	8.0	na
Public consumption	-6.4	-2.9	1.1	0.8	-2.4	0.6	9.5	2.0	na
Gross fixed investment	-25.8	-26.0	-7.5	-19.3	-5.7	-11.2	2.4	18.0	na
Exports of goods and services	na	na	7.3	-2.0	4.2	2.7	-4.5	6.0	na
Imports of goods and services	na	na	16.6	6.9	10.6	-14.1	-21.7	16.0	na
Industrial gross output	-14.1	-20.9	-3.3	-4.0	1.9	-5.2	8.1	9.0	na
Agricultural gross output	-4.4	-12.0	-7.6	-5.1	0.1	-12.3	2.4	4.0	na
Employment				*(Percentage change)*					
Labour force (end-year)	-1.4	-1.4	-1.5	0.5	-0.6	0.2	1.1	na	na
Employment (end-year)	-1.7	-3.4	-3.1	-0.6	-2.1	-2.0	2.8	na	na
				(In per cent of labour force)					
Unemployment (end-year)	6.0	7.8	9.0	9.9	11.2	13.3	11.7	9.7	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	875.0	311.4	197.7	47.8	14.7	27.6	86.1	20.8	21.4
Consumer prices (end-year)	840.0	204.4	128.6	21.8	10.9	84.5	36.8	20.1	17.5
Producer prices (annual average)	941.9	337.4	236.5	50.8	19.7	7.0	58.9	31.6	na
Producer prices (end-year)	895.0	233.0	175.0	25.6	7.4	23.0	69.8	27.8	na
Gross average monthly earnings in economy (annual average)	904.7	277.3	119.5	48.4	20.2	15.2	44.4	43.1	na
Government sector [1]				*(In per cent of GDP)*					
General government balance	-7.3	-10.4	-6.0	-8.9	-7.9	-8.0	-3.3	3.0	3.0
General government expenditure	43.6	45.1	39.1	42.4	44.4	41.4	38.4	35.8	na
General government debt (domestic)	na	na	na	na	na	na	na	na	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	na	200.0	125.8	30.6	29.8	19.8	57.2	62.4	na
Domestic credit (end-year)	na	335.6	87.8	48.3	22.2	68.2	34.1	26.0	na
				(In per cent of GDP)					
Broad money (M2, end-year)	19.0	16.0	13.9	13.4	14.8	16.6	15.5	16.5	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Central bank refinance rate (uncompounded)	210.0	180.0	160.0	48.0	28.0	60.0	55.0	25.0	na
Treasury bill rate (all maturities) [2]	103.2	263.0	104.1	33.6	36.6	48.1	16.0	12.0	na
Lending rate	na	na	320.0	146.8	32.0	41.7	38.3	18.0	na
Deposit rate	na	na	102.0	55.1	16.8	17.1	9.4	5.0	na
				(Roubles per US dollar)					
Exchange rate (end-year) [3]	1.2	3.6	4.6	5.6	6.0	20.7	26.8	28.2	na
Exchange rate (annual average) [3]	1.0	2.2	4.6	5.1	5.8	10.0	24.6	28.2	na
External sector				*(In millions of US dollars)*					
Current account [4]	na	8,041	7,982	12,562	2,321	1,097	24,963	46,324	35,500
Trade balance [4]	15,342	17,024	20,725	22,934	17,363	17,100	35,846	60,703	50,400
Merchandise exports [4]	59,646	67,542	82,913	90,564	89,008	74,883	75,306	105,565	102,000
Merchandise imports [4]	44,304	50,518	62,188	67,630	71,645	57,783	39,460	44,862	51,600
Foreign direct investment, net	na	500	1,663	1,665	4,036	1,734	746	-346	2,000
International reserves (end-year), excluding gold	na	5,000	14,400	11,276	12,895	7,801	8,457	24,500	na
External debt stock [5]	na	126,500	127,000	135,100	134,100	157,700	154,600	142,198	na
				(In months of imports of goods and services)					
International reserves (end-year), excluding gold	na	0.9	2.1	1.6	1.7	1.3	1.9	4.7	na
				(In per cent of current account revenues, excluding transfers)					
Public debt service due [6]	na	23.6	19.6	16.6	10.9	14.2	23.0	13.1	na
Public debt service paid [6]	na	4.6	6.5	6.4	5.5	8.5	28.9	17.3	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, millions) [7]	148.7	148.4	148.3	148.0	147.5	146.4	145.7	145.4	na
GDP (in millions of roubles)	171,500	610,700	1,585,000	2,145,656	2,522,000	2,696,000	4,545,100	6,946,000	8,900,000
GDP per capita (in US dollars)	1,133	1,867	2,343	2,829	2,953	1,848	1,268	1,697	na
Share of industry in GDP (in per cent)	34.4	32.8	29.0	29.5	28.4	29.1	31.9	32.1	na
Share of agriculture in GDP (in per cent)	8.2	6.5	7.2	7.3	6.7	6.0	6.9	6.6	na
Current account/GDP (in per cent)	na	2.9	2.3	3.0	0.5	0.4	13.5	18.8	11.6
External debt - reserves, in US$ millions	na	131,500	132,600	153,824	151,205	176,199	170,243	143,500	na
External debt/GDP (in per cent)	na	49.3	42.3	39.4	37.7	68.0	96.7	68.1	na
External debt/exports of goods and services (in per cent)	na	179.8	157.3	159.0	159.2	210.9	211.9	145.8	na

[1] General consolidated government includes the federal, regional and local budgets and extra-budgetary funds and excludes transfers.
[2] The 1998 figure is the yield on obligations of the Central Bank of Russia.
[3] Data in new (denominated) roubles per US dollar. From 1 January, 1998, one new rouble = 1,000 old roubles.
[4] Data from the consolidated balance of payments, which covers transactions with both CIS and non-CIS countries.
[5] Data include public debt only. Debt to former COMECON countries is included.
[6] Difference between due and paid arises from accumulation of arrears on debt servicing.
[7] Data as of 1 January of the following year.

Slovak Republic

Key reform challenges

- **Sustained fiscal stability requires social welfare and pension system reform and strict control of new state guarantees as well as comprehensive reform of tax administration to improve budget revenues.**
- **The legal environment for enterprises needs to be improved through greater transparency and higher standards of corporate governance, efficient entry and exit rules, and strengthened minority shareholder and creditor rights.**
- **Recent progress in energy tariff reform should provide the basis for privatisation and liberalisation of power generation and energy distribution.**

Stabilisation

The fiscal position remains fragile.
The general government deficit is likely to rise above 4 per cent of GDP in 2001 and 2002, owing in part to removal of the import surcharge and higher expenditures on bank restructuring, exercised state guarantees and social welfare. The total of outstanding state guarantees reached approximately SKK 150 billion at the end of 2000, equivalent to about 16 per cent of GDP. The government restricted issuance of new guarantees in 2001 to rollovers of existing guarantees, principally for Slovak Railways and the dominant power generating company, Slovenske elektrarne, and new guarantees for a bridge loan of the National Property Fund, a municipality infrastructure project in Bratislava and Slovak Railways. The government is committed to improving public finance management and tax administration although planned fiscal decentralisation will test the capacity of the civil service to implement the new rules.

Enterprise reform

Competitiveness of the enterprise sector has increased ...
Productivity in the manufacturing sector has increased by 50 per cent in the last seven years, rising by 8 per cent in 2000 alone. This exceeds both the 38 per cent increase in real wages and the 28 per cent increase in euro-denominated unit labour costs in the same period. However, there was a large difference between the performance of local enterprises, which in general did not perform well due to governance problems and high debts, and the performance of foreign-owned enterprises. Further improvements in enterprise performance are expected due in part to foreign strategic investments in Slovnaft, a large oil refinery, and Vychodoslovenske zeleziarne, a dominant steel company.

... but a further increase in greenfield foreign direct investment is needed.
There was a substantial increase in foreign direct investment (FDI) in 2000 to more than US$ 2 billion, exceeding 10 per cent of GDP. The sale of the dominant telecommunications company, Slovak Telecom, in June 2000 accounted for about half of the total. A further increase in privatisation-related FDI in 2001 is expected, particularly if a 49 per cent stake is sold in the gas transit company, Slovensky Plynarensky Priemysel (SPP), which links Russia with western Europe. Existing large foreign investors, such as Volkswagen and US Steel, may attract foreign-owned suppliers but an increased effort is needed to improve the business environment for take-overs and for the establishment of smaller enterprises. It is also essential that the authorities diversify the economy as Volkswagen and US Steel each account for about 15 per cent of exports and, together with their suppliers, for more than 20 per cent of GDP.

Further measures are necessary to improve the investment climate.
The government has set up a commission for the preparation of new bankruptcy legislation which will take into account experience with the recent amendments to the bankruptcy code, the latest of which was enacted in August 2000. Further legislative changes, including amendments to the Commercial Code and a new Securities Act, are currently being discussed by parliament. However, the government needs to improve the court system to increase its transparency, lower corruption and shorten the length of court proceedings.

Infrastructure

Utility tariffs have increased as part of energy sector reforms.
The government increased administered prices of energy by 17 per cent on average in February 2001 to move towards cost-recovery levels and to lower cross-subsidisation between industrial users and households. In preparation for the privatisation of the dominant power generating company, Slovenske elektrarne, the grid and heating plants will be separated into independent entities by November 2001. In July 2001 the government liberalised the domestic electricity market for large end-users whose annual consumption exceeds 500 GWh. The government also appointed advisors for the privatisation of Slovenske elektrarne and the regional distribution gas and power companies.The monopoly state-owned gas transit and distribution company, SPP, was transformed into a joint-stock company in July 2001. The sale of a 49 per cent stake with management control is expected in the next few months.

Liberalisation, stabilisation, privatisation

1990

Jan	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

2000

Mar	EU accession negotiations started
Dec	OECD membership
Dec	Import surcharge abolished

Enterprises, infrastructure, finance and social reforms

1990
Jan Two-tier 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) collapses

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
Sep Major steel company sold to strategic investor
Nov Independent financial markets regulator established
Dec Largest bank sold to strategic investor

2001
Jul New banking law enacted

Railway reform has progressed.
The monopoly state railway company, Slovak Railways, will be divided into two separate entities, one responsible for railway infrastructure and the other taking over the transport and trade services. Management and accounts of freight and passenger services will be separated in the new company with the aim of splitting the transport services company into two separate companies. Railway debt, including that owed to the power distribution companies to be privatised, had reached SKK 40 billion by the end of 2000, equivalent to about 4 per cent of GDP. Passenger transport prices remain well below cost-recovery levels despite an increase of 12 per cent in February 2001. Freight tariffs increased by 15 per cent at the same time. The government is working on a project to reduce losses through route cancellations, transfers to regional authorities, privatisation of some assets and removal of subsidies for high-speed train tariffs.

Financial institutions

Bank privatisation and restructuring have advanced.
The two largest state-owned banks were sold in 2001. The largest bank in terms of assets, Slovenska sporitelna, was sold to Erste Bank of Austria for €425 million in January 2001. The second-largest bank, Vseobecna uverova banka, was sold to the Italian banking group IntesaBCI for €550 million in July 2001. The government has retained a majority stake in three financial institutions: the third-largest bank, Investicna a rozvojova banka, the medium-sized Postova banka and the dominant insurance company, Slovenska poistovna. All three are scheduled to be sold by the end of the year. The privatisation of the two largest banks was preceded by the transfer of SKK 108 billion worth of bad assets (more than 10 per cent of GDP) from the two banks to state consolidation agencies in 1999-2000. The first package of bad loans with a nominal value of SKK 13 billion (US$ 261 million) was sold off by the state agency, Slovenska konsolidacna, for SKK 431 million (US$ 8.7 million), about 3.3 per cent of the nominal value, to a consortium of CSFB and a Slovak brokerage, Penta Group, in June 2001.

New banking legislation has been introduced.
A new banking act was enacted in July 2001, aligning banking legislation with EU directives and strengthening banking supervision. The new act includes important provisions on bank management, accounting standards, transparency, financial accounts of financial groups being reported on a consolidated basis, and monitoring of market risks.

The capital market remains illiquid.
Despite establishment of the new independent financial market regulator in November 2000, the Bratislava stock exchange remains a relatively small market, with a capitalisation of US$ 3.3 billion (15 per cent of GDP) and illiquid, with turnover at an annual average of US$ 60 million, about 2 per cent of market capitalisation. There have been no primary initial public offerings since the start of trading on the local stock market in April 1993 and about two-thirds of shares have rarely traded. The lack of liquid shares on the market and the fact that the remaining large state-owned enterprises will be privatised through direct sales to strategic investors instead of share offerings through the local capital market may hinder the planned introduction of mandatory private pension funds in 2003.

Social reform

Health care costs continue to rise.
The provision of health care services has been characterised by growing costs and increasing debts to SKK 10.2 billion, equivalent to 1.3 per cent of GDP at the end of 2000. The government plans to review the existing health care system, focusing on closing some under-used health care facilities and establishing a supplementary health insurance scheme. Consideration will also be given to strengthening incentives for medical practices to balance patient and medical costs more effectively.

