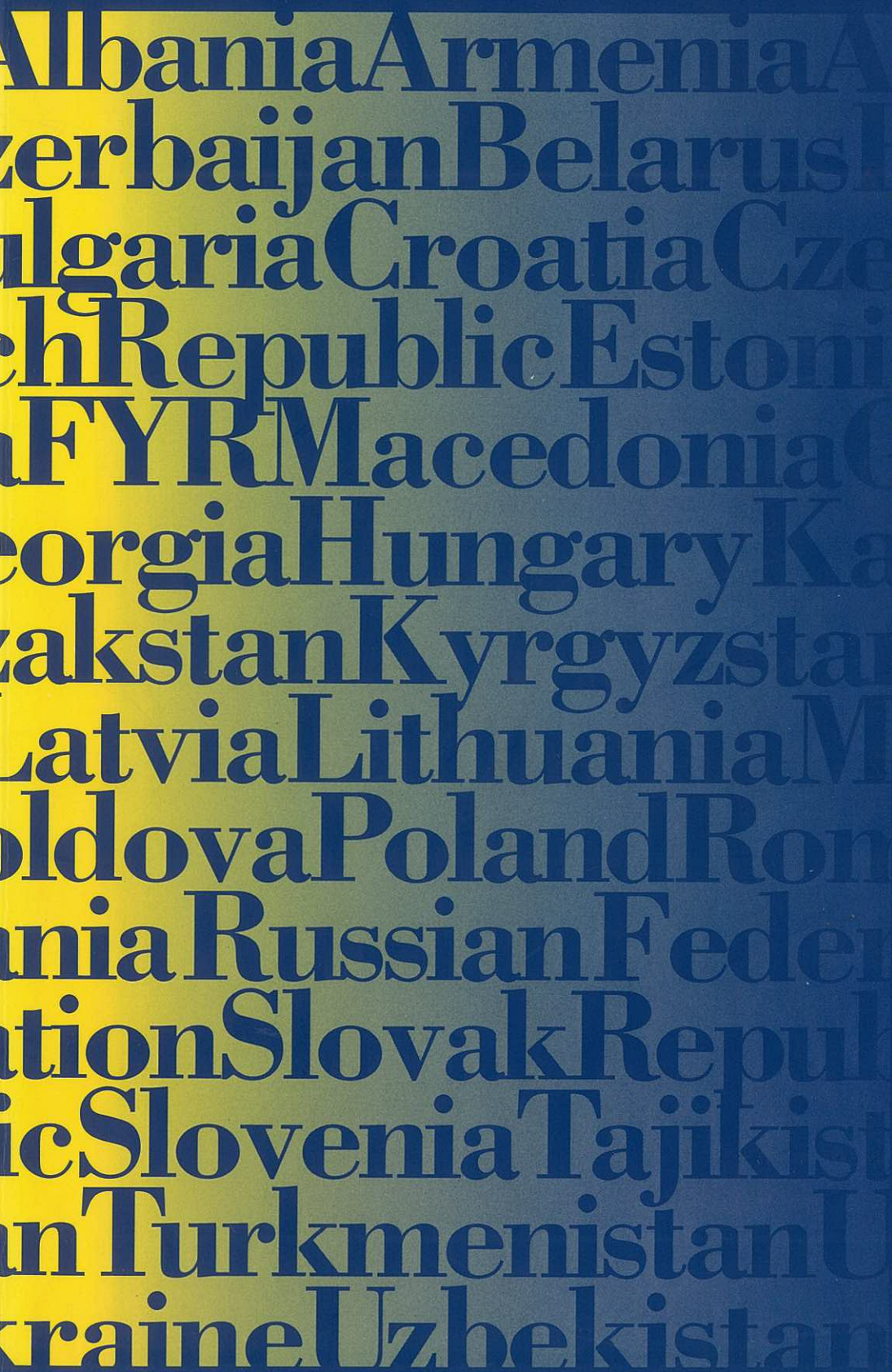
Transition report 1995

Investment and enterprise development



Economic transition in eastern Europe and the former Soviet Union

Measuring transition in each country

Investment: conditions, impacts and prospects

Enterprise development

Macroeconomic progress and outlook

European Bank
for Reconstruction and Development

Guide to readers

Country grouping

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

Eastern Europe	Albania, Bulgaria, Croatia, Czech Republic, FYR Macedonia, Hungary, Poland, Romania, Slovak Republic and Slovenia
Former Soviet Union	Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine and Uzbekistan
Baltic states	Estonia, Latvia and Lithuania
CIS	The countries of the former Soviet Union excluding the Baltic states
Countries of operations	The EBRD's member countries in eastern Europe and the former Soviet Union

Abbreviations

The Bank, EBRD	The European Bank for Reconstruction and Development
BIS	Bank for International Settlements
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)
CMEA	Council for Mutual Economic Assistance (former)
CSFR	Czech and Slovak Federal Republic
EFTA	European Free Trade Area
EU	European Union
FSU	Former Soviet Union
FDI	foreign direct investment
G-7	Group of 7 (Canada, France, Germany, Italy, Japan, UK and USA)
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
GSP	Generalised system of preferences: exception to the Gatt's MFN principle, established to accord lower tariff rates (than MFN) for industrial country imports from developing countries
IFI	international financial institution
IMF	International Monetary Fund
MFN	most-favoured nation: GATT principle that gives a country tariff treatment equal to the lowest rate generally offered to other countries
na	not available
NAFTA	North American Free Trade Agreement
NMP	net material product
OECD	Organisation for Economic Cooperation and Development
PPP	purchasing power parity
SMEs	small and medium-sized enterprises
UN	United Nations
UNECE	United Nations Economic Commission for Europe
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNICEF – ICDC	International Child Development Centre
VAT	value added tax
WTO	World Trade Organisation

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Transition report

Contents

Foreword

The purpose of the EBRD is to foster the transition to the market economy in the countries of eastern Europe and the former Soviet Union. The Bank's principal means of furthering this objective is participation in investments that promote the development of the private sector. Its activities must therefore be informed by an analysis of both the transition and the role of investment in the process. The series of annual *Transition Reports*, of which this is the second, is intended to further this analysis, as a contribution both to the EBRD's own effectiveness and to the activities of those, whether in business, government, academic life or elsewhere, who are participating in or studying the process of transition.

As last year, Part I of the Report is devoted to defining, measuring and assessing the movement of transition, and Part IV to macroeconomic developments and forecasts. The main themes for this year are investment, in Part II, and enterprise development, in Part III. Investment will be the central instrument of change over the next period of the transition and is now beginning to recover in a number of countries in the region. The quality and level of that investment will be key to shaping the transition over the next decade. Many of the economies of the region have returned to growth in the last year or two. However, if the reforms and sacrifices of recent years are to realise their full potential in terms of a well-functioning market economy, the investment process will require strong support. That support must take the form of deepened reforms and strengthened macroeconomic stabilisation, but external investors have a crucial role to play. The next phase of the transition will be vital – the responsibilities associated with this historic process are great but so too are the opportunities.

Institutional change, both in terms of the enterprise itself, and the business, financial, legal and social framework underpinning the enterprise and the market process, lies at the heart of transition. That this institutional change will take time was a key message of last year's *Transition Report* and comes through strongly again. That this change takes time does not, of course, imply that the process should be delayed or pursued less rigorously. Indeed, the evidence is coming through still more strongly that those who embarked on the process early and more firmly have experienced the emergence of growth sooner and at lower social and economic costs.

Production of the *Transition Report* is the work of the Office of the Chief Economist working as a team, but this year we have had the most welcome contribution of the Office of the General Counsel, which is responsible for Chapter 6. The team, which drew on all parts of the Office of the Chief Economist, was led by Mark Schankerman, Director of Policy Studies, who provided intellectual direction and the overall structure for the Report. Within the OCE the editorial process for the Report was the responsibility of Kasper Bartholdy, Mark Schankerman, Andrew Tyrie and myself. Anne Maklan bore the heavy burden of coordinating production within the OCE with equanimity and efficiency and with the strong support of her administrative colleagues.

Principal responsibility for the chapters is as follows. Chapter 1, the introductory chapter, was by myself with the assistance of Vanessa Glasmacher. The authors of Chapter 2, on the measurement of transition, were Alex Neuber and Mark Schankerman, with the assistance of Mâcé Mesters, Kasper Richter and Ksenia Yudaeva. Annex 2.2 in Chapter 2 forms the foundation of the work on measuring the transition and draws on the input of the whole office. It was organised primarily by Alex Neuber. Chapter 3, which views the investment process from an economy-wide perspective, was written by Hans Peter Lankes with the assistance of Pietro Garibaldi. Chapter 4 analyses investment from the perspective of restructuring and sectoral reallocation: this

chapter was written by Hans Peter Lankes, with assistance from Maria Nikolakaki and Ksenia Yudaeva. Chapter 5, on the financing of enterprise investment, was written by Stephen Fries with the assistance of Carlo Sdralevich. Chapter 6, on legal reform related to investment, was written primarily by Gerard Sanders and François April of the Office of the General Counsel, with input from other members of the OGC. Chapter 7, which analyses the transition impact of investment projects, was co-authored by Robin Burgess and Mark Schankerman with substantial input from Kasper Richter. Chapter 8, on the links between ownership, governance and enterprise restructuring, was written by Philippe Aghion, Mark Schankerman and Andrew Tyrie, with input from Lina Takla. Mark Schaffer kindly helped us in preparing the data presented in the chapter. Chapter 9, on small and medium-sized enterprises, was written by Ian Goldin and Francesca Pissarides, with substantial input from Kimya Kamshad and the assistance of Michele Clara. Steven Fries was responsible for Chapter 10, which analyses the development of financial institutions and markets, with assistance from Mayamiko Kashingwe and Carlo Sdralevich. Chapter 11, including the annex, was written by Kasper Bartholdy and Chapter 12 by Kasper Bartholdy with the assistance of Vanessa Glasmacher. They also compiled the macroeconomic data series for each country, with input from the EBRD country economists. Ivan Szegvari provided information and insights on developments in Russia for several chapters. Willem Buiter, John Flemming and Ricardo Lago provided helpful input into a number of chapters. While we have attempted to be as up-to-date as possible, the cut-off date for revisions to most of the draft chapters was early August 1995.

The OCE would also like to thank Andre Newburg for reading and commenting on the entire Report, and Bart le Blanc for his valuable comments. Sandy Donaldson (copy-editing), Victoria Jones (publications), Simon de Nicola (design), Tony Lambrou (design) and Steven Still (design) have provided invaluable assistance in this effort.

We have benefited from discussions with our colleagues at the World Bank, particularly Alan Gelb and his collaborators, who are working on the 1996 *World Development Report* (which will focus on transition), and a number of researchers at the World Bank studying transition. Many people outside the EBRD assisted us in gathering data and other information about countries in the region and we would like to thank them collectively. Some are mentioned in individual chapters.

The assessments, statements and views expressed in this *Transition Report* are not necessarily those of the EBRD. The Office of the General Counsel is responsible for those in Chapter 6. The responsibility for those in other chapters is taken by myself on behalf of the Office of the Chief Economist.

Nicholas Stern
Chief Economist

2 October 1995

Executive summary

Chapter 1

Introduction: opportunities and challenges in transition

This introductory chapter emphasises that the transition is about institutional change, involving not only the advance of the private sector but also a fundamental transformation of the role of the state, in particular in the economic, financial and legal institutions underpinning the market economy. The past year has seen great advances in the region, in terms of the transition itself, in the resumption of growth and investment, and in the control of inflation. Deep-seated and long-lasting challenges remain, however, in creating, developing and strengthening underlying institutions and in restructuring enterprises to overcome the industrial and environmental legacy of decades of the communist system. The main themes of the Report, in particular the leading role of high-quality investment, are summarised in Section 1.7.

Chapter 2

Transition: measurement and indicators

The chapter provides an account of changes in transition over the past year. It presents a detailed description of transition progress in each of 25 countries of the region, including a summary table with country-specific indicators for the stage reached in various areas of reform. While the past year has seen important advances in transition across the region, the most rapid change is now taking place in the countries of the CIS. In the largest of these, Russia, privatisation has advanced substantially, relying heavily on a transfer of shares to insider owners (managers and employees). Russian prices and foreign trade have been increasingly liberalised, although about a third of prices remain subject to restrictions.

After initial reluctance, in the second half of 1994 Ukraine embarked on widespread liberalisation of prices and foreign trade and on privatisation of selected large companies. Most of the smaller CIS countries have, over the past year, liberalised prices and foreign trade while tightening subsidy and credit policies, and most of these countries have begun implementing mass privatisation. In Kyrgyzstan and Moldova, following comprehensive reform and stabilisation packages in 1993, the market focus is becoming entrenched, with prices freed, competition from imports, and advancing privatisation. The countries of eastern Europe and the Baltics, all of which implemented market liberalisation and small-scale privatisation in 1990-92, are facing the longer-term challenges of institution-building associated with large-scale privatisation, enterprise restructuring and financial sector reforms.

Evidence is provided on the changes over time of key social indicators. Mortality rates in Russia and the Baltic states increased by 40-70 per cent between 1989 and 1994, reversing the trend seen in the 1980s. On the other hand, mortality rates in the fast-reforming east European transition countries evolved during 1989-94 largely in line with the trend observed in the preceding decade.

An annex to Chapter 2 presents official data on the private sector share of GDP. These data were collected by the EBRD from statistical agencies and ministries in the countries in the region specifically for publication in this Report.

Chapter 3

Investing for growth

This chapter examines the pattern of investment in recent years and discusses its role in the growth process. The available evidence suggests that investment has fallen, but also that investment began falling before reforms had started, and that fast reform creates the conditions for dynamic investment. Measured against the key role that it should play in providing the infrastructure for private sector development, government investment is low in many transition economies.

Sustained high growth rates will be needed for convergence with Western standards of living, but the transition economies can tap substantial "productivity reserves" in the form of under-utilised human capital, and close a technology and management gap. This should make returns to investment high and thus investment easier to finance. Nevertheless, for the growth process to be sustained, domestic and, in particular, private savings will have to rise. External financing is bound to be limited as a share of total financing for a region as large as 400 million people. However, external participation, through finance and in other ways, can play a crucial role in developing and anchoring reforms and in transferring intangible forms of capital.

Chapter 4

Determinants of investment in the transition

This chapter argues that the price of existing factors of production – including human capital – has in many cases been driven well below their potential yield and thus, compared with similar projects in more mature market economies, potential returns to investment are high. Returns can differ substantially among sectors, depending on the degree of technological obsolescence of existing assets, the effect of shifts in demand and prices, and the scope for complementarities with assets now in excess supply. Given the inherent complexities and uncertainties, a policy of

attempting to target "winners" is unlikely to be successful. Government investment policy should concentrate on facilitating the response to opportunities by helping to reduce or mitigate uncertainty – perhaps the most serious impediment to investment – and administrative constraints, as well as investing in the infrastructure necessary for dynamic private sector development.

Chapter 5

Financing enterprise investment

The evolution of the financing of enterprises is discussed using recent experiences in the Czech Republic, Romania and Russia. In the transition, the financial sector acquires an increasing role, replacing that of government, in mobilising savings for investment and in exercising financial discipline over enterprises. However, as the government withdraws and as the financial sector takes time to transform, the evidence shows that enterprises become heavily reliant on their own internal funds. For enterprises that are controlled by government, by inside managers and workers or by dispersed outside shareholders, there is thus an absence of the financial discipline that can arise from owners or providers of outside finance. The greater provision of outside finance (debt and equity issues) to enterprises with weak governance can become an important source of financial discipline. Recourse to outside finance can be promoted by fostering the development of the financial sector to make outside finance more easily available. A second, complementary, approach involves measures to promote product market competition, primarily through trade liberalisation, enforcement of anti-monopoly laws and facilitation of market entry, which can potentially increase the demand for outside finance.

Chapter 6

The contribution of law to fostering investment

This chapter provides an overview of the legal rules affecting investment in the countries of the region and seeks to assess the effectiveness of those rules by evaluating the degree to which they are clear, accessible and adequately supported administratively and judicially. An annex sets out a country-by-country assessment of these issues. A table also provides a summary score for each country under two broad headings: the extensiveness of the legal rules on investment and the effectiveness of those rules. It shows that the countries of eastern Europe have in general made greater progress than those of the CIS both in adopting legal rules and in applying and enforcing them. Few countries, however, have investment rules which closely approximate to international standards. In those countries that do, the laws are often compromised by being unclear, inaccessible or poorly supported administratively or judicially. Throughout the region, most countries have made more progress in enacting law than in ensuring its effectiveness. In particular, the judicial and administrative support is frequently poor.

Chapter 7

Transition impact of investment projects

Investment projects, if carefully selected, can advance the transition process. Three critical dimensions of the transition impact of projects are identified: the development of market-based relationships between enterprises, the promotion of market-oriented skills and learning, and the development of a competitive market environment. Examples of EBRD and other IFI projects are provided to illustrate these transition impacts, in particular those involving infrastructure services, privatisation and restructuring, and the development of competitive interactions between banks and enterprises. The promotion of learning, in the sense of reskilling, can enhance the compatibility of the existing stock of "human capital" with markets and new processes. Small and medium-sized enterprises are identified as attractive vehicles for testing and demonstrating the profitability of new processes. To the extent that these types of high-transition-impact projects generate benefits that are not captured by the original investors, there is a role for governments, development agencies and international financial institutions in the promotion of such projects.

Chapter 8

Ownership, governance and restructuring

The structure of ownership greatly influences the scope for effective corporate governance. This in turn influences the degree of restructuring which is likely to take place. These issues are discussed, largely with reference to four countries: the Czech Republic, Hungary, Poland and Russia. Privatisation programmes have dramatically altered ownership structures in these countries in recent years, but the early evidence suggests that these reforms have not necessarily improved corporate governance significantly. From the best available survey evidence, it appears that "inside" ownership may be delivering less effective governance than dominant outside ownership. In particular, it seems that "deep restructuring", involving substantial new capital investment, is being undertaken to a much greater degree in firms with dominant outsider-ownership, especially those owned by foreign investors. Deep restructuring may be achieved by other means; in particular, the development of securities markets can contribute to better governance and more active restructuring by facilitating a concentration of outside ownership. The design of mass privatisation schemes, in countries that have not yet embarked on the process, can benefit from the experience of the early reformers.

Chapter 9

Small and medium-sized enterprises

SMEs play a special role in transition, as vehicles for experimentation in product markets (discovering competitive advantage), and by providing demonstration effects, among other functions. They allow flexibility in highly uncertain environments, provide re-employment opportunities for displaced employees and managers from the state sector, and provide productive use for household savings in markets with underdeveloped financial institutions, especially in the early to middle stages of transition. An accompanying annex summarises the development of the SME sector in each of the countries of the region, providing official data and additional information on the size and characteristics of the sector, and the contribution of SME-related legislation and other support programmes implemented by the government.

Governments can promote SMEs, along with all economic activity, by providing a stable macroeconomic environment and a "level playing field". This involves removing the range of restrictions and biases against SMEs inherited from command economies and placing SMEs on the same regulatory and tax footing as other economic activity. International financial institutions can also help by providing a combination, not generally available elsewhere, of lending, equity and technical assistance for SMEs.

Chapter 10

Developing financial institutions and markets

Progress in financial reform is examined here. Despite advances in reform of banking regulations, enforcement capacity is limited, particularly in the CIS. In eastern Europe, the problem of bad loans is pervasive and the pace of bank privatisation has been slow. In the Baltics and the CIS, there has been extensive entry of new private banks, some of which have gained market prominence, and consolidation of the weaker new private banks has begun. The international financial institutions are assisting the development of a core of private banks to serve as the nucleus of a viable banking system. As the asset quality problem is resolved in the region, market conditions should allow banks to operate profitably. Since banking markets remain small and mostly concentrated, further entry into banking will be required, but this process must be disciplined by adequate minimum capital requirements and effective regulation.

There has also been progress in setting up securities markets, but less in establishing and enforcing regulations in this area. The method of privatisation heavily influences the development of securities markets in the region, which are either highly undercapitalised or illiquid, compared with those of advanced industrial and high-growth East Asian countries. Securities markets are important both to provide effective governance after mass privatisation and to finance riskier investments (increasingly so for countries constrained by EU accession guidelines for safe banking).

Chapter 11

Recent economic developments

Macroeconomic performance is the subject of this chapter. Most countries in eastern Europe and the Baltics recorded healthy output growth during 1994 and the first half of 1995, following a precipitous contraction over the preceding three years. Output is still declining in most of the CIS countries but at a gradually slower pace. Thus, the picture emerging is one of growth in those countries that entered the process of market-oriented transition and macroeconomic stabilisation in earnest around 1989-91, and of gradual stabilisation of output in those countries that entered the process a few years later.

Inflation has fallen sharply during the past two years in the vast majority of the countries of the region. With one exception, all the countries in eastern Europe and the Baltics are likely to see consumer price inflation of less than 50 per cent a year by the end of 1995. A sharp deceleration in the pace of price increases has also been recorded in many countries of the CIS, although the level of inflation in most of these countries remains substantially above 100 per cent a year. Most strikingly, Georgia, Kyrgyzstan and Moldova have brought inflation down to 1-3 per cent a month during the first seven months of 1995.

An annex to the chapter presents a tabular summary for each country of macroeconomic developments in recent years. Most of the data series come from official national sources, and the systemic change in both the economic and statistical systems imply that problems of interpretation are severe. These issues are discussed in detail in this same annex.

Chapter 12

Forecasts and prospects

A compilation of country-specific forecasts for growth and inflation is presented, summarising perceptions among forecasters of prospects for countries in the region. For most countries in eastern Europe and the Baltics, GDP is forecast to grow by 3-6 per cent in both 1995 and 1996. For the CIS as a whole, negative growth of 4-9 per cent is predicted for 1995, followed by a turnaround to positive growth of less than 1 per cent in 1996. Most forecasters are predicting further progress towards price stability during 1995 and 1996 throughout the region.

The chapter includes a discussion of the accuracy of earlier predictions for growth and inflation based on comparisons between forecasts and outturns. On this evidence, the ability of forecasters to predict short-term developments in GDP and inflation in eastern Europe and the Baltic countries appears to have improved in 1994. However, the precision of their short-term predictions for the evolution of the same variables in the CIS countries seems to have deteriorated sharply.

Transition report

Part I

Assessing progress in transition

Introduction: opportunities and challenges in transition

1

1.1 Introduction

The purpose of the European Bank for Reconstruction and Development is "... to foster the transition towards open market-oriented economies ..." (Article 1 of the Agreement Establishing the EBRD, 29 May 1990). The purpose of the *Transition Report* is "to examine the transition in the Bank's countries of operations and to measure, interpret and understand its progress" (*Transition Report*, 1994, p. 3).

Transition is the process through which open market-oriented economies are being established. It involves changing and creating new institutions. The indicators in Chapter 2 of this Report are intended to capture the stage that each economy has reached in its move to a market system. Accordingly these indicators focus on the basic elements of a market economy: enterprises; the markets in which enterprises and households interact with each other; and the financial and other institutions that underpin enterprises, markets and transactions. In constructing and presenting these indicators we have, with some extensions and refinements, adopted the approach initiated in last year's *Transition Report*. The movement of these indicators over time charts the transition.

From this definition of transition, and the associated bases for the indicators, it is clear that market-oriented *transition* is, as a concept, sharply different from economic *development*. Development refers to the enhancement of the standard of living of individuals. Central to the definition of standard of living are command over resources, education and health. Countries in eastern Europe, the Baltics and the CIS have embarked on market-oriented transition, in large part because they believe it will advance development. However, as many recognised at the outset, there will be substantial sacrifices of important aspects of development to be made on the way. One of the main themes of this Report is that, although many of these sacrifices have been severe, the rewards of transition, in terms of a resumption of growth, are already appearing strongly in many of the countries of the region.

Market economies vary considerably: in the extent, organisation and regulation of markets; in the types of enterprises, legal systems, financial institutions, capital markets, labour relations, pension arrangements and housing markets; and in the structure of social support. To put it more generally, they vary both in the detailed operations of economic institutions and in the role of the state in economic life. For all the economies in the region, there are basic choices to be made in the next few years within these dimensions that will be crucial in determining the kinds of economy and society that will evolve. Thus, while there are core features which a market economy must possess, there is no unique destination for the transition.

Just as the destinations will vary, the starting points for the transition at the end of the 1980s differed greatly across the countries of the region. The countries outside the former Soviet Union had seen four decades of communism whereas the former Soviet Union itself (excluding the Baltics) had experienced seven. Thus for the former Soviet Union only those over 85 years old at the start of transition could have a clear memory of an alternative to the command economy, and that alternative was in many respects semi-feudal. On the other hand, some countries, such as the Czech Republic, were among the leading industrial market economies between the two World Wars. Others, such as Hungary, embarked on experiments in reform in the 1970s and 1980s. A few, such as Poland, had extensive private sectors at the outset of transition, in particular in agriculture. Some countries, such as Albania, Bulgaria, Hungary, Poland, Russia and the former Yugoslavia, began the process with substantial international debt, whereas for most others international debt was negligible. In all these respects the economies differed in their experience.

The economies of the region also differed at the outset of transition regarding their endowment of natural resources. Some countries, such as Kazakstan, Russia, Turkmenistan and Uzbekistan, are very rich in petroleum, gas and minerals. Others, such as Ukraine, have little in the way of natural resources, but are rich in fertile land. The highly concentrated and distorted industrial structures of the Soviet system left some newly independent countries, such as Belarus, heavily dependent on the production of a range of defence and capital goods for which there is now little demand.

For all these reasons, the point of origin of the market-oriented transition varied radically across eastern Europe, the Baltics and the CIS. These differences in both origin and destination imply that one cannot and should not expect a unique route for the transition. There are, however, certain fundamentals of market economies that must be part of any successful transition. These include key elements that we embody in our transition indicators in Chapter 2 – private enterprise, competitive markets and sound institutions as a basis for commercial transactions. The fiscal and monetary disciplines required for macroeconomic stability are themselves fundamental for the development of a well-functioning market economy. Indeed we shall see, in the next and other chapters, that those countries that have recognised and acted on these fundamentals have not only shown the greatest progress in transition but have also experienced an earlier resumption of growth and lower costs of adjustment.

The countries of eastern Europe, the Baltics and the CIS have embarked on a *political* as well as an *economic* transition. Indeed, Article 1 of the Agreement Establishing the EBRD explicitly states that its purpose is to foster the transition towards open

market-oriented economies in "... countries committed to and applying the principles of multiparty democracy, pluralism and market economics". The combination of political and economic liberalism was explicit. The focus of this (and the previous) *Transition Report* is on the economic transition (corresponding to Article 2 which describes the "functions" of the Bank in terms of economic activities to fulfil its purpose). A detailed account of the political transition is beyond the scope of this Report, but there are certain crucial features of the relationship between economic and political transition, in theory and practice, on which we shall comment here.

Taking the empirical aspects first, the establishment of multiparty democracy in much of the region is striking. By and large, constitutions have been written and observed, political parties have emerged, there is lively and open discussion in the media, and power has changed hands in free and open elections. For most countries in the region the speed of establishment and the robustness of democratic political systems is likely to be viewed as remarkable in a historical perspective.

The democratic process has seen the electorate in a number of countries express concern over the disruption and stresses of transition. Yet it is impressive, and important to recognise, that throughout the region there have been few reversals of either political or economic reforms. Reservations have been expressed over the speed and the administration of the reforms, and the vulnerability of key groups. And in some countries the speed of market-oriented transition has been slow. Yet in the vast majority of countries in the region the basic direction of the reforms has not been subject to serious political challenge.

Democracy and democratic structures are not, however, uniform or complete and they cannot be taken for granted. There is much more to democracy than multiparty elections. Democratic institutions take time to become firmly rooted and require responsible participation from government and populace. Thus, while the democratic advance has been striking, democracy is not wholly secure.

The former Soviet Union and the former Yugoslavia cut across numerous linguistic, ethnic and religious boundaries. Many tensions, which had been suppressed and controlled in these regions under the old regimes, have recently broken out. There has been ethnic strife in a number of countries of the region. As the experience of Africa in the last two to three decades has shown, this can be devastating for people's livelihoods and for economic development.

The mandate of the EBRD states its support for multiparty democracy and associated rights, as did the population of much of the region at the time of the fall of the command economy. Economic and political processes are linked and, in particular, we should consider the implications of market-oriented transition for political development. Some, including Balcerowicz, have argued that a successful and rapid market-oriented transition is required for the protection of democracy.[1] Attempts to establish a market economy can, if poorly managed and overly protracted, generate stresses and difficulties that could undermine democracy and provide the circumstances for an authoritarian take-over. A successful transition, however, as experience is already showing, delivers the kind of rewards that can strengthen both the political and economic commitment to reform.

1.2 The state in transition

The market-oriented transition involves a redefinition of the role of the state. It does not imply a reduction of the state to a minimal entity. There are a number of key responsibilities the state must fulfil if a market economy is to function effectively. The most important is to provide economic order in transactions and macroeconomic stability. Without the former, market transactions and decisions are undermined. Effective economic decision-making requires an ability to assess economic returns. This does not, of course, mean the absence of uncertainty, but it implies an understanding of stable "rules of the game" so that rational calculation of cost and reward is possible. Similarly, inflation can have a corrosive effect on rational decision-making through the volatility and obscurity it brings to the price signals that are at the heart of the market process. Inflation undermines both the quality and quantity of investment by distorting enterprise decision-making, by engendering short-termism and by diverting energies to purely financial manipulation (see Chapter 3).

While these two factors are primary and basic, the responsibilities of the state in a well-functioning market economy are much more extensive. Many of these pertain to the nature of the rules of the game, importantly the promotion of competition, both domestic and through international trade, and, in particular, entry into markets. This includes the removal of arbitrary barriers to entry associated with quotas, licences, permits, regulations, cartels and other restrictive practices. On the other hand, the regulation of privatised utilities and genuine natural monopolies will be necessary if the establishment or abuse of special market positions is to be avoided. And financial institutions will require regulation to protect transactions against external and internal breaches of trust and manipulation. Well-functioning laws and legal institutions (see Chapter 6) will be required to support the honest and effective corporate governance which is basic to both the quantity and quality of investment and production decisions.

Since the main focus of the *Transition Report* is the establishment of the conditions necessary for vibrant market development, including state regulation of the rules of the game in markets, there is only limited discussion of social issues (mainly concentrated in Chapter 2, Section 2.3). The following will briefly highlight the important role of the state in providing the social infrastructure necessary for development.

[1] See, for example, Balcerowicz (1995).

Health and education are fundamental areas of activity both in their own right and for the functioning of the economy. Decisions concerning the way in which they operate will shape the society and the economy. Many of these decisions lie ahead for much of the region. There are major areas of health and education for which substantial public involvement will be desirable. However, we must distinguish here between the funding and the provision of such services – both for physical and for social infrastructure. Some aspects of health and education could, and arguably should, be both privately funded and privately provided, while most would argue that education up to a certain age should be both compulsory and publicly funded, although it may or may not be publicly provided.

Some of the most challenging aspects of transforming the role of the state arise from burdens inherited from the structures of the old system – in particular, problems concerned with social protection and the restructuring of state-owned enterprises. As in many advanced industrial economies, the promises embodied in the existing pension systems are putting intolerable burdens on the budgets of many countries of the region. The reform in the provision to existing pensioners, the method of finance, the structure of the future entitlements and contributions, and the role of the private sector constitute an urgent task for the next years throughout the region. Decisions here will have a profound effect not only on the budget but also on capital markets and savings decisions.

A related, but distinct, obligation of the state is the establishment of a social safety net or social protection. Most would accept that the state has, at a minimum, the obligation to protect the population from starvation and destitution. The nature and level of such protection is a fundamental choice. Further, the absence of such protection can be a hindrance to the reallocation of labour, which will be a crucial part of the transition. The provision by enterprises, in some CIS countries, of many aspects of social services, including elements of housing, education and health, poses a challenge for enterprise reform.

The change in the role of the state along these dimensions (the rules of the game, health, education, restructuring state-owned enterprises and social protection) constitutes unfinished business, even in the countries of the region that are most advanced in the transition. The further redefinition of the role of the state remains a profound challenge for all countries of the region.

1.3 Private sector development

Great strides have been made in most countries in the region in establishing a private sector. In 9 out of 25 countries the private sector accounts for more than 50 per cent of GDP (see Table 2.1 in Chapter 2). There remain, however, many difficulties in its functioning and numerous obstacles and impediments to its growth. The coming years are crucial to the pace and form of its development. The private sector needs the guidance provided by sound examples of successful private investment projects together with a policy and administrative environment that will allow it to develop in a strong and rational manner. Some policy challenges and responses are described in broad terms below. Many of them are taken up in more detail in Parts II and III of this Report.

Excessive regulation and arbitrary obstacles abound – in large part inherited from the old regime. Some of these obstacles arise from the confusion of a system under change in which new legal and administrative structures have been transplanted in a hurry and in which there are many conflicting and ambiguous laws and regulations. Other problems can stem from the behaviour of bureaucrats with ill-defined responsibilities who may be anxious to take a personal share in any rewards.

A second set of obstacles to private sector development lies in the evolution of financial institutions and markets. Again, we find substantial progress, particularly in legal and regulatory reform, but fundamental difficulties remain which will take time to overcome. Newly emerging or privatised firms with an entrepreneurial leadership and good ideas will need capital to grow and adjust. The availability of external finance generally depends on both track records and collateral, but there may be little to offer on either count. Indeed, given that most enterprises have only existed for a few years, track records are necessarily short. Accounts (and business plans) are understandably requested by a lender and firms are likely to find great difficulty, given their inexperience, in providing data in the form required. Collateral requires legal underpinning if it is to secure a loan, and the status and enforcement of property rights might be unclear in the presence of often contradictory claims and uncertain obligations (see Chapter 6).

The financial institutions are themselves new and embarking on a learning process. The financial sector was virtually absent in the old regime and had to be created from scratch. The Czech Republic had 8,000 bankers in 1991 and 55,000 by the end of 1994.[2] Banking skills and judgement depend on experience and relationships and these take time to establish. The uncertainties of new initiatives, legal insecurity and the lack of track records are endemic to the transition. These have, in some cases, been compounded by macroeconomic instability.

Bad loans contribute to the precariousness of the financial position of many banks and to the need for recapitalisation and restructuring. Banking regulations and effective supervision take time to develop. All these difficulties imply that the financial system in the countries of the region, notwithstanding the great progress in some areas, is as yet deficient in providing adequate support to economic expansion. In these circumstances it is not surprising that most bankers are reluctant to lend beyond the short term. Indeed, enterprises appear to be heavily dependent on internal finance (see Chapter 5). There is therefore a key role for the international financial institutions (IFIs), in particular the EBRD, in strengthening institutions and stimulating investment finance for the private sector (see Chapter 10).

[2] Vit (1995).

A third set of challenges to private sector development lies in the restructuring of large enterprises. Many of these enterprises are saddled with a product range for which there is little or no demand, obsolete equipment, an oversized workforce with an inappropriate mix of skills for a market economy, a set of expensive social responsibilities to their workforce and large debts. The problems are daunting and must be tackled on a large scale. This is in contrast to the restructuring of problem industries in Western societies, which can be supported by profits and tax revenues arising elsewhere in the economy. It is not easy to find finance for the restructuring of industries in the region. In addition to the scale of the finance required, it will have to be long term, will involve considerable risk and will require accompanying technical cooperation and grants. There are many examples of the restructuring of single industries in Western economies which required many years, and the problems in transition countries are much deeper and more extensive than those of a single industry in an advanced industrial country.

A fourth challenge to private sector development is the establishment of viable corporate governance. Managers and workers have to adapt to a new system of private ownership in which they are responsible to the owners of the firm. The relationship between ownership and control depends on transparency in operation, clear rules of the game, and structures through which owners can express their preferences or dissatisfaction. All of these three elements will take time to establish and will require legal underpinning. The problems are particularly severe when firms are privatised to "insiders" so that workers and managers have great powers relative to outside shareholders (see Chapter 8).

Progress in establishing corporate governance requires good models of behaviour, enforcement of commercial law and practices, and viable and strong secondary markets for securities. This is an area where the experience and expertise of IFIs and foreign investors can play a crucial role in establishing the right environment. For example, irresponsible behaviour by private agents or by government in dealing with shareholders can seriously undermine both foreign and domestic investment.

In addition to the legal and financial infrastructure, the physical infrastructure also poses a number of challenges to private sector development. Modern telecommunications are crucial for the viability of enterprises. Environmentally sound and reliable electricity and water supplies are also essential for their effective operation. Cost-effective investment in market-oriented infrastructure on a large scale, involving both the private and public sectors, will be required.

We have listed many challenges to private sector development inherent in the transition process. As the strong progress in this sphere has demonstrated, the challenges are formidable but not insurmountable. They exist, albeit in a less serious form, in many mature market economies. Their severity does mean, however, that it will be many years before the region's private sectors function as in a mature market economy. In this basic sense, the transition will take many years to complete.

1.4 The resumption of growth and investment

For the majority of the countries of the region, the period of declining output is over. For many of them the prospects for an extended period of strong growth are very good. Indeed, many of them share a number of the key features underpinning the outstanding growth of East Asia over the last few decades. These include an outward orientation of the economy, macroeconomic stability, an educated labour force, nearby countries containing many strategic investors (in this case the EU), and a large potential nearby market (again the EU). Of course, they also have many difficult legacies from the old regime, but nevertheless for many of them the outlook is promising. The challenge will be to overcome the obstacles described and to develop economic and financial arrangements and skills that allow the potential to be realised.

The opportunities for investment created by this potential growth will be large. If medium-term to long-term growth rates of 5 per cent, or higher, are to be attained then investment finance of the order of 20 per cent or more of GDP will be required. The investment tasks are rendered more challenging by the high degree of obsolescence of the existing capital stock, the requirements of restructuring and the inadequate infrastructure of most of the countries of the region.

The limitations on available finance from abroad indicate that over the medium term a country's investment must, for the most part, be financed from its own savings. That is a key lesson from the East Asian experience. It is, therefore, of paramount importance to strengthen the financial sector and institutions, which will allow the mobilisation and allocation of domestic savings. That is one of the reasons that the financial sector has been such a high priority for the EBRD and other IFIs.

External investors can, of course, play an important role in providing investment and finance. But they will also play a vital role in developing basic skills and technology and providing models for higher standards of quality. The establishment of quality, both in terms of products and of capital investment, is crucial to seizing market opportunities and achieving growth.

The task of realising the growth and investment potential is immediate and central to the next stages of transition (see Chapter 3). If these investment opportunities are grasped over the next five or ten years, many of the countries of the region are likely to be launched on a process that could be self-sustaining. The task will be lengthy and daunting, however. A simple numerical example is instructive. If living standards are currently of the order of one-third of those in western Europe (as may be the case for a number of east European countries currently seeking accession to the EU) then a growth rate of 3 percentage points above those in western Europe for the next quarter of a century will be required to bring living standards to two-thirds of those in western Europe. The long period of waste and decay under the old regime has made the task of "catch-up" an enormous challenge. The magnitude of this task and the depth of the restructuring problem means that it will be a long haul. But the prospects for many countries and the investment opportunities are now looking highly promising.

1.5 Integration into the world economy

As documented in last year's *Transition Report*, the reorientation of international markets since 1990 has been remarkable. The countries of eastern Europe and the Baltics have rapidly reoriented their trade towards the Western market economies, while trade between the CIS and the West began only in 1994 to rise after a decline during the preceding three years. The EU has clearly dominated as the destination for "new" exports and is now the main trading partner for most countries in eastern Europe and the Baltics. Meanwhile, intra-regional trade has declined sharply, although there has been a revival, from low levels, in trade between east European countries during 1994-95.

Progress in market development and the realisation of potential growth rates will depend crucially on the trading policies of other countries and, in particular, the EU. Since the beginning of the 1990s, overall OECD tariff levels on imports from eastern Europe, the Baltics and the CIS have been generally non-discriminatory.[3] Problems of protection by OECD partners do arise, however, especially in so-called sensitive areas, including textiles and clothing, agriculture, and iron and steel, in which the countries of operations often have a comparative advantage but in which OECD countries have been particularly reluctant to embrace free trade. Total sales from the region account for only around 1-4 per cent of the OECD area's total imports of these sensitive products.[4] It is vital that the progress the OECD has made in opening its markets be maintained and extended.

Those countries in eastern Europe and the Baltics that are partners to "Europe Agreements" with the EU will benefit from favourable tariff and non-tariff treatment. By the summer of 1995, Europe Agreements had been signed by Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and the Slovak Republic. Slovenia and the EU had initialled an Agreement. These countries will see EU customs duties on their exports of steel products, coal, textiles and clothing eliminated by 1997 at the latest. If the Europe Agreements are not revised, then countries will enjoy free trade with the EU in all industrial products by the year 2001. However, even after that date, agricultural trade will not be subject to free trade, and anti-dumping and safeguard clauses which can be invoked by EU producers in response to a substantial drop in their market shares will remain in place. Furthermore, barriers will remain significant for transition economies not covered by these agreements.

The last year has seen the emergence of accession to the EU as a key issue for most of the countries in eastern Europe and the Baltics (see the more detailed discussion of this issue in Chapter 11). A "White Paper"[5] outlining the steps to be taken within the countries applying for accession was circulated in the spring of 1995 and endorsed by the meeting of the EU summit in Cannes in June. The advance of the transition will be a central part of this story – promoting the transition is promoting the conditions for accession. It is unlikely, however, that accession for any country will occur much before the turn of the century. The Inter-Governmental Conference (IGC) of the EU states, to start in 1996, will form a major part of the process. This IGC is unlikely to be completed before the middle of 1997 and this must be followed by a process of ratification by member states that could take one or two years. And agreement among existing members is likely to require major reforms to the Common Agricultural Policy and the Structural and Regional Funds as the new members would place substantial demands on such funds. Further, the problems that originated in the old command regimes and that require economic reform and restructuring for their resolution will subsist far beyond the year 2000. Accession to the EU will be an event of great importance, but it will not be the end of the transition.

A number of the countries in the region are members of the World Trade Organisation (WTO), including the Czech Republic, Hungary, Poland, Romania, the Slovak Republic and Slovenia. There are currently requests for WTO accessions from Albania, Armenia, Belarus, Bulgaria, Croatia, Estonia, FYR Macedonia, Latvia, Lithuania, Moldova, Russia, Ukraine and Uzbekistan. It is important for their market growth that membership be granted speedily and that the WTO move strongly in its task of advancing the openness of world trade.

The integration of countries in transition into the world economy goes far beyond trade. These countries are creating the conditions for successful foreign direct investment (FDI), from which they will benefit greatly in terms of skill transfer. Foreign investment into the region nevertheless remains very low. In 1994, the total FDI into eastern Europe, the Baltics and the CIS, a region with a population of 400 million, was similar to that into Malaysia with a population of 19 million.

The advance of FDI will depend to a great extent on conditions in the countries of the region: it is up to them to create the conditions where FDI can expand. However, at the same time foreign investors may have been slow in responding to the vast investment opportunities in the region. One promising sign is an increase in the geographical diversification of FDI flows into the region (Chapter 3).

Working with domestic investors, FDI is likely to contribute to the conditions for its own success. The workforce and natural resources of the region have high potential. The task is to create and discover comparative advantages through investment, technology upgrading and trade. Now is a time when creativity can establish industries, products and patterns of trade that will determine the structure of economies. It is a time for domestic and international entrepreneurs to work together.

[3] The tariff levels are based on most favoured nation (MFN) status, which gives a country tariff treatment equal to the lowest rate generally offered to other countries. Most countries also enjoy privileges under the general system of preferences, which was established as an exception to the MFN status to accord lower tariff rates for imports into industrial countries from developing countries.

[4] OECD (1994).

[5] European Commission (1995).

1.6 The challenges ahead

The achievements in the majority of the countries over the last five years have been remarkable. Macroeconomic stabilisation, price liberalisation and extensive privatisation have been achieved in much of the region. In most cases the period of output decline is over and, with the right conditions, policies and assistance, countries can look forward to an extended period of growth. For such countries the challenges are to deepen the reforms, to restructure large enterprises, to seize the investment opportunities, and to establish and redefine the role and responsibilities of the state in the market economy. The response to the challenges of the next phase of the transition will be vital in defining the form of the market economy and the success in economic growth of the countries of the region.

Private enterprises and investment, the focus of this Report, lie at the centre of these challenges. Private enterprises that have been established or privatised face serious problems in financing growth and restructuring, in corporate governance, in their legal, administrative and social environment, and in the supporting infrastructure. IFIs, investors and governments all have key roles to play in fostering the development of these new enterprises and in allowing further enterprises to be born and flourish.

The investment challenge will be immense. There are markets to be sought and established, equipment and workplaces to be constructed, and the right management skills to develop. The basic infrastructure will be crucial to this process. Modern telecommunications and transport are essential to establishing the links that a modern firm must have if it is to be successful in the world economy. Reliable and environmentally sound water and power supplies are similarly vital ingredients in the effective operation of the modern firm. The government must seek to ensure the supply of these infrastructural elements in a flexible and competitive manner. This will require a regulatory environment that provides incentives for investment, while at the same time protecting consumers against the abuse of monopoly positions. The government must also ensure the supply of infrastructure without imposing intolerable burdens on the public finances. For all these reasons commercially-oriented infrastructure is a high priority for EBRD investments.

It must be recognised, nevertheless, that the progress in transition and the resumption of growth are far from uniform. There are still a few countries for which progress in transition has been slow. However, even here there are encouraging signs of movement. There have been important breakthroughs, for example in Ukraine and Armenia over the last year. Reform programmes are on the way in much of Central Asia. But in countries for which political as well as economic transition has moved less far, investment is still difficult to stimulate.

Evidence elaborated in this *Transition Report* indicates that those countries that have moved most firmly in transition and stabilisation have suffered the lowest costs in the process and are starting to see the rewards. These rewards have not come instantly but they can and do begin to appear within two to four years of decisive transition measures being implemented. While living standards will take some time to recover, in historical terms four years must be regarded as a remarkably short period for the returns on such a radical economic and social change to start to emerge. The arguments for further advance of reform in countries at earlier stages of transition are now observable and powerful.

The next phase for the more advanced countries will be to realise, through investment and further reform, the growth potential that is now emerging strongly. For the countries less advanced in the transition, the crucial reforms must be enacted quickly. For all countries of the region the next five years will be fundamental in shaping their economies and societies.

1.7 The central themes of the Report

A number of key themes emerge from this *Transition Report* concerning the performance of the economies of the region and the progress of their transition. The most striking feature of performance over the past year is that most countries of the region are now showing economic growth. For these countries the period of output decline is over. Trade with advanced countries, particularly in the EU, continues to expand for much of eastern Europe. Intra-regional trade is also showing signs of recovery. However, there are some economies, particularly in the CIS, where output is still falling and persistent high inflation remains a problem despite recent progress. While in most cases the initial shocks may be over, no country has regained its output level of 1989. The challenge remains to consolidate macroeconomic stabilisation so that, together with further advance in the transition, the groundwork is laid for sustained economic growth.

The transition to the market economy has indeed advanced strongly in the past year. The changes have been greatest in countries that had moved less rapidly in the early 1990s. We are seeing a number of countries, including the largest in the region, Russia and Ukraine, moving into and through intermediate stages of transition. The process is far from smooth, however, with stops as well as starts. Countries that embarked on the transition earlier and more firmly have shown further advances in the continuing development of economic, financial and legal institutions, but the task is great and this process of institutional development will take time.

In many economies of the region the fraction of output coming from the private sector is well above 50 per cent and most prices are liberalised. But this does not mean that the transition is over. Important milestones have been passed, but the institutional structures are still far from working as they need to in an advanced industrial economy. This Report shows that the functioning of basic elements of a market economy, including the structure of the enterprise and its corporate governance, competition policy, the banking system, securities markets and the legal structure, remains weak. That institution-building takes time was a major theme of last year's *Transition Report* and this Report underlines this conclusion emphatically.

Privatisation and its aftermath provide some key examples. One cannot simply privatise and expect firms immediately to function like their counterparts in advanced economies. The form of privatisation used – with its implications for the role of insiders, for whether outsider ownership is dispersed or not, and so on – is a basic determinant of the subsequent performance of firms. The further development of post-privatisation structures of ownership and management will be fundamental to the further advance of the transition. Financial institutions and securities markets, which provide both finance and some elements of outside control, will have a key role to play. These are areas where international financial institutions can make important contributions. In all these activities they can also contribute by setting standards of business ethics – responsible behaviour is a key ingredient for an efficient market economy.

Restructuring of enterprises and the economy will be central to the further progress of the transition. There are many dimensions to restructuring, including management, organisation, employment, divestiture of social assets, balance sheets, product mix, technology and marketing. While some changes can move quickly, restructuring on other dimensions, particularly those involving investment in new production processes, takes longer to achieve and must be underpinned by effective corporate governance and financial institutions. Some of the restructuring will be required to meet environmental, energy and safety standards of international organisations such as the EU. The industrial legacy of the decades of the command economy cannot be overcome in only a few years.

Investment must play a leading role in the process of transforming both enterprises and the economy. The movement towards the market economy, the resumption of growth, the reduction of inflation, the competitive real exchange rates – all have created promising conditions for investment. But substantial obstacles remain. The challenge is now to generate the investment needed for vigorous growth and to continue and deepen the transition. The necessary private investment will be committed only if there is a stable macroeconomic environment with effective financial, legal and regulatory institutions. Macroeconomic stability and development of effective institutional frameworks are well along the way in much of eastern Europe and the Baltic states, but there is much to be done to ensure that these institutions function to the standard of advanced industrial economies. And in the CIS both the macroeconomic stability and the institutional framework are fragile and in some dimensions still embryonic.

The next period of the transition must be led by high-quality investment. The old regime did generate large amounts of investment but much of it was of poor quality, of low productivity, undirected to demand, and dangerous or polluting. With the right kind of institutions, leadership and partnership, the private markets in these countries can deliver the quality investment which is necessary for successful economic growth. The IFIs must play their part in moving the investment process forward by supporting high-quality projects, providing resources and facilitating technical assistance. In this context foreign direct investment and partnership can carry great benefits in providing market skills, management, technology and finance, as well as effective corporate governance.

Private investment cannot flourish in isolation. As well as effective liberalisation, it requires human and institutional capital, which are key to making it profitable. It also requires infrastructure. The private sector can and must be central to the finance and operation of infrastructure facilities, given the scale and nature of the task. However, governments must play a major role, including setting the rules of the game governing the scope of private and public activity in these sectors, and providing regulation to safeguard competition and consumer interests, as well as making their own direct investments. These are areas where the IFIs have considerable global experience and can help mobilise the necessary finance on the scale required. With the right level, quality and balance of investment the prospects for growth are encouraging.

Lastly, we must note that the social upheavals of the past few years have been very severe in much of the region. The rise in mortality in the Baltic states and the CIS represents loss of life on a scale that has received insufficient recognition. It surely represents deep underlying stresses. The strains of the transition process must be recognised and understood, but that recognition is likely to emphasise still more strongly the case for the continued advance of the economic reforms.

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Transition: measurement and indicators

2

The transition indicators reported in this chapter focus on key aspects of liberalisation and institution-building, grouped under four broad headings: enterprises, markets and trade, financial institutions and the legal system. There are strong complementarities among these different areas of reform, some of which are discussed later, so that lack of progress on one dimension can undermine the potential benefits of advances on another. A proper assessment of a country's progress should take these complementarities into account.

Table 2.1 displays the share of the private sector in economic activity (which is quantified), and scores the transition indicators for each country based on a qualitative classification system. While the scoring in each reform area is by its nature only approximate, the country-level transition indicators do provide a cross-country comparison of the stage of transition along different dimensions, while movements in scores over time indicate the pace of reform.

We have refined the transition indicators and the classification system first presented in the 1994 *Transition Report*, although we have retained the basic structure. Comparing this year's Table 2.1 with last year's, the principal changes in the transition indicators are the following:

- Last year's category "price liberalisation and competition" is broken into two separate categories with competition policy defined as a separate transition indicator. The heading "competition policy" encompasses a number of aspects of policy and institution-building that were not fully captured by the earlier consolidated category. This is of particular importance since the industrial structure of socialist economies inherited by transition economies showed a very high degree of industrial concentration and vertical integration. As few countries have undertaken substantial pre-privatisation restructuring, the tasks of post-privatisation regulation in some sectors are significant. As public utilities are privatised, and liberalisation increases the scope for competition in some infrastructure sectors (e.g. telecommunications and transport), there will be greater need for a properly targeted, efficiency-enhancing competition and regulatory policy if the market system is to function effectively.

  The classification criteria for the competition policy indicator involve two areas: first, whether competition legislation and institutions are in place and the degree to which they function effectively and, second, the extent to which statutory and regulatory barriers to entry have been removed. However, because of limited availability of information at this time, the assessment of competition policy in Table 2.1 is based primarily on an evaluation of progress in legislation and institution-building, although supplementary evidence on trade liberalisation, the growth of the private sector and other available information is also taken into account. In future *Transition Reports* the basis for evaluation will be broadened.

- Securities markets and non-bank financial institutions is introduced as a new category. As transition advances, the important role of non-bank financial intermediation and the challenges in establishing effective supporting regulation are becoming more apparent.

- The extensiveness and effectiveness of legal rules on investment is introduced as another new category. The associated indicator is based on an assessment not only of the extent of coverage and content of relevant statutes, but also the clarity and accessibility, the administrative support, and the judicial enforcement of the law. Chapter 6 presents in tabular form a detailed description of reform in this area.

- We have included an additional score of 4* for each transition dimension. This score is used to indicate that the policies and performance standards achieved in that category are not very different from those in an advanced industrial economy (taking into account the fact that these economies themselves vary substantially). This should be seen as a division of the old 4 category into an upper and lower range and does not involve any rescaling of other parts of the scoring structure.

- The classification criteria for several indicators have been refined to reflect more fully the diversity in the rate and direction of reform in the region. The 1994 classification system is otherwise left largely intact, in order to allow comparisons over time.

In revising the classification criteria, still greater emphasis has been placed on assessing the actual performance standards resulting from policy reform (rather than the existence of the measures *per se*), particularly in the areas of regulatory reform and institutional development. In making all of these refinements, we have been careful to ensure that the country scores that were published in the 1994 *Transition Report* were compatible with the modified classification criteria (i.e. that no country would have received different scores in 1994 based on the revised criteria).

In reading the transition indicators and their classification, the following factors should be kept in mind. First, the classification system in each area of reform is hierarchical. The requirements for a higher category include all those of a lower category. Second, to the extent that different transition indicators are complementary, they need to be read together. The effectiveness of reform in one

area may be undermined if there are significant distortions in closely linked areas which "spill over". A good example is the liberalisation of domestic energy prices in Russia. Although there were no controls on the domestic price of oil products in 1994, energy export quotas and taxes depressed domestic prices significantly below world prices, and thus prolonged energy-inefficient production, slowed restructuring and weakened investment incentives in Russia's promising energy sector. The liberalisation of these export restrictions in early 1995 significantly raised oil prices in Russia.

This vividly illustrates the links between price and trade liberalisation, but there are other important examples of complementarity. These include the role of capital markets (including associated regulatory and legal frameworks) in ensuring that large-scale privatisation delivers effective corporate governance and enterprise restructuring (issues taken up in Chapter 8), the need for competition policy to safeguard against monopolistic outcomes from large-scale privatisation, and the pervasive importance of effective legal reform in underpinning reform in many other areas (discussed in Chapter 6).

As in the 1994 *Transition Report*, there are some important areas of reform that are covered in the detailed Annex 2.2 but have not been included as separate transition indicators. Among these, the most important are fiscal reform, the mix of public and private provision of social services including health, education and pensions, and more generally the redefined role of the state. Different approaches to these areas within mature market economies make it difficult to identify a clear standard against which to appraise the transition economies.

Table 2.1

Progress in transition in eastern Europe, the Baltics and the CIS [1]

(see classification system for transition indicators overleaf)

		Enterprises			Markets and trade			Financial institutions		Legal reform
Countries	Private sector share of GDP in %, mid-95 (rough EBRD estimate)	Large-scale privatisation	Small-scale privatisation	Enterprise restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Extensiveness & effectiveness of legal rules on investment
Albania	60	2	4	2	3	4	1	2	1	2
Armenia	45	2	3	2	3	3	1	2	1	2
Azerbaijan	25	1	1	2	3	2	1	2	1	1
Belarus	15	2	2	2	3	2	2	2	2	2
Bulgaria	45	2	3	2	3	4	2	2	2	3
Croatia	45	3	4*	2	3	4	1	3	2	3
Czech Republic	70	4	4*	3	3	4*	3	3	3	4
Estonia	65	4	4	3	3	4	3	3	2	3
FYR Macedonia	40	2	4	2	3	4	1	3	1	2
Georgia	30	2	3	2	3	2	1	2	1	2
Hungary	60	4	4*	3	3	4*	3	3	3	4
Kazakstan	25	2	2	1	3	3	2	2	2	2
Kyrgyzstan	40	4	4	2	3	4	2	2	2	2
Latvia	60	2	4	2	3	4	2	3	2	2
Lithuania	55	3	4	2	3	4	2	3	2	2
Moldova	30	3	3	2	3	4	2	2	2	2
Poland	60	3	4*	3	3	4*	3	3	3	4
Romania	40	2	3	2	3	4*	1	3	2	2
Russian Federation	55	3	4	2	3	3	2	2	2	2
Slovak Republic	60	3	4*	3	3	4*	3	3	3	3
Slovenia	45	3	4*	3	3	4*	2	3	3	3
Tajikistan	15	2	2	1	3	2	1	1	1	1
Turkmenistan	15	1	1	1	2	1	1	1	1	1
Ukraine	35	2	2	2	3	3	2	2	2	2
Uzbekistan	30	3	3	2	3	2	2	2	2	2

[1] Most advanced industrial economies would qualify for the 4* rating for almost all the transition indicators. Table 2.1 assesses the status rather than the pace of change. For instance, Slovenia's score of 4* on small-scale privatisation, despite the absence of a comprehensive privatisation programme, reflects the fact that small-scale activity in Slovenia was largely private before transition began.

Classification system for transition indicators [2]

Transition element	Category	Description of the category
Large-scale privatisation	1	Little progress
	2	Comprehensive scheme almost ready for implementation; some sales completed
	3	More than 25 per cent of large-scale state-owned enterprise assets privatised or in the process of being sold, but possibly with major unresolved issues regarding corporate governance
	4	More than 50 per cent of state-owned enterprise assets privatised in a scheme that has generated substantial outsider ownership
	4*	Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance
Small-scale privatisation	1	Little progress
	2	Substantial share privatised
	3	Nearly comprehensive programme implemented, but design or lack of government supervision leaves important issues unresolved (e.g. lack of tradability of ownership rights)
	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
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 break up dominant firms
	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	Strong financial discipline at the enterprise level; substantial improvement in corporate governance through government restructuring programme or an active corporate control market; significant action to break up dominant firms
	4*	Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring
Price liberalisation	1	Most prices formally controlled by the government
	2	Price controls for several important product categories, including key infrastructure products such as utilities and energy; state procurement at non-market prices remains substantial
	3	Substantial progress on price liberalisation including for energy prices; state procurement at non-market prices largely phased out
	4	Comprehensive price liberalisation; utility pricing ensuring cost recovery
	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 most quantitative and administrative import and export restrictions; almost full current account convertibility at a unified exchange rate
	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.
	4*	Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership in GATT/WTO

[2] 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 is provided in Annex 2.2. The classification system presented here builds on the 1994 *Transition Report* and may be refined further in future editions.

Classification system for transition indicators [2]

Transition element	Category	Description of the category
Competition policy	1	No competition legislation and institutions; widespread entry restrictions
	2	Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms
	3	Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions
	4	Significant enforcement actions to reduce abuse of market power and to promote a competitive environment
	4*	Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets
Banking reform and interest rate liberalisation	1	Little progress beyond establishment of a two-tier system
	2	Significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceilings
	3	Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks
	4	Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening
	4*	Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services
Securities markets and non-bank financial institutions	1	Little progress
	2	Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities
	3	Substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (e.g. investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework
	4	Securities laws and regulations approaching IOSCO standards; substantial market liquidity and capitalisation; well-functioning non-bank financial institutions and effective regulation
	4*	Standards and performance norms of advanced industrial economies: full convergence of securities laws and regulations with IOSCO standards; fully developed non-bank intermediation
The extensiveness and effectiveness of legal rules on investment	1	Legal rules often very unclear and impose significant constraints to creating investment vehicles, security interests or repatriation of profits; availability of legal advice is limited; judicial and administrative support of the law is substantially deficient
	2	Legal rules often unclear; legal advice often difficult to obtain; legal rules impose constraints to creating investment vehicles, the taking of security or repatriation of profits; judicial and administrative support of the law is rudimentary; where adequate legal rules or legal advice exist, administration of the law is deficient
	3	Legal rules do not impose major obstacles to the creation of investment vehicles, the taking of security or the export of profits; legal rules are reasonably clear and specialised legal advice is available; judicial and administrative support of the law is often inadequate; where such support is adequate, legal rules often impose significant constraints
	4	Legal rules are clear, generally do not discriminate between foreign and domestic investors and impose few constraints; specialised legal advice readily available; investment laws reasonably well administered and supported judicially, although that support is sometimes patchy
	4*	Legal rules closely approximate generally accepted standards internationally and are readily ascertainable through sophisticated legal advice; investment laws are well administered and supported judicially, particularly regarding functioning of courts and land and the orderly and timely registration of proprietary or security interests

2.1 General trends in transition

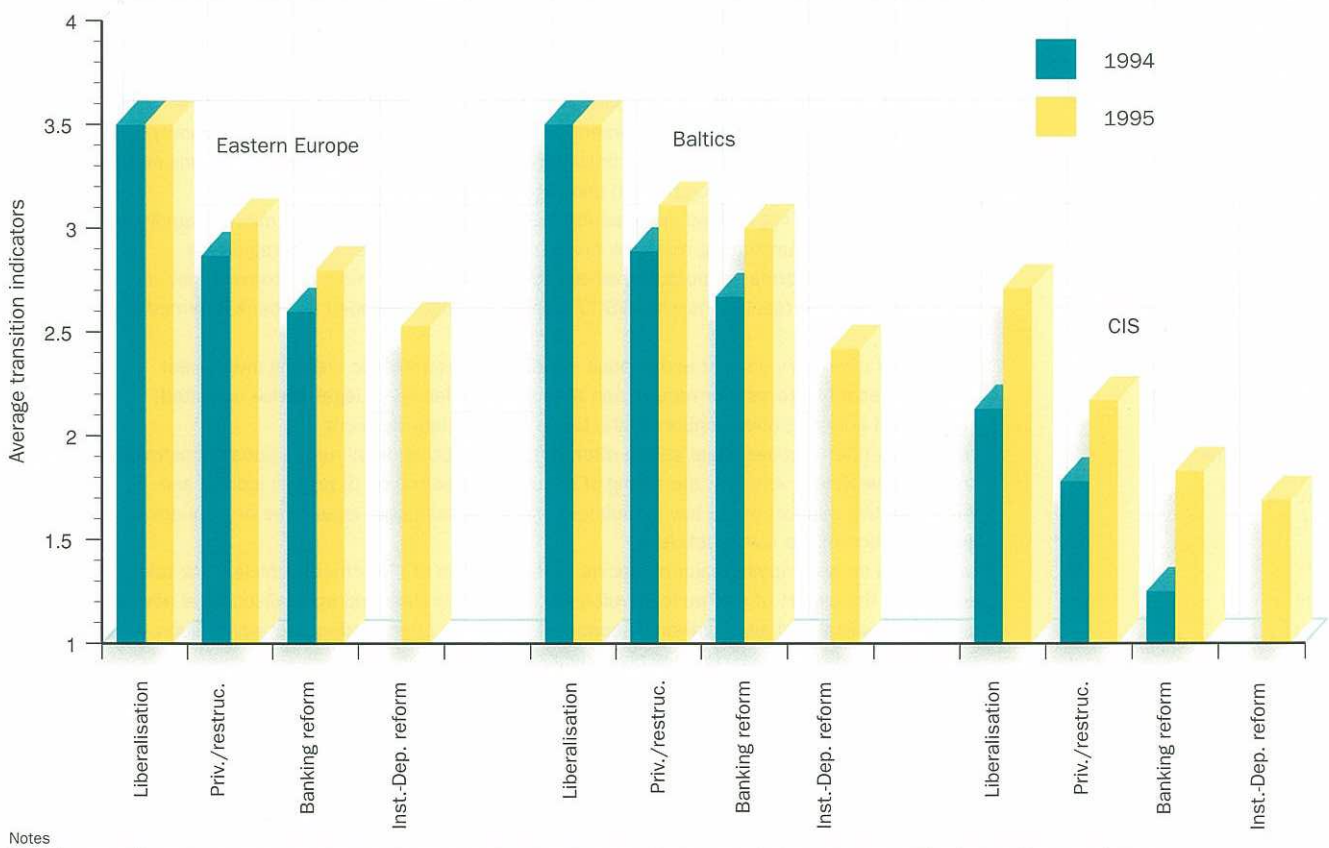
The discussion in this section is organised around Table 2.1, which presents, in tabular form, scores on a number of dimensions of the transition stage for 25 countries in the region. The table should be seen as only a summary of, and not a substitute for, the more detailed descriptive material set out in Annex 2.2, on which it is based. The specific dimensions are examined in somewhat greater detail in Section 2.2.