Pension costs are becoming unsustainable.
There has been no significant change in the pay-as-you-go pension system since the beginning of transition. The government spent about 13 per cent of GDP on social transfers in 2000, the main item being expenditure on pensions. The share of the population aged 65 and over increased from 8.9 per cent in 1985 to 11.1 per cent in 1999 and further increases are expected. The retirement age, currently at 60 for men and 54-57 for women depending on the number of children, needs to be raised and the pension level adjustment method amended, among other pension reform measures, to ensure the sustainability of the pension system. The state pension system is currently supplemented by four supplementary private pension companies, with 233,000 clients and SKK 4.1 billion in assets, equivalent to about 0.5 per cent of GDP.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Stabilisation
Share of general government tax revenue in GDP – **34.2 per cent**
Exchange rate regime – **floating**

Privatisation
Primary privatisation method – **direct sales**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **yes**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **8.6 per cent**
Private pension funds – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	na	21.8	21.8	21.8	21.8	15.1	14.7	15.2	na
Number of goods with administered prices in EBRD-15 basket	5.0	5.0	5.0	5.0	5.0	5.0	4.0	4.0	3.0
Share of trade with non-transition countries (in per cent)	na	39.5	44.9	45.6	49.4	54.2	62.0	62.0	64.0
Share of trade in GDP (in per cent)	117.0	93.2	91.6	94.7	100.9	104.6	110.9	109.1	128.4
Tariff revenues (in per cent of imports) [1]	2.6	2.3	3.4	3.3	2.9	3.3	2.6	2.7	2.2
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	4.0	4.0	4.0	4.0	4.3	4.0	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	3.7	4.7	6.7	8.4	9.7	10.2	10.8	11.0	14.7
Private sector share in GDP (in per cent)	30.0	45.0	55.0	60.0	70.0	75.0	75.0	75.0	80.0
Private sector share in employment (in per cent)	28.4	40.8	52.8	59.6	63.1	64.6	68.9	70.0	75.0
EBRD index of small-scale privatisation	4.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	2.0	3.0	3.0	3.0	3.0	4.0	4.0	4.0	4.0
Enterprises									
Budgetary subsidies (in per cent of GDP)	4.0	3.7	3.0	2.6	2.3	2.4	2.0	1.9	4.0
Effective statutory social security tax (in per cent)	na	73.9	75.0	89.7	94.1	93.3	86.9	80.7	na
Share of industry in total employment (in per cent)	30.1	27.8	27.5	28.1	27.7	25.0	26.6	24.4	23.0
Change in labour productivity in industry (in per cent)	7.3	-1.1	9.0	4.0	2.5	3.8	7.8	2.6	7.2
Investment rate/GDP (in per cent)	32.9	32.7	29.4	27.4	36.9	38.6	40.8	30.1	na
EBRD index of enterprise reform	2.0	3.0	3.0	3.0	3.0	2.7	2.7	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	15.5	16.7	18.7	20.8	23.2	25.9	28.6	30.8	na
Railway labour productivity (1989=100)	67.6	65.4	60.7	68.7	60.8	63.1	60.8	53.0	61.0
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	2.9 (95)	3.1 (95)	3.2 (95)	2.9 (95)	2.8 (na)	3.5 (na)	na
Electricity consumption/GDP (1989=100)	94.0	93.1	90.9	95.3	92.8	86.4	77.3	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.1	2.1	2.6
Financial institutions									
Number of banks (of which foreign owned)	na	28 (13)	29 (14)	33 (18)	29 (14)	29 (13)	27 (11)	25 (10)	23 (13)
Asset share of state-owned banks (in per cent)	na	70.7	66.9	61.2	54.2	48.7	50.0	50.7	49.1
Non-performing loans (in per cent of total loans)	na	12.2	30.3	41.3	31.8	33.4	44.3	32.9	26.2
Domestic credit to private sector (in per cent of GDP)	na	30.4	23.0	26.3	30.4	42.1	43.9	40.5	37.6
Stock market capitalisation (in per cent of GDP) [2]	na	na	7.3	6.7	11.5	9.3	4.7	3.8	3.9
EBRD index of banking sector reform	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	3.0
EBRD index of reform of non-banking financial institutions	1.0	2.0	2.7	2.7	2.7	2.3	2.3	2.3	2.3
Legal environment									
EBRD rating of legal extensiveness (company law)	na	na	na	na	na	3.0	3.0	4.0	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	3.0	2.0	3.3	3.0
Social sector									
Expenditures on health and education (in per cent of GDP)	na	9.1	8.5	8.9	11.1	10.7	10.2	9.9	9.6
Life expectancy at birth, total (years)	71.8	72.4	72.3	72.3	72.7	72.7	72.6	72.7	na
Basic school enrolment ratio (in per cent)	95.7	94.9	94.4	94.3	93.4	na	93.9	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

[1] Refers to import tariffs, customs duties and import surcharge.

[2] Data from Bratislava Stock Exchange.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	*Projection*
Output and expenditure				*(Percentage change in real terms)*					
GDP	-3.7	4.9	6.7	6.2	6.2	4.1	1.9	2.2	3.0
Private consumption	-1.5	1.0	3.0	8.2	5.6	5.3	0.1	-3.4	na
Public consumption	-2.2	-11.4	2.1	21.0	4.0	4.0	-6.9	-0.9	na
Gross fixed investment	-5.4	-5.0	5.3	32.0	12.0	11.1	-18.8	-0.7	na
Exports of goods and services	-0.5	14.2	3.0	0.7	17.6	12.2	3.6	15.9	na
Imports of goods and services	-0.8	-3.4	9.2	17.2	13.1	19.9	-6.1	10.2	na
Industrial gross output	-5.4	6.8	8.3	2.5	1.7	3.4	-3.4	9.1	na
Agricultural gross output	-8.1	4.8	2.3	2.0	-1.0	-5.9	1.0	3.2	na
Employment				*(Percentage change)*					
Labour force (end-year)	-0.2	2.2	1.2	2.1	1.0	0.9	0.9	2.0	na
Employment (end-year)	-2.6	-1.0	2.4	-1.4	-2.3	-1.0	-1.8	-1.4	na
				(In per cent of labour force)					
Unemployment (end year)	14.4	14.6	13.1	12.8	12.5	15.6	19.2	17.9	na
Prices and wages				*(Percentage change)*					
Consumer prices (annual average)	23.2	13.4	9.9	5.8	6.1	6.7	10.6	12.0	7.4
Consumer prices (end-year)	25.1	11.7	7.2	5.4	6.4	5.6	14.2	8.4	6.9
Producer prices (annual average)	17.2	10.0	9.0	4.1	4.5	3.3	3.8	9.8	na
Producer prices (end-year)	18.8	9.4	7.1	4.7	4.4	1.6	7.7	10.0	na
Gross average monthly earnings in economy (annual average)	18.4	17.0	14.3	13.3	13.1	9.6	7.2	6.5	na
Government sector [1]				*(In per cent of GDP)*					
General government balance	-6.0	-1.5	0.4	-1.3	-5.2	-5.0	-3.6	-3.6	-4.1
General government expenditure	47.6	45.5	45.2	47.0	45.5	42.9	43.3	45.4	na
General government debt	31.5	28.0	24.6	24.5	23.7	26.0	28.4	30.4	na
Monetary sector				*(Percentage change)*					
Broad money (M2, end-year)	16.8	20.1	19.1	16.6	9.1	2.7	13.0	15.4	na
Domestic credit (end-year)	na	8.2	7.6	14.4	3.1	11.2	7.5	9.1	na
				(In per cent of GDP)					
Broad money (M2, end-year)	63.9	64.3	65.4	68.7	66.2	62.1	64.6	68.5	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinancing rate	na	na	na	9.7	19.2	11.3	8.7	8.0	na
3-months BRIBOR	na	na	na	14.9	26.5	18.3	14.3	7.9	na
Deposit rate [2]	8.7	9.2	8.2	6.2	8.7	10.4	9.9	5.6	na
Lending rate [2]	14.1	14.4	14.8	13.2	16.2	16.2	13.5	10.8	na
				(Koruna per US dollar)					
Exchange rate (end-year)	33.2	31.3	29.6	31.9	34.8	36.9	42.1	47.4	na
Exchange rate (annual average)	30.8	32.0	29.7	30.7	33.6	35.2	41.4	46.2	na
External sector				*(In millions of US dollars)*					
Current account	-601	665	391	-2,098	-1,952	-2,059	-1,083	-713	-1,327
Trade balance	-932	59	-228	-2,293	-2,081	-2,293	-1,103	-917	-1,350
Merchandise exports	5,447	6,691	8,579	8,831	9,639	10,667	10,197	11,870	12,750
Merchandise imports	6,379	6,633	8,807	11,124	11,720	12,959	11,301	12,786	14,100
Foreign direct investment, net	107	236	194	199	84	374	701	2,058	2,000
Gross reserves (end-year), excluding gold	395	1,605	3,306	3,403	3,204	2,867	3,366	4,077	na
External debt stock	3,380	4,660	5,678	7,670	9,896	11,902	10,518	10,804	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold	0.6	2.3	3.7	3.1	2.8	2.3	3.1	3.4	na
				(In per cent of current account revenues, excluding transfers)					
Debt service due	8.4	8.6	9.1	10.6	12.4	11.2	16.5	17.1	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, millions)	5.3	5.3	5.4	5.4	5.4	5.4	5.4	5.4	na
GDP (in millions of koruna)	390,600	466,200	546,000	606,100	686,100	750,800	815,300	887,200	981,186
GDP per capita (in US dollars)	2,384	2,721	3,423	3,679	3,802	3,970	3,650	3,556	na
Share of industry in GDP (in per cent)	35.4	30.6	29.1	29.5	26.8	25.5	24.2	25.8	na
Share of agriculture in GDP (in per cent)	6.6	7.4	6.3	5.9	4.8	4.4	4.4	4.4	na
Current account/GDP (in per cent)	-4.7	4.6	2.1	-10.6	-9.6	-9.7	-5.5	-3.7	-6.4
External debt - reserves, in US$ millions	2,985	3,055	2,372	4,267	6,692	9,035	7,152	6,727	na
External debt/GDP (in per cent)	26.6	32.0	30.9	38.8	48.5	55.9	53.4	56.3	na
External debt/exports of goods and services (in per cent)	45.7	52.1	51.8	70.4	83.8	91.8	86.3	76.5	na

[1] General government includes the state, municipalities and extra-budgetary funds. The general government balance excludes privatisation revenues.

[2] Weighted average over all maturities. Lending rate excludes loans at zero interest rate since 1995.

Slovenia

Key reform challenges

- **The provision of state aid to enterprises undergoing restructuring has become more transparent. However, the privatisation of restructured enterprises and the closure of non-viable firms should be pursued more vigorously.**
- **The liberalisation and privatisation of infrastructure are advancing and the government should maintain the momentum by developing an appropriate institutional framework.**
- **The planned privatisation of state-owned banks would enhance competition in the banking system and the implementation should adhere to the agreed timetable.**

Liberalisation

Capital account transactions are liberalised further.
While restrictions on inward and outward direct investments were lifted in 1999, restrictions on portfolio flows remained in the form of fiduciary accounts. Under this system, a foreign portfolio investor could only purchase securities through a brokerage or a bank, debited to the fiduciary account opened at the bank. Upon purchase, a bank had to pay a premium for the purchase of the right to buy foreign currency, unless the buyer of securities renounced his right to sell them within a certain period. Effective from July 2001, foreign portfolio investments for all long-term securities (shares and bonds) are no longer subject to these obstacles although some restrictions remain for investments in short-term securities with maturities of less than six months. Foreign investor participation in the Ljubljana stock exchange has dwindled from the peak in 1997, when foreign investors accounted for more than 20 per cent of the market turnover, to 1.5 per cent in 2000.

Stabilisation

Widespread indexation contributes to persistent inflation.
The average annual rate of inflation increased to 8.9 per cent in 2000 from 6.1 per cent in 1999, due mainly to oil price increases, and these inflationary pressures have persisted in the current year. This is due in part to the almost full indexation of nominal wages, pensions and interest rates and there are risks that inflationary expectations are becoming further entrenched. The central bank, which has traditionally been concerned with external competitiveness, must seek to ensure that both inflation and inflationary expectations remain in check. This could be achieved by clarifying the overriding objectives of monetary policy.

Privatisation

The Slovene Development Corporation is to be closed.
At mid-2001 the state still held shares in around 200 mainly large companies through the state-owned Slovene Development Corporation (SRD). The SRD was established in 1998 with the mandate of liquidating or restructuring troubled enterprises before privatisation and managing state assets. It also directs funds to privatised firms for restructuring purposes, raising concerns that it has become an extra-budgetary vehicle to provide enterprise subsidies. In order to comply with EU competition policy requirements, which specify rules on state aid, in April 2001 the government decided to close the SRD at the end of 2001. In 2000 the SRD sold its stakes in 15 companies, generating revenues of SIT 3.3 billion (€16 million). By the end of July 2001 it had divested its holdings in six more companies and announced tenders for its shares in a further six companies. The unsold assets of the SRD will be transferred to the Ministry of Finance upon closure. The SRD continues to be actively involved in the restructuring of troubled companies. In March 2001 it invested DM 26.5 million in Tovarna Vozil Maribor (Maribor Vehicles Factory) and in April 2001 the government obliged the SRD to provide funding to a troubled state-owned shoemaker, Peko.

Enterprise reform

Steel restructuring moves ahead.
In November 2000 the government began to restructure four major steel companies under the Slovene Steelworks holding company, in line with EU competition policy requirements. The government will discontinue state subsidies to the companies from the beginning of 2002. It is planned that the companies' non-core activities will be liquidated and their core activities privatised in 2002. In preparation for the privatisation, the government intends to take over the Slovene Steelworks' €220.5 million debt at the end of 2001.

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

2001
- Jul Restrictions on foreign investment in long-term securities removed

Enterprises, infrastructure, finance and social reforms

1990
Apr Enterprise restructuring agency established

1991
Oct Bank restructuring agency established

1992
Sep Restructuring of socially owned enterprises begins

1993
Jan Bank rehabilitation begins
Apr Competition law adopted
Jun Company law enacted
Jul Electric power sector law adopted
Dec Railway law adopted

1994
Jan IAS introduced
Jan Bankruptcy law enacted
Jan Investment company law adopted
Mar Securities law enacted
Aug BIS capital adequacy adopted
Sep Insurance law adopted

1995
Jan Telecommunications and postal services separated
Sep Competition agency established

1996
Jan First privatised company listed on stock exchange
Jul First bank bankruptcy initiated

1997
Feb First GDR issue
May Telecommunications law adopted
Jul Bank rehabilitation concluded
Jul Take-over 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
Jul Independent energy regulator established

2001
Apr New telecommunications law adopted
Jul Independent telecommunications regulator established

Infrastructure

A foreign strategic investor takes control of the second-largest mobile operator.
In February 2001 Austrian mobile telephony operator Mobilkom acquired a 49 per cent stake in Simobil, the country's second-largest mobile operator in terms of the number of subscribers. Another 26 per cent plus one share was acquired by Teleimpuls, a company 49 per cent owned by Mobilkom. The entire value of the transaction was DM 237 million. Mobilkom's entry is notable, as it is the first foreign investor to hold a controlling stake in a telecommunications company. Its presence is also likely to increase competitive pressure in the mobile telephony market, currently dominated by Mobitel, which is a subsidiary of the state-owned fixed-line monopoly, Telekom Slovenia.

Telecommunications market has been liberalised.
The new telecommunications act adopted in April 2001 provides a framework for the liberalisation of the telecommunications market and the establishment of an independent regulator. The law is in line with EU legislation. The government is planning to reduce its 65 per cent share in Telekom Slovenia to less than 50 per cent through public offerings and sales to a strategic investor. However, privatisation is only likely to take place when market conditions improve. A government decree for the establishment of an independent regulator, the Agency for Telecommunications, was issued in July 2001. In 2000 the Competition Protection Office (CPO) investigated a complaint filed by an Internet service provider, ABM, involving the alleged abuse by Telekom Slovenia of its dominant position in the fixed-voice telephony market. The CPO ruled in favour of ABM but Telekom Slovenia has filed an appeal at the court and the judgement is still pending. Telekom Slovenia was also in dispute with Incotel, a subsidiary of a Canadian Voice-over Internet Protocol (VoIP) service company, over inter-network connections. A court decision in July 2001 ruled in favour of Incotel, thereby establishing competition in the speech telephony services market for the first time.

Liberalisation of the electricity market advances gradually.
In accordance with the Energy Act of September 1999, an independent regulator, the Energy Agency, was established in July 2000 and started operations in January 2001. However, the provision of new licences for distribution and sales companies and the setting of an appropriate tariff formula were not in place in time for the market liberalisation for large users that became effective in April 2001. The government has therefore established a six-month transition period, during which energy prices will be frozen. In April 2001 the Energy Agency began publishing use-of-network tariffs and issuing licences. Borzen, a newly established market operator and a subsidiary of the Slovenian national electricity transmission company, ELES, has begun to undertake the role of managing the wholesale electricity market with the eventual goal of establishing a daily market for electricity trading.

Financial institutions

The entry of strategic foreign investors is enhancing competition.
While banks in Slovenia are generally more efficient and profitable than their counterparts in other EU candidate member countries, the banking system had been held back by the oligopolistic behaviour of the three largest banks that controlled over 50 per cent of the banking system at the end of 2000. However, liberalisation in 1999 of foreign entry and of foreign borrowing by residents and abolition of interest rate ceilings on deposits have created a more competitive environment. In May 2001 Société Générale (France) successfully acquired a 96.5 per cent stake in SKB, the third-largest bank in terms of assets. Privatisation plans are moving forward for the two largest banks, Nova Ljubljanska Banka (NLB) and Nova Kreditna Banka Maribor (NKBM). The government has decided to sell 65 per cent minus one share of NKBM to a foreign strategic investor during 2001, reducing its stake to 25 per cent plus one share. An international public tender for NKBM was announced in July 2001. With respect to NLB, the government has decided to reduce its 83 per cent stake to 25 per cent plus one share and to sell 34 per cent to "key investors" and 14 per cent minus one share to portfolio investors. An international public tender was announced in September 2001. During the process, shareholdings in the three affiliated banks will be consolidated.

Social reform

A new wage adjustment mechanism is being adopted.
Incomes policy has long played an important role in establishing the framework for setting wages in both the public and private sectors. The social partners – the government, employers and labour unions – agree annually to a formula under which wages are adjusted to inflation. While this policy has resulted in real wage increases below the increases in labour productivity, backward-looking adjustments to inflation have meant that price increases caused by external shocks had a persistent effect. At the end of 2000 the social partners in the public sector reached an agreement whereby wages will adjust to expected inflation with an element of further adjustment if price increases exceed a pre-established threshold. In May 2001 the social partners in the private sector also agreed to a forward-looking wage adjustment formula for wage increases from January 2002.

Liberalisation
Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **vouchers**
Tradability of land – **full except foreigners**

Infrastructure
Independent telecoms regulator – **yes**
Separation of railway accounts – **yes**
Independent electricity regulator – **no**

Social reform
Share of the population in poverty – **1.3 per cent**
Private pension funds – **yes**

Stabilisation
Share of general government tax revenue in GDP – **39.5 per cent**
Exchange rate regime – **managed float**

Enterprises and markets
Competition Office – **yes**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **yes**
Secured transactions law – **restricted**
Securities commission – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	23.7	19.8	18.4	22.5	22.4	20.4	17.0	14.3	13.7
Number of goods with administered prices in EBRD-15 basket	5.0	6.0	5.0	5.0	5.0	4.0	2.0	2.0	1.0
Share of trade with non-transition countries (in per cent)	na	74.6	75.2	76.0	73.9	73.3	74.1	75.5	73.1
Share of trade in GDP (in per cent)	100.4	97.2	97.3	94.2	92.9	96.6	96.9	92.1	103.5
Tariff revenues (in per cent of imports)	6.7	7.3	7.0	7.1	6.2	4.0	2.9	2.5	1.7
EBRD index of price liberalisation	3.0	3.0	3.0	3.0	3.0	3.3	3.3	3.3	3.3
EBRD index of forex and trade liberalisation	3.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.0	0.0	0.4	0.9	1.4	2.2	2.5	2.6
Private sector share in GDP (in per cent)	30.0	40.0	45.0	50.0	55.0	60.0	60.0	60.0	65.0
Private sector share in employment (in per cent)	16.0	19.0	22.0	48.0	na	na	na	na	na
EBRD index of small-scale privatisation	3.0	4.0	4.0	4.0	4.3	4.3	4.3	4.3	4.3
EBRD index of large-scale privatisation	1.0	2.0	2.0	2.7	2.7	3.0	3.0	3.0	3.3
Enterprises									
Budgetary subsidies (in per cent of GDP)	2.9	2.6	2.0	1.9	1.4	1.4	1.5	1.7	1.5
Effective statutory social security tax (in per cent)	88.4	98.4	94.6	92.4	91.6	93.7	94.9	93.5	na
Share of industry in total employment (in per cent)	na	44.1	42.2	43.2	42.1	40.5	39.5	37.8	na
Change in labour productivity in industry (in per cent)	na	na	10.5	-3.9	4.0	2.7	5.4	5.7	na
Investment rate/GDP (in per cent)	18.4	18.8	19.8	21.4	22.6	23.5	24.2	27.4	26.7
EBRD index of enterprise reform	1.0	2.0	2.7	2.7	2.7	2.7	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	2.7
Infrastructure									
Main telephone lines per 100 inhabitants	24.8	26.4	28.7	30.8	33.3	35.8	38.1	42.7	45.5
Railway labour productivity (1989=100)	79.0	76.2	94.2	119.2	103.4	117.0	120.2	118.4	123.0
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	6.75 (92)	7.36 (95)	7.40 (95)	9.37 (97)	9.75 (99)	8.73 (99)	na
Electricity consumption/GDP (1989=100)	104.4	101.5	101.9	99.4	96.7	96.1	94.9	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.6	2.6	2.9
Financial institutions									
Number of banks (of which foreign owned) [1]	45 (2)	45 (5)	44 (6)	39 (6)	36 (4)	34 (4)	30 (3)	31 (5[1])	28 (6[1])
Asset share of state-owned banks (in per cent)	na	47.8	39.8	41.7	40.7	40.1	41.3	41.7	42.2
Non-performing loans (in per cent of total loans) [2]	na	na	13.8	9.3	10.1	10.0	9.5	8.6	8.5
Domestic credit to private sector (in per cent of GDP)	23.3	22.1	23.1	27.5	28.8	28.6	32.8	35.8	na
Stock market capitalisation (in per cent of GDP)	na	na	4.1	1.8	3.6	9.3	12.2	11.9	24.0
EBRD index of banking sector reform	2.0	3.0	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	2.7	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	3.0	3.0	4.0	4.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	4.0	3.0	4.0	3.7
Social sector									
Expenditures on health and education (in per cent of GDP)	12.3	13.1	12.8	13.2	13.1	13.3	13.3	13.1	13.5
Life expectancy at birth, total (years)	73.3	73.3	73.4	73.4	74.4	74.7	74.8	75.1	na
Basic school enrolment ratio (in per cent)	97.6	97.8	96.7	97.3	99.8	99.8	98.2	na	na
Earnings inequality (GINI-coefficient)	26.0	27.6	27.5	35.8	29.8	30.7	na	na	na

[1] Includes one foreign branch.

[2] Changes in non-performing loans data compared with previous Transition Reports are due to the change of loan categories included in non-performing loans (see definitions).

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				(Percentage change in real terms)					
GDP	2.8	5.3	4.1	3.5	4.6	3.8	5.2	4.6	2.2
Private consumption	13.9	4.0	9.1	2.0	2.8	3.3	6.0	0.8	na
Public consumption	5.3	2.1	2.5	3.4	4.3	5.8	4.6	3.1	na
Gross fixed investment	10.7	14.1	16.8	8.9	11.6	11.3	19.1	0.2	na
Exports of goods and services	1.9	9.4	1.1	3.6	11.6	6.7	1.7	12.7	na
Imports of goods and services	13.0	6.0	11.3	2.1	11.9	10.4	8.2	6.1	na
Industrial gross output	-2.8	6.4	2.0	1.0	1.0	3.7	-0.5	6.2	na
Agricultural gross output [1]	-4.2	4.2	1.6	1.1	-2.9	3.1	2.3	na	na
Employment [2]				(Percentage change)					
Labour force (mid-year)	0.1	0.5	1.7	-0.6	2.1	1.8	-2.0	0.0	na
Employment (mid-year)	-2.3	0.7	3.6	-0.5	2.3	1.0	-1.7	0.2	na
				(In per cent of labour force)					
Unemployment (mid-year)	9.1	9.1	7.4	7.3	7.1	7.6	7.4	7.2	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	32.9	21.0	13.5	9.9	8.4	8.0	6.1	8.9	8.6
Consumer prices (end-year)	22.8	19.5	9.0	9.0	8.8	6.5	8.0	8.9	8.0
Producer prices (annual average)	21.6	17.7	12.8	6.8	6.1	6.0	2.1	7.6	na
Producer prices (end-year)	18.6	18.2	7.9	5.8	6.8	3.6	3.5	9.2	na
Gross average monthly earnings in economy (annual average) [3]	47.8	25.4	18.4	15.3	11.7	9.6	9.6	10.6	na
Government sector [4]				(In per cent of GDP)					
General government balance	0.6	-0.2	-0.3	-0.2	-1.7	-1.4	-0.9	-1.3	-1.5
General government expenditure	44.1	43.6	43.4	42.9	43.8	44.4	44.5	44.1	na
General government debt	21.1	18.5	18.8	22.7	23.2	23.7	24.5	25.1	na
Monetary sector				(Percentage change)					
Broad money (M3, end-year)	63.2	43.3	28.1	20.5	24.3	19.8	13.2	15.3	na
Domestic credit (end-year)	101.4	27.2	35.1	13.2	14.2	22.4	19.3	16.7	na
				(In per cent of GDP)					
Broad money (M3, end-year)	35.7	39.7	42.4	44.4	48.5	51.9	52.4	54.7	na
Interest and exchange rates				(In per cent per annum, end-year)					
Discount rate	18.0	16.0	10.0	10.0	10.0	10.0	8.0	10.0	na
Interbank market rate (average)	34.7	24.7	15.9	10.2	9.8	5.6	6.9	7.2	na
Deposit rate (31-90 days)	30.2	27.9	20.8	11.2	13.9	7.0	9.6	10.9	na
Lending rate (short-term working capital)	42.6	38.5	28.0	18.3	20.3	12.3	15.2	16.3	na
				(Tolars per US dollar)					
Exchange rate (end-year)	131.8	126.5	126.0	141.5	169.2	161.2	196.8	227.4	na
Exchange rate (annual average)	113.2	128.8	118.5	135.4	159.7	166.1	181.8	222.7	na
External sector				(In millions of US dollars)					
Current account	192	574	-100	31	12	-147	-783	-612	-335
Trade balance	-154	-336	-953	-825	-776	-789	-1,245	-1,139	-886
Merchandise exports	6,083	6,832	8,350	8,353	8,408	9,091	8,623	8,808	9,160
Merchandise imports	6,237	7,168	9,303	9,178	9,184	9,880	9,868	9,947	10,046
Foreign direct investment, net	111	131	183	188	340	250	144	110	385
Gross reserves (end-year), excluding gold [5]	788	1,499	1,821	2,297	3,315	3,639	3,168	3,196	na
External debt stock	1,873	2,258	2,970	3,981	4,123	4,915	5,400	6,217	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold [5]	1.3	2.2	2.0	2.6	3.8	3.8	3.3	3.4	na
				(In per cent of current account revenues, excluding transfers)					
Debt service [6]	na	4.7	6.5	8.5	8.4	13.0	7.7	9.1	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 millions of tolars)	1,435,095	1,852,997	2,221,459	2,555,369	2,907,277	3,253,751	3,648,401	4,035,518	4,477,232
GDP per capita (in US dollars)	6,370	7,231	9,418	9,439	9,103	9,793	10,050	9,073	na
Share of industry in GDP (in per cent)	29.3	30.3	28.3	27.9	28.0	28.1	27.3	27.7	na
Share of agriculture in GDP (in per cent)	4.5	4.0	3.9	3.9	3.7	3.6	3.2	2.9	na
Current account/GDP (in per cent)	1.5	4.0	-0.5	0.2	0.1	-0.8	-3.9	-3.4	-1.8
External debt - reserves, in US$ millions	1,085	759	1,149	1,684	808	1,277	2,232	3,021	na
External debt/GDP (in per cent)	14.8	15.7	15.8	21.1	22.6	25.1	26.9	34.3	na
External debt/exports of goods and services (in per cent)	25.1	26.1	28.6	38.0	39.4	44.2	51.3	58.1	na

[1] Agricultural value added.

[2] Based on labour force survey data. Those figures have been consistently lower than those calculated as officially registered unemployment.

[3] Data for all enterprises employing three or more persons.

[4] General government includes the state, municipalities and extra-budgetary funds. Privatisation revenues from state and socially owned enterprises are placed below the line. Balances from 1999 are based upon the new budget classifications.

[5] Total reserves excluding gold of the Bank of Slovenia.

[6] Long-term debt only.

Tajikistan

Key reform challenges

- **Heighted tensions within Central Asia following the military intervention in Afghanistan require of the government a focus on safeguarding the Tajik peace agreement and macroeconomic stability.**

- **In order to make effective use of international donor support, the government needs to strengthen public sector management and governance. High external debt restricts access to the fresh inflows of foreign investment.**

- **Effective implementation of bankruptcy legislation as well as further strengthening of the financial sector are needed to spur improvements in management and performance of privatised enterprises.**

Liberalisation

Tajikistan gains observer status at the WTO but internal liberalisation remains incomplete.
Tajikistan has a relatively open trade system with a simple average tariff rate of 8.3 per cent (individual tariff rates range from 0 to 30 per cent) and no significant non-tariff barriers. The country officially applied for WTO membership in May 2001 and gained observer status in July but full membership is still several years off. Progress is being made with the planned phase-out of cotton and aluminium sales taxes by 2002-03 and the harmonisation of legislation with WTO requirements. Despite significant openness to foreign trade, domestic commerce remains restricted by poor transport infrastructure, local government intervention and licensing requirements that benefit domestic vested interests, such as private cotton gins and traders.

Stabilisation

Macroeconomic stability has been restored …
Inflation surged in the second half of 2000 due to loose monetary policy and external shocks such as rising fuel prices and the closure of the Tajik-Uzbek border. In October 2000 the government introduced a new currency, the somoni, which, after an initial fall in value, stabilised in the first half of 2001. The resumption of tight monetary policy under IMF guidance has contributed to renewed stability and has supported a surge in GDP growth to move them 10 per cent in the first half of 2001. Since approving the third annual programme of the Poverty Reduction and Growth Facility (PRGF) in October 2000, the IMF disbursed two tranches of US$ 8 million each in 2001. However, in August 2001 the IMF failed to conclude its third review of the PRGF, as the government delayed key structural reforms.

… but fiscal sustainability and the large debt burden are key concerns.
The fiscal position remains precarious. Around one-half of government revenue is tied to debt service obligations, and the present net value of external debt exceeds 400 per cent of annual state revenues. Against this background, the government is negotiating debt rescheduling agreements with its largest bilateral creditor, Russia, but no agreement had been reached by August 2001. Heightened regional tensions will put further pressure on the fiscal position, but may trigger additional international support. Meanwhile, efforts to strengthen fiscal performance are continuing. A treasury law has been enacted, regional treasuries have been set up in all the country's administrative districts and a unit for major taxpayers has been created. Fiscal policy continues to be hampered, however, by the lack of a medium-term expenditure framework.