Apart from the leading indicator – the share of the private sector in GDP – the table is organised around four broad areas of reform. The first focuses on the basic unit of production, the enterprise, and covers small-scale and large-scale privatisation and restructuring. The second area focuses on the openness and competitiveness of markets, including price liberalisation, competition policy, and trade and foreign exchange market liberalisation. The third centres on financial institutions, including banking reform and the development of non-bank financial intermediation and securities markets. The financial institution transition indicators pay attention both to the growth of private sector activity in financial services and to the development of effective regulation for banking and securities markets. The fourth area covers investment-related legal reform, including the content and scope of statutes and various aspects of enforcement.

Table 2.1 reveals distinct patterns, some associated with specific areas of reform throughout the region (as reflected by similar scores down a column) and others delineating certain "transition groups" of countries with similar progress across the range of reform areas (as represented in the table by rows with similar scores). A distinct ranking of progress in different areas of reform has emerged, reflecting in large measure the degree to which particular reforms involve institutional development and thus take more time.[3] Most countries exhibit this ranking, but their speed of reform has varied.

This ranking is illustrated by Chart 2.1 which provides (unweighted) average scores for three categories of reform for eastern Europe, the Baltics and the CIS as of mid-1994 and mid-1995. Most countries in the region have addressed "first-round" reforms: the widespread liberalisation of prices, external trade and currency arrangements, and privatisation of small-scale units, all of which constitute necessary conditions for the development of private sector activity. These measures involve limited institu-

Chart 2.1 Progress in reform across the region



Notes

The columns provide average scores for the transition indicators for 1994 and 1995, taken from Table 2.1 in the respective *Transition Reports*. The categories are:

(i) Liberalisation: price liberalisation, and the trade and the foreign exchange system;
(ii) Privatisation/restructuring: large-scale privatisation, small-scale privatisation and enterprise restructuring;
(iii) Banking reform; and
(iv) Institution-dependent reform: competition policy, banking reform, securities markets and non-bank financial institutions, and investment-related legal reform.

Category (iv) has been scored only for 1995 as most of the constituent indicators did not exist in 1994. Throughout, scores of 4* have been treated as 4 for the averages.

[3] We emphasise that the relevant factor here is the extent to which different areas of reform involve institution-building. The fact that this process takes time underlines the importance of starting it early. As a descriptive matter, the observed patterns described in the text broadly confirm earlier analyses about feasible reform sequences, e.g. Fischer and Gelb (1990) and Hinds (1990), with the possible exception of development of securities markets and private non-bank financial institutions, whose importance may not have been fully recognised initially.

tional development and could thus be adopted rapidly. The early lead of countries in eastern Europe and the Baltics has been narrowed by continued progress in this area in most of the CIS. However, despite substantial liberalisation in most countries, energy prices remain well below cost recovery levels in the region. Further liberalisation is necessary to improve price signals for investment and, indirectly, to reduce environmental pollution, but the short-run impact on enterprises and households may limit the politically feasible speed of adjustment.

Progress in "second-round" reforms, which include large-scale privatisation and enterprise restructuring, has been slower. These initiatives require more preparation, both to build the necessary political consensus and to create the implementation infrastructure. Many countries in eastern Europe and the Baltics have privatised a major share of their large-scale enterprises, most notably the Czech Republic, Estonia, Hungary and the Slovak Republic. Within the CIS, Kyrgyzstan, Russia and Uzbekistan have implemented fairly comprehensive large-scale privatisation programmes. Land privatisation has been particularly slow in the CIS. The long history of collectivisation and the very large size of farms (with associated methods and equipment) generate severe problems in designing and organising privatisation. And there has been no political consensus on how to proceed.

Significant progress has been made in enterprise restructuring, especially in eastern Europe and the Baltics. This primarily reflects progressively hardened budget constraints and enterprise autonomy associated with macroeconomic stabilisation (elimination of budgetary and off-budget subsidies), product market liberalisation and privatisation policies, rather than special government restructuring programmes.

It is evident from Chart 2.1 that policies addressing "third-round" challenges – banking reform, private non-bank financial institutions, competition policy and investment-related legal reform – are still at a relatively early stage in most transition countries. Very few countries have successfully restructured the banking system, including recapitalisation and bank privatisation, and put in place an effective system of prudential regulation and supervision (see Chapter 10 for details). Institutional reform in financial markets lags behind the rapid and largely unregulated growth in these markets, as evidenced by recent securities market scandals in Russia and Romania (see Section 2.2), and the general lack of proper custody and registry facilities in emerging stock markets (see Chapters 6 and 10). Effective financial market regulation will be required to underpin the continued growth in finance to enterprises from "outsiders" (in the form of debt and equity, as opposed to retained earnings). Outside finance can not only support investment but also improve corporate governance and deepen capital markets.

Competition policy has also been slow to develop in most countries. Although many of the countries in the region have some form of competition legislation and have charged an agency with implementing this legislation, only a few have taken significant enforcement action. There has been some limited divestiture of conglomerates and monopoly distribution facilities, but in some countries competition policy takes the form of profit margin controls for specified "monopolies". Such practices (for example, in Azerbaijan) suggest a danger that competition policy may become a surrogate for widespread price controls, and limit important gains in price liberalisation.

Lastly, many countries in the region have made substantial progress in introducing legal rules that facilitate domestic and foreign investment. The clarity and accessibility of investment-related law (including timely publication of laws and availability of legal assistance) vary considerably, being typically weaker in the countries of the CIS (including Russia) than in eastern Europe and the Baltics. Even more important, Chapter 6 documents that it has proved difficult in almost all countries to establish the necessary administrative apparatus and, to a lesser extent, judicial enforcement to support these statutory reforms.

2.2 Specific developments in transition

The private sector's share in GDP

During the last year the private sector share in economic activity has exhibited some convergence across the region. In eastern Europe and the Baltics, the private sector share increased modestly (less than 5 percentage points) from already comparatively high levels, whereas substantially larger gains were recorded for some CIS countries. Gains of about 10 percentage points have accrued in countries that have embarked in earnest during 1994-95 on comprehensive large-scale privatisation (Estonia, Georgia, Moldova, Slovenia and Uzbekistan).

The private sector share of GDP will tend to grow more slowly for countries that initiated reform, including comprehensive privatisation, relatively fast and early, simply because further expansion of the private sector in these countries will have to come primarily from the formation of new firms and from higher growth rates in private enterprises than in state firms. In making cross-country comparisons, the limitations of the data need to be kept in mind, particularly the scope of the "informal economy" and the treatment of cooperatives and partially privatised enterprises, which varies across countries. The nature of ownership, the quality of governance and relationship with government vary greatly within the private category and across countries. Thus the notion of what is private is not straightforward. Annex 2.1 provides a more detailed analysis of private sector shares of employment and GDP across the region and over time.

Large-scale privatisation

The pace of large-scale privatisation has varied sharply across countries. Following the highly visible voucher-based mass privatisation programmes in the Czech Republic, Lithuania, Russia and the Slovak Republic, a wider span of countries has embarked on similar programmes (including Armenia, Georgia, Kazakstan, Kyrgyzstan, Latvia, Moldova, Slovenia and Ukraine). Other countries (including Albania, Bulgaria, Poland and Romania) have adopted voucher-based mass privatisation programmes, and some of these programmes are almost ready for

implementation. In 1994 Belarus launched a voucher-based programme but in early 1995 the government cancelled the results of the first auction. The biggest setback in the region over the past year has been the recent cancellation of the second wave of the Slovak voucher privatisation programme.

Privatisation does not by itself ensure improved enterprise performance or lead to more active restructuring. The impact of privatisation on enterprise behaviour depends very much on whether the change in ownership delivers outside pressure on managers to do well (see Chapter 8). Privatisation that concentrates ownership in the hands of insiders (workers and management) can undermine prospects for rapid restructuring. This may to some extent have occurred in some of the countries that have undertaken mass privatisation (including Lithuania, Russia and Uzbekistan). In some other countries (including the Czech Republic and the Slovak Republic) the design of mass privatisation has led to a dispersed outsider ownership. The dilution of ownership in turn poses a problem for corporate governance by making it difficult for owners to exert pressure on managers. The unwinding of this problem, through gradual concentration in a few hands of shareholdings in individual companies, will require a well-functioning market for securities.

In order to circumvent exactly this problem (and in order to raise finance from abroad in a manner that would not add to the external debt), Estonia and Hungary have put the emphasis in their comprehensive privatisation programmes on sales of majority stakes to strategic (often foreign) investors, mainly for cash. Estonia has in some cases combined the sale of majority stakes to a strategic investor with sales of minority stakes for mass-distributed vouchers, and has thereby extracted some benefits of mass participation while escaping the problems that are associated with diluted ownership.

A number of countries, such as Kyrgyzstan and Uzbekistan, are attempting to improve corporate governance by mandating conversion of closed joint-stock societies into open joint-stock societies, thereby increasing the tradability of shares and restricting the scope of insider ownership in further privatisation. If supported with effective development of securities markets (including regulation), this could improve the structure of ownership and control, accelerate enterprise restructuring and increase the willingness of capital markets to provide outside finance (see Chapters 8 and 10). The first hostile takeover bid in Russia in July 1995 is evidence of this process being at work, as is the increasingly assertive role played by financial intermediaries in the Czech and Russian privatisation programmes. Countries that have privatised a significant part of state enterprises through voucher-privatisation, such as Kyrgyzstan, Lithuania and Russia, have now begun to sell part of the remaining stakes to strategic investors through cash auctions.

Policies regarding the privatisation of "strategic" sectors, such as energy, telecommunications and other public utilities, differ widely across countries. Some countries largely exclude these sectors from privatisation (such as Bulgaria and Moldova), while others have postponed privatisation in these areas (Poland, Russia and Uzbekistan). Yet others have begun to offer strategic investors significant minority interests (Czech Republic, Hungary and Kazakstan). Since these sectors are typically important bottlenecks to private sector development, such policy differences may have important implications for investment in these sectors and for future growth in the economy as a whole.

Small-scale privatisation

Privatisation of small enterprises was implemented in many countries in the very early phases of reform (including Albania, the Baltic states, the Czech Republic, Hungary, Kyrgyzstan, Poland and the Slovak Republic). In most cases, small-scale privatisation has, together with price and trade liberalisation, been implemented more comprehensively than other reforms (see last year's *Transition Report*). In the countries of the former Yugoslavia, most small-scale units were already privately owned before the initiation of comprehensive market-oriented reforms. Within the CIS, significant progress on small-scale privatisation has been made recently by Armenia, Georgia, Kazakstan, Moldova, Ukraine and Uzbekistan. However, Azerbaijan, Belarus and Turkmenistan still have not privatised significant shares of their small enterprises.

While small-scale privatisation has advanced widely, both privatised small firms and new start-ups have faced severe constraints to their growth. As Chapter 5 documents, the availability of outside finance (both term lending and equity) is very limited in most countries of the region, even those at more advanced stages of transition. This has been compounded by the historic bias of banks towards larger, state-owned enterprises. The lack of secured transactions (collateral) laws is one of the most important legal shortcomings affecting the ability of small enterprises to obtain finance. Other frequently cited obstacles to growth include licensing requirements that restrict entry, lack of commercial space and high regulatory costs that impinge most severely on small firms (see Chapter 9 for more discussion). Two manifestations of these and other obstacles are the high share of inactive small firms (in some countries more than 50 per cent of registered companies are inactive) and significant levels of informal activity. The "informal sector" is typically estimated at between 10 and 25 per cent of GDP (see Annex 2.1 for details).

Privatisation of farms has reached an advanced stage in many countries. Much of agriculture is now in private hands in Albania, Armenia, Bulgaria, the Czech Republic, Hungary, Moldova, Poland, Romania and the Slovak Republic. In other countries, including Russia, ownership reform has been slower in agriculture than in other sectors, reflecting serious practical difficulties and the political and ideological opposition in some countries to the privatisation of land. Agriculture has been dominated by very large farms for more than four decades in most countries in the region, so that restitution to the original owners is not a realistic option. The existing ownership structure of land takes many forms, which complicates the privatisation process. Much of the existing capital equipment and production methods are unsuitable for smaller-scale agriculture, which further slows the effective privatisation and restructuring of agricultural production.

In many countries of the CIS, most importantly in the Central Asian countries and in Georgia, agricultural land cannot be privately owned, although this prohibition has been largely mitigated by the introduction of inheritable long-term leases. In Russia, private ownership of land is legally allowed but there are significant restrictions on the sale of land. A new land code is under discussion in the parliament, but no major breakthrough is expected in this area in the near future. Private farmers currently own only about 7 per cent of the agricultural land. Large state farms and cooperatives have been reregistered in new forms of collective ownership, without any major impact on the effective governance and performance of agricultural enterprises. The break-up of these cooperatives started in late 1993, but has been proceeding at a very slow rate since then. Ukraine, where progress in reform will be an important ingredient in any expansion of its potentially strong agricultural sector, introduced private land ownership in late 1994, but it remains subject to certain restrictions and implementation is still on hold.

Significant progress has been made in privatisation of housing in some countries, with more than 50 per cent privatised in, for example, Albania, Armenia, Georgia, Lithuania, Moldova and Uzbekistan. This is an important development because private ownership of housing provides incentives for renovation of the existing housing stock and investment in new residential and commercial property, and can eventually facilitate labour mobility needed for enterprise restructuring.

Enterprise restructuring

The bulk of restructuring in transition economies has been brought about by progressively hardened budget constraints, created by product market competition and sharp reductions in direct and indirect (interest rate and other off-budget) subsidies. Thus, the extent of market-based enterprise restructuring reflects the effectiveness of price and trade liberalisation, privatisation, macroeconomic discipline and banking reform, as well as illustrating the important complementarities among them.

The most significant advances over the past year have been made by a number of CIS countries, including Armenia, Georgia, Kazakstan, Kyrgyzstan and Moldova, which have sharply reduced enterprise subsidies and extension of credit on soft terms through the banking system. Armenia, Azerbaijan and Kazakstan have adopted new bankruptcy laws. The Kazak law includes a provision for out-of-court settlement which, given the time and cost involved in legal bankruptcy proceedings, should facilitate effective implementation.

Two of the main factors that have slowed the restructuring process are the ineffective implementation of bankruptcy laws and insider privatisation. Most countries in the region have passed bankruptcy laws (most recently Croatia and FYR Macedonia), but the incidence of bankruptcy and liquidation is still very limited except in a few countries (including the Czech Republic and Hungary). This reflects both the difficulty in establishing effective legal and regulatory institutions required to implement such laws, and political sensitivity about increased open unemployment. The dominance of insider ownership from mass privatisation has also slowed the pace of fundamental restructuring required for sustained competitiveness and growth (including changes in management structures, product mix and new investment), although extensive labour shedding has occurred even in enterprises privatised to insiders (see Chapter 8).

Starting from a low level, the enforcement of bankruptcy laws has picked up in a number of countries, including the Czech Republic, Estonia, Poland, Slovenia and the Slovak Republic, where it has helped accelerate restructuring. Progress has been less marked in other countries where there is moderately tight financial discipline but where the threat of bankruptcy or liquidation is less effective (e.g. FYR Macedonia, Latvia, Lithuania, Romania and Russia). At the other end of the spectrum, the lack of macroeconomic discipline and limited privatisation activity has led to little noticeable restructuring in Tajikistan and Turkmenistan.

A number of government and IFI-sponsored restructuring agencies have been established during the last few years, for example in Albania (1993), Armenia (1995), FYR Macedonia (1994), Kazakstan (1995), Kyrgyzstan (1994), Romania (1993) and Uzbekistan (1995). Their aims are to restructure enterprise balance sheets, isolate inter-enterprise arrears, divest viable elements and liquidate non-viable firms. There has been relatively limited progress to date, but it may be too early to make a full assessment of these attempts.

Liberalisation of prices, wages and interest rates

Liberalisation of prices, wages and interest rates is a key precondition for market-oriented investment and growth (liberalisation of credit markets and interest rates is discussed below in the subsection on Banking reform). Price signals are at the heart of enterprise decision-making and must be as clear and non-distorted as possible. Furthermore, successful macroeconomic stabilisation requires large reductions of subsidies, which imply significant movement in, and liberalisation of, prices. This has been recognised by reforming countries throughout the region. By mid-1995 all countries of the region had undertaken extensive price liberalisation, except Turkmenistan and, until recently, Belarus.

The most important commodity remaining controlled in all countries is energy. Since the pre-reform level of energy prices in most of the region, especially in the former Soviet Union, was only a small fraction of the world-market level, full liberalisation involves very sharp real price adjustments, far exceeding those experienced by the advanced industrial economies during the oil shocks of 1973-74 and 1979-80. Net energy-importing countries have been compelled by balance of payments pressures to adjust domestic energy prices towards world levels, but most of them have not yet completed the process of liberalisation, especially for electricity. In some countries of eastern Europe (including Hungary, Poland and Slovenia) industrial prices for natural gas, oil and oil products are roughly comparable to those in western

Europe. In Kyrgyzstan, Moldova, Ukraine and Uzbekistan domestic prices for imported fuels, including oil, gas and coal, are now close to world-market levels.

However, the net energy-exporting countries have been much slower to adjust prices until very recently. Kazakstan and Russia maintained domestic price controls and anti-export policies on oil and gas products until 1994, but during the past year both countries have significantly liberalised the pricing and export of these products. Despite the fact that domestic energy prices are now largely market-determined in these countries, these markets are subject to strong government intervention. Kazak oil prices are still only 60 per cent of world levels, partly due to export capacity constraints, while significant export taxes maintain oil prices at about 70 per cent of world-market levels in Russia. None the less, oil prices for both enterprises and households have been sharply raised in both countries during the last year. Russian export taxes, including those for oil and gas, are scheduled to be phased out by the end of 1995.

In most countries of the region, prices remain well below cost recovery levels for non-traded energy, especially electricity, and for most key infrastructure services including water, telecommunications and public transport, despite considerable progress over the last year. For example, in 1994 the industrial electricity price in Hungary was 56 per cent of the level in Germany, and in Poland only 43 per cent of that level, despite the fact that unit costs of electricity in these countries are unlikely to differ substantially. The most extreme case of underpricing is Turkmenistan, where important commodities, including water, gas and electricity, are actually given free to enterprises.

A number of countries in the CIS have liberalised the vast majority of retail prices, and have complemented this with trade liberalisation measures (especially Armenia, Georgia, Kazakstan, Kyrgyzstan, Moldova, Russia, Ukraine and Uzbekistan). Most of the CIS countries have largely phased out their state-order systems. This has put strains on the severely underdeveloped competitive distribution channels, particularly in the agricultural sector. To the extent that distribution of commodities is forced to rely on privatised state trading companies with market power, the incentives provided by price signals to primary producers (including farmers) are weakened or distorted. Some countries, including Russia and Ukraine, have sought to develop competing private distribution channels, for example by establishing agricultural commodity exchanges dealing in spot and futures contracts. More extensive development of distribution networks to facilitate new competitive interactions between private sector suppliers and buyers will take time (see Chapter 7).

During the past year Bulgaria continued to backtrack from the extensive price liberalisation which the country had undertaken in 1991. It expanded administrative controls on prices and profit margins, reducing the share of unrestricted prices from 90 per cent of the basket of goods in the consumer price index in 1991 to 69 per cent in mid-1994, and further, to 54 per cent at present.

Wages in the private sector are largely market-determined in most, but not all, countries in the region. Many countries have reduced the use of incomes policies, which had served in the past to prevent the "decapitalisation" of state-owned enterprises through unwarranted wage increases. The widening scope of privatisation has mitigated this problem. Still, there is further scope for liberalisation. A number of countries retain various forms of controls over private sector wages (e.g. a direct incomes policy in FYR Macedonia and Slovenia, the use of an "excess wage" tax in Russia and Turkmenistan, and discretionary control over nominal wages in Kazakstan). Poland terminated its "excess wage" tax in mid-1994 and now sets only indicative norms for wage negotiations.

In most CIS countries, public sector wages, pensions, social benefits and even some important aspects of the tax system are directly or indirectly linked to the minimum wage. As a consequence, any adjustments in the minimum wage inevitably have major implications for the public finances. For example, if the Ukrainian parliament had decided in February 1995 to raise the monthly minimum wage from KBV 60,000 (US$ 0.5) to the official poverty line at the time, KBV 780,000 (US$ 6.3), the budget deficit would have increased by 23 per cent of GDP (the proposal was passed in a first reading in December 1994 but abandoned in 1995). In Russia, President Yeltsin vetoed a minimum wage adjustment passed by the Duma because of its serious fiscal implications.

Trade and foreign exchange liberalisation

The liberalisation of trade and the market for foreign exchange strongly complements price liberalisation. Comprehensive trade liberalisation is necessary to ensure that liberalised domestic prices for tradable goods and services adjust to world price levels and thus reflect scarcity values. The resulting sharp change in input and product prices after trade and price liberalisation allows firms to discover their competitive advantage, and thus underpins market-oriented restructuring of tradable goods sectors.

The countries of eastern Europe and the Baltics by and large adopted comprehensive trade liberalisation in the early stages of reform. There have been some increases in tariffs subsequently, but these economies remain very open by international standards. By mid-1995 Europe Agreements with the EU had been signed for Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and initialled for Slovenia, typically with provisions for phased programmes of liberalisation in certain "sensitive" sectors including agriculture and textiles (see further details in Chapter 11).

Trade liberalisation in agriculture has been considerably slower than in other sectors. Both east European and Baltic countries maintain significant tariff barriers in agriculture. As members of GATT and the WTO, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic and Slovenia have converted (or are now converting) all quantitative restrictions on agricultural products into tariffs. However, the Czech Republic, Hungary, Poland and the Slovak Republic decided in August 1995 to accelerate the liberalisation of agricultural trade under the Central European Free Trade

Agreement (which Slovenia is expected to join in January 1996). This will involve eliminating about one-third of all agricultural tariffs by early 1996,[4] with no import duties for most products as of 1998. Slovenia, Bulgaria, Romania and the Baltic states are planning to undertake similar agricultural trade liberalisation. However, over the last year Bulgaria imposed new export restrictions and bans as well as high export taxes, largely on agricultural commodities, in conjunction with its partial reversal of domestic price liberalisation.

A number of countries in the CIS accelerated the liberalisation of foreign trade. Belarus, Kazakstan, Kyrgyzstan, Moldova, Russia and Ukraine have signed Partnership and Cooperation Agreements (PCA) with the EU. However, these agreements must still be ratified by the European and the national parliaments. Armenia and Georgia have substantially eliminated the state agencies that controlled trade with the CIS countries, and Kazakstan has also made progress in this area. All three countries have liberalised the trading system with non-CIS countries. In Tajikistan and Turkmenistan, trade is still dominated by the state-order system. Ukraine has significantly liberalised its foreign trade regime since mid-1994 and removed a significant tax on exporters by unifying its exchange rates at market levels. Where surrender requirements for hard-currency export revenues are still in place (as in Ukraine and most other CIS economies), these are now typically at market-level exchange rates. In mid-1995, Tajikistan became the last CIS economy to introduce its own currency, the Tajik rouble. Both Georgia and Ukraine are set to replace their interim currencies with fully fledged national currencies by the end of the year.

A number of countries solidified the credibility of their trade and foreign exchange reforms by committing to Article VIII of the IMF's Articles of Agreement. Under this article, a country commits not to adopt restrictions on payments for current international transactions, to avoid discriminatory currency practices and to provide convertibility for foreign-held balances of its currency. Over the past year, a number of countries have made this commitment, including the Czech Republic, Croatia, Kyrgyzstan, Latvia, Moldova, Poland and Slovenia.

Competition policy

Ensuring a competitive market environment in transition economies (as in other economies) requires price liberalisation to provide appropriate price signals, trade liberalisation to impose international efficiency and quality standards, and competition policy to maintain unrestricted entry and exit of firms. Most countries in the region had not undertaken significant restructuring of conglomerates and other dominant firms before price liberalisation or privatisation. There remains considerable potential for abuse of market power in these economies, in the production, distribution and infrastructure sectors. Import competition can serve as the primary tool of competition policy for tradable goods and services in small open economies, such as the Baltics, but most countries will also need more proactive approaches. Freedom of entry is the key to effective competition. It is important that competition policy focuses on preventing entry-deterring behaviour by incumbent (both state-owned and private) enterprises and on removing regulatory and statutory barriers to entry. Direct government control of prices is a blunt instrument of competition policy, although it may be occasionally needed on a limited basis.

The Czech Republic, Estonia, Hungary, Poland and the Slovak Republic are developing competition policy and institutions broadly consistent with EU guidelines in the area, but many other transition countries have either no or only rudimentary legal and institutional frameworks for this purpose. It is not surprising that progress in this area has been relatively slow, since establishing effective competition policy involves considerable institution-building and the development of specialised skills. In most countries that do have legislation and competition agencies, there has been relatively little enforcement.

Moreover, in some countries in the CIS, competition policy is being misused as a tool to continue widespread price controls. For example, the anti-monopoly authority in Azerbaijan exercises extensive price controls by regulating the mark-ups of more than 1,000 enterprises designated as "monopolies". The anti-monopoly agency in Russia (recently given ministerial status) must now approve the privatisation of designated "monopolies", defined as any enterprise with a market share greater than 35 per cent. More than 400 privatisations were rejected on this basis over the last year. Ukraine and Russia passed decrees that support the creation of financial-industrial groupings that threaten to cartelise their economies further. The challenge of creating effective, and properly focused, competition policy remains throughout most of the region.

Banking reform

Developing effective financial systems remains a central challenge in the region. As of mid-1995, most of it was still significantly "underbanked". The banking sectors are typically small relative to the size of the economy, the large share of non-performing loans adversely affects bank lending and profitability, and large interest margins (used to support recapitalisation) often impose very high loan rates. The vast bulk of enterprise investment is financed out of internally generated funds, even in the more advanced countries of eastern Europe (see Chapter 5). There is a strong need for greater provision of outside finance (term loans and equity), both to fund private investment and to impose outsider discipline on privatised firms (see Chapter 10).

None the less, government-initiated recapitalisations, restructuring and privatisation of banks, and improved supervision of the banking system, are starting to pay off in some countries of eastern Europe in terms of a strengthened and more effective banking sector. Different approaches have been adopted to deal with the stock of non-performing loans. The recapitalisations have aimed to compensate banks for the write-off of non-performing loans incurred prior to a specified date and to raise their capital

[4] The Additional Protocol No. 2 from August 1995 also foresees zero import duties for "medium sensitive" manufactured goods as of 1996.

adequacy. In some countries, such as the former Czechoslovakia in 1991, these loan obligations were transferred to new institutions, which have sought to recover payment. In some other countries, including Hungary and Poland, the banks maintain the non-performing loans on the balance sheet, but the governments have encouraged them to engage in debt work-outs with enterprise debtors by offering to reduce government claims on problem enterprises on the condition that the banks reduce their claims on the same enterprises.

Without clear post-recapitalisation incentives for commercial and prudent operation of banks, there is a very real danger of repeated accumulation of bad loans (as happened after the partial recapitalisation in 1992 in Hungary). In Poland, for example, such incentives have been linked to privatisation of banks. The privatisation of state-owned banks has been particularly comprehensive in the Czech Republic and the Slovak Republic, in the context of the mass privatisation schemes. Other countries, including Hungary and Poland, have privatised a few of the largest banks primarily through sales to strategic investors. In addition, in some east European countries there has been a marked increase over the last few years in the presence of new private (including foreign-owned) banks. The market structure and performance of the banking sectors are discussed in more detail in Chapter 10.

Systemic bank reform is still at a relatively early stage in most CIS countries. In a number of them, including Russia, past high inflation has eroded the value of non-performing loans and reduced the asset quality problem, but banks remain undercapitalised and continue to issue loans that subsequently become non-performing. This latter problem reflects both government pressure on state banks to provide credit to particular clients and inadequate banking regulation and supervision of private and state banks.

In Russia and the Baltics, banking reform has involved substantial entry of new commercial banks, together with efforts to weed out or restructure insolvent players. This approach involves the risk of bank failures, at least until effective bank supervision is in place. Given the systemic risk associated with failure of large banks, governments may intervene to bail out such banks (as recently occurred in Latvia) rather than allow market discipline to be exercised on both shareholders and depositors. The consolidation of the undercapitalised commercial banking system and the development of effective banking regulation in Russia and most of the CIS remain difficult challenges.

While development of financial institutions is proceeding slowly, countries in the CIS are consolidating progress on macroeconomic discipline. Fiscal and monetary policies have tightened over the last year (see Chapter 11), direct credits for industrial enterprises have largely been phased out (except in Belarus, Tajikistan and Turkmenistan), and interest rates are mostly market-determined in the region.

Non-bank financial institutions and securities markets

In transition economies, non-bank financial institutions and securities markets can fulfil two important roles. First, given the limited availability of bank-intermediated debt finance in the early and intermediate stages of transition, securities markets and a variety of funds can provide alternative sources of debt and equity finance to the emerging private sector. Second, these institutions provide a secondary market in ownership and, thereby, control of enterprises, which is crucial in improving corporate governance. The latter is particularly important in the wake of mass privatisation programmes which, while playing a central role in the transition, have brought with them serious problems for corporate governance (see Chapter 8).

To fulfil these functions, a sound legal and regulatory framework is required, one that provides, *inter alia*, independent share registries, secure settlement procedures, protection of minority shareholders and effective supervision. Moreover, the market infrastructure has to provide transparency, security of property rights and liquidity. Progress in this area has been slow. Most countries in the region (18 out of the EBRD's 25 countries of operations) have established rudimentary stock exchanges and, to a lesser extent, private financial intermediaries, but the level of activity is limited in most cases and the regulatory rules and institutions to enforce them lag even further. As a result, financial scandals such as the MMM pyramid scheme in Russia and the Caritas pyramid scheme in Romania have served to undermine public confidence in domestic financial institutions and markets, and contribute indirectly to capital flight. In the more advanced transition economies (including the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia), the markets and regulatory framework are better developed, but even there the markets remain relatively thin and illiquid in comparison to those in advanced industrial economies and fast-growing East Asian countries (see Chapter 10).

Despite these difficulties, in a number of countries financial intermediaries have succeeded in gaining concentrated ownership stakes. However, in the Czech Republic and the Slovak Republic, many of the funds have not adopted proactive roles in corporate governance, due partly to cross-ownership by banks that are also debt-holders in the funds' enterprise portfolios. Russian investment funds, on the other hand, appear to be more assertive in exercising their control, including forcing changes in enterprise management. Recent government actions in the Slovak Republic and Belarus may undermine the effectiveness of financial intermediaries in providing the potential benefits from corporate governance. In the Slovak Republic the future of some of the investment funds is uncertain, following the recent government legislative proposals to cancel the second wave of voucher privatisation, while in Belarus the licences of the 38 investment funds were temporarily suspended in early 1995 (though 35 were reinstated in August 1995).

A dynamic market economy requires effective corporate governance and unrestricted entry. Well-developed securities markets can make a central contribution by facilitating governance and financing new entry. Achieving this will require the development

Table 2.2

Social indicators for countries of the region

		Education indicators		Health indicators		Demographic indicators					
	PPP-GNP per capita in 1993[1]	Primary enrolment rate[4]	Secondary enrolment rate[4]	Immunisation rate[2]	Low birth weight[3]	Crude birth rate[5]	Male life expectancy at birth[6]	Female life expectancy at birth[6]	Infant mortality rate	Under-5 mortality rate	Aged 20-59 mortality rate[7]
Czech Republic	7,550	99.7	88.5	98.6	5.9[c]	10.4	68.9[a]	76.6[a]	7.9	11.6[b]	3.7[b]
Hungary	6,050	99.1[a]	81.4	99.8[a]	8.7	11.3	64.5[a]	73.8[a]	11.5	13.5	6.7
Poland	5,000	97.1	82.0	97.8[a]	7.2	12.5	67.4[a]	76.0[a]	15.1	17.3	4.3
Slovak Republic	6,290	99.5	90.2	na	6.7	12.4	68.3	76.5	11.2	13.2	3.9
Slovenia	10,585	95.5	84.7	93.9[a]	5.2[a]	9.8	69.4[a]	77.3[a]	6.5	8.2	3.6
Estonia	6,320[a]	94.2	84.6	78.2	5.0	9.5	61.0	74.0	14.5	17.4	8.0
Latvia	5,010	84.9	81.2	84.8	5.0	9.5	61.6[a]	73.8[a]	15.5	20.1	9.4
Lithuania	3,110	94.1	83.4	88.1	4.3	11.6	63.0[a]	75.0[a]	13.9	18.2	7.1
Albania	999	85.0[a]	na	90.1[b]	5.6[a]	19.2[a]	69.3[d]	75.4[d]	33.2[a]	44.1[c]	2.2[d]
Belarus	6,240	93.5	84.2	90.8	4.1	10.7	63.5	74.3	13.2	16.2	6.6
Bulgaria	4,100	97.1	65.0	93.3	7.5	9.4	67.2	74.8	16.3	20.9	4.6
Moldova	2,870	77.0	74.0	90.0	6.1	14.3	64.3[a]	71.1[a]	22.6	28.5	6.9
Romania	2,800	99.4	75.5	93.9[a]	10.9[a]	10.9	66.6[b]	73.2[b]	23.9	30.3[a]	5.2[a]
Russia	5,050	94.2[a]	71.7	89.6	6.3	9.4	58.2	71.4	18.7	25.0	9.1
Ukraine	4,450	82.7	46.9	93.5	na	10.0	66.0[c]	74.0[b]	14.3	19.9[a]	6.5[a]
Armenia	2,040	na	na	87.7	7.4[a]	13.6	67.9[a]	74.4[a]	15.1	24.2[a]	4.2[a]
Azerbaijan	2,190	na	76.0	61.0[b]	5.4[a]	21.4	65.2[a]	73.9[a]	26.9	45.2	5.7
Georgia	1,750	86.6[a]	75.9[a]	30.5[a]	5.8[a]	10.7	68.7[d]	76.1[d]	23.2	17.4[b]	4.1[d]
Low-income[8]	1,370	89.5[10,b]	41.0[11]	88.6[9]	11.3[10]	28.0	61.0	63.0	64.0	103.0	na
Without China & India	1,347	58.0[10,b]	na	na	21.4[10]	40.0	54.0	57.0	89.0	144.0	na
China	2,330	96.0[b]	53.0[11]	94.0[9]	6.0[c]	19.0	68.0	71.0	30.0	54.0	na
Lower-middle income[8]	3,891	68.9[10,b]	53.0[11]	79.9[9]	11.0[10]	23.0	64.0	70.0	40.0	63.0	na
Upper-middle income[8]	8,318	91.0[10,b]	53.0[11]	78.1[9]	10.6[10]	24.0	66.0	72.0	36.0	43.0	na
High-income[8]	18,682	97.0[10,b]	92.0[11]	86.3[9]	6.5[10]	13.0	74.0	80.0	7.0	9.0	na

Notes

The data, except column 1 and the last 4 rows, were compiled by UNICEF-ICDC and reported, for a subgroup of countries, in *Central and Eastern Europe in Transition. Regional Monitoring Report 3*, 1995. Unless otherwise indicated, the figures refer to 1994. The symbols indicate the following years: [a] 1993, [b] 1992, [c] 1991 and [d] 1990. When available figures were rounded, we have put a zero after the decimal point. The country groupings in this table follow the pattern that is set out on page 24.

[1] PPP stands for purchasing power parity. The estimates quoted here are taken from the *World Development Report 1995* (World Bank), except for Albania and Slovenia. Estimates for the latter come from PlanEcon *Review and Outlook for Eastern Europe* (June 1995). To compute these estimates, each country's nominal GNP per capita was divided by the "purchasing power parity", defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one US dollar would buy in the United States. Given the difficulties of measurement, particularly where many statistical offices and price mechanisms were in a state of flux, the PPP-GNP figures should be treated with some circumspection.

[2] Figures refer to the unweighted average of immunisation rates for diphtheria and measles.

[3] Defined as the percentage of live births weighing less than 2,500 grams.

[4] Figures refer to net enrolment rates, defined as the percentage of the relevant age group enrolled in primary and secondary school education.

[5] Defined as the number of live and still births in a year per 1,000 population.

[6] Defined as the expected number of years for a newborn, assuming the prevailing mortality rates remain unchanged.

[7] Calculated as the unweighted average of mortality rates for the age groups 20-39 and 40-59.

[8] The figures shown in these rows are weighted averages of available observations for low, lower-middle, upper-middle and high income countries as defined according to the World Bank's classification. The exception is column 1, which refers to unweighted averages. Countries are categorised based on the following ranges for the *World Bank Atlas* (1994) estimates of nominal GDP per capita: low income US$ 695 or less; lower-middle income US$ 696-2,785; upper-middle income US$ 2,786-8,625; and high income US$ 8,626 or more. Unless otherwise indicated, the data refer to 1993. Among the countries of the table Albania, Armenia and Georgia are "low" on this definition; Belarus, Estonia, Hungary and Slovenia are "upper-middle"; and the remaining 11 are "high".

[9] Refers to the most recent estimates of the indicator provided in *Social Indicators of Development 1995* (World Bank).

[10] The group averages should be interpreted with care since data are available only for a subset of countries. Comparability across countries may be limited by variation in data collection, definitions and statistical methods.

[11] Figures refer to gross enrolment rates, defined as the number of pupils enrolled in primary and secondary school education as a percentage of the population in the relevant age group.

[12] The values for China and India are 94 and 88, respectively.

[13] The values for China and India are 53 and 44, respectively.

of stable regulatory and legal frameworks that enable organised, competitive trading by investors and fund managers. This task remains largely uncompleted.

2.3 Social indicators and transition

As described in Chapter 1, development and transition are distinct but mutually dependent processes. Transition involves the development of market-oriented economies whereas development refers to the advancement of the standard of living. None the less, it is a commonly held view that the transition process has imposed

considerable costs in terms of the standard of living throughout the region, for example in deterioration of basic dimensions such as education and health. It is important to ask whether all countries in the region have incurred such costs similarly, or whether those countries that embarked on reform earlier and more aggressively (as described earlier in this chapter) have incurred different costs in terms of decline in these social indicators.

This section provides some evidence on this issue. It begins by comparing the *levels* of some key dimensions of the standard of living (including health, education and income) across countries of eastern Europe, the Baltics and the CIS. Comparisons are made both within the region and worldwide. The next subsection presents evidence on the *changes over time*, both before and during the transition period, in order to assess how the pace of reform in different countries of the region has been related to these social indicators.

Cross-country comparison of social indicators

Drawing on information collected by UNICEF, Table 2.2 provides some of the key social indicators for countries in eastern Europe, the Baltics and the CIS.[5] Countries are grouped roughly according to geographical criteria. The table focuses on 18 countries of the region for which usable and up-to-date data are available. Croatia, FYR Macedonia and the five republics of Central Asia are not represented. Whenever 1994 data were unavailable, the most recent observation was applied. As reference points, comparable information on the World Bank groups of low, lower-middle, upper-middle and high income countries is included. The table includes data on GNP per capita (in purchasing power parity terms), education (primary and secondary enrolment rates), demography (crude birth rate), health (immunisation rate, low birthweight rate) and mortality (life expectancy, group-specific mortality rates).[6]

The first column in Table 2.2 documents the wide differences in income among the economies of eastern Europe, the Baltics and the CIS. Using the World Bank's classifications system (which is based on nominal, not PPP-adjusted, GNP), most of the transition countries in the sample (11 out of 18) fall in the lower-middle income group, three are in the lower income category, and the remaining four fall in the upper-middle income group. Moreover, the lower-middle income group is under-represented because six of the seven countries of eastern Europe and the CIS that are excluded from the table would fall into this category.

The table highlights four important features. First, there are systematic differences in social indicators across countries of the region. Economies that belong to the upper-middle income group show, on the whole, higher development indicators than other countries. The exceptions are for male life expectancy and mortality rates for the 20-59 age group, where there is no uniform pattern. The differences between the low and lower-middle income countries of the region with respect to (non-income) development indicators are less clear-cut.

Comparing the different income-based country groups with each other (the last six rows in the table), a strong association of higher income levels with more favourable levels for social indicators is evident. An important exception to this pattern is China, which is a low income country engaged in the transition towards a more market-based economy, but systematically achieves social indicator values typical of countries in the high income category.

Second, with few exceptions, the economies of eastern Europe, the Baltics and the CIS perform significantly better than the average for the World Bank income group in which they are classified. The health indicators, immunisation and low birthweight rates in the region are high compared with the reference values for the middle income groups. Infant mortality rates and under-five mortality rates are considerably lower than those of the relevant worldwide reference groups. Life expectancy in the region slightly exceeds the group reference values for women, but male life expectancy is on the whole similar to middle income countries. In education, the countries of the region achieve enrolment rates similar to upper-middle and high income countries.

Third, crude birth rates are very low across the region, except in Albania and Azerbaijan, even in comparison with high income countries. An already sharp decline in this rate during the 1980s has accelerated for most, but not all, countries during the transition process (see next subsection). This acceleration may be due both to the increased economic uncertainty that has accompanied the transition process for most groups in the population, and an increase in the private cost of having children, brought about by the dismantling of the socialist system.

There are a few notable exceptions. For example, Estonia tends to display lower scores on the development indicators than the other countries of the region in the high income group (apart from the indicator for low birthweights). The social indicators for Lithuania and Poland, on the other hand, are similar to their neighbouring upper-middle income countries of central Europe. Georgia is on the whole more advanced in terms of social indicators than the other Transcaucasian republics, but it displays a dramatically low level of immunisation rates of 30 per cent. This signifies a drastic failure of preventive health care with consequences that may only be evident in the coming years.

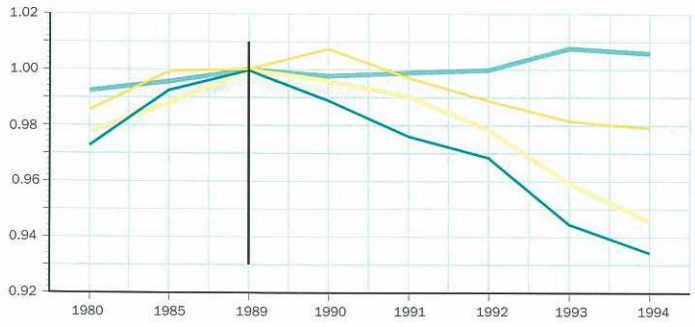
To summarise, while there is considerable diversity among these countries in terms of income per capita and some variation in social indicators, their level of health and education is more advanced than the typical level for countries in other parts of the world with equivalent GNP per capita. Their indicators resemble those seen in the upper-middle income category for most

[5] We would like to thank Giovanni Andrea Cornia, Director of the Economic and Social Policy Research Programme at UNICEF-International Child Development Centre in Florence, Italy for providing access to these data (unpublished at the date this Report was prepared).

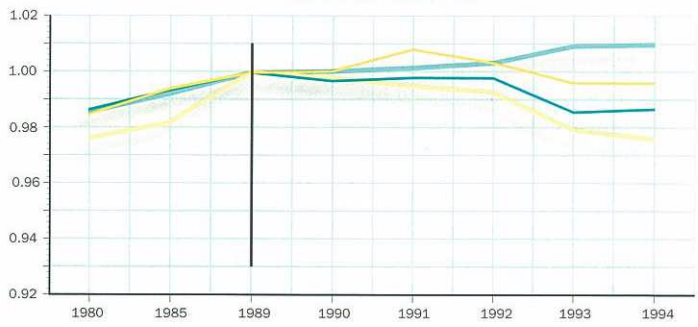
[6] A comprehensive overview of the social dimensions in the region would include a discussion of inequality, poverty and indicators of social cohesion like the crime rate. Such an analysis lies beyond the scope of this Report and, in any case, would be severely impeded by the lack of reliable data.

Chart 2.2 Change in social indicators in countries of the region

Male life expectancy at birth

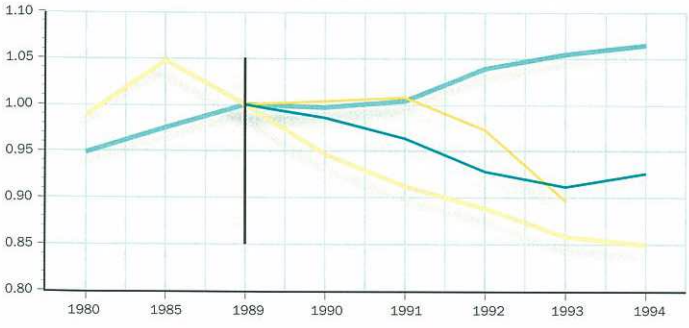


Female life expectancy at birth



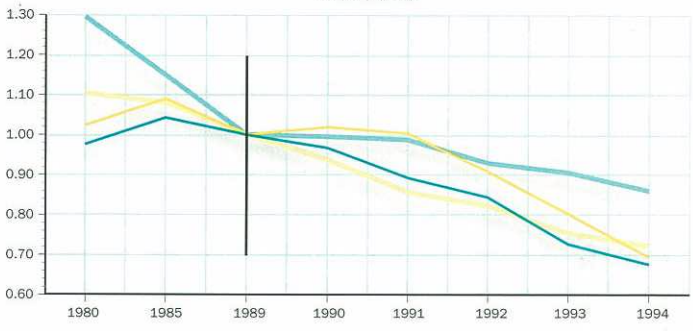
Group 1: 1980-85 for Czechoslovakia, 1985 Hungary missing, 1994 only for Slovak Republic and Hungary;
Group 3: missing include 1985 Bulgaria and Romania, and 1991-93 Albania and 1993 Romania, 1994 available for Belarus, Bulgaria and Russia;
Group 4: 1990 Armenia and 1991-93 Georgia missing, 1994 available for Azerbaijan.

Secondary enrolment rate



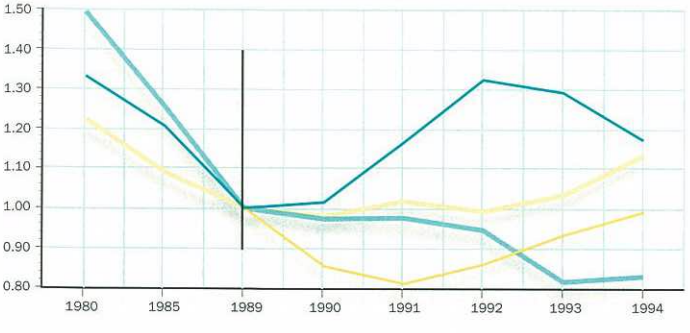
The 1989 observations for the Czech Republic, Estonia and Lithuania were missing. To construct the index, it was assumed that the growth rate for these countries in 1989 equals the one for its country group.
Group 2: missing include 1980-85 Estonia and Lithuania, 1991 Lithuania;
Group 3: no observations on Albania, 1980-85 Belarus, Moldova and Ukraine;
Group 4: no observations on Armenia, 1980-85 Azerbaijan, 1994 Georgia.

Crude birth rate



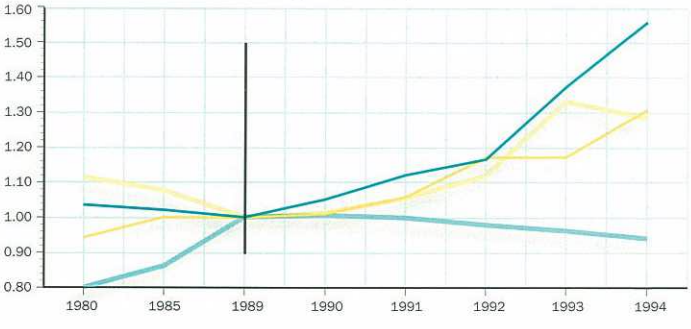
Group 1: 1980-85 for Czechoslovakia;
Group 3: 1994 Albania missing.

Under-5 mortality rate



Group 1: 1980-85 for Czechoslovakia, 1993-94 Czech Republic missing;
Group 3: missing include 1980-85 Belarus, Moldova and Ukraine, 1992-94 Albania, 1994 Romania and Ukraine, 1994 Albania;
Group 4: missing include 1980-85 Armenia, Azerbaijan and Georgia, 1993-94 Georgia, 1994 Armenia.

Age 20-59 mortality rate



Group 1: missing include 1980-85 Czech Republic, Hungary and Slovenia, 1993-94 Czech Republic;
Group 2: 1980-85 Estonia and Lithuania missing;
Group 3: 1980-85 available only for Russia, missing include 1991-94 Albania, 1993 Romania 40-59 mortality rate, 1994 Albania, Romania and Ukraine;
Group 4: missing include 1980-85 and 1994 Azerbaijan, 1991-93 Georgia.

Group 1
Group 2
Group 3
Group 4

The groups are defined as follows:
Group 1: Czech Republic, Slovak Republic, Hungary, Poland and Slovenia;
Group 2: Estonia, Latvia and Lithuania;
Group 3: Albania, Belarus, Bulgaria, Romania, Moldova, Russia and Ukraine;
Group 4: Armenia, Azerbaijan and Georgia.

countries, and are similar to worldwide high income countries for the economies of eastern Europe. These achievements are particularly remarkable, as they already incorporate the worsening of social indicators (discussed below) which has taken place in many countries of the region since 1989.

Changes over time in social indicators

Chart 2.2 documents recent changes over time in some of the social indicators listed in Table 2.2. The 18 countries are divided into four groups. Group 1 contains selected countries of eastern Europe (the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia). Group 2 comprises the Baltic states (Estonia, Latvia and Lithuania). Group 3 contains the other east European countries and CIS countries (Albania, Belarus, Bulgaria, Moldova, Romania, Russia and Ukraine). Group 4 covers the Transcaucasian countries (Armenia, Azerbaijan and Georgia). The reported averages for each group are unweighted mean values.

To simplify presentation, the indicators were expressed as percentages of their 1989 values. When interpreting the graphs in Chart 2.2, it is important to bear in mind that they conceal the differences in absolute levels of the underlying indicators that were highlighted in Table 2.2. The UNICEF data set provides information on individual countries for 1980, 1985 and the period 1989-94. The pre-1989 data set is incomplete and does not always distinguish between the Czech Republic and the Slovak Republic or the different republics of the former Soviet Union.

The charts reveal that different country groups experienced very different changes in social indicators. For Group 1 there was an improvement or a continuation of pre-transition trends in the development of social indicators, whereas the countries of Groups 2-4 saw a dramatic deterioration in these indicators. This is true for all of these social indicators. Crude birth rates dropped dramatically between 1989 and 1994 for all four groups, but in Group 1 to a lesser extent. The rate of decline remained roughly constant between 1980 and 1994 for Group 1, while it drastically accelerated after 1989 for the other groups. Secondary enrolment rates rose for Group 1 between 1989 and 1994 at a rate that was broadly equivalent to that experienced in the 1980s. For the other country groups, secondary enrolment rates declined after 1989.

A similar picture emerges for mortality rates. Infant and under-five mortality rates fell in Group 1 before 1989 and continued to decline in subsequent years. For the other country groups, infant and under-five mortality rates increased in the 1990s, reversing their earlier trend. These increases in mortality rates were modest compared with those experienced by the 20-59 age group. For Russia and the Baltic states, as extreme cases, the index increased between 40 and 70 per cent in the period 1989-94. On the other hand, the average of this indicator for Group 1 declined by more than 10 per cent over the same period (despite an increase in Hungary).

Male and female life expectancy rose throughout the region during the 1980s. While this trend broadly continued in country Group 1 after 1989, it was reversed in the 1990s in the other country groups. Life expectancy dropped by a greater percentage for men than for women. Together with the evidence on mortality rates, this suggests that the transition process has affected the male working-age population most severely.

While there are some country-specific exceptions, and the full extent of changes in social indicators during the transition process will only be evident in the coming years, the evidence strongly suggests two important conclusions. First, the eastern European countries in Group 1 were more successful at coping with the dramatic changes that characterise transition than countries in the other three groups. The Group 1 transition countries are among those that instituted reform earlier and faster. They are also among the relatively wealthier of the transition economies. This indicates that transition can be successfully implemented without experiencing a worsening in social indicators. On the other hand, Estonia, a country well advanced in the transition process, incurred social costs on a similar scale to those of more slowly reforming countries. Thus, rapid and successful transition towards a market economy may not in itself be sufficient to prevent a decline in the standard of living.

The second finding is that all of the late and slower-reforming countries, which fall into Groups 2-4, have experienced a dramatic deterioration in social indicators since 1989. Far from improving these dimensions of the standard of living, it is clear that slow or postponed market-oriented reform has been associated with a sharp deterioration in indicators of social development.

This superior performance of the faster-reforming countries in Group 1 is of great significance. It translates into large improvements for the population in social development in these countries, relative to those in Groups 2-4. To illustrate this point, consider the following implications of the figures on mortality and life expectancy presented in Chart 2.2. The number of deaths of working-age adults (male and female) in the countries of Groups 2-4 was about 434,000 higher in 1994 alone than it would have been if the age 20-59 mortality rates for these countries had followed the trend (not the level) observed in Group 1 countries between 1989 and 1994. For children under five, the corresponding figure for 1994 was about 103,000.[7] The differences in life expectancy are also striking. The average (weighted by population) life expectancy of males in Groups 2-4 was 4.3 years shorter in 1993 (not computable for 1994) than it would have been if the trend observed in the Group 1 countries since 1989 had been

[7] These estimates are computed as follows. For each country in Groups 2-4, say country A, the value of the mortality rate in 1989 is multiplied by the cumulative percentage change over the five-year period 1989-94 observed for the Group 1 countries (averaged over those countries). The difference between the actual mortality rate in 1994 and this hypothetical rate is then multiplied by the population in the relevant age group for 1994 in country A. This yields the estimate of the "additional" deaths for country A. These figures are summed up for all countries in Groups 2-4 to obtain the figure quoted in the text. We emphasise that this procedure does *not* compute what would have happened to the number of deaths if the *level* of mortality had been the same in Group 1 and Groups 2-4 in 1994. It computes only what would have happened to the number of deaths if the percentage change from 1989-94 in mortality rates in Group 1 had been achieved in Groups 2-4 as well.

achieved. Female life expectancy was 2.6 years shorter on this account.[8]

The decline in social indicators is likely to be the consequence of a number of factors.[9] Unemployment, lower wage income, and aggravation of pre-existing nutritional imbalances for large parts of the population account for some of this development. Additionally, insufficient maintenance of water and sewerage systems have led to worsening sanitary conditions, which contributed to outbreaks of infectious diseases in some areas of the region. Furthermore, economic uncertainties and the necessity to cope with new circumstances, in particular for the population of working age, point to stress-related factors as direct causes for a decline in life expectancy and rise in mortality rates. This is supported if one examines the specific causes of mortality, particularly for males, where deaths from strokes, heart disease, suicide and alcoholism have risen sharply.[10]

2.4 Concluding remarks

The past year has seen important advances in market-oriented reforms in most of the region.[11] Particularly rapid change is now taking place in the countries of the CIS, most of which are pursuing comprehensive reform programmes. Meanwhile, most of the countries in eastern Europe and the Baltics are consolidating the reforms that they began three to five years ago.

In the largest CIS country, Russia, privatisation has advanced substantially, relying heavily on a transfer of shares to insider owners (managers and employees). Russian prices and foreign trade have become increasingly liberalised, although about a third of prices remain subject to local restrictions. The access of companies to government subsidies and soft bank credits has gradually been tightened over the past three years.

After initial reluctance, Ukraine embarked in the second half of 1994 on a far-reaching liberalisation of prices and foreign trade and on pilot privatisation of selected large companies. Meanwhile, the government and the central bank of Ukraine implemented a substantial tightening of enterprise access to subsidies and credit.

Each of these two large countries is now moving through the intermediate stages of transition to the market economy. Important investment opportunities will accompany these changes, but there will be major challenges in ensuring responsible corporate governance in the enterprise sector, in improving the effectiveness of the banking system and, in the case of Ukraine, in pushing ahead with privatisation.

The bulk of the smaller CIS countries have taken equally impressive action to broaden the role of markets and to intensify competition between enterprises. Armenia, Azerbaijan, Georgia, Kazakstan and Uzbekistan have all during the past year freed up prices and foreign trade, and tightened subsidy and credit policies. Most of these countries have also initiated implementation of mass privatisation schemes. In Kyrgyzstan and Moldova, where comprehensive packages of reform and stabilisation measures were already introduced in 1992-93, the market focus is becoming entrenched, with prices freed and domestic producers subject to competition from imports. Privatisation in these countries has gathered pace over the past year, and a sustained firmness in credit and subsidy policy has helped ensure pressure on enterprises to restructure their operations.

For all of the CIS countries, a key challenge will be to establish credible and stable institutions that can support investment and growth. In this context, further strengthening of banks and securities markets will be essential. It will also be important to ensure that enterprise managers are subjected to commercial pressure from banks or "outside owners" to make sound and market-based strategic decisions.

The enhanced market orientation of most CIS economies has created a wealth of opportunity for private investors. Substantial interest among foreign investors is evident from the results of a survey conducted over the past year by the EBRD (see Chapter 4). However, investors will be cautious. During the first years of reform, the prospect of high profitability may, from their point of view, be partly offset by uncertainty about the permanence of reforms, market prospects, relative price developments and macroeconomic stability. A sharp rebound in investment will be needed to enable the CIS countries to recover the output losses they have suffered in recent years (Chapter 11). Inducing investors to participate in and generate this recovery will require consistent government adherence to market-oriented principles and macroeconomic stabilisation policies. In these circumstances, and with the associated uncertainty, IFIs can play an especially important role as co-financiers for private investment, as guarantors against particular types of event risk, and as sources of finance for infrastructure that can help make private risk-taking in these countries a more attractive proposition.

The countries of eastern Europe and the Baltics, all of which implemented "first-round" reforms (market liberalisation and small-scale privatisation) in 1990-92, have embarked with varying degrees of intensity on the more challenging second-round and third-round measures (large-scale privatisation, enterprise restructuring and financial sector reforms). The Czech Republic, Estonia, Hungary and the Slovak Republic have privatised most of their large enterprises in the manufacturing sector. A number of other countries in eastern Europe and the Baltics are likely to advance their privatisation programmes to a comparable stage over the coming year. It remains a major challenge, however, throughout eastern Europe

[8] The computational procedure is identical to that in footnote 7.

[9] UNICEF (1994).

[10] UNICEF (1994).

[11] Overall, only Bulgaria, Tajikistan and Turkmenistan have shown minimal advance in the transition over the past year.

and the Baltics, to establish and sustain corporate governance in enterprises and to ensure market-based enterprise restructuring. This process may be helped along in the years ahead by increasingly vibrant local stock markets which will facilitate gradual concentration of ownership in the hands of strategic investors.

The establishment of corporate governance and the supply of finance for a recovery of investment in eastern Europe and the Baltic countries can also be strengthened by improvements in the functioning of domestic banks. Governments in a few countries have recapitalised their largest banks sufficiently to allow them to operate with prudential ratios that are broadly consistent with BIS guidelines. Some of the largest banks in the Czech Republic, Hungary, Poland and the Slovak Republic have been privatised. Nevertheless, reform of the banking system has far to go in these countries.

The role of banks as a source of finance for private investment remains modest. The ability of domestic banks to attract savings and efficiently channel them to investment must be built up gradually over a number of years. Low ratios of total bank lending to GDP throughout the countries of eastern Europe and the Baltics indicate that the supply of banking services remains inadequate. Banking skills depend critically on experience that can only be established with time. In addition, the soundness of many banks remains questionable despite government-financed recapitalisations. Without further advance in the privatisation of large banks it will be difficult for the government to provide an effective response to the serious policy challenge of establishing incentives and imposing financial discipline on bank managers. Moreover, the recent banking crisis in Latvia is a reminder of the challenges that will continue to confront bank regulators and supervisors in most of the transition countries, even after bank privatisation.

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Annex 2.1. Estimates of private sector activity in transition countries

This annex presents estimates of the share of GDP and employment accounted for by the private sector in eastern Europe, the Baltics and the CIS during the period 1989-94. The estimates are drawn from official national sources including ministries of finance, statistical offices and privatisation agencies. Some of the numbers have not been published before. The annex provides figures both at the aggregate and sectoral levels, when available. The first section briefly discusses various statistical problems associated with any attempt to measure private sector activity in transition economies. The second section provides a summary picture of private sector activity in transition economies as of the end of 1994. The more detailed estimates for eastern Europe, the Baltics and the CIS are presented in the last two sections.

Methodological issues

The growth of the share of GDP or employment accounted for by the private sector can come from five sources: the creation of new private businesses, the growth of existing private businesses, the privatisation of state-owned enterprises, the decline of the existing state sector and foreign investment. Reliable assessment of private sector activity in transition economies is hindered by various statistical problems, and only approximate estimates can be made of the changes of ownership that have taken place since the start of the transition process in 1989.

Statistical offices in many transition countries define the private sector (or non-state sector) to include all enterprises with majority private ownership.[1] However, net output produced in a state-owned factory leased by a private enterprise should also be considered as private for the present purpose, and is normally included by statistical offices in the private or non-state sector. However, some economic units may be classified as part of the non-state sector but still enjoy only limited independence from state control. Cooperatives and collectives are a good example. Under communist rule, cooperatives and collectives, together with the state sector, constituted the so-called socialised sector. All communist countries had large cooperative or collective sectors, especially in agriculture, which were effectively run as part of the state sector.[2] During the past five years, new legislation in many countries has converted traditional state-controlled cooperatives and collectives into genuine cooperatives or private corporations, but the precise nature of the state involvement in the cooperative sector still varies from country to country.

Most experts agree that hidden activities are now more pervasive than under communist rule and that this situation has led to the under-recording of both the growth of existing private enterprises and the registration of new, active private enterprises. In the newly liberalised economic environment, some private entrepreneurs may have both the incentive and the capacity to hide productive activities from the authorities either to avoid taxes, social security contributions or regulatory and legal requirements, or because the activities are illegal. Official national sources in Bulgaria, Estonia, Hungary, Lithuania, Poland, Romania and Russia have reported to the EBRD that their estimates of GDP and private sector activity were at least partially corrected for hidden activities, whereas no adjustments were made by official sources in Croatia and the Czech Republic.

Estimates made by statistical agencies of legal hidden activities fall mainly in the range of 10-25 per cent of GDP. In Hungary, a specially organised survey found that the share of the hidden economy (defined as that share which escapes the tax authorities) had increased from 13.1 per cent of official GDP in 1980 to 29.6 per cent of official GDP in 1992 (only part of which is taken into account in the official GDP-estimates for Hungary).[3] Estimates for other countries have been collected by the EBRD from national statistical agencies.[4] For Estonia such estimates indicate that the informal economy in 1994 accounted for 35 per cent of the value added in the private sector, and about 20 per cent of total GDP. In Slovenia the "grey" economy has been estimated to account for 20 per cent of GDP and 26 per cent of employment. In Bulgaria hidden activities of registered private enterprises account for an estimated 16.8 per cent of GDP in 1994, up from an estimated 4.3 per cent of GDP in 1992. In Romania the share of GDP accounted for by the gross value added in the hidden economy was estimated at 6.7 per cent in 1992, 9.0 per cent in 1993 and 10.0 per cent in 1994.

The centrally planned economies used to rely on the Material Product System (MPS), which does not record "non-material services" (e.g. banking and insurance, medical care, housing, education, scientific research, business and personal services), areas in which the emerging private sector is expected to contribute significantly. Official sources tend to be ill-equipped to monitor this contribution, but coverage of it is gradually improving. A good example is Bulgaria, where the statistical agency recently revised upwards its estimate of value added in the private sector in order to take into account more complete data for value added derived from owner-occupied dwellings.

[1] The difference between private and non-state is not always clear. In most cases, these two categories are used interchangeably, but in some countries the non-state sector includes companies in mixed ownership and the private sector excludes such companies. In some countries, the term "private sector" used to apply to 100 per cent non-state companies only, but later was extended to include companies in mixed ownership. See the footnotes to the tables for details of the definitions used in each country. See footnote 8 for definitional peculiarities in some of the CIS countries.

[2] Exceptions existed even under communist rule in the form of "new cooperatives" in the former Soviet Union and small cooperatives in Hungary, which enjoyed greater independence from the state.

[3] Vertes and Arvay (1994).

[4] Estonian Market and Opinion Research Center Ltd.; Ljubliana Institute for Economic Research, Slovenia; National Statistical Institute, Bulgaria; National Committee for Statistics, Romania.

Table 1.

Private sector share in GDP and employment in eastern Europe, 1989-94

Private sector share (%)

	In GDP						In employment					
	1989	1990	1991	1992	1993	1994	1989	1990	1991	1992	1993	1994
Bulgaria[1]	–	–	16.6	25.3	35.9	40.2	5.5	5.9	10.1	17.7	28.3	34.7
Croatia[2]	–	18.8	25.2	34.9	41.2	44.9	–	–	21.8	26.9	37.5	46.6
Czech Republic[3]	11.2	12.3	17.3	27.7	45.1	56.3	1.3	6.9	18.8	31.1	47.1	–
including cooperatives	–	–	–	–	–	–	14.2	19.1	28.4	38.6	52.8	–
Hungary	14.9	–	33.0*	44.0	52.4	–	–	–	–	–	–	–
including cooperatives[4]	29.0	–	41.0*	48.1	55.6	–	–	–	–	–	59.4	–
Poland	28.6*	31.4	45.3	48.2	53.5	56.0	45.7	45.8*	51.1*	57.0*	57.6	59.8
Romania	12.8	16.4	23.6	26.4	32.0	35.0	5.9	9.2	33.6	41.0	43.8	51.4
including cooperatives	–	–	–	–	–	–	31.2	31.2	38.4	44.0	46.3	53.4
Slovak Republic[5]	–	–	–	22.0	24.6	43.8	1.0	5.0	12.8	18.4	22.2	31.9
including cooperatives	–	–	–	32.4	39.0	58.2	17.5	20.0	25.9	30.4	33.2	40.5
Slovenia[6]	8.1*	11.4*	15.7*	19.5*	–	–	13.0*	14.7*	17.5*	19.9*	–	–

Sources

National Statistical Institute, Bulgaria; State Institute of Macroeconomic Analysis and Forecasting, Croatia; Czech Statistical Office; Hungarian Central Statistical Office; Central Office of Planning and Central Statistical Office, Poland; National Commission for Statistics, Romania; Statistical Office, Slovak Republic; Institute of Macroeconomic Analysis and Development, Slovenia.

Notes

Estimates are for the private sector excluding cooperatives, unless otherwise indicated. An asterisk indicates numbers taken from the EBRD (1993), when more recent official numbers were unavailable. In most cases these data cover only 100 per cent privately-owned enterprises.

1 Data for 1994 are preliminary.

2 End-of-year data; employment data for the period before 1993 include only 100 per cent privately owned firms; for 1993-94 mixed firms with more than 50 per cent private ownership and transformed firms are also included.

3 Share in GDP estimates are for the "non-state sector".

4 Employment: excluding financial corporations.

5 Before 1994, firms with mixed ownership were excluded from the definition of the private sector; for 1994, such firms were partially included in the definition of the private sector.

6 Excluding socially managed enterprises.

Private sector activity in transition countries in 1994

Official estimates of private sector activity gathered by the EBRD from statistical agencies in the region are summarised in Chart 1 for those countries for which 1994 data were available.[5] These will in many cases differ somewhat from the EBRD estimates that are listed in Table 2.1 of this Report due to the factors that are discussed country by country in Annex 2.2.

Official estimates indicate that the private sector accounts for more than half of GDP in a number of countries that have implemented comprehensive, large-scale privatisation (including the Czech Republic, Hungary, Kyrgyzstan, Lithuania, Russia and the Slovak Republic). Poland, however, had the largest private sector share as of end-1994, at 59.8 per cent, although the country has yet to implement a comprehensive privatisation programme. The dominance of the private sector in employment in Poland reflects in part the prominence of the private sector in agriculture prior to the onset of comprehensive market reforms and the rapid growth of new enterprises.

The non-state sector remains particularly small in Belarus and Ukraine, due to relatively slow progress in privatisation and in market liberalisation (at least until recently in Ukraine). The large difference between the GDP and employment shares of the private sector in some countries of the CIS may be partly due to the prevalence of workers on "unpaid leave" as a form of hidden unemployment in these countries. Some of the differences across countries in the private sector shares also reflect definitional quirks. For example, Bulgaria excludes cooperatives from the definition of the private sector, while Russia and Latvia include former collective farms in the non-state sector.

Changes in private sector activity in eastern Europe

Croatia, Hungary and Poland reported substantial private sector activity as early as 1989, reflecting earlier reforms introduced in Hungary after 1968, Poland in the 1980s, and Yugoslavia after 1950. Poland was the only CMEA country to maintain a large part of agriculture in private hands. In Hungary a substantial share of economic units with mixed ownership and decentralised decision-making had been created before 1989. In the former Yugoslavia private enterprise played a substantial role in agriculture, construction and certain services. Bulgaria, the former Czechoslovakia and Romania started the reform period with smaller private sectors.

Table 1 presents estimates of private sector GDP and employment shares in eastern Europe for the period 1989-94. The countries that started the transition process with relatively sizeable private sectors (Hungary, Poland and Croatia) remained in front in the early reform years, but the Czech Republic and the Slovak Republic, where rapid progress on large-scale privatisation compensated for the small initial private sector, had caught up

5 1994 numbers were not available for Hungary; 1993 numbers were included in Chart 1 because privatisation in Hungary finished before 1994.

Percentage share of GDP and employment accounted for by private sector (including cooperatives) in eastern Europe and former Soviet Union in 1994

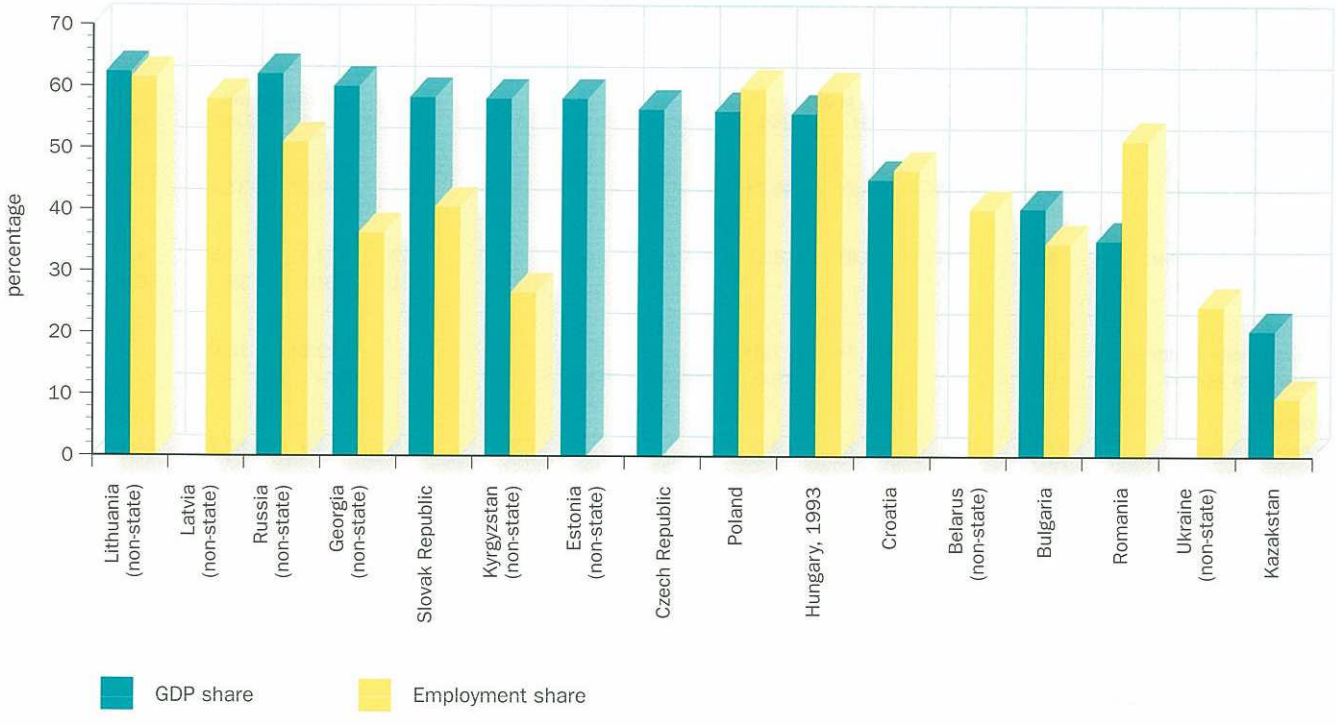

Table 2.

Sectoral breakdown of the private sector share in value added and employment in eastern Europe, 1994

Private sector share (%)

	In value added			In employment		
	Agriculture	Industry	Services	Agriculture	Industry	Services
Bulgaria[1]	79.5	18.4	48.9	66.5	7.9	40.5
Croatia[2]	79.5	38.5	40.0	–	–	–
Czech Republic[3]	82.1	59.0	49.5	23.2	45.2	50.9
including cooperatives[4]	–	–	–	77.0	48.0	53.0
Hungary[5]	68.1	54.1	59.7	77.0	61.6	51.6
Poland[6]	–	38.0	89.0	–	–	–
Romania	85.2	15.0	35.4	89.5	21.3	36.8
Slovak Republic	–	53.1	–	–	–	–

Sources

National Statistical Institute, Bulgaria; State Institute of Macroeconomic Analysis and Forecasting, Croatia; Czech Statistical Office; Hungarian Central Statistical Office; Central Office of Planning, Poland; National Commission for Statistics, Romania; Statistical Office, Slovak Republic.

Notes

Estimates are for the private sector excluding cooperatives, unless otherwise indicated.

1 Preliminary data. Excludes cooperatives in the private sector for the 1990-94 period; employment: 1993 data.

2 Employment data before 1993 include only 100 per cent privately owned firms; after that mixed firms with more than 50 per cent private and transformed firms are also included.

3 GDP estimates are for the non-state sector.

4 Employment: 1993 data.

5 Including cooperatives and excluding financial corporations; 1993 estimate.

6 Services include retail trade only.

with them by 1994. The Czech and Slovak figures clearly reflect the completion of the first "voucher privatisation wave" in late 1992 and the first half of 1993. For the Slovak Republic the large jump in 1994 reflects primarily a definitional change (see the footnotes to the table).

Previously published estimates for private sector activity in Bulgaria for the period 1991-93 have been revised to reflect the availability of more complete estimates for the hidden economy and private sector activity.[6] In Romania the growth in the share of the private sector in employment (and decline in the share of

6 Previous estimates for the private sector share in GDP were: 7.2 per cent in 1989, 9.5 per cent in 1990, 11.9 per cent in 1991 and 15.6 per cent in 1992. The revision is mainly based on the inclusion of services derived from owner-occupied dwellings.

Table 3.

Private sector share in GDP and employment in the Baltics and the CIS, 1989-94

Private/non-state sector share (%)[1]

	In GDP						In employment					
	1989	1990	1991	1992	1993	1994	1989	1990	1991	1992	1993	1994
Armenia												
non-state sector	8.1*	11.7*	24.2*	36.7*	–	–	11.8*	15.2*	29.0*	37.1*	–	–
Belarus												
pure private sector	5.1*	5.5*	6.8*	8.1*	–	–	1.2	1.2	2.3	3.5	4.7	6.2
non-state sector	–	–	–	–	–	–	19.7	26.1	29.1	35	36.9	40.2
Estonia												
pure private sector	–	–	17.7*	22.0*	–	–	–	–	10.5*	15.0*	–	–
non-state sector[2]	–	–	–	45.0	50.6	58.0	–	–	–	–	–	–
Georgia												
non-state sector	17.6*	28.1	27.3	49.0	56.9	60.0	20.5	24.5	24.9	30.7	34.3	36.3
Kazakstan												
pure private sector	15.0*	7.2*	12.2*	–	–	20.2	3.3*	3.8*	4.4*	–	–	9.0
Kyrgyzstan												
non-state sector	–	–	–	–	56.4	58.0	–	–	–	–	–	–
Latvia												
pure private sector	–	–	–	–	–	–	–	8.0	12.0	31.0	47.0	53.0
non-state sector[3]	–	–	–	–	–	–	13.9*	19.0	22.0	44.0	55.0	58.0
Lithuania												
pure private sector	10.4*	11.6*	15.4*	20.0*	–	–	2.4*	3.7*	15.5*	25.4*	–	–
non-state sector	–	–	16.0	37.0	57.0	62.3	20.0	22.3	29.8	41.3	54.2	61.5
Moldova												
non-state sector	–	–	–	–	–	–	26.0	31.0	36.0	38.0	47.0	–
Russia												
pure private sector	5.3*	6.0*	10.1*	14.0	21.0	25.0	1.6*	2.6*	4.8*	18.3	28.1	31.0
non-state sector	–	–	–	25.0	52.0	62.0	–	18.0	25.0	31.0	46.0	51.0
Ukraine												
pure private sector	–	7.6	7.8	5.6	7.5	–	–	–	–	–	–	–
non-state sector	–	23.9	32.6	30.0	41.0	–	–	–	–	17.1	19.6	24.5
Uzbekistan												
non-state sector	–	–	–	38.8	46.7	54.2	–	–	–	42.2	48.7	59.7

Sources

State Directorate of Statistics, Registration and Analysis, Armenia; National Committee on Statistics and Analysis, Belarus; State Statistical Office, Estonia; Ministry of State Property, and State Committee of Social-Economic Information, Georgia; State Statistical Committee, Kazakstan; Ministry of Finance, Kyrgyzstan; Central Statistical Bureau, Latvia; Department of Statistics, and Ministry of Economics, Lithuania; State Department of Statistics, Moldova; State Statistical Committee, and Working Center for Economic Reform, Russian Federation; Ministry of Statistics, Ukraine; Presidential State Committee on Forecasting and Statistics, Uzbekistan.

Notes

Estimates are for the private sector excluding cooperatives, unless indicated otherwise. Numbers were taken from the EBRD (1993), where recent official numbers were unavailable (marked with an asterisk).

1 "Pure private sector" refers to economic enterprises that are 100 per cent privately owned. The "non-state sector" is a broad concept which includes, in some countries, collective farms and companies with only minority non-state ownership.

2 1994-estimate refers to private share of value added in non-financial corporations.

3 Non-state sector, excluding agricultural statutory companies, i.e. former collective farms.

employment accounted for by cooperatives) reflects mainly the privatisation and corporatisation of agricultural cooperatives in 1991. Their dissolution and the redistribution of land to members or former owners largely account for the tripling of the private sector share in employment during this short time period. Progress has been much slower in other sectors in Romania. The sharp differences between the private sector shares in GDP and in employment for Romania, and for the Slovak Republic, might be a result of definitional differences in private sector coverages, but this has not been confirmed by the national statistical offices that provided the data.

Sectoral progress in eastern Europe

The agricultural sector in the centrally planned economies was and often still is highly concentrated, with food processing, distribution and supply typically managed by a few large state monopolies. Rapid corporatisation of agricultural cooperatives resulted in the very high contribution of the private sector to sectoral production and employment (Table 2).

Slow progress in large-scale privatisation in most countries in eastern Europe accounts for the lower contribution of the private sector to industry, compared with agriculture and services.

Table 4.

Sectoral breakdown of the private sector share in value added and employment in the Baltics and the CIS, 1994

Private/non-state sector share (%)[1]

	In value added			In employment		
	Agriculture	Industry	Services	Agriculture	Industry	Services
Belarus						
pure private sector	–	–	–	12.9	2.4	–
Georgia						
non-state sector	74.7	21.9	52.7	82.8	21.3	17.8
Kyrgyzstan						
non-state sector	83.6	50.7	32.1	–	–	–
Lithuania						
non-state sector	–	–	–	96.5	56.4	48.5
Moldova						
non-state sector[2]	83.0	48.0	33.8	30.0	5.0	–
Russia						
non-state sector[3]	80.0	55.0	–	84.6	21.1	51.4
Ukraine						
non-state sector[2]	82.6	38.0	23.0	–	–	–

Sources

Ministry of Statistics and Analysis, Belarus; State Committee on Social-Economic Information, Georgia; Ministry of Finance, Kyrgyzstan; State Department of Statistics, Moldova; State Statistical Committee, and Working Center for Economic Reform, Russian Federation; Ministry of Statistics, Ukraine.

Notes

1 "Pure private sector" refers to economic enterprises that are 100 per cent privately owned. The "non-state sector" is a broad concept which includes, in some countries, collective farms and companies with only minority non-state ownership.

2 Share of private sector in production, not value added.

3 Share of non-state sector in value added; share of private sector in employment; the non-state sector accounts for about 67 per cent of industrial employment.

Bulgaria and Romania, which have not yet embarked on comprehensive large-scale privatisation, have the smallest share of the private sector in industry.

While the service sector accounts for the major share of economic activity in advanced industrial economies (62 per cent of GDP and 67 per cent of the labour force in 1990), centrally planned economies showed a clear bias against the service sector.[7] Banking and insurance, personal and business services, and medical services, for example, were not considered productive activities under communist rule, and the development of private sector activity in this part of the economy has relied primarily on the entry of new firms. In order to meet previously unsatisfied demand, newly formed private firms, together with recently privatised small businesses, have led to a substantial increase in the private share in the service sector. In some parts of the service sector, such as retailing, small-scale privatisation has been the principal way for the state to divest its assets.

Progress in the Baltics and the CIS

Table 3 presents estimates of the private sector share in GDP and employment for the Baltics and some CIS countries. In interpreting these figures, differences in the statistical treatment of ownership structures should be kept in mind.[8]

Some private sector activity existed already at the beginning of the transition process in the Baltics and the CIS countries, especially after several new private forms of business arrangements were introduced in 1988, including new cooperatives, leasing arrangements and small enterprises with substantial independence from state plans and budgets. These and other types of private sector arrangements have been expanding among the successor states, although at an uneven pace.

The significant decline of GDP since 1989 played a much more important role in explaining the share of GDP and employment accounted for by the private and non-state sectors in the Baltics and CIS countries (especially in the Transcaucasus) than in eastern Europe. Calculations based on official estimates show that the size of the non-state sector in Georgia fell in absolute terms in 1991, 1993 and 1994, and that it remained unchanged in Armenia in 1992, although the share of the private sector in GDP rose in these years. Progress on privatisation in the Baltic States, Russia and Kyrgyzstan, combined with the GDP decline, resulted in a

7 When possible, education was excluded from services.

8 National statistics in some CIS countries (Belarus, Russia, Kazakstan, Kyrgyzstan, Ukraine) classify enterprises according to four mutually exclusive categories of ownership: domestic, private, mixed, state and foreign. The "private" category covers only firms that are 100 per cent privately-owned (in some countries excluding joint-stock companies). The "mixed" category includes joint-stock companies with private domestic ownership combined with state or foreign stakes. In Ukraine and Belarus, leasing arrangements with the state are included in the mixed sector. Kyrgyzstan and Belarus attributed to the non-state sector those companies from the "mixed" category which were between 51 and 99 per cent privately owned. Russia and Ukraine treat the whole mixed sector as a part of the non-state sector. Former collective farms are often included into the non-state sector together with corporatised state firms.

significant increase of the private and non-state share of GDP in these former Soviet economies (Table 3). In other republics, such as Belarus, more modest estimates clearly reflect the slow progress on privatisation and market liberalisation.

Sectoral progress in the Baltics and the CIS

In the agricultural sector, corporatisation of collective and state farms accounts for the large contribution of the private sector (Table 4). However, it is important to emphasise that, while even state-owned industrial enterprises in the Baltics and the CIS countries (except for armament production) usually enjoy substantial independence from the state, agriculture continues to rely heavily on state support. Moreover, the change in the ownership status of farm cooperatives has been nominal in many CIS countries, with limited real consequence. The numbers for Belarus are not strictly comparable with those for other countries because collective farms are not included in the private sector, but they are elsewhere. In most CIS countries, the "individualisation" of agriculture has not been successful. Consequently, the size of the private sector in Belarus may serve as a reasonable indicator of the true share of the private sector in agriculture for the rest of the CIS countries.

In Kyrgyzstan and Russia, progress in large-scale privatisation, together with the disruption of industrial state sector activity, accounted for the relatively large contribution of the private sector to industry. Georgia, Belarus and Ukraine have proceeded slowly in large-scale privatisation. In the service sector, newly formed private firms, together with recently privatised small businesses, led to a substantial increase in the private share.

Concluding remarks

The private sector is active in all countries in the region, and in many cases accounts for a very substantial share of GDP and employment. Mass privatisation has been a major contributory factor to the growth in the share of the private sector in overall economic activity. In countries that have already undertaken large-scale privatisation, further expansion will rely more heavily on the formation of new firms, the growth of existing firms, and foreign direct investment. In the others, including Bulgaria, Romania and a number of the CIS countries, the private sector share should increase rapidly as privatisation progresses. For this reason, one should expect some convergence across the region in the shares of the private sector during the coming years. It should be emphasised, however, that increased private ownership does not by itself ensure improved performance. That depends very much on whether the change in ownership delivers effective incentives and control of enterprises (see Chapter 8).

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Albania

The reform process was initiated in 1991, and a comprehensive programme was adopted in 1992. Price and trade liberalisation as well as privatisation of farm land and small-scale enterprises is virtually complete.

Enterprises

Size of the private sector

Seventy per cent of total employment is estimated to be in the private sector, which accounts for at least 60 per cent of GDP.

Large-scale privatisation

A voucher-based mass privatisation programme was approved early in 1995. Voucher distribution to approximately one million eligible people began in June 1995. The scheme involves privatisation of about 1,000 state enterprises with total employment estimated at 160,000. These include utilities and subsidiaries in the mining and petroleum sectors, but exclude enterprises under the Ministry of Defence. Actual completed privatisation of large companies has been insignificant.

Small-scale privatisation

The Privatisation Law (1991) and subsequent amendments regulate the privatisation of small-scale entities (less than 15 staff). Privatisation progressed rapidly in 1991-92, largely through employee buy-outs. Privatisation of retail shops is virtually complete. Since mid-1993, responsibility for the small-scale privatisation programme has rested with the National Agency for Privatisation. The programme includes entities with less than 300 employees or a book value of less than US$ 0.5 million. As of June 1995 about 2,775 enterprises had been sold, generating 2.2 billion leks of 1994 government revenue

Privatisation of land is regulated by the Law on Land (1991). By the end of 1993, 92 per cent of agricultural land had been privatised, primarily in 1991-92 as farmers took over the land of former cooperatives. The sale and purchase of land was originally prohibited. In July 1995 two new laws regulating land ownership and its sale and purchase were passed. The first allows sale and purchase of agricultural land. It also transforms the titles to usage of the land into property titles. The second law allows foreign individuals or companies to buy land if they combine the purchase with a three times as large investment in the usage of the land. The sale of state-owned housing is regulated by the Law on the Privatisation of State Housing (1992) and by subsequent by-laws. By 1995, 98 per cent of state buildings had been privatised.

Property restitution

According to two laws passed in 1993, former owners and their heirs can claim compensation or restitution for earlier government expropriation of non-agricultural land. For property that has been privatised, the law prescribes co-ownership between the new and former owners

Growth of private enterprise

Employment in the non-agricultural private sector rose from about 50,000 at end-1992 to 130,000 at end-1993. The private sector presently accounts for 20 per cent of employment in the non-agricultural sector. The establishment of small enterprises in trade, transport and services has been partly financed by the large inflow of remittances from abroad.

Enterprise restructuring

Much enterprise restructuring has happened over the past two years in response to sharp tightening of enterprise access to bank credits and government subsidies. The rapid accumulation of inter-enterprise arrears in 1991-92 was halted in early 1993 by the nationwide move to a system of payment before delivery. Inter-enterprise arrears were netted out and a strictly limited set of financially viable firms were granted the financial means to write off their claims on non-viable companies. Despite the adoption by parliament of a bankruptcy law in 1992, no bankruptcies have yet taken place. An agency was established in 1993 to restructure or terminate the operations of 32 large companies. Plans by the Agency to initiate the liquidation or privatisation of several large problem enterprises have been scrapped and these enterprises were included in the mass privatisation programme approved early in 1995.

The bankruptcy law covers only state-owned companies but has never been applied.

Markets and trade

Price liberalisation

Price liberalisation has been extensive, but 25 commodities remain subject to administrative price setting. Price controls and subsidies (amounting to less than 1 per cent of GDP) remain on public transport, rail fares, postal tariffs and rural water supply. Price controls also apply to the provision of electricity. While electricity prices now cover 50-60 per cent of long-run production cost, suppliers only receive half as the remainder is excise taxes.

Competition policy

A draft competition law was reviewed by the Council of Ministers in February 1995.

Trade liberalisation

Since 1992 there have been virtually no quantitative restrictions on imports and very few on exports.

In May 1995 parliament approved the latest customs law, introducing three new customs tariffs: 7 per cent on raw materials, machinery and equipment, previously exempt from duty; 25 per cent on most consumer goods; and 40 per cent on luxury goods.

Currency convertibility and exchange rate regime

The exchange system is largely free of restrictions on current account transactions including on profit repatriation. Controls remain on capital transactions but not on repatriation of initial capital by foreign investors. The exchange rate is freely determined in the interbank market, which competes with a number of private dealers and foreign exchange bureaux.

Wage liberalisation

There are no longer wage ceilings for state-owned or private enterprises. An agreement is in place between government and the largest trade union to index government wages to the prices of 24 basic consumer goods and services. The minimum wage was equivalent to $32 per month in early 1995.

Interest rate liberalisation

There is no cap on deposit or lending rates, but banks have generally followed the central bank in setting rates. Real interest rates on both deposits and lending have been positive since the first quarter of 1993.

The Bank of Albania sets minimum deposit rates and issues guidelines for the formation of lending rates with the aim of maintaining positive real rates on deposits and credits. According to the IFC, annualised interest rates in the informal credit sector are as high as 100 per cent (whereas annual end-year inflation for 1995 is projected at less than 10 per cent). This is the main source of outside finance for the private sector, apart from remittances from family/friends who migrated abroad.

Financial institutions

Banking reform

The central bank has the right to issue operating licences to commercial banks, approve mergers and division of banks, and approve the issue of securities. The state-owned Savings Bank takes the bulk of household deposits. These deposits are channelled via the central bank to the state-owned National Commercial Bank (NCB) which undertakes more than half of all lending to enterprises. Another important state-owned bank is the Rural Commercial Bank.

A large share of new bank lending extended since mid-1992 has become non-performing. In October 1992, the government provided state bonds to the banks to offset the write-down of non-performing loans that had been extended to the former agricultural cooperatives. None of the established commercial banks has yet been privatised. However, a law on the privatisation of the state banks is currently being drafted. The NCB has recently been recapitalised, its ownership clearly allocated to the Ministry of Finance and its capital separated from that of the central bank. Three partly-foreign-owned private banks are currently operating in Albania. In July 1995 new regulations were approved concerning minimal capital requirements for new banks (US$ 1 million for local banks and US$ 2 million for joint-venture banks).

A law on checks has been drafted but not yet approved; almost all transactions are still in cash. Only short-term lending (up to six months) is available from the banking sector, which is actively financing the public deficit. A large informal credit market with strong repayment history exists. Lending to private enterprises is primarily through the informal credit sector.

Non-bank financial institutions

A draft law on investment funds has been prepared. The Albanian-American Enterprise Fund has recently been established, but has yet to make its first investment.

Securities markets and instruments

A stock exchange is to be established before the end of 1995. New securities laws are in place.

Fiscal and social safety net reform

Taxation

Until 1990 the state budget relied on three main revenue sources: the turnover tax, enterprise profit transfers and social security contributions. All of these were paid by the enterprises. Reforms since 1991 have introduced a personal income tax, property tax and customs duties. They have replaced profit transfers by profit taxation and removed the most notable inefficiencies in the turnover tax system. In 1992 the profit tax rate was set at 30 per cent, the progressive rates for personal income taxation at 5-40 per cent, and the basic turnover tax at 15 per cent. Despite the new revenue sources, there has been a very sharp drop in revenues collected from enterprises. None of these rates have changed since then.

A VAT of 12.5 per cent (with few exemptions) is to be introduced during the second half of 1995.

Social security

The government has, over the last 2-3 years, placed pensions and unemployment insurance on an actuarially sound basis: an individual unemployment insurance contribution has been introduced as well as phased increases in social security tax rates; a one-year limit on eligibility for unemployment insurance was introduced; and earnings-related unemployment benefits has been replaced by flat payments linked to minimum pensions. The government has improved targeting of social assistance to the most vulnerable groups by replacing price subsidies with targeted income transfer programmes, means-testing social assistance and enforcing eligibility requirements. Social security contributions are 32.5 per cent of the payroll (6 per cent paid by employer).

Armenia

A reform package focusing on price liberalisation, land privatisation and tax reform was adopted in January 1992. However, Armenia was unable to proceed with reforms and stabilisation due to the conflict in Nagorny-Karabakh, and the blockade imposed on the country by neighbouring states.

Armenia's reform efforts regained momentum in 1994 with the support of an IMF Structural Transformation Facility and a World Bank Rehabilitation Credit. Macroeconomic stabilisation is gradually taking hold and important structural reform measures have been implemented.

Enterprises

Size of the private sector

The private sector is likely to account for about 40-45 per cent of GDP.

Large-scale privatisation

A "voucher" privatisation programme was approved in 1994 that provided for privatisation of about 5,000 both large and small-scale enterprises (35 per cent of productive assets owned by the government), but for some "strategic" enterprises privatisation has been deferred at least until 1997. Distribution of vouchers to the Armenian population started in October 1994 and was completed in March 1995. By mid-1995, about 1,100 medium and large-scale industrial enterprises had been converted into joint-stock companies with 20 per cent of the shares distributed to employees. The first privatisation auction, involving 10 medium and large-scale enterprises, was concluded in May 1995. Financial intermediaries have played a limited role so far. More than 900 medium and large-scale enterprises are to be privatised by end-1995, which would raise the share of non-state sector in GDP to 70 per cent.

In the agricultural sector almost all of the more than 800 state and collective farms have been broken up, and over 300,000 private farms have been created.

Small-scale privatisation

By May 1995, about 740 small-scale enterprises had been privatised outside the agricultural sector (up from 350 by end-1993); a further more than 1,000 small enterprises are to be privatised in the remainder of 1995, and the remaining about 2,300 enterprises are scheduled to be privatised before the end of 1996. Employees have the first option to buy via cash or vouchers; otherwise, the enterprise is offered for sale by auction. About 50 per cent of the housing stock has now been privatised and the remainder is scheduled to be privatised by the end of 1995.

Land privatisation is virtually complete. As the first among the CIS countries, Armenia permitted private ownership in agricultural land already in the late 1991 and 90 per cent of Armenian farm-land was in private hands by mid-1992.

Property restitution

No property restitution had taken place in Armenia by mid-1995.

Growth of private enterprise

New private enterprises have emerged rapidly in Armenia, although their development has been hampered by an incomplete legal framework, shortages of energy and other inputs and trade barriers imposed by Armenia's neighbours.

Enterprise restructuring

During 1994-95, substantial financial discipline has been imposed on state enterprises by the elimination of subsidies and cheap credits, clearance of arrears, and improved payments compliance. Pre-privatisation restructuring is monitored by the government and focuses on debt workouts and reduction of arrears, labour shedding, divestitures and spin-offs, new marketing strategies, and management changes. A law on bankruptcy was approved by parliament in 1995. Ten loss-making enterprises were to be placed in a restructuring programme by August 1995; a substantial number of other loss-makers are to be liquidated soon.

Markets and trade

Price liberalisation

Fairly comprehensive price liberalisation was introduced in January 1992 in Armenia as in most other CIS countries. Due to lasting barriers by neighbouring countries to trade with Armenia, further price liberalisation was delayed. Price liberalisation was revived in October 1994. Since then, only few goods and services have been subject to price controls and subsidisation (bread, urban transport, state-owned housing, communal services, domestic phone calls) or to limits on profit margins (bread, electricity, natural gas). During the first half of 1995 subsidies on bread and electricity prices were reduced substantially, and in July 1995 bread prices were fully liberalised. Rents are to be liberalised by the end of 1995. Cross subsidies between users of various utility services are to be removed, and electricity tariffs are to be set so as to cover at least operations and maintenance costs.

Competition policy

An Anti-monopoly law is to be submitted to the autumn session of the new Parliament, which was elected in July 1995. In order to improve resource allocation state purchases above US$ 50,000 have been offered for competitive tendering since February 1995. State procurement for interstate barter trade is conducted on a competitive basis.

Trade liberalisation

Armenia has progressively removed most of the regulatory obstacles to external trade. Import tariffs at rates of 0-10 per cent are applied to most non-CIS imports, but tariffs levied on some luxury items are as high as 50 per cent. Import and export licences are required only for health, security and environmental reasons. There are no export taxes. The role of interstate barter agreements has gradually diminished. The dismantling of an interstate trade agreement with Russia is planned for the end of 1995. Difficulties in securing continuity in transport and energy supplies have been caused by border closures by neighbouring countries. This constraint now appears to be loosening.

Currency convertibility and exchange rate regime

A national currency, the dram, was introduced in November 1993 and became the sole legal tender in March 1994. The exchange rate is determined in foreign exchange auctions that are held several times a week. The exchange rate is floating. The export surrender requirement was reduced to 30 per cent on 1 January 1995 and was eliminated by mid-1995. There are no restrictions on repatriation of profits and capital. Most current account transactions have been liberalised.

Wage liberalisation

A Wage Indexation Law was adopted in early 1992, giving the government discretion over nominal wage adjustments. A "minimum consumption basket" is used to guide monthly minimum wage adjustments to price increases.

In June 1995, minimum monthly wages in budget organisations were raised to 430 drams (US$ 1), and the minimum wage in non-budget organisations was raised to 540 drams (US$ 1.25).

Interest rate liberalisation

Interest rate limits were removed in the last quarter of 1994. The Central Bank's refinance rate is determined by the outcome of credit auctions and turned positive in real terms in early 1995.

Financial institutions

Banking reform

A two-tiered banking system was created in 1987-88 in Armenia as in the rest of the Soviet Union. There are five large specialised former state banks and some 40-50 other private commercial banks. The Central Bank of Armenia (CBA) and the five largest banks are to be the subject of international audits by end-1996, including portfolio reviews, and financial sector reform strategies will be formulated dependent on the quality of the banks' loan portfolio. The CBA's supervisory capacity and the system of prudential regulation have improved considerably over the past year. International accounting standards will be introduced from 1 January 1996.

In June 1995, the 35 per cent limit on foreign shareholdings in the financial sector was abolished. The first foreign-owned bank, Midland-Armenia, was established at the end of June 1995.

Non-bank financial institutions

In late 1994, an Investment Fund Decree was passed that allowed funds to own up to 40 per cent of shares in any given enterprise. A state insurance company and several private insurance companies are active in Armenia. A private deposit insurance company is under way.

Securities markets and instruments

Securities markets are in an embryonic stage. A share registry system has been implemented and a unit in the Ministry of Finance has been established to supervise capital markets.

Fiscal and social safety net reform

Taxation

Major tax reform took place in 1992 with the introduction of a value added tax (VAT) of 20 per cent, an *ad valorem* excise tax (10-73 per cent), an enterprise profit tax (12-25 per cent) and a personal income tax (12-45 per cent).

Current government programmes call for VAT tax exemptions to be reduced, excise rates to be increased and collection efforts to be enhanced. A property tax on enterprises and households is to be introduced by January 1996.

Social security

Social government expenditures (including consumer subsidies) are high (reached 20 per cent of GDP in 1993), but average benefits are low. In this situation, the government plans to reduce expenditure on subsidies and the pension system by increasing the retirement age, flattening the pension structure, delinking the pension from the minimum wage and reducing special privileges. The phasing out of consumer subsidies (especially energy) may require offsetting compensation for the most vulnerable groups.

Azerbaijan

The reform process initiated as part of perestroika in 1987 was continued in early 1992, after independence, with new tax legislation, a foreign ownership law, price liberalisation, property reform, currency reform and improvements to banking legislation. A comprehensive stabilisation and economic reform programme was initiated early in 1995, supported by a Systemic Transformation Facility from the IMF.

Enterprises

Size of the private sector

The private sector, including informal activity, may account for about 15-25 per cent of GDP.

Large-scale privatisation

A government programme put forward in April 1994 envisaged privatisation of medium-sized enterprise (50-300 employees) in 1996-98 and large-scale privatisation from 1998.

A privatisation programme, approved by parliament in July 1995, aims to transform at least 20 large enterprises into joint-stock companies and sell majority stakes to both domestic and foreign purchasers. A plan to use vouchers for a mass privatisation scheme has also been approved.

Small-scale privatisation

The government programme of April 1994 earmarked 8,000 small enterprises (about 30 per cent of the total) for privatisation in 1994-95.

Little progress was made. A new privatisation programme, also approved by parliament in July 1995, envisages that small enterprises (less than 50 workers) will be auctioned or sold directly to individual workers before the end of 1995. This would result in the privatisation for about 9,000 small enterprises, accounting for about 5 per cent of state assets.

Property restitution

In November 1991 all former Soviet property in Azerbaijan was nationalised. There is no individual property restitution law.

Growth of private enterprise

Over 10,000 small private enterprises are registered with local authorities, but many are inactive. Development of the sector is hampered by the delay in Presidential approval of a new Company Law, passed by parliament in spring 1993.

Enterprise restructuring

The pre-independence management structure and relationship between enterprises and ministries remains largely intact, supported by budgetary subsidies and bank credits to enterprises. There has been some managerial reform of large enterprises by division into smaller units.

At the end of 1994 subsidised credits to state-owned enterprises from the two major state banks, Agroprom and Prominvest, were terminated. In the spring of 1995, direct subsidies from state budget, including those on bread, were eliminated. A new Bankruptcy Law was approved by parliament in July 1994.

Markets and trade

Commodity price liberalisation

In January 1992, 70-80 per cent of producer and consumer prices were liberalised, with further rounds of liberalisation later in 1992 and 1993, leaving bread and energy as the main goods under price controls. Energy prices were at about a quarter of international market prices.

Bread prices were liberalised late in 1994. Prices of oil and oil products were raised to about half world levels at the beginning of 1995, with the intention to reach parity with world market prices within the next few months. However, price regulation in the utilities, housing and transport will remain for the time being.

Competition policy

The State Anti-monopoly Committee, established in 1993, regulates mark-ups in nearly 1,000 enterprises categorised as monopolistic. A law on Unfair Competition was passed by parliament in 1993 but is still awaiting Presidential approval.

Trade liberalisation

The dominant role of central government in foreign trade is being reduced. All quotas and licensing restrictions for both imports and exports were removed by spring 1995, with the exception of some "strategic goods", including oil and cotton.

Currency convertibility and exchange rate regime

Since May 1994 the official manat rate has been set weekly, based on a weighted average of exchange rates quoted by commercial banks authorised to deal in foreign exchange. Plans are being drawn up by the National Bank to promote an interbank foreign exchange market. Both current and capital account convertibility is heavily restricted.

Wage liberalisation

Wage ceilings have been imposed on enterprises since May 1994. The real value of the minimum wage, which sets the benchmark for determining social benefit payments and public sector wages, has declined significantly over the last 12 months.

Interest rate liberalisation

Real interest rates have been positive for most of 1995.

Financial institutions

Banking reform

The rudiments of a new two-tier banking system were established in August 1992 with the National Bank Law and the Law on Banks and Banking Activities. Since 1992 around 200 very small commercial banks have been created which together account for about 10 per cent of total credit to enterprises and individuals.

Four state banks (Prominvest, Agroprom, Amanat, International) are protected from competition from commercial banks by a number of measures, including a decree in June 1994 which requires state-owned enterprises to bank with the state sector, and selective tax privileges. New minimum capital requirements are likely to force consolidation of the 200 small commercial banks by the end of 1995. The National Bank of Azerbaijan has been granted significant powers to exercise prudential regulation but enforcement is patchy.

Non-bank financial institutions

There are no active investment funds in Azerbaijan.

Securities markets and instruments

Although a Law on Securities and Stock Exchange has been passed, no Stock Exchange has been established.

Fiscal and social safety net reform

Taxation

In 1992 turnover and sales taxes were replaced with a value added tax, and new enterprise profits tax was introduced along with new excise duties, a car ownership tax, a royalty in petroleum production and a progressive personal income tax. Laws on import customs tariffs and export taxes were adopted to enable further trade liberalisation; the latter is not yet effective. Plans are being drawn up to extend the base of VAT to non-CIS imports and to reduce exemptions.

Social security

In 1992 the Social Protection Fund, created from a merger of two pre-existing social security programmes, was established to provide pensions and social allowances financed by payroll contributions.

Belarus

Despite the official adoption of several market-oriented programmes since 1992, Belarus has been slow in implementing restructuring and privatisation of state-owned enterprises and macroeconomic stabilisation. However, substantial progress in these areas is now under way in the context of a tentatively agreed stand-by arrangement with the IMF.

Enterprises

Size of the private sector

As of mid-1995, the private sector probably accounted for approximately 15 per cent of GDP (although the non-state sector, which is a broader concept, was officially estimated to account for about 40 per cent of employment in 1994).

Large-scale privatisation

Privatisation of state-owned enterprises began in 1991 on the basis of legislation passed within the former Soviet Union. In July 1994, a voucher-based privatisation programme was launched, but only 5.6 per cent of total assets were privatised in 1994. By the end of March 1995, 40 per cent of the population had applied for vouchers. A total of 38 investment funds have been licensed. Government dissatisfaction with the level of fund activity led to a temporary suspension of their licences in early 1995 and the cancellation of the results of the first voucher auction. This suspension was reversed with respect to 35 funds in August 1995.

Genuine privatisation of large state-owned enterprises, with majority ownership and decision-making powers transferred to private investors, has not yet taken place.

In August 1995, the government unveiled a list of 1,000 enterprises which are to be privatised before the end of the year. Foreign investors will be invited to participate in this round of privatisation.

Small-scale privatisation

By mid-1995, 6.5 per cent of the population had received "property vouchers". Privatisation of small enterprises, including leasing and spin-offs from large state-owned firms, has been somewhat more successful than that of large enterprises. Privatised firms are mostly found in services, trading and transport. But the total share of privatised small-scale firms in output and employment is significantly smaller in Belarus than in neighbouring countries. About one-third of the country's housing units have been privatised; in most cases ownership was transferred to the former tenants. Farmland has not been privatised on a significant scale.

Property restitution

No property restitution has taken place to date.

Growth of private enterprise

Private businesses accounted for about 20 per cent of enterprises in the non-agricultural sector in 1993, including about 15,000 small businesses and 1,200 joint ventures with foreign investors.

As of early 1995, private companies accounted for 19.3 per cent of all companies, collectives for 47.5 per cent, state enterprises for 18.8 per cent, cooperatives for 4.6 per cent and joint ventures for 2 per cent. Fully private and cooperative enterprises accounted for only 6.6 per cent of the total employment. There are approximately 3,500 joint ventures with US$ 100 million in paid-up capital, but the majority are thought to be inactive and to be used as vehicles for tax evasion.

Enterprise restructuring

There has not yet been a significant restructuring of state enterprises. The Bankruptcy Law was enacted in 1992, but has been inoperative.

Budgetary subsidies to enterprises amounted to 4 per cent of GDP in 1994. By February 1995, 2,079 enterprises (25.5 per cent) of those checked by the Ministry of Statistics showed losses. According to estimates from the Ministry of the Economy, 600 enterprises are insolvent, but no bankruptcy cases have been initiated.

Markets and trade

Price liberalisation

A large share of producer prices were liberalised in early 1992; however, after prices had been freed, ceilings on wholesale and retail margins were introduced to limit price increases. These margin limits were eliminated in November 1994. Rents and energy prices remain administratively controlled.

As a result of the recent agreement with the IMF, most prices for food and agricultural products were liberalised in 1994-95. Utility rates were raised to 60 per cent of the cost recovery level in July 1995. This percentage is scheduled to increase to 80 per cent by the end of 1995. Domestic prices for oil and gas are to cover import costs.

Competition policy

The State Anti-monopoly Committee was established in 1991, and enabling legislation and administrative regulations were approved in 1992-93. As a first step, the Committee broke up a major trading conglomerate. The Committee also monitors and regulates monopolistic enterprises, controlling profit margins in enterprises accounting for about 30 per cent of industrial output in 1993.

Wholesale trade monopolies were broken up in 1994 and the first half of 1995. The output prices for natural monopolies (about 50, largely in public utilities) remain regulated, but other enterprises are subject to investigation only when there is evidence of monopolistic practice. The Anti-monopoly Ministry has successfully pursued a few cases.

Trade liberalisation

In May 1994, Belarus broadly unified its export and import duty system with that of Russia, resulting in average tariff rates of 15-20 per cent.

Tariffs on imports from Russia were eliminated under the January 1995 customs agreement, which was later extended to include Kazakstan. Export tariffs and non-tariff restrictions have been removed in 1995.

Currency convertibility and exchange rate regime

The Belarussian proposal of a monetary union with Russia was rejected by Russia in early 1995. The Belarussian rubel remains much less convertible than the Russian rouble. The required surrender of foreign exchange earnings at onerous exchange rates has been cut back in 1995.

Wage liberalisation

The 1990 Law on Enterprises allowed for the free determination of wages; however, many enterprises follow adjustments in public wages. In 1992 an excess wage tax was introduced. The minimum wage is set by parliament and is periodically adjusted for inflation; as of March 1995, it was 60,000 Rbl.

Interest rate liberalisation

Despite decontrol of interest rates to industry and commerce in October 1994, a significant amount of credit has continued in 1995 to be allocated at preferential rates through the state-owned banks on government recommendations, particularly to agriculture. Directed credit is likely to be cut back for the fourth quarter of 1995.

Financial institutions

Banking reform

The 1990 Law on the National Bank and Law on Banks and Banking Activities established the National Bank of Belarus, which operates as the central bank, and five banks constituted from former branches of the specialised banks of the former Soviet Union. 47 new banks have been licensed, mostly during 1994.

As of January 1995, total assets were US$ 1.6 billion, and total paid-in capital US$ 40 million. Over 85 per cent of assets and loans were concentrated in Sberbank (the Savings Bank), Belagroprombank, and the five large former state and commercial banks. Banks were required to increase their foundation capital to an equivalent of ECU 2 million by January 1996. The minimum size of the foundation capital has been set at ECU 5 million for foreign banks.

The seven largest banks, all of which are predominantly owned and controlled by the state, account for about 90 per cent of all assets in the banking sector. Foreign and joint-venture banks account for less than 1 per cent of all banking assets.

In September 1995, Belarus Bank (a joint-stock bank) was merged by Presidential Decree with the state-owned Sberbank. Shareholders are to be compensated at the nominal value of their shares.

Non-bank financial institutions

Assets of non-bank financial institutions represent less than 10 per cent of all assets in the financial sector. There are over 70 insurance companies with an estimated annual premium income of US$ 6 million, of which one-third is accounted for by the state insurance company.

There are 34 operating licensed investment funds, holding about 8 million vouchers. A presidential decree of March 1995 suspended the activities of all funds. This suspension was lifted in August 1995.

Securities markets and instruments

The Law on Commercial Paper and Stock Exchanges was passed in 1992. The Belarus Stock Exchange trades once a week, with only 10 companies (mostly banks) actively traded. There are 30 minor stock and commodity exchanges with still less activity.

Fiscal and social safety net reform

Taxation

Tax revenues amount to 30 per cent of GDP (40 per cent if contributions to non-budgetary funds are included). Statutory tax rates are generally high, although there are many exemptions. Tax compliance is comparatively good, partly because of the large state share in GDP. The VAT, which accounts for more than 25 per cent of revenues, is levied at a basic rate of 20 per cent. It is levied at an origin base, which favours imports and discourages exports. Profits tax accounts for another 25-30 per cent of total tax revenues. Its basic rate is 30 per cent, the same as the top marginal rate for personal incomes.

Social security

Despite the steep decline in output (at least 40 per cent since 1991), the official rate of unemployment was only 2.1 per cent as of end-1994. As elsewhere, the continued provision of employment and the services that often go with it (e.g. education, health services) has effectively been a major component of the social security system.

Social security payroll taxes are levied at 35 per cent of the wage bill for private companies, and 30 per cent for agricultural producers. In addition, a 12 per cent payroll tax is earmarked for Chernobyl-related expenditures.

Bulgaria

Market-oriented reform and a programme of macroeconomic stabilisation were launched in 1991. However, government intervention into markets and into enterprise finances remains significant and there has recently been some backtracking on price reform and foreign trade. New small private enterprises have emerged quickly in the trade and services sectors, but restructuring and privatisation of large enterprises and banks has been slow.

Enterprises

Size of the private sector

Due to delays in large-enterprise privatisation, the private sector's share of GDP appears to have increased by only 4 percentage points in 1994, to 40 per cent, according to official estimates, which also indicate that the private sector in 1994 accounted for 37 per cent of employment (and 80 per cent of GDP in agriculture, 50 per cent in services, but only 18 per cent in industry as a result of slow privatisation). The private sector's share of GDP may have grown more strongly recently and may have surpassed 50 per cent in mid-1995.

Large-scale privatisation

There has been significant resistance to privatisation from line Ministry officials and management. By June 1995, only 63 large-scale enterprises had been privatised by the Privatisation Agency (PA) and 280 procedures opened. The PA is responsible for the approximately 1,200 enterprises whose book value of fixed assets exceeds US$ 1 million. Management and employees can bid for up to 20 per cent of shares on preferential terms (with a 50 per cent discount). Important sectors (including energy and telecoms) are to remain excluded from privatisation. The privatisation process is open to foreign investors.

Total cumulative sales proceeds by mid-1995 were 7.5 billion leva, of which 4.1 billion leva were in the form of bonds, mainly Brady Bonds (see details below). The first round of a "mass-privatisation-scheme" is being prepared for launch in late 1995 but delays in implementation may occur. The programme is to encompass some 200 large enterprises with around US$ 1.5 billion in fixed assets. Payment is to be 70 per cent in vouchers (distributed to the population) – primarily through the intermediation of Privatisation Investment Funds – and cash/bonds (30 per cent). Regulations were adopted in August 1995, but details of the programme are still under discussion.

It has been possible since November 1994 to use Brady Bonds and domestic bad-loan bonds (ZUNKs) as payment assets in the context of privatisation. This has provided a short-term boost to privatisation. However, severe restrictions have been placed on the transfer abroad of profits and capital from Brady-privatisations and no more than 50 per cent of the shares in individual companies can be purchased from Brady Bonds.

Small-scale privatisation

A law regulating small-scale privatisation was adopted in January 1993. Most small-scale privatisation has taken place through restitution of some 20,000 municipal entities. 2,300 other enterprises fall below the threshold of responsibility of the Privatisation Agency (70 million leva), of which 274 had been privatised by the respective line Ministers by June 1995, primarily through management buy-outs.

Property restitution

Significant restitution has taken place, following the Law on Ownership Restoration (1992) and the Compensation Law (1993). Few land titles have been issued, but 60 per cent of agricultural land has been handed back to the original owners through "final land decisions" recognised as ownership documents and accepted as collateral. Recent legislation that favours cooperatives restricts the ability to sell restituted land under certain conditions.

Growth of private enterprise

Reportedly 460,000 private enterprises were registered by mid-1994 (96 per cent of which were micro-sized), including around 8,000 joint ventures with foreign entities (mostly engaged in retail trade). A recent EBRD survey found that as few as 20 per cent of registered enterprises in the manufacturing sector are active.

Enterprise restructuring

In 1991, the government broke up 871 of the largest monopolies into 3,485 independent state-owned enterprises. While direct budgetary subsidies have largely been eliminated, financing of losses through the banking system and through payments arrears remains pervasive. The assumption of pre-1991 non-performing bank assets by the government (which was accompanied by the injection into banks of state bonds worth 27 per cent of GDP in 1993-94) was to be connected to stricter lending criteria but has not led to a material change on this score. While a new bankruptcy law has been in force since July 1994, implementation is being handled very cautiously. Arrears of more than 50 per cent interest due and 70 per cent of tax liabilities of state enterprises had emerged by late 1994. Defensive restructuring (i.e. without net investment) is taking place mainly as a result of product market competition. A cut-down on liquidity in the banking system since late 1994 may also have contributed.

Markets and trade

Price liberalisation

In February 1991, about 90 per cent of prices in the consumer basket were liberalised (excluding primarily energy and public transport). But new controls were subsequently introduced in the form of ceiling prices for petrol (1992) and for other fuels (1993) and controls on tobacco and certain other products (March 1994). Since mid-1994, government "monitoring" of basic food prices and restrictions on profit margins has strongly expanded, reducing the share of genuinely free prices to 54 per cent, with below-inflation adjustments to administered prices. The effectiveness of these controls is doubtful, but they generate uncertainty. No liberalisation is expected during 1995. Distortions in producer prices, as a result of direct controls and *de facto* distribution monopolies, are more substantial still, and have entailed *ad hoc* restrictions on exports and subsidisation of production inputs. The single most important distortion is in electricity prices, which remain among the lowest in the world, even after increasing by 25-38 per cent from 1 September 1995.

Competition policy

The Law on Commerce (1991) eliminated *de jure* monopolies and established an anti-trust body. Former conglomerates were broken up, but there has been no active anti-trust policy in important areas such as agro-industrial wholesale trade. A regulatory framework for 'natural' monopolies is missing.

Trade liberalisation

Imports were significantly liberalised in 1991. A simplified import tariff schedule was adopted in 1992, with tariffs ranging from 5 to 40 per cent, few exemptions and a relatively low dispersion in tariff rates. Only one formal import quota remains (on ice cream). Export taxes and quantitative export restrictions are used as a complement to domestic price controls. Export taxes on wheat and sunflower oil were raised substantially in mid-1994. However, efforts to join the WTO have intensified in 1995, and gradual liberalisation is foreseen under the "Europe Agreement" with the EU (see Chapter 11 for details on this).

Currency convertibility and exchange rate regime

The lev has been floating freely since February 1991 and is internally convertible. Profits and invested capital may be repatriated by foreign investors in hard currency, except for debt-equity swaps with Brady bonds where restrictions apply.

Wage liberalisation

The government has since 1989 been taxing enterprise wage fund increases in industry beyond a defined threshold. However, compliance with these tax obligations has been weak. In 1991 wage setting began to be based on tripartite discussions between government, unions and employers. In spite of a mechanism for indexing wages (imperfectly) for inflation, real wages dropped significantly between 1992 and 1994. Earlier this year, the unions agreed to a reduction in (backward-looking) indexation for minimum wages to 80-85 per cent of the change in the consumer price index.

Interest rate liberalisation

Interest rates were freed in 1991. Real rates on both deposits and credit in the banking system were negative in 1994, and spreads were large (up to 38 percentage points). However, due to the importance of central bank refinancing for most banks the rate at which the central bank makes such funds available has dominated interest rate developments. Real rates turned positive in the first quarter of 1995 and the lending/deposit spread was significantly reduced as a tightening of monetary policy led to increased competition for deposits. However, the central bank base rate was cut by more than half between April and July 1995, to a level below the projected end-year inflation rate.

Financial institutions

Banking reform

A two-tier banking system was introduced in 1989, but a legal framework for this system came only in 1992. The central bank has demonstrated a certain independence by maintaining a restrictive monetary policy since late 1994 (recently eased) and forcing the government to finance an increasing share of its deficit through issuance of securities. During 1993 a Bank Consolidation Company (BCC) became sole holder of state shares in banks.

The original total of 66 state banks had been merged into 10 by late 1994 as part of a World Bank supported restructuring programme. So far no state-owned bank has been either privatised or liquidated. By the same date, there were two foreign banks and three branches of foreign banks. There were 23 private banks which accounted for 18 per cent of total bank assets.

Banking supervision has developed slowly. New rules on capital adequacy and liquidity were introduced in 1993 but remain deficient and poorly enforced. Legislation to recapitalise state banks was passed in December 1993, and long-term (low-yielding) so-called ZUNK bonds with a total value equivalent to US$ 2.7 billion had been injected into the banks by December 1994 to offset the impact on bank balance sheets of provisioning against pre-1991 bad claims. Stricter lending criteria were to be linked to this operation (including ceilings on credits to the

largest loss-making enterprises), but still 75 per cent of loans of the 10 large state banks were classified at the end of 1994, and capital adequacy ratios were negative if loan loss provisions were properly taken into account. In mid-1995 two of the largest banks (Economic Bank and Mineral Bank) were given additional state-financed support through the replacement of low-yield recapitalisation bonds in the amount of US$ 825 million. Plans for bank privatisation have not yet been passed by parliament, but the BCC has initiated sales of minority stakes in private banks.

Non-bank financial institutions

New pension fund institutions have been formed, but operate in a legal vacuum and remain weak. Privatisation Investment Funds are to start operating under the Mass Privatisation Scheme due to be launched in 1996. Private insurance is developing partly with support from the EBRD. A law regulating investment funds was passed in June 1995.

Securities markets and instruments

A full range of 3-, 6- and 9-month T-bills have been issued since 1993, as well as longer-term treasury bonds (with maturities of up to 10 years). Trading in the secondary interbank market for government securities reached 523 billion leva (approximately US$ 10 billion) in 1994. Since 1992, 14 stock exchanges and a large number of commodities exchanges have been in operation. Trading in shares is thin because of the limited progress with privatisation so far. Daily turnover in share-trading is the equivalent of about US$ 50,000. A law on securities and stock exchanges was adopted in July 1995 which is likely to lead to a significant consolidation of stock exchanges.

Fiscal and social safety net reform

Taxation

Fiscal reform was initiated in the early 1990s as budget revenues dropped by 52 per cent in real terms between 1990 and 1992. Personal income tax rates range from 20 to 50 per cent. The dividend tax rate is 20 per cent and there are two basic profit tax rates: 30 per cent and 40 per cent (50 per cent for banks). Enterprises with more than 50 per cent state participation must contribute 10 per cent of profits to the municipalities in which they are located. Special tax relief for companies with foreign equity participation has been eliminated. The rate of value added taxation (introduced in April 1994) is 18 per cent. In the first half of 1995, revenues undershot budgetary targets by a significant margin, partly due to the weakness of tax administration.

Social security

Social security is financed by payroll taxes of 35-50 per cent and transfers from the state budget. At present entitlement levels and demographic trends, Bulgaria's pensions system is not sustainable. The ratio of pensioners to contributors was 86 per cent in 1994, as a result of overly generous entitlement criteria, an ageing population and the early retirement of redundant workers. Correspondingly, although expenditure on social protection represented 14 per cent of GDP in 1994, real benefit levels were extremely low.

The government has approved in principle a draft law separating social security from the budget by setting up a Social Security Fund.

Croatia

The first elements of "market socialism" were introduced in 1952. In 1976 a law on "associated labour" institutionalised "social ownership". In 1988, the so-called "Markovic reforms" included widespread price, import and foreign exchange liberalisation. A comprehensive programme was adopted in the second half of 1991, which included further liberalisation and led to the creation of the central banking system, the introduction of temporary currency, and a national budget. The framework for private ownership was laid down. A Labour Law and a Law on Business Association were adopted. In October 1993, parliament adopted a comprehensive macroeconomic stabilisation and reform programme.

Enterprises

Size of the private sector

The private sector is likely to account for about 45-50 per cent of total GDP, when allowance is made for activity that escapes official statistics.

Large-scale privatisation

The inheritance of "social ownership" of former Yugoslavia provided for a degree of self-management to the enterprises at the time when Croatia became an independent nation. The Law on the Transformation of Enterprises with Social Capital (April 1991), administered by the Privatisation Fund, requires the conversion of almost all "socially owned" enterprises (about 3,600) into joint-stock companies. By mid-1995, about 3,000 applications for autonomous privatisation had been received, of which about two-thirds had been approved. Of these, a little over 1,000 have been 100 per cent privatised, and in another 900 the state has retained a minority stake. Ten of the largest state enterprises, including INA (the state-owned petrochemical company), most utilities and the banks, are to be privatised under separate legislation.

The acceleration of privatisation is now a government priority. A new ministry for privatisation and state holding assets management has recently been formed. A new privatisation law is currently being drafted under which a voucher scheme is envisaged. This law is likely to obtain parliamentary approval in late autumn 1995. Plans are being drawn up to privatise some telecommunications activity.

Small-scale privatisation

Extensive small-scale private sector activity already existed under the former Yugoslav law. The small-scale privatisation process, started after independence, has largely been completed.

Property restitution

No law on restitution has yet been sent to parliament, although a law is under preparation.

Growth of private enterprise

The number of registered enterprises increased from 55,000 in December 1992 to 122,000 by January 1995. Many of these are inactive. Nevertheless, the number of active enterprises has at least doubled over the past two years. A Company Trading Law, passed in January 1995, will require companies to re-register.

Enterprise restructuring

Workers' councils for enterprises have been replaced by management boards. There has so far been only limited success in the transformation of management structures, with or without privatisation.

Several major enterprises have been closed down as a consequence of restructuring. Plans are being drawn up to restructure the shipyards. A Bankruptcy Law is being drafted, with likely approval by parliament before the end of 1995.

Markets and trade

Price liberalisation

All direct price controls have been removed, including those on energy and food. Some indirect controls remain, largely through government influence on major enterprises, particularly in the energy sector.

Competition policy

A draft Law on Competition and Monopoly is still under consideration. The draft law deals with conditions prohibiting restraints on trade, monopolistic practices, and abuse from mergers and dominant position. A competition protection agency is to be established to implement the policy.

Trade liberalisation

The foreign trade system is liberal. All quantitative restrictions have been removed.

Croatia applied to become a member of the World Trade Organisation in October 1994 and negotiations are under way.

Currency convertibility and exchange rate regime

The exchange rate of the national currency, the kuna, is floating but the National Bank intervenes in light of market conditions in the interbank market. Croatia has officially notified the International Monetary Fund that it accepts all obligations from Article VIII (full current account convertibility) of the IMF Articles of Agreement.

Wage liberalisation

Some wage controls are still in place for the state-owned sector. There are no wage restrictions on private enterprises.

Interest rate liberalisation

Banks are free to set their own credit and deposit interest rates.

Financial institutions

Banking reform

At independence the National Bank of Croatia was made the regulatory authority of a two-tiered banking system. The Banking Law of 1993 provides the main regulatory framework for commercial banks. The Law on Bank Rehabilitation (providing a procedure by which banks will be recapitalised) and the Law on the Deposit Insurance Agency were both passed by parliament in June 1994. Five of the ten biggest banks are being audited with a view to subsequent recapitalisation. This process has been delayed and will now take place early in 1996.

In mid-1995 (in accordance with this Law) savings banks were put under the control the National Bank. Out of about 40 operative savings bank, six had obtained a licence from the national bank by mid-1995 and 20 more had applied. The National Bank is drawing up plans to restructure and privatise the major commercial banks, whose shareholders are the major debtors.

Czech Republic

After the Velvet Revolution in the Czech and Slovak Federal Republic (CSFR) in November 1989, a market-oriented reform process was initiated during 1990 and a comprehensive programme was adopted in January 1991. Since dissolution of the CSFR in January 1993, the Czech Republic has enjoyed political stability and a well-performing economy. Its mass privatisation programme was completed in March 1995.

Non-bank financial institutions

There are about 170 small savings unions and savings cooperatives. A new Insurance Law was adopted in 1994 and envisages an open market for the insurance industry. Insurance business is supervised and regulated by the Ministry of Finance. There are 14 insurance companies and two reinsurance companies.

Securities markets and instruments

A new legal and accounting framework was introduced in autumn 1994, but the securities markets are developing slowly. The Zagreb Stock Exchange auctions privatisation shares weekly. Very few shares are listed and traded. Total turnover in 1994 was about US$ 280 million. There has been modest activity in a recently established informal over-the-counter market. A new Law on Investment Funds and a new Securities Law are being considered by parliament.

Fiscal and social safety net reform

Taxation

In January 1994 Laws on Tax Administration, Income Tax, Profit Tax and Sales Tax were enacted. There is a corporate tax on profits at 25 per cent, with relief for modernisation of production facilities and for war reparation. Turnover taxes on consumer goods have been halved to 20 per cent. Preparatory work has begun on a value added tax (VAT) to be introduced in January 1997. Excise duties on, *inter alia*, petrol, alcoholic and non-alcoholic drinks, coffee and tobacco, were introduced in mid-1994.

Social security

Payroll taxes paid by employees, including social security contributions, run at between 50 per cent and 70 per cent of gross salary. The pension fund is likely to be reformed in response to projections which indicate that payments will exceed receipts within a few years. By mid-1995 there were 770,000 pensioners, a heavy burden for the 1.3 million estimated workforce.

Enterprises

Size of the private sector

According to official estimates, the non-state sector accounted for 56.5 per cent of GDP in early 1995, before accounting for the effects of the second round of voucher privatisation (which was completed at the end of 1994). Taking into account this second round plus the likelihood that private sector activity is substantially under-recorded in official statistics, the private sector may have accounted for about 65 per cent of GDP in late 1994 and perhaps 70 per cent in mid-1995.

Large-scale privatisation

The sale of most large-scale state assets has been implemented in two privatisation "waves", although the government retains shares in a number of major commercial and financial enterprises. The first wave was launched by the former Czechoslovakia in May 1992 and was completed by mid-1993. In the Czech Republic (where it included 1,900 enterprises with a book value of CZK 650 billion) it comprised sales of shares (for cash) to domestic and foreign investors and the transfer of CZK 212 billion worth of shares in 988 firms through a voucher-based "mass privatisation" scheme.

The second wave started in the Czech Republic in March 1994 with the intention of selling 2,000 more companies by a combination of conventional cash-based sales and the transfer of shares through vouchers. On 1 March 1995, when shares in "second-wave companies" had been distributed to voucher holders, the Czech mass privatisation was completed, having shifted a large proportion of the economy into private hands, with voucher privatisation accounting for around one-third of the total book value of assets privatised. Approximately 70 per cent of the vouchers had been placed with investment funds which had used them to purchase shares.

The National Property Fund retains shares in a number of companies, although the government has recently announced its intention to sell its remaining shares in some 1,400 small and medium-sized companies and to sell some of its shares in a number of larger companies, partly with the intention of increasing the flow of foreign direct investment into the economy. In mid-1995 the government announced that it had approved the sale of 49 per cent of the state-owned petrochemical company and 27 per cent of SPT Telecom to consortia of Western companies.

Small-scale privatisation

The sale of small state-owned enterprises was launched in January 1991 and largely completed during 1992. Approximately 22,000 enterprises were auctioned in what is now the Czech Republic, raising more than CZK 30 billion in revenues. Direct foreign ownership of land is not allowed, but ownership through a Czech legal entity, wholly owned by foreigners, is permitted.