Privatisation

Significant progress has been achieved in enterprise sales …
During 2000, 646 state-owned enterprises were privatised (568 small enterprises and 78 medium-sized and large enterprises) and privatisation revenues of around US$ 11.6 million (1.4 per cent of GDP) were the highest in history. In 2000 the government also auctioned off the remaining 22 state-owned cotton ginneries, mostly to domestic investors. Small-scale privatisation is largely complete and the government is now focusing on larger enterprises. By August 2001, out of 955 enterprises subject to privatisation, 349 medium-sized and large enterprises had been sold. Despite this progress, post-privatisation restructuring is hampered by the lack of investment funds, including from foreign investors, who remain deterred by the security situation. The largest industrial companies, including the aluminium smelter, TADAZ, the power company, Barki Tojik, and all other utilities, remain state-owned.

… but land reform has slowed down.
The land reform process slowed down in 2000 as local government interests have been reluctant to cede control over former collective farms. Under the IMF's PRGF, 30 state and collective farms were to be converted into private farms by the end of 2000 through the issue of land share certificates to private farmers but this target was not met. The government is now committed to issuing private land certificates in 40 farms by May 2002 under the World Bank's second Structural Adjustment Loan and is progressing towards that goal. Existing private farms, however, face significant problems, including persistent government interference, dilapidated irrigation infrastructure and lack of access to finance.

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	Licences 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
Jun	State cotton trading company liquidated

2000

Jul	Official exchange rate unified with curb market rate
Aug	Privatisation of cotton ginneries completed
Oct	New currency (somoni) introduced
Dec	New treasury system set up

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

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 of banks tightened
Feb Directed credits by NBT renewed
Oct Energy and transport sector restructured
Oct Anti-monopoly agency set up

2001
Mar Public audit office established (not independent)

Enterprise reform

The recovery is spreading from TADAZ to other branches of industry ...
Industrial output increased by 10.3 per cent in 2000 and rose a further 8.6 per cent in January-May 2001. A primary source of growth remains at TADAZ, which employs around 10 per cent of the industrial labour force and accounts for 57 per cent of industrial output. Between 1997 and 2000 aluminium production almost doubled from 160,000 tonnes to 307,000 tonnes and was up a further 8.5 per cent in mid-2001. The smelter has a maximum capacity of 517,000 tonnes but this is unlikely to be reached in the absence of major new investment. During 2001 industrial output growth has spread to other sectors. Food processing, forestry, construction materials and printing all grew by more than 30 per cent in the first half of the year.

... but concerns over weak governance structures persist.
Standards of governance in enterprises remain weak as a result of insider ownership, significant remaining government influence and conflicts of interest within the public sector itself. The law on bankruptcy, adopted in 1992 and amended several times since, is largely ineffective. Signs of growth-oriented restructuring are consequently rare. The state property committee has estimated that around 70 per cent of the medium-sized and large privatised companies are insider-owned and controlled. Government officials often retain direct stakes in important sectors, such as cotton production and trade. To improve matters, the government has set up an audit office although the extent of its independence remains in doubt.

Infrastructure

Organisational reforms shake up public utilities but changes in behaviour are slow.
The government is restructuring and reorganising public infrastructure. With support from international lenders, regulatory and operational functions in transport, telecommunications and power have been or will be separated from operational units. A new transport law and a new energy law were approved in October 2000, leading to the creation of separate transport and energy ministries with the role of formulating policy in their respective areas. An anti-monopoly agency was set up at the same time with the task of regulating tariffs of public monopolies. A new telecommunications law is in preparation, providing for the incorporation of Tajiktelecom, the fixed-line operator, as a majority state-owned company (5 per cent of shares are owned by employees) and the creation of an independent regulator. However, these reforms are not likely to lead to a rapid change in behaviour.

Deficits in the energy sector are a significant drain on state-owned utilities.
As in many other transition economies, affordability constraints and political resistance to restructuring have led to an increase in non-payments in the energy sector and delays to necessary tariff adjustments. In 2000, average electricity tariffs were raised by almost 70 per cent but they are still at only about one-third of cost recovery levels. Non-collection of charges for power and natural gas amounted to 3.8 per cent of GDP in 2000, with another 2 per cent of GDP in provisions for bad debts from previous years. The energy debts of TADAZ alone are estimated at US$ 100 million, or almost 10 per cent of GDP. Under a sector reform project support by the Asian Development Bank, power tariffs will be gradually increased and the financial autonomy of Barki Tojik will be strengthened.

Financial institutions

Bank restructuring makes further progress.
In June 2001 the restructuring agreements signed between the National Bank of Tajikistan (NBT) and the four largest commercial banks (accounting for 84 per cent of total assets) expired. The programme has been partially successful in restoring positive net worth among these banks, improving loan recovery, staff training and credit assessment procedures. However, two large banks, Amonatbank and Agroinvestbank, remain financially weak. Public confidence in the financial system is low and bank deposits were less than 3 per cent of GDP in 2000. A planned increase in minimum capital requirements to US$ 2 million by the end of 2001 is expected to lead to further sector consolidation. The NBT has created a specialised unit to facilitate bank liquidation and has strengthened its supervision capacity, revoking the licences of two banks in 2000 and the first half of 2001. Confidence in the financial sector would be further enhanced under plans to prevent the tax authorities from reviewing customer accounts when conducting corporate tax inspections at commercial banks.

Social reform

Poverty alleviation becomes a central policy focus but fiscal limitations loom large.
Tajikistan remains the poorest country in the CIS. According to the Tajikistan Living Standard Survey (TLSS), 83 per cent of the population live below the official poverty line of TR 20,000 (approximately US$ 17) per month, and the average wage is about one-third of the household subsistence level. From January 2001 the minimum wage was increased threefold, but it is still only 3 somoni (less than US$ 1.50) per month. The major sources of poverty are linked to the rural economy, which employs over half of the labour force. Collective farm labour is paid badly or not at all and forced into subsistence production on marginal household plots. Around 20 to 30 per cent of the total production area is unused because of the breakdown of the irrigation and drainage systems. Increasing divisions are also appearing in the access to social services for the poor as government expenditures have been cut. The government is working with international donors on enhancing the efficiency of social services and moving towards a system of targeted cash benefits.

Liberalisation

Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **yes**

Stabilisation

Share of general government tax revenue in GDP – **12.9 per cent**
Exchange rate regime – **managed floating**

Privatisation

Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de facto**

Enterprises and markets

Competition Office – **yes**

Infrastructure

Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector

Capital adequacy ratio – **12 per cent**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform

Share of the population in poverty – **95.8 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
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	2.0	2.0	1.0	1.0	1.0	1.0	1.0	na
Share of trade with non-transition countries (in per cent)	na	na	75.6	58.9	52.7	28.2	27.6	23.6	46.1
Share of trade in GDP (in per cent)	na	157.7	135.9	260.5	147.8	138.5	99.4	125.1	164.1
Tariff revenues (in per cent of imports)	na	0.9	4.0	1.2	0.6	2.6	6.2	2.1	1.8
EBRD index of price liberalisation	2.0	1.7	1.7	2.7	3.0	3.0	3.0	3.0	3.0
EBRD index of forex and trade liberalisation	1.0	1.0	1.0	2.0	2.0	2.0	2.7	2.7	3.3
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.7	0.9	1.1	1.4	1.6	2.1	2.7	4.0	5.4
Private sector share in GDP (in per cent)	10.0	10.0	15.0	25.0	30.0	30.0	30.0	40.0	40.0
Private sector share in employment (in per cent)	na	na	na	53.0	55.0	58.0	57.0	63.0	58.0
EBRD index of small-scale privatisation	2.0	2.0	2.0	2.0	2.0	2.3	3.0	3.0	3.3
EBRD index of large-scale privatisation	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.3	2.3
Enterprises									
Budgetary subsidies (in per cent of GDP) [1]	10.9	8.0	10.9	6.9	0.7	1.1	0.6	0.8	0.7
Effective statutory social security tax (in per cent)	55.3	69.8	109.9	17.8	22.1	47.7	33.8	na	na
Share of industry in total employment (in per cent)	13.1	11.5	11.1	9.9	10.5	8.5	8.3	7.6	7.2
Change in labour productivity in industry (in per cent)	-22.5	8.2	-22.5	-3.2	-23.1	16.6	10.3	19.4	18.4
Investment rate/GDP (in per cent)	na	23.1	22.3	14.7	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	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure									
Main telephone lines per 100 inhabitants	4.8	4.6	4.5	4.5	4.2	3.8	3.7	3.7	na
Railway labour productivity (1994=100)	na	na	100.0	121.7	87.3	70.8	100.9	85.9	83.8
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	na	na	na	na	na	na	na
Electricity consumption/GDP (1989=100)	134.6	132.1	162.3	178.9	183.7	161.9	160.4	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	1.1	1.1	1.1
Financial institutions									
Number of banks (of which foreign owned)	10 (na)	15 (na)	17 (na)	18 (na)	23 (na)	28 (5)	20 (5)	20 (3)	17 (4)
Asset share of state-owned banks (in per cent)	na	na	na	na	5.3	30.3	29.2	6.9	6.8
Non-performing loans (in per cent of total loans)	na	na	na	na	2.9	3.0	3.2	15.8	10.8
Domestic credit to private sector (in per cent of GDP)	na	na	na	na	4.0	4.8	7.7	10.0	11.3
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	2.0	na	2.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	na	3.0	na	1.7
Social sector									
Expenditures on health and education (in per cent of GDP)	11.7	8.5	12.8	3.9	3.5	3.4	3.3	3.1	3.2
Life expectancy at birth, total (years)	68.2	62.2	66.0	68.3	68.4	68.4	68.5	68.6	na
Basic school enrolment ratio (in per cent)	92.5	87.1	87.0	86.6	85.1	84.9	87.8	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

[1] Data from IMF. Excludes special cotton financing from the National Bank of Tajikistan.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure	*(Percentage change in real terms)*								
GDP	-11.0	-18.9	-12.5	-4.4	1.7	5.3	3.7	8.3	6.0
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed investment	na	na	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	-7.8	-25.4	-13.6	-24.0	-2.1	8.1	5.0	10.3	na
Agricultural gross output	-7.1	-6.5	-25.9	2.0	3.6	6.3	3.8	12.4	na
Employment	*(Percentage change)*								
Labour force (annual average)	-2.1	0.5	0.2	-6.0	3.5	0.8	-4.0	-1.5	na
Employment (annual average)	-3.3	-0.1	0.5	-6.6	3.4	0.3	-3.9	-1.7	na
	(In per cent of labour force)								
Unemployment (annual average) [1]	1.2	1.7	2.0	2.6	2.8	2.9	2.8	2.5	na
Prices and wages	*(Percentage change)*								
Consumer prices (annual average)	2,195.0	350.0	609.0	418.0	88.0	43.2	27.6	32.9	39.4
Consumer prices (end-year)	7,343.7	1.1	2,133.3	40.5	163.6	2.7	30.1	60.8	15.0
Producer prices (annual average)	1,080.0	327.8	1,080.0	449.0	95.7	27.8	41.2	43.5	na
Producer prices (end-year)	5,995.9	301.9	628.3	77.7	121.7	5.9	64.0	33.9	na
Gross average monthly earnings in economy (annual average)	746.3	116.1	164.2	219.6	68.3	84.8	26.6	37.7	na
Government sector [2]	*(In per cent of GDP)*								
General government balance	-20.9	-4.6	-3.3	-5.8	-3.3	-3.8	-3.1	-0.6	-0.5
General government expenditure	54.2	52.2	20.8	19.0	17.0	15.8	16.6	14.2	na
General government debt	na	na	na	na	na	na	na	na	na
Monetary sector	*(Percentage change)*								
Broad money (M3, end-year) [3]	na	na	na	93.2	110.7	53.9	19.7	59.6	na
Domestic credit (end-year)	na	na	na	94.0	201.8	363.6	-5.3	32.7	na
	(In per cent of GDP)								
Broad money (M3, end-year) [3]	90.0	81.7	20.5	8.3	8.6	8.1	7.4	8.8	na
Interest and exchange rates	*(In per cent per annum, end-year)*								
Monetary policy rate	na	na	na	na	na	na	na	na	na
Interbank interest rate (up to 1 month) [4]	na	na	152.5	72.0	81.0	36.4	20.1	30.0	na
Deposit rate (up to 3 months) [5]	30.0	30.0	100.0	109.0	89.0	15.7	11.4	27.0	na
Lending rate (up to 3 months) [5]	30.0	30.0	500.0	122.0	74.0	49.7	23.2	18.6	na
	(Tajik somoni per US dollar)								
Exchange rate (end-year) [6]	0.0125	0.0355	0.2940	0.3280	0.7480	0.9770	1.4360	2.2000	na
Exchange rate (annual average) [6]	0.0102	0.0221	0.1044	0.2930	0.5640	0.7770	1.2380	1.8230	na
External sector	*(In millions of US dollars)*								
Current account	-200	-163	-99	-75	-61	-120	-36	-62	-80
Trade balance	-183	-127	-59	-16	-60	-139	-27	-46	-48
Merchandise exports	456	559	779	770	746	586	666	790	877
Merchandise imports	639	686	838	786	806	725	693	836	925
Foreign direct investment, net	9	12	10	18	18	25	21	22	22
Gross reserves (end-year), excluding gold	2	1	4	14	30	65	58	87	na
External debt stock	509	760	869	948	1,108	1,213	1,230	1,231	na
	(In months of imports of goods and services, excluding alumina and electricity)								
Gross reserves (end-year), excluding gold	0.4	0.0	0.1	0.3	0.6	1.5	1.7	2.4	na
	(In per cent of exports of goods and services, excluding alumina and electricity)								
Debt service	14.9	12.1	36.1	34.1	15.1	15.7	11.9	15.1	na
Memorandum items	*(Denominations as indicated)*								
Population (end-year, millions)	5.7	5.8	5.9	5.9	6.0	6.1	6.1	6.2	na
GDP (in millions of somoni)	7.1	20.2	64.8	308.5	632.0	1,025.2	1,345.0	1,806.8	2,670.2
GDP per capita (in US dollars)	121.8	159.1	105.9	177.0	186.6	216.3	177.4	159.9	na
Share of industry in GDP (in per cent) [7]	32.8	22.0	34.0	25.7	19.7	18.1	19.1	20.4	na
Share of agriculture in GDP (in per cent) [7]	21.0	19.1	36.2	36.0	27.1	19.8	16.8	17.4	na
Current account/GDP (in per cent)	-28.8	-17.8	-16.0	-7.1	-5.4	-9.1	-3.4	-6.3	-7.2
External debt - reserves, in US$ millions	506.7	759.0	865.0	934.0	1,078.0	1,147.7	1,171.9	1,144.0	na
External debt/GDP (in per cent)	73.2	83.0	140.0	90.0	98.9	91.9	113.2	124.2	na
External debt/exports of goods and services (in per cent)	353.1	193.3	217.2	169.1	218.3	290.2	303.7	297.3	na

[1] Officially registered unemployed. The World Bank estimates the true unemployment rate in 1998 at about 30 per cent of the labour force.

[2] Excludes transfers from the state budget to the Pension Fund and Employment Funds.

[3] Series before 1998 is for broad money only, subsequently includes foreign currency deposits.

[4] Rate is determined at credit auctions by National Bank of Tajikistan.