Property restitution

A Restitution Law was adopted by the CSFR in October 1990. About 30,000 industrial and administrative buildings, forests and agricultural plots (nationalised between 1948-55), and 70,000 commercial and residential entities (nationalised during 1955-59) have been handed back to the original owners. The value of assets returned has been estimated in the range CZK 70-120 billion.

Growth of private enterprise

By the first quarter of 1995 the total number of businesses had fallen slightly to 1.17 million from 1.2 million at end-1993.

Enterprise restructuring

The main pressure on enterprises to restructure has come from a combination of tight subsidy and credit policies, import liberalisation, and privatisation. The first Bankruptcy Law was introduced in 1991, but it effectively excluded external creditors from forcing companies into bankruptcy. The current law, introduced in April 1993, allows all creditors to take bankruptcy cases to court after a 3-month protective period (which can be extended to 6 months in special cases).

Between late 1992 and May 1995 a total of 4,500 bankruptcy petitions had been filed with some 600 bankruptcies actually declared. In July 1995 parliament approved a draft amendment to allow companies to write off bad debts. It enables firms to write off up to 10 per cent of their unpaid pre-1995 receivables from their pre-tax results each year and 100 per cent of new uncollectable receivables post-1994.

Markets and trade

Price liberalisation

In January 1991, 85 per cent of consumer prices were decontrolled and further liberalisation measures were undertaken during that year. Overall it is estimated that only 5 per cent of prices remain regulated. The only remaining significant controls pertain to utility charges, rents and public services. Mark-ups in the energy sector remain closely regulated. From 1 July 1995, rents for flats which are still regulated by the state were increased between 22-30 per cent.

Competition policy

A Competition Law was passed in 1991 and amended in November 1993 to widen the definition of illegal practice and to increase maximum fines. Another objective was to make the law more consistent with EU legislation. In 1994 the Economic Competition Ministry completed 73 administrative proceedings (including 15 against cartel agreements) and imposed fines totalling CZK 33.7 million.

Trade liberalisation

Almost complete liberalisation of quantitative controls on imports and exports was undertaken in 1991. The Czech Republic has maintained a very liberal trade regime; the average import tariff is 5 per cent and there are no serious administrative barriers to trade. On 1 February 1995 the interim version of the Czech Republic's "Europe Agreement" with the EU was converted into the fully-fledged version (see details in Chapter 11). The Czech Republic became a member of WTO in December 1994. In June the government decided to cancel the ECU-denominated clearing account through which trade with the Slovak Republic had been organised since early 1993. The bilateral Payments Agreement is likely to cease to be effective from October 1995.

Currency convertibility and exchange rate regime

The exchange rate is pegged to a basket comprising the Deutschmark and the US dollar. The weight of the DM is 65 per cent. The new Foreign Exchange Law, effective on 1 October 1995, provides full current account convertibility and partial capital account convertibility. According to the draft law, Czechs will have the right to convert crowns into hard currency to buy foreign real estate, and Czech companies will have the right to buy foreign currency to make investments abroad. On the side of capital inflows the main restriction will apply to purchase of real estate in the Czech Republic by non-residents. Under the current law on inward investment, foreigners can repatriate profits and income from investment and other sources.

Earlier in the year, the Czech National Bank (CNB) abolished the requirement whereby foreign residents in EU countries wishing to undertake direct investment in the Czech Republic had to obtain a foreign exchange licence, although the reporting requirement remains.

In April 1995, the CNB imposed a 0.25 per cent tax on foreign exchange transactions, payable by banks and other participants in the foreign exchange interbank market. The aim was to slow the inflow of some types of foreign capital. In June limits were placed on the amount of foreign currency borrowing banks could undertake.

Wage liberalisation

A tax on "excessive increases" was imposed during 1991, with the agreement of the unions. The tax expired at the end of 1992 but was reintroduced (unilaterally by the government following the break-up of the CSFR in 1993) and was applied to all enterprises with more than 25 employees. Real wage increases were to be kept below 5 per cent with allowances made for trends in sales. In July 1995 the government abolished these controls.

Interest rate liberalisation

Interest rates were freed progressively from 1990 onwards, with complete liberalisation in April 1992.

Financial institutions

Banking reform

A two-tiered banking system was adopted in 1990. The Czech National Bank (CNB) was established in January 1993 as the successor to the former State Bank of Czechoslovakia. Most commercial banks are privately owned, including former state banks privatised during 1993. However, CSOB, which is the international trade bank, is still majority government-owned. The state retains a substantial minority ownership in the other main banks, and foreigners are not allowed to purchase bank shares without explicit approval by the CNB. At the end of 1994 the Czech banking sector included 58 licensed commercial banks (of which 56 were operating), comprising 16 wholly Czech-owned banks, 20 partly foreign-owned banks and 21 entirely foreign-owned banks and one state-owned institution (the Consolidation Bank).

During the CSFR period, a state-owned Consolidation Bank was established in March 1991 to take over Kcs 110 billion (20 per cent of credit to enterprises) of "permanent revolving credits" (perpetual loans issued at low interest rates for inventory financing). Further state-financed recapitalisation of the banks, totalling Kcs 50 billion was conducted in November 1991 (these recapitalisation figures cover CSFR as a whole).

Despite efforts to strengthen banks' balance sheets through the work of the Consolidation Bank and the issue of bonds by the National Property Fund, the volume of non-performing loans remains a problem. At the end of March 1995 the volume of classified loans reached 39 per cent of total credits. Non-performing loans (more than 90 days overdue) represented 25 per cent of all loans. Non-performing loans on the books of the Consolidation Bank represented one-fifth of all non-performing loans. Recent legislative changes will allow banks to claim tax relief on provisions against such loans. The CNB wishes to consolidate the banking sector, following the failure of three banks in 1994. It has restricted the issuance of new bank licences and has encouraged small banks to merge.

Parliament has recently created the legal framework for providing mortgage credits. From July 1995, mortgage credits can be granted to interested persons for up to 70 per cent of the price of existing pledged property.

Non-bank financial institutions

By May 1995 there were 365 investment companies and 279 investment privatisation funds registered in the Czech Republic. In addition there were more than 60 private insurance companies, some under foreign ownership. In May 1995 the parliament passed an Act on Savings and Credit Cooperatives, allowing formation of such cooperatives from 1 January 1996 by groups of at least 30 persons underwriting a minimum of CZK 100,000.

Securities markets

The Law on the Stock Exchange and Securities was adopted in 1992. The Prague Stock Exchange and the RM-system (an over-the-counter exchange) began operating during the first half of 1993. Foreigners are free to trade shares (except bank shares for which they need an explicit approval of the CNB). Profit repatriation is subject to payment of income taxes on capital gains.

By May 1995, securities of 1,750 Czech companies were traded on the Prague Stock Exchange, including unquoted shares of 674 enterprises from the second wave. Trading volumes increased significantly in 1994, with stocks accounting for 70 per cent of turnover and bonds for 30 per cent, although it is estimated that a large proportion of trades continue to be conducted over the counter. In February 1995, the Rules for Direct Stock Exchange Trading were amended and a new method for recording, concluding and settling direct stock exchange trades was introduced with an emphasis of automated data processing. At mid-1995 amendments are also being drafted to the securities law, *inter alia* to improve transparency of trades.

Fiscal and social safety net reform

Taxation

A comprehensive tax reform was implemented in January 1993. It introduced a value added tax and streamlined the corporate profit tax and personal income tax.

A number of significant changes to the tax regime were introduced on 1 January 1995. The higher VAT rate was reduced from 23 per cent to 22 per cent, while the lower rate (mainly for food and energy) continued to be 5 per cent. This is the first of a series of VAT reductions aimed at harmonising tax rates with those applied in the EU. The basic rate of corporate tax was reduced from 45 per cent to 41 per cent and the top marginal rate for income tax was lowered from 44 per cent to 43 per cent. In June parliament voted for further reductions. Thus from the start of 1996, the corporate tax rate will be 40 per cent and the maximum personal income tax rate will be lowered to 39 per cent.

Social security

The fiscal reform in 1993 also transferred funding for social security from general taxation to an insurance-based system. Social security contributions amount to 37 per cent of the wage sum for employers and 13 per cent of wages for employees.

In June 1995 parliament voted to spend some of the 1994 budget surplus on higher pensions. Thus as of July 1995 various kinds of pensions will be raised including old-age pensions, disability, partial disability, widows' and orphan's pensions.

Estonia

In January 1989, while still a republic of the Soviet Union, Estonia introduced a law on economic autonomy. The law gave Estonia independence in price and wage setting, fiscal strategy and financial policies. Market reforms accelerated following Estonia's independence in August 1991. Since then industry has largely been privatised and significant progress towards macroeconomic stabilisation has been made.

Enterprises

Size of the private sector

According to official estimates, the private sector accounted for 49 per cent of industrial production in the first half of 1995, up from 40 per cent at end-1993. The share of the private sector in GDP may now be in the order of 65 per cent.

Large-scale privatisation

Virtually all large enterprises have been privatised, except for those in the transport, telecommunications and energy sectors, including oil-shale mining and electricity supply. The Privatisation Act (1993) allows sales of assets for both vouchers and cash. In practice, the privatisation strategy has been based on the East German Treuhand model. The majority of firms have been sold through tenders and direct sales, with no discrimination against foreign bidders. Important criteria for deciding on bids have been viable business plans submitted by the bidders as well as credible commitments to new capital investments. These criteria have favoured strategic investors over management and employees. During the two years to spring 1995, 192 companies were sold under this programme for a total of approximately US$ 100 million. Minority shares have in some cases been sold for vouchers, distributed to the Estonian population (other types of vouchers, usable for other purposes, have also been issued, as indicated below).

Small-scale privatisation

Rapid small-scale privatisation has been based on the Law on the Privatisation of State-owned Trade and Service Enterprises (1991) and amendments to this Law (passed during 1992). By mid-1995, privatisation of small enterprises (e.g. shops, other services and farms) had been largely completed through employee buy-outs and auctions. An Act on Privatisation of Housing was passed in May 1993 but implementation has been slow, mainly because of time-consuming land surveys and, to some extent, legal uncertainties. Vouchers specifically for housing purchases were issued to almost one million citizens in late 1993.

Property restitution

More than 200,000 claims for restitution had been submitted by the April 1993 deadline. By February 1994 approximately half of these had been validated. However, the need to carry out land surveys as well as legal problems have slowed the process.

Growth of private enterprise

The establishment of new private enterprises started with the adoption of the Enterprise Law in 1989. New private enterprises grew rapidly in number, primarily in retail trading, catering and commerce. Since 1992, about 10,000-12,000 new small private enterprises have been established annually, according to the Estonian Association of Small Businesses. By end-1994, 81,548 enterprises and organisations were registered in Estonia; some 65 per cent of which were in full private ownership, 8 per cent were owned by cooperatives and 11 per cent were under some form of mixed ownership.

Enterprise restructuring

Restructuring of privatised state enterprises has generally been left to investors. In the context of privatisation, investors have been asked to submit business and restructuring plans as part of their bids. A Bankruptcy Law was passed in September 1992 and was quickly implemented, notably during the banking crisis of late 1992. By mid-1995, bankruptcy procedures were initiated against about 1,000 enterprises, mostly agricultural cooperatives. Overall, bankruptcy procedures are implemented more rigorously in Estonia than in most other countries of eastern Europe, the Baltics and the CIS.

Markets and trade

Price liberalisation

The phase-out of price controls started in late 1989 as part of the programme of economic autonomy. By the end of 1992 most price controls had been abolished. Only prices for housing and "natural" energy monopolies continue to be controlled/regulated. Electricity tariffs have been raised, but continue to be set below the cost of power supply. Furthermore, there is a chain of arrears from electricity customers to the power utility (state-owned) to the oil-shale industry (state-owned).

Competition policy

A Competition Law was passed in June 1993 and amended in February 1995. Implementation is monitored by a Competition Board, with some enforcement. Given the small size of the country, the main competitive force has been external competition, liberal rules for establishment of new companies, and comprehensive privatisation.

Trade liberalisation

Virtually all restrictions on foreign trade have been abolished. Import tariffs apply only to furs (16 per cent) and to sea and road vehicles (10 per cent). Export controls and tariffs have been removed completely, with the exception of an export tariff on items of cultural value, including arts and antiques.

A most-favoured-nation treaty was agreed with Russia in 1993, but it remains unratified, and from mid-1994 Russia doubled its tariffs on imports from Estonia. A "Europe Agreement" with the EU was signed in June 1995 (see Chapter 11). These developments are likely to expedite further the redirection of Estonia's exports from Russia to the West.

Currency convertibility and exchange rate regime

An independent national currency, the kroon (or EEK), was introduced in mid-June 1992 under a currency board arrangement. The kroon is pegged to the Deutschmark at 8 EEK/1 DM. There is full current account convertibility.

Wage liberalisation

Wage setting (apart from the minimum wage) became free of administrative central controls in 1990. However, the government has subsequently relied in part on an incomes policy to contain wage inflation. The government has at times set a ceiling for pay increases in state-owned enterprises. Wage setting in the private sector remains free and wage negotiations are decentralised. The monthly minimum wage was raised to the equivalent of DM 56 in September 1994. It is now less than 20 per cent of the average wage.

Interest rate liberalisation

The central bank (Bank of Estonia) does not interfere with the setting of interest rates by commercial banks except through indirect instruments. In view of the kroon's peg to the Deutschmark, interest rates generally track DM rates, although spreads in Estonia continue to be high (10-15 percentage points between deposit and lending rates). Lending rates (3-6 months) are in the same order of magnitude as the rate of consumer price inflation expected for 1995, i.e. 20-25 per cent. Thus, interest rates on deposits are negative in real terms if measured against 1995 inflation.

Financial institutions

Banking reform

An Estonian-based two-tier banking system became fully operational after the currency reform in June 1992. Between 1989 and 1992, 42 domestic commercial banks were established, mostly small and undercapitalised. Foreign banks were also permitted to operate in Estonia. After a banking crisis in late 1992 and early 1993, the government raised the minimum capital requirement and more stringent supervision of commercial banks by the Bank of Estonia (BoE) was introduced. The number of domestic banks was almost halved through mergers or liquidations.

After the failure of the Social Bank and its subsequent rescue by the government in 1994, the BoE further strengthened its supervision of the banking sector. For example, 11 of the 21 remaining domestic banks were asked in 1994 not to pay dividends and to use earnings to bolster their capital positions. Several new regulations aimed at improving the banking sector's stability became effective in early 1995. As a result the number of domestic banks is expected to decrease substantially over the next few years.

Non-bank financial institutions

As of June 1995 the Estonian Securities Board had registered 18 investment funds.

Securities markets

The Securities Market Act was adopted in 1993. Shares in investment funds, enterprise and banks are traded over-the-counter at the computerised depository which was opened in September 1994. The start-up of regular operations of the Tallinn stock exchange is scheduled for 1996.

Fiscal and social safety net reform

Taxation

The tax structure was changed substantially in January 1994 but has remained largely unchanged since then, with VAT being levied at 18 per cent, and individual as well as corporate income tax being levied at a flat rate of 26 per cent. In 1994, 52 per cent of individual income tax revenues and 20 per cent of total tax revenues went to the country's 255 local governments. This represented approximately 70 per cent of all local government revenues.

Social security

Employers contribute 33 per cent of wages and salaries towards social security (20 per cent for pensions and 13 per cent for medical insurance). The average pension (on a pay-as-you-go basis) was about 30 per cent of the average wage in 1994, and a further fall in this ratio is expected for 1995.

FYR Macedonia

Following 1988 reforms throughout the former Yugoslavia, which included widespread price, import and foreign exchange liberalisation, independence in April 1992 was accompanied by radical economic reform. A new currency was introduced alongside a first attempt at macroeconomic stabilisation, further price liberalisation and elaboration of plans for privatisation. A second bid for macroeconomic stabilisation was initiated early in 1994, accompanied by implementation of more far-reaching enterprise and institutional reform.

Enterprises

Size of the private sector

Private activity, including the informal sector, probably accounts for 30-40 per cent of GDP.

Large-scale privatisation

The Agency of FYR Macedonia for the Transformation of Enterprises with Social Capital (ATESC), set up under the privatisation law of June 1993, is receiving applications for privatisation from large-scale enterprises, which have until December 1995 to prepare voluntary privatisation plans. About 120 companies had been sold off (primarily in management buy-outs) by mid-1995 out of 800 companies scheduled to be sold this year. About 400 enterprises were privatised in 1989 under the laws of former Yugoslavia, primarily in employer buy-outs. A major obstacle to more rapid privatisation has now been addressed by the Law on Labour Relations, which created a "labour redeployment fund" to assist those made unemployed by restructuring to find new work.

Small-scale privatisation

Over 90 per cent of all enterprises are privately owned. Almost all of these are small.

Property restitution

A draft law on restitution is in preparation and has received a first reading in parliament.

Growth of private enterprise

Since 1989 there has been rapid growth in the number of private enterprises, from a low base. Nearly 80,000 small private enterprises have registered since 1990. Official statistics (from the Social Accounting Office) indicate that about 20,000 of these are active.

Enterprise restructuring

A task force was established in 1994 to implement restructuring of large-scale enterprises. A "special restructuring programme" has been introduced by ATESC to restructure 23 of the largest loss-making enterprises and the two largest utility companies. The "labour redeployment fund" which assists workers made unemployed by restructuring to find new work, together with reforms to the social assistance programme, will facilitate restructuring. Since the introduction of the latest stabilisation programme in early 1994, further borrowing by (or subsidies to) these enterprises has been severely curtailed. The 1989 Bankruptcy Law of former Yugoslavia is still in force.

Markets and trade

Commodity price liberalisation

About 80 per cent of prices in the retail price index are free of controls. Price controls apply to, *inter alia*, flour, bread, electricity and oil derivatives. There have been large increases in the relative price of electricity and oil derivatives, with further increases planned to bring prices close to cost recovery levels.

Competition policy

A draft law on competition is being prepared.

Trade liberalisation

Goods in only 2 per cent of all import categories are affected by quantitative import restrictions (these include chemicals, steel and some foodstuffs). Customs duties were levied at an average rate of 9.5 per cent in 1994.

Currency convertibility and exchange rate regime

The denar has been floating since the beginning of 1994. There is near full current account convertibility.

Wage liberalisation

The wage control law of December 1993 restricted wage increases to 1.5-2.5 percentage points less than targeted inflation, with a subsequent adjustment to compensate 50 per cent for inflation in excess of target. This type of regulation has been extended until the end of 1995.

Interest rate liberalisation

Real interest rates are positive and largely market-determined, although a bank-by-bank credit ceiling is in place.

Financial institutions

Banking reform

Financial sector reform was slow to get under way but has recently accelerated with the creation of a Bank Rehabilitation Agency (BRA). There are 25 commercial banks and 15 savings houses. The non-performing loans of the largest bank (Stopanska Banka), which comprised two-thirds of the credit base, have been transferred to BRA, and replaced in the bank's balance sheet by government bonds. One of the large branches has been split off and bought by its management. It is intended that, with World Bank support, the recapitalisation and privatisation of the truncated banks will be completed by the end of 1995.

Non-bank financial institutions

Non-bank financial intermediaries are at a relatively early stage of development, as is regulation of the sector. There is only one, state-owned, insurance company.

Securities markets and instruments

There is no stock exchange and no securities market regulation.

Fiscal and social safety net reform

Taxation

The January 1994 tax reform streamlined the sales tax, reducing the number of rates from 21 to three. There is now a general rate of 25 per cent, and rates of 5 per cent for food and 10 per cent for most services. Excise duties on oil, alcohol, cigarettes and cars were increased in April 1994. Personal income tax rates have been consolidated and many exemptions have been removed. To improve tax enforcement, an inland revenue service was created from the merger of the Social Accounting Office and part of the Ministry of Finance.

Social security

Extensive pension fund reform has been undertaken with an increase in the retirement age and the removal of automatic indexation. Means testing has been introduced for general social security benefits.

Georgia

Enterprises

Size of the private sector

The non-state sector (as defined in Georgian statistics) may now account for about 55-60 per cent of GDP. The private sector (defined more narrowly to include only companies with more than 50 per cent private ownership) may account for roughly a third of GDP.

Large-scale privatisation

A programme for large-scale privatisation started in May 1994 with a presidential decree, on the basis of which about 750 out of the country's 900 large-scale enterprises have been corporatised. By mid-1995 about 30 per cent of the shares in these joint-stock companies have been sold or, in some cases, given away to employees. A voucher-based programme for large-scale privatisation was adopted in March 1995 with the objective to sell at least 35 per cent of the total shares of corporatised enterprises at voucher auctions. Cash-based sales methods will continue to be used as well. Vouchers, each with a face value of US$ 30, have been distributed to the population. The first auction took place in June 1995 with shares in 25 companies on offer. The voucher programme envisages about 50 further auctions and is to be completed by 1 July 1996. Land on which the enterprises reside cannot be bought by private entities but can be leased.

Small-scale privatisation

By mid-1995 about 50 per cent of the almost 10,000 state-owned small-scale enterprises (defined as those that had assets of less than Rb 30 million and fewer than 50 employees at end-1992) had been privatised, mainly in the retail and trade sector. The government intends to sell off all the 5,000 small-scale enterprises still in state hands by the end of 1995.

A significant share of housing in Georgia was already in private hands before independence: privatisation of housing is now virtually complete. More than half of the agricultural land has been privatised in small plots via long-term leasing (private land ownership is not permitted). The government intends to keep approximately 25 per cent of the agricultural land in state hands.

Property restitution

No property restitution has taken place in Georgia.

Growth of private enterprise

Georgians have a tradition for entrepreneurship. There are more than 65,000 registered small businesses. However, a significant portion of these are inactive as the legacy of civil war continues to plague the economy. However, the country has become increasingly dependent for its daily survival on the emerging private – and largely informal – economy.

Enterprise restructuring

The main sources of pressure on enterprises to restructure have been war-induced interruptions of supplies, the collapse in old foreign trading links with other CIS countries and, especially in the past year, tighter fiscal and credit policies. Most of the formal economy continues to be highly monopolistic. A Law on Bankruptcy was adopted by the parliament in 1991 without any significant enforcement.

Markets and trade

Price liberalisation

Prices are free of administrative control, with the exception of prices for bread (which continues to be rationed), gas, electricity, municipal services, pharmaceutical products, public transportation and telecommunications. The state order system was completely phased out on 1 June 1995. All direct price subsidies that used to be provided by the state are now eliminated.

Competition policy

The government is currently preparing draft legislation for competition policy with the assistance of the World Bank.

Trade liberalisation

Trade with countries of the former Soviet Union had been largely based on bilateral trade agreements and barter arrangements. By mid-1995 the system of bilateral agreements has been eliminated and the trading system with non-CIS countries has been substantially liberalised. Export licensing is being phased out gradually.

Currency convertibility and exchange rate regime

An interim and parallel currency, the Georgian coupon, was introduced in April 1993 and was declared sole legal tender in August 1993. A fully-fledged national currency – the lari – is to be introduced in late 1995. The currency surrender requirement (currently 12 per cent) is to be scrapped by the end of 1995.

Wage liberalisation

Adjustments to minimum wages have lagged behind inflation. Real disposable income, reflecting non-wage earnings and income from the informal economy, is rising substantially. Minimum monthly wages were raised from 1 July 1995 to 3 million coupons (US$ 2.2) For the government sector, a new wage grid introduced in July 1995 increased the minimum wage to 3.5 million coupons per month (US$ 3) and raised the dispersion of wages within that sector.

Interest rate liberalisation

With progress in financial stabilisation and financial sector reforms real interest rates have become positive and market-determined. Commercial banks are completely free to set interest rates.

Financial institutions

Banking reform

The first banking laws were adopted in August 1991. A new Law on the Central Bank was passed in mid-1995 and the draft Law on Banks and Banking Activity has been submitted to parliament. The national Georgian (as opposed to Soviet) two-tier banking system was created in 1991. It consists of the National Bank of Georgia (the central bank), five specialised state-owned banks (only one of which has been corporatised), and about 220 small domestic commercial banks (about half of which are owned principally by state enterprises; only a few are fully private). The state-owned banks hold more than 90 per cent of the assets, branches and personnel. The central bank still uses directed credits. Unofficial estimates indicate that bad debts comprise between 14 per cent and 35 per cent of the portfolios of state-owned banks. Licences of around 40 banks have been withdrawn in 1995.

The National Bank has improved its supervisory capacity and issued new prudential standards in March 1995. It has raised the minimum capital requirement to the equivalent of US$ 100,000, and plans to increase it further to US$ 500,000 over the next few years. A study of the five former state sectoral banks has been commissioned with a view to develop a plan for recapitalisation.

Non-bank financial institutions

Although some new investment funds and a few insurance companies exist, non-bank financial institutions do not play a significant intermediation role in Georgia.

Securities markets and instruments

No stock exchange exists in Georgia.

Early stabilisation efforts and structural reforms in 1992 were interrupted by a civil war, which led to drastic output decline, hyperinflation and a suspension of structural reforms in 1993 and most of 1994. In September 1994, the government began implementation of a comprehensive stabilisation and reform package.

Fiscal and social safety net reform

Taxation

The principles of a new tax system were laid down in a law passed in December 1993. Enterprises are subject to profit taxation (governed by a law adopted in January 1994) with rates between 10 and 35 per cent, and property taxation at a rate of 1 per cent. A personal income tax was established in January 1994, with marginal rates of up to 20 per cent. There is no separate capital gains tax.

The tax reform package approved by parliament in late 1994 increased the VAT rate from 14 to 20 per cent and eliminated most VAT exemptions. As tax revenues remain at critically low levels, the overall fiscal strategy for 1995 emphasises revenue collection.

Social security

The social safety net provides minimal cash benefits to half of the population, including pensioners, the unemployed, children, refugees, students, single mothers and state employees at the bottom of the wage scale.

Hungary

Having experimented with increased enterprise autonomy since 1968, Hungary embarked on more ambitious market-oriented reforms between 1988 and 1991. Comprehensive liberalisation was introduced for prices and foreign trade, the tax system was revamped, the banking system became increasingly market-based and privatisation was initiated. Comprehensive small-scale privatisation was implemented in 1992-93. Large-scale privatisation has been implemented gradually but steadily. By the middle of 1995 control of most of the formerly state-owned large companies had been transferred to the private sector.

Enterprises

Size of the private sector

The Hungarian Central Statistical Office (CSO) has estimated the GDP-share of the private sector in 1993 at 55 per cent. The private sector is likely to have accounted for more than 60 per cent of GDP in mid-1995.

Large-scale privatisation

On 9 May 1995 a new Privatisation Law was passed by parliament. The law merges the two main privatisation agencies (the State Property Agency and the State Holding Company) into the State Privatisation and Asset Management Company. According to intentions stated in the new law, 46 companies will remain fully state-owned, including postal services and the railways. The state will maintain majority stakes in the electrical grid and the country's only nuclear power plant, and 25 per cent ownership in large banks. The number of companies with majority state ownership will eventually fall to 161, compared with 252 under the previous privatisation law. The government plans in the near future to sell minority stakes in the main oil and gas company (MOL), the main electricity company (MVM) and five regional gas companies, and a 10 per cent stake in the telephone company (MATAV), which is already partly privatised.

Among the 1,862 companies that have been managed by the State Property Agency (SPA), state ownership had been reduced to less than 50 per cent in 902 companies by April 1995 (up from 736 in June 1994). About 542 of the original companies were in liquidation. These companies represented 55-60 per cent of the asset value of all the companies under SPA administration. Among the 210 companies handled by the State Holding Company, state ownership had been reduced to less than 50 per cent in 28 by March 1995. These companies represented about 35 per cent of the asset value of all the companies under the administration of the State Holding Company. Foreign investment has played a major role in privatisation in Hungary. Government cash revenues from privatisation dropped in 1994 to Ft 22 billion (0.5 per cent of GDP) from Ft 43 billion in 1993 and Ft 63 billion in 1992.

Small-scale privatisation

Out of 10,423 state-owned shops and small enterprises in 1990, a total of 9,990 had been transferred into private hands by March 1995 (up from 9,065 in June 1994).

Property restitution

About 1.2 million Hungarians have been granted "compensation coupons" as restitution, mainly for nationalisation of property. Coupons have in practice been usable mainly towards the purchase of land.

By the end of 1994 about 2 million hectares of land had been sold to half a million people for compensation coupons. A further round of compensation was initiated in 1994 and land auctions for 185,000 hectares are to be completed with coupon participation in 1995.

Growth of private enterprise

By April 1995, there were 1.05 million registered businesses of which 96,578 were legal entities (joint-stock companies, etc.) – up from 75,654 at the end of 1993.

Enterprise restructuring

Restructuring has been achieved mainly through subsidy reduction and tightening of access to finance for loss-making enterprises, resulting in production cutbacks, rationalisation and reduction of employment in large former and current state-owned enterprises.

Hungary's Law on Bankruptcy was enacted on 22 October 1991 but was substantially amended in September 1993. The new version of the law no longer forces companies with overdue liabilities to declare bankruptcy, and allows a qualified majority of creditors to decide on an out-of-court restructuring. The revision has slowed the rate of bankruptcies and liquidation: there were 189 new bankruptcy cases and 5,711 liquidation cases in 1994, down from 987 and 7,242 cases in 1993. The first quarter of 1995 saw 38 new bankruptcy and 1,791 new liquidation cases.

The framework for state-financial bank recapitalisation has included incentives for banks to help restructure the balance sheets of enterprises. In December 1992 and December 1993, the state purchased bank claims on enterprises (see details under "banking reform"), and subsequently forgave some of this debt. Separately, the government has negotiated restructuring of enterprises' bank debt in two rounds, inducing banks into settlement by offering a reduction of state claims (in the form of overdue tax and social security contributions) on the debtor enterprises in return for bank concessions. In total, the two phases have led to restructuring of Ft 30 billion worth of enterprise debt out of a total Ft 149 billion of debt in the 1,950 participating enterprises.

Markets and trade

Price liberalisation

More than 90 per cent of consumer prices, weighted by their share in the consumer price index, are free of administrative controls. The Laws on Electricity and Gas require that prices for these products must cover costs by 1 January 1997. Accordingly, prices for these products were raised sharply in January and September 1995, and further substantial increases are scheduled for 1996.

Competition policy

The Law on the Prohibition of Unfair Market Practices, passed in 1990, provided the legal framework for the work of a newly established anti-monopoly office. More than 100 decisions were made by the office in 1994, resulting in fines in excess of Ft 600 million. Regulation for some agricultural goods and utilities is subject to the rulings of other state bodies.

Trade liberalisation

Trade liberalisation has been phased in gradually. In 1989 licensing requirements and quotas were eliminated for 40 per cent of imports (in value terms based on 1988). This ratio was raised to 65 per cent in 1990, 90 per cent in 1991 and stood at 92 per cent in 1994. Some consumer goods imports are regulated by the so-called "global quota", with individual ceilings set for about 20 product groups. A number of industrial and "sensitive" products (i.e. textiles and agriculture) remain substantially protected by import tariffs. Some of these tariffs are being phased out for trade with the EU in accordance with Hungary's "Europe Agreement" (see details on this agreement in Chapter 11). Hungary became a member of the WTO in December 1994.

On 20 March 1995, Hungary introduced an 8 per cent import surcharge on all goods, except primary energy carriers and machinery for investment. The surcharge is to be phased out during the first half of 1997.

In accordance with the new GATT agreement, Hungary eliminated quantitative restrictions on farm product imports in January 1995. In preparation for this, Hungary had raised the average agricultural import tariff to 37 per cent in November 1994 (up from about 20 per cent one year earlier).

Currency convertibility and exchange rate regime

The forint is convertible for trade-related transactions. Each Hungarian can currently purchase US$ 800 worth of foreign currency a year at the official exchange rate for tourism abroad.

The exchange rate is pegged to a basket of currencies. The basket was changed in May 1994 from previously 50 per cent US dollar and 50 per cent Deutschmark to now 30 per cent US dollar and 70 per cent ECU.

The Law on Investment by Foreigners in Hungary of 1988 guarantees the foreign investor the option of repatriating profits and capital in the currency of the original investment and full and immediate indemnification for any loss resulting from nationalisation or expropriation.

Wage liberalisation

Attempts to control wages by taxing wage increases above a defined limit were abandoned in 1993.

Interest rate liberalisation

The government removed administrative control of interest rates on deposits and loans for enterprises in 1987, and for households in 1991-92.

Financial institutions

Banking reform

A two-tier banking system was introduced in 1986. The law on commercial banks, operative since January 1992, imposes the Basle-defined standard for capital adequacy on Hungarian banks, but temporary exemptions have been granted to the large state-owned banks.

State-owned banks have benefited from several rounds of state-financed recapitalisations. In 1990, the government permitted the savings banks to swap low interest housing loans for so-called housing bonds carrying market-linked interest rates. At the end of 1991, the state granted commercial banks guarantees for doubtful loans worth Ft 10 billion. In the autumn of 1992, the government launched what became a series of initiatives to improve the balance sheets of banks that were partly state-owned and had a capital adequacy ratio below 7.25 per cent. The total state injection of bonds into the banking sector since early 1992 amounts to Ft 334 billion, about 8 per cent of 1994 GDP. Following these initiatives, capital adequacy as measured in the official audited balance sheets exceeded 8 per cent in all the large banks by end of 1994.

Kazakstan

Partial reforms were introduced following independence in December 1991, but a more comprehensive programme was implemented in January 1993. Tighter monetary and fiscal policies from the middle of 1994 have reduced inflation and stabilised the currency. Progress on structural reforms has been uneven: the privatisation programme is under way, and measures have been adopted in 1995 to provide a framework for commercial activity, but enterprise restructuring remains slow.

Enterprises

Size of the private sector

The non-state sector accounted for 20 per cent of GDP in 1994, according to official estimates. Given the progress made with privatisation over the last year, the private sector's share is likely to be between 20 and 30 per cent (the private sector excludes companies with minority private ownership – these are included in the non-state sector).

Large-scale privatisation

The National Privatisation Programme for 1993-95 launched the mass privatisation of medium-sized enterprises (200-500 employees) through auction and sale of shares to investment privatisation funds (IPFs). In the second half of 1994 points-denominated vouchers were distributed to the public, who in turn invested their vouchers in the IPFs. Since then two major waves of auctions have taken place, but the government's goal of privatising 30 per cent of the assets of non-agricultural medium-sized and large enterprises has not yet been met.

Following the sale of shares of some 530 joint-stock companies in coupon auctions by the end of 1994, the shares of a further 260 companies were offered for sale in the first quarter of 1995. To date 169 IPFs have been established, which by the end of the first quarter of 1995 were estimated to have acquired over 40 per cent of the population's coupons. The IPFs invest the vouchers in the 51-90 per cent of shares offered by each enterprise (employees receive 10 per cent and the state may retain up to 39 per cent). At the end of 1994 the IPFs had acquired shares in over 550 enterprises. The government plans to increase the number of firms included in the auctions to 150 per month from mid-1995.

The privatisation of the largest enterprises started in July 1993 with the first successful tender and continues on a case-by-case basis. The government has finalised a list of about 130 large companies to be privatised. By early 1995 five large transactions had been completed. The government has also been considering the use of management contracts whereby an enterprise is placed under the management of a foreign company. Tenders have been offered for five-year contracts to enable foreign companies to manage 18 large enterprises. More generally, a new law on foreign direct investment was adopted at the end of 1994 which built on the existing liberal investment law, permitting the repatriation of profits.

Small-scale privatisation

In 1994, 5,000 small-scale enterprises (those with less than 200 employees) were offered for sale, a little above the planned total.

By March 1995, a further 1,200 small-scale enterprises had been offered for sale by auction and it was planned to have a total of about 10,000 enterprises offered for sale by mid-year. The programme was to be accelerated from mid-year, when more firms were to be auctioned each month. Specialised cash auctions were introduced in March for foreign investors.

Privatisation has been extended to farms and agro-industries and, by the end of 1994, over 1,450 state farms (about 66 per cent of the total) had been privatised or were undergoing privatisation. This has involved providing farm workers with long-term leases to land and then distributing shares in non-land farm assets to those with land rights.

Property restitution

There has been no property restitution in Kazakstan.

Growth of private enterprise

At the beginning of April 1994, more than 11,000 private businesses (excluding farms), 2,000 cooperatives, 1,400 joint ventures and 17,000 private farms were registered. Private farms and plots account for 35-70 per cent of the major agricultural products.

According to official data, there were over 32,600 small-scale enterprises registered by March 1995, of which 20,000 were private companies (though not all are likely to be active).

Enterprise restructuring

Progress on enterprise restructuring has been slow, partly because of parliamentary delays in approving legislation to implement the government's restructuring plan for about 400 enterprises, announced in September 1994, but also because the original bankruptcy law as well as labour market regulations have inhibited lay-offs.

During the first half of 1995, the government prepared for the implementation of enterprise reform with the establishment of a fund for the support of agriculture and a Rehabilitation Bank (with World Bank assistance). The latter, funded from the state budget but intended to operate independently from government, will be responsible for the financial operations of enterprises with a large debt burden, with the aim of restructuring them over a four-year period. Most of the remaining problem companies will be restructured by a rehabilitation agency under the Ministry of the Economy. Progress in this area will also depend on the effectiveness of the new Bankruptcy Law, approved in April 1995, which includes a provision for out-of-court settlement.

Markets and trade

Price liberalisation

In January 1992, most prices were freed. Administered prices for bread and bakery products were liberalised in October 1994 and all related budget subsidies eliminated. Only utility tariffs, including electricity, remain regulated, although prices of a number of other products are subject to anti-monopoly regulations. As part of the implementation of these regulations, all fixed prices for domestic crude oil and oil products were abolished in December 1994, and ceilings on the margins of oil refiners were removed in April 1995.

Competition policy

The existence of monopolies in trade and distribution remain an impediment to competition. A new Anti-monopoly Law was introduced in June 1994, which gives the anti-monopoly committee the power to regulate the prices of natural monopolies. Additional measures have included the removal of the monopoly rights of state trading organisations in external trade of strategic goods and the termination of compulsory deliveries of grain to the state in December 1994. In

The Foreign Trade Bank has been privatised. Three other of the four largest commercial banks remain state-owned. The law on commercial banks requires a reduction in state ownership in all banks to less than 25 per cent by end-1997. There is a substantial presence on the Hungarian banking scene of smaller private banks, many with foreign participation. Privatisation of the main household bank, the National Savings Bank (NSB) began in July 1995. In total about 25 per cent of the shares in NSB were sold to private investors in July.

Non-bank financial institutions

Domestic insurance companies were among the first to be privatised and foreign companies have established themselves in the Hungarian insurance sector. Social security funds are in deficit and have been borrowers rather than investors in domestic capital markets. A law passed in 1993 enabled the first non-state pension funds to be established. The Law on Investment Funds was passed in 1991. In late 1994 there were 21 investment funds with the combined capital of US$ 240 million.

Securities markets and instruments

In June 1990, the Budapest Stock Exchange was opened and a new regulatory framework was introduced (the Act on Economic Associations, the Securities Act and the Act on Mutual Funds). Turnover is dominated by trade in treasury bills. About 40 stocks are listed, with a capitalisation at end-1994 of roughly US$ 1.5 billion, about twice the level in 1993. Many Hungarian companies are listed on West European markets, and one on the US NASDAQ.

Fiscal and social safety net reform

Taxation

In 1988-89 the government introduced value added and personal income taxes, while streamlining taxation of enterprise income and radically reducing subsidies. The resultant drop in consumption taxes and direct taxation of enterprise income was largely offset by steep increases in taxation of personal income through the PIT and social security contributions.

Reforms in the last few years have focused on removing sector/activity-based tax reliefs. Special tax incentives for foreign investors were largely phased out by the end of 1993 (except for grandfathering until year 2003 for already active projects). Personal income is taxed progressively at rates up to 44 per cent. There are two VAT-rates of 12 per cent and 25 per cent.

In January 1995 the corporate income tax rate was cut from 36 per cent to 18 per cent, but a tax of 23 per cent was introduced for dividends.

Social security

Social security reform is at a relatively early stage. An increase in the retirement age (which is now 55 for women and 60 for men) has been contemplated but not implemented. Due to demographic factors, the cost of the pension system is expected to grow substantially over the next two decades in the absence of change in eligibility criteria. Recent government efforts to tighten family allowances and sick leave benefits were struck down by the Constitutional Court in June of 1995. Eligibility for unemployment benefits has been tightened substantially over the past three years.

Employer and employee payroll tax contributions (covering contributions to funds for pensions, health, unemployment insurance and vocational training) were lowered from respectively 52.5 per cent and 12 per cent of the wage sum in 1993 to 50.5 and 11.5 per cent in 1994.

February 1995 the government set up a commission to develop plans for the demonopolisation of some of the 80 state holding companies which have responsibility for about 1,700 enterprises, focusing first on grain milling and petroleum distribution.

Trade liberalisation

Substantial trade liberalisation was achieved by the first half of 1995, following the abolition of all export quotas and the elimination of most import and export licences. Exemptions from payment of import and export duties were abolished. A Partnership and Cooperation Agreement was signed with the EU in January 1995, which will enable Kazakstan to establish closer economic and political ties over a 10-year period, and includes an MFN agreement for trade in goods. In early 1995 Kazakstan signed a trade agreement with Russia providing for a zero customs tariff on respective imports.

Currency convertibility and exchange rate regime

A new national currency, the tenge, was introduced on 12 November 1993. The tenge is convertible for the purpose of foreign trade undertaken by enterprises. Success in lowering inflation, combined with National Bank of Kazakstan (NBK) intervention in the foreign currency auctions, has helped stabilise the exchange rate. Official and commercial rates are largely unified, with rates set in the Kazak Interbank Currency Exchange, in which all the main banks participate. From the beginning of 1995, foreign currency can no longer be used for domestic transactions. The 50 per cent surrender requirement for export proceeds was abolished in August 1995.

Wage liberalisation

The Law on Employment of the Population (1991) gives the government discretion on nominal wages and minimum wage adjustment. The average monthly wage was about 4,800 tenge in mid-1995 (approximately US$ 75).

Interest rate liberalisation

In 1994 interest rates were positive and high in real terms. In recent months rates the fall in inflation has permitted a reduction in interest rates at periodic intervals, but rates remain positive in real terms. Directed credits were abolished in early 1995 and limits were placed on the amount of NBK net credits to the government. During the first four months of 1995 virtually all NBK credit was extended via credit auctions (in which only those banks that meet prudential standards can participate), up from 60 per cent at the end of 1994.

Financial institutions

Banking reform

A two-tier banking system was introduced in 1987. The main banking laws were adopted in April and June 1993. The banking system consists of the National Bank and about 200 commercial banks, with another 30 licensed banks dealing in hard currency. However, credit continues to be channelled mainly through four specialised state banks which hold 80 per cent of the assets of the banking system.

Steps have been taken to strengthen the banking sector, including presidential approval, in February 1995, of an NBK Programme for the Reform of the Banking Sector. Its main features include: adoption of a law establishing the independence of the central bank, a requirement that banks provide guarantees for all payment orders they forward for clearing and settlement (in an attempt to avoid accumulation of inter-enterprise arrears), adoption of BIS guidelines for prudential supervision, the introduction of on-site examinations, compulsory risk classification of assets and provisioning requirements, and tougher licensing policy, including the closure of unviable banks (at least 20 banks were closed in 1994).

In addition, plans for the specialised banks include the transfer of some of the non-performing loans of the Agroprombank to a new agricultural support fund. The former foreign trade bank (Alem Bank) has already been split into a commercial bank and a state-owned Exim Bank to guarantee foreign credits. In mid-1995, following the establishment of a commission to oversee the operations of the commercial bank, it was decided to link the Alem commercial bank with the Savings Bank. In addition, the State Development Bank, which had been established in September 1994, is to be merged with the Exim Bank.

Non-bank financial institutions

The corporate governance role of the IPFs has been strengthened by increasing the ownership share each fund may hold in a single enterprise to 31 per cent, from 10 per cent previously.

Securities markets and instruments

The Law on the Circulation of Securities and the Stock Exchange was adopted in June 1991, and amended in April 1993. A stock exchange (the Central Asian Stock Exchange) was subsequently established.

Fiscal and social safety net reform

Taxation

In 1994 overall government revenues were only 17 per cent of GDP. Action is being taken to improve tax collection (computerisation of VAT administration is under way) and the targeting of social security payments.

A new Tax Code, effective 1 July 1995, simplifies and modernises the tax system. It reduces the number of taxes from 49 to 11, and improves incentives by reducing both tax rates and tax concessions and by moving away from production-based taxes. The 45-55 per cent profits tax was replaced by a 30 per cent corporate income tax for companies (45 per cent for banks and insurance companies), and the maximum income rate tax was set at 40 per cent. A uniform VAT was introduced at 20 per cent. To compensate for the expected decline in revenues resulting from these changes, the average import duty was raised from 5 to 15 per cent, excise taxes were imposed on certain goods and VAT was extended to imports from non-CIS countries.

Social security

Social security payments include an employment fund levy of 1 per cent of wages and a pension fund contribution of 37 per cent of wages.

Given the decline in the real value of many benefits, the general aim of policy has been to improve the targeting of benefit payments. When bread prices were liberalised, income supplements to vulnerable groups were increased by 30 per cent. The pension system will be reformed by increasing the level of benefits, combined with a gradual increase in the retirement age.

Kyrgyzstan

Following independence in December 1991 a comprehensive market-oriented reform programme was initiated in July 1992. Substantial progress in macroeconomic stabilisation has been made since the introduction of the national currency, the som, in May 1993. Structural reforms including privatisation and agricultural reform have accelerated under a new policy framework introduced in 1994-95.

Enterprises

Size of the private sector

The private sector accounted for 26 per cent of employment as of end-1994. The non-state sector, which includes companies with majority state ownership that have been partially privatised, accounted for 58 per cent of GDP as of end-1994. Given that the state still owns majority stakes in many of these partially privatised enterprises, and that early privatisation in agriculture has been largely a national transfer of ownership, this figure tends to overstate the size of the true private sector which may be closer to 40 per cent. The authorities believe that up to 20 per cent of GDP may originate in the informal economy, of which only a small share is presently reflected in official figures.

Large-scale privatisation

The predominant privatisation method in 1992-93, applied to 500-600 medium and large-scale enterprises, was to transform state-owned enterprises into joint-stock companies and transfer share ownership to the workers' collectives, with the state usually retaining a large ownership share.

In January 1994 the government passed a new Concept Note which provides for the sale of remaining state shares in already privatised medium to large-scale enterprises through voucher and cash auctions. Medium (100 to 1,000 employees) and large-scale enterprises (over 1,000 employees) will be transformed into joint-stock companies as a first stage before privatisation. International tender rounds are under way for 10-70 companies. A further 27 enterprises have been grouped in the restructuring agency ERRA (see below). The remaining medium and large-scale state-owned companies (estimated at 1,500) are being privatised as follows: 5 per cent of shares are given free to employees, 25 per cent are sold at coupon auctions, while 70 per cent are sold at cash auctions.

As of August 1995, 75 per cent of the total pool of vouchers had been distributed to the population. Half of these had been invested. Of the invested vouchers 0.5 per cent had been used to privatise housing, 25 per cent had been bought from individuals by investment funds which had in turn invested in shares, and 74 per cent had been invested directly by individuals and legal entities into individual enterprises. Between April 1994 and August 1995, cash auctions for 322 enterprises and voucher auctions for 634 enterprises were held.

A total of 914 companies were to be privatised in the 1994-95 mass privatisation programme. As of August, state-ownership had been reduced to less than 1 per cent in 287 of these enterprises, to less than 50 per cent in a further 287 and to less than 70 per cent in yet another 114.

Small-scale privatisation

Privatisation of the approximately 4,600 previously state-owned small trade outlets, retail and service establishments was largely completed by end-1994.

Land reform began in 1991-92, with the reorganisation of some of the state and collective farms, creating 17,000 peasant farms (10-30 hectares) and new agricultural cooperatives from 165 of the 470 state and collective farms. A revised programme has been implemented since early 1994. In January 1994 the government passed a new Concept Note recommending privatisation of all remaining state-owned small-scale enterprises (with up to 100 employees) through cash auctions. A decree of February 1994 provides for 49-year leases that can be sold (only to Kyrgyz citizens), exchanged, rented or used as collateral; in the second half of 1995 parliament is to discuss a proposal to eliminate the constitutional provision against private ownership of land. The remaining state-owned collective farms are to be privatised by end-1995; by early 1995, some 80 per cent of all state and collectively owned farms had been reorganised, but a significant number continue to operate as collective farms. Land tenure rights and land demarcation/registration are still inadequate.

Property restitution

Kyrgyzstan has no restitution programme. A Land Fund covering up to 25 per cent of arable land is to be created, for redistribution of land or compensation for nationalisation in past decades. Criteria for eligibility are still under discussion.

Growth of private enterprise

While the formation of new private enterprises, particularly in trade and services, is accelerating, the process is impeded by a lack of finance and inadequate infrastructure. Privately owned small-scale agriculture (less than 30 hectares/farm) accounted for 65 per cent of non-grain agricultural production in 1994.

Enterprise restructuring

Tight credit policies have led to a sharp rise in inter-enterprise arrears since 1992, to a level of 30 per cent of GDP by end-1993; these have started to decline at the end of 1994 due to remonetisation of the economy and a strengthening of the perception among local suppliers that it does not pay to deliver to companies with a poor payments record.

In May 1994 a Presidential decree established the Enterprise Reform and Resolution Agency (ERRA) for a period of four years to oversee restructuring of 29 large, loss-making, state-owned enterprises. Diagnostic studies on 20 companies are complete, and the remainder are to be completed by year-end. After divestiture of social assets, some production lines are thought to be viable. International tenders for some of the companies are being prepared.

Market-based restructuring and corporate governance will be enhanced by a decree issued in February 1995, which requires all companies that have been privatised as closed-joint stock companies (i.e. companies whose shares are not tradeable) to convert to open joint-stock companies within four months, making it possible for outsiders to acquire stakes.

The Insolvency Law, enacted in January 1994, was followed by a number of decrees aiming to impose financial discipline on state-owned enterprises, improve corporate governance, and restructure or liquidate large, loss-making enterprises. No bankruptcies have been enacted so far, owing to unresolved inter-enterprise arrears and banking system insolvency. Recent implementing instructions have introduced out-of-court settlement procedures in order to sidestep the implementation bottlenecks in the legal system.

Markets and trade

Price liberalisation

There are few direct controls on prices. In March 1994, all limits on retail margins were eliminated except for that on bread. Bread prices were freed in November 1994.

Domestic prices of imported fuels have gradually been liberalised. Domestic prices for oil, gas and coal are now close to world market prices following increases in US dollar terms of 167 per cent in 1993 and 44 per cent in 1994. Domestic prices of district heating, natural gas for domestic users, and electricity remain subsidised. Elimination of energy subsidies is a sensitive political issue.

Competition policy

In December 1993 the maximum profit margins for monopoly producers were eliminated. The Anti-monopoly Law of January 1994 defines "monopoly producers" as those with a domestic market share of at least 35 per cent. Their number was reduced to 50 in September 1993, to 15 in February 1994, and to 9 in May 1994 (five of which are classified as natural monopolies). The process of determining which firms constitute monopolies will be further examined with a view to limiting state regulation only to natural monopolies such as electricity, water and railways.

Demonopolisation has led to the partial break-up of the bread and grain conglomerate and the elimination of three large transport holding companies in late 1994. In 1995-96 the government plans to break up and privatise two other agricultural input/output conglomerates.

Trade liberalisation

In early 1994, the trade system was substantially liberalised. Remaining import and export licensing agreements were lifted, and export taxes reduced. The number of export taxes was reduced from 50 to nine in May 1994, and further to two in May 1995 (on hides and skin). A temporary export tax on silk cocoons was introduced in 1995. All export taxes are to be eliminated by end-1995.

The common customs union with Kazakstan and Uzbekistan, established in early 1994, provides for duty-free import of goods of these countries. In late 1994, a differentiated system of customs duties was replaced by a flat duty of 10 per cent on all imports from non-CIS countries.

Currency convertibility and exchange rate regime

The national currency, the som, was introduced in May 1993 and allowed to float (with some intervention). In March 1995 the authorities introduced full current account convertibility in accordance with the obligations under Article VIII of the IMF's Articles of Agreement.

Wage liberalisation

Increases in the state-sector wage bill are to be limited to targeted future inflation rates. The 1995 profit tax law stipulates that the total wage bill that is deductible for tax purposes in any enterprise cannot exceed 10 times the number of employees multiplied by the minimum wage.

Labour mobility has been enhanced by the elimination of residency restrictions.

Interest rate liberalisation

Interest rates are market determined. Interest rate ceilings on treasury bill auctions were removed in early 1994. Real interest rates turned sharply positive in early 1994 and stayed at very high levels (100-150 per cent per annum) throughout the first three quarters of 1994. Despite a fall in nominal rates in line with inflation in late 1994 and early 1995, real interest rates on loans are still prohibitive at 30-40 per cent a year. Segmentation of the credit market is high, with significant variation in lending and deposit rates between banks.

Financial institutions

Banking reform

A two-tier banking system was established in 1991. In 1992 a comprehensive Central Bank Law and a Commercial Bank Law were enacted; the former made the National Bank of Kyrgyzstan (NBK) independent. Following the introduction of the som in May 1993, the NBK introduced several indirect monetary instruments, including weekly forex sales to the interbank market, treasury bill and credit auctions; reserve requirements were unified at 15 per cent and a Lombard facility was introduced. There is a Law on Pledge, and a Law on Collateral is to be submitted to parliament in 1995 including out-of-court settlement procedures.

The banking system is dominated by three large state-owned banks: Agroprom, Promstroibank and Kyrgyzstan Bank, together accounting for 85 per cent of total assets of the banking sector. There are also 14 commercial banks, which were mostly established after 1991 by state-owned enterprises and ministries, and the Savings Bank; three of the 14 are partially foreign owned. As of end-1994, the state held majority shares in only three banks, including the savings bank. The level of financial intermediation is very low, with the M2/GDP ratio among the lowest in the world at below 10 per cent.

Non-performing loans and associated undercapitalisation make the majority of banks presently technically insolvent. Prudential regulations have recently been tightened. Minimum capital adequacy requirements have been introduced (defined in terms of som and equivalent to approx. US$ 1 million for local banks and US$ 2 million for foreign banks) as have liquidity ratios, reserve requirements, loan classification and provision guidelines, as well as limits on lending to shareholders and single borrowers. The National Bank's supervisory capacity has been significantly strengthened. In 1994, three small commercial banks were closed and another six placed under NBK supervision; in 1995 two further licences were suspended. The NBK also instituted a freeze on new lending to enterprises in arrears, and has limited access to refinance auctions. As part of a reform of the banking system, legislation preparing a deposit insurance fund and amendments to the Central Bank Law and the Commercial Bank Law are being drafted. Systemic reforms, including possibly recapitalisation of select banks, is being prepared by the NBK jointly with the World Bank.

Non-bank financial institutions

A regulatory framework for investment funds has been introduced. Since 1993, 29 investment funds have been licensed, of which only 12 have thus far actively participated in privatisation auctions. They have accounted for some 25 per cent of demand at the coupon-based auctions.

Thirty insurance companies and one pension fund are in operation. Their activities are prescribed by government regulations.

Securities markets and instruments

The Law on Securities and Stock Exchanges was passed in December 1991. Treasury-bill auctions have taken place since 1993, but were limited to sales of 3-month bills until recently; secondary market trading remains very thin.

In May 1994, the government established the State Agency for Securities in charge of securities regulations. In September 1994, the Coupon Trading Center starting trade in privatisation coupons, and the Stock Exchange commenced operations in May 1995. An independent share registry and tight listing requirements should ensure a significant degree of transparency and property rights security. While trading is still very thin (five companies listed by August 1995, but 30+ expected by mid-1996), the institutional basis for a secondary market in shares is given. Extension of trade to T-bills, regional currencies and municipal bonds is planned.

Fiscal and social safety net reform

Taxation

The tax system includes a profit tax, the rate of which was reduced from 35 to 30 per cent for most businesses in January 1994. The new profit tax law of January 1995 eliminates most exemptions and deductions; provisions for deduction of accelerated depreciation exist, but no loss carryover provisions. The personal income tax of January 1995 includes in-kind payments in the tax base and requires the filing of tax declarations. Marginal rates range from 10 to 40 per cent. A retail sales tax of 5 per cent, covering those goods not covered by the turnover-based VAT tax, is to be eliminated as of January 1996. A genuine VAT at 20 per cent will be introduced in January 1996.

Social security

Employers pay a payroll tax of 33 per cent in the state and enterprise sector and of 23 per cent in the collectivised agricultural sector. 85 per cent of the tax accrues to the Pensions Fund and 15 per cent to the Social Insurance Fund. Employers also pay 1.5 per cent to the Unemployment Fund, and employees 2 per cent to the Pension Fund and 0.5 per cent to the Unemployment Fund. In 1994, the three funds were consolidated into the Social Fund.

In 1994, total social expenditures amounted to some 18 per cent of GDP, or more than half of government expenditure. Due to the tight fiscal situation, regional governments were in arrears on social payments and wages of some 3.3 per cent of GDP at end-1994. In order to improve the efficiency of the social safety net, the government is to consolidate all existing benefits under the system and other cash benefits into a single cash benefit payable to individuals earning less than the minimum wage.

The authorities estimate that 60 per cent of the population lives below the poverty line, and another 20 per cent at the poverty line.

After regaining independence in 1991, Latvia adopted in mid–1992 a comprehensive reform package, involving price and trade liberalisation, small-scale privatisation and macroeconomic stabilisation. Progress has been rapid in all of these areas. Less progress has been made on large-scale privatisation.

Enterprises

Size of the private sector

The share of the non-state sector in GDP was officially estimated at 58 per cent in 1994, with industry remaining far below this average but agriculture and services exceeding the average. The private sector share of GDP is likely to be at a similar level in 1995.

Large-scale privatisation

Large-scale privatisation is still lagging behind other areas of reform, although the privatisation law of February 1994 streamlined the process of privatisation by creating an independent Privatisation Agency and a State Property Fund. The mass distribution of privatisation vouchers, which started in 1994, was completed in March 1995. By then, certificates with an aggregate face value of lats 2.8 billion had been distributed to 2.2 million residents. The vouchers are tradable and can be used for the purchase of shares in state-owned companies as well as for the purchase of land and housing units.

The privatisation programme emphasises international tenders and public offerings of shares. The first international tender of 45 enterprises were offered to the public under a pilot programme in January 1995. Overall about 200 large enterprises (accounting for 10-20 per cent of industrial output) are expected to be privatised by the end of 1995. Significant ownership shares in 50 of these will be sold for vouchers.

Small-scale privatisation

More than half of agricultural land has been privatised. The privatisation of small enterprises in the services and trade sector, most of which were previously owned by municipalities, is almost completed, with significant foreign participation, mainly from Scandinavia and Germany. Furthermore, an estimated 40 per cent of the country's housing units have been privatised.

Property restitution

By the end of 1994, some 231,000 restitution claims for land in towns and cities had been submitted. Of these, 13 per cent had been settled. Claims for the restitution of urban land can be submitted during a period of 10 years. In order to avoid uncertainty for new owners of privatised property, the government issues guarantees to the new owners, which basically provide for the security of ownership of the privatised land and compensation for the claimants in case their claims are accepted.

Growth of private enterprise

From 1991 to mid-1995, an estimated 30,000 new private enterprises were created, mostly in services and trading. There are no significant administrative obstacles to entry. As in the other Baltic states, one of the most important obstacles to the establishment of new private enterprises is lack of long-term finance.

Enterprise restructuring

Restructuring has largely been left to the new owners of privatised firms. The emphasis in Latvia's privatisation process has been on strategic investors including foreign investors, rather than on the transfer of ownership to workers and management on to a large share of the population. As a result, restructuring in privatised countries has been pursued relatively vigorously. One indicator of this is that open unemployment was 6.8 per cent of the labour force by early 1995, the highest rate in any former Soviet country.

Although a bankruptcy law was passed in 1991 it has been ineffective. Therefore, and because outright budgetary subsidies to enterprises were eliminated early in the transition process, inter-enterprise arrears have posed a serious problem, particularly in 1994 and early 1995. There has been a particular lack of payment discipline among energy customers, especially consumers of electricity.

Markets and trade

Price liberalisation

Price liberalisation began in early 1991 and was virtually completed by late 1992. Few formal price controls remain. Rents and public transport and heating prices are set by municipalities, often with inadequate allowance for capital costs. Electricity tariffs charged by the state-owned power utility are approved by the central government. They cover about 60 per cent of economic costs at present. An increase to full economic cost level is envisaged by the authorities only for the year 2005.

Competition policy

An Anti-monopoly Law was passed in 1991, with subsequent amendments in 1993. Compliance with the law is monitored by the Anti-monopoly Committee. Competition policy is scheduled to be harmonised with EU legislation within four years. As in other small countries with a liberal trade regime, imports are the main competitive force in the economy.

Trade liberalisation

As in the other Baltic countries, the trade regime continues to be very liberal. Quantitative restrictions on exports and imports as well as export tariffs have been virtually eliminated. Import tariffs are generally modest (1 per cent *ad valorem* on raw materials and component parts, and a 15 per cent most-favoured-nation rate on finished products), except in the agricultural sector which remains protected by an average production-weighted tariff of more than 50 per cent. Latvia has been very successful in redirecting its exports to Western markets, as share in total exports outside the former Soviet Union is expected to reach 54 per cent in 1995 compared to 46 per cent in 1993 and almost complete dependence on the Soviet Union prior to 1989.
The "Europe Agreement" with the EU (see details in Chapter 11), signed in June 1995, together with expected accession to the WTO this year, should further improve Latvia's integration into the world economy.

Currency convertibility and exchange rate regime

The lats has been informally pegged to the SDR since February 1995 via central bank intervention in foreign exchange markets. Base money is fully backed by net international reserves. Latvia offers complete and effective current and capital account convertibility with no repatriation or surrender requirements.

Wage liberalisation

Wages are set freely by enterprise managers, with union influence remaining modest. The existing minimum wage legislation is without material impact on wage setting in the private sector.

Interest rate liberalisation

Banks have been free to set interest rates since 1992. The spread between lending and deposit rates has fallen recently but remains about 15-20 percentage points. Based on the expected 1995 inflation in the order of 20-25 per cent, deposit rates of all maturities are negative in real terms.

Financial institutions

Banking reform

The Central Banking Law of May 1992 established a two-tier banking system. Latvia's largest bank, Banka Baltija (BB), became insolvent and was put under government administration in the second quarter of 1995. Around one-fifth of Latvia's population of 2.5 million had deposits with BB. They will have deposits of up to 200 lats covered by the government. Equity holders in BB have lost their holdings.

Following the BB crisis, bank supervision has been strengthened. The portfolios of two of Latvia's largest banks, the Latvian Universal Bank and the Latvian Savings Bank, have been strengthened through treasury-funded recapitalisations. Out of 54 banks operating at the beginning of 1995, less than 40 are still in business, only 16 of which have a full banking licence including deposit taking. Further closures are expected.

Non-bank financial institutions

About 10 insurance companies are active in Latvia. Some of these are partly or fully owned by foreign insurance firms (from Scandinavia, Germany and the USA). All but one (life insurance) are private. Investment funds play only a minor role.

Securities markets and instruments

Treasury bill auctions were introduced in December 1993; a secondary market window has been established by the central bank to strengthen money-market operations. Eleven commodity exchanges are operating, some of which are expected to be amalgamated.

A securities law was introduced recently to support the opening of the stock market in Riga in mid-1995. The number of listed companies is expected to expand to 50 by year-end.

Fiscal and social safety net reform

Taxation

Total tax revenues are expected to amount to about 38 per cent of GDP in 1995. Personal income tax and a pay payroll tax account for approximately 45 per cent of this, with indirect taxes, mainly VAT, and corporate profit tax accounting for another 33 per cent and 8 per cent, respectively. The top rate of the progressive personal income tax is 35 per cent. The standard VAT rate has been 18 per cent since November 1993. Since mid-1994, the standard VAT rate has also applied to food.

Social security

The social security payroll tax is 37 per cent (of the wage-sum) for employers, and 1 per cent for employees. Pensions and unemployment benefits are financed from these revenues. A gradual transformation of the pay-as-you-go system to a funded system has been initiated. The number of pensioners per 1,000 employees has been projected to increase from 391 to 429. As a first step to reduce the financial burden on the system, the retirement age has been increased by 1 year (to 61 for men and 56 for women). In addition, it is intended to widen the role of means-tested social benefits.

Lithuania

Since regaining independence in 1991, Lithuania has introduced comprehensive market-oriented reforms and has achieved a comparatively high degree of macroeconomic stability. Over the past year Lithuania has made significant further progress in macroeconomic stabilisation.

Enterprises

Size of the private sector

According to government estimates, the share of the non-state sector in GDP increased to around 60 per cent in 1994, with the share being lower in industry and higher in agriculture and the services sector. The GDP-share of the private sector, which is a narrower concept than the non-state sector (as, for example, the latter includes companies with minority private ownership while the former does not) may be about 55 per cent.

Large-scale privatisation

Privatisation is based on the Law on Initial Privatisation of State Property (passed in late 1991 and amended in 1993). Originally only voucher privatisation had been envisaged, but some cash auction sales have also taken place. Preference has generally been given to employees and management (with up to 50 per cent of shares reserved for these new shareholders).