[5] Interest rates were set by the parliament until June 1995. Thereafter rates refer to one to three month maturity.

[6] Both Russian roubles (until 1994) and Tajik roubles (until October 2000) are converted to Tajik somoni.

[7] Figures are based on current prices. Variations in the shares thus reflect *inter alia* changes in relative prices.

Turkmenistan

Key reform challenges

- **The government should seize the opportunity created by high growth rates to liberalise markets and trade, particularly the foreign exchange market, and to increase transparency of its financial operations.**
- **The removal of price subsidies in the energy sector is essential to strengthen the financial autonomy of the state energy companies and to allocate both sector revenues and natural resources more efficiently.**
- **The Foreign Exchange Reserve Fund will need to be reformed to become accountable and to distinguish clearly between the functions of macroeconomic stabilisation, savings for future generations and key public investments.**

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 bill issued
Dec	Land reform decreed

1997
Mar	Gas deliveries halted to non-paying CIS customers
Apr	Large-scale privatisation law adopted

1998
Apr	Exchange rate unified
Sep	Large forex premium on parallel market re-emerges

1999
Jan	Gas exports to Ukraine resumed
Apr	Gas exports to Ukraine again interrupted
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

2000
Nov	Resumption of gas exports to Ukraine

Liberalisation

Price distortions in the energy sector remain a major source of inefficiency.
Both gas and oil are sold domestically at prices below short-run operational costs. Untargeted subsidies provided by the energy sector are estimated by the World Bank at about US$ 600 million (15 per cent of GDP). Export constraints reduce the true value of energy resources (in particular gas) and the burden of subsidies prevents the state-owned gas and oil companies, Turkmengas and Turkmenneft, from obtaining sufficient revenues to undertake key investments and are a cause of major inefficiencies due to waste and lack of targeting. The government is moving towards the introduction of tighter administrative limits on the domestic usage of oil and gas but has hesitated to consider price adjustments to limit resource waste.

The burden of wheat subsidies is reduced.
From May 2001 individuals who want to claim government coupons for subsidised flour and bread have to apply to a committee consisting of the local Hakim (head of local government), the Ministry of Finance and the Ministry of Social Welfare. Self-application is likely to reduce the number of people claiming subsidies and is expected to limit leakage through the onward sale of subsidised wheat. However, the state order system remains in place for wheat and cotton farmers and therefore any liberalisation of consumer prices is unlikely to feed through into rural incomes or to provide incentives for productivity increases.

Stabilisation

Monetary expansion in 2000 has had little effect on inflation.
During June-July 2000 the monetary base almost doubled as a result of generous central bank credits to agriculture, and by the end of the year broad money was up 82 per cent. However, inflation increased only modestly. While the government argues that this reflects increased money demand, there are notable restrictions on the retrieval of funds from bank accounts. The increase in official wages by 90 per cent in 2000 and the fall in the parallel exchange rate by 35 per cent suggest that low official inflation may hide pent-up price pressures (as was the case under central planning). In July 2001 the President issued a decree cancelling all inter-budgetary tax and credit arrears, which in May 2001 totalled about 7.5 per cent and 18 per cent of GDP respectively. This could provide a renewed boost to domestic liquidity and may increase inflationary pressure further.

The use of foreign exchange earnings remains opaque.
As a resource-dependent economy, Turkmenistan is highly vulnerable to fluctuations in cotton and oil prices and market access for its natural gas exports. This calls for prudent management of foreign exchange earnings, most of which are held in the Foreign Exchange Reserve Fund (FERF), which is controlled by the President. Discretionary spending from the FERF, particularly as foreign credit dries up due to high debt levels, could present a considerable macroeconomic risk, in addition to concerns over governance under the present arrangement. Moreover, high export taxes (30-50 per cent) on cotton and energy are major impediments to market-based development in these sectors.

Privatisation

Little progress in privatisation or land reform has been made since 1997.
Since the first phase of privatisation of small enterprises in the retail trade and services sector came to a halt in 1997, progress in privatisation has been limited. The 1998 pilot programme for the privatisation of 18 larger state companies led to only six actual sales. The remainder became blocked in the political approval process. The Ministry of Finance has now taken back the privatisation agenda from the special unit created, with World Bank support, at the State Agency for Foreign Investment. The government's major concerns continue to be to safeguard both employment and existing inter-enterprise linkages. Privatisation in the energy sector is not foreseen for some time and the land reform process has stalled as few private land titles have been issued to existing leasehold farmers.

Enterprises, infrastructure, finance and social reforms

1992

Jun	Bankruptcy law adopted

1993

Oct	Company legislation enacted
Nov	Two-tier 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 Transcaspian gas pipeline signed
Dec	President Bank created

2000

Jun	Trans-Caspian pipeline consortium (PSG) reduces presence
Jun	Directed credits renewed
Jun	Citizens banned from holding foreign bank accounts
Dec	Private licences for Internet services revoked

Enterprise reform

A difficult investment climate stifles private sector development.
While official data indicate that production of consumer goods was up 15 per cent year-on-year in January-May 2001 and retail sales were up 13 per cent, a survey of 2,014 enterprises conducted by UNDP and the government's statistical office in 2000 reveals the difficult situation of most domestic private enterprises. According to the survey, only 28 per cent report positive growth prospects, 24 per cent are close to bankruptcy and 48 per cent are in financial difficulties. Taxation, limited access to foreign exchange, interference by the State Commodity Exchange and lack of access to affordable bank credit are cited as the biggest obstacles to private businesses. Another indication of current difficulties is that around 60 per cent of the sample were founded in 1993-95, with few new entrants since. Almost one-third of the companies had obsolete capital equipment.

Turkmenistan is negotiating new PSAs.
Existing Production Sharing Agreement (PSA) legislation has helped to maintain investor interest in the energy sector despite significant transportation problems, political risks and, as yet, a relatively unknown resource base. Wintershall of Germany, Phillips of the United States and Maersk of Denmark are involved in bilateral negotiations for three new offshore blocks under the PSA model contract. The one-stop-shop arrangement set up in 1997 creating a "Competent Body" in charge of all regulatory and operational issues with the PSA licencee is working well. However, the state-owned part of the energy sector remains unreformed despite a formal separation of regulatory and operational functions. The state energy concerns are not financially autonomous, significant transfers take place between the various entities and the allocation of revenues for investments into the sector remains highly discretionary. This could hamper the sector's ability to carry out necessary maintenance investments and will limit the government in negotiating higher equity stakes in future PSAs.

Infrastructure

Turkmenistan ties its fate to its old CIS gas customers.
The proposed Trans-Caspian pipeline project failed to materialise following the gas find at Shakh Deniz in Azerbaijan. Therefore, Turkmenistan is reorienting its strategy towards rebuilding its export links with the CIS, and Ukraine in particular. In June 2001 the Presidents of Turkmenistan and Ukraine signed a five-year gas purchasing agreement for 50 billion cubic metres (bcm) per year, with payment terms of 50/50 cash and barter and a border price of US$ 42 per 1,000 cm. The Florida-based gas trading company, Itera, has also signed a new 10 bcm delivery contract for 2001, bringing gas exports through the Central Asia gas pipeline to around 40 bcm this year. However, throughput has been repeatedly slowed down in recent months by payment delays from Ukrainian customers, while capacity constraints are likely to prevent further increases in coming years, in the absence of significant modernisation investments.

Financial institutions

The financial sector continues to serve primarily the state-owned economy.
The financial sector continues to be dominated by state-owned or state-influenced institutions and 95 per cent of all loans continue to go to state-owned enterprises. Private enterprises are almost entirely dependent on the few IFI-sponsored credit lines available. Directed credits from state-owned Daikhan Bank to agriculture at subsidised (1 per cent nominal per year) interest rates are set to continue. State control has kept the sector small but has allowed the enforcement of a relatively tight regulatory framework. Minimum capital requirements are high at US$ 5 million (at the official rate), international accounting standards are planned to be made mandatory this year, and standard capital adequacy, liquidity and maximum exposure limits are in place. However, without more fundamental sector liberalisation, the impact of these institutional reforms is likely to be limited.

Social reform

Poverty remains widespread in rural areas but infant mortality has been reduced.
Economic growth of over 30 per cent over the past two years should have helped to reduce the poverty rate from around 50 per cent, measured against the official poverty line in 1998. Turkmenistan has also recorded notable improvements over the past decade in reducing infant mortality from 53 per 1,000 live births in 1989 to reportedly 26 per 1,000 in 2000. However, the large increase in government income from gas exports in recent years has not been reflected in a rise in public investment in the social sector, and there are serious concerns about the quality of services in education in particular as a result. Many present high school leavers have insufficient qualifications to meet the demands of a private market economy. Moreover, given ongoing distortions in agriculture, the current recovery is doing little to improve income opportunities for the rural poor.

Liberalisation
Current account convertibility – **limited**
Interest rate liberalisation – **limited de jure**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenue in GDP – **25.8 per cent**
Exchange rate regime – **multiple exchange rates**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **no**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **10 per cent** [1]
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **no**

Social reform
Share of the population in poverty – **34.4 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Liberalisation									
Share of administered prices in CPI (in per cent)	20.8	18.8	18.8	18.8	18.8	16.7	6.3	6.4	na
Number of goods with administered prices in EBRD-15 basket	7.0	6.0	5.0	5.0	5.0	5.0	4.0	4.0	na
Share of trade with non-transition countries (in per cent)	na	na	23.3	31.8	32.4	38.8	72.6	61.0	22.7
Share of trade in GDP (in per cent)	233.4	78.1	184.9	137.2	140.9	74.1	68.8	105.8	143.7
Tariff revenues (in per cent of imports) [2]	na	na	na	0.3	0.3	0.4	0.3	0.5	na
EBRD index of price liberalisation	1.0	1.0	1.7	2.0	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									
Privatisation revenues (cumulative, in per cent of GDP)	na	na	0.1	0.2	0.2	0.2	0.2	0.3	0.3
Private sector share in GDP (in per cent)	10.0	10.0	15.0	15.0	20.0	25.0	25.0	25.0	25.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	1.0	1.0	1.0	1.7	1.7	2.0	2.0	2.0	2.0
EBRD index of large-scale privatisation	1.0	1.0	1.0	1.0	1.0	2.0	1.7	1.7	1.7
Enterprises									
Budgetary subsidies (in per cent of GDP)	na	na	1.6	1.7	0.8	0.6	1.6	na	na
Effective statutory social security tax (in per cent)	na	na	na	na	na	na	na	na	na
Share of industry in total employment (in per cent)	9.8	10.4	10.0	10.1	10.3	11.2	12.5	12.6	na
Change in labour productivity in industry (in per cent)	-12.3	-5.9	-25.9	14.0	25.9	-39.5	11.4	11.0	33.0
Investment rate/GDP (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of enterprise reform	1.0	1.0	1.0	1.0	1.0	1.7	1.7	1.7	1.0
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	6.5	6.8	7.6	7.1	7.4	8.2	8.2	8.2	na
Railway labour productivity (1991=100)	74.8	60.4	41.2	34.0	28.7	27.9	27.8	26.9	28.1
Electricity tariffs, USc kWh (collection rate in per cent) [3]	na	na	na	na	na	na	0.8 (na)	0.5 (na)	na
Electricity consumption/GDP (1989=100)	74.3	79.6	79.9	82.4	82.9	77.3	76.9	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	1.1	1.1	1.1
Financial institutions									
Number of banks (of which foreign owned) [4]	na	na	na	67 (3)	68 (4)	67 (4)	13 (4)	13 (4)	13 (na)
Asset share of state-owned banks (in per cent)	na	na	na	26.1	64.1	68.3	77.8	96.6	na
Non-performing loans (in per cent of total loans)	na	na	na	11.2	11.4	13.9	2.2	0.5	na
Domestic credit to private sector (in per cent of GDP) [5]	na	na	na	na	5.7	7.8	9.5	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	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)	6.2	6.3	5.3	5.1	4.4	8.0	9.8	7.1	10.8
Life expectancy at birth, total (years)	na	na	na	na	na	65.7	65.9	66.1	na
Basic school enrolment ratio (in per cent)	91.7	92.0	91.8	83.9	83.2	83.1	na	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

[1] Calculated with a risk weight of zero for all loans to state-owned enterprises which are thus assumed to be implicitly guaranteed by the state.
[2] Refers to differential excise taxes on imports; Turkmenistan does not levy import tariffs.
[3] Households are entitled to free electricity allowance of 45 KWh per family member per month; excess usage is charged at just under 1 US cent per KWh.
[4] The number of banks until 1997 includes all branches of Agricultural Bank. In 1998 these were unified into one Agricultural Bank.
[5] Manat credit to state-owned and private firms.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure				*(Percentage change in real terms)*					
GDP	-10.0	-17.3	-7.2	-6.7	-11.3	5.0	16.0	17.6	10.0
Private consumption	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na
Gross fixed investment	na	na	na	na	na	na	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	4.0	-27.9	21.4	30.7	-33.0	25.8	13.0	29.0	na
Agricultural gross output	8.0	-17.6	4.5	-45.2	123.7	8.7	35.0	17.0	na
Employment				*(Percentage change)*					
Labour force (end-year)	3.1	2.5	9.2	-0.1	0.2	5.5	na	na	na
Employment (end-year)	4.4	1.4	5.0	1.8	2.0	1.3	0.7	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)	3,102.0	1,748.0	1,005.3	992.4	83.7	16.8	24.2	8.3	11.2
Consumer prices (end-year)	9,750.0	1,327.9	1,261.5	445.8	21.5	19.8	21.2	7.4	10.1
Producer prices (annual average)	na	na	na	na	na	na	na	na	na
Producer prices (end-year)	na	na	1,293.0	na	na	10.3	na	na	na
Gross average monthly earnings in economy (annual average)	2,119.3	587.7	639.8	757.1	220.0	46.3	21.9	60.3	na
Government sector [2]				*(In per cent of GDP)*					
General government balance	-4.1	-2.3	-2.6	0.3	0.0	-2.6	0.0	0.4	0.0
General government expenditure	19.4	19.2	23.1	16.3	25.3	24.6	19.4	25.3	na
General government debt	na	na	na	na	na	na	na	na	na
Monetary sector				*(Percentage change)*					
Broad money (M3, end-year)	na	983.9	448.0	411.7	81.2	83.2	22.6	81.9	na
Domestic credit (end-year)	na	915.0	402.8	1,389.3	88.4	77.8	24.6	24.4	na
				(In per cent of GDP)					
Broad money (M3, end-year)	22.2	25.6	18.8	8.1	10.2	14.9	12.7	20.3	na
Interest and exchange rates				*(In per cent per annum, end-year)*					
Refinance rate	na	50.0	15.0	105.0	35.0	30.0	27.0	20.0	na
Interbank market rate	na	na	55.0	121.4	45.2	30.0	27.0	15.0	na
Deposit rate (1 year) [3]	50.0	206.0	80.0	130.0	41.1	24.2	27.1	na	na
Lending rate (1 year) [3]	108.0	300.0	70.0	200.0	52.6	58.6	41.8	11.3	na
				(Manats per US dollar)					
Exchange rate (end-year) [4]	30	75	2,442	5,126	5,222	8,148	8,200	8,260	na
Exchange rate (annual average) [4]	na	42	240	3,546	4,627	5,500	8,524	7,742	na
External sector				*(In millions of US dollars)*					
Current account	776	84	24	2	-580	-935	-527	413	-50
Trade balance	1,100	485	441	304	-231	-523	-166	766	400
Merchandise exports	2,693	2,176	2,084	1,692	774	614	1,162	2,508	2,700
Merchandise imports	1,593	1,691	1,644	1,388	1,005	1,137	1,328	1,742	2,300
Foreign direct investment, net	79	103	233	108	108	62	89	131	150
Gross reserves (end-year), excluding gold [5]	818	927	1,165	1,172	1,285	1,379	1,541	1,789	na
External debt stock	168	418	550	668	1,356	1,750	2,050	2,300	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold [5]	4.5	4.5	5.8	7.0	9.3	9.2	9.2	9.1	na
				(In per cent of exports of goods and services)					
Debt service	na	1.7	11.7	13.6	26.5	73.6	46.6	21.1	na
Memorandum items				*(Denominations as indicated)*					
Population (end-year, millions)	3.9	4.0	4.6	4.7	4.9	5.0	5.2	5.4	na
GDP (in millions of manats)	5,584,000	87,200	652,000	7,751,700	11,108,800	13,995,000	20,056,000	22,900,000	29,413,479
GDP per capita (in US dollars)	1,390	517.0	591.9	464.1	495.1	509.9	452.5	552.5	na
Share of industry in GDP (in per cent)	55.1	38.1	52.8	54.4	32.9	27.6	32.0	38.0	na
Share of agriculture in GDP (in per cent)	11.5	32.7	16.2	12.6	20.2	25.2	27.0	26.0	na
Current account/GDP (in per cent)	14.1	4.0	0.9	0.1	-24.2	-36.8	-22.4	13.9	-1.5
External debt - reserves, in US$ millions	-650.0	-509.0	-615.0	-504.0	70.5	370.7	509.0	510.7	na
External debt/GDP (in per cent)	3.1	20.0	20.2	30.6	56.5	68.8	87.1	77.8	na
External debt/exports of goods and services (in per cent)	5.8	16.9	22.9	33.5	132.4	214.9	149.2	82.9	na

Note: Data dissemination by Turkmen authorities has become increasingly restrictive. Data for 2000 is thus subject to considerable uncertainity.

[1] Every Turkmen citizen is guaranteed employment, thus official unemployment does not exist. According to a household survey, unemployment was 19 per cent in 1998.

[2] Significant off-budget expenditures occur through extra-budgetary funds and directed lending. The overall deficit was around 10-15 per cent of GDP during 1998-2000.

[3] Deposit and lending rates are quoted for legal entities at joint-stock banks. For 1996-99, data are average for loans and deposits of three to six months maturity. Lending and deposit rates for 1993-96 are the highest of the total range. All interest rates are annual uncompounded.

[4] 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 and the commercial rate, given as the buying rate offered at commercial banks until September 1998 and the black market rate thereafter. Weights are variable depending on the relative size of official and shuttle trade.

[5] Foreign exchange reserves of the central bank plus the foreign exchange reserve fund.

Ukraine

Key reform challenges

- **Progress in negotiations on WTO accession remains a priority and this requires certification, licensing and customs procedures that meet international standards.**
- **Approval of a land code and mortgage law would help to establish a land market and develop agricultural production, one of Ukraine's main areas of comparative advantage.**
- **The new government should continue privatisation to strategic investors under transparent procedures, which has begun with some success in the power sector.**

Liberalisation

Progress towards WTO accession remains slow.
Ukraine is in its eighth year of negotiations on accession to the WTO. Some progress has been made in bilateral negotiations, especially on industrial products, and a law on standardisation has been passed, bringing Ukrainian standards in line with international norms. Nevertheless, a meeting of the WTO working party in June 2001 indicated that the implementation of laws and regulations relating to customs, import licensing and technical standards still need to be strengthened. A common customs tariff was approved in April, but the new Customs Code, under consideration for two years, has yet to be adopted.

Protection of intellectual property rights needs to be strengthened.
The US Trade Representative (USTR) classified Ukraine as a priority foreign country in March 2001, criticising the government for failing to enforce copyright laws, especially for the production of compact discs, which had led to allegations of piracy. The authorities responded by tightening customs regulations, introducing legislation which raises the penalties for violation of intellectual property rights (IPR) and strengthening domestic legislation to ensure consistency with the agreement on the trade-related aspects of IPR, a part of the WTO. However, in August the USTR announced that trade sanctions would be imposed unless further action was taken to curb illegal production.

Stabilisation

IMF programme resumption may facilitate implementation of the Paris Club agreement.
Economic growth has strengthened over the last year, accompanied by a reduction in inflation, higher budgetary cash revenues, a continuing surplus on the current account and a stronger exchange rate. During most of this period disbursements under the IMF programme were delayed owing to the failure to meet certain structural conditions. However, in September 2001 the IMF agreed to resume lending, which will not only boost reserves but may also enable the government to complete negotiations with the Paris Club creditors. The latter came to a collective agreement with Ukraine on debt rescheduling in July (arrears have mounted since debt repayments were suspended in January 2000) but this needs to be confirmed by agreements with individual creditors.

A new tax liability law has largely ended the "kartoteka" practice.
A key tax reform was formal abolition of kartoteka and its replacement by a tax collateral system. Under kartoteka, the authorities could freeze the bank accounts of enterprises for alleged non-payment of tax, which constrained the use of bank accounts. The new law also permitted enterprises to write off tax arrears accumulated up to the end of 1999, estimated at HR 18 billion (US$ 3.3 billion), and reschedule any arrears incurred during 2000.

Privatisation

Large-scale privatisation has proceeded but receipts fall short.
The government originally intended to sell stakes in several major utilities and industrial companies, partly to raise HR 5.9 billion for the budget in 2001, equivalent to the initial projection of the fiscal deficit (on IMF terms) of 3 per cent of GDP. In the first eight months of the year HR 1.8 billion was raised (less than 1 per cent of GDP). In response to an anticipated shortfall of receipts, the State Property Fund (SPF) subsequently identified over 650 industrial companies in which stakes could be sold. During the year the SPF has sold stakes in larger companies through tenders, cash auctions and via the stock exchange. A number have been purchased by Russian companies, especially in oil refining.

The government seeks to forestall asset stripping.
Earlier in the year two energy utilities were forced by creditor gas suppliers to sell assets to repay overdue debts in order to avoid bankruptcy but the disposals were at prices allegedly below market value. While the courts have since ruled that these operations were legal, the government as a shareholder in these companies has taken measures to block the sales and is preparing amendments

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 reintroduced
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

2001
Feb Law on settlement of tax liabilities signed
Jul External debt restructuring 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
Jul	Presidential decree issued on banking sector development
Oct	Minority shareholder rights strengthened
Dec	Law on banks and banking adopted
Dec	Chernobyl nuclear plant closed

2001

Jan	SME support programme initiated
Apr	Six power utilities privatised
Jul	Licence of Bank Ukraina withdrawn
Jul	Presidential decree on measures to improve investment climate

to the bankruptcy legislation. This would in future prevent such sales by enterprises where the state ownership share exceeds 25 per cent. In addition to potentially diluting shareholder value, these asset sales had an adverse impact on investor perceptions of the privatisation process.

Enterprise reform

A new Land Code would help to consolidate agriculture sector reform.
Agricultural producers have responded to a number of incentives, including the initial privatisation of 11,000 collectives (which were transformed into more than 15,000 private farms), the government's decision to stop providing commodity backed loans and, from the beginning of this year, the removal of the ban on the bankruptcy of agricultural enterprises. Approval of the Land Code (which passed first reading in 2000 but failed at second reading earlier this year) is necessary to provide a system of land registration and mortgage-based finance.

Private start-ups have been more successful than other types of enterprise.
An IFC survey of over 2,100 enterprises concluded that there had been an overall improvement in financial performance during 2000, with 64 per cent of the sample recording profits. Growth in value added was higher in private start-ups compared with privatised and state-owned enterprises; the majority of these companies were also small (less than 50 employees). The extent of competition was shown to be one of the main incentives to undertake restructuring (with many large state-owned companies sheltered by soft budget constraints such as energy and tax arrears). The number of SMEs rose by over 10 per cent in 2000 to almost 220,000 (excluding individual entrepreneurs). Growth was particularly strong in the agricultural sector as the collective farms were transformed into private entities as well as in the transport and property sectors.

Infrastructure

Six power companies have been sold to strategic investors …
Majority stakes in six power distribution companies were sold to strategic investors in April 2001 for HR 865 million (US$ 160 million) although the sale value was less than anticipated. The sales followed an agreement between the government and the bidders that the power companies would restructure their debts to the energy market, tariffs would be raised to ensure a 17 per cent annual rate of return for seven years and non-paying customers could be cut off. Sales of the remaining companies are likely to be delayed until a review of the first round results has been completed. Successful privatisation would underpin the progress that has been made in improving cash collection ratios from the distribution companies to the Energomarket, which averaged 60 per cent in the first half of 2001, compared with 41 per cent in 2000.

… but preparations for the sale of Ukrtelecom have advanced slowly.
Following a tender, the government has appointed a consortium to act as its advisor for the privatisation of the telecommunications utility. However, the regulatory framework needs to be strengthened before privatisation, and the government has submitted draft legislation to the Rada for the establishment of an independent regulator. In July 2001 the government announced that the sale of 37 per cent of the utility to a strategic investor via a tender would be postponed until next year although this would be preceded by the sale of 13 per cent to employees on favourable terms. Separately, there has been no action on the privatisation of the gas transit system although the President announced in June to the Foreign Investment Advisory Council that Ukraine was ready for discussions.

Financial institutions

Further consolidation is required in the banking sector.
The Law on Banks and Banking Activity, which took effect in January 2001, has clarified the procedures for opening and liquidating banks and strengthened the powers of the National Bank (NBU) in these areas. It also set differential capital requirements for banks – the highest minimum requirement is €5 million for banks operating nationwide. Although there have been improvements in enforcing loan-loss provisions, over 150 banks are still operating, some with inadequate capital. In July the government announced that Bank Ukraina, which had suffered large losses, would be liquidated. Commercial bank lending to the private sector has increased, reflecting a strong increase to the agricultural sector (much of which attracts interest rate subsidies).

Social reform

Progress on reforming the pension system remains slow.
With an estimated 29 per cent of the population defined as poor, the President launched a strategy in August 2001 to overcome poverty in Ukraine. Pensioners, especially the elderly, are a vulnerable group, although the increase in cash revenues to the budget enabled the government to pay the outstanding state pension arrears by the third quarter of last year. The government's proposals on mandatory state and voluntary private pension insurance were rejected by the Rada at first reading in October 2000. Nevertheless, consideration is still being given to ways in which a later retirement age could be phased in, which would help to counter an expected deterioration in the dependency ratio.

Liberalisation

Current account convertibility – **full**
Interest rate liberalisation – **full**
Wage regulation – **no**

Privatisation

Privatisation method – **primary vouchers**
Secondary privatisation method – **MEBOs**
Tradability of land – **limited de facto**

Infrastructure

Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **yes**

Social reform

Share of the population in poverty [2] – **29.4 per cent**
Private pension funds – **no**

Stabilisation

Share of general government tax revenue in GDP – **29.2 per cent**
Exchange rate regime – **independently floating**

Enterprises and markets

Competition Office – **yes**

Financial sector

Capital adequacy ratio – **8 per cent**
Deposit insurance system – **no** [1]
Secured transactions law – **yes**
Securities commission – **yes**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
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	11.0	11.0	6.0	2.0	2.0	2.0	2.0	na	na
Share of trade with non-transition countries (in per cent)	na	na	38.7	40.3	45.5	57.1	53.6	57.4	58.5
Share of trade in GDP (in per cent)	91.9	85.3	80.7	84.1	79.4	69.9	71.7	80.4	96.5
Tariff revenues (in per cent of imports) [3]	0.3	1.2	1.1	1.7	1.2	1.9	2.4	2.3	na
EBRD index of price liberalisation	1.0	1.0	2.0	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	3.0	3.0	3.0	2.7	3.0	3.0
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.1	0.3	0.4	0.7	0.8	1.3	1.9	3.2
Private sector share in GDP (in per cent)	10.0	15.0	40.0	45.0	50.0	55.0	55.0	55.0	60.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	1.0	2.0	2.0	2.0	3.0	3.3	3.3	3.3	3.3
EBRD index of large-scale privatisation	1.0	1.0	1.0	2.0	2.0	2.3	2.3	2.3	2.7
Enterprises									
Budgetary subsidies (in per cent of GDP) [4]	na	na	13.3	5.8	6.5	5.0	na	na	na
Effective statutory social security tax (in per cent)	92.6	81.2	88.5	79.4	78.7	79.9	76.7	80.2	na
Share of industry in total employment (in per cent)	30.2	29.3	28.2	26.2	25.6	24.6	21.0	na	na
Change in labour productivity in industry (in per cent)	-1.8	-3.0	-20.3	-4.5	2.5	9.0	2.8	na	na
Investment rate/GDP (in per cent)	27.1	24.3	25.5	23.3	20.7	19.8	19.3	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	2.0	2.0	2.0	2.0	2.0	2.3	2.3	2.3	2.3
Infrastructure									
Main telephone lines per 100 inhabitants	14.7	15.2	15.7	16.1	18.1	18.5	19.1	19.1	na
Railway labour productivity (1989=100)	66.7	53.3	46.9	46.1	40.7	42.4	42.2	41.7	44.9
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	na (60)	na (65)	2.46 (70)	3.13 (80)	2.89 (79)	2.25 (84)	na
Electricity consumption/GDP (1989=100)	105.0	112.2	127.2	138.6	139.4	137.7	133.5	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	2.0	2.0	2.4
Financial institutions									
Number of banks (of which foreign owned)	133 (na)	211 (na)	228 (1)	230 (1)	229 (6)	227 (12)	175 (12)	161 (15)	154 (14)
Asset share of state-owned banks (in per cent)	na	na	na	na	na	13.5	13.7	12.5	11.9
Non-performing loans (in per cent of total loans) [5]	na	na	na	na	na	na	34.6	34.2	32.5
Domestic credit to private sector (in per cent of GDP)	0.0	0.0	0.0	0.0	1.4	2.5	7.8	8.6	na
Stock market capitalisation (in per cent of GDP) [6]	na	na	na	na	na	7.4	1.9	4.5	6.9
EBRD index of banking sector reform	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	2.0
EBRD index of reform of non-banking financial institutions	1.7	1.7	1.7	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	2.0	2.0	2.0	3.3
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	2.0	2.0	2.0	2.0
Social sector									
Expenditures on health and education (in per cent of GDP)	8.6	8.5	10.1	10.0	8.7	9.5	7.9	6.6	7.0
Life expectancy at birth, total (years)	68.9	67.9	67.9	67.1	67.3	67.3	67.3	67.3	na
Basic school enrolment ratio (in per cent)	91.5	91.0	90.7	90.9	90.8	90.2	89.0	na	na
Earnings inequality (GINI-coefficient)	25.1	36.4	na	na	41.3	na	na	na	na

[1] Although there is no general deposit insurance, deposits of the saving banks are covered by a formal deposit insurance scheme.
[2] Based on an international poverty line. The poverty rate based on the national poverty line is 26.7 per cent.
[3] Refers to taxes on international trade and transactions.
[4] Refers to consumer and producer subsidies.
[5] Changes in non-performing loans data compared with previous Transition Reports are due to the change of loan categories included in non-performing loans (see definitions).
[6] Data from Stock Market Survey.