The voucher-based first phase of the ownership transfer involved 6,700 enterprises, 84 per cent of which had been privatised by the end of June 1995, according to the Central Privatisation Commission. The framework for the second phase, which provides for cash sell-offs of assets valued at a total of US$ 375 million went before parliament in July 1995.

Small-scale privatisation

Small-scale privatisation was based on the same law as large-scale privatisation. Progress in the sale of small units has been substantial with 2,318 of 2,660 eligible small enterprises having been privatised (9.4 million out of 12.4 million litai in asset value). The privatisation of farmland was preceded by the break-up of 1,100 collective and cooperative farms into 12,300 units designated for privatisation. By mid-1995, privatisation of housing and farmland was largely completed. Foreign citizens, joint ventures and firms with foreign capital cannot own land but can lease land for up to 99 years.

Property restitution

The deadline for restitution applications by former owners of nationalised land was March 1994. Restitution has been granted in 86,000 cases, based on 500,000 applications. Property restitution has been impeded by administrative and legal difficulties. Uncertainty surrounding the legal ownership of properties, which may yet be returned to the original owners, continues to complicate a number of privatisation cases.

Growth of private enterprise

The share of truly new enterprises in manufacturing production and employment continues to be small. There is some discrimination against foreign investors (e.g. through a need to have a local partner and sometimes through the administration of tax laws). But a large number of mostly small new firms have been established in the services sector. Various legal barriers to entry and restrictive licensing requirements for production and distribution have been removed. Unavailability of medium- to long-term credit is probably the key obstacle to broad-based small enterprise growth, with property uncertainty also playing an important role.

Enterprise restructuring

Direct subsidies to enterprises have been largely discontinued (except for agriculture, energy and housing), and credit policies of banks have, especially, in the most recent years, been relatively tight. However, privatised companies continue to be owned, to a large extent, by worker cooperatives favouring job security over rationalisation and labour-shedding. Management has in many cases remained intact after privatisation. A Bankruptcy Law was passed in September 1992, but supporting regulations and institutional arrangements required for enforcement were not finalised until several years later. These are now largely in place but, in practice, bankruptcy proceedings have been initiated only against very few firms.

Markets and trade

Price liberalisation

Prices of food, consumer and industrial goods were fully liberalised during 1991-92. Restrictions remain on prices for energy and housing. Some prices for transport and utilities fall short of costs (when capital replacement is included in the cost calculation).

District heating prices were raised significantly in the winter 1994-5 and in June 1995. According to the government, these prices now cover the cost of supply, including depreciation on revalued assets. Electricity prices are, however, still below economic costs, particularly when necessary safety improvements to, or the replacement of, the Ignalina nuclear power plant, the country's dominant power generator, are taken into account. Arrears of energy customers amounted to 1.5 per cent of GDP as of February 1995. As a consequence, the utilities were unable to pay their import bills.

Competition policy

Some action has been taken to split up conglomerates, but there is no consistent policy on this. An Agency for Prices and Competition has been established, with the ability to negotiate margins with enterprises whose market share exceeds 40 per cent, but with no effective power to break up monopoly enterprises. Profit margins of many distribution networks continue to be very high. Competitive pressures come mainly from the liberal trade regime and from tight fiscal and monetary policies.

Trade liberalisation

Foreign trade has been freed of non-tariff restrictions. Import tariffs are generally moderate. Since mid-1994, import tariffs on some agricultural products have been reduced further. The elimination of the few remaining export restrictions has been delayed. A "Europe Agreement" with the EU was signed in June 1995 (see Chapter 11 for details).

Currency convertibility and exchange rate regime

Lithuania introduced a currency board system of monetary management in early 1994, with a peg to the US dollar at the rate of 4 litas per US dollar. This system involves a very high degree of commitment to exchange rate stability. There is virtually full convertibility of the litas on both the current and capital account.

Wage liberalisation

Wage-setting was liberalised in mid-1993. A (low) minimum wage which does not significantly affect private sector wage setting has been enforced.

Interest rate liberalisation

Restrictions on interest rate setting by commercial banks have been abolished. Despite the currency board, nominal interest rates, particularly medium and long-term rates, remain significantly higher than US dollar rates quoted in the West, but they are negative in real terms (based on the expected 1995 inflation rate of 30-35 per cent in Lithuania).

Financial institutions

Banking reform

The Commercial Banking Act of June 1992 introduced prudential regulation. In early 1993, the Bank of Lithuania transferred its remaining commercial functions to the State Commercial Bank. Twenty-seven commercial banks were in operation in mid-1995, including three large banks with majority government ownership. The assets of these three banks account for about half of all assets held by commercial banks. The government has delayed the planned reduction to minority status of its share in the three large commercial banks. A large number of small non-bank enterprises have been engaged in unregulated deposit-taking and lending, increasing the fragility of the financial system. Since mid-1994, the Bank of Lithuania has strengthened its central bank role and capabilities and shown its resolve in several temporary suspensions of bank licences. Competition between commercial banks has become stronger, which has led to reduced interest margins.

Non-bank financial institutions

Investment funds held 31 per cent of all privatised capital by August 1994.

Securities markets and instruments

A National Stock Exchange began operations in September 1993. At the end of 1994 more than 180 securities were listed by the National Stock Exchange, and 29 brokers had been registered. The trading volume was equivalent to US$ 2.5 million per month.

Fiscal and social safety net reform

Taxation

Since mid-1990, a series of tax reforms provided Lithuania with a tax structure broadly similar to market economies. A new VAT at 18 per cent became effective in April 1994. Corporate income tax reform introduced a flat rate of 29 per cent but the many exemptions severely eroded the tax base. The personal income tax schedule is progressive up to a maximum marginal rate of 33 per cent. Recently, tax administration has been improved and a number of exemptions have been abolished and loopholes plugged.

Social security

Real levels of government transfers to households have fallen sharply in recent years. Pension payments, on a pay-as-you-go basis, represented 4 per cent of GDP in 1993. The social insurance payroll tax amounts to 30 per cent for employers and 1 per cent for employees.

Moldova

After the disintegration of the Soviet Union in 1991, a reform programme was adopted in early 1992, the legal components of which included a Property Law, a Privatisation Law, and the Law of Agrarian Reform and Land Code. In March 1993 parliament adopted the "Action Plan for the Stabilisation and Recovery of the Economy" and the Privatisation Plan, leading to an IMF-supported stabilisation programme in September 1993. In July 1994, the government adopted a new constitution enshrining the rules of the market economy into the republic's guiding principles, and formally launched a large-scale privatisation programme.

Enterprises

Size of the private sector

The private sector's share of GDP is likely to be in the range 25-35 per cent.

Large-scale privatisation

The March 1993 Privatisation Plan envisaged the privatisation within two years of about 1,600 enterprises (40-50 per cent of state assets), mostly through voucher privatisation. Some state corporations have been designated to remain in state ownership, including some utilities, scientific institutes and large-scale food processing companies. Little progress was made until the middle of 1994. Since June 1994, 874 state companies have been sold, of which 472 were medium and large companies and 402 small ones. In 1995 the pace of privatisation has accelerated further. The 1995-96 privatisation programme, approved in March 1995, schedules another 1,450 enterprises for privatisation. 804 of the firms will be privatised for vouchers, 183 for cash, and the remainder for a combination of vouchers and cash. Voucher privatisation is to finish by 15 November 1995.

Small-scale privatisation

The sale to private entities of small-scale units began in September 1993 with the first auctions. More than two-thirds of housing is in private hands, and privatisation of the remaining 350,000 unoccupied or state-owned dwellings is under way. Some small-scale land ownership was already permitted before Moldova gained independence. Agricultural privatisation is under way with the transfer of shares of some state and collective farms to present and former farm employees. At least 10 per cent of state holdings in agriculture were transferred to private owners in 1992 and further sales took place in 1993. Agro-processing enterprises will be converted into joint-stock companies with 50 per cent share distribution to suppliers, 20 per cent to employees and 30 per cent to the Ministry of Privatisation. Privatised land will not be tradable until January 2001.

The 1995-96 Privatisation Programme envisages the privatisation of virtually all small-scale enterprises.

Property restitution

No property restitution has taken place.

Growth of private enterprise

More than 35,000 private businesses had been registered in Moldova as of end-1994, which represents a sixfold increase as compared with end-1992. However, only about half are currently thought to be operating.

In December 1993 there were 256 registered joint ventures, of which 104 were operational. About 350 joint ventures were registered by end-1994.

Enterprise restructuring

Over the past year a tight fiscal monetary policy regime has exerted great pressure on the enterprises to restructure operations. A Bankruptcy Law was adopted in 1992 but has been largely ineffective. Revised legislation is being drawn up which will enable creditors to trigger bankruptcy proceedings.

In September 1994, 25 private enterprises were declared bankrupt by the arbitration court as a result of suits brought against them by local authorities. The government identified and initiated liquidation proceedings against a further seven state enterprises.

Markets and trade

Price liberalisation

In January 1992 consumer goods prices were liberalised, with the exception of those for bread, dairy products, some transport prices, and utilities. Initially indirect price control remained through heavy producer regulation and strict retail margin controls, but 1993 saw some liberalisation and an increase in milk prices to 75 per cent of production costs.

By 1 January 1995 the government had removed margin controls on most goods. The remaining margin controls on commercial transactions of selected goods at the retail and wholesale levels were to be eliminated by end-June 1995 but this has been subject to delay. Energy prices, among others, remain well below cost.

Competition policy

Legislation governing anti-monopoly activity was passed in early 1992 but has been relatively ineffective.

Trade liberalisation

The State Monopoly on foreign trade was abolished in 1992. In April 1993 the generalised export licensing system was replaced by a restricted list, mainly related to security, cultural goods and medical items. By the end of 1994 export quotas had been removed except for grain and grain products. At the same time the licensing procedure was simplified. The import regime is fairly unrestricted though average tariff levels remain high by the standards of the transition economies.

On 28 November 1994 the EU and the Government of Moldova signed a Partnership and Cooperation Agreement. On 1 January 1995, Moldova lowered its maximum tariff to 50 per cent, with the exception of a small number of luxury goods. By December 1995 the government intends to reduce the maximum tariff rate tariff to 20 per cent.

Currency convertibility and exchange rate regime

November 1993 saw the introduction of a new national currency, the leu. The exchange rate is largely market determined with currency auctions three times a week. The Transdniestr region introduced a separate currency in late August 1994. Since January 1994 most payments and transfers for current transactions and some capital transfers have been free of controls. The export-earning surrender requirement, with 35 per cent to be compulsorily sold on the domestic interbank market, was eliminated in November 1994.

In accepting Article VIII of the IMF agreement at the end of June 1995, Moldova declared its currency convertible for current account transactions. The nominal exchange rate of the leu has remained relatively stable. In July 1995 an agreement was signed on simultaneous circulation of both the Moldovan leu and Transdniestr's rouble in the Transdniestr region. The frequency of trading sessions on the interbank market was increased, from three times a week to daily, in February 1995.

Wage liberalisation

Before 1993, indicative wage levels were imposed by law. This practice has been replaced by wage floors.

Interest rate liberalisation

Since the introduction of the leu, Moldovan lending and deposit rates have been linked to the rate established at auctions for National Bank credit. Real interest rates have been significantly positive since 1994. The commercial banks set their own interest rates, following the refinancing rate quoted by the National Bank of Moldova.

Financial institutions

Banking reform

In mid-1991 a two-tier banking system was established. Credit operations of the central bank were initially subject to significant influence by the government and parliament. In 1993 the central bank's powers were enhanced. The Law on the National Bank and the Law on Financial Institutions were adopted by parliament in July 1995. The former states price stability as the primary policy goal of the central bank, the latter regulates licensing and banking standards.

The financial sector consists of four large banks and 23 other commercial banks, all of which were transformed into joint-stock companies in 1991. Minimum capital requirements were raised progressively over the last two years. Some banks remain severely undercapitalised.

Non-bank financial institutions

There are currently 15 investment funds and 8 trust companies. Moldovan citizens can offer their national patrimonial bonds in exchange for shares in a fund. The funds participate at auctions and buy shares in the newly privatised companies. Trust companies act as intermediaries, buying shares upon instruction by the owners of the bonds.

Securities markets and instruments

The National Commodity Exchange of Moldova was set up in April 1991. A decree concerning securities markets and commodity exchanges was issued in February 1992. In December 1993 a consortium of local banks and investment trusts announced the intention to establish a stock exchange.

In June 1995 Moldova opened its first stock exchange with 95 per cent of trading being in shares of privatised companies. The first auction of government securities was held in March 1995.

Fiscal and social safety net reform

Taxation

Major tax reforms in 1992-93 included the introduction of a VAT, restructuring of the personal income tax, the introduction of several new taxes including a road tax, some import tariffs and an extension of the VAT base. A progressive enterprise profits tax with the rate at 32 per cent was also introduced. VAT has been charged at 20 per cent since January 1993.

Fundamental changes in tax provisions were approved on 8 June 1995 which will affect the provisioning for losses and taxes of Moldovan commercial banks.

Social security

Companies are liable for social security fund taxes, and payments to the unemployment fund, amounting to 45 per cent of the payroll.

Poland

Tentative market-oriented reform began in 1981-82, with measures aimed at reducing economic administration, increasing enterprise autonomy, and strengthening workers' self management. The 1989 Balcerowicz plan launched much more comprehensive market-oriented reforms. With the election of a left-of-centre coalition government in September 1993, the pace of structural reform, in particular that of privatisation, initially slowed. However, implementation of the long-delayed Mass Privatisation Programme began in the second half of 1995.

Enterprises

Size of the private sector

The share of the private sector has increased steadily since the start of comprehensive reform, albeit at declining pace. According to official estimates, the private sector share of GDP rose to 56 per cent of GDP in 1994 from 54 per cent in 1993 and 31 per cent in 1990, while that of total employment increased to 61 per cent in 1994 from 59 per cent in 1993 and 49 per cent in 1990.

Large-scale privatisation

The 1990 Privatisation Law introduced a multi-track approach to privatisation. Under the two main privatisation tracks, enterprises can be liquidated and their assets sold, leased or transferred to a new private company, or they can be commercialised (for example through conversion into joint-stock companies, with lessened influences of workers' councils) and then privatised through share sales. By end-1993, 25 per cent (more than 2,000) of the 8,841 enterprises owned by the government in July 1990 had been privatised and 6 per cent had been transformed into treasury-owned joint-stock companies.

In 1994, an additional 321 enterprises were privatised and 244 enterprises were commercialised, raising the cumulative privatisation total to 29 per cent of the initial number of state-owned enterprises, with an additional 9 per cent of this total being commercialised.

In 1995, the long-delayed voucher-based mass privatisation programme got under way, with the selection of the management for 15 National Investment funds in February and the allocation of 413 enterprises to the Funds in July-October. An additional 106 firms are to be transferred to the funds later this year.

A new Privatisation Law was passed in July 1995, which would reinforce the recent trend toward commercialisation and would transfer authority for initiating privatisation away from the Minister of Privatisation to other government ministries. Privatisation of enterprises in strategic sectors would require parliamentary approval. The President's veto of the bill was overridden by parliament.

Small-scale privatisation

Most small retail, wholesale and construction enterprises (approximately 20,000) were privatised by local governments early in the Balcerowicz reform period.

Property restitution

Under current law, restitution claims may only be enforced if the original nationalisation law provided for compensation and none was paid. While several thousand restitution claims have been filed, compensation has been awarded to individuals in only a few cases, although a significant amount of property has been returned to the church.

Growth of private enterprise

The number of private companies reached 2.2 million at end-June 1995, up from 1.9 million at end-1993.

Enterprise restructuring

Important sources of pressure on enterprises to restructure have included tight fiscal and monetary policies and a liberal import regime. The level of government subsidisation of producers fell from 4.5 per cent of GDP in 1989 to 0.8 per cent in 1992. The 1992 Law on the Financial Restructuring of Enterprises and Banks required the nine state-owned commercial banks to enter into debt restructuring negotiations (outside of the courts) with those enterprises whose loans had been declared non-performing by independent auditors.

Commercial banks have been renegotiating debts of the 600 larger enterprises that accounted for most of their bad loans. Conciliation agreements were reached by the April 1994 deadline with about one-third of the enterprises accounting for over one-half of the bad loans. Another 25 per cent of the enterprises were placed under liquidation or bankruptcy proceedings. The remainder regained creditworthiness, had their debts auctioned off by the banks, or their collateral executed. During 1994, outstanding loans by commercial banks to state enterprises declined by 11 per cent in real terms.

Markets and trade

Price liberalisation

Most prices were liberalised in 1990-91. Those for district heating, electricity, gas, medicines (basic), rents in local authority housing, and spirits remain centrally administered. Coal prices are distorted by the continued operation of loss-making mines. The Agency for Agricultural Markets intervenes extensively in the farm sector through price supports, export subsidies, credit guarantees and management of the commodity reserves.

In 1994, industrial gas prices roughly equalled economic costs, while that for residential gas covered about 76 per cent of distribution costs. District heating tariffs covered on average about 60 per cent of costs. Electricity charges were about one-half of the long-run marginal production cost for the industry.

Competition policy

The 1990 Law on Monopolistic Practice serves to prevent anti-competitive behaviour, to foster development of competition and safeguard the interest of consumers. In 1990, the Anti-Monopoly Office (AMO) was founded. Enterprises with a market share over 80 per cent have been closely monitored by the AMO, and their number was reduced to about 70 in 1994 from nearly 200 in 1990. In addition, the AMO has ordered the split-up of 20 regional state enterprises in local markets.

Trade liberalisation

In 1990, most tariff and non-tariff barriers to trade were suspended or sharply reduced and the state monopoly on foreign trade was ended. Average tariffs declined to 5.5 per cent in mid-1991 from 18.3 per cent in 1989. Import and export licensing was eliminated to cover a limited range of products (cigarettes, dairy products, natural gas, petroleum and spirits). After a significant deterioration in the trade balance, suspended import tariffs were reimposed in late 1991. The average tariff increased to 18.4 per cent in 1992 and, in 1993, a 6 per cent import surcharge was imposed. Multilateral trade agreements were reached with the EU, EFTA, and CEFTA in 1992-93 (see details in Chapter 11 on Poland's "Europe Agreement" with the EU).

In January 1995, the average tariff on industrial goods was reduced to 9.3 per cent and the import surcharge was reduced to 5 per cent. In May 1995, quantitative restrictions on agricultural imports were converted into tariffs in line with the GATT Uruguay Round. In July 1995, Poland became a member of the WTO.

Currency convertibility and exchange rate regime

Convertibility of the zloty was introduced in January 1990. Exchange restrictions on travel allowances and other invisible payments were maintained. The 1991 Law on Companies with foreign participation gives foreign investors the right to purchase foreign exchange with zlotys for the transfer of profits and for repatriation of capital without a special permit, provided that the initial investment was made with zlotys purchased at the official exchange rate. Following the introduction of a fixed exchange rate in January 1990, the regime was changed to a pre-announced crawling peg against a basket of currencies in October 1991. The rate of crawl was 1.8 per cent per month. In August 1993, there was a 7.4 per cent step devaluation of the zloty against the basket of currencies but after that the monthly crawl of 1.8 per cent was resumed.

In December 1994, a new Foreign Exchange Law was passed, which allowed for the full current account convertibility of the zloty and, in June 1995, Poland accepted the obligations of Article VIII of the IMF's Articles of Agreement. The rate of crawl in the peg was slowed in several steps to 1.2 per cent in February 1995. In May 1995, the exchange rate regime was modified to allow the zloty to fluctuate within a band of ±7 per percentage points around the central rate, the devaluation of which is 1.2 per cent per month.

Wage liberalisation

An excess-wage (Popiwek) tax was imposed on state enterprises in 1990, contributing to a yearly average 8.4 per cent decline in real wages in the enterprise sector from 1990-93. The excess wage tax was suspended in August 1994 and replaced for the remainder of that year with regulations linking wages to increases in the relevant enterprise's profitability.

Real wages in the enterprise increased in 1994 by 4.2 per cent. In January 1995, a new law on wage negotiations introduced a consensus approach under which negotiations between labour and management are guided by indicative norms set by a tripartite commission consisting of the government, employers and worker representatives.

Interest rate liberalisation

In January 1990, banks were permitted to set deposit and interest rates freely. The refinancing rate of the National Bank of Poland (NBP) on credits for central investments has been replaced by more market-oriented rates, such as Lombard rates (discounts of treasury bills) and re-discount rates (discounts of bills of exchange). Since 1992, the NBP has engaged in open market operations.

Financial institutions

Banking reform

The Banking Law (1989) and the NBP Act (1989) divided the banking system into two tiers. Between 1989-91, the commercial banking operations and branches of the nine regional departments of the NBP were transformed into independent commercial banks. Two of the nine large state-owned commercial

banks were privatised in late 1993 and in early 1994. In 1989, in addition to the nine commercial banks, four specialised state banks were in operation (two savings banks, a foreign trade bank and a bank for agriculture). Many new private banks were licensed in 1991-92 after enactment of the Banking Law.

Bank supervision is carried out by the NBP, through its General Inspectorate of Banking Supervision. Since 1992, the issuance of new banking licences has slowed substantially. The system of prudential regulation includes: a minimum 8 per cent risk-weighted capital ratio calculated substantially in accordance with international standards, monthly reporting of liquidity levels, classification of the quality of bank assets, provisions with respect to problem loans, and limits on foreign exchange positions. The Law on Financial Restructuring provided for the recapitalisation of seven of the nine state-owned commercial banks, one of the two state savings banks and the bank for agriculture. This recapitalisation was implemented in 1993 by issuing to the troubled banks state bonds 2.1 billion new zloty (1½ per cent of GDP).

A third state-owned commercial bank was privatised in early 1995. The 1994 Law on the Banking Deposit Guarantee Fund came into force in February 1995, providing a bank-funded scheme of deposit insurance for all commercial banks. It provides full coverage for deposits up to ECU 1,000 and 90 per cent coverage for deposits up to ECU 3,000. In the latter part of 1994, the second state savings banks was recapitalised with state bonds in the amount of 0.4 billion new zloty (0.2 per cent of GDP) and the agriculture bank received a second recapitalisation totalling 1.5 billion new zloty (0.7 per cent of GDP). At the end of 1994, after the recapitalisation, the agricultural bank still had negative net worth of 2.4 billion new zloty (1.1 per cent of GDP). The banking system remains small relative to the size of the economy. The ratio of broad money to GDP at the end of 1994 was 37 per cent. The banking sector also appears hesitant to increase its commercial lending.

Non-bank financial institutions

The 1991 Law on the Public Trading of Securities and Trust Funds permits the establishment of open-end investment funds and the first such fund was established in 1992. The 1990 Insurance Law established principles for authorisation of insurance companies, minimum capital and solvency criteria and rules for setting up a guarantee fund. In 1990, there were nine insurance companies operating in the domestic market. Two state-owned insurance companies dominated the market.

In May 1995, the securities commission authorised the establishment of three new open-end investment funds. At that time, there were also 40 insurance companies, 11 of which had majority foreign ownership.

Securities markets and instruments

The Warsaw Stock Exchange reopened in 1991. The Act Establishing the Warsaw Stock Exchange (1991) provided the basic legal framework for securities activities. The 1991 Law on Public Trading in Securities and Trust Funds (1991) regulates the public offerings of securities, the establishment of open-end investment funds, and the operations of securities brokers. Under that law, the Securities Commission is charged with supervising the securities markets and is equipped with enforcement powers. The number of listed companies rose from 9 in 1991 to 44 in 1994, market capitalisation rose from 0.2 per cent of GDP in 1991 to 3.5 per cent of GDP in 1994, and turnover values (for shares) rose from 0.04 per cent of GDP in 1991 to 11.1 per cent of GDP in 1994. Since 1991, short-term treasury bills have been issued with maturities ranging from one month to one year. Treasury bond maturities now range up to five years, with floating interest rates.

Fiscal and social safety net reform

Taxation

Recent years have seen a substantial overhaul of the tax system. A corporate profits tax with a uniform rate of 40 per cent was introduced in 1989; an unemployment insurance scheme financed by a 2 per cent payroll tax was initiated in 1990; a personal income tax with three marginal rates (20, 30 and 40 per cent) was launched in 1992; and a value added tax was introduced in 1993 with three rates (22, 7, and 0 per cent). The payroll tax to fund social security was raised in two steps to 45 per cent in 1992 from 38 per cent in 1989. In 1993, the payroll tax for the Labour Fund was raised to 3 per cent. Personal income tax rates were increased in 1994 (to 21, 33 and 45 per cent). As a result of these measures, the composition of government revenues has shifted dramatically. The share of levies on enterprises in total state budget revenues fell from 43 per cent in 1989 to 13 per cent in 1994. In 1994, the VAT and personal income tax accounted for 70 per cent of state revenues.

Social security

Outlays from the Social Insurance Fund and the Labour Fund have increased rapidly in recent years due to demographic trends, generous incentives for early retirement and rising unemployment. Their expenditures amounted to 16.0 per cent of GDP in 1994, up from 8.3 per cent in 1989. At the same time, transfers from the state budget to these funds have increased sharply. Pensions and benefits are indexed to wages.

In May 1995, the cabinet agreed on a proposal for pension reform, which has been circulated for public comment. Total expenditures of the main social funds in 1995 are expected to reach 16.6 per cent of GDP, while transfers from the state budget to these funds is projected at 14.5 per cent of total expenditures.

Reforms began in November 1990 with radical price liberalisation and the devolution of decision-making power to enterprises. Gradual further reform steps, including small-scale privatisation, import liberalisation, subsidy reduction and improvements in tax management, followed in 1991-92. Since mid-1993, a serious effort has been made to tighten the budget constraint facing enterprises and to improve efficiency in the allocation of credit and foreign exchange.

Enterprises

Size of the private sector

According to official estimates, the private sector has increased its share of GDP from 32 per cent in 1993 to 35 per cent in 1994 and accounts for approximately 51 per cent of total employment. In the first half of 1995, the private sector's share of value added in different sectors was estimated at 12 per cent for industry, 50 per cent for construction, 46 per cent for services, 69 per cent for domestic trade and 12 per cent for industry.

Large-scale privatisation

By mid-1995, more than 1,100 companies had been privatised, primarily through management/employee buy-outs.

In 1992, the National Agency for Privatisation designed a more comprehensive scheme for privatisation of medium-sized to large enterprises. The scheme involved the establishment of five "private ownership funds" and one "state ownership fund". The latter holds 70 per cent of the shares in 6,280 "commercial companies" while the rest are held in the five "private" funds which are themselves joint-stock companies.

A new Privatisation Law was passed on 21 March 1995. Under the new Law, Romanians will be able to purchase state assets using "certificates of ownership", distributed to 15.5 million individuals in 1992, and higher-value coupons. The distribution of coupons to adult Romanian citizens started in August 1995. The new privatisation framework foresees the sale through various means of about 3,900 medium-sized to large companies by the end of 1995. The privatisation programme is to be carried out in three stages: distribution of coupons (August and September), subscription for shares in enterprises on offer (15 September to 15 December) and the exchange of certificates of ownership and coupons for shares (15 December 1995 to 31 March 1996). After 1 April 1996 the coupons and certificates of ownership are to become invalid. Up to 60 per cent of the ownership in an individual company may be sold for coupons and certificates of ownership, with the remaining at least 40 per cent to be sold for cash. Prices of assets sold for certificates and coupons will not be determined through auctions or other market-clearing mechanisms but will be based on the enterprise book value.

Large-scale privatisation in the agricultural sector has advanced under the guidelines laid down in the Land Law of 1991, according to which 4.9 million Romanians are entitled to reclaim small plots from state holdings. More than 90 per cent of the new landowners have received "temporary property certificates". Conversion of these into formal land titles is

progressing gradually. The government expects to have converted 60 per cent of the ownership certificates into formal titles by the end of 1995.

Small-scale privatisation
More than 7,000 small units (shops, etc.) have been put up for sale and about 3,000 have been privatised, involving 13,500 employees. Some 83 per cent of all agricultural land is in private hands, following the break-up of large farms into small units (see the description of this break-up under "large-scale privatisation" above).

Property restitution
A new law on property restitution, passed by both houses of parliament in June 1995, was overruled by Romania's constitutional court in July 1995. This law would have granted restitution rights to former owners of around 250,000 residential properties that had been confiscated by the state in the post-war period.

Growth of private enterprise
The number of registered companies with private capital increased to 457,703 by June 1995, up by about 50 per cent on 1993. The number of family establishments which accounts for about 47 per cent of the total, increased in 1994 by 5 per cent.

Enterprise restructuring
The main restructuring tool has been subsidy reduction and attempts to introduce market-oriented credit policies. A renewed effort at strengthening financial discipline in enterprises was initiated in the second half of 1993 and is still being pursued. Credit policies have been tightened, a restructuring agency has been established (with EU-Phare support) and financial supervision has intensified for 25 enterprises that account for the bulk of inter-enterprise arrears.

A Bankruptcy Law was passed by parliament in March 1995 and is to become effective on 28 August 1995. The law will not apply to the largest state sector companies, the "regies autonomes", for which special bankruptcy legislation will be drafted later this year. Between 1991 and March 1995 (i.e. prior to the passage of the Bankruptcy Law) two state companies had been liquidated and about 30 had been declared insolvent under a 1991 law on the liquidation of businesses.

Markets and trade

Price liberalisation
Romania freed half of the prices in the consumer goods basket in November 1990. Price liberalisation picked up again in 1993 as consumer subsidies were phased out, mark-up limits were eliminated and the number of consumer goods under direct price control dropped to five. Prices for oil and other energy products remain subject to state control.

Competition policy
Romania does not at present have an anti-trust law.

Trade liberalisation
Most licensing requirements for export and import were eliminated in May 1992, leaving quantitative import restrictions only for a few products related to public health or security. There are no duties on exports, and the tariff treatment of imports is fairly liberal.

The full version of Romania's "European Agreement" with the EU came into force on 1 February 1995. An interim version had been in force since May 1993. The most important aspect of the agreement is the establishment over 10 years (from May 1993) of free trade in industrial goods between Romania and the EU. This part of the agreement has been fully operational under the interim arrangement. In June 1995, Romania applied formally for EU membership (see further details on the Europe Agreement in Chapter 11). Romania became a member of WTO in December 1994.

Currency convertibility and exchange rate regime
The leu is virtually fully convertible for the purpose of foreign trade transactions and for repatriation of capital and profits of foreign investors. In April 1994, the interbank foreign exchange rate was in principle unified with the rate quoted by the so-called "bureaux" (which cater for individuals). The gap between the two rates has occasionally over the past year broadened to up to 15 per cent but by mid-1995 the gap had narrowed to less than 5 per cent. The exchange rate of the leu is floating.

In August 1994 Romania launched an interbank foreign exchange market. Since July 1995 foreign banks with local branches have been able to operate as dealers on this market. Exposure is limited to US$ 1 million or the equivalent in local currency converted at the official rate.

Wage liberalisation
Collective bargaining is well established. The government pursues an incomes policy by taxing "excessive" wage increases.

In July 1995 a social agreement between the government, the employers' association and the trade unions on minimum wages was signed. In consultation with the social partners, the government will revise the gross minimum wage every six months.

Interest rate liberalisation
Commercial banks are free to set their interest rates. On 1 August 1994, an interbank money market was set up. In June 1995 the money market produced its first Bucharest Interbank Offered Rate.

Financial institutions

Banking reform
A two-tier banking system was created in December 1990 as the commercial functions of the National Bank of Romania (NBR) were spun off to the Romanian Commercial Bank (RCB). The banking system consists of 28 licensed banks, of which 20 have private and mixed – state and private – capital. In December 1994, private banks represented 30 per cent of the capitalisation in the banking sector. Five foreign banks have branches in Bucharest.

In 1991, the government bought from the banks 90 per cent of their non-performing claims, and then cancelled the loans, the total nominal value of which was 150 billion lei (6.8 per cent of 1991 GDP). The banks' balance sheets improved markedly between 1991 and 1994 on account of this recapitalisation, reinforced by another injection in 1992 of state capital in the amount of 50 billion lei (0.8 per cent of 1992 GDP) and large spreads between lending and deposit rates during much of this period. A July 1995 regulation by the NBR allows banks to make tax-deductable provisions for general credit risk.

Non-bank financial institutions
Romania's insurance market has 37 companies, most of which are private. The insurance sector is dominated by three state firms. Brokerage firms have emerged throughout Romania in anticipation of trading in the new stock market (see below) towards the end of 1995.

Securities markets and instruments
The National Bank of Romania issued the first treasury bills in March 1994.

A law establishing a public stock exchange was passed in July 1994 and at the end of the year the parliament appointed the National Securities Commission (NSC). The new stock exchange officially opened on 23 June 1995 and is scheduled to begin trading late in the year. The NSC, which will regulate the market, has licensed 25 securities companies to operate on the exchange.

Fiscal and social safety net reform

Taxation
Substantial tax reforms have been implemented. Personal income is taxed on a progressive schedule (in 1994 at rates from 5 per cent to 60 per cent). The value added tax is levied at a flat 18 per cent. On 1 January 1995 the rate was reduced to 9 per cent for some foodstuffs and medicines.

Fundamental changes to the profit tax system were introduced on 1 January 1995. A single rate corporate profit tax of 38 per cent replaced the dual-rate tax to which companies were liable and is applicable to all permanently established legal entities, including limited-liability and joint-stock companies with foreign investment. The standard rate of VAT is 18 per cent.

Social security
Romania's social security system is financed in part through a payroll tax (in 1994, the employers' contributions amounted to 32.5 per cent of the wage sum; employees paid an additional 1 per cent of the wage sum).

Russian Federation

Partial reforms were introduced in 1987-91 in the framework of perestroika. A radical reform package focusing on economic liberalisation and privatisation was adopted in January 1992. Considerable progress has been made on a wide range of structural reforms but very uneven advance has been achieved in financial stabilisation. In 1995, a comprehensive stabilisation programme was launched with the assistance of an IMF Stand-by Agreement.

Enterprises

Size of the private sector

According to official sources, the non-state sector, including all corporatised enterprises, irrespective of the share of state ownership, accounted for 62 per cent of GDP and 51 per cent of employment as of end-1994. In getting from these data to an estimate of the private sector share of GDP, two important factors need to be taken into account. One is that the non-state sector, as opposed to the private sector, includes companies with majority state ownership. The other is that the official data for GDP and for non-state activity are likely to capture only a part of the activity in the private sector (see Annex 11.1). Taking these factors into account, the private sector is likely to account for about half of Russia's GDP.

Large-scale privatisation

By July 1994, 15,052 medium and large-scale enterprises, employing more than 80 per cent of the industrial workforce, had been privatised in a voucher-based privatisation scheme. A proposed framework for the second (post-voucher) cash-based phase of privatisation was finally launched by presidential decree in July 1994 after having twice been rejected by parliament. The implementation of the programme came to a practical halt in late 1994. The programme is now being redesigned and is to be fully reactivated from September 1995. State shares in 140 key enterprises are to be sold before the end of the year. However, the original target to raise over Rb 9,000 billion in privatisation revenue in 1995 is likely to missed by a wide margin. Government blocks of shares will be sold primarily to strategic investors. For 3,054 "strategic enterprises", including mainly large-energy, defence utility companies, majority state ownership is to be retained for at least two to three years.

Enterprises are to receive 14 per cent of cash privatisation revenues while the rest will be shared between federal and local governments. In the second stage of privatisation, enterprises will be able to buy the land and buildings with which they are associated. Voucher-privatisation has so far in Russia favoured management and employees and has resulted in a predominance of insider ownership. According to estimates based on recent surveys, 43 per cent of shares (including 20 per cent of non-voting shares) in privatised companies are owned by workers, 17 per cent by management and 11 per cent by the state, while 29 per cent is dispersed among outsiders, primarily investment funds, foreigners and domestic individual investors. Since workers and to some extent even the state are typically passive in exercising their ownership rights, enterprise management often enjoys effective control of the enterprises.

Farm privatisation has made limited progress so far. More than 80 per cent of the agricultural land is owned by large farms with some form of collective ownership (re-registered state and collective farms, joint-stock companies and partnerships) and 11 per cent remains state property. Only around 7 per cent is in the hands of private peasant farmers or urban dwellers with small household plots. Although members of the agricultural collective are entitled formally to opt out of the collective and take their share of land with them, this is in reality done only in very rare cases. The Nizhny Novgorod model of decollectivisation has not become a widespread practice, despite a government resolution to this effect in late 1993. Property rights over agricultural land remain subject to heavy restrictions. The current version of the Land Code recently adopted by the State Duma in its first reading retains most of these restrictions.

Small-scale privatisation

By mid-1995 more than 100,000 state-owned small-scale businesses (with less than 200 employees), had been transferred into private hands. The overwhelming part of the privatised businesses were in the retail trade, public catering and consumer services sectors, where private entities account for 80 per cent of activity. Progress in small-scale privatisation varies heavily across geographical regions. Small firms have been sold primarily through employee buy-outs or public auctions.

The number of private farms increased modestly during 1994, from 270,000 to 279,000. About 40 per cent of the housing stock was already in either private or cooperative ownership at the end of the Soviet period. Since Russian independence between 30-35 per cent of the remaining state-owned housing stock has been privatised. However, the system of housing maintenance and provision of utilities is still largely unreformed.

Property restitution

No property restitution to former owners has yet taken place.

Growth of private enterprise

There are around one million registered small businesses. Estimates suggest that an additional two to three million small businesses exist but most remain unrecorded. Macroeconomic and legal uncertainties, obstacles to registration and licensing, lack of access to external finance and commercial space as well as extortion threats are among the key obstacles. The government offers a two-year tax holiday for small enterprises. A new federal programme for support of small businesses in 1996-97 was recently adopted, with priority attached to small farms and conversion of military enterprises.

In mid-1995 the number of joint ventures and foreign companies amounted to approximately 16,000, of which less than half were operational.

Enterprise restructuring

Drastic cuts in federal financial transfers to the enterprise sector, from 31.6 per cent of GDP in 1992 to less than 5 per cent in 1994, have been partly offset by subsidies from local governments, widening tax exemptions and enterprise arrears. Nevertheless, there can be little doubt that enterprise financial discipline has strengthened substantially since 1992, especially following the tightening of fiscal and monetary policy in early 1995. The main beneficiaries of subsidies continue to be the agricultural and coal sectors and the largest enterprises in machine building, defence, chemical and metallurgical sectors.

A Bankruptcy Law became effective in March 1993. So far less than 300 bankruptcy cases have been taken to the arbitration courts. No case has been completed. A Federal Bankruptcy Agency was established in September 1993 to deal with insolvency/bankruptcy for enterprises in which the state holds more than 25 per cent of the shares. To date about 1,400 companies have been put on the Agency's insolvency register and a few hundred of these are scheduled for liquidation. Despite limited implementation of the law so far, the threat of bankruptcy appears now to be influencing enterprise behaviour.

Enterprise restructuring has consisted of changes in the product mix, reductions in working hours, sending workers on unpaid leave, divesting enterprise assets and reducing obvious sources of wastage.

Markets and trade

Price liberalisation

In early 1992, about 80 per cent of wholesale prices and 90 per cent of retail prices were freed from federal administrative controls. Only basic necessities and a restricted list of producer goods and services remained subject to federal price controls. However, widespread direct and indirect price controls as well as price and profitability ceilings for monopolies continued to be applied at local level. At the beginning of 1995 such controls covered approximately a third of all prices.

A presidential decree from March 1995 envisages the removal of all price regulations, both federal and local, for all goods and services except for those related to natural or state monopolies. The implementation of the decree will decrease the share of controlled prices to 16-17 per cent. Domestic oil product prices are liberalised and in mid-1995 stood at about 70 per cent of the world price levels. Gas prices are still administered and have been approaching world market levels much more slowly than prices for oil.

Competition policy

The Law on Competition and Limitation of Monopolistic Activity in the Goods Market was adopted in March 1991. Pro-competition policies have remained largely ineffective so far. A register of dominant firms was established in 1992; at the outset it listed more than 2,000 enterprises. A monopoly was defined in the register as an enterprise with market share of at least 35 per cent.

Enterprises that are on the monopoly register need the approval of GKAP (the anti-monopoly agency) to privatise. Mergers are also subject to prior approval. In 1994, GKAP refused privatisation of 400 enterprises, which dominated their respective markets. The Duma adopted a Law on Natural Monopolies in mid-1995 but it was returned by the President for revisions.

Anti-trust activities have focused until recently on price and profitability controls for monopolies and controls on concentration of ownership during the privatisation process.

Trade liberalisation

Imports were basically freed from administrative controls in 1992. A comprehensive system of import subsidies was phased out in late 1993. The export regime was substantially liberalised in the first half of 1994 as the scope of the export quota and licensing system was sharply reduced and export taxes were cut. The export quota system was completely scrapped with the elimination of quotas on energy products in early 1995. Export taxes are to be phased out by the end of 1995.

Import tariffs were very low in 1992-93. Sharp increases in July 1994 and July 1995 raised the average weighted tariff level to 12.7 per cent. However, a cap of 30 per cent is being introduced to individual tariffs. The government has committed itself to

reduce gradually the degree of import protection as part of its pledge to comply with WTO rules.

Intra-CIS trade remains subject to various administrative controls. Russia has signed an agreement with Belarus and Kazakstan on the creation of a customs union.

Currency convertibility and exchange rate regime

The exchange rate was unified in mid-1992 and the rouble has been floating since then (it is now traded in daily auctions). The rouble is convertible for current account purposes, including for profit repatriation by foreign investors. Many elements of capital account convertibility are *de facto* also in place. Foreign exchange earnings are subject to a 50 per cent export surrender requirement at the market exchange rate. In January 1994 the use of foreign currencies for cash transactions within Russia was prohibited.

The exchange rate is currently pegged within a band of 4,300-4,900 roubles per dollar.

Wage liberalisation

A tax-based incomes policy applies to both state and non-state enterprises. The key instrument of this policy is a tax on the excess of the enterprise average wage level over a certain multiple (currently six times) of the official minimum wage. This tax is, however, scheduled to be abolished in 1996. Public sector wages are also set as multiples of the nominal minimum wage. The minimum wage stood in August 1995 at 55,000 roubles (US$ 12). The average monthly wage was about 480,000 roubles (approximately US$ 105) in June 1995.

Interest rate liberalisation

Interest rates have been liberalised. Since July 1993 the refinance rate has closely followed the benchmark interbank market rate. Real interest rates on credits have been positive since October 1993 with the exception of the November 1994 to January 1995 period (based on a comparison between the interest rates during particular months and the realised inflation rates for the same months).

Financial institutions

Banking reform

A two-tier banking system was created in 1987 as part of the perestroika reforms. Russian laws on the central bank and commercial banking activities were adopted in December 1991. Due to very liberal prudential regulations and weak supervision the number of commercial banks has increased sharply. On 1 June 1995 there were 2,561 commercial banks (either spin-offs of former sectoral banks or new banks) out of which 1,050 had a charter capital of less than Rb 500 million. The minimum capital requirement is to be raised gradually to reach ECU 5 million in 1999 (this target is specifically defined in terms of ECU rather than roubles). Existing banks were to reach a capital level of Rb 2 billion by early 1995. In 1995, minimal reserve requirement for rouble accounts were significantly increased. Banking supervision was tightened: in the first half of 1995, 71 banks had their licence withdrawn, compared with 65 in 1994 and 19 in 1993. A World Bank and EBRD supported reform programme aims to create a core select group of banks that would be capable of complying with international prudential standards and which would in return become eligible for certain privileges.

Tight restrictions were imposed on foreign banks in November 1993 but were subsequently eased. The aggregate capital of foreign-owned banks in Russia must not exceed 12 per cent of the total capital of the Russian banking system by June 1999. In early 1995, there were 17 foreign banks which accounted for 7 per cent of the total capital of banks in Russia.

A new draft law on banking and banking activities, providing among other things for stricter banking regulations, was passed by the parliament in mid-1995 and is likely to enter into force in autumn 1995.

Non-bank financial institutions

Following the enactment of enabling legislation in 1992, about 650 investment funds have been created. Such funds played an intermediary role in the voucher privatisation scheme by collecting vouchers and investing them in enterprise shares. Subsequently some of the financial companies, including pyramid schemes (such as MMM), have collapsed prompting a renewed push for basic regulation. In mid-1995 a new legal framework for mutual funds was launched.

The legal basis for insurance activities was established in 1992 and is scheduled to be amended in late 1995. There are around 2,700 insurance companies but only 20-30 of these are adequately capitalised. The two main state insurance companies have gradually lost their leading position in the market. Foreigners are not allowed to hold majority stakes in insurance companies. There are about 600 private pension funds. Financial leasing activities are regulated by presidential decree from September 1994 and an ensuing government resolution from mid-1995. A draft law "On Leasing" covering both financial and operative leasing as well as registration issues for leased properties has been submitted to parliament.

Securities markets and instruments

In an almost unregulated environment the securities markets have developed spectacularly in terms of volume, market participants, the available range of instruments and sophistication. There are about 70 authorised stock exchanges (and 100 commodity exchanges with stock exchange departments). Government bonds of different maturity, gold certificates, hard currency bonds, corporate and municipal bonds, currency futures and corporate and bank shares, along with other securities, are traded in increasing volumes. So far the dominating instrument has been the three-month T-bill launched in May 1993 with more than 60 auctions to its name so far. Securities markets are still fragmented both geographically and among financial instruments.

The equity market started to develop in earnest following voucher privatisation. There is a liquid market for about 50 company shares. About 90 per cent of the transactions are carried out on the OTC market. Share prices are very volatile (equity prices, which more than halved between September 1994 and February 1995, had recovered strongly by July). Market capitalisation, based on an index covering roughly the 200 most actively traded firms, stood at US$ 22 billion in June. Russian investors as well as international investment banks and funds are increasingly active in the market, which was originally dominated by Western hedge funds. Risks and transaction costs are unusually high, partly reflecting the still rudimentary market infrastructure. In terms of share registration and custodial and settlement services, qualitative changes are under way. Drafts of a fully-fledged securities law and of a law "On Joint Stock Companies" were adopted in principle by the parliament in mid-1995 but will be signed into law only after some revisions.

Fiscal and social safety net reform

Taxation

The first key departure from the traditional Soviet fiscal system was the replacement of the administrative centralisation of enterprise with a normative enterprise tax system during the perestroika period. Principal further tax reforms took place in 1991-92, including the introduction of a value added tax (VAT) and excise taxes, the creation of the legal base for a market-based tax system. Since then tax regulation has been introduced in an *ad hoc* fashion, regulatory changes are frequent, while tax exemptions, avoidance and arrears are widespread. The tax base has been eroded as a result of sharp output falls and a shift of economy activity toward the informal sector.

Taxes are charged at the federal, regional and local levels. Revenue shares and expenditure assignments between the different levels of government are still not clearly defined. The main (total) tax rates were as follows in mid-1995: enterprise profit tax 35 per cent, VAT 21.5 per cent and personal income tax 12-30 per cent. The share of profit tax accounts in total tax revenues is three to seven times higher in Russia than in western Europe. Taxation of personal income and natural resources is low in international comparison. The profit tax burden is bloated by a combination of high inflation, a pre-payment obligation and the specific features of the Russian accounting system.

Social security

The social safety net is financed mainly through a range of extra-budgetary funds (the Pension fund, the Employment fund, the Social insurance fund and the Social support fund), local budgets and heavy enterprise expenditures on social services. The extra-budgetary funds are financed by payroll taxes totalling 40 per cent of the wage bill.

Slovak Republic

After the Velvet Revolution in the Czech and Slovak Federal Republic (CSFR) in November 1989, a market-oriented reform process was initiated during 1990 and a comprehensive programme was adopted in January 1991. Following rapid privatisation in 1992-93, further progress on privatisation has, however, slowed, especially following the recent decision to cancel the second round of voucher privatisation.

Enterprises

Size of the private sector

The private sector is officially estimated to have accounted for 58 per cent of GDP in 1994. Official estimates indicate that the private sector in May 1995 accounted for 62 per cent of industrial output and 80 per cent of construction activity (compared with 57 per cent and 74 per cent respectively in 1994). On the basis of these figures, the private sector may have accounted for about 60-65 per cent of GDP by mid-1995.

Large-scale privatisation

A comprehensive sell-off of state assets has been pursued through two "privatisation waves". The first of these was launched by the CSFR in May 1992 and completed by mid-1993. In the Slovak Republic it involved 750 enterprises with book value of SKK 166 billion (SKK denotes the Slovak crown). In this process, SKK 80 billion worth of shares in 503 firms were distributed through a voucher-based "mass privatisation" scheme which created 8.5 million shareholders in the Czech and Slovak Republics. The balance of the assets were sold by standard methods including direct sales and public tenders.

The second wave of privatisation commenced with the distribution of vouchers in September 1994, but was then delayed by the change of government towards the end of 1994 and by an internal debate over the most appropriate method of privatisation. In mid-1995 the government approved amendments to the 1991 Privatisation Law which cancelled the second wave. Amendments were also made to the laws regarding investment funds, and parliament adopted a law concerning state interests in enterprises. Parliament approved these three laws in early September, following a presidential veto.

Under the new legislation, the 3.5 million voucher holders will each be entitled to receive 5-year bonds with a nominal value of SKK 10,000, to be issued (and guaranteed) by the National Property Fund (NPF). Bond holders may hold the bonds until maturity, or use them for a number of defined purposes, including the purchase of shares in privatised companies in which they are employed or the purchase of shares from assets in the NPF portfolio. The immediate effect of the cancellation of the second wave of voucher privatisation is that most of the assets to be privatised in the future will be via direct sales, including management and employee buy-outs.

The law relating to state interests identifies over 20 companies which will not be privatised (mainly in gas and electricity generation, telecommunications, armaments and agriculture). It also lists a further 40 companies, some of which have already been partially privatised, and which are defined as "strategically important" (mainly in mining, chemicals, construction, engineering and the agricultural sectors). The state will retain ownership in these and enjoy special voting rights.

Small-scale privatisation

The sale of small state-owned enterprises was largely completed during the first round of privatisation in 1992, with approximately 10,000 enterprises auctioned off.

Property restitution

A restitution law was adopted by the CSFR in October 1990. About 30,000 industrial and administrative buildings, forests and agricultural plots, which had been nationalised during 1948-55, as well as 70,000 commercial and residential entities nationalised during 1955-59, have been handed back to the original owners. A further law on restitution covering former church property was adopted in the Slovak Republic in October 1993.

A restitution fund was established by the NPF in 1993 to provide financial compensation to those whose claims could not be met by the return of property. The fund usually receives 3 per cent of each privatised company and currently has stakes in some 500 companies with a market value of over SKK 2 billion. Revenues (estimated at SKK 500 million in 1995) from sales of shares and dividends are used to meet claims.

Growth of private enterprise

The number of profit-making institutions rose from 34,200 in October 1994 to almost 40,200 in mid-1995. Over 95 per cent of these are private sector companies.

Enterprise restructuring

The main restructuring tools have been indirect: privatisation and tight access to credit and subsidies for enterprises. Restructuring has essentially been left to the new private owners. The initial Law on Bankruptcy was passed in August 1991 with virtually no possibility of external creditors forcing companies into bankruptcy. The current law became effective in June 1993, allowing creditors to bring bankruptcy cases to court after a three-month protective period.

At mid-1995 there were almost 1,100 proposals for liquidation under the Act; 53 companies had been put into liquidation and there had been one out of court settlement.

Markets and trade

Price liberalisation

In January 1991, 85 per cent of consumer prices were decontrolled. The only remaining significant controls pertained to utility charges, rents and public services. In addition, mark-ups were closely regulated in the energy sector. It is now estimated that less than 10 per cent of prices are regulated, mainly utility tariffs, oil and certain chemical products.

Competition policy

A competition law was passed in 1991 and amended in October 1993 to bring it close to consistency with EU legislation. The European Commission's "White Paper" on Accession to the EU will necessitate changes to the legislation in this area to conform to EU directives. There is a liberal legal and regulatory environment for foreign investors, with no restrictions on repatriation of profits and invested capital.

Trade liberalisation

Almost complete liberalisation of quantitative controls on imports and exports was undertaken in 1991. The average import tariff is 6 per cent. A 10 per cent import surcharge on consumer goods was introduced in March 1994. Export licences are required only for certain natural resources. The government has indicated it is likely to lower the import surcharge from the beginning of 1996 if the balance of payments develops satisfactorily. The bilateral Payments Agreement for trade with the Czech Republic is likely to cease to be effective in October 1995.

On 1 February 1995, the interim version of the Slovak Republic's "Europe Agreement" was converted into the fully-fledged version (see details in Chapter 11). The Slovak Republic became a member of WTO in December 1994.

Currency convertibility and exchange rate regime

Current account convertibility for enterprises was introduced in January 1991. Some restrictions on capital remain. The exchange rate is pegged to a basket in which the Deutschmark has a weight of 60 per cent and the US dollar a weight of 40 per cent.

The draft of a new foreign exchange law was approved by parliament, valid from 1 October 1995, which will enable the Slovak Republic to move further towards full current account convertibility.

Wage liberalisation

A tax on "excessive increases" was imposed during 1991, with agreement from unions, to regulate the rise in real wages. The tax expired at the end of 1992. Remaining selective controls on wages were abolished in late 1994.

Interest rate liberalisation

Interest rates were freed progressively from 1990 onwards, with complete liberalisation in April 1992. In mid-1995 the discount rate, at 11 per cent, was close to the rate of inflation, with lending rates positive in real terms.

Financial institutions

Banking reform

A two-tiered banking system was adopted in January 1990. Laws on the central bank and commercial banks were passed in February 1992. With the split of the CSFR, the National Bank of Slovakia (NBS) was established in January 1993 as the Slovak successor to the former State Bank of Czechoslovakia. At the end of 1993, 20 banks, including seven foreign bank branches and representative offices, were operating in the Slovak Republic.

The regulatory regime sets the required capital adequacy (following the Basle definition) at 6.25 per cent by the end of 1993 and 8 per cent by the end of 1996. During the CSFR-period, a state-owned Consolidation Bank was established in March 1991 to take over Kcs 110 billion (20 per cent of credits to enterprises) of "permanent revolving credits" (perpetual loans characterised by low interest rates and issued for inventory financing). Further state-financed recapitalisation of the banks totalling Kcs 50 billion was conducted in November 1991 (these recapitalisation figures cover CSFR as a whole).

At the end of March 1995, 30 banks (including the NBS) were licensed to operate, with over SKK 24 billion of equity capital, employing over 21,000 staff. Of these banks, 28 were operational, including 10 with foreign participation and a further 9 which are branches of foreign (mainly Czech) banks and two which remain state-owned.

The policy of the NBS over the last year has been to strengthen the banking sector through a tougher licensing policy and a strengthening of supervisory capability. Non-performing loans, however, remain a source of concern. To assist with the restructuring of banks' balance sheets, the NBS approved regulation with effect from July 1995 that banks should adopt five categories of accounts receivable, based on a financial analysis of the debtors, and make provisions against each category. Some banks have strength-

ened their own position by maintaining relatively large spreads, thus increasing retained earnings. According to the National Bank, the average interest margin was 5.16 per cent at the end of 1994, 0.6 per cent below the level at the beginning of 1994.

Non-bank financial institutions

At the beginning of 1995 about 160 investment funds were in operation, the majority dating from the first round of coupon privatisation. The shares of the funds are traded on the stock market and represent an important part of the total trade on the exchange. The future of some of the funds is now in doubt following the government's decision to cancel the second round of coupon privatisation as some funds have incurred financial losses owing to preparations for the second round. In addition, the amendments to the Investment Funds Act will limit the funds' role as owners of enterprises.

Securities markets and instruments

The Bratislava Stock Exchange, the RM-system (an over-the-counter exchange) and the Bratislava Options Exchange began operations during the first half of 1993. In March 1994, nine companies were listed on the stock exchange. The RM-system trades in nearly 600 companies distributed under the voucher privatisation scheme. Foreigners are free to participate in the market for shares; profit repatriation is subject to payment of income taxes on capital gains.

Because the markets are fragmented and lack liquidity, it is estimated that over 80 per cent of all trades are over the counter. Parliament has adopted amendments to the Securities Law which will provide for the establishment of an independent regulatory body to protect investors rights; it will centralise trading on the official market with the requirement that all trades be registered, published and completed at prices set by the exchange, thus promoting greater transparency. It will also increase the minimum capital requirements for brokers.

Fiscal and social safety net reform

Taxation

A comprehensive tax reform was implemented in January 1993, introducing a value added tax (VAT) in two tiers at 23 per cent and 5 per cent, streamlining corporate and individual income taxes, and transferring funding for social security from general taxation to an insurance-based system. In July 1993, the VAT rates were raised to 25 per cent and 6 per cent. Further revisions in January 1994 reduced the corporate tax rate from 45 per cent to 40 per cent, and the maximum personal income tax rate from 47 per cent to 42 per cent.

Social security

Employers and employees contribute 38 per cent and 12 per cent respectively of the employees' gross income for health and social security contributions. Legislation is currently under preparation to improve the targeting of social benefits.

Enterprises

Size of the private sector

According to official estimates, the private sector accounted for almost 20 per cent of GDP (and employment) in 1993. This ratio is likely to have risen since then to more than one third.

Large-scale privatisation

By mid-1995, 215 enterprises had been formally privatised; another 478 had obtained ministerial approval for their privatisation plan but were awaiting court approval. The programme is expected to be completed by the end of 1995. Privatisation of the "socially owned" enterprises is governed by a law passed in December 1992. The government's objective is to privatise 1,549 of such companies before the end of 1995. The first step of the privatisation process, i.e. the preparation of an "opening balance sheet" and submission of privatisation plans to the Agency for Restructuring and Privatisation, was completed by 1,359 companies within the deadline of 31 December 1994. Their sale will, in part, take place through mass privatisation in support of which "ownership certificates" have been issued to all Slovene nationals. The value of each ownership certificate is linked to the age of the citizen. The certificates can either be exchanged for shares directly in enterprises or for shares in the Investment Funds.

A maximum of 20 per cent of the shares in each company can be distributed to employees. A further 40 per cent of the shares will be transferred to three funds: 20 per cent to the Development Fund, 10 per cent to the Pension Fund and 10 per cent to a fund which will compensate individuals for previous nationalisations.

Banks, insurance companies and public utilities will remain majority state-run in the short-term.

Small-scale privatisation

Almost all small-scale trade and service activity is in the hands of the private sector. Extensive small-scale private activity existed under former Yugoslav law.

Property restitution

Under the 1993 Law on Denationalisation, land and buildings can be returned to former owners. A compensation fund is being recapitalised with shares in privatised companies. (See the comments on large-scale privatisation above.)

Growth of private enterprise

In mid-1995, there were 56,000 private companies in Slovenia (40 per cent up on 1993) employing about 90,000 people.

Enterprise restructuring

Substantial action has been taken to break up large "socially managed" enterprises into smaller units. Slovenia's law on bankruptcy and liquidation was approved in 1989 and is being enforced.

In November 1994 a law was passed to regulate the privatisation of companies rehabilitated by the Slovenian Development Fund (SKLAD). The fund, which has held some 100 companies in its portfolio, is restructuring enterprises in preparation for their privatisation. The current fund portfolio totals 53 companies. The remainder of the 100 companies have been privatised.

Markets and trade

Commodity price liberalisation

Price liberalisation was almost complete by mid-1994. In the first half of 1995, the regulated energy price was raised by 15 per cent and telephone charges by 26 per cent. Electricity prices cover all operating costs plus approximately 60 per cent of the depreciation element. Natural gas prices are close to EU levels.

Slovenia

A comprehensive reform programme was adopted in 1990 after independence. Liberalisation of prices and trade, extensive restructuring of industry and banking reform have taken place, alongside successful macroeconomic stabilisation. Comprehensive mass privatisation is proceeding according to schedule.

Competition policy

During the first half of 1995 the anti-monopoly commission, the Office for the Protection of Competition (OPC) conducted a cartel investigation of the agreement among Slovene banks to set a maximum deposit rate. A government decree imposed during the summer 1994 authorises OPC to handle complaints by Slovene companies about dumping and subsidised imports.

Trade liberalisation

By end-1994, 98 per cent of imports were free from quantitative restrictions. The government is committed to further liberalisation and to the elimination of all non-tariff barriers. Slovenia became a full member of GATT in September 1994. In June 1995 a "Europe Agreement" for Slovenia was initialled, setting out terms of associate membership of the EU (see Chapter 11 for details). Slovenia is expected in the near future to become a member of the Central European Free Trade Agreement (also involving the Czech Republic, Hungary, Poland and the Slovak Republic).

Currency convertibility and exchange rate regime

The national currency, the tolar, was introduced in October 1991 and is fully convertible for current account transaction. The exchange rate is floating although interest rate policy kept the rate *vis-à-vis* the Deutschmark within a narrow band during the first 8 months of 1995. Every foreign currency loan to a Slovene beneficiary of a duration less than five years requires an interest-free deposit with the central bank of 40 per cent of the loan amount.

Wage liberalisation

In an attempt to control wage increases, a law was passed in April 1994 levying a 50 per cent tax on wages above a defined level. In practice both this and previous attempts to control wages through legislation and taxation have met with limited success. In May 1995 trade unions and the Chamber of Commerce (with the latter representing employers) signed a new Wages Agreement, according to which wages will be indexed imperfectly to inflation. The Agreement also specifies both a maximum and a minimum wage.

Interest rate liberalisation

Commercial banks are free to set their deposit and lending rates. Since the establishment of the national currency, rates have been highly positive in real terms.

The government is gradually phasing in a regulation that will reduce the role of backward-looking inflation rates in the setting of interest rates (the convention has hitherto been to quote interest rates in "real" terms). In February 1995 all 34 banks signed an agreement to cap interest rates on savings indefinitely. This agreement is under investigation by the anti-monopoly authorities.

Tajikistan

A comprehensive economic reform programme has not yet been adopted. Due to civil war, reform measures have been limited in scope. The authorities are currently working on the formulation of a reform programme. Tajikistan introduced an independent national currency, the Tajik rouble, in May 1995 (the last republic of the former Soviet Union to do so).

Financial institutions

Banking reform

A national two-tiered banking system was introduced in 1991. The Bank of Slovenia became the central bank responsible for monetary policy, exchange rate management and the regulation of commercial banks. To reduce the dominance of the largest bank, Ljubjanska Banka (LB), the government carved out separate banks from some of LB's subsidiaries. There are 34 banks in total; the two largest are state-owned. In 1993 a state agency recapitalised two state-owned banks by swapping state bonds (in an amount equivalent to 6 per cent of GDP) for bad loans.

The government intends to present a law on privatisation of banks to parliament in October 1995, but privatisation of the largest two state-banks is not expected before 1997. Since September 1994 all banks have satisfied the minimum capital adequacy requirement, which was raised from 6.25 per cent to 8 per cent in August 1994. Bank supervision is well developed.

Non-bank financial institutions

About 20 licensed management companies have set up investment funds that will invest "ownership certificates" on behalf of citizens (see the comments on large-scale privatisation above). The funds can participate in auctions organised by the Slovenian Development Fund where shares of privatised companies are sold for cash or ownership certificates.

In September 1994 parliament passed a law regulating insurance companies, in accordance with directives about the level of capital at risk.

Securities markets and instruments

Securities markets are regulated by the Law on Securities (1989 and 1990), the Law on Money Market and Capital Market, and the New Securities Market Act of 1994. The Ljubljana Stock Exchange was founded in December 1989. A total of 34 securities are listed, and 57 members are registered for trading. Government, municipal and enterprise bonds are traded.

A law on financial operations with foreign entities (which will provide the regulation of dematerialisation and foreign investment) and a take-over law are expected later in the year. Within this framework, many privatised companies appear to be waiting for these laws to be passed before going public. The government has extended the deadline for investment of ownership certificates (see comments on large-scale privatisation above) from 30 June 1995 to end-1995 to accommodate privatisations planned for later this year. In January 1995 an over-the-counter market was opened on the Ljubljana Stock Exchange, with eight companies acting as brokers. The Ljubljana Commodities Exchange is planning to start futures trading by end of 1995.

Fiscal and social safety net reform

Taxation

Following a comprehensive reform of tax legislation in 1990-93, corporate profits are taxed at a rate of 20 per cent; and personal incomes at a maximum marginal rate of 50 per cent. There is a sales tax of 20 per cent for goods and 5 per cent for services. Dividends are taxed at a 25 per cent rate for residents and 15 per cent for non-residents.

Social security

The Slovene pension system was partially reformed in 1992. Social security contributions by employers and employees are contributed at a rate of 22.9 and 22.4 per cent respectively of the gross wage. The share of expenditures for pensions in GDP is growing and in 1994 amounted to 14 per cent.

Enterprises

Size of the private sector

The share of the private sector in GDP is likely to be about 10-20 per cent.

Large-scale privatisation

A Law on De-statisation and Privatisation of Property was adopted in February 1991. Privatisation methods include lease (with or without option to buy), creation of joint-stock companies, employee buy-outs and free transfer of state property. The privatisation process, which initially proceeded rapidly, slowed down considerably after the civil war broke out in 1992 and little progress has been achieved since then. Among the enterprises that are subject to the privatisation law, 159 (out of 1,304) had been privatised by mid-1995. Privatisation has mainly taken the form of ownership transfers to labour collectives or leasing arrangements.