	1993	1994	1995	1996	1997	1998	1999	2000	2001
								Estimate	Projection
Output and expenditure					(Percentage change in real terms)				
GDP	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2	5.8	7.0
Private consumption	na	na	na	-9.5	-1.6	1.4	-2.2	5.2	na
Public consumption	na	na	na	-5.4	-2.3	-3.5	-7.9	-1.9	na
Total investment	na	na	na	-20.1	2.1	2.6	0.1	12.1	na
Exports of goods and services	na	na	-16.9	3.8	-2.8	-4.8	2.1	8.1	na
Imports of goods and services	na	na	20.0	-2.5	1.2	3.1	1.8	-7.3	na
Industrial gross output	-8.0	-27.3	-12.0	-5.1	-0.3	-1.0	4.0	12.9	13.5
Agricultural gross output	1.5	-16.5	-3.6	-9.5	-1.9	-9.8	-6.9	7.6	6.5
Employment					(Percentage change)				
Labour force (annual average)	-0.3	0.1	2.4	-0.7	-0.5	0.4	0.3	0.1	-0.7
Employment (annual average)	-2.3	-3.8	3.0	-2.1	-2.7	-1.1	-2.4	-5.6	na
					(In per cent of labour force)				
Unemployment (end-year)	0.3	0.3	0.3	1.3	2.3	3.7	4.3	4.2	na
Prices and wages					(Percentage change)				
Consumer prices (annual average)	4,743.0	891.0	377.0	80.0	15.9	10.5	22.7	28.2	12.5
Consumer prices (end-year)	10,155.0	401.0	181.7	39.7	10.1	20.0	19.2	25.8	9.0
Producer prices (annual average)	4,619.0	1,144.0	488.0	51.9	7.7	13.2	32.0	20.9	10.5
Producer prices (end-year)	8,668.0	774.0	172.0	17.3	5.0	35.3	15.7	20.8	8.0
Gross average monthly earnings in economy (annual average)	2,254.5	786.1	483.9	71.4	13.3	7.2	6.3	29.2	na
Government sector [1]					(In per cent of GDP)				
General government balance	-16.2	-7.7	-6.1	-3.2	-5.4	-2.8	-2.4	-1.3	-1.7
General government expenditure	54.5	51.4	33.0	39.9	44.2	38.7	36.1	35.8	na
General government debt	na	na	26.7	22.7	26.6	45.7	55.3	44.9	na
Monetary sector					(Percentage change)				
Broad money (M3, end-year)	na	540.0	113.0	36.6	33.9	25.3	40.4	45.4	na
Domestic credit (end-year)	na	na	190.9	42.3	32.5	47.3	38.0	23.5	na
					(In per cent of GDP)				
Broad money (M3, end-year)	33.9	26.7	12.6	11.5	13.4	15.3	16.9	18.5	na
Interest and exchange rates					(In per cent per annum, end-year)				
Refinancing rate	240.0	252.0	105.0	40.0	35.0	60.0	45.0	27.0	na
Treasury bill rate (3-month maturity) [2]	na	na	164.0	51.0	44.0	40.0	45.0	18.0	na
Deposit rate [3]	160.0	209.0	66.0	33.0	18.0	23.0	21.0	9.0	na
Lending rate [3]	184.0	250.0	127.0	80.0	49.0	19.0	55.0	9.0	na
					(Hryvnias per US dollar)				
Exchange rate (end-year)	0.25	1.04	1.79	1.89	1.90	3.43	5.22	5.44	na
Exchange rate (annual average)	0.11	0.50	1.47	1.83	1.86	2.45	4.13	5.44	na
External sector					(In millions of US dollars)				
Current account	na	-1,163	-1,940	-1,185	-1,511	-1,296	834	1,481	1,008
Trade balance	-2,500	-2,575	-2,702	-4,296	-4,205	-2,584	-482	779	642
Merchandise exports	12,800	13,894	14,244	15,547	15,418	13,699	12,463	15,722	16,879
Merchandise imports	15,300	16,469	16,946	19,843	19,623	16,283	12,945	14,943	16,237
Foreign direct investment, net	na	151	263	531	581	744	479	587	795
Gross reserves (end-year), excluding gold	162	651	1,134	1,994	2,375	782	1,090	1,469	na
External debt stock [4]	4,213	7,167	8,013	8,839	9,553	11,483	12,439	10,544	na
					(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	na	0.4	0.7	1.1	1.3	0.5	0.9	1.0	na
					(In per cent of exports of goods and services)				
Debt service	na	11.2	8.0	6.6	7.5	11.2	16.6	10.1	na
Memorandum items					(Denominations as indicated)				
Population (end-year, millions)	51.9	51.7	51.5	51.1	50.5	50.1	49.7	49.3	na
GDP (in millions of hryvnias)	1,483	12,038	54,516	81,519	93,365	102,593	130,451	172,952	208,191
GDP per capita (in US dollars)	635	728	720	872	993	835	636	645	na
Share of industry in GDP (in per cent)	27.6	30.0	34.4	27.5	26.4	24.6	33.2	na	na
Share of agriculture in GDP (in per cent)	21.6	16.0	14.5	12.2	11.8	11.4	12.3	na	na
Current account/GDP (in per cent)	na	-3.1	-5.2	-2.7	-3.0	-3.1	2.6	4.7	2.6
External debt - reserves, in US$ millions	4,051	6,517	6,804	6,881	7,136	10,701	11,349	8,881	na
External debt/GDP (in per cent)	12.8	19.1	21.4	19.9	19.0	27.5	39.4	32.6	na
External debt/exports of goods and services (in per cent)	na	43.1	46.4	43.6	46.7	65.2	76.2	53.0	na

[1] General government includes the state, municipalities and, from 1994, extra-budgetary 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.

[4] Official debt.

Uzbekistan

Key reform challenges

- **If effectively implemented, recent moves to liberalise the foreign exchange market and the trade regime would remove the most important distortions in the economy and lay the foundations for market-based growth.**
- **Unless state orders are phased out and land reform is initiated, the recent fall in cotton and grain production is unlikely to be reversed.**
- **To address persistent external imbalances and to improve living standards, it is key that the government reaches an agreement with the IMF, which would open the door to concessional external finance and a reduction in commercial debts.**

Liberalisation

Uzbekistan moves towards currency convertibility ...

While a multiple exchange rate regime is still maintained, the decrees on access to foreign currency issued in June and July 2001 have reduced distortions in the economy significantly. Almost all imports are now conducted at the over-the-counter (OTC) rate, which is close to the current underlying market rate, according to EBRD estimates. Since export surrender requirements are also at this rate, rather than the over-valued official exchange rate, exporting has become more attractive. All debt service and repatriation of profits will also be conducted at the OTC rate. Furthermore, the Republican Monetary Committee ceased to be in charge of rationing foreign exchange. However, it remains unclear if rationing will continue or if the OTC rate will be fully market-determined. Since the OTC rate has changed little since its introduction, while the underlying market rate has depreciated, distortions are likely to re-emerge unless the OTC rate is truly floated.

... and away from state trading.

As part of the recent decrees liberalising the forex market, certain "liquid" goods, including cotton, can now be sold in free auctions to foreign and domestic buyers. This is a significant change from the previous arrangement, under which all cotton used to be sold either to the Ministry of Foreign Economic Relations for export or to Uzbeklegprom, the association of joint-stock textile enterprises. Proceeds from the auctions must still be fully surrendered to the central bank but are now exchanged at the OTC rate rather than at the less favourable official rate. However, as with the changes to the foreign exchange regime, implementation of the open auctions will be key. In the auctions so far, the volumes sold have been too small to have a significant impact.

Stabilisation

The rise in external debt has been arrested ...

Foreign debt has remained roughly stable in 2000-01 after rising by around US$ 1 billion annually in recent years, in part by restricting access to sovereign guarantees. Import rationing led to a trade surplus of US$ 494 million in 2000, up from US$ 203 million in 1999. The effective real depreciation resulting from recent adjustments to the exchange rate regime should further support the external balance and thus limit the need to increase foreign debt. However, confidence in the government's stabilisation policies remains low as the black market premium rose during June-August 2001. An agreement with the IMF on steps to move towards full convertibility is thus critical if confidence is to be restored and the strain of the high debt service burden on public and external finances is to be reduced.

... while the budget implications of forex liberalisation remain uncertain.

The recent reforms to the foreign exchange market will have an ambiguous effect on the government budget. The loss of revenues from moving the export surrender requirement to the OTC rate is likely to be offset by further restricting the access of importers to the overvalued official rate. Partial liberalisation measures were introduced in July 2000 and their impact on the budget seems to have been neutral. Nevertheless, since part of the sovereign guaranteed debt will now have to be serviced at the OTC rate, this could increase defaults, lead to the build-up of debts in the banking sector and ultimately would represent a significant liability to the budget. Increased spending on defence, currently running at 8-9 per cent of GDP, is putting a further strain on the budget.

Privatisation

Large-scale privatisation proceeds slowly.

Large-scale privatisation is still lagging behind the progress made in neighbouring countries and the government continues to be reluctant to sell majority stakes. The current large-scale privatisation programme includes 38 major enterprises that are to be sold to foreign investors. However, a majority stake (51 per cent) is on offer in only one company, the national telecommunications company, Uzbektelekom. An international consortium for this sale has been chosen as financial consultant and the government intends to complete the privatisation by the end of 2002. The list of companies in which only minority stakes are being offered includes most companies in the oil and gas sector. The state holding Uzbekneftegaz has been split into eight companies, which the authorities want to privatise sequentially. In the light of earlier unsuccessful attempts to privatise minority shares, the success of the current privatisation programme is doubtful. A foreign exchange system that hinders the repatriation of profits continues to be a major impediment to foreign direct investment. In the oil and gas sector the country is increasingly looking to Russian energy companies as a source of investment but it is also implementing Production Sharing Agreements for the first time with Western/Uzbek joint ventures.

Liberalisation, stabilisation, privatisation

1991

Sep	Independence from Soviet Union

1994

Jan	New currency (som) introduced
May	Foreign investment law adopted

1995

May	Foreign investment law amended
Oct	IMF programme adopted

1996

Jun	Privatisation programme adopted
Oct	IMF programme suspended

1997

Nov	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 per cent
Feb	Introduction of trade barriers against Kazakh and Kyrgyz imports
Jun	Tender for large copper plant cancelled
Jul	Partnership and cooperation agreement with EU effective
Dec	New large-scale privatisation programme announced

2000

May	Two administrative exchange rates unified
Jun	Access to subsidised hard currency restricted

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
Mar First treasury bills issued
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

2001
Mar State railway company restructured

Enterprise reform

Reform of the agricultural sector is proceeding slowly.
Government interference in the sector is still pervasive. The harvest of the two main crops, cotton and grain, fell last year by almost 20 per cent due to adverse weather conditions and under-investment. State procurement of cotton, which is at a fraction of world market prices, continues to cover around 70 per cent of the total harvest. State-procured cotton is ginned by the State Cotton Ginning Association, which operates outdated Soviet gins that are unable to produce high-quality output. In an effort to improve the ginning industry, the government has allowed a private company to procure and gin cotton in the Gulistan district, and it would like to privatise other gins to attract investment. The increased emphasis on domestic processing and the growing number of foreign-Uzbek joint ventures in the textiles sector are increasing the demand for cotton in Uzbekistan by around 10 per cent a year, with a corresponding decline in cotton fibre exports.

Infrastructure

Uzbektelekom is prepared for privatisation.
In recent years the telecommunications sector has benefited from substantial investments, financed to a large extent by Japanese credits. As a result, the number of digital lines had risen to 700,000 at the end of 2000. Eleven of Uzbekistan's 13 regional capitals have modern digital AMTS lines. However, in terms of lines per capita, Uzbekistan is behind most of its regional neighbours and therefore substantial additional investment in the sector is needed. Having unsuccessfully tried to attract additional foreign direct investment into the sector, the government has now decided to restructure it and raise money through privatisation. In 2000 it merged the national and international provider and formed Uzbektelekom. The Post and Telecommunication agency that currently owns Uzbektelekom will regulate the telecommunications sector after privatisation. Interventionist tendencies remain, however. In early 2001 the licences of several private Internet providers were revoked.

The railway sector monopoly is being broken up.
With the support of the ADB and the EBRD, Uzbekistan has begun breaking up the state railway transport monopoly. A special committee and the State Property Committee will reappraise the company's fixed assets and form a statutory fund, which will include the assets of enterprises and divisions of the current state railway company, Uzbekiston Temir Iullari. Passenger and cargo transport enterprises will be restructured as joint-stock companies in 2002-03 with a view to future privatisation. However, rail track operation and maintenance, transport logistics, locomotives and repair and service companies will remain under a state-owned holding.

Financial institutions

The banking sector remains under state control.
The banking sector continues to be dominated by the state banks, the largest of which is the National Bank of Uzbekistan. Much of the government's National Investment Plan is operated through the banking system, which channels credits to state enterprises under government guarantees, often at preferential rates. A major form of state intervention in the sector has been to place limits on cash withdrawals from the banking system, from both domestic and foreign currency deposits. This has allowed the government to control inflation and the outflow of foreign exchange to the parallel market but remains a key obstacle to market-based growth of the sector. Plans for the privatisation of the major state-owned banks, under preparation since 1998, appear to have been put on hold.

Social reform

Social protection needs to counterbalance the effects of economic policies.
There is no official poverty line in Uzbekistan that is comparable with international standards. However, based on data from the Ministry of Macroeconomics and Statistics, families in need of social assistance were defined as having an average per capita income at or below 1.5 times the official minimum monthly wage, approximately US$ 17 (US$ 9) at the official (market) rate. Using this criterion, the proportion of people in need of assistance was 14 per cent in 1999. The incidence of poverty is highest in rural areas, particularly among families without private land plots, and among single-parent households. This highlights the need for agricultural reforms to increase rural incomes. On the positive side, Uzbekistan has a relatively well-targeted social safety net, making innovative use of traditional community structures for allocating state assistance.

Liberalisation
Current account convertibility – **limited**
Interest rate liberalisation – **limited de facto**
Wage regulation – **yes**

Stabilisation
Share of general government tax revenue in GDP – **30 per cent**
Exchange rate regime – **multiple exchange rates**

Privatisation
Primary privatisation method – **MEBOs**
Secondary privatisation method – **direct sales**
Tradability of land – **limited de jure**

Enterprises and markets
Competition Office – **yes**

Infrastructure
Independent telecoms regulator – **no**
Separation of railway accounts – **no**
Independent electricity regulator – **no**

Financial sector
Capital adequacy ratio – **8 per cent**
Deposit insurance system – **no**
Secured transactions law – **restricted**
Securities commission – **yes**

Social reform
Share of the population in poverty – **14 per cent**
Private pension funds – **no**

	1992	1993	1994	1995	1996	1997	1998	1999	2000
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	5.0	5.0	1.0	1.0	1.0	na	na	na
Share of trade with non-transition countries (in per cent)	na	na	45.6	34.9	47.3	38.2	47.4	53.5	37.8
Share of trade in GDP (in per cent)	156.0	120.4	99.6	73.2	62.1	69.3	54.4	67.5	85.2
Tariff revenues (in per cent of imports) [1]	1.3	2.4	2.5	2.6	1.6	1.6	1.9	0.7	na
EBRD index of price liberalisation	2.0	2.0	3.0	3.0	3.0	2.7	2.0	2.0	2.0
EBRD index of forex and trade liberalisation	1.0	1.0	2.0	2.0	2.0	1.7	1.7	1.0	1.0
Privatisation									
Privatisation revenues (cumulative, in per cent of GDP)	0.0	0.2	0.7	1.6	2.4	2.5	2.6	2.7	2.7
Private sector share in GDP (in per cent)	10.0	15.0	20.0	30.0	40.0	45.0	45.0	45.0	45.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na	na	na
EBRD index of small-scale privatisation	1.0	2.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of large-scale privatisation	1.0	1.0	2.0	2.7	2.7	2.7	2.7	2.7	2.7
Enterprises									
Budgetary subsidies (in per cent of GDP)	10.7	7.6	2.7	3.4	4.0	3.2	na	na	na
Effective statutory social security tax (in per cent)	na	5.4	na	33.5	35.9	na	na	na	na
Share of industry in total employment (in per cent)	13.9	14.1	13.1	12.9	12.9	12.8	12.7	12.8	12.6
Change in labour productivity in industry (in per cent)	-1.7	2.3	10.5	-1.6	4.4	6.3	5.3	5.0	2.9
Investment rate/GDP (in per cent)	12.9	14.6	18.3	27.3	29.3	21.7	19.2	na	na
EBRD index of enterprise reform	1.0	1.0	1.0	2.0	2.0	2.0	2.0	2.0	1.7
EBRD index of competition policy	1.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Infrastructure									
Main telephone lines per 100 inhabitants	6.7	6.6	6.9	7.6	6.7	6.4	6.5	6.7	na
Railway labour productivity (1989=100)	69.2	52.3	33.1	28.1	27.3	26.9	27.1	26.6	34.2
Electricity tariffs, USc kWh (collection rate in per cent)	na	na	na	na	na	1.7 (na)	1.9 (80)	1.2 (90)	na
Electricity consumption/GDP (1989=100)	119.1	118.3	120.1	118.2	117.6	116.1	110.8	na	na
EBRD index of infrastructure reform	na	na	na	na	na	na	1.7	1.7	na
Financial institutions									
Number of banks (of which foreign owned)	30 (na)	21 (1)	29 (1)	31 (1)	29 (2)	30 (4)	33 (4)	35 (5)	34 (6)
Asset share of state-owned banks (in per cent)	21.7	15.9	46.7	38.4	75.5	70.6	67.3	65.8	77.5
Non-performing loans (in per cent of total loans)	0.0	0.0	0.0	0.0	0.0	0.4	0.1	0.1	0.0
Domestic credit to private sector (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	1.3	3.8	na	0.8	1.1
EBRD index of banking sector reform	1.0	1.0	1.0	1.7	1.7	1.7	1.7	1.7	1.7
EBRD index of reform of non-banking financial institutions	1.0	1.0	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	2.3	2.3	2.7	3.0
EBRD rating of legal effectiveness (company law)	na	na	na	na	na	2.0	2.0	2.3	2.7
Social sector									
Expenditures on health and education (in per cent of GDP)	14.8	13.4	11.8	11.0	11.1	10.4	11.2	10.8	na
Life expectancy at birth, total (years)	na	na	na	na	na	69.2	69.4	69.6	na
Basic school enrolment ratio (in per cent)	87.5	87.9	88.6	na	89.0	89.7	na	na	na
Earnings inequality (GINI-coefficient)	na	na	na	na	na	na	na	na	na

[1] Refers to custom duties and export taxes.

	1993	1994	1995	1996	1997	1998	1999	2000 Estimate	2001 Projection
Output and expenditure				(Percentage change in real terms)					
GDP	-2.3	-4.2	-0.9	1.6	2.5	4.4	4.1	4.0	3.0
Private consumption	na	na	-30.2	22.8	15.9	8.3	14.4	na	na
Public consumption	na	na	6.7	-2.2	-17.2	16.0	na	na	na
Gross fixed investment	na	na	na	na	17.0	20.0	na	na	na
Exports of goods and services	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na
Industrial gross output	4.1	1.0	0.2	6.3	6.5	5.8	6.1	3.5	na
Agricultural gross output	1.3	2.2	2.3	-6.5	5.8	4.0	5.9	-1.0	na
Employment				(Percentage change)					
Labour force (end-year)	-20.4	-1.3	3.7	1.4	1.4	1.4	0.4	1.7	na
Employment (end-year)	-0.1	-1.3	3.7	1.3	1.4	1.4	0.4	1.6	na
				(In per cent of labour force)					
Unemployment (end-year) [1]	0.3	0.4	0.4	0.4	0.4	0.5	0.5	0.6	na
Prices and wages				(Percentage change)					
Consumer prices (annual average)	534.0	1,568.0	304.6	54.0	58.9	17.8	29.1	24.2	25.9
Consumer prices (end-year)	885.0	1,281.4	116.9	64.3	27.6	26.1	25.2	28.0	23.0
Producer prices (annual average)	2,545.0	1,428.0	499.0	107.0	52.0	48.4	35.5	40.0	na
Producer prices (end-year)	1,919.0	1,425.0	217.4	75.4	40.3	48.4	34.5	36.0	na
Gross average monthly earnings in economy (annual average)	1,147.8	1,314.6	276.6	99.7	75.2	57.5	60.2	24.2	na
Government sector [2]				(In per cent of GDP)					
General government balance	-10.4	-6.1	-4.1	-7.3	-2.4	-3.0	-2.8	-1.2	-1.0
General government expenditure	46.4	35.3	38.7	41.6	32.5	34.5	33.2	31.8	na
General government debt	na	na	na	na	na	na	na	na	na
Monetary sector				(Percentage change)					
Broad money (M3, end-year)	785.1	725.9	144.3	113.3	45.6	28.1	38.0	25.3	na
Domestic credit (end-year)	854.4	525.3	80.0	188.8	51.4	74.7	35.0	13.8	na
				(In per cent of GDP)					
Broad money (M3, end-year)	53.5	34.7	18.2	21.0	17.5	16.1	14.7	11.9	na
Interest and exchange rates				(In per cent per annum, end-year)					
Refinancing rate	na	na	84.0	60.0	48.0	48.0	42.0	na	na
Treasury bill rate (3-month maturity)	na	na	na	36.0	26.0	17.6	16.0	na	na
Deposit rate (1 year)	30.0	60.0	90.0	28.0	15.0	12.0	12.0	na	na
Lending rate (1 year)	na	100.0	105.0	50.0	28.0	33.0	30.0	na	na
				(Soms per US dollar)					
Exchange rate (end-year) [3]	1.3	28.0	39.3	65.7	108.5	178.7	348.4	631.3	na
Exchange rate (annual average) [3]	1.0	11.4	33.0	44.7	90.7	131.8	257.2	483.5	na
External sector				(In millions of US dollars)					
Current account	-429	119	-21	-979	-583	-38	-163	185	144
Trade balance	-378	213	237	-706	-72	171	203	494	500
Merchandise exports	2,877	2,940	3,475	3,534	3,695	2,888	2,790	2,935	2,800
Merchandise imports	3,255	2,727	3,238	4,240	3,767	2,717	2,587	2,441	2,300
Foreign direct investment, net	48	73	-24	90	167	140	121	73	71
Gross reserves (end-year), excluding gold	856	676	815	772	374	533	783	810	na
External debt stock	1,039	1,107	1,771	2,381	2,594	3,484	4,310	4,363	na
				(In months of imports of goods and services)					
Gross reserves (end-year), excluding gold [4]	3.8	3.0	2.9	2.2	1.1	2.2	3.3	3.5	na
				(In per cent of export of goods and services)					
Debt service [5]	0.7	10.5	17.0	9.0	9.0	13.0	17.8	26.2	na
Memorandum items				(Denominations as indicated)					
Population (annual average, millions)	21.9	22.3	22.7	23.1	23.6	24.0	24.5	25.0	na
GDP (in millions of soms)	5,095	64,878	302,787	559,100	976,830	1,358,780	2,048,000	3,049,000	3,954,135
GDP per capita (in US dollars)	233.1	255.4	404.4	541.0	457.1	429.6	325.4	252.3	na
Share of industry in GDP (in per cent)	22.4	19.8	20.0	20.0	19.0	21.0	20.8	21.0	na
Share of agriculture in GDP (in per cent)	27.9	38.0	32.0	26.0	29.0	26.0	28.0	27.0	na
Current account/GDP (in per cent)	-8.4	2.1	-0.2	-7.8	-5.4	-0.4	-2.0	2.9	2.7
External debt - reserves, in US$ millions	183	431	956	1,609	2,220	2,951	3,527	3,553	na
External debt/GDP (in per cent)	20.4	19.5	19.3	19.0	24.1	33.8	54.1	69.2	na
External debt/exports of goods and services (in per cent)	36.1	35.9	47.1	60.8	64.0	108.9	154.5	148.7	na

[1] Officially registered unemployment. No labour force survey based estimates available.

[2] Includes extra-budgetary funds but excludes local government.

[3] Roubles per US dollar untill 1993. Since 1996, dual exchange rates are in operation. Data show the weighted average of the official exchange rate (40 per cent), the bank rate (30 per cent) and the parallel market rate (30 per cent). Starting from 2001 the weights have changed to official rate (20 per cent), OTC rate (50 per cent) and black market rate (30 per cent).

[4] As a share of merchandise imports only for the year 1993.

[5] Figures for 1993 refer 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 revenue in GDP
General government includes central government, extra-budgetary 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.

Enterprise reform

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 institutions

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 regional survey of secured transactions laws.

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
Percentage of population living on less than US$ 4.3 (in 1995 US$ at PPP) a day per person. Selected years 1995-99.

Source: Household survey data compiled by the World Bank.

Private pension funds
Options: *yes, no.*

Source: EBRD staff assessments.

Liberalisation

Share of administered prices in CPI (in per cent)
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 to non-transition economies (in per cent)
Ratio of mechanise exports and imports to non-transition 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 (in per cent)
Ratio of exports plus imports to GDP.

Source: See the Macroeconomic Indicators tables.

Tariff revenues (in per cent of imports)
Tariff revenues include all revenues from international trade. Imports are those of merchandise goods.

Source: EBRD surveys of national authorities and IMF country reports.

Privatisation

Privatisation revenues (cumulative, in per cent 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 (in per cent)
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

Definitions and data sources for structural and institutional indicators

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, 1994-2000, and IMF staff estimates, 1989-93.

Private sector share in employment (in per cent)
The "private sector shares" of employment represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector employment includes employment in private registered companies, as well as in private entities engaged in informal activity in those cases where reliable information on informal activity is available.

Sources: EBRD staff estimates, 1994-2000, and IMF staff estimates, 1989-93.

Enterprise reform

Budgetary subsidies (in per cent 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 (in per cent)
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 per cent of total payroll for a statutory rate of 10 per cent 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 and construction in total employment (in per cent)
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 (in per cent)
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 tariff, US cents per kilowatt-hour (collection ratio in per cent)
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.

Ration 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 per cent share, end-of-year.

Source: EBRD survey of central banks.

Asset share of state-owned banks (in per cent 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 per cent, end-of-year.

Source: EBRD survey of central banks.

Bad loans (in per cent of total loans)
Ratio of non-performing loans to total loans. Non-performing loans include substandard, doubtful and loss classification categories for loans, but excludes loans transferred to a state rehabilitation agency or consolidation bank, end-of-year.

Source: EBRD survey of central banks.

Credit to private sector (in per cent of GDP)
Ratio of total outstanding bank credit to the private sector at end-of-year, including households and enterprises, to GDP.

Source: IMF, *International Financial Statistics* and IMF country reports.

Stock market capitalisation (in per cent 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.

Fiscal and social reform

Expenditures on health and education (in per cent 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.*

Life expectancy at birth, total (in years)
Life expectancy is defined as the average age reached by an individual after the first day of life, excluding deaths at birth.

Source: World Bank, *World Development Indicators.*

Basic school enrolment ratio (in per cent)
Gross rates of school enrollment in per cent of the 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 a 0.3 decimal points added or subtracted for + and – ratings that were first introduced in 1997 and retroactively added to years 1989-96 in the *Transition Report 2000.* For definitions of the rating scores, see Tables 2.1 and 2.2 and Annex 2.1 (for legal transition indicators). The infrastructure rating is an unweighted average of five sector-specific reform ratings for power, railways, roads, telecommunications and water.

Source: EBRD staff assessments.

Methodological notes

Definitions and data sources for macroeconomic indicators

Data for 1993-2000 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 2001 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 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 in informal markets. Wage data are from national authorities and often exclude small enterprises as well as the informal sector.

Government sector

Data for the general government, including local government and extra-budgetary funds, where available. Data for most countries are from IMF country reports. Budget balance data can differ from official estimates due to different budgetary accounting, in particular with respect to privatisation revenues and foreign lending.

Monetary sector

Broad money is the sum of money in circulation outside banks and demand deposits other than those of the central government. It also includes quasi-money time, savings and foreign currency deposits of the resident sectors other than the central government. Data 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. Turkmenistan and Uzbekistan operate dual exchange rate systems or have substantial parallel markets with significant premiums on the official exchange rate. Please refer to the table footnotes for details on the reported exchanges 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 2001

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 extensive experience as an investor in the region, the Report offers comprehensive analysis of progress in the transition to market economies and of macroeconomic performance and prospects.

Country-by-country assessments provide invaluable information on progress in the key areas of market liberalisation, stabilisation, privatisation, enterprise reform, infrastructure, financial institutions and social reform. Further information is provided in statistical tables covering structural and institutional reforms and macroeconomic performance, making this annual publication essential reading for investors, policy-makers and researchers.

The special theme of this year's *Transition Report* is energy in transition. It looks in particular at energy production, focusing on oil and gas, as well as energy consumption and energy efficiency. The *Transition Report* highlights the challenges facing the energy-rich countries in the region in managing their resource wealth prudently. It discusses key policy issues, such as the need to strengthen governance and transparency in the energy sector and to increase savings to preserve national wealth for future generations. It also looks at tariff reform as a means of improving energy efficiency and examines ways of ensuring that the poor do not suffer as a result of tariff adjustments. The *Transition Report* also highlights the complementary role that private investment in the power sector can play in improving energy efficiency if accompanied by a strong regulatory framework.

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