Small-scale privatisation

About 600 small-scale enterprises were privatised in the 1991-92 privatisation programme. As of May 1995, 1,156 small such enterprises (less than 7 per cent of total number of enterprises) had been privatised at the local level. Both employee buy-outs and sales to outsiders were used; the latter method was applied mainly to enterprises in the trade and services sectors. A further 675 enterprises are to be privatised by the end of 1995. Private ownership of (agricultural) land is not envisaged; land may be assigned to agricultural collectives or joint-stock companies without the right of resale or it may be leased to farmers on a long-term basis. By October 1993, more than 50 per cent of all dwellings had been privatised. Significant progress has been made in the privatisation of housing.

In agriculture, 6 per cent of cultivated land, which accounted to estimated 30 per cent of total agricultural production, had been leased to private farmers by 1994.

Property restitution

There has been no property restitution to pre-communism owners in Tajikistan.

Growth of private enterprise

Obstacles to the growth of the private sector include difficult entry and exit rules, lack of finance, limited access to business information, strict labour regulations and an incomplete legal framework.

Enterprise restructuring

As with privatisation, enterprise restructuring began in 1991 but stalled as a result of the war and political instability and has yet to gain momentum. A Law on Bankruptcy was passed in June 1992 but few companies have been forced into bankruptcy. The 1995 decree on "The identification of Bankrupt Enterprises" represents an effort to speed up rehabilitation and restructuring of inefficient enterprises.

The number of people on compulsory unpaid leave or shortened working hours increased fivefold in 1994; and huge stocks of inter-enterprise arrears were accumulated.

Markets and trade

Price liberalisation

In January 1992 the government lifted price controls on 80 per cent of all goods. However, in 1993 some price controls were reintroduced. Prices in industry were regulated under the monopoly law, and 17 basic consumer items (including bread, milk, rents and public transport) were controlled by executive order. In 1995, some of these price controls have been eased. Being unable to solve bread-shortage crises, the Tajik government freed bread prices from 20 August 1995.

Competition policy

Major sectors of the economy remain highly concentrated, often with only one state-owned supplier in a given market segment. A new anti-monopoly law is being drafted.

Trade liberalisation

A command system, based on state orders, quotas, export licences and centralised trading, dominates production and trade. Until October 1993, export licences were classified into 33 categories and were subject to 10 different rates of surrender requirement, ranging from 32 per cent to 100 per cent of export proceeds. In November 1993 a new decree unified the different surrender requirements at 30 per cent of export proceeds for those exports that were not traded by the general contractors. Customs duties range from 5 per cent to 100 per cent of the rouble value of imports.

According to a Presidential Decree of 27 June 1995, quotas and licences for exporting of all goods except cotton fibre and aluminium were to be abolished from 1 July. Since the beginning of 1995, all cotton produced must be sold to the Directorate for Cotton-Processing Industry, which, according to Presidential Decree, will be paid for at international prices. However, the government plans to remove the state monopoly on cotton from the beginning of 1996.

Foreign trade is mainly based on barter agreements, with the exception of cotton and aluminium, which are traded for hard currency.

Currency convertibility and exchange rate regime

Until recently, the Russian rouble remained the official currency.

On 10 May 1995 (the last republic in the former Soviet Union to do so), Tajikistan introduced its independent national currency, the Tajik rouble, with a flexible exchange rate regime (the currency exchange started to operate in mid-May 1995). In practice the government and the central bank control major foreign exchange transactions in order to channel resources to priority sectors. Capital transactions require licensing by the central bank, but there are no restrictions on the repatriation of profit and capital by foreigners.

Wage liberalisation

Wages remain largely determined or by norms set by the government via the Law on Wage Indexation (December 1993). The minimum wage is set at the equivalent of about US$ 2 per month. In the first quarter of 1995, the average wage was about 39,700 Russian roubles (US$ 7.76) well under the 55,900 Russian roubles it costs to cover the monthly need of one person for basic foods.

Interest rate liberalisation

Interest rates remain centrally controlled. Credit allocation has favoured reconstruction following the civil war.

Financial institutions

Banking reform

The Law on Banking Activities and the Law on the National Bank were adopted in February 1991. Apart from the National Bank the financial sector in Tajikistan is dominated by 14 large specialised banks, three of which account for well over 70 per cent of total lending. The first joint venture was ready to start operations in January 1995.

The National Bank still imposes maximum lending margins on commercial banks and directs credit resources to priority sectors. Structural weaknesses remain in the form of insolvency and low portfolio quality, inadequate capital levels, lack of banking skills and an ineffective framework of prudential regulations and supervision.

Non-bank financial institutions

One state and several cooperative insurance companies are operating.

Securities markets and instruments

No securities market had been established by mid-1995.

Fiscal and social safety net reform

Taxation

The value added tax has, since early 1992, been set at 20 per cent. A flat sales tax of 3 per cent in addition to the VAT was introduced from 1 July 1994. The basic profit tax rates range from 25 per cent (for farmers and small enterprises) to 60 per cent (in brokerage). Personal income is taxed at progressive rates of up to 40 per cent for monthly income of more than 43 times the minimum wage.

Social security

The authorities are planning to restructure social expenditures away from universal support towards targeted assistance to the needy. The existing system includes a large number of social payments (30 per cent of budget expenditure). In January 1995, arrears in the payment by the government of pensions and allowances amounted to some 74 per cent of total pensions and allowances due in 1994. According to the State Statistical Agency, only 1,400 unemployed were actually receiving unemployment benefit in March 1995, out of 7,300 unemployed qualified for the benefit.

Turkmenistan

Since gaining independence in 1991, Turkmenistan has made some progress on price reform and has established a national currency. However, no comprehensive market-oriented reform package has been designed.

Enterprises

Size of the private sector

According to government estimates, the officially recognised private production or service units employ about 22 per cent of the labour force and account for 9 per cent of GDP. Government estimates indicate a total private sector share of GDP of about 18 per cent, including the "home industry" and Sunday market trading.

Large-scale privatisation

Privatisation remains largely at the planning stage. No significant effort has been made to privatise large-scale state-owned enterprises.

A Presidential Decree of 13 May 1994 foresees a voucher-type privatisation process with preferences granted to members of workers' collectives, but preparations for implementation are at a very early stage.

Small-scale privatisation

The government's policy has been to kick off the privatisation process with the sale of small service units. In total, about 850 small entities in the service sector, mostly shops, had been privatised by late 1994. In agriculture, a small share of the land has been leased to private individuals. Land ownership has been legalised. The maximum plot size that can be owned privately is 50 hectares.

Property restitution

Turkmenistan has no programme of property restitution.

Growth of private enterprise

Official estimates point to the existence of about 21,000 private production or service units, excluding the "home industry" and informal trading entities.

Enterprise restructuring

Little effort has been made to initiate orderly restructuring of enterprises. Since the second half of 1993, enterprises have been faced with shortages of imported production materials due to a sudden drop in the country's gas-related hard currency revenues, but have been helped to keep employees on the payroll through the rapid extension of credits from the banking system. The Law on Bankruptcy was passed in June 1992 but few companies have been forced into bankruptcy to date.

Markets and trade

Price liberalisation

About half of all retail sales are transacted without direct price intervention from the government. There are price controls for "necessities", "goods under presidential review" and "other consumer goods". "Necessities" is a term which covers 24 products, mainly foodstuffs, for which the price is set by presidential decree. "Goods under presidential review" covers 40 goods, including petroleum products for households, and urban transportation, the prices of which can be altered only after submission by the relevant ministry of a request to the President. For items in the category "other consumer goods" (473 items, including cotton fabrics and knitwear) price changes, usually based on cost plus mark-up, require agreement from the Ministry of Economy and Finance. A number of items, including water, gas and electricity, are distributed to the population and to Turkmen enterprises for free.

Competition policy

Turkmenistan does not have an anti-trust law.

Trade liberalisation

Centralised state trading remains a prevalent influence on both foreign trade and production. However, duties and implicit taxation through surrender of foreign currency at unfavourable exchange rates can be very high. The establishment of a commodity exchange, on 1 August 1994, has led to further centralisation of foreign trading operations. All trade transactions (domestic or foreign) exceeding 250,000 manat must be carried out at (or be registered and endorsed at) the official commodity exchange.

Currency convertibility and exchange rate regime

In principle, Turkmenistan introduced full currency convertibility and a unified exchange rate for the purpose of trade transactions when the manat was introduced on 1 November 1993. Potential investors in Turkmenistan are confronted with three different exchange rates for the manat: the official rate, the commercial rate and the black market rate. The commercial rate applies to few and typically small transactions such as foreign exchange commission for tourists. The official rate is used for all enterprise transactions involving import and export, including the 100 per cent mandatory currency surrender for exports. The official exchange rate was changed on 18th September 1995 from 75 to 200 manat per US dollar. At that time the black market exchange rate stood at about 700 manat per dollar. Exporters of oil and gas enjoyed a somewhat lower 60 per cent currency surrender requirement but were forced to accept the more onerous exchange rate of 10 manat per US dollar. High currency surrender requirements at low exchange rates imply a heavy tax on exporters.

Wage liberalisation

A statutory minimum wage is set by the state and wages tend to be adjusted at the same time and at uniform percentage rates throughout the state-owned sector. Uniformity is exercised in part through the imposition of a tax on excess wage increases at rates of 50-150 per cent.

Interest rate liberalisation

Commercial banks have little freedom to set interest rates. Rates have in practice been highly negative in real terms. In mid-February 1995, the President issued a decree which ordered banks to cut nominal lending rates to 15 per cent a year (less than the average monthly rate of inflation in the first half of 1995). Directed credit still plays a dominant role.

Financial institutions

Banking reform

Upon the introduction of Turkmenistan's national currency, the manat, in November 1993, the State Bank became Turkmenistan's central bank. Turkmenistan's banking sector now includes 21 commercial banks. Some banks are owned by state enterprises which are also the main recipients of loans from these banks. Eight of the commercial banks are privately owned: three in the form of cooperatives and two in the form of 50 per cent foreign-owned, joint-stock companies. The five largest state banks, and a number of so-called "specialised banks", are used heavily by the state as an instrument for distribution of directed credit and play a dominant role in the financial sector. Most banks are in need of major restructuring.

In mid-February 1995, the President issued a decree that retroactively instructed all banks to surrender 75 per cent of profits made in 1994 to the state

budget, and ordered banks to cut lending rates to 15 per cent a year.

Non-bank financial institutions
No venture funds are operating in Turkmenistan.

Securities markets and instruments
There is no securities market in Turkmenistan.

Fiscal and social safety net reform

Taxation
The standard rate of profit taxation (introduced in 1991 to replace profit transfers to the budget) was reduced from 45 to 35 per cent in January 1992 and further to 25 per cent in 1993. Certain exemptions are offered to foreign investors and some sector-specific rates apply. The personal income tax structure was simplified in June 1994; rates now range from 0 to 10 per cent. The VAT was reduced to 20 per cent in 1993 with a preferential rate of 10 per cent for certain staple goods. Export taxes were eliminated in 1994. Otherwise, few major changes to the tax system have been introduced in the past 1½ years.

Price subsidies accounted in 1992 for about one-third of central and local government expenditure. Gas-related tax revenues dropped sharply in 1993 as Russia phased out the practice followed during 1992 of settling 15-20 per cent of gas deliveries from Turkmenistan in hard currency at world market prices.

Social security
The social security system is partly financed by payroll taxes set at 20 per cent of wages.

Enterprises

Size of the private sector
The private sector is likely to account for 35 per cent of GDP, of which a large share is likely to be in the informal sector.

Large-scale privatisation
Large-scale privatisation was slow until 1994. Between 1990 and 1994, some 2,650 medium and large enterprises were sold, mostly through non-competitive methods to employees; another 1,600 were leased to employees. In July 1994, mass privatisation was suspended altogether by parliament. However, a Presidential Decree of November 1994 introduced a new voucher-based mass privatisation programme and instructed the State Property Fund to privatise at least 8,000 medium and large-scale enterprises in 1995. In December 1994 parliament lifted its moratorium on mass privatisation, but replaced it with a list of 6,147 enterprises in the transport, communications and energy sectors that were to be excluded from privatisation; this list was extended in March 1995 by 90 enterprises in the oil refining, defence and food processing industries. Although the Ukrainian parliament rejected the 1995 Privatisation Programme in April 1995, a Presidential Decree on privatisation, issued in June, overrules the parliamentary rejection.

As of August 1995, 5,200 medium and large enterprises had been approved for inclusion in the mass privatisation programme by the Cabinet, including agro-industrial enterprises (25 per cent), leased enterprises (15 per cent), and enterprises in various stages of privatisation (60 per cent). New non-tradable vouchers are being distributed to all eligible citizens who did not use their privatisation accounts in the pre-1995 mass privatisation programme. By August 1995 around one-third of the population had either collected a privatisation certificate (around 9 million) or opened a privatisation account (8 million).

Around 70 per cent of the shares in enterprises will be available for sale in the voucher auctions, while 30 per cent will be available through other means, such as for cash tenders and for compensation certificates. Some 200 million tradable compensation certificates are to be issued to the holders of 54.3 million accounts at the Savings Bank as of January 1992 in compensation for loss of real money balances through hyperinflation. Voucher and certificate holders can bid directly in auctions for shares or bid via investment funds.

By April, auction centres were operating in all 27 oblasts, but the network of bid centres was still insufficient. By June, five auctions for over 600 enterprises had been concluded. However, out of 387 medium and large-scale enterprises put up for sale in the first three monthly auctions, only 102 were successfully sold; sales below nominal value and total bids worth less than 70 per cent of shares offered led to the withdrawal of enterprises, under the current framework. Privatisation of the companies from the agribusiness sector is proceeding particularly slowly, as these are subject to closed subscription (in the sense that 51 per cent must be sold to agricultural producers).

Small-scale privatisation
Parliament adopted a Law on Privatisation of Small State-owned Enterprises in March 1992. By end-1994 only 7,967 of some 80,000 small enterprises (less than 200 employees) were actually transferred from state ownership into private hands, while approximately half of all enterprises were held in collective ownership through leases. The use of leasing arrangements with buy-out rights, often extended to employee collectives, has left many enterprises in an intermediate state of privatisation.

In the early 1990s, several partial reform programmes were adopted only to be abandoned. Reforms during 1993 and early 1994 were gradual and inconsistent. Since October 1994, Ukraine has made headway with macroeconomic stabilisation, price and trade liberalisation, and has begun to implement a new mass privatisation programme.

On 1 September 1995 many leases expired, requiring the leaseholders to exercise their buy-out right if they want to avoid the auctioning of the enterprises.

A decree issued in December 1994, provided measures to accelerate small-scale privatisation, including the *de facto* liberalisation of local real estate markets, the application of competitive methods (tenders and auctions), the curtailing of leasing arrangements, and monetary incentives for state property fund employees and local authorities. In 1995, 13,500 retail outlets are to be privatised. However, of the 9,647 small businesses scheduled for privatisation in the first half of 1995, only 2,166 were actually sold. There is strong regional variation, with small-scale privatisation near-complete in Luhansk, Mariupol, Zaporizhzhya, Khmelnitsky, Cherkasy and Ushhorod.

Residential privatisations have proceeded rather more successfully, with 28 per cent of Ukraine's 8.5 million flats privatised since 1993, although the process has decelerated significantly in early 1995.

Privatisation in agriculture has been less successful. The Land Code that was introduced in 1992 allows private as well as state and cooperative ownership of agricultural land. A decree of November 1994 introduced private land ownership including the rights to sell, lease or bequeath land to Ukrainian citizens, subject to no changes in its usage. It also made it possible for farmers to separate themselves from collective farms by claiming their share in land and fixed assets. However, until the decree is passed by parliament, it is not effective. The development of the agricultural land market and private farming are also being constrained by a six-year moratorium on land sales and by the failure to distribute identifiable land shares to the state and collectives so that they can be registered and mortgaged. Land tenure rights and foreclosure procedures for land held as collateral are still to be established. Although the share of state-owned land had fallen to 35 per cent by early 1994, three-quarters of all land is still managed by collective farms. By August 1995 around 12 per cent of agricultural land was cultivated by families on 0.5ha household plots, and 33,000 private farmers cultivated 2 per cent of agricultural land in 20ha farms. In July 1995 the government declared that residents are now allowed to buy or lease land plots for business activities, which have not been designated for agricultural use. Land ownership will not be limited and can be acquired with a privatised object.

Property restitution
There has been no restitution for former owners of nationalised property in Ukraine.

Growth of private enterprise
The strengthening of government controls in 1993, coupled with confiscatory tax regulations, led to the emergence of a large informal economy. As liberalisa-

tion progresses and regulations become more transparent, it is expected that these activities will integrate gradually into the formal economy.

Enterprise restructuring

Virtually the entire formal economy remains highly monopolised and exhibits a high degree of integration and concentration. Enterprise budget constraints have remained soft because of budgetary subsidies and directed credits from the banking system. The first half of 1995 saw the closure of 15 coal mines and the symbolic cutting off of gas supplies to 2,000 enterprises with payment arrears (for one day only). A mechanism is being established to control the flow of subsidies to large enterprises by making payments conditional on specified targets on restructuring. Financial discipline remains weak, however; the rise in energy prices has led to significant increases in domestic arrears. Since mid-1995, collection by gas and electricity companies has improved as the cut-off of supply to users in arrears has become a credible threat.

The Law on Bankruptcy was adopted in May 1992. There has been little enforcement thus far. A January decree supports the creation of financial-industrial groups and could strengthen the cartelisation of domestic industry, thus slowing restructuring.

Markets and trade

Price liberalisation

Until a comprehensive reform programme was introduced in October 1994, price controls were pervasive throughout the whole economy and agriculture was dominated by the state procurement system. Prices were set administratively for housing and transport, goods of "social significance" and goods produced in monopolistic sectors. In addition, profit margins were subject to regulatory limits.

In October 1994 the majority of direct price controls, most ceilings on profit margins as well as the advance notification/approval of price increases in goods of "social significance" and those produced by monopolies were eliminated. Price adjustments led to increases in energy prices, agricultural prices and communal tariffs by factors of from three to seven. A competitive wholesale market for electricity is to operate from the fourth quarter of 1995; retail prices are to be based on regulated mark-ups over costs.

Further price adjustments towards cost recovery/border prices were made in December 1994, February 1995 and July 1995. Price controls remain only for bread, public utilities, public transportation, fuel for households and rents. Producer price controls remain only for utilities (gas, electricity, central heating, water supply and sewage), public transport and rents.

Prices in the coal-mining sector were gradually increased between October and December 1994 and have reached world price levels (except for residential use). Wholesale producer prices for crude oil and natural gas have reached 83 per cent of world market prices, including a rent payment introduced by decree in December 1994. A wholesale natural gas price of US$ 80 was introduced in March 1995 for all industrial consumers, which is equivalent to the price in Germany. Residential consumer prices for natural gas are at a level between 46 and 77 per cent of the price level in Germany. Prices for housing and utilities have been at 20 per cent of costs since July 1995 and are to rise to 60 per cent by year-end. Electricity prices are above cost recovery levels for industrial users and below cost recovery levels for residential users.

Competition policy

The February 1992 Law on Limitation of Monopolistic Activities provides the basic framework for competition policy and established the Anti-monopoly Committee, the activities of which are further governed by the November 1993 Law on the Anti-monopoly Committee. According to the 1994 report of the committee, 400 monopoly enterprises in 460 regional product markets were identified. The Committee analysed some 5,000 cases, of which 31 per cent concerned abuse of market power, 37 per cent unfair trading practices, 27 per cent discrimination of enterprises by authorities, and 5 per cent anti-competitive agreements.

According to anti-monopoly regulations introduced in November 1994, the approval of the Anti-monopoly Committee is required for the creation, merger and acquisition of enterprises if (1) the aggregate asset value and sales volume exceeds US$ 2 million, if (2) the aggregate share of a particular product market held by the founders exceeds 35 per cent, or if (3) the expected market share of the entity to be established exceeds 35 per cent. These low threshold requirements will affect many newly-founded enterprises.

Trade liberalisation

A system of state contracts and barter arrangements dominated exports and imports until the end of 1994. While virtually all exports were subject to restrictive licensing, imports outside the trade order system were relatively free of tariff and non-tariff restrictions. In October 1994 the liberalisation of the export sector was initiated by the abolition of quotas and licensing requirements, except for grain, coal, cast iron and metal scrap. In December 1994 these were lifted on all products except grain; restrictions on grain were phased out on 1 July 1995, but reintroduced on 17 August.

Export quotas only apply to goods subject to voluntary export restraints (VERs) under international agreements. Export pre-registration is still required for goods subject to VER agreements and foreign anti-dumping actions; for the latter, indicative prices are set by the government to avoid such actions.

State procurement has been significantly reduced and is taking place at market prices; it is being replaced with agricultural commodity exchanges, which are starting to function. Import tariffs range between 10 and 20 per cent and there are no quantitative restraints on imports. In June 1995 an Interim Agreement on trade was signed with the EU, which represents the first step towards the entry into force of the Partnership and Cooperation Agreement.

Currency convertibility and exchange rate regime

In October 1994 the existing multiple exchange rates were unified. The official exchange rate is now determined at the Ukrainian Interbank Currency Exchange; trading has increased to five times a week and access has been broadened. Banks are now free to sell hard currency directly to their customers within agreed margins of the official rate.

The government has postponed the phased introduction of a new currency, the hryvna, to 1996. As of 1 August 1995, the use of foreign currency for domestic trade has been prohibited. In the same month, the NBU also significantly liberalised the regulations governing the opening and operation of foreign currency accounts by residents and non-residents in Ukraine.

Wage liberalisation

A wage tariff system is still in effect under which wage coefficients for workers of different skills are set on the basis of the minimum wage. Wage coefficients are negotiated between the Cabinet of Ministers, the Ministry of Labour and the trade unions in what is called the "General Tariff Agreement". In April 1995, the incomes policy applied in 1994, which kept wage increases to 80 per cent of inflation, was dismantled by parliament. The government intends to reintroduce it in the budgetary sphere in order to slow strong wage growth.

Interest rate liberalisation

A large share of bank lending takes the form of state-directed credits at heavily subsidised interest rates. Since March 1995 real interest rates on credits as well as on deposits have gradually become positive.

Financial institutions

Banking reform

Ukraine's financial system is still underdeveloped and an effective regulatory system is only gradually being developed. Like other countries of the former Soviet Union, Ukraine adopted a two-tier banking system in 1991. The banking system consists of the National Bank of Ukraine, the five successor banks of the Ukrainian branches of former state-owned specialised banks, and more than 200 smaller (often undercapitalised) private commercial banks. The five former state-owned specialised banks, two of which remain state-owned and three of which are majority-owned by state enterprises, account for 97 per cent of all bank branches, 70 per cent of total bank assets, and 63 per cent of all credits outstanding. A decree of July 1995 intends to raise the government's stake in the latter three to 35 per cent; this will not involve any capital injection, but includes the cancellation of loans extended to the government in compensation for earlier undervaluation of former state property among the banks' assets. Credit to the private sector is scarce as commercial banks have become more risk-averse; the spreads among lending and deposit rates are high and loans are mainly short-term.

Regulations and supervision have gradually improved. A new minimum capital requirement of ECU 3 million for new banks (ECU 5 million for minority foreign-owned banks and ECU 10 million for majority foreign-owned banks) was introduced in January 1995; existing commercial banks have to raise their capital to ECU 0.5 million by January 1996. The authorities have also introduced prudential regulations comprising a capital adequacy ratio, a loan classification scheme, exposure limits and shareholding constraints. In addition, the inspection department of the NBU and its 25 branch offices is being enhanced. Statutory auditing requirements are being upgraded. In April, a draft law on monetary policy was submitted which reinforces the focus of the NBU's mandate on price and monetary stability and bank supervision.

Consolidation of the banking sector is accelerating. As of May, 70 of the 226 commercial banks had capital below the required level, and the NBU was considering the revocation of 20 licences of banks with capital below ECU 0.2 million. In the first half of 1995, the NBU liquidated 8 banks, and reorganised another 10; 85 banks not in compliance with prudential standards were under special control of the NBU.

Non-bank financial institutions

Non-bank financial institutions in Ukraine include trust companies, investment funds, insurance companies and, in recent months, credit unions and pension funds. There are around 600 insurance companies. 265 investment funds, investment companies and trust funds have received licences from the State Property Fund; over 500 capital market intermediaries have been licensed by the Ministry of Finance, with some overlap between these groups. Funds must have a minimum capital of US$ 20,000. 80 per cent of privatisation certificates have been bought by 30-40 investment trusts and funds.

A comprehensive regulatory framework is lacking;

activities are regulated by a February 1994 decree "On Investment Funds and Investment Companies" and an amending decree of March 1995. Present supervisory functions are fragmented between various government agencies. In an attempt to tighten supervision, in August the State Property Fund revoked the licences of 14 trust companies for violation of regulations.

Securities markets

The Law on Securities and Stock Exchange has been in effect since January 1992. As of early 1995, there were 91 exchanges operating in Ukraine, with an average of 50 brokers each; 14 of these traded in stocks, 4 in real estate, and the remainder in commodities, but trading was concentrated in Kiev. Trading capacity in the stock market will need to be expanded to deal with the expected large increase in volumes that will accompany the mass privatisation programme. Most trade still takes place in Kiev, through an unregulated over-the-counter market. The more regulated and centralised trading systems include the Ukraine Stock Exchange, which was established in 1991 and presently has 67 brokerage houses registered as its members, and the "Central Depository" system. Overall trading volumes are very small, averaging only US$ 3,000 per day. No independent and transparent share registration and share custody system exists; minority shareholders' rights are not protected. A June 1995 decree mandates the creation of the State Committee on the securities market to provide regulatory oversight. Since March 1995 several successful auctions for 3, 6 and 9-month treasury bills have been held. The stock exchange also trades investment certificates of investment funds.

Taxation

A number of new tax laws and decrees have been introduced since independence in 1991. A decree from December 1992 sets the rates for the two-tiered value added tax at 22 per cent and 28 per cent, subsequently lowered to 20 per cent. Another decree adopted the same day set excise taxes on a string of goods at rates of 10-85 per cent. The Law on Income Taxation of Enterprises and Organisations (1992) provides for the taxation of enterprise revenues at 35 per cent. The Decree on Income Taxation of Individuals, effective since 1 January 1993, sets marginal rates at 10-50 per cent. In January 1995 a new law replaced the previous 22 per cent tax on gross corporate income with a 30 per cent tax on net corporate income, (with a 45 per cent tax on intermediary and wholesale businesses and a 60 per cent rate on casinos and gambling activities). In addition, the law eliminated the five-year tax holiday for enterprises with foreign investments registered after 1 January 1995. It allows enterprises to apply accelerated rates of depreciation to their fixed assets and to carry forward their losses for a period of five years. The recent application of VAT on imports is increasing the tax burden due to the lack of deductibility on the sale of final goods.

Social security

The Ukrainian social security system is still in large part enterprise-based. The extrabudgetary funds in the social sphere are financed by payroll taxes, with employers paying 37 per cent of the wage bill for the social and pension funds, and 12 per cent for the Chernobyl and unemployment funds. Employees pay 1 per cent of their wage to the pension fund and 3 per cent to the Chernobyl fund. More than half of the expenditures of the extrabudgetary funds are funded from general taxation.

Enterprises

Size of the private sector

The genuine private sector is likely to account for about 25-30 per cent of GDP. The non-state sector's share of GDP was officially estimated at around 50 per cent of GDP at the beginning of 1995. The non-state sector includes all companies that have been corporatised, including those for which the state retains majority ownership. (This is the main source of difference between the GDP-share of the private sector and the GDP-share of the non-state sector.)

Large-scale privatisation

Phase II of the privatisation programme, launched in early 1994, focuses on medium and large-scale enterprises. In 1994, a total of 9,774 enterprises were privatised including 2,884 medium and large-scale companies. The previous practice of creating closed joint-stock companies (with limited transferability of shares) has been replaced with corporatisation with tradable shares. Privatisation methods have been diverse and include most importantly auctions, direct sales, joint venture privatisations and flotation on the stock exchange. The first auctions of medium and large-scale enterprises took place in March 1994. While corporatisation and allocation of shares to employees is proceeding fast, involvement of outside investors has been much slower than planned.

A mass privatisation scheme using investment funds is under way. Although the elaboration and adoption of a fully fledged programme is being delayed, presidential decrees providing for acceleration of privatisation and the creation of a network of private investment funds were issued in mid-1995. The state is to retain, for the time being, a majority interest in strategic sectors, such as energy, fuel and gold mining. The government is committed to limit the combined share of state and insider ownership in non-strategic enterprises to less than 50 per cent. The 1995 privatisation target is to sell 2,046 enterprises – of these, 513 (including about 300 large ones) had been privatised by the end of May. In addition, more than 1,000 privatisation deals were effected outside the centrally controlled system during this period.

Small-scale privatisation

Small-scale privatisation was initiated in late 1992 based on the laws of November 1991 on Denationalisation and Privatisation and on Lease. To date, over 47,000 small-scale businesses have been privatised or leased, primarily to worker collectives. Around 40 per cent of these were originally (during Phase I of the programme, lasting until early 1994) privatised as closed companies (with non-tradable shares) and with 51 per cent of the shares being retained by the government. Retail trade, consumer services, public catering and local industry privatisation is very advanced. Housing privatisation is 96 per cent complete. Since January 1994 cash auction has become the most common method of small-scale privatisation. In early 1995 many previous restrictions on privatised companies were removed.

Property restitution

There has been no property restitution for former owners of nationalised property in Uzbekistan.

Growth of private enterprise

By early 1995 more than 20,000 private enterprises had been registered. In addition there were 14,235 private farms which, together with household plots, occupy 10-11 per cent of agricultural land. Presidential decrees of January and July 1995 on private entrepreneurship have loosened the registration rules and eased the tax burden. Half of the privatisation income is earmarked for financial support of small enterprises.

Transition to a market-based economy started in 1992, with partial and gradual reforms in 1992-93, accelerated in 1994. A comprehensive programme was adopted for 1995 and beyond, with strong assistance from the international financial institutions.

Enterprise restructuring

Enterprise restructuring has been hindered by the predominantly insider nature of the privatisation process so far, and lack of political willingness to allow widespread unemployment and bankruptcies. State farms have been transformed into cooperatives or joint-stock companies without any major impact on enterprise behaviour. The Law on Bankruptcy was adopted in May 1994. No bankruptcy cases have yet been initiated.

Markets and trade

Price liberalisation

The bulk of consumer prices were liberalised in January 1992. This process was subsequently partly reversed and a rationing system was introduced for a wide range of goods. Since early 1994 liberalisation has resumed. The state order system has been phased out except for cotton and grain. The remnants of the rationing system and profitability ceilings were abolished in early 1995, and now apply only to certain medicines and natural monopolies. Prices that remain administered are being adjusted to cost-recovery or world market levels. Oil and oil product prices are to reach world-market level by late 1995.

Competition policy

The Law on Restrictions of Monopolistic Activities was adopted in July 1992 and amended in March 1993. A new anti-monopoly law is expected to be adopted by mid-1995. Monopolies are defined by the draft law as enterprises (or specific products) with market shares of more than 35 per cent, or those that engage in certain specified activities. In late 1994, 611 enterprises and 1,534 products were identified as monopolies at either the national or regional levels. A Competition Agency monitors market activity. A separate Office of Public Utility Regulation is being established for the administration of utility prices.

Trade liberalisation

Following years of timid reform, foreign trade liberalisation started in earnest in early 1994. Customs duties on all imports were suspended until mid-1995 and the plan was to introduce uniform low-level tariffs in the second half of 1995. By early 1995, the number of product categories subject to export quotas and export licensing systems had been reduced from 70 to 11. However, the list includes cotton and gas, accounting for over half of the country's non-gold export. In 1994, a 15 per cent tax on foreign exchange proceeds was eliminated and the surrender requirement was increased to 30 per cent (to be surrendered at the market exchange rate). Export taxes applied to 65 product groups and ranged from 5 per cent to 50 per cent in 1994, but both their scope and level has been reduced in 1995. However, the bulk of foreign trade is still channelled through state-owned foreign trade companies and there are limits on enterprise access to hard currency for the purchase of imports.

Currency convertibility and exchange rate regime

A fully fledged national currency, the sum, was introduced in mid-1994. The exchange rate was unified in November 1994. Foreign currency auctions are now accessible to all banks, and are held twice a week (since April 1995). Private companies still have limited access to hard currency and rules for repatriation of profits generated in local currency are non-transparent. The government is committed to making the sum convertible for current account purposes by the end of 1995.

Wage liberalisation

Minimum wages and pensions are adjusted every few months to keep pace with inflation. For 1995 a tax-based income policy was adopted for state enterprises.

Interest rate liberalisation

During 1994-95 both deposit and lending rates were raised sharply, with lending rates occasionally reaching positive levels in real terms. A system of directed and subsidised credits is still in place, although its scope has been reduced sharply. Since March 1995 the central bank refinance rate has been based on interest rates observed in the interbank money market.

Financial institutions

Banking reform

A two-tier banking system was introduced in early 1988. There are about 35 commercial banks, including three private banks and three joint-venture banks. Seven foreign banks have offices in Uzbekistan but no foreign bank has opened a branch there. Corporate banking remains dominated by Agroprombank and Promstroibank, while foreign exchange transactions are channelled primarily through the National Bank for Foreign Economic Activity.

Prudential regulations, including capital adequacy and provisioning rules and exposure limits, remain loose compared with international standards. Minimum capital requirements were raised in late 1994. A new draft banking law has been submitted to the parliament. International audit of the largest banks has started.

Non-bank financial institutions

One state-owned and several private insurance companies, including a major joint venture, are active in Uzbekistan. A few leasing companies have emerged but there is no law on leasing. A wide range of investment funds are being established. They are expected to play a key role in further rounds of privatisation.

Securities markets and instruments

A law on Securities and the Stock Exchange was adopted in September 1993. A Republican Stock Exchange, a National Share Depository and a National Investment Fund were created in 1994. Currently 570 enterprises and banks are listed on the stock exchange but market capitalisation remains low. There are plans to issue government bonds during the second half of 1995.

Fiscal and social safety net reform

Taxation

Key reform measure were undertaken in early 1992 with the replacement of the turnover tax by a VAT (currently 18 per cent) and excise taxes and the creation of legislative basis for the tax system.

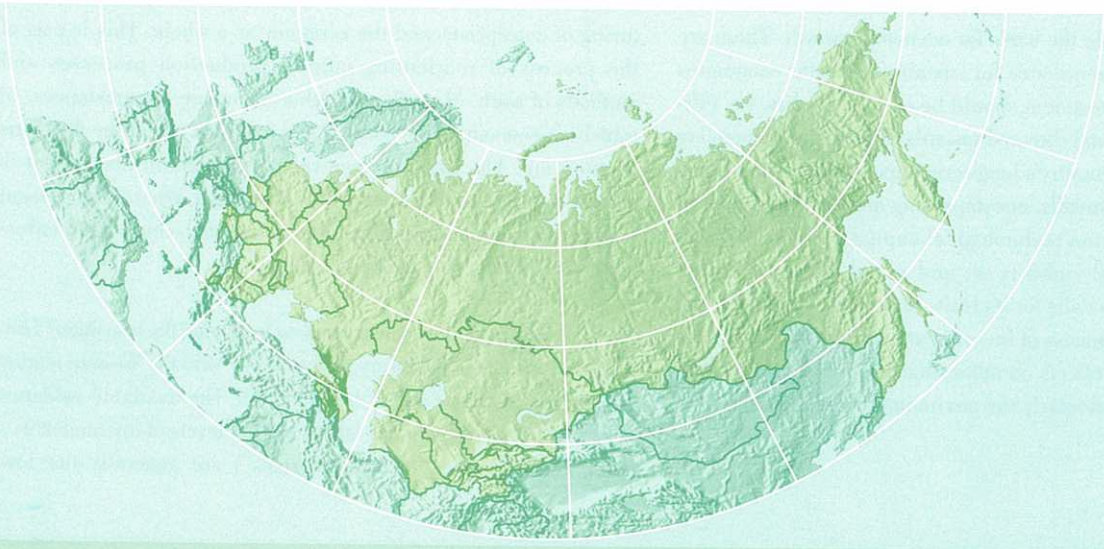
Tax reform accelerated in 1995 with the change from an enterprise income tax to a profit tax (with a maximum 38 per cent rate), the elimination of the 20 per cent tax on amortisation, a reduction in the number of tax exemptions and an increase in property and land tax rates.

Social security

Pension expenditures accounted for about 10 per cent of GDP in 1994. In 1995 measures have been taken to limit the entitlements of the less vulnerable groups and in August 1995 a revised system for adjustments of pensions was introduced. The system of family allowances has been rationalised to a single benefit linked to the minimum wage.

Transition report

Part II



Investment

Investing for growth

3

A primary objective of the economic reforms is to improve living standards, of which income is a key component. Thus a successful transition must generate the basis for economic growth. There are three "technical" prerequisites for sustained growth: economies need to invest; the investment should be of good quality, i.e. efficient in terms of cost and directed towards demand; and financing it should be within a country's long-term capabilities.[1] Investment should be conceived broadly, encompassing additions to physical, human, institutional and technological capital (see Box 3.1). In addition, the political viability of, and social justification for, growth in democracies calls for its fruits to be widely spread,[2] and any appraisal of the process of investment and growth should take careful account of its effects on other (non-income) aspects of the standard of living, particularly the environment and health.

During the economic transition, investment is important not only to increase a nation's capital stock, but also to deepen the restructuring of enterprises and the economy as a whole. This is part of the process of reorienting output, production processes and methods of work. More than in other economic circumstances, in transition economies the *quality* of investment should be the focus of attention. The link between restructuring and investment is central to the subject matter of this *Transition Report*. The present chapter intends to place developments at the sectoral and enterprise level within the aggregate context.

How has aggregate investment fared so far during the transition? How much investment is necessary to "catch up" with the Western market economies, and how will it be financed? The available evidence suggests that investment has fallen, but the levels of investment as a share of GDP (the "investment rates") are generally not low.

Box 3.1
Concepts of capital and investment

Physical investment

Most of the data to be assessed in this and the following chapters relate to the simplest type of investment represented by industrial plant, machinery and structures. Capital goods are not, however, confined to the industrial sector but exist also in the service, household and public sectors. The classification of household expenditures between investment (for example, buying a house or motor car) and consumption (for example, buying a restaurant meal) is not always simple. We normally think of shoes and shirts as consumer goods but they are as durable as some hand tools or pieces of equipment. Some assets are referred to as "social capital", such as the housing stock, roads, water facilities, power stations and railways, whether these are privately or publicly owned. It is helpful to distinguish them from industrial equipment for three reasons: they are complementary in use, they are intimately related to public policy whether through ownership or regulation, and they are quantitatively at least as important in the aggregate as industrial capital.

Human capital

Households as well as state organisations are involved in health and education expenditures many of which can, at least in part, be regarded as investments in the sense that they confer benefits in subsequent periods. These investments contribute to the stock of skills, competencies and capacities of the labour force, known as human capital. As in the case of physical capital, the valuation of the stock involves not only measuring current expenditure but also depreciation (through retirement, death, incapacity) and obsolescence since unimproved skills can become less valuable as available technology advances.

Technological capital

We can also think of the stock of available technological knowledge as constituting a form of capital and of expenditure to enlarge it as a form of investment. Economies not at the forefront of technological progress can acquire much useful knowledge relatively cheaply by "importing" it from abroad rather than by undertaking original research to extend the frontiers of knowledge. Importation may carry the obligation to pay royalties to the foreign supplier where the knowledge is protected by intellectual property rights.

Some knowledge is only of use in conjunction with particular pieces of equipment in which it is said to be embodied. Disembodied technological advances enable previously installed equipment and previously trained workers to operate more effectively. Perhaps more frequently, technological advances are embodied and can only reduce production costs if supplementary investment is also made in particular forms of physical or human capital. In a distorted and inefficient economy, there are opportunities for better management and organisation (management "technologies") to raise output or reduce the use of resources quickly with only a modicum of investment, typically in human capital and consulting services.

Institutional capital

Throughout this *Transition Report* a central theme is the importance for the transition of the development of the key institutions of a market economy: from effective and responsible enterprises and entrepreneurship, to legal frameworks and judicial institutions, competition authorities and others. Building these institutions – the essence of the transition – takes time, legislative effort, training and so on, all of which represents investment in appropriate skills, attitudes and habits as well as offices and equipment.

[1] These conditions are captured by the Harrod-Domar growth equation: $g = s/v$, where 'g' is the growth rate, 's' is the savings rate (including both domestic and foreign savings), 'v' stands for the incremental capital-output ratio (i.e. the investment needed to produce an additional unit of output), and investment should be interpreted to include both physical and other types of capital (see Box 3.1). Thus the growth rate can be increased by increasing the savings rate or decreasing the incremental capital-output ratio (increasing the quality of investment). While Harrod's formulation came in the late 1930s it is at the heart of much of modern growth theory, which shows that this argument applies even when account is taken of the limitations on the supply of labour. More recent developments in "endogenous growth" theory show that long-run *growth* rates can also be affected by the initial *levels* of human, physical and technological capital when these forms of capital generate positive external benefits. This last point may be relevant in assessing growth prospects for transition economies (see Section 3.3).

[2] Gross inequalities of income and wealth appear to constrain longer-term growth even in authoritarian regimes. See, for instance, Dornbusch and Edwards (1991).

Investment began falling before reforms had started. Evidence and data on investment are problematic, particularly in transition, where both reality and statistical methods are in a state of flux. It appears, however, that early-reforming countries have seen a more rapid stabilisation and in some cases a turnaround in investment activity.

Sustained high growth rates will be needed for convergence towards Western standards of living. There is reason to believe that the transition economies will be able to tap substantial "productivity reserves" in the form of under-utilised human capital, and close a technology and management gap. This should make returns to investment high and thus investment easier to finance. Nevertheless, for the growth process to be sustained, domestic and, in particular, private savings will have to rise. External financing is bound to represent a limited share of total investment financing. However, external participation, through finance and other channels, can play a crucial role in developing and anchoring reforms and in transferring intangible forms of capital from the West to eastern Europe, the Baltics and the CIS. While public savings should be encouraged, their role in investment finance in the short to medium term will be constrained by other transition-specific pressures on public finances (see Chapter 6 of last year's EBRD *Transition Report*).

3.1 The investment and savings effort under central planning[3]

Under the command system, output and investment decisions were, in principle, taken by the planners on the basis of quantitative targets. Consumption and savings were "residuals" which were forced to adjust. Most savings took place within the government-enterprise sector, through direct and indirect taxation and retained earnings of enterprises. Savings were transferred between enterprises to accord with investment plans through the national budget. In market economies a much greater proportion of national income accrues directly to households and, therefore, a larger share of national savings is determined by and accumulated in the household sector. The financial system plays the crucial role of intermediating savings and investment.

Direct control of consumption and savings allowed the socialist economies to sustain very high savings and investment rates by international standards.[4] Savings and investment in the countries of eastern Europe, the Baltics and the CIS are estimated to have been on average of the order of 32 per cent of GDP in the period 1977-88. This compares with a world average of about 24 per cent of GDP and an average of 21 per cent in the advanced industrial countries over the same period. However, the efficiency of the investment undertaken by socialist economies was low, both in terms of cost and relationship with demand. Investments were normally not made on the basis of profitability but determined by the objectives of the central plan, the bargaining power of the different enterprises, and other non-market criteria, which also failed to mitigate in the direction of quality.[5]

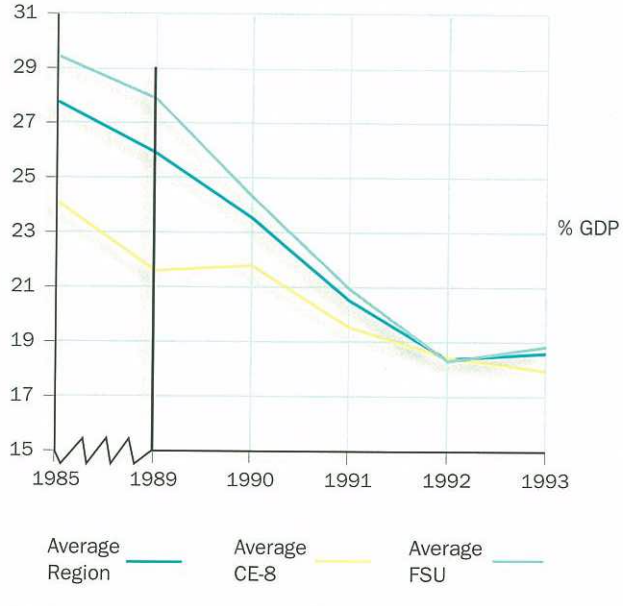
The investment rate in the region began declining during the 1980s, that is, before the collapse of the communist regimes. Chart 3.1 shows falls of approximately 1.5 and 2.5 percentage points between 1985 and 1989 in eastern Europe and in the former Soviet Union, respectively.[6] Among the possible explanations for this pre-transition decline is the greater enterprise autonomy introduced by perestroika in the former Soviet Union and under reform policies in Hungary and Poland. This autonomy was often used to increase the wage bill to the detriment of investment. There have also been arguments that the high cost of forced savings in terms of foregone consumption, together with the low returns as a result of investment inefficiency, may have gradually raised pressure on politicians to improve consumption possibilities.

3.2 Investment trends during the transition

For the region as a whole, the trend decline in investment rates accelerated after the start of market-oriented reforms. As Chart 3.1 indicates, the average fixed investment/GDP ratio in the east European economies is estimated to have declined from 21.6 per cent in 1989 to 17.9 per cent in 1993. A similar but more pronounced fall can be observed in the Baltics and the CIS (where the ratio fell from 27.8 to 18.8 per cent of GDP).

Chart 3.1

Share of fixed investment in GDP, 1985-93



Source
Table 3.1.

Note
GDP weights from 1993.

[3] This section draws partly on Temprano (1995).

[4] Kornai (1992; pp.160-70) discusses the ideological, political and institutional motivations behind the high savings and investment rates that were observed in socialist countries.

[5] Chapter 4, Section 4.1 provides evidence on the inefficiency of the capital stock accumulated under central planning. However, both investment and GDP growth were probably overstated (see Annex 11.1).

[6] The figure presents averages weighted with 1989 purchasing power parity GDP. The eight east European countries are Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republic and Slovenia; the average for the former Soviet Union is estimated on the basis of time series for Belarus, the three Baltic states, Kyrgyzstan, Russia and Ukraine.

Table 3.1

Investment in national accounts statistics, 1985-94

Gross domestic investment including changes in stocks (current prices)

	1985	1989	1990	1991	1992	1993	1994
				Per cent of GDP			
Albania	33	32	29	6	10	14	20
Armenia	28	39	32	32	26	14	–
Azerbaijan	–	10	21	11	9	–	–
Belarus	21	30	27	30	32	37	–
Bulgaria	32	33	26	23	20	14	15
Croatia	47	43	31	26	30	15	–
Czech Republic	28	27	29	30	24	17	20
Estonia	33	33	30	17	15	23	–
FYR Macedonia	–	–	32	15	11	10	18
Georgia	34	28	31	28	32	–	–
Hungary	26	27	25	21	15	20	21
Kazakstan	47	40	43	31	–	–	–
Kyrgyzstan	–	–	27	29	53	29	21
Latvia	35	36	40	34	41	9	16
Lithuania	34	34	34	22	19	23	13
Moldova	30	31	26	31	65	7	–
Poland	28	39	26	20	15	15	19
Romania	33	27	30	28	32	30	–
Russia	33	34	30	39	35	26	25
Slovak Republic	32	30	33	35	27	22	17
Slovenia	23	18	17	15	16	25	22
Tajikistan	30	25	16	15	31	–	–
Turkmenistan*	42	25	25	54	42	–	–
Ukraine	27	20	18	22	29	30	–
Uzbekistan	32	32	32	19	25	29	22

* Refers to 'Accumulation'

Gross fixed investment (current prices)

	1985	1989	1990	1991	1992	1993	1994
				Per cent of GDP			
Albania	32	31	31	6	10	–	–
Armenia	–	16	11	4	–	–	–
Belarus	–	–	23	23	24	26	28
Bulgaria	26	26	21	18	16	12	18
Croatia	18	15	16	14	11	15	–
Czech Republic	26	26	26	23	25	23	27
Estonia	30	29	24	22	22	23	–
FYR Macedonia	–	–	17	23	23	17	17
Georgia	–	–	23	19	16	6	–
Hungary	23	22	19	19	20	18	20
Kyrgyzstan	–	–	23	17	15	12	13
Latvia	32	32	23	6	11	14	16
Lithuania	32	32	29	19	13	24	20
Moldova	26	22	19	18	14	–	–
Poland	21	16	21	20	17	16	16
Romania	30	30	20	14	17	16	–
Russia	30	32	29	25	20	21	21
Slovak Republic	29	28	31	28	22	27	26
Slovenia	23	18	18	19	18	19	21
Tajikistan	12	19	9	7	5	–	–
Ukraine	27	11	8	6	12	10	9
Uzbekistan	–	31	31	12	7	–	–

Sources
National Statistical Institutes, IMF, OECD, PlanEcon, World Bank, EBRD estimates.

Note
Pre-price liberalisation Post-price liberalisation

Three countries are missing from the table due to insufficient information: Azerbaijan, Kazakstan and Turkmenistan.

Data issues

Before turning to more detailed evidence, a word of caution is warranted regarding investment data. As is well known, most data series in the transition economies – and historical ones in particular – suffer from a substantial margin of error (see Annex 11.1). Even more than price or output data, however, investment statistics are bedevilled by problems of definition, accounting and coverage.[7] As a result, estimates from the same source can differ substantially in repeated revisions, and cross-country comparisons should be viewed with more than the usual degree of scepticism. As a general rule, relative magnitudes (i.e. shares of GDP) and nominal data tend to be more reliable than absolute and "real" data. Difficulties with "real" data are due to, among other causes, the difficulty of choosing the appropriate weights in an environment of rapidly changing prices. Even relative magnitudes can present certain puzzles, e.g. the low investment rate in fast-growing Poland compared with the high recorded rate in Russia. While many of these problems cannot be solved here, the data displayed in the following tables reflect informed choices by the EBRD made on the basis of various series available for each country.

Reform and investment ratios

A closer look at the experience of individual countries shows diversity which appears to be linked to the depth and speed of reforms. Measured fixed investment fell sharply in virtually all countries in the late 1980s and early 1990s, both in real terms and as a share of GDP.[8] There appears to be a link between this decline and the process of liberalisation.

After an initial fall, the share of fixed investment in GDP stabilised in countries that were liberalising comparatively slowly, and turned around in many of the countries that were liberalising more swiftly. The role of reform can be further assessed by analysing the sequence of price liberalisation and changes in the (fixed) investment rate. Table 3.2 shows the association between changes in the investment rate and the timing of the first significant steps in introducing market prices, as described in the transition indicators of Chapter 2 (to distinguish the pre- and post-liberalisation periods in Table 3.1, mildly and strongly shaded fields indicate that prices have been partially and comprehensively liberalised, respectively). An example may help in the interpretation of Table 3.2. In Ukraine the investment share started to fall more than two years before liberalisation (first row) and investment began to pick up in the same year as liberalisation (first column). The evidence does not allow unequivocal conclusions, but it does suggest that liberalisation had a positive effect on the investment rate. Two key observations emerge from Table 3.2.

First, in no country did the investment share begin to drop *after* price liberalisation was initiated. The timing of price liberalisation and investment decline coincided in four countries (see the fourth row); in all others the first significant drop in the investment share preceded price liberalisation. Second, in many cases, including all of the fast-reforming countries, the investment share began to stabilise or to rise contemporaneously with or within a year from price liberalisation.

Table 3.2

Sequence of price liberalisation and changes in the share of fixed investment in GDP

		Investment share picks up/stabilises (after)				
		Same year	1 year	2 years	> 2 years	Continues to fall throughout period covered
Investment share drops (years before liberalisation)	> 2 years	Ukraine	–	–	–	Armenia, Georgia, Moldova, Tajikistan
	2 years	Latvia	Estonia	–	Kyrgyzstan	–
	1 year	Albania, Poland	Lithuania, Romania, Russia	–	Bulgaria, Croatia	Uzbekistan
	Same year	Slovenia (no change)	Hungary, Czech Republic	Slovak Republic	–	–
	na	Belarus	FYR Macedonia	–	–	–

Note

Based on Table 3.1. Three countries are missing from the table due to insufficient information: Azerbaijan, Kazakstan and Turkmenistan.

[7] Definitions of what constitutes an investment appear to differ across countries, in particular regarding the borderlines between capital alteration and maintenance, work in progress and investment, and valuation changes on existing assets. For instance, it appears that in certain countries of the former Soviet Union the revaluation of assets that became necessary because of inflation was partially accounted for as "investment". Accounting problems in an inflationary environment affect estimates of inventories and depreciation. And coverage problems can be severe, especially in estimates of private sector investment activity.

[8] An exception appears to be Belarus, where broad-based reform has not yet proceeded very far.

The cumulative fall in the investment rate is less severe in countries that have liberalised comparatively rapidly, and the subsequent recovery is stronger. As shown in Table 3.3, countries that were at an advanced stage of transition in mid-1994 experienced on average a fall of 3.4 percentage points in their investment/GDP ratio between 1989 and the trough. The average recovery from the investment trough represented almost two-thirds of the previous fall by 1994. For countries that were at an intermediate stage of transition, these figures were 16 per cent and a quarter, respectively, while in countries at earlier stages of transition the fall represented 14 percentage points and recovery has not yet been reported.

Table 3.3

Variations in the ratio of fixed investment to GDP

	Cumulative drop after 1989 (1)	Recovery by latest available date (2)	Recovery ratio (2)/(1)
	Percentage points		*Fraction*
Advanced transition stage as of mid-1994			
Croatia	-4	4	1.00
Czech Republic	-3	4	1.33
Estonia	-7	1	0.14
Hungary	-4	2	0.50
Poland	0	0	0.00
Slovak Republic	-6	4	0.67
Slovenia	0	3	–
Average	*-3.4*	*2.6*	*0.61*
Middle transition stage as of mid-1994			
Albania	-21	–	–
Bulgaria	-14	6	0.43
FYR Macedonia	–	0	–
Kyrgyzstan	-11	1	0.09
Latvia	-26	10	0.38
Lithuania	-19	7	0.37
Moldova	-8	–	–
Romania	-16	2	0.13
Russia	-12	1	0.08
Average	*-15.9*	*3.9*	*0.25*
Early transition stage as of mid-1994			
Armenia	-12	–	–
Belarus	0	5	–
Georgia	-17	–	–
Tajikistan	-14	–	–
Ukraine	-5	3	–
Uzbekistan	-24	–	–
Average	*-12.0*	–	–

Source
Table 3.1.

Note
The transition stage reflects the average of six scores of progress in reform, as set out in the *Transition Report*, 1994, Table 2.1. Advanced, middle and early transition countries are those whose average score fell in the range 3.0-3.5, 2.0-2.9 and 1.0-1.9 respectively.

In spite of the initial declines, Table 3.4 shows that fixed investment shares remain at fairly high levels when compared with the OECD average (which was 20.6 per cent in 1994). One interpretation could be that the adjustment or market "correction" from the situation of forced savings under central planning has been established fairly quickly, and we may now be observing longer-run investment rates. However, most of the countries for which no recent information on the fixed investment rate is available are likely to be in the "below 15 per cent" category.[9] Moreover, the data limitations described earlier should invite some scepticism, in particular regarding countries of the CIS. For instance, the continued high measured investment levels in Belarus and Russia have not been reflected in economic growth.

Some brief comments, and caveats, are necessary on changes in stocks; and by extension on the aggregate "domestic investment" series in Table 3.1 (which represents the sum of changes in stocks and fixed investment). Since changes in stocks are subject to serious revaluation difficulties during periods of high inflation and other measurement problems, not too much should be read into available estimates of their evolution over time.[10] Nevertheless, there is clearly a pattern of substantial stockbuilding in the early years of liberalisation in all countries (linked no doubt to the fall in aggregate demand), and of subsequent reductions in stocks. Stocks and fixed investment appear to go through opposite motions, which accords well with aggregate demand based investment theories: when fixed investment falls, stocks rise, and vice versa, except in Poland, the Slovak Republic and Slovenia, where the two variables have at times moved in the same direction.

Table 3.4

Fixed investment/GDP in 1993-94 (where available)

< 15 per cent	Georgia, Kyrgyzstan, Ukraine
15-20 per cent	Bulgaria, Croatia, FYR Macedonia, Hungary, Latvia, Poland, Romania
> 20 per cent	Belarus, Czech Republic, Estonia, Lithuania, Russia, Slovak Republic, Slovenia

Source
Table 3.1.

[9] These countries include Albania, Armenia, Azerbaijan, Kazakstan, Moldova, Tajikistan, Turkmenistan and Uzbekistan. In all of these except Turkmenistan, investment rates in GDP were extremely low in the last available estimates.

[10] Typically, stockbuilding in OECD countries represents less than 1 per cent of GDP. In many transition economies, it is reported to have reached up to half of GDP in certain years.

Aggregate output and investment

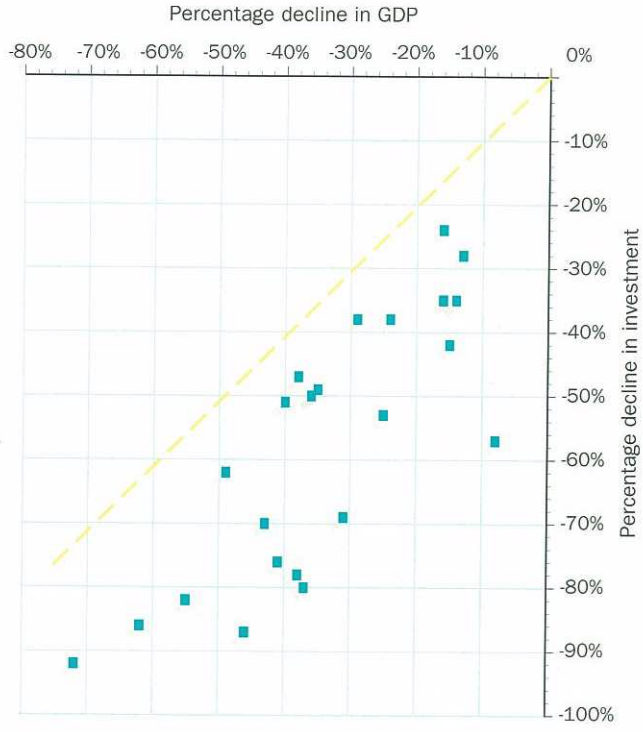
Does the GDP-collapse explain the fall in investment rates? We have seen measured output fall by about 15 per cent in eastern Europe and by about 50 per cent in the Baltics and the CIS, and a fall in investment that was proportionately greater; the points in Chart 3.2 all lie below the 45° line. As is well known, causality between aggregate investment and output can go either way, and they can both be driven by common third factors. Thus, an "autonomous" fall in investment (for instance as a result of uncertainty or a cutback in public investment) reduces aggregate demand and therefore GDP. Low capacity utilisation due to an economic downturn may discourage investment. And impaired coordination of business decisions following the demise of central planning, in the absence initially of functioning markets, can affect both production and investment independently.

The evidence on the relation between GDP and investment is inconclusive and illustrates some of the limitations of the "aggregate approach" in analysing the transition. The sequence of events allows a simple although rough assessment of causality. In the absence of foresight, changes in the "causing" variable would be expected to precede those in the other variable. Table 3.5 classifies countries according to how variations in GDP and in the investment-to-GDP ratio followed each other in time. Along the rows, the classification reflects the sequence during the initial (significant) fall in both series in the early 1990s, whereas the columns record the events during recovery (if any). Thus, for example, in Lithuania the initial investment decline lagged behind the output fall (first row) but the investment rate led in the recovery (second column).

Although the available annual data do not allow a very discriminating analysis, they show a surprising diversity of experiences both during the initial fall and during the recovery. The table nevertheless yields one very important observation: in no country has growth led the investment rate during the recovery. Investment is much more likely to serve as a motor for output recovery than vice versa. This emphasises the importance of policies designed to facilitate investment in a strategy to deliver growth in the transition economies. Recall also that investment rates remained moderately high in most of the region. This suggests that investment during the economic transition is driven more by sectoral reallocation

Chart 3.2

Change in GDP and gross domestic investment 23 countries (1989-94)



Source
Table 3.1 and Annex 11.1 (Table on GDP growth).

Table 3.5

Change in the fixed investment ratio in relation to GDP growth

		Sequence during recovery					
	The investment ratio...	lags	leads	is contemporaneous	is counter-cyclical	is constant	no recovery or no data
Sequence during the initial fall	lags	–	Albania, Lithuania	Bulgaria, Czech Republic	Belarus	Romania, Russia	Georgia
	leads	–	Latvia	–	–	–	Armenia, Moldova, Tajikistan
	is contemporaneous	–	Croatia	Estonia, Slovenia	FYR Macedonia	Hungary	Kyrgyzstan, Ukraine, Uzbekistan
	is counter-cyclical	–	–	–	Poland	–	–
	is constant	–	–	–	Slovak Republic	–	–

Source
Table 3.1 and Annex 11.1 (Table on GDP growth). Three countries are missing from the table due to insufficient information: Azerbaijan, Kazakstan and Turkmenistan.

Table 3.6

Investment by ownership

	1989	1990	1991	1992	1993	1994
			Per cent of GDP			
Bulgaria						
Domestic investment	32.9	25.6	22.6	19.9	14.2	14.6
Private investment	1.5	0.9	0.6	0.4	3.1	–
State-sector investment	31.4	24.7	22.0	19.5	11.0	–
Government (budget)	6.9	3.1	2.0	2.7	1.9	1.7
Non-government[1]	24.5	21.6	20.0	16.8	9.1	–
Czech Republic						
Domestic investment	26.8	28.6	29.9	24.0	17.0	20.4
Private investment	1.1	1.5	2.8	3.3	4.1	–
State-sector investment	25.7	27.1	27.1	20.7	12.9	–
Government (budget)	6.2	6.1	5.6	6.5	4.2	4.9
Non-government[1]	19.5	21.0	21.5	14.2	8.7	–
Estonia						
Domestic investment	32.7	30.2	17.1	15.4	22.8	–
Private investment	–	–	–	1.4	1.6	–
State-sector investment	–	–	–	14.0	21.2	–
Government (budget)	–	–	3.1	1.3	2.1	2.0
Non-government[1]	–	–	–	12.7	19.1	–
Latvia						
Domestic investment	35.6	40.1	33.7	41.2	9.2	15.9
Private investment	–	0.7	0.6	2.3	1.3	–
State-sector investment	–	39.4	33.1	39.0	7.9	–
Government (budget)	–	–	–	1.5	1.1	2.0
Non-government[1]	–	–	–	37.5	6.8	–
Lithuania						
Domestic investment	34.1	34.3	22.2	18.1	22.7	13.0
Private investment	6.6	7.0	5.4	5.4	8.3	5.2
State-sector investment	27.5	27.3	16.8	12.7	14.3	7.8
Government (budget)	–	7.4	7.7	4.7	4.0	1.6
Non-government[1]	–	19.9	9.1	8.0	10.3	6.2
Romania						
Domestic investment	26.8	30.2	28.0	32.3	30.1	–
Private investment	–	–	–	2.6	4.7	–
State-sector investment	–	–	–	29.3	25.1	–
Government (budget)	–	7.7	6.0	5.8	4.3	5.7
Non-government[1]	–	–	–	23.5	20.8	–
Russia						
Domestic investment	33.8	30.1	39.1	35.4	25.8	25.0
Private investment	–	–	0.3	0.4	0.9	–
State-sector investment	–	–	38.8	35.0	24.9	–
Government (budget)	–	–	–	4.5	4.0	3.8
Non-government[1]	–	–	–	30.5	20.9	–

Source
National Statistical Offices, Temprano (1995).

[1] Derived as public investment minus government investment.

considerations rather than by aggregate supply and demand. These determinants of investment, and the central role investment plays in the reallocation process, are discussed in the next chapter.

Public and private investment

Table 3.6 provides some evidence of a shift from public to private decision-making over investment – while aggregate investment falls, private investment rises moderately in most of the countries covered. As was to be expected, the timing of the shift is closely related to the privatisation process in each country.[11] Survey data in Poland provide a detailed picture of enterprise investment that underlines how important the new private sector can be in leading the investment dynamics.[12] In 1993, these data show, the investment-to-sales-ratio of new private firms was more than twice as high (5.8 per cent against 2.2 per cent) as for corporatised state enterprises, with privatised firms (4.4 per cent) and traditional state enterprises (2.5 per cent) in between. However, where privatisation leaves enterprises under weak or inappropriate governance – for instance as a result of insider control or dispersed outside ownership – investment may be delayed. The same effect can arise from delayed privatisation. As underlined in Chapter 8, privatisation in itself is often insufficient to generate the governance and motivations that induce investment, at least in the short run. As management and governance in privatised firms improve and respond to new circumstances with effective restructuring, investment will recover and indeed will play a crucial role in the restructuring process.

Another cause of the switch in the pattern of investment from public to private has been the relative decline in public (budgetary) investment, which has been cut back – often more than proportionately – in line with the collapse of budgetary revenues that has been witnessed in many countries.[13] Despite this decline, public investment/GDP ratios remain on average at approximately the levels normally seen in industrial countries. Thus, for those countries for which a basic sectoral breakdown of investment is available, the average government investment/GDP ratio was 3.6 per cent in 1993, exactly the same as the average ratio in OECD countries in that year.[14]

This similarity in public investment shares may be a worrying rather than an encouraging sign. The appropriate level of public investment may well be higher during the transition than in other circumstances. This is because there are crucial infrastructure demands to sustain the growth of the private sector during the transition. As discussed in Chapter 6, infrastructure plays, through complementarities and forward linkages, a vital role in supporting and stimulating private sector investments. These benefits cannot always be captured through fees or tariffs. It is important to emphasise, however, that in both the operation and funding of infrastructure there is an often unexploited potential for private sector involvement, which is particularly valuable in the presence of severe budgetary constraints.

Support for infrastructure, including the promotion of commercial operations and private sector provision, will remain a central activity for the international financial institutions. It accounts for around one-third of the EBRD's stock of projects. The countries of the region will continue to require support in this area for a considerable period, given budgetary pressures, the damaging and dangerous environmental legacy of the old regime, the scale of the challenge to provide infrastructural support for a developed market economy, and the "newness" of the issues involved in establishing a commercial basis for infrastructure activity.[15] While the main focus of this year's *Transition Report* is the private enterprise and private investment, this does not imply any lack of emphasis on the importance of infrastructure investment in taking the transition forward. Indeed the private investment necessary to transform the economies and establish growth will not be able to flourish without it. The issue will reappear at many points throughout this Report.

3.3 The possibilities and requirements for growth

How much investment is "needed"? Should investment rise substantially beyond current levels in the transition economies? Though often asked, these are social planners' questions. In a market environment, the focus should be on what makes investing attractive, how constraints on investment can be relaxed, what kinds of investments can lead the processes of transition and growth and how they can be stimulated.

Nevertheless, simple relationships between aggregate investment and growth can be instructive to illustrate the magnitude of the challenge and to guide further analysis. The rate of growth of GDP can be described as the ratio between the investment share in GDP and the incremental capital-output ratio (ICOR).[16] Developing countries with per-capita incomes in the same range as the former centrally planned economies and low population growth had, on average, an ICOR of around 5 in the period 1974-89.[17] Under these conditions, sustained growth of 4 per cent a year would require the transition economies to invest 20 per cent of their GDP. "Catching up" with income levels in OECD countries within a generation would call for substantial sacrifices indeed. Assuming that current average income in the transition economies

[11] Again, it is important to stress problems of data quality, which are compounded here by classification problems. Time series may correctly reflect trends, but some of the movements in the data may also reflect changes in statistical methodologies that allow a more accurate estimate of small private activity and housing investments. The increase in the private investment shares in Bulgaria and Romania in 1993 is partly explained by such factors.

[12] Belka et al. (1994).

[13] Two warnings must be given on the reliability of the data on public investment presented in Table 3.6. For the pre-transition period and for several countries, the government investment statistics shown may include investment actually undertaken not by the state but by state enterprises, which would exaggerate the downward tendency in public investment recorded since 1989. Second, in several countries public investment is overstated (both in the pre-transition and the post-transition figures) because the data also include capital transfers from the state.

[14] Temprano (1995) p.10.

[15] A valuable discussion of these issues is to be found in the World Bank's 1994 *World Development Report*.

[16] An ICOR of "5", for instance, implies that five ECU have to be invested to yield one ECU of annual GDP. All productivity growth is implicitly ascribed to capital. The growth process in this illustration is described by the Harrod-Domar equation (see footnote 1 above), after substituting the investment rate for the savings rate.

[17] This refers to 20 developing countries with annual income levels of US$ 2,000-6,000 per capita in 1974 and a rate of population growth of less than 2 per cent. Average GDP growth of this group over the 1974-89 period was 4.0 per cent, while the investment-to-GDP-ratio averaged 21.1 per cent (Summers and Heston (1993).

represents one-fifth of the OECD average (in purchasing power parity terms), and that OECD countries grow by 2 per cent a year, investment rates of 36 per cent (growth of 7.2 per cent) would be needed over a period of 30 years to draw even.[18] A closer look at the sources of medium-term productivity growth, however, suggests that this scenario is overly pessimistic. There are various reasons to believe that the ICOR is (or will be) lower in the transition economies than in middle-income developing countries.

Part of the scope for productivity increases is independent of capital investment. After an initial fall at the beginning of reforms, measured labour productivity rose strongly in many transition economies (see Chapter 11 for discussion). In the east European countries for which data are available, the continuing fall in aggregate employment while production stabilised around 1993-94 suggests that part of the productivity increase was due to the redundancy of previously "hoarded", unproductive labour. In some countries, such as Poland, labour productivity in manufacturing continued to grow at a fast pace even after employment levels began to stabilise, in spite of relatively low recorded levels of investment. This reflects in part greater production efficiency as a result of improved work incentives, better management, production logistics, etc. – all of which were neglected under central planning. Continued progress during the restructuring process toward Western levels of management quality and incentives can boost productivity growth rates for some time to come.

There is also considerable scope in the transition economies for investment-related ("embodied") productivity gains, which should reduce the ICOR in these countries. These issues are discussed in more detail in Chapter 4. Since technology lags behind Western countries in many sectors – and is now often commercially available to companies in the region – substitution of new processes or products for technologically obsolete old ones will allow productivity to rise even when only replacement investment takes place. Furthermore, the process of structural change has caused capital scarcity in high value-added sectors, and investment in these can have a high yield and thus, taken together, a substantial effect on growth.

Most importantly, however, the transition economies are endowed with levels of human and social capital that far exceed the norm in their income category (see Table 2.2 for evidence on social indicators, including health and education). The mismatch between these assets and the low-value stock of physical capital represents a productivity reserve that can be tapped by new investment of the right quality. New investment can potentially generate higher value added than in most developing countries because the skilled operators and engineers are there to make it work (often with limited retraining investment). Since much human and social capital is currently "structurally unemployed" as a result of economic dislocation, this value added represents a net gain to these economies. In the longer term, the human capital is a source of technical progress and can thus contribute to ongoing productivity gains.

All these factors should make it possible for transition economies to grow faster than OECD countries in the medium term, even in the absence of very high investment rates, and therefore contribute to some convergence of living standards toward the levels in the West. The human capital "reserve" should also enable productivity growth beyond the levels that characterise most developing countries.

However, the legacy of the old regime has left obstacles to growth, as well as opportunities for it. The credibility of institutions and reliability of commitments, which have characterised the East Asian experience, will take time to achieve in the transition economies. Both macroeconomic stability and institutional development help explain the variation in foreign investment per capita among transition countries and between them and East Asia, including China.[19] Transition has also reduced the effectiveness of government in many countries and constrained its budgetary latitude; the state's ability to actively promote growth is seriously impeded. Another important factor is that investment and savings rates, though not low in the transition economies, tend nevertheless to lag far behind those of the Asian economies. New or improved financial institutions leading to a better mobilisation and channelling of savings should clearly improve the medium-term growth performance of transition countries.

This discussion suggests that it is reasonable to expect medium-term growth rates above OECD and LDC levels, but still lower than the double-digit performance of the East Asian tigers, in those transition economies that will have completed the necessary macroeconomic and institutional reforms.

3.4 Savings

Despite the potential for large productivity increases, growth and eventual convergence with the Western market economies will require substantial amounts of new investment. A significant investment effort in economies of this size will have to be financed primarily by domestic savings. Investment finance is the topic of Chapter 5, but some considerations regarding the likely development of savings should be useful here.[20]

Current rates of savings in transition economies reflect to a considerable extent the recession and the initial difficulties linked to the process of systemic transformation. As transition economies gradually strengthen and restructuring in the enterprise and financial sectors proceeds, domestic savings rates should increase. This is particularly clear in the case of corporate savings, since enterprise profitability is likely to improve quickly with the resumption of

[18] According to the *World Bank Atlas* methodology, the average GNP per capita in 1993 was US$ 4,381 (in purchasing power parity terms) in the 25 transition economies of eastern Europe and the former Soviet Union, while it was US$ 19,636 in the OECD countries. In addition, this calculation assumes no population growth in both OECD and transition countries.

[19] See also Chapter 4 for a discussion of investor uncertainty and FDI.

[20] The following draws partly on Temprano (1995).

growth.[21] Economic recovery and continued progress in structural reforms is likely to increase public savings, both by increasing revenues and by reducing unemployment benefits and (explicit and implicit) subsidies to loss-making enterprises and banks. The impact of economic growth on the savings rate of households is less clear. The positive influence of economic expansion and structural reform on public and household savings may be at least partially offset by adverse demographic developments unless governments in the transition economies move fast to reform their pension systems. In the short and medium run, therefore, the bulk of the rise in savings necessary to finance higher investment is likely to come from increased corporate savings. Indeed, as in most of the successful economies, much of the new investments undertaken by private enterprises will be directly financed with retained profits (see Chapter 4).

This should, however, not be taken to imply that foreign capital will not play an important role in the financing of investment growth in transition economies.[22] According to the forecasts for the region as a whole contained in the IMF *World Economic Outlook* of May 1995, the negative gap between average domestic savings and investment rates to be covered by foreign savings is projected to increase to 6 per cent of GDP by 1996, up from 3.8 per cent in 1994. This is the result in almost equal parts of both a projected rise in investment rates and a continuing decline in domestic savings rates.

When it comes in the form of foreign direct investment, external capital can provide services that extend beyond financing to management abilities, marketing networks and technology. Such "packages", which cannot always be "unbundled" for selective import, can be particularly useful during the transition both directly by modernising parts of the economy and indirectly by providing demonstration effects and other external benefits.

Official foreign capital flows, lastly, will continue to play a key role in the transition economies. Conditional official assistance linked to sensible reform programmes not only contributes to cover the gap between domestic savings and investment but also acts as a catalyst for domestic and foreign investment by reducing uncertainty and increasing the chances that the reforms will succeed. As systemic transformation proceeds, those countries with a stable macroeconomic framework should be able to increasingly rely (as some are already doing) on private capital inflows to cover the current account gap and any debt repayments.

3.5 Concluding remarks

The picture that emerges from this chapter is that, after a decline reflecting as much the artificially high starting point as the temporary dislocations of reform, the prospects for investment in the transition economies are bright. Fast reform is a condition for dynamic investment, not a brake on it. Aggregate developments do not reveal much about the underlying "story", which is structural in nature. Our optimism regarding future investment and medium-term growth in the transition economies reflects in part the existence of productivity reserves – such as a large endowment of human capital – that can be tapped by profit-oriented investors. These will be discussed in greater detail in the next chapter. Effective governance in enterprises will be needed to align the incentives of managers with the long-term commercial interests of their firms and to induce high-quality investments (see Chapter 8). Government has an important role to play in facilitating investment, by reducing uncertainty, providing the framework for market-based contracts and complementing private investment with the necessary infrastructure. The chapters in Part II of this Report highlight different aspects of the role of governments. Lastly, domestic savings will be the primary source of finance for the investment effort and there is reason to believe that it will pick up gradually as a result of economic recovery and the strengthening of domestic financial intermediation (Chapters 5 and 10). External finance can complement domestic savings, but it can be particularly valuable by enhancing the quality of investments and the investment process.

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[21] Domestic savings represent the aggregate of household, corporate and public sector savings. These different sources of savings are interdependent: for instance, public and corporate savings interact through taxes, public and household savings through the pensions system, and corporate and household savings through the intermediary of capital markets.

[22] Note, however, that the growth contribution of foreign capital is smaller in terms of GNP than GDP, the difference being dividends and interest payments accruing to foreigners for the capital services rendered. Foreign and domestic savings as sources of investment finance are thus not equivalent.

Determinants of investment in the transition

4

Economic transition is about change: in the way decisions are made, in the institutions that underlie economic relationships, in the organisation of enterprises, and in the composition of production and consumption. Transition economies are marked by an exceptional range of assets – human, physical and institutional – requiring the radical overhaul for which investment is essential. The focus of this chapter, in contrast with the more aggregate approach of the preceding chapter and the financial emphasis of the next chapter, is on the sectoral and technological aspects of change and investment during the transition.

In transition economies, the process of investment is not merely a question of accumulating a little more, or more sophisticated, equipment. The distortions of the old regime prevented capital and other resources being used in the way in which they might most fruitfully have satisfied wants. Many of the distortions have been eliminated by liberalising prices and trade and by abandoning controls. Prices, costs and returns now guide most investment decisions. However, investment during the transition differs from investment in other circumstances because of its importance in facilitating the reallocation (or rededication) of existing human and material capital from lower to higher value uses while adapting the structure of the capital stock to that required by the market.

During the transition process, many investments should offer a high return as existing assets represent sunk costs[1] and their use may often be upgraded with only minor additional expense. However, the reallocation of resources may encounter obstacles or bottlenecks, including a high level of uncertainty over policies and prices and underdeveloped financial systems which may prevent available funds from flowing to their most productive uses. Since change in the transition is all pervasive, the ability of the "invisible hand" to facilitate and coordinate investment decisions is severely tested, well before the markets themselves have fully matured. Government policy would be similarly strained in attempting to steer these developments. Its first priorities must be in providing the predictable macroeconomic, regulatory and institutional framework needed for investment to respond to the existing opportunities.

In this chapter, we focus on what is "different" about investment during the economic transition. After briefly discussing the nature of the capital stock inherited from the period of central planning (Section 4.1), we analyse the decline in its value as a result of reform (Section 4.2). This capital loss, and its structure, explain the potential for high-yielding investment as a result of scarcity and complementarities with existing assets. Together with a review of developments in the structure of investment, these arguments are developed in Section 4.3. A discussion of constraints on the response of investment to these "fundamentals" follows in Section 4.4, focusing particularly on the role of uncertainty, and a brief discussion of policy implications concludes (Section 4.5).

Because of data restrictions, most of the evidence and analyses refer to investment in physical capital. For the same reason, and because much of the "story" behind investment during the transition is hard to measure, there will be a focus on principles and examples rather than more detailed quantitative analysis.

4.1 The inherited capital stock

The capital stock that the transition economies inherited was accumulated under central planning, a product of what Kornai describes as "the age of forced growth".[2] Among the characteristics of that age were: (i) that consumers had little voice in determining overall investment rates in a system primarily controlled by agents whose interests or inclinations lay in expansion; (ii) that, therefore, investment priorities were geared heavily towards investment and producer goods; and (iii) that incentives were not linked to efficiency, with prices, costs and economic returns playing only a minor role in guiding the structure and technology of the capital stock.

As a result of the first of these characteristics, investment rates as a share of national income were consistently and impressively high, while consumption was suppressed – this was discussed in Chapter 3. As a result of the second, a capital stock was built up over time whose sectoral and technological structure was far removed from that generated in market economies. The third characteristic accounts for an extremely low efficiency of capital in generating value added (even if valued at the distorted prices of the old system). A particularly stark example of inefficiency are the energy coefficients in GDP. Compared with the OECD area, the energy intensity of GDP in 1992 was about four times higher in the east European countries, and more than six times higher in many countries of the former Soviet Union (see Table 4.1).[3] While the command system was wasteful of all resources, its lack of attention to prices and opportunity cost made it especially wasteful of resources in which it was particularly well endowed. It is in this sense an unfortunate accident of history that some of the command economies were also those with very large resources of oil, gas and coal.

Chart 4.1 plots investment shares in GDP against GDP growth rates of six centrally planned economies (CPEs) from 1974 to 1989, as

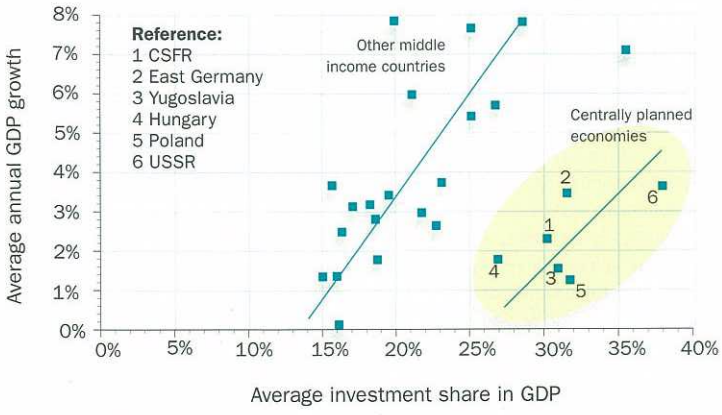
[1] "Sunkness" refers to the fact that these funds cannot simply be converted into another form of asset (e.g. into money) or adapted for a different use without additional investment. Reform can lead to a total loss of value of assets in their previous application; because of sunkness, their opportunity cost then falls to zero.

[2] Kornai (1992), p. 197.

[3] Industrial and geographical structure as well as climate may explain a minor part of the variation.

Chart 4.1

Growth and investment in middle income countries and centrally planned economies, 1974-89



Source
Summers and Heston (1993).

Note
Countries in the sample have the following characteristics:
1. GDP per capita in 1974 – US$ 2,000-6,000
2. Average annual population growth over the period is less than 2 per cent.

well as those of 20 countries that are broadly comparable in terms of population growth (as a proxy for labour force growth) and income per capita (US$ 2,000-6,000 annually in 1974). It is evident from this comparison that the CPEs have been singularly unable to translate high investment rates into growth. In fact, fitting lines that relate these two variables, as is done in Chart 4.1, suggests a "rightward" shift in the functional relationship between them in CPEs. It appears that CPEs were not showing the kind of productivity growth that arose from both human and physical capital in other countries.[4]

This is not the place to discuss the causes of this inefficiency and lack of dynamism,[5] but it is clear that the system induced waste and excessive vertical integration to keep control over supplies, which prevented taking advantage of opportunities for improving productivity. A further result of the priorities of the old system was a systematic choice of technologies that neglected the environment. Lastly, the combination of economic stagnation, very large capital stocks and waste meant that even the high investment ratios could not prevent a lengthening of the average age of the capital stocks in the later years of central planning. At reunification, for instance, this had reached 18 years in East Germany as against eight in the Federal Republic.[6]

This capital stock constituted the initial endowment of the transition economies with which to face the challenge of the market.

Table 4.1

Energy intensities in eastern Europe and the former Soviet Union, 1992

	TPES[1]/GDP ratios (tonnes oil equivalent per US$ 000)	TPES[1] per capita (tonnes oil equivalent)
Eastern Europe[2]	**1.49**	**2.56**
Bulgaria	1.62	2.14
Croatia	na	1.29
Czech Republic	1.70	4.17
Hungary	0.82	2.47
Poland	1.24	2.43
Romania	1.72	1.86
Slovak Republic	1.85	3.55
Slovenia	na	2.82
Former Soviet Union[1]	**2.78**	**4.79**
Azerbaijan	4.33	3.69
Belarus	1.29	3.76
Estonia	1.70	4.74
Kazakstan	3.44	5.74
Russia	2.69	7.24
Turkmenistan	3.02	3.45
Ukraine	2.98	4.94
Uzbekistan	3.70	3.11
OECD countries[3]	**0.40**	**4.84**
Canada	0.55	7.88
France	0.37	4.03
Germany	0.41	4.22
Italy	0.32	2.75
Japan	0.26	3.63
United Kingdom	0.41	3.74
United States	0.43	7.78

Source
CEPII, IEA, PlanEcon.

1 Total primary energy supply.
2 Unweighted average.
3 Weighted average all OECD.

4.2 Structural change and the capital stock

Transition "shocks" to the value of capital

Despite its general lack of efficiency, the inherited stock of assets was valuable to enterprises under the set of relative rewards imposed by the central planners. Reform severely disrupted the existing structure of rewards, even though large quasi-fiscal deficits in many of the transition economies are evidence that the impact on enterprises was partly cushioned by the financial system. The inherited capital stock was exposed to several "shocks": shifts in relative prices and allocations, a radically different structure of demand, changes in environmental and other regulations, and exposure to superior technologies. None of these shocks is "exclusive" to the transition. However, their suddenness, magnitude and pervasiveness during the transition are unusual.[7]

4 The regression lines are defined in terms of the rate of growth (dependent variable), the investment share in GDP (independent variable) and a shift factor. This is obviously a simplification of what is in reality a very complex relationship, and there are a number of possible underlying theories. However, an analysis of the roots of low productivity growth under central planning is not our main focus here.

5 See, for instance, Le Houerou (1995); Kornai (1992).

6 Eickelpasch (1995). In Poland in 1993, 37 per cent of the fixed capital of enterprises surveyed in a World Bank research project was older than 15 years, and 57 per cent older than 10, in spite of a rebound in investment activity that had begun by that time (Belka et al. 1994).

7 They are also accompanied by new forms of institutions and behaviour – a "shock" which does distinguish the transition.

These shocks are discussed in the following since they are important for subsequently deriving the structure and productivity of investment. The plausible assumption is made here that capital and its embodied technology are mostly irreversible, once installed.[8] Were it not for this feature, capital could simply migrate to the sectors now favoured by the new prices or demand, and mutate into new technologies and shapes with no obvious consequences for its value.

Relative price shocks

Relative prices of products and inputs into production have readjusted as a result of price liberalisation, foreign competition and the elimination of subsidies. Even at a very aggregate level, these shifts can be dramatic. For components of the consumer basket, Table 4.2 shows that, except for Bulgaria among the countries selected, the price of services has risen much faster since the beginning of liberalisation than other prices. For industrial sales prices, the selection in Table 4.3 illustrates that prices of raw materials and intermediate goods into production have often left prices in sectors that manufacture final products far behind. To pick an extreme example, in Russia the prices of energy and fuels rose by factors of 6 and 7, respectively, relative to the price of textiles.

We should expect the value of the capital stock to fall in those sectors in which input and output prices and subsidies move so as to reduce real net cash flows, and vice versa.[9] While the market value of capital services falls in some sectors, however, this is not equivalent to retirement of the capital (scrapping) except where cash flows insufficient to finance wages force installations to close down.[10] Even where this is not the case, we should often see equipment operating at below capacity (if this helps to reduce operating costs) and the scrapping point brought forward.

Box 4.1

Relative prices and the value of capital

The valuation of capital is central to this chapter and deserves some analytical clarification. Capital goods can be valued at the cost of producing or releasing them (supply price) or at the value they represent to users (demand price). In principle, this applies to all forms of capital, but we will here concentrate for simplicity on physical, commercial assets.

In the short run, the supply of capital goods is often inflexible and the market-clearing price will tend to reflect the "user value" of existing capital stocks. In the longer run, especially where capital goods imports are an option, it will be the supply price that determines market values, but supply and demand prices will also show some tendency to converge as stocks of assets increase (or decline) over time. As a result, in transition economies, assets in certain sectors suddenly "favoured" by demand may rise steeply in value initially, and fall behind general price increases later on, and vice versa.

The demand price of capital goods is perhaps the most difficult of these concepts. It reflects the expected stream of net income that can be derived from their application in production, the variability of that stream (risk) in conjunction with the degree of irreversibility of an investment, as well as the discount rate at which future income is discounted to its present value. The determinants of the net income stream include on the one hand the prices of outputs, material inputs and non-material inputs such as labour, in short the structure of relative prices in the economy. On the other, the efficiency with which the capital goods help transform units of inputs into units of output – i.e. their technical coefficients (as well as management ability). The discount rate will generally be dictated by the returns to funds in alternative, relatively risk-free investments (such as US Treasury Bonds). Lastly, risk – with respect to relative price movements, regulations, etc. – in a transition environment is to a large extent a function of the speed and decisiveness of reforms, a point that is addressed in Section 4.4.

Table 4.2

Relative prices of consumer goods, selected countries*

	Bulgaria[1]	Hungary[2]	Kazakstan[2]	Latvia[3]	Poland[1]	Russia[1]
			(Consumer Price Index = 100)			
Food	109	100	114	91	74	102
Beverages & tobacco	38	87	–	66	87	35
Non-food	–	–	84	–	110	79
Clothing	64	87	–	67	–	–
Housing, electricity, heat	73	142	–	145	–	–
Services	86	106	172	249	175	307

* Change in price over the period relative to the average consumer price index.

Sources
OECD short-term economic indicators; *Russian Economic Trends*.

1 1990-94.
2 1989-94.
3 1991-94.

8 While equipment can sometimes be refitted (e.g. gas-guzzling engines in cars or aeroplanes, environmentally damaging power-generating technology), rededicated (e.g. military-industrial plants), or relocated (computers, transport equipment), this will tend to involve substantial new investment. These issues are taken up again in Section 4.3.

9 See Box 4.1 on capital valuation. Note that a simple one-to-one relationship between cash flow and the market value of physical capital exists only under strict assumptions which include perfect foresight of investors, the absence of intangible capital, and others.

10 "Capital services" is employed here for simplicity; in fact, equivalence between cash flow and capital services is only given in the absence of taxes and market power.

Table 4.3

Relative industrial producer prices, selected industries and countries

Industrial sector	Belarus[1]	Bulgaria[2]	Poland[3]	Russia[4]
	(Industrial Producer Price Index = 100)			
Energy	127	142	219	222
Fuel	185	148	179	188
Ferrous metals	86	230	109	130
Chemical	123	148	94	118
Machine-building	36	73	61	83
Electrical/electronic	–	65	61	–
Building materials	98	115	86	97
Glass	30	114	92	–
Textiles	53	78	57	30
Food	62	109	103	81

Sources
National Statistical Yearbooks, *Russian Economic Trends*.

Note
Change in price over the period relative to the average industrial producer price index

1 Dec. 1991-Mar. 1995
2 1989-93
3 1985-93
4 Dec. 1991-Dec. 1994

Table 4.4

Changes of sector shares in GDP at current prices, 1989-1993

	Industry	Agriculture	Services[1]
	Change in share (% of GDP)		
Albania	-26.4	6.7	19.7
Armenia	-22.5	47.9	-25.4
Azerbaijan[2]	7.7	0.7	-8.4
Belarus	5.2	-5.5	0.3
Bulgaria	-23.5	1.3	22.2
Croatia[3]	-3.6	2	1.6
Czech Republic	-10	-0.4	10.4
Estonia	-8.4	-9.9	18.3
FYR Macedonia[2]	-7.3	2.6	4.7
Georgia	-21.3	34	-12.7
Hungary	-8	-8	16
Kazakstan	9.2	-15.1	5.9
Kyrgyzstan	-6.7	4.1	2.6
Latvia	-13.1	-4.3	17.4
Lithuania	-3.3	-6.7	10
Moldova	1.8	-11.9	10.1
Poland	-19.4	-5.9	25.3
Romania	-19.3	6.7	12.6
Russia	-11.1	-5.6	16.7
Slovak Republic	-14.9	-2.7	17.6
Slovenia	-8.9	0.2	8.7
Tajikistan	1.3	6.1	-7.4
Turkmenistan[4]	1.7	-4.3	2.6
Ukraine	-3.5	13.5	-10
Uzbekistan	2.7	-7.8	5.1

Sources
Computed from data from national statistical offices, *World Tables* (World Bank), *Trends in Developing Economies* (World Bank), UNECE.

1 Calculated as a residual for some countries.
2 Change over 1989-92.
3 Change over 1990-93.
4 Change over 1989-91.

Changes in the structure of demand

Trade liberalisation, the new power of consumer preferences and the cutback in defence spending in many transition economies have shifted sectoral and geographical patterns of demand. Table 4.4 illustrates that there have been dramatic shifts, over a period of only four years, even at a broad sectoral level of disaggregation. The service sector has gained substantially in most countries in terms of shares at the expense of industry and, to a lesser extent, of agriculture. More detailed data show wide differences in the performance of individual industries within these aggregates.[11] This has brought opportunities to some industries and severe adjustment problems to others. To the extent that prices were not flexible enough to accommodate demand (or that products would not find a buyer whatever the price) the result has been "structural unemployment" of the capital stock in the now neglected sectors – reduced capacity utilisation that will not be overcome by a cyclical upturn in aggregate demand. In accounting terms, the excess capacity should be written off. There will also be gainers from these demand shifts, with capital in the "favoured" sectors enjoying temporary scarcity rents. The same propositions developed here for "physical" capital apply to human capital, to the extent that it is application-specific (i.e. they apply to certain forms of on-the-job training but not to general education which is "fungible").

Changes in regulations

In various countries of the region, particularly the east European candidates for accession to the EU, environmental and health and safety regulations have begun to be adapted to Western standards. Existing installations, for instance in the power-generating and chemical industries, will have to comply with these standards over time, often by deadlines that are likely to lie well within their economic lifetimes. Consequently, refitting or premature scrapping will be required, reducing the discounted value of capital services and thus the market value of equipment and perhaps structures. Investment needed to achieve environmental "parity" with the EU has been estimated at ECU 91 billion for the six large central and south-east European candidates for accession,[12] implying substantial annual spending if measured as a share of 1990 GDP (Table 4.5). While some of the investment will take

11 Chart 4.3 illustrates the variation of output and investment shares in Romanian industry.

12 These are Bulgaria, the Czech Republic, Hungary, Poland, Romania and the Slovak Republic.

place as part of the normal replacement cycle of capital goods and structures,[13] it will place impossible burdens if any attempt is made to compress it into a period of five years or so. The environment is an area where international partners have both an incentive to collaborate and expertise to impart. It is likely to be of special importance in the activities of the international financial institutions in the coming years.

Technology shock

The liberalisation of external transactions has made technologies and products available to economic agents in eastern Europe, the Baltics and the CIS that are sometimes far superior to domestic ones, especially given the new set of input prices. This is equivalent to an innovation shock – "creative destruction", in Schumpeter's terminology.[14] The impact on existing capital in this case derives not from changes in the product markets but directly from competition in the markets for capital goods. The capital stock in the affected sectors is relegated to an obsolete "vintage", and its market value can decline sharply independently of any changes in product and input prices or demand. For instance, if the profit rate on gross revenues generated by "old" machinery is 10 per cent, new equipment that helps to save input costs representing another 10 per cent of sales value can double profits and thus – assuming everything else remains constant – the user value of the machinery. As illustrated by Table 4.1 in the previous section, the efficiency differential, for instance regarding the use of energy, can be very large.

Measures of the decline in the market value of capital

The "shocks" described in the previous section can be synthesised in a drop in the value of inherited capital that combines conventional measures of physical decay with a structural and technological rate of obsolescence.[15] Many of the changes do not take place once and for all, but over various years. If they are initially underestimated – and there is some evidence of that – this increased depreciation can also be a drawn-out process. An exception to this is East Germany, which adopted Western prices, regulations and demand structures virtually "overnight", on 1 July 1990. According to estimates, at reunification between 50 per cent and two-thirds of the capital stock became subject to write-off under West German accounting rules.[16]

However, accounting rules do not generally reflect market values. Unfortunately, in the absence of well-functioning stock markets (pre- and post-reform) it is very difficult to estimate changes in the value of installed capital. The closest that Western market economies have come to such an experience in recent history was the oil price shock of the 1970s. Between 1973 and 1974, the industrial share price index dropped by 23 per cent in the United States and 41 per cent in the UK.[17] While many other factors influence stock prices, it is likely that this crash was heavily influenced by the instant loss in value of company assets that were either energy-intensive or dedicated to the production of energy-intensive goods (such as certain models of motor car).

A different approach to measuring the effective size of the inherited capital stock under market conditions is to approximate it by that which would generate the same value of output in comparable market economies. Taking account of measures of human capital and labour endowments in the transition economies, Borensztein and Montiel, for instance, estimated that between 50 and 75 per cent of the pre-transition capital stock in the former Czechoslovakia, Hungary and Poland should be written off.[18] This methodology values capital in proportion to value added at market prices, and the implied write-off thus reflects primarily the high technical input coefficients of the existing capital stock. Some of these may show

Table 4.5

Investment needs to achieve regulatory and emission standard parity with the EU

	Czech Republic, Slovak Republic	Poland	Hungary	Bulgaria	Romania	Total
Investment needs (ECU billion)	17.7	30.4	12.3	11.5	19.1	91.0
Investment need per capita (ECU)	1,128	796	1,160	1,304	837	947
Annual investment need as % of 1990 GDP [1]	2.8%	4.0%	3.3%	4.5%	3.9%	3.7%

Source
Environmental Resources Management (1993), based on estimates by IFO Institut für Wirtschaftsforschung, Munich.

[1] Assuming costs are spread over 15 years.

[13] Hence, one should not ascribe the full amount of the investment to stricter environmental regulation. Note that much of the investment will have to be done by municipalities, not the enterprise sector. The detailed estimates were prepared in 1993 as part of EBRD/EU-Phare-sponsored research into the implications of harmonisation of regulations in the environmental field. The estimates are derived from case studies covering the fields of air (Poland), water pollution (Hungary) and treatment of waste (Czech Republic), and represent a high-case scenario, i.e. they imply meeting high western European environmental and technological standards, and not necessarily those that would represent the appropriate balance between cost and priorities of the transition economies. See Environmental Resources Management (1993).

[14] The industrial history of Western market economies abounds with examples. Among the more prominent ones is the "sudden" obsoleteness of existing computers every time a new, more powerful generation of these machines is introduced, with corresponding falls in their market value.

[15] Baily (1981) develops such an approach.

[16] Estimates by the Institut für Angewandte Wirtschaftsforschung and the Deutsches Institut für Wirtschaftsforschung, according to Sinn and Sinn (1992), p. 44.

[17] Industrial share price indices reported in the *International Financial Statistics*, IMF.

[18] Borensztein and Montiel (1991).

some flexibility, for instance, allowing for substitution of labour for energy services in agriculture. The estimates would therefore overstate the value depreciation of the capital stock. However, neglect of the structural and regulatory changes and "technology shock" elaborated in the previous section in turn suggests a downward bias.

4.3 Returns to investment

What does the value-contraction of the capital stock imply for investment? In Chapter 3 we elaborated on the potentially high growth-contribution of investment in a transition setting. In essence, new capital can make a significant contribution to economy-wide productivity growth because: (i) new physical capital can complement valuable existing assets such as human capital which are now in excess supply; and (ii) it should differ from the inherited capital stock in quality and sectoral allocation and could thus initially enjoy scarcity rents.

Equivalently, the returns to new capital, *if well invested*, can be expected to be high. Investment in the transition is "special" in that we should not assume that the growth in the capital stock is more or less balanced across sectors – as may be a reasonable approximation in more mature market economies. Its composition is crucial and is the subject of this section. The focus is on enterprise investment; public investment is briefly discussed in Section 4.5. It should be noted that the following discussion perhaps provides perhaps a somewhat optimistic assessment of the investment process in the transition economies. In fact, investment is subject to a variety of constraints which are taken up in Section 4.4.

Broad trends in the sectoral allocation of investment

It is instructive to view some evidence of sectoral investment patterns in the transition economies. Data on sectoral changes in investment that allow cross-country comparisons over various years are not easy to obtain. Table 4.6 provides our aggregation to the "smallest common denominator" – agriculture, two industrial sectors, four service sectors – for 13 countries. The figures represent the variation in the share of the respective sector in total investment, between 1989 and 1993. We have created three loose country groupings based on the country-specific progress in transition that had been made by mid-1994.

A clear pattern that emerges is the loss in the share of agriculture and, to a lesser extent, of industry, in favour of the service sectors. This pattern is valid for all subgroups, though differences emerge regarding gainers and losers within the service sectors. The trade sector has most consistently posted gains, while there is surprising variation in housing investments across countries, perhaps partly explained by institutional differences in this sector. The presence of uncertainty over investment outcomes, which tends to constrain investment in capital-intensive sectors, may explain part of the early improvements in the relative position of (less capital-intensive) services (this is discussed in Section 4.4). Some of the contraction in certain sectors reflects particularly severe state and municipal budget cuts (low infrastructure investment in the bottom group) and geographical specificities (high infrastructure investment in the Baltics), and one should be careful not to interpret all movements as a function of the economic transition alone.

Table 4.6

Changes in sectoral investment shares (1989-93) [1]

	Agriculture	Industry	Construction	Transport & communication	Trade	Housing	Other services
				In per cent of total investment			
Czech Republic	-7.5	-0.9	-0.7	-0.2	0.1	-5.2	14.2
Slovak Republic	-7.6	-7.5	0.3	7.6	1.6	0.3	5.3
Hungary	-6.8	1.0	0.2	6.6	0.7	-2.9	1.2
Slovenia	1.2	-9.9	-0.9	5.9	2.1	5.3	-3.7
Poland	-5.0	-3.1	0.8	-1.5	3.3	-7.7	13.0
Sub-average	*-5.1*	*-4.1*	*0.0*	*3.7*	*1.6*	*-2.0*	*6.0*
Latvia	-19.6	-0.6	-1.0	19.3	1.7	7.4	-7.2
Lithuania	-10.3	-5.4	-3.0	12.4	0.8	1.6	4.1
Kyrgyzstan	-13.5	-1.0	-1.4	9.3	-0.1	7.2	-0.4
Sub-average	*-14.5*	*-2.3*	*-1.8*	*13.7*	*0.8*	*5.4*	*-1.2*
Russia	-1.8	-7.5	-8.2	-3.9	8.2	10.3	2.9
Bulgaria	-5.7	-3.9	-0.4	0.8	9.3	-3.5	3.4
Romania	-11.1	3.7	-0.6	2.6	6.6	-5.0	3.8
Kazakstan	0.6	8.2	-4.4	-7.4	0.6	3.5	-1.0
Ukraine	-7.4	-1.7	-0.9	-4.0	1.1	8.4	4.5
Sub-average	*-5.1*	*-0.2*	*-2.9*	*-2.4*	*5.2*	*2.7*	*2.7*
Overall average	***-7.3***	***-2.2***	***-1.5***	***3.7***	***2.8***	***1.5***	***3.1***

Source
Elaborated on the basis of data provided by national statistical offices.

[1] Example: The share of agriculture in total investment in Lithuania fell from 14.6 to 4.3 per cent between 1989 and 1993, hence by 10.3 per cent of total investment.

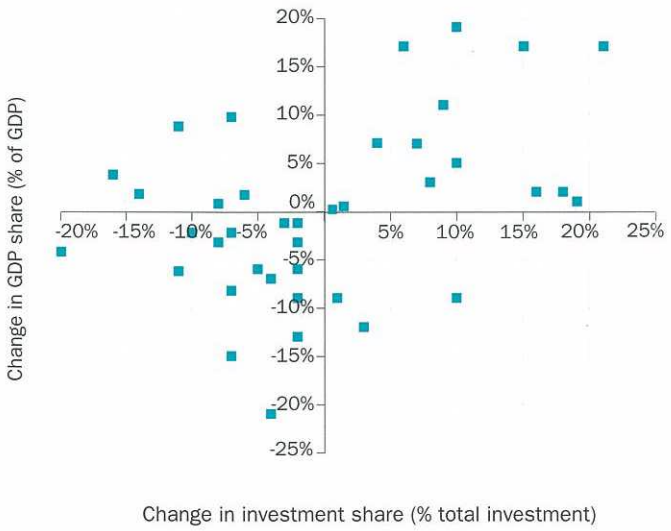
Net cash-flow, technology and the structure of investment

The broad investment trends suggest that an adjustment process is in motion whereby the "central planning biases" in the production structure of the transition economies are gradually being overcome. Services were consistently underrated under central planning. Shifts in demand and prices caused by the switch from planners' to consumers' choices might thus provide a simple explanation for the investment trends.[19]

As discussed, it is plausible to assume that capital specific to the sectors favoured by price and demand shifts (more generally cash flow) should rise in value, drawing in new investment to increase production capacities, whereas that in the declining sectors should fall, with correspondingly sluggish investment activity. Over time, with capital stocks adjusting to their new equilibrium sectoral structure, scarcity rents should end and returns to investment activity in all sectors should return to "normal". When all this takes place within a framework of declining aggregate GDP and investment, we should nevertheless expect investment of the sectors favoured by the new relative prices to expand as a *share* of the total.[20]

Chart 4.2

Change in GDP and investment shares of agriculture, industry and services (13 countries, 1989-93)

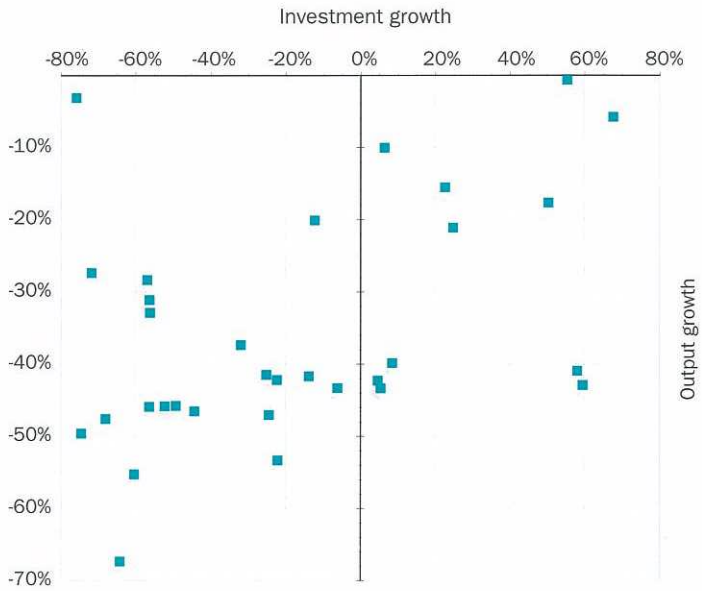


Sources
Tables 4.4 and 4.6.

Note
Each point represents the change in investment and GDP shares of either agriculture, industry or services in one of the 13 transition countries for which consistent data are available.

Chart 4.3

Sectoral output and investment growth in Romanian industry, 32 sectors (1990-93)



Source
Romanian Statistical Yearbook, various issues.

Employing output shares as a proxy for demand, this proposition turns out to hold reasonably well at the broad level of sectoral aggregation chosen here. Chart 4.2 plots variations in the sectoral shares in GDP and investment of agriculture, industry and services in 13 countries in transition, over the period 1990-93.[21] Three-quarters of points in the scatter-plot lie within either the first or third quadrants, indicating that the relative importance of sectoral investment and GDP changed in the same direction.

There is little evidence, however, of changes in investment having generally been more drastic than output changes, as one might have expected. Strong movements in investment shares coincide with only moderate ones in output shares and vice versa, with numerous points in the second and fourth quadrants.

Some of this could of course be explained by differences in the depth of the transition process among the countries in the sample. Nevertheless, a more disaggregated look at the performance of industrial sectors, as displayed in Chart 4.3 for Romania, suggests that other factors must also have been at work. Examining levels rather than shares, output in all sectors declined. Nevertheless, investment growth, in some cases substantial, was measured in 13 of the 34 sectors of Romania's industrial classification system.[22] A positive correlation between investment and output growth exists but is weak (the correlation

[19] The direction of structural change can be "predicted" by employing the Chenery- method of identifying "stylised" patterns for market economies of the same income level, size and natural resource endowment as the economies in transition (Chenery, 1960). Results from such studies confirm the likelihood of structural change away from agriculture and industry and towards the service sectors in transition economies. For example, Döhrn and Heilemann (1995) perform estimates for four central European countries.

[20] This ignores the role of subsidies. The phasing out of subsidies can lead to higher prices and lower profitability at the same time. Cash flow would be a better measure of resource pull.

[21] That is, each point in the scatter-plot refers to one of the three sectors in one of the 13 countries.

[22] Two further sectors, both with positive investment and negative output growth, are not shown. They displayed extreme values.

coefficient is 0.24). Altogether, industrial investment fell by only 7.6 per cent, while output collapsed by 39 per cent.[23]

It is likely that a relationship between investment and demand is hard to pick up at a disaggregated level partly since differences in technological obsolescence are obscuring it. The technological gap that separated productive assets from those in now competing market economies varied widely among sectors. There is no reason *a priori* to suspect that it was greater or lesser in sectors that benefited from liberalisation.

How does this affect the calculation of the individual investor? As a general rule, investment will tend to flow into those sectors in which capital is particularly scarce, to take advantage of scarcity rents. Simplifying somewhat, scarcity is a function of the "gap" between the stock of capital in a sector (with new technologies) that could be sustained by demand, and that which currently obtains. It is then clear that, if output price changes are favourable to a sector, while its capital stock is heavily depreciated due to obsolescence, returns to investment in this sector will be potentially high and vice versa. When favourable output prices together with a valuable capital stock or unfavourable conditions on both counts prevail, the effect on returns is harder to predict, since it will depend on aggregate demand conditions.

While empirical information to illustrate these propositions is hard to obtain, they may explain some of the variance observed in Charts 4.2 and 4.3. A further hypothesis based on complementarities between different assets is elaborated in the following subsection.

Complementarities between different assets

Once we take into account that firms employ various forms of capital, the possibility arises that they depreciate at different rates. However, as long as they are closely bound together, such as usage-specific machinery and the structures to house it, the potential value of assets that are only weakly affected by relative price changes can often not be realised without new investment. This is true for individual firms as well as for sectors or the economy as a whole. An example of the latter is the presence of a surplus of engineers and scientists who, though perhaps "mobile", may not find productive applications once complementary physical capital has declined in value because of obsolescence, or because the market demands somewhat different abilities. The market value of such capital can decline sharply as a result, although its potential productivity, given some new investment, is great. In view of the high levels of human capital indicators in the transition economies (see Chapter 2), this is a highly relevant issue.

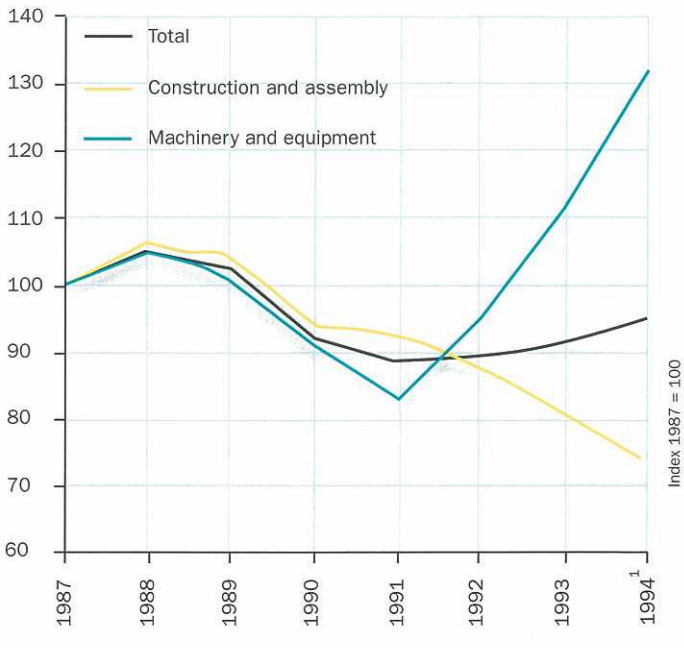
To illustrate the implications for investment, we analyse two cases of complementarity. First consider a factory in, say, Poland, that runs an obsolete assembly line in good-quality buildings. Replacing a share, maybe a small share, of the company's capital – namely all or part of the equipment – together perhaps with managerial and organisational changes, can bring it up to the standard of its (foreign) competitors. Since the buildings and other usable assets represent sunk costs, the returns to this investment would be higher than, say, that of competitors abroad in expanding their production capacity.[24] This effect is magnified when, as has happened in various transition economies and sectors, the unit labour cost falls as a result of declines in wages disproportionate to the decline in potential labour productivity.

The development of investment outlays by the enterprise sector in equipment and buildings, during the Polish transition, provides a vivid illustration of the point made here (Chart 4.4). After first declining jointly until 1990, investment in equipment rose rapidly while building investment continued to fall. Table 4.7 shows that Poland's experience is shared by other east European countries that are recovering from recession (except Hungary), while equipment investment had not yet picked up in the countries of the former Soviet Union.

A second example should illustrate that the same considerations apply for human capital, perhaps still more strongly. Consider an accountant, say, in a Ukrainian firm, with skills that are quite

Chart 4.4

Poland 1987-94: investment in construction and machinery



Source
GUS (National Statistical Office), *Monthly Statistical Bulletin*, various issues.

1 First three quarters only.

[23] An alternative approach is to view growth in investment as a function of relative prices instead of output. Again, except for Poland, changes in investment show little correlation with relative industrial sales prices at a detailed industry level: the correlation coefficient for the period 1990-93 is -0.3 for the Czech Republic, 0.46 for Poland and 0.08 for Romania. Computed from data in the *Statistical Yearbooks* (Statistical Offices) of the Czech Republic (17 industrial sectors), Poland (23 sectors) and Romania (24 sectors).

[24] This phenomenon should be viewed as in fact combining two types of investment, rededication and "new" (i.e. replacement), of which only the latter is measured in investment statistics.

specific to the Soviet system of recording financial and physical flows. Such skills cannot generate the kind of information that would allow the firm to take appropriate decisions in a market environment, receive access to bank loans, etc. As can be observed in many transition economies, skilled workers may end up engaging in petty trading activities or others that do not make use of much of their human capital. Effectively, this capital "depreciates". However, it consists of various components, including years of primary and secondary schooling, post-secondary training that raised the ability to think conceptually, and only a relatively small component that was specific to the now obsolete accounting skills. A similarly small investment in training in market-based accounting methods could re-establish a high level of productivity, with the difference between the "new" value to the firm and the value of an unskilled activity representing the returns to this investment. Again, as in the case of the equipment investment previously discussed, the sunk cost of this accountant's general education can cause these returns to be very high.

Table 4.7

Share of machinery and equipment investment in total fixed investment (per cent)

	1990	1991	1992	1993	1994
Bulgaria	45	47	46	46	–
Czech Republic	46	46	46	52	57
Estonia	–	–	–	58	–
Hungary	46	46	48	48	45
Latvia	42	33	34	37	–
Lithuania	–	25	23	37	–
Poland	35	35	39	42	47
Romania	41	39	37	45	45
Slovak Republic	46	51	–	–	–
Slovenia	45	54	51	60	62
CIS	54	–	48	41	43

Source
UNECE Economic Survey of Europe in 1994-95, Table 3.2.15.

The two examples can be combined and extended to other cases where complementarities between different forms of capital characterise the investment process.[25] The effect, as in the previous considerations regarding scarcity, is that marginal returns to capital in individual sectors and activities can be very high.

4.4 Investment-constraining factors

The previous sections have pointed out the potential for investment in the transition economies. However, the scale and pervasiveness of the adjustments during the economic transition within a framework of nascent and weak institutions can severely strain the ability of investors to respond to these opportunities. As a consequence, potentially useful capital may gradually decay, and knowledge wither away. Perhaps the most important constraint is uncertainty, but others include coordination problems in the presence of market linkages, problems in financing investment, continuing government intervention, deficient governance and high transaction costs. While the discussion in Section 4.3 emphasised "fundamentals" and did not stress cross-country differences in the investment process that we should observe – except for the requirement of substantial liberalisation – the constraining factors differ widely between countries. It is the existence of these constraining factors, the high potential and the cost of delay, that provide a strong justification of the participation of a financial institution such as the EBRD acting on the frontier of the investment process.

Uncertainty and investment

Uncertainty, the waiting option and the structure of investment

Uncertainty – over market developments, prices, legal problems and changes in government regulations – is a central feature of transition. Once we recognise the inevitable uncertainty about the evolution of these parameters, we see that waiting can enhance the value of an investor's opportunity by reducing the chances of the resources committed to it proving inappropriate in quantity, form or embodied technology. Prospective investors may delay their projects in the hope that uncertainty will be dissipated. When the investor has some notion of the distribution of returns, the value of the "wait and see option" can be calculated and set against the net present value of the investment. It is easy to show that even a small amount of uncertainty can result in a high "option value" as long as relatively safe alternatives for "parking" funds exist and there is little difference in principle between investing now or later – the cost of waiting for a year is then only the difference between the expected yield of the investment and that of the alternative, while the potential "cost" of investing, should events take an unfavourable turn, could be a significant capital loss.

Uncertainty affects different types of investment differently, since the exposure of the investor is a function of the degree of irreversibility of the commitment and its duration, and the opportunity cost of delay varies. Because of a smaller exposure, the presence of uncertainty tends to discourage investments in sectors with low capital requirements and a high turnover to a lesser degree, such as labour-intensive industrial sectors (e.g. clothing), trade and a variety of other services. Services are also less penalised because of the often greater reversibility of their capital investments. Computers, offices and warehouses, to pick some examples, are not as inherently dedicated to a particular use as an assembly line tends to be. The opportunity cost of delay, in turn, depends on characteristics such as the competitive situation in a market and the ability to pre-empt competitors. The chance of acquiring a strategic asset such as a brand name in a new market, or natural resource exploration and extraction rights, can be a strong incentive to invest before the competition does, even in the presence of uncertainty.

There is no reason to assume, *a priori*, that the sectors that are least discouraged by uncertainty are also those in which the potential productivity of investment is highest. As a result, prolonged uncertainty not only limits overall amounts invested, it can also introduce

[25] Note that putty-clay technology for all capital investments is not a necessary condition for these conclusions to hold. In the accountant's case, only the specialised Soviet accounting skills represented such a technology.

Box 4.2

Evidence on the relationship between inflation, investment and growth

Evidence of a harmful effect of inflation on both growth and investment is presented in Table 4.8. This result is corroborated by three econometric studies which use data covering the last three decades. The first two studies, using data for over 100 countries, found that a permanent increase in inflation by 10 percentage points per year reduces the growth of real GDP per capita by 0.2 to 0.3 percentage points per year and lowers the ratio of investment to GDP by 0.4 to 0.6 percentage points every year.[1] Beyond a point (say, for inflation rates above 100 per cent a year), however, further increases in the inflation rate have a declining incremental (negative) effect on real GDP and investment. The third study arrives at the result that the volatility of the return on capital has a depressing effect on investment and that this effect is greater for developing countries than for industrial economies.[2] Further, it finds that – after trying a range of indices of political and economic instability as explanatory variables – only inflation seems to be clearly and robustly correlated with the volatility of the return on investments.

On the other hand, at lower rates of inflation (say 20 per cent a year or lower) there is less evidence of any clear pattern of covariation between inflation and growth or between inflation and other observable indices of efficiency, such as total factor productivity. Thus, in speaking of the damaging effects of inflation on performance, one must be clear that it is the high rates of inflation that are at issue.

1 Fischer (1993).

2 Pindyck and Solimano (1993).

Table 4.8

Some economic characteristics of fast-growing and slow-growing countries

Averages of:	Fast growers	Slow growers	t-statistic *
Inflation rate	12%	31%	1.7
Black market exchange rate premium	14%	57%	3.8
Investment/GDP	23%	17%	5.2
Export/GDP	32%	23%	2.3

Source

Levine and Renelt (1990, Table 2). Sample of 109 countries; fast growers are the 56 countries whose growth rate of per-capita income exceeds the mean; slow growers are the remaining 53 countries.

* The rule of thumb is that t-statistics close to 2 or higher signal that the averages are significantly different in statistical terms with a high (95 per cent) probability.

distortions in the pattern of capital accumulation, with potentially long-term consequences. A country may be led far down a low-tech, low-capital path while valuable human capital decays.

Reform path and uncertainty

While transition tends to engender uncertainty, there have been marked differences between countries regarding its extent and duration. Government policy tends to be the principal source of these differences. Decisiveness and swiftness in implementing reforms are important in mitigating uncertainty. As long as a "backlog" of reforms remains, relative prices and other investment conditions are subject to change, enhancing the value of the waiting option. One of the key sources of uncertainty is inflation, which, in addition to its direct detrimental effects, often reflects deeper political and social causes of uncertainty. Evidence on a negative relationship between inflation and growth and investment in large country samples is presented in Box 4.2.

An illustration for the countries in transition is provided by an analysis of foreign direct investment (FDI) patterns in the region, based on a recent survey of investors carried out by the EBRD.[26,27] In December 1994 the EBRD sent a questionnaire to more than 11,000 companies worldwide, representing approximately 80 per cent of world enterprise capitalisation. Companies were asked to provide a short profile of their investment intentions in the EBRD's countries of operations.[28]

Some of the results are shown in Charts 4.5 and 4.6. In each case, the vertical axis measures the existing number of investment projects of the firms in the survey, per capita, in each of the EBRD's countries of operations. On the horizontal axis, Chart 4.5 uses the transition indicators developed in the 1994 *Transition Report* to measure progress in transition, while the logarithm of inflation in 1993 is reported in Chart 4.6.[29] The results indicate that countries that are comparatively advanced in market-oriented transition and price stabilisation have attracted significantly more foreign investment than other countries.[30] The evidence from the survey sample is confirmed by the distribution of balance of payments data on FDI presented in Table 4.9.

In Chart 4.7 an attempt is made to capture the extent to which investors are "waiting" and to relate it to price stability as an indicator of uncertainty. It uses information from the survey to construct a ratio between "considered but deferred" investments[31] and the number of those already undertaken. The positive correlation between this "waiting ratio" and inflation (a correlation

26 This study is part of the Programme of Policy Studies to Promote Private Sector Development being conducted by the Office of the Chief Economist of the EBRD.

27 Foreign investment is particularly sensitive with regard to uncertainty, since alternative investment opportunities tend to exist in other locations. This reduces the opportunity cost of not investing in a particular country and thus enhances the waiting option.

28 This assessment was made based on information from the Worldscope Database. 1,450 companies completed the questionnaire. The response rate was high when measured against the number of large companies likely to consider investing in eastern Europe and the former Soviet Union. Addressees included, for instance, a large number of heavily capitalised municipal enterprises and other companies that would be unlikely to consider investing in the EBRD's countries of operations. As expected, the response rate among these companies was low.

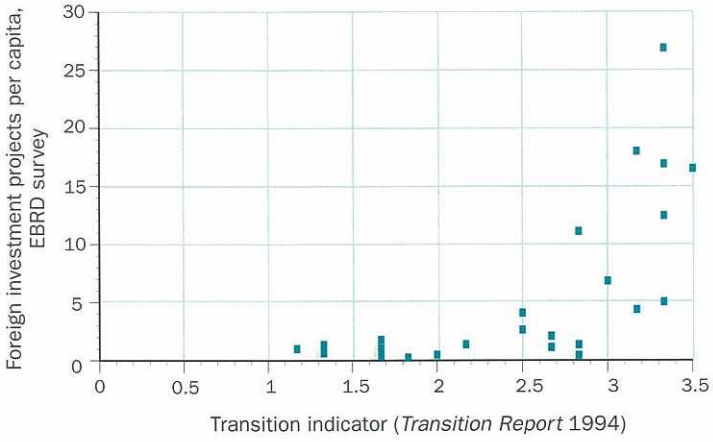
29 The transition "scores" are taken from Table 2.1 of the EBRD *Transition Report* 1994 rather than from the corresponding table of the present Report, given the timing of the survey. In Chart 4.6 inflation for 1993 is used since there tends to be a lag in the effect of inflation on investment decisions.

30 Note that both the transition indicators and inflation show a significant exponential relationship with the level of per-capita investments. That is, the cost of greater macroeconomic instability or the lack of reform can be very high at the margin.

31 The survey instrument included questions concerning future investment plans, including a "concrete plans" and a "wait and see" category.

Chart 4.5

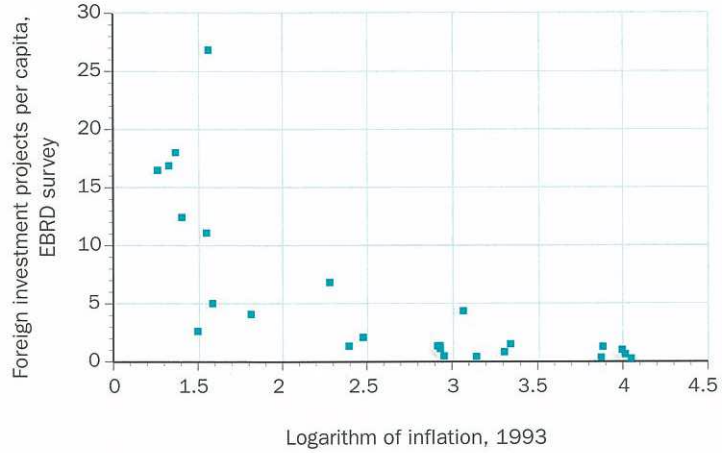
Foreign direct investment and transition level – 25 countries in transition



Note Each point reflects the number of investments in a country that had been undertaken by the companies in the survey, divided by population size (in millions), and the average of six scores that a country received in different areas of reform, in Table 2.1.

Chart 4.6

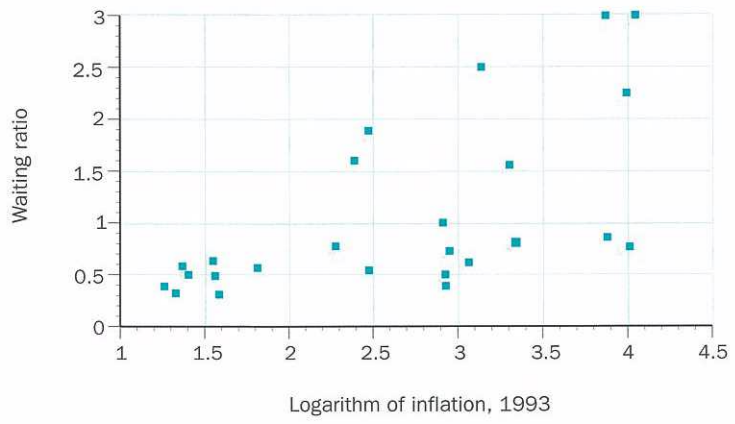
Relation between inflation and foreign direct investment – 25 countries in transition



Note Each point reflects the number of investments in a country that had been undertaken by the companies in the survey, divided by population size (in millions), and the logarithm of the rate of inflation in 1993.

Chart 4.7

Plot of the "waiting ratio" against inflation – 25 countries in transition



Note The "waiting ratio" is defined as the ratio of the number of investments that companies in the EBRD survey indicated they were considering to undertake (if conditions improved), and the number of investments that they had already undertaken.

Box 4.3

Foreign investment: increasing geographical diversification

As described in last year's *Transition Report*, most foreign investment in the region is concentrated in a small number of countries. However, the dominance of the top five countries is gradually eroding, from 83 per cent of the total in 1992, to 78 per cent in 1993 and 68 per cent in 1994 (Table 4.9). The share of the top two countries in cumulative terms, Hungary and the Czech Republic, has fallen even more significantly, from 59 per cent in 1992 to 35 per cent in 1994. This tendency towards a greater geographical diversification is also evident in the per-capita data, which show an increasingly strong performance of small countries in eastern Europe and the Baltics. It is likely that these developments are explained primarily by the continuing progress in reform in a wide range of countries.

coefficient of 0.61) can be interpreted as a measure of the potential for investments once uncertainty subsides.

Other constraints on investment

Various other factors can prevent investment from responding to the opportunities set out in Section 4.3. They are discussed briefly here for reference. Some of these factors are taken up again in subsequent chapters of this Report.

Coordination failures

Production processes are not self-contained. Any economic activity has to rely on access to necessary inputs and clients, the services of utilities, distribution systems, business services such as advertising and legal advice, and so on. When change is incremental, such as in most market economies most of the time, individual investments can be generally inserted into existing networks of such linkages. When change is as drastic as during the economic transition, the presence of vital linkages can no longer be taken for granted, in particular when some of the necessary goods or services are not tradable. An investment may then have great potential, but only if other investments with which it interacts are undertaken at the same time – investment in a car factory and in parts suppliers, or an agribusiness investment together with the creation of wholesale markets and other infrastructure. Each of these investments may then be postponed because of the danger of being left isolated. The potential for this problem to arise is particularly large in more sophisticated processes – those required to catch up with Western technology. Conversely, however, positive interaction can generate bursts of investment feeding on each other.[32] The problem is that, while these linkages can provide benefits to the economy as a whole, they are not seen as returns realisable by the investor who generates them. Linkages are further discussed in Chapter 6.

[32] There is a parallel in the economic development debate of the 1940s and 1950s, when these considerations led to proposals of a "big push", in which the government should take an active role in catalysing investment across broad fronts to overcome such coordination failures. These ideas have recently been taken up by the new literature on growth; see, for instance, Murphy, Shleifer and Vishny (1989). Some of the East Asian development successes have been partly ascribed to a coordinating role of government. Even if correct, this is highly demanding of the skills and credibility of governments and public administrations, qualities that are not easily replicable in other circumstances.

Table 4.9

Foreign direct investment in the economies in transition (US$ million)[1]

	1989	1990	1991	1992	1993	1994	Cumulative 1989-94	Per capita Cumulative	Per capita 1994
Albania	–	–	–	32	45	53	130	38	16
Armenia	–	–	0	0	0	3*	3	1	1
Azerbaijan	–	–	0	0	20	50*	70	10	7
Belarus	–	–	50	7	18	10*	85	8	1
Bulgaria	–	–	–	42	55	105	202	22	12
Croatia	–	–	–	13	72	98	183	38	20
Czech Republic	–	120	511	983	517	850	2,981	289	83
Estonia	–	–	–	58	160	253	471	295	158
FYR Macedonia	–	–	–	–	–	5	5	2	2
Hungary	187	311	1,459	1,471	2,339	1,146	6,913	671	111
Kazakstan	–	–	–	–	473	330*	803	47	19
Kyrgyzstan	–	–	–	–	10	25	35	8	6
Latvia	–	–	–	43	51	155*	249	92	57
Lithuania	–	–	25	27	61	60	173	46	16
Moldova	–	–	–	–	14	23*	37	9	5
Poland	–	–	117	284	580	542	1,523	40	14
Romania	–	–	–	77	94	428	599	26	19
Russia	–	-400	-100	700	400	1,000*	1,600	11	7
Slovak Republic	–	–	–	100	156	187	443	84	35
Slovenia	–	1	41	113	112	88	355	178	44
Tajikistan	–	–	–	8	9	12	29	5	2
Turkmenistan[2]	–	–	–	11	104	100*	215	55	26
Ukraine	–	–	–	170	200	91	461	9	2
Uzbekistan	–	–	–	9	48	87	144	7	4
Total	**187**	**32**	**2,103**	**4,148**	**5,538**	**5,701**	**17,709**	**45**	**14**

Source
Central bank annual reports, IMF, EBRD estimates.

1 Data for Georgia were not available.

2 FDI data for Turkmenistan are subject to more than the usual degree of uncertainty.

* 1994 estimated.

Financing

When financial systems are weak and underdeveloped and capital markets shallow, potentially high rates of return do not translate into investments in a straightforward way. As Chapter 4 demonstrates for various transition economies, in such circumstances most investment has to rely on internal financing by enterprises. The need for cash flow makes investment decisions hostage to prior (rather than future) favourable relative price developments (or the presence of market power) and prevents the reallocation of investible funds across sectors to their highest-yielding uses. As Section 4.3 has argued, good investment opportunities in the transition economies – in particular for replacement investment – may often be found in sectors adversely affected by the relative price changes. This assigns a strategic role to financial sector development in the investment process, perhaps more acutely so than in settled market economies.

Transaction costs and government interventions

Efficient investment processes in the transition economies are, lastly, impeded by a host of factors that can be subsumed under the notion of transaction costs. Some of these lie in the nature of the adjustment process – efficient coordination mechanisms to substitute for central planning do not spring up overnight – and time and continuing reform will serve to overcome them. Others have their root in government interventions or administrative systems that are badly adapted to the challenges of a market economy. One such source of difficulties for investors results from the interplay between the tax system and inflation, and is illustrated in Box 4.4. As shown, effective rates of profit taxation can be highly sensitive to inflation under certain conditions, such as accounting rules that do not take account of rising replacement values of assets.

Box 4.4

The influence of inflation on the enterprise tax burden

The company tax burden under inflation depends on the details of a country's tax system as much as on statutory rates. If tax codes are badly adapted to the effects of inflation on the valuation of assets and revenue and cost flows, they can become a serious deterrent to investment. In some cases, companies may benefit from high inflation, at the expense of the tax authorities. This is particularly true if the companies are allowed to pay taxes on a particular flow of income long after the income is earned. The longer they are permitted by tax regulations to wait (or the lower the penalty for non-compliance), the greater will be the extent to which inflation will erode the real value of their tax liability. At the same time, however, the tax legislation may include stipulations that lead to particularly harsh profit taxation when inflation is high. One example would be a stipulation that forces companies to use historical costs to assess depreciation allowances. Another (which has been applied in many countries in eastern Europe and had a great impact, for example, in Poland in 1990) is a requirement that companies pay tax on the nominal appreciation of their inventories.

The sensitivity of profit taxation to inflation is illustrated in Table 4.10. The data in the table reflects the results of simulations, rooted in a data-set that pertains to a concrete private investment project in which the EBRD participates. A first round of simulations tested specifically within the framework of detailed tax codes for Hungary and Russia the impact on the company tax bill of changes in the rate of inflation and in the tax collection lag.

Table 4.10 measures the tax burden with reference to the "effective rate of taxation", which is defined for a particular investment project as the percentage gap between the internal rate of return before and after taxation.[1] The simulations take into account country-specific taxes levied on profits, dividends, assets, capital gains, sales and certain cost items. They also make adjustments for country-specific rules governing indexation, interest-deductibility, carry-forward of losses, investment incentives, depreciation rules and other features of the tax code.[2] None the less, it is important to be aware that such simulations cannot capture the full complexity of the tax treatment in individual cases. For instance, the Russian tax system is often perceived as unpredictable and insufficiently transparent, factors that cannot well be reflected in our figures.

The simulations that were based on Russia's tax code illustrate the potential importance of collection lags at high rates of inflation. Should inflation return from the current comparatively modest levels to the 2,000 per cent seen in 1992, then the effective rate of profit taxation (ERT) could wind up as high as 77 per cent if – as is currently the case – interest payments were only partly deductible and there were no lag between the time at which income was earned and the time at which taxes on this income were paid. On the other hand, the ERT could be as low as 6 per cent if there were a six-month collection lag at this high level of inflation and the company managed to contract considerable debt. Using the 1994 inflation rate in Russia of 203 per cent, the ERT could wind up anywhere between 15 per cent and 53 per cent, depending on collection lags and debt/equity ratios. In practice, the Russian tax authorities introduced as early as in 1992 a system of monthly advance payments for both the VAT and the profit tax. Thus the high tax

[1] The calculations were made with the help of the Marginal Effective Tax Rate (METR) software developed at the World Bank, which we modified to suit the context of our simulations.
For the METR model, see Dunn and Pellechio (1990).

[2] The simulations take account of the following provisions of the tax codes:
Corporate income tax in Russia is charged at a standard rate of 35 per cent. Taxable income is gross income less operating costs and deductions. Dividends are excluded from the tax base for profit tax purposes but are subject to a final withholding tax. The proceeds of share issues and bank loan repayments used for capital investment can be written off against taxable profit. However, there are some limitations on interest deductibility. The simulations assume that half of interest payments are deductible. There is no specific provision for inventory valuation and capital gains are subject to profit tax. Depreciation allowances follow the straight-line method. Wages are deductible to up to four times the minimum wage, which is set by the government and is usually much lower than the average wage. Losses may be carried forward for five years. Dividends paid to resident and non-resident companies are subject to a final withholding tax of 15 per cent. Dividends paid to resident individuals are subject to income tax (deducted at source), but final withholding tax at a flat 20 per cent rate applies to dividends paid to non-resident individuals. Business property tax at a maximum rate of 2 per cent is levied by local governments. There are a number of investment incentives for small enterprises. Tax incentives may not decrease the amount of taxable profit by more than 50 per cent. Most companies are required to make monthly advance payments for income tax.
The tax system in Hungary has been radically changed in 1995. Corporate income tax is currently levied at 18 per cent, but an additional 23 per cent tax is due on income distributed to shareholders. Capital gains are included in taxable income and charged at a rate of 18 per cent. The Hungarian tax law permits a number of deductions from the tax base for depreciation allowances. Interest paid by the company is treated as an ordinary business expense but there are some limitations on shareholder

Table 4.10

Sensitivity of the effective profit tax rate to inflation

Country	End-year inflation (per cent)	No collection lags, Debt-to-equity ratio 0	No collection lags, Debt-to-equity ratio 0.5	No collection lags, Debt-to-equity ratio 1.5	Collection lag: 6 months, Debt-to-equity ratio 0	Collection lag: 6 months, Debt-to-equity ratio 0.5	Collection lag: 6 months, Debt-to-equity ratio 1.5
		Effective tax rate (per cent)					
Russia	0	32.4	32.0	32.3	32.4	32.0	32.3
	2,318 (1992 actual)	76.9	50.5	31.6	14.3	9.9	6.3
	203 (1994 actual)	52.6	34.4	26.4	29.0	19.2	14.9
	145 (1995 forecast)	49.4	33.3	26.4	30.5	20.8	16.6
Hungary	0	37.9	36.2	33.6	37.9	36.2	33.6
	21.2 (1994 actual)	42.9	37.7	31.1	38.9	34.1	28.2
	28 (1995 forecast)	44.0	37.7	30.5	38.7	33.2	26.9

Note
The same rate of inflation was assumed to apply over the entire life of the project (30 years).

rates quoted in Table 4.10 for the "no collection lag" simulations may reflect reality for those companies that fully comply with the tax code.

If inflation in Russia falls to the more modest levels experienced in Hungary in 1990-94, then the effective rate of taxation will be much less sensitive to changes in collection lags and to additional reductions in the rate of inflation. The data for Hungary in Table 4.10 illustrate this. The difference in the effective rate of taxation between the 28 per cent forecast for 1995 and a no-inflation situation represents at most 6 percentage points, whereas for any given financing structure shifts in collection lags from zero to six months would reduce the rate by at most 5 percentage points (still substantial but small compared with the effect at much higher rates of inflation).

The cross-country data for 1994 (in Table 4.11) show not surprisingly that the ERT was most sensitive to the length of collection lags in countries that registered comparatively high levels of inflation. The ERTs spanned (with no collection lag and a debt-to-equity ratio of 0.5) a range from 38 per cent in Hungary to 87 per cent in Ukraine. With a collection lag of six months, ERTs varied from 34 per cent in Hungary to 49 per cent in the Czech Republic.

lending. The law requires straight-line depreciation with a loss carry-forward of up to five years. Tax is paid under a system of corporate self-assessment, where advance payments are required, based on the previous year's liability. Fines are levied for failure to pay the taxes. There is no withholding tax on dividends paid to resident or non-resident recipients. Dividends paid to resident individuals are subject to 20 per cent withholding tax if the paying company has not paid corporate income tax and to a 10 per cent withholding tax if it has. Effective 1 January 1995, no investment incentives are available to new companies.
In addition, a number of local taxes, import-export duties, and minor other taxes exist in both Russia and Hungary. Inflation is not taken into account in the tax codes of either country.

Table 4.11

Effective tax rates in selected countries in transition

Country	End-year inflation 1994	No collection lags		Collection lag: 6 months	
		Debt-to-equity ratio		Debt-to-equity ratio	
		0	0.5	0	0.5
	(per cent)	Effective tax rates (per cent)			
Bulgaria	122	83	55	54	36
Czech Republic	10	59	51	55	49
Hungary	21	43	38	39	34
Poland	30	63	47	54	41
Romania	62	–	61	–	47
Russia	203	53	34	29	19
Slovak Republic	12	51	42	48	40
Slovenia	18	51	41	46	37
Ukraine	401	86	87	36	37

Note
The same rate of inflation was assumed to apply over the entire life of the project (30 years).

Other impediments shall only be listed here, for brevity. Thus regulatory and administrative complexities still hamstring flexible investment decisions in many countries, and multiple and rapidly changing taxes tend to confuse it; legal systems erect obstacles to bankruptcies – thus binding resources that could find more productive uses – and prevent the use of assets as collateral for lending; payment and settlement systems, though rapidly developing, still tax what should otherwise be simple transactions; market and economic information is often scarce; the basic infrastructure for business, such as telecommunications, tends to be deficient; and an underdeveloped housing market restricts the mobility of labour. Together, these factors curtail the responsiveness of investment to the opportunities outlined in Section 4.3. There is some further discussion of these issues in Chapters 6, 7 and 9.

4.5 Concluding remarks: the role of policy

The key message of this chapter is that returns to investment in the transition are potentially high, both socially – to society as a whole – and for the individual investor. Impressive labour productivity growth rates in the more advanced transition economies, well beyond the initial period of rationalisation, illustrate this point (see Chapter 11).[33] While the focus of this chapter has been on decentralised decisions rather than on policy, there are nevertheless a number of broad messages for the role of governments in supporting the investment process.

Perhaps most importantly, what constitutes a high-productivity or even just sensible enterprise investment during the period of transition is a very complex question. Marginal returns to capital are determined by factors that allow few broad conclusions regarding the appropriate sectoral or product composition of investment. A policy of attempting to target "winners" is likely to be a losing proposition. The information problem is better solved in a decentralised process by managers and entrepreneurs. That is what the market is for. Government investment policy should concentrate on facilitating the response to opportunities by helping to overcome the constraints identified in Section 4.4.

This suggests that the principal task for policy is to mitigate uncertainty, by stabilising the macroeconomy, allowing relative prices to adjust rapidly to their long-term, market-determined levels, and establishing predictable and transparent rules. A stable environment for investment is necessary not only to increase its quantity, but even more so to ensure its (sectoral and technological) quality, which should be the principal source of productivity growth during the economic transition. Rapid and decisive reforms have been successful in achieving these objectives in various countries of the region.

The discussion of investment-constraining factors suggests further scope for policies in promoting linkages, spurring the development

[33] A more thorough analysis of total factor productivity growth would have to substantiate these propositions. However, since recent net additions to the capital stock in the transition economies have not been higher than in Western market economies, an increase in the average capital intensity of production is unlikely to explain much of the growth in labour productivity.

of the financial sector and reducing transaction costs, including those caused by arbitrary or unnecessary government regulations and interventions. As in other contexts, the development and maintenance of infrastructure are crucial for private enterprise and investment during the transition. While this point has been discussed in Chapter 3, it is worth repeating that many areas of infrastructure are no longer "natural monopolies" because of technological developments and more diverse demand. This opens the possibility of private sector involvement in the provision of these services and in the funding of the required investments – an important consideration for cash-starved reforming governments. Even where private funding is excluded because of the size and duration of the required capital exposure, private management of public services is often possible and desirable.

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Financing enterprise investment

5

The command economy delivered only low growth, despite high investment, because the investment was of low quality. Under central planning investments were misallocated, and with inadequate or bizarre incentives in enterprises they were inappropriately designed, badly utilised and poorly maintained. In the transition toward a market-oriented economy, an autonomous, if not private, financial sector gains a greater role in mobilising savings by allocating them to investments and by exercising financial discipline over enterprises. This chapter examines how the financing of enterprise investment has evolved so far in the transition. Particular consideration is given to the questions of how, and how far, the lack of finance has held back enterprise investment and whether the evolving financial structures are conducive to improving the quality of investment and the financial discipline on enterprises. Several policy measures to strengthen the financing of enterprises are proposed.

Aggregate data on the financing of enterprises in a representative sample of countries provide the analytical base for this chapter. These countries are the Czech Republic, Romania and Russia, which differ not only in terms of their pattern of enterprise finance at the start of the transition, but also in their progress in developing decentralised or market-based sources of finance. The period covered by the sample discussed is 1990-94. The main identified sources of finance are gross savings of the enterprises themselves (profits after taxes and distributions plus depreciation), bank lending and government transfers for investment. There are also some data on the supply of foreign savings to fund enterprise investment.

5.1 Financing of state enterprises under the old regime

Under central planning, the investment of enterprises was among the most strictly controlled aspects of their operations, and the way in which investment funds were allocated reflected how this control was implemented by government.[1] Most fixed investments by state-owned enterprises were largely funded directly through the state budget. The share of fixed investment financed by savings of the individual enterprise or by bank credits was relatively small. Any surpluses accruing to enterprises after the sale of their products and deduction of costs were typically transferred to the state through a variety of taxes and levies. With the partial reforms to central planning in the 1980s, enterprise autonomy increased and self-finance by enterprises and bank credits gained in significance.

A second method of control was through provision of short-term credits to fund inventories through the state banking system, which provided both the information required to monitor their levels and a means of exercising control if there was an excessive accumulation of stocks relative to planned targets. Interest rates on these bank loans were kept low: in certain countries and periods, below the rate of inflation.

The role of state banks under central planning was largely passive, apart from exercising administrative control over inventory accumulation. The state banking system comprised the central bank and specialised banks controlled by the central bank. The accounts that enterprises held with these banks were designated for particular purposes, such as fixed investment, material inputs and wages. Money deposited or created for one particular purpose could not be converted into money for another purpose without administrative approval. This internal inconvertibility of money through segmentation of enterprise accounts occurred either within the central bank or between it and the specialised banks. For investment funds provided in the form of credits, the interest rates on the loans were low and their repayment was subject to bargaining between the bank and enterprise.

5.2 Financial reform and development

Comprehensive market reforms require a much greater degree of enterprise autonomy than was achieved under the partial reforms to central planning. This increased autonomy has arisen in part from a winding down of direct government outlays and directed credits for enterprise investment, and in part from an overhaul of enterprise taxation to allow the greater accumulation of savings. This autonomy has been reinforced in some countries through enterprise privatisation and transformation of banking.

The transformation of banking has involved splitting up the monolithic banking system controlled by the central bank into a two-tier system with a central bank and autonomous commercial banks, along with the establishment of internal convertibility of money. This initial change, buttressed by strengthening prudential regulation and supervision and by recapitalising and privatising state banks, has helped to increase the autonomy of enterprises by hardening formerly soft credits (see Chapter 10).

The patterns of enterprise finance that emerge from this chapter reveal that, as the state begins to withdraw from direct support for enterprise investment and to transform banking, enterprises become much more dependent on their internal cash flows to finance investment. It also appears that enterprises as a whole accumulated substantial financial assets as the comprehensive market reforms were being implemented. This period of enormous structural change and great uncertainty may well have encouraged enterprises to postpone fixed investment outlays until a more

[1] Kornai (1992) pp. 131-159.

stable economic framework emerged.[2] While the significance of bank lending has also tended to increase with progress in transition, the heavy dependence on internal finance remains.

5.3 Challenges ahead

One might be tempted to argue that the heavy reliance on enterprise savings to finance investment in transition economies, bearing a remarkable similarity to the pattern of corporate finance in advanced industrialised countries, is desirable. However, in transition economies the ownership structure of enterprises is not conducive to efficient decisions. In some countries, privatisation has been slow, leaving the bulk of enterprises in state ownership. In others, mass privatisation has achieved the rapid transfer of enterprise ownership to the private sector, albeit at the expense of weak enterprise governance by private owners.[3] In each case, the controlling owners of enterprises tend to be either the state or the managers and workers on the one hand, or dispersed outside shareholders on the other. None of these ownership structures are likely to be a source of strong financial discipline (Chapter 8). Therefore, from a perspective which emphasises the role of finance in improving allocations and decisions, as opposed to simply the patterns of flows, the funding of enterprise investment predominantly by internal cash flows does not mark a particularly dramatic departure from the previous regime.[4]

For those enterprises with weak governance structures, greater provision of outside finance can provide an important source of financial discipline. Outside finance can also improve the allocative efficiency of investment. If access of enterprises to outside finance were severely restricted, the allocation of investment would be impaired, since only those enterprises with both sufficient gross savings and profitable investment opportunities would undertake investments. In a well-functioning market economy, only the latter should be the key determinant of whether an investment takes place.

To facilitate and to promote recourse to outside finance, there are two complementary areas for policy. Both entail important considerations for outside potential investors. The first is fostering the development of the financial sector to expand the supply and effectiveness of outside finance (see Chapter 10). The second involves measures to promote product market competition, primarily trade liberalisation, enforcement of anti-monopoly laws or regulations and facilitation of market entry, to keep profits in check and to boost the demand for outside finance (see Chapter 2). This line of argument presumes that the basic fiscal reforms of eliminating the direct government financing of enterprise investment and of overhauling enterprise taxation have already been undertaken. Clearly, the measures to expand the demand for and supply of outside finance should move together.

5.4 Measuring the sources of investment finance

Cross-country comparisons of investment finance encounter a range of challenging issues, and the present analysis is no exception. There are basic issues concerning whether to focus on the outstanding stock of financial claims on enterprises or the flow of these claims and, since enterprises not only raise outside finance but also invest in financial assets, whether to analyse financial claims on a gross or a net basis. The comparability across countries of data and their quality are also important considerations.

Two considerations weigh in favour of the flow approach for the purpose at hand. First, since investment is a flow concept, the question of how investment is being financed is thus primarily about the financing of flows. In terms of stocks, the equivalent question would be how the existing physical capital stock of enterprises was financed in terms of their balance sheets. Of course, the two concepts are linked, with the outstanding stocks at a point in time both representing the cumulation of past flows and being key determinants of future flows. Given the dramatic changes in financial arrangements in transition economies, however, cumulating the past financing of investment is much less relevant to the issue of investment finance than are the new flows. Second, given the high inflation in some countries and the wide range of accounting practices with regard to depreciation, comparability across countries of stock data based on enterprise accounts would be limited. Similar concerns arise in the flow data, but some of the bias in the data can be more clearly identified. For these reasons, the approach taken in this chapter focuses on financing of investment rather than that of the existing capital stock.

The second measurement issue concerns whether a particular type of financial flow should be measured on a gross or a net basis. For example, should bank lending to enterprises be scored on a gross basis or reported net of deposit taking? Similarly, should the acquisition of securities by enterprises be netted against the amount of securities that they issue? To the extent that the objective is to examine the financing of physical investment, the netting of financial flows serves to isolate the amount of funds actually available for investment. The reporting of financial flows on a net basis, however, can risk understating the significance of a particular source of financing. For example, since this chapter analyses aggregate data, the role of banks could be understated if some firms are net depositors with banks while others are net borrowers. The net flow figure at the aggregate level could well indicate zero bank financing, even though banks would clearly be financing some firms.

As with the stock versus flow issue, there is no single answer to the question of whether to measure financial flows on a gross or a net basis. The approach taken here largely reflects data considerations that restrict much of the analysis to net financing flows. However,

[2] This empirical observation calls into question the emphasis on financial constraints as a primary factor in the downturn in investment in the region. For expositions of that view, see Calvo and Coricelli (1992, 1994) and Calvo and Kumar (1994).

[3] See also *Transition Report*, EBRD (1994), pp. 49-68.

[4] Of course, the introduction of domestic and foreign product market competition does impose a significant discipline on enterprise behaviour. The incentives and constraints faced by enterprise managers and workers have also been altered by the reforms.

in transition economies, the scope for the acquisition of financial assets by enterprises is limited primarily to domestic bank deposits and capital flight.

This chapter focuses on three countries in the region: the Czech Republic, Romania and Russia. The extent of country coverage reflects primarily the availability of data on investment, profitability and depreciation, and net bank lending that are consistent in terms of their coverage of enterprises. The time period for the analysis is 1990-94, to the extent available data allow. The enterprise data are typically compiled by each country's central statistical office from tax or other financial reports filed by enterprises. The coverage of these data can be restricted according to enterprise size, with small enterprises in some cases excluded from the database. On bank lending to and deposit taking from enterprises, alternative data are available from the balance sheets of commercial banks, as compiled by a country's central bank. There can be significant discrepancies between the data on bank lending based on enterprise data and that from commercial banks. These discrepancies reflect both the differences in data sources and in the extent of coverage of the enterprise sector.

Apart from enterprise savings and bank lending, a significant source of finance for investment has been the government. The direct support of government to enterprises has taken the form of current subsidies, such as those for producer prices and operating losses, and transfers to enterprises for investment. The former are typically recorded as revenues to enterprises and reflected in their profitability, while the latter are recorded as financing items. This type of investment finance remains significant in the Czech Republic and Russia. Government support for the enterprise sector in Romania was largely channelled through the banking system. Where possible, current subsidies to enterprises are reported along with their gross savings.

Another source of finance for enterprise investment is the foreign sector. In principle, foreign investment can involve either the acquisition of existing assets or the provision of finance for investment. Some data on this source of investment finance are available for the Czech Republic and Russia. In these countries, the emerging domestic securities markets represent another potential source of finance. However, for the period covered by this chapter, primary issuance of securities in the domestic markets was very limited. The Prague Stock Exchange opened in April 1993, while the securities activities of the Russian exchanges only picked up after the completion of the mass privatisation programme in the middle of 1994.

5.5 Composition of investment financing

The data on enterprise investment and its financing are obtained primarily from the central statistical offices of each country and a number of qualifications are necessary. It must be emphasised that the concepts of enterprise and of investment used in Russia differ substantially from those in the Czech Republic and Romania. In the latter two countries, the statistical coverage of enterprises includes state enterprises and private companies with at least 15-20 employees. In Russia, however, the enterprise is the fundamental unit of the economy as inherited from the previous regime. The concept of an enterprise is very broad and covers all economic organisations, including non-profit organisations and entities that would typically be considered part of the government sphere, such as schools. Moreover, it is common for commercial enterprises to provide public services, such as housing, education and health care, to their employees. The sharp distinction that is drawn between government and enterprises in a market economy thus remains blurred in Russia as a carry-over from central planning.

In addition, the Russian data on investment distinguish between new fixed investment, repairs to existing capital and inventory investment. Available official data on financing of investment applies only to new fixed investment, the equivalent to net fixed investment in a market economy. As under central planning, the bulk of stock building appears to be financed with bank credits.

The analysis of how enterprise investment is financed in transition economies begins with the Czech Republic. The main reforms that have affected the financing of enterprises are in the areas of fiscal policy and banking. As part of the comprehensive reform programme in the former Czechoslovakia launched in January 1991, current subsidies to enterprises and households were cut sharply, while the tax rate on enterprise profits was halved, along with a substantial reduction in the turnover tax. A two-tier banking system was implemented in 1990, with the newly formed Consolidation Bank taking over low-interest and some non-performing loans beginning in 1991. The authorities have moved steadily to strengthen the prudential regulation and supervision of banks.

The share of gross savings of Czech enterprises in their investment has averaged 129 per cent for the period 1990-94 as a whole (Table 5.1). The fact that enterprise savings exceeded physical investment reflects the accumulation of financial assets, in particular during the period 1990-91. In subsequent years, however, Czech enterprises have been net borrowers from banks and other financial institutions, although the ratio of gross savings to investment by enterprises remains high, averaging 81 per cent in 1993-94. Subsidies to enterprises have declined steadily as a share of gross enterprise savings, falling from 34 per cent in 1990 to 18 per cent in 1994.

The net borrowing of Czech enterprises from banks and other financial institutions has fluctuated significantly. In 1990-91, enterprises accumulated net financial assets with banks and other institutions amounting to 118 per cent of physical investment. However, in 1993-94 enterprises obtained net outside finance amounting to 79 per cent of investment. Some caution is warranted in interpreting these figures because of the large "residual" in the data, movements in which tend to offset the fluctuation in outside finance. Data based on the accounts of commercial banks on net lending to enterprises point to less extreme fluctuations. Moreover, these data also reveal a significant increase in the recourse of enterprises to foreign savings as a source of outside finance in 1993-94. Capital transfers for investment by Czech enterprises rose sharply in 1992 to 42 per cent of investment, but then tapered off in subsequent years.

Table 5.1

Composition of the financing of investment in non-financial enterprises, as percentage of total investment

	1990	1991	1992	1993	1994	Average
Czech Republic						
Gross financial savings	65.8	228.8	189.0	77.1	85.4	129.2
Net borrowing from banks and other financial institutions	-74.0	-161.5	6.9	95.0	62.3	-14.3
Capital transfers from the state	11.6	42.3	30.0	27.9	21.1	26.6
Other	96.6	-9.6	-125.9	-100.0	-68.8	-41.5
Romania						
Gross financial savings	52.4	96.5	89.0	–	–	79.3
Net borrowing from banks	30.2	3.1	4.7	–	–	12.6
Capital transfers from the state	20.3	6.7	6.0	–	–	11.0
Other	-2.9	-6.3	0.3	–	–	-2.9
Russia						
Decentralised resources	63.0	70.0	70.0	63.0	66.0	66.4
Gross financial savings	–	51.0	31.0	19.0	–	33.7
Credit of commercial banks	–	–	10.0	6.0	–	8.0
Other	–	19.0	29.0	38.0	–	28.7
Centralised resources	37.0	30.0	30.0	38.0	34.0	33.8

Sources
Czech Republic: Czech Central Statistical Office.
Romania: *Statistical Yearbook*, various issues.
Russia: Le Houerou (1995), Astapovich (1995).

Note
Investment figures for Russia refer to the whole economy, which approximately coincides with the system of enterprises, and are measured according to the concept of "new fixed investment" (see text).

In Romania, the pattern of investment finance depicts the withdrawal of the state from the direct and indirect financing of enterprise investment. This was achieved as much through high inflation, which raised enterprise profits relative to bank lending, as by changes in fiscal and banking policies. The ratio of enterprise savings to physical investment increased significantly from 1990 to 1991, rising from 52 per cent to 96 per cent. The share of gross savings in enterprise investment has remained broadly stable since then. The increased reliance on internal savings mirrors other developments. The share of net borrowing from the banks dropped sharply, from 30 per cent in 1990 to 3 per cent in 1991, while at the same time the share of capital transfers from the state declined from 20 per cent of investment to 7 per cent. This does not include the substantial write-down of enterprise debts in 1990-91.

The sharp rise in gross enterprise savings as a share of Romanian enterprise investment between 1990 and 1991 reflects in part the interaction of high inflation with the local accounting system. The valuation of inventories at historical cost during the high inflation of 1991-93 resulted in large paper profits. However, the combination of high paper profits and a top 45 per cent marginal tax rate on profits left enterprises with insufficient liquidity to replace inventories at current costs. As a result, enterprises accumulated arrears both on taxes due and on accounts payable to other enterprises. In addition, new banking and central bank laws were passed in April 1991 which established the principle of universal banking and made banks responsible for their lending decisions. However, the repeated recapitalisation of state banks in 1990-92 may have weakened the incentive of banks to impose financial discipline on enterprises. The government's direct financing of enterprise investment through the budget was significantly reduced in the April 1991 macroeconomic stabilisation programme. At same time, enterprise taxation was overhauled, although the tax burden on enterprises remained relatively heavy.

In Russia, the financing of enterprise investments remains substantially unreformed. The share of government financing in new fixed investment of enterprises has remained broadly unchanged, fluctuating between 30 per cent and 38 per cent from 1990-94. Direct government financing includes budgetary outlays by the federal and local governments and by extra-budgetary funds, as well as direct central bank lending to enterprises. Since the enterprise accounts are on a cash rather than accrual basis, government financing does not include the significant tax arrears that enterprises have built up with the government, leading to the overstatement of after-tax profits and understatement of government financing. The bulk of budgetary outlays for investment are targeted to a few key production sectors, such as agriculture, fuel and energy, communications and defence. Only a fraction of these centralised investment programmes could be considered as involving the provision of public goods. The extra-budgetary funds provide resources for both public investments, such as roads, and for commercial investment in specific industrial sectors. Similar to earmarked funds under central planning, these resources are raised through specific levies and can only be spent on investment projects in particular sectors or activities.

The share of gross enterprise savings in investment has fallen from 51 per cent of new fixed investment in 1991 to 19 per cent in 1992-93. This largely reflects a corresponding fall in depreciation allowances. While there has been a partial reform of enterprise taxation in 1991, the depreciation of fixed assets has not been adequately adjusted for inflation. Bank lending for new fixed investment remains limited, averaging 8 per cent of investment in 1992-93. As under central planning, the bulk of bank lending for

enterprises reported on the basis of data from commercial banks would appear to be for accumulation of inventories. While data on enterprise deposits in domestic banks is not available, the accumulation by enterprises of financial balances outside Russia has been significant. A recent estimate of foreign assets held by Russian enterprises and households amounts to US$ 43 billion, much of which was accumulated in 1991-94 (Box 5.1). This amount is equivalent to 21 per cent of new capital investment during this period.

While the ability to make cross-country comparisons is limited by the differences in statistical concepts among the three countries, a few broad conclusions emerge from the data. First, in the period of considerable uncertainty surrounding the introduction of far-reaching structural reforms and macroeconomic stabilisation, enterprises in the Czech Republic and Russia accumulated significant financial assets. This opens a question about the extent to which financial constraints contributed to the slump in fixed investment. At least in this period, the causality may well have run from a contraction in the demand for investment goods by enterprises to the decline in outside finance, rather than in the reverse direction. However, as growth and investment demand recover, the inherent weaknesses in the financial sectors are likely to hold back both the supply of outside finance and actual investment. Second, the Czech and Romanian data support the hypothesis that early in the transition enterprises are heavily dependent on their internal savings to finance investment, as the state withdraws from direct outlays on investment and as the nature of bank lending changes. In Russia, this preliminary step in the transformation of enterprise finance had not yet taken place. Third, as the domestic financial system begins to develop, outside finance (particularly bank lending) accounts for an increasing share of enterprise investment. In the Czech Republic, it is noteworthy that access to bank lending is not confined just to domestic banks but extends to international institutions as well. This reflects in part the low transfer risk in the Czech Republic, limited term lending by Czech banks and financing of multinational enterprises by their international banks.

Box 5.1

Russian capital flight

The accumulation of foreign assets has been a major vehicle for saving by Russian enterprises and households. It is estimated that these assets now amount to US$ 43 billion (see table below). One part of this total is legal capital flight, which consists of enterprises' hard currency deposits in Russian banks plus cash dollars, held mostly by individuals, including those operating in the grey economy. The build-up of hard currency deposits took place in 1992, and that of cash holdings in 1994. The remainder is illegal capital flight, which consists primarily of assets held abroad as cash, securities or real estate. These assets were accumulated most strongly in 1992-93.

(In billions of US dollars)

	1991	1992	1993	1994
Legally held assets	7.6	14.0	16.8	24.9
Deposits	2.6	9.0	9.1	9.4
Cash	5.0	5.0	7.7	15.5
Illegally held assets	3.0	8.4	15.5	18.2
Total	**10.6**	**22.4**	**32.3**	**43.1**

Sources
Work by A. Lushin and M. Sarafanov, as reported by *Russian Economic Trends*, Monthly Update, April 1995.

5.6 Sectoral composition of enterprise savings and investment

The sectoral composition of enterprise savings and investment provides additional information on the role of internal finance in transition economies, allowing a disaggregated analysis of financial flows among enterprises. A potential bias in using aggregate data on enterprise financing is that some of the variation among enterprises becomes concealed. The sectoral data, to some extent, overcome this problem. The sectoral analysis is limited to the Czech Republic, where the distortions to accounting data from inflation are less pronounced than in the other two countries.

The sectoral breakdown of enterprise gross savings (profits before taxes and distribution plus depreciation) and investment for the Czech Republic reveals that in most sectors savings exceeded investment for the period 1990-93 (Table 5.2).

The three sectors in which investment exceeded savings were manufacturing, transport and other services. The latter category includes housing, education and health. Investment in manufacturing exceeded gross savings in that sector by a substantial margin. The sectoral pattern of enterprise savings and investment thus reveals considerable diversity, in which the accumulation of financial assets by a number of sectors is counter-balanced by the financing requirements of the manufacturing, transport and other services sectors. As a result, the financing flows recorded on a net basis understate the significance of outside finance to the enterprise sector. That being said, it must also be noted that the majority of sectors appear to have relied extensively on internal finance for investment. Only in transport did before-tax profits plus depreciation fall below 50 per cent of investment for the period as a whole.

The sectoral pattern of the balance between enterprise savings and investment, moreover, points to possible divergences following the introduction of market reforms between the return on the existing capital stock in a sector (average return to capital) and the return to investment in that sector (marginal return to capital). In particular, both the shift in relative prices across sectors for inputs and outputs and the extent to which their existing capital stocks became obsolete can vary widely across sectors (see Chapter 3). As a result, some sectors may choose not to invest in new equipment and structures even if the existing capital stock is generating adequate cashflows. This may provide at least a partial explanation for the accumulation of financial balances during this sample period in the agriculture, mining, electricity, gas and water, construction, trade and service, and communications sectors. In contrast, despite low profitability there has been significant fixed investment in the transport sector.

Table 5.2

Czech Republic: enterprise savings and investment by sector, in billions of 1989 Czech crowns

Sector	1990	1991	1992	1993	Average	
Agriculture	0.3	9.3	-20.3	0.4	-2.6	Total investment
	18.5	3.4	-1.4	2.4	5.7	Profits+depreciation
	18.2	-5.9	19.0	2.0	8.3	Balance
Mining	3.4	1.1	-0.6	0.1	1.0	Total investment
	0.4	0.2	7.5	5.9	3.5	Profits+depreciation
	-3.0	-0.9	8.0	5.8	2.5	Balance
Manufacturing	188.1	92.4	98.5	97.0	119.0	Total investment
	108.2	104.7	44.2	28.0	71.3	Profits+depreciation
	-80.0	12.3	-54.2	-68.9	-47.7	Balance
Electricity, gas and water	3.6	2.0	10.4	13.6	7.4	Total investment
	0.3	-0.2	21.2	15.5	9.2	Profits+depreciation
	-3.3	-2.3	10.8	1.9	1.8	Balance
Construction	6.4	8.3	-20.4	4.4	-0.3	Total investment
	6.8	4.3	3.4	3.7	4.5	Profits+depreciation
	0.4	-4.0	23.8	-0.7	4.9	Balance
Trade and services	27.3	11.0	-7.9	2.6	8.2	Total investment
	20.3	7.3	5.5	2.3	8.9	Profits+depreciation
	-7.0	-3.7	13.5	-0.3	0.6	Balance
Transport	11.9	11.9	11.3	10.7	11.4	Total investment
	5.1	-1.6	-4.2	-0.1	-0.2	Profits+depreciation
	-6.8	-13.5	-15.5	-10.8	-11.7	Balance
Communications	2.8	3.8	3.6	7.9	4.6	Total investment
	7.3	6.3	7.4	7.9	7.2	Profits+depreciation
	4.5	2.5	3.7	0.0	2.7	Balance
Other services	17.8	12.1	13.3	21.1	16.1	Total investment
	24.2	1.0	6.1	3.9	8.8	Profits+depreciation
	6.4	-11.2	-7.2	-17.2	-7.3	Balance

Source

Statistical Yearbook of the Czech Republic, 1993 and 1994.

Notes

Due to insufficient detail of the primary source, "Other services" includes housing, which should belong to "Construction".

The internal balance does not take tax liabilities into account.

Figures are in real terms, calculated using the 1989 c.p. product deflator index for the relevant industrial sector.

The considerable diversity in profitability and investment opportunities among enterprises will place a heavy demand on the financial sector to reallocate savings to the most efficient investments. This demand for intermediary services will be fuelled by the recovery in growth and investment and the adjustment of enterprises to structural reforms. The level and efficiency of investment will thus depend crucially upon the ability of the domestic banks and other financial institutions to provide these services. While there is some evidence in the Czech Republic that banks are reallocating savings among enterprises, there remains considerable weaknesses in the financial system that could hold back investment and growth as the need for enterprise restructuring deepens.

5.7 Investment finance in developing and industrial countries

While a distinguishing feature of enterprise finance in transition economies is the dominant role of internal savings following the introduction of far-reaching market reforms, any assessment of this financial structure requires a broader perspective. A starting point for this is a comparison with the composition of investment finance in other countries. Several recent empirical studies examine the composition of financing in developing and industrial countries.

Data on the composition of finance for enterprise investment is available for nine developing countries (India, Jordan, Korea, Malaysia, Mexico, Pakistan, Thailand, Turkey and Zimbabwe).[5] These data are based on the financial accounts of the top 50 manu-

[5] Singh and Hamid (1992).

facturing companies quoted on the stock markets in each country. The enterprise coverage is thus less comprehensive within each country than that above, but it is estimated that the top companies in these developing countries usually account for at least half of the output of all non-financial enterprises. Bearing in mind the usual caveat about the limited cross-country comparability of the data due to differences in accounting practices, a number of points emerge from these data. First, external equity and debt account for the bulk of investment, about 68 per cent on an unweighted average basis (Table 5.3).

Table 5.3

Composition of financing of non-financial enterprises in selected developing countries (1980-88), in per cent of total investment

	Internal	External	Of which	
		Total external	Equity	Debt
India	34.9	65.1	14.0	51.1
Jordan	11.6	88.4	46.6	41.8
Korea	21.0	79.0	44.3	34.6
Malaysia	66.8	33.2	14.9	18.3
Mexico	26.3	73.7	69.4	4.3
Pakistan	42.0	58.0	20.4	37.6
Thailand	24.1	75.9	40.9	35.0
Turkey	17.5	82.6	60.9	21.7
Zimbabwe	42.9	57.1	35.2	21.9

Sources
Calvo and Kumar (1994) based on Singh and Hamid (1992).

There is considerable variation among the countries, but the only exception to this general observation is Malaysia, where external finance accounted for just 33 per cent of enterprise investment. Second, equity finance plays a more significant role than debt in the financing of investment. On an unweighted basis, internal savings and outside equity comprised 70 per cent of net investment. Only in India did debt financing exceed the total of internal finance and outside equity, at 51 per cent to 49 per cent.

One contrast between the financing of enterprises in developing countries and those in transition economies is that enterprises in developing countries are much more reliant on outside debt and equity finance than are those in the Czech Republic, Romania and Russia. This largely reflects the withdrawal of government from the direct or indirect provision of finance for enterprise investment and the time required to transform the financial sectors. While developing countries also need extensive financial development, the necessary structural changes to the financial institutions and markets in these countries is less profound. One similarity also emerges from the cross-country comparison of enterprise finance. Enterprises in both developing countries and those in transition rely extensively on equity finance.

It is also possible to make comparisons of enterprise finance with selected industrial countries. Recent data on the composition of investment finance are available for Germany, Japan, the United Kingdom and the United States of America.[6] The composition of finance is presented on both a gross and a net basis, since the acquisition of financial assets by enterprises in industrial countries is significant. There are a number of stylised facts regarding the composition of investment finance in industrial countries (Table 5.4).

Table 5.4

Gross and net sources of enterprise finance, percentages (1970-89)

	Internal	External	Of which			
		Total external	Equity	Bank loans	Other	Stat. adj.
Germany	80.6	19.4	0.9	11.0	7.5	0.0
	(62.4)	(37.6)	(2.3)	(18.0)	(17.3)	0.0
Japan	69.3	30.7	3.7	30.5	-3.5	0.0
	(40.0)	(60.0)	(3.9)	(34.5)	(21.6)	0.0
UK	97.3	10.8	-10.4	19.5	1.7	-8.0
	(60.4)	(39.7)	(7.0)	(23.3)	(9.4)	0.0
US	91.3	17.4	-8.8	16.6	9.6	-8.7
	(62.7)	(37.3)	(-4.9)	(14.7)	(27.5)	0.0
Average, net	86.0	19.6	-3.7	19.4	3.8	–
Average, gross	56.4	43.6	2.1	22.6	18.9	–

Source
Corbett and Jenkinson (1994), Tables 2 and 3.
Note
The first row for each country refers to net sources of finance, the second to gross.

First, enterprise savings are the most significant source of finance, accounting for 56 per cent of gross finance. On a net basis, the share of enterprise savings rises to 86 per cent, reflecting the use of internal funds to purchase financial assets. The country with the lowest share of internal finance is Japan, where enterprise savings account for 40 per cent of gross financing and 69 per cent of net financing or investment. Second, bank lending is the next most significant source of outside finance, accounting for 23 per cent of gross financing and 19 per cent on a net basis. Japanese enterprises have the largest share of bank financing, 35 per cent and 31 per cent on a gross and net basis, respectively. Third, outside equity plays only a minor role in enterprise financing, comprising 2 per cent of gross financing and -4 per cent of net financing. The negative share of outside equity in net financing in the United Kingdom and the United States reflects primarily the large volume of mergers and acquisitions and of share repurchases, both of which involve the purchase of equities by enterprises funded primarily with internal savings or debt.

At first glance, the share of enterprise savings in the financing of investment in transition economies appears remarkably similar to that in transition economies, in the sense that both rely heavily on internal finance. However, such a straightforward comparison would be quite misleading. Given the weak ownership structures of many enterprises in transition economies, a primary concern is

[6] Corbett and Jenkinson (1994). For an earlier study, see also Mayer (1990).

the extent to which outside investors are able to impose financial discipline. In industrial countries, the financial sector is highly enmeshed with enterprises, financing not only physical investments but also the acquisition of financial assets. For this reason, the gross financing of enterprises portrays more accurately the significance of outside finance to enterprises in industrial countries. Moreover, in the early periods of industrialisation, outside finance played a much greater role in the financing of investment.[7]

The provision of outside finance to enterprises brings with it greater financial discipline. Outside investors must evaluate carefully the value of investments relative to the alternatives. This caution reflects the real possibility that the inside managers of enterprises, who by virtue of their position are better informed about the value of investments, will opportunistically seek external finance only when outsider investors overvalue the claims.[8] Outside investors must also constantly monitor their investments to ensure that their interests are being respected. However, the role of outside investors in evaluating and monitoring investments is imperfect and costly, and internal finance is widely viewed by enterprises as the more preferable financing source.[9] In any event, the financial discipline provided by outside investors arises not so much from their being the dominant source of funding for the existing physical capital and stocks of enterprises, but from providing the finance for new investments.

5.8 Outside investors, financial development and growth

The comparison of investment financing in transition economies with that in developing and industrial countries illustrates the limited role of outside investors as a consequence of transition. This limited role can hamper financial discipline in transition economies where most enterprises are only weakly controlled by their existing owners. Moreover, the lack of access to outside finance can also constrain the allocation efficiency of investment by limiting investments to those enterprises that have both sufficient gross savings and profitable investment opportunities. This constraint is likely to become more binding since the recovery in growth and investment appears to be occurring more rapidly than the reform and development of financial sectors in the region. Available empirical evidence generally supports the importance of these considerations.

One measure of outside investor involvement in evaluating and monitoring enterprise investments is the overall development of domestic financial institutions and markets. A well-functioning financial system, of course, also provides additional services to savers such as portfolio diversification and liquidity. Due to its impact on both efficiency of investment and services to savers, one would expect a strong link between financial development and investment, productivity and growth.

While there are many possible channels through which development of the financial sector can boost growth, available empirical evidence points to a strong overall impact. A recent study of over 80 countries for the period 1960-89 reveals that measures of banking development are positively and significantly correlated with real per-capita GDP growth, real per-capita capital stock and productivity gains (Box 5.2). In addition, regression analysis revealed that measures of financial development at the beginning of the sample period were significant in predicting future growth rates, which supports the hypothesis that financial development contributes to growth and is not simply a consequence of it. The potential impact of financial development on growth also extends to securities activities. As with banking, a recent study has focused on the link between stock market development and growth for the period 1976-93. Available evidence indicates that measures of stock market development are positively and significantly correlated with growth and its components (Box 5.2). Again, the regression analysis indicates that measures of stock market develop-

Box 5.2
Financial development and economic growth

The significance of financial development in promoting growth has long been the subject of empirical investigation. The contemporaneous expansion of the financial sector with growth of the real economy is a well-documented feature of development and industrialisation. However, the issue remained whether the financial sector was making an active contribution to this growth or simply responding passively to developments in the real economy that were leading growth. Two recent studies provide some additional evidence on the direction of causality between financial development and growth, not only with respect to banking but also to securities activities.[1] The evidence comes from regression analysis which serves to identify factors that contribute to cross-country variations in growth. A number of factors have been identified as significant in explaining variation in long-run growth rates across countries. The non-financial factors that have been identified as having a significant impact on growth include: real GDP per capita at the start of the sample period, initial secondary school enrolment, number of revolutions and coups, initial ratio of government consumption to GDP, and initial inflation rate.

Measures of the initial conditions in the financial sector have been added to examine their contributions to economic growth. These include the ratio of broad money to GDP, the ratio of stock market turnover to market capitalisation and the ratio of turnover to GDP. The initial values for each of these variables is significant in explaining variations on long-run growth among countries.

A related issue is whether both the measures of banking and securities activities reveal independent effects on growth or whether these measures are simply proxies for each other. This issue was also taken up in the study on stock market development and growth. When measures of banking and securities activities at the beginning of the sample period were simultaneously included in regression equations for real per capital GDP growth, both types of measures were significant in explaining subsequent growth rates. This result suggests that development of both banking and securities activities make valuable contributions to growth.

1 King and Levine (1993) and Levine and Zevros (1995).

7 Taggert (1985).

8 Myers and Majluf (1984).

9 The taxation of dividend income at both the enterprise and household levels typically reinforces the preference for internal finance. However, the tax deductibility of interest payments can swing this preference toward debt, particularly in a period of high inflation (Chapter 4).

ment at the beginning of the sample period, especially those of liquidity, are strongly correlated with future growth rates.

The available empirical evidence thus points to a strong link between financial development and investment, productivity and growth. These studies do not allow identification of the specific channels through which the financial sector influences developments in the real economy, be it the evaluation and monitoring of enterprise investments, diversification or liquidity. Nevertheless, financial development necessarily involves an increased role for outside investors in enterprise finance.

5.9 Concluding remarks

This chapter has examined how enterprise investment has been financed in a representative cross-section of countries in transition, the Czech Republic, Romania and Russia, for the period 1990-94. In each country, the sample period begins before the introduction of comprehensive market reforms. The initial observations thus provide some indication of how enterprises were financed under the previous regime. The observations over time also reveal how the transition to a market economy influenced the financing of enterprises in each country. In the Czech Republic and Romania, the withdrawal of the state from financing enterprise investment has largely involved the cutting back of government transfers for investment, reform of enterprise taxation and transformation of banking. These reforms have led to a significant increase in enterprises' reliance on internal finance. In Russia, however, the government has yet to engineer its withdrawal from the financing of enterprise investment to anything like the same extent. This will involve not only the reform of enterprise taxation, but also the clear separation of commercial investments by enterprises from investments in social goods and services. This will require the divestiture of social assets by enterprises and the comprehensive reform of the government's capital budgeting process. As these structural reforms are implemented, it can be anticipated that enterprises would initially become much more reliant on internal savings to finance investment.

The nature of the structural reforms required for the transition will almost inevitably lead to a period of extensive reliance on internal finance by enterprises to fund their investments. It might be tempting to draw quick comparisons with the extensive reliance on internal finance in industrial countries and to conclude that extensive reliance on internal finance was desirable in transition economies. However, such comparisons and conclusions would be very misleading. The high reliance on internal finance by state enterprises or those that have been privatised to dispersed outside shareholders or to insiders resembles the pattern of enterprise finance from the previous regime, in terms of management and decision-making process and the aggregate flow of funds. The mechanisms for the efficient allocation of capital in the operating and investment decisions of enterprises remain weak. Under these conditions, the efficiency of investment may well continue to languish near the low levels realised in the previous regimes.

One way to promote the increased use of outside finance by enterprises is to foster market competition through trade liberalisation and anti-monopoly policies. Many countries in the region liberalised trade significantly early in the transition; however, as adverse impacts on enterprise profitability in certain sectors and on the balance of payments materialised, there was a reversion to increased protectionism. Once again, trade protection in the region is declining, in part due to the effects of EU Association Agreements reached with certain countries in eastern Europe and with the Baltics. Also, for these countries, accession to the EU would require a more effective implementation of competition policy. For those countries that are not associated with the EU, it is important to maintain progress in these areas, both in their own right and to promote the increased recourse to outside finance for enterprise investment. The support of the EBRD and other IFIs for the entry of private enterprises into new markets can also help to spur competition.

The development of the financial sector itself must, of course, remain a priority. There has been considerable focus on the development of banking in the region, and rightly so. Banks provide basic transaction services not only for industry and commerce, but also for securities activities. As such, banks are fundamental to a market economy. However, the capacity of banks to intermediate domestic savings into enterprise investments may be limited, at least for while. While securities markets have emerged quickly in a number of countries, they remain small and largely illiquid. Even those markets that have been spurred on by mass privatisation programmes lack the liquidity necessary to promote primary issues. Moreover, the domestic investment and insurance companies remain relatively small. Thus, taking banking and non-banking sub-sectors together, it will be a long time before the financial sector shows the strength (typical of advanced industrialised countries) necessary to generate and allocate savings effectively. It will remain a key area for IFIs to involve themselves in institution building, both through direct investment in particular institutions and in developing sector-wide structures. While this institution building is taking place, the activities of the IFIs, and the EBRD in particular, will remain strongly "additional".

Lastly, while securities markets and non-bank financial institutions clearly offer a potential substitute to bank intermediation of savings, it is important to recognise the potential complementarities between these alternative forms of financing. For example, by listing its shares on a stock exchange, a company can improve the availability of information about its financial performance, both through the monitoring of share price developments and the public disclosure of financial accounts. Similar complementarities can also exist between development of the domestic financial sector and access to foreign savings. A well-functioning domestic financial system that can exercise effective control over enterprises can facilitate the inflow of foreign portfolio investments.

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The contribution of law to fostering investment

6

Law provides both rules for investment and a vital part of the environment in which investments succeed or fail. For investment to flourish, the right legal rules must be in place. As important as what the rules say, however, is what they mean in practice. A pristine statute on investment that is unknown, unadministered and unenforced is ineffective.

This chapter looks at how conducive the laws of the region are to fostering investment, including foreign investment. First, it considers the extent to which those laws approximate the generally accepted view internationally of which laws best foster investment. Second, it evaluates *effectiveness* of investment laws, that is the extent to which such laws are clear, accessible, and adequately supported administratively and judicially.

A country-by-country assessment of these issues is presented in Annex 6.1, from which some conclusions are drawn. The assessments are based on the results of a survey involving ministries of justice, selected private law firms, and academic and other experts familiar with the laws of the countries of the region. Box 6.2 explains the nature of the survey and caveats required in using the material. Table 6.1 also provides a score for each country.

6.1 Investment rules of the region in relation to generally accepted standards

Legal rules that best foster investment do not proceed from first principles. It is possible, however, to evaluate investment laws in the countries of the region against the benchmark of legal rules that are generally accepted internationally as fostering investment. This evaluation reveals whether existing rules are likely to win the approval of the investing community, including foreign investors.

Box 6.1 identifies the source and content of those legal rules. These include laws that recognise private property rights, enable profits to be taken out of the country and protect against uncompensated expropriation. Also important are laws that enable the registration of security interests, provide a legal framework for investment vehicles, and prohibit discrimination between domestic and foreign investment, whether through licensing regimes, discriminatory taxation systems or other means. A country-by-country assessment of how investment laws of the countries of the region compare with investment rules that are generally accepted internationally is provided in the first column of Annex 6.1.

6.2 The effectiveness of laws affecting investment

The remainder of this chapter, including the last three of the four columns in Annex 6.1, examines the effectiveness of legal rules affecting investment. Three questions are asked: how clear and accessible is the law affecting investment?; how well supported is it administratively?; how well supported is it judicially?[1]

How clear and accessible is the law affecting investment?

The second column of Annex 6.1 measures the clarity and accessibility of investment laws against three main benchmarks. The first is the textual clarity of laws, including regulations and administrative rulings. From a textual perspective, laws designed to foster investment may achieve the opposite effect if they are unclear, confusing or contradictory. Where executive decrees and legislative acts are contradictory, the paramount document must be made explicit. The second is the extent to which law has been disseminated. Laws that have not been published widely or promptly are of limited use and may even be counterproductive. Draft laws should be made public in order to elicit comments from various stakeholders (e.g., investors, administrative agencies, courts) which can then be considered for the final texts of laws. Important court judgements on issues of principle should also be widely disseminated to show how the law is interpreted and applied. The third is the availability of comprehensive, independent and adequately supported legal advice to help investors to understand the detailed nature and practical implications of investment laws.

How well supported administratively is investment law?

Besides being clear and accessible, laws fostering investment must be adequately funded and administered if they are to be useful. The third column of Annex 6.1 identifies whether some of the elements of an effective administration are in place in the countries of the region. These elements include a clear demarcation of responsibilities between the various arms of government, but with effective coordination between them. The tax administration office, police and courts need to be properly funded, regarding both personnel and infrastructure. If a particular law requires specific action to be undertaken by investors, the administrative mechanisms necessary must be provided. For example, if a special licence is necessary for the opening of a foreign bank account, the licensing body must issue such licences promptly and in accordance with transparent and consistently applied guidelines. Certain legal rights need to be supported by administrative bodies, such as clear and reliable real property rights which depend on an effective land cadastre.[2] Similarly, secured transactions depend on shares and other security interests (such as mortgages and liens) being noted on public registers.

1 These questions are consistent with the philosophy underlying the three considerations discussed in Box 6.1, namely what the rule of law demands, what recognition of economic rights requires, and what are the prescriptive attempts at the international level to promote a legal environment conducive to investment.

2 An official public register of property rights and boundaries.

Box 6.1

Generally accepted legal rules on investment

The generally accepted view internationally of which laws best foster investment can be discerned by drawing on the rule of law, the recognition of economic rights as human rights, and prescriptive attempts at the international level to promote a legal environment conducive to investment.

Rule of law

Investment laws have the greatest credibility within a legal system founded on the rule of law, where the application of laws bears a degree of predictability and consistency, and their enforcement is reviewed by independent parties, usually courts. An important function of the rule of law is that the exercise of the power of the state should be limited to recognised and accepted circumstances. A consequence of the rule of law is that resultant legal rules are better valued by citizens because they are more predictable and embody generally accepted rights and obligations.

Economic rights as human rights

International human rights texts – most prominently the Universal Declaration of Human Rights – enshrine the right to property and, by extension, permit contractual freedom generally. In addition, the Preamble to the Agreement Establishing the EBRD welcomes "the intent of Central and Eastern European countries to further the practical implementation of multiparty democracy, strengthening democratic institutions, the rule of law and respect for human rights and their willingness to implement reforms in order to evolve towards market-oriented economies".

The sources of investment rules at the international level

Numerous sources contribute to the evolving definition of a legal environment best suited to investment. (None the less, it should be noted that universal agreement on such a definition remains an elusive goal, particularly among certain developing countries, hence the references in this discussion to prescriptive rules that are generally accepted internationally.) The writings of jurists, arbitral awards and a small number of decisions of public international tribunals, most notably the International Court of Justice, may be understood as establishing best practices from the perspective of the international investor. A number of bilateral investment treaties, national investment codes and a few multilateral instruments (such as the UNCTC *Draft Code of Conduct on Transnational Corporations* and the OECD *Guidelines for Multilateral Enterprises*) further contribute to what may be viewed as internationally accepted legal rules on investment. A useful distillation of such views, which also contains a prescriptive or best practice element, is the recent World Bank *Guidelines on the Treatment of Foreign Investment*. (Although concerned principally with direct foreign investment, much of the rationale of the *Guidelines* is equally relevant to domestic and indirect foreign investment.)

Regional standards sometimes both reflect and influence the content of international standards. The commercial laws of the European Union are particularly relevant, because for most countries aspiring to EU membership, harmonising their commercial laws with those of the EU is a legislative priority.

The content of generally accepted legal rules on investment

The generally accepted view internationally of which legal rules best foster investment can be distilled from the above. Central to this view is the proposition that states should not discriminate between foreign and local investors without due cause. This implies that there should be an open admission policy for all investors, which would obviate the need for special screening procedures for foreign investments, except in rare circumstances such as where an investment proposal has compelling national security implications. Furthermore, the non-discrimination tenet extends to all aspects of the treatment of such investments and would thereby prohibit laws that establish a taxation regime designed especially for foreigners (whether more or less favourable) or that require foreign investors or foreign-owned local companies to obtain special administrative approvals or licences. Legal rules that impose special restrictions on the repatriation of wages and profits of foreign investors would also be proscribed.

A model legal regime regulating investment, apart from treating foreign and local investors equally, would include property laws that recognise private property rights and protect against uncompensated expropriation, particularly by the state, and laws enabling investments to be secured, particularly through the registration of security interests. Investment vehicles, especially in the form of companies, must also be recognised to allow participants to enter the investment market. Equally, their exit must be allowed by bankruptcy laws.

On a more sophisticated level, laws relating to investment funds and other special investment vehicles, together with adequate securities legislation, will allow more diverse participants in the investment market. Taxation, currency convertibility and capital flows, labour, custody and settlement, and intellectual property rights are other issues affecting investment which need to be addressed in ways that meet the commercial needs of investors generally. The existence of criminal laws to underpin the security of investments is also an important element of a model legal framework.

Comparing the laws of the countries of the region with generally accepted legal rules on investment

The first column of Table 6.1 illustrates the extent to which the laws of the countries of the region approximate the generally accepted legal rules on investment discussed above.

How well supported judicially is investment law?

To be effective, laws fostering investment must not only be clear, accessible and well-administered but also enforceable before courts comprising independent and trained judges. The fourth column of Annex 6.1 evaluates judicial enforcement of investment laws on the basis of judicial impartiality and independence (from both government interference and financial vulnerability), the readiness of the courts to enforce foreign judgements and arbitral awards without re-examining the merits of the case, the availability of procedural due process, and the actual record of enforcement of laws to date, including criminal laws affecting investment.

6.3 The extent and effectiveness of investment laws

Table 6.1 provides a numerical assessment of how conducive the laws of the countries of the region are to fostering investment. Laws have been scored, in respect of each country, against two indicators: the extent to which legal rules affecting investment approximate investment rules that are generally accepted internationally; and the effectiveness of legal rules affecting investment, that is, the extent to which such legal rules are clear and accessible and adequately supported administratively and judicially. The classification system is explained in text accompanying Table 6.1 and further information on the methodology is provided in Box 6.2.

Progress in investment-related law reform

(See classification system for transition indicators opposite.)

Table 6.1

Laws fostering investment

Country	Extensiveness of legal rules	Effectiveness of legal rules	Overall score
Czech Republic	4	4	4
Hungary	4*	3	4
Poland	4*	3	4
Bulgaria	4	3	3
Croatia	3	4	3
Estonia	3	4	3
Slovak Republic	4	3	3
Slovenia	3	4	3
Albania	2	2	2
Armenia	3	2	2
Belarus	3	1	2
FYR Macedonia	3	2	2
Georgia	3	1	2
Kazakstan	3	1	2
Kyrgyzstan	3	2	2
Latvia	3	2	2
Lithuania	3	2	2
Moldova	3	2	2
Russian Federation	4	1	2
Romania	3	2	2
Ukraine	3	2	2
Uzbekistan	3	1	2
Azerbaijan	2	1	1
Tajikistan	2	1	1
Turkmenistan	2	1	1

Classification system for transition indicators

Transition element	Category	Description of the category
The extensiveness of legal rules on investment	1	Legal rules are very limited in scope, and impose substantial constraints on creating investment vehicles, security over assets or to the repatriation of profits. Indirect investment is not specifically regulated.
	2	Legal rules are limited in scope and impose significant constraints on creating investment vehicles, adequate security over assets, or the repatriation of profits.
	3	Legal rules do not impose major obstacles to creating investment vehicles and security or to repatriating profits. However, they are in need of considerable improvements.
	4	Legal rules do not discriminate between foreign and domestic investors and impose few constraints on creating a range of investment vehicles and security instruments. Indirect investment is specifically regulated.
	4*	Legal rules closely approximate generally accepted standards internationally and impose few restrictions, including on the creation of sophisticated investment vehicles or security. Indirect investment law is well developed.
The effectiveness of legal rules on investment	1	Legal rules are usually very unclear and often contradictory and the availability of independent legal advice is very limited. The administration of the law is substantially deficient (e.g. little confidence in the abilities and independence of the courts, no or poorly organised security and land registers).
	2	Legal rules are usually unclear and sometimes contradictory. Legal advice is often difficult to obtain. The administration and judicial support of the law is rudimentary.
	3	While legal rules are reasonably clear and ascertainable through legal advice, administrative or judicial support is often inadequate (e.g. substantial discretion in the administration of laws, few up-to-date registers).
	4	The law is usually clear and legal advice is readily available. Investment laws are reasonably well administered and supported judicially, although that support is sometimes patchy.
	4*	The law is clear and readily ascertainable. Sophisticated legal advice is readily available. Investment law is well supported administratively and judicially, particularly regarding the efficient functioning of courts and the orderly and timely registration of proprietary or security interests.
Overall score		The overall score allocated in the third column of the table is based on the assessment made in respect of the two indicators; it also draws on other survey information. These overall scores are reproduced in Table 2.1, together with a description of the overall criteria for each category.

6.4 Commentary on Annex 6.1

The commentary is organised largely by looking across countries on particular issues, at the extent of laws fostering investment, at the clarity and accessibility of the law, effective administration and judicial enforcement. Where appropriate some regional groupings are highlighted.

Several points should be borne in mind when reading the commentary. First, it should be remembered that legal reform proceeds from different stages of development within each country. In the countries of eastern Europe and the Baltics a relatively well developed legal framework for a market economy, including civil and commercial codes and a business culture, had existed before the Second World War. The effects and memory of these were not completely eroded and in some cases former practices and laws could be reinstated or revived. This is in contrast to the CIS countries which, for the most part, embarked on the task of constructing a market-oriented legal framework without having any recent history or tradition of market-oriented legal systems. Second, while the commentary and table examines whether countries meet certain legal standards this should not be taken to imply that there is a single optimal legal structure covering investment to which all countries should move.

Extent of laws fostering investment

In general, the countries of eastern Europe have the most favourable rules for investment in the region. Almost all such countries permit foreigners to own property through locally held companies and some now permit land to be owned directly. Additional restrictions sometimes apply to agricultural land. Most countries are in the process of liberalising or have recently liberalised foreign ownership. East European countries generally do not require governmental approval for investment proposals, with the exception of Romania, and in many cases exchange control regulations are minimal. Most of the countries of eastern Europe have adopted international standards regarding expropriation which permit taking of property only for public purposes and with compensation. Such countries have laws regulating, to varying degrees, indirect investment vehicles (apart from Bulgaria, which is in the course of enacting such laws). Most countries in eastern Europe have passed legislation for the creation of stock exchanges.

In the Baltics, the legal rules fostering investment appear to be approaching the level of development of some of the east European countries. At present, indirect investment in domestic securities and investment funds is specifically regulated in Estonia but not in Latvia or Lithuania.

In the CIS countries investment rules are generally less extensive than in the east European countries, with the exception of Russia where, despite a lack of clarity in many areas, the rules fostering investment are among the most developed in the region. Progress in the rest of the CIS has been slower. Land ownership by foreigners or by foreign-owned local companies is more restricted, although leasing is possible. As in eastern Europe many countries are actively engaged in further land law reform. Laws concerning the regulation of indirect investment vehicles are limited in scope, and stock exchanges are generally poorly developed. Although profits may be repatriated, transfers of foreign currency usually require central bank approval.

Clarity and accessibility of the law

Drafting of laws

The legislative process greatly influences the clarity and predictability of the law. Uncertainty may arise where wide discretion is granted to the executive to modify investment rules, without prior consultation, and by way of executive decree. Incoherent rules may result where different ministries have responsibility for drafting laws and fail to coordinate their efforts. Across the CIS countries, the executive plays a larger role in this respect; in most countries of eastern Europe and, to varying degrees, those of the Baltics, the making of legal rules lies primarily with the legislature.

In eastern Europe the standards of drafting are generally high, with laws prepared by legally trained personnel. However, even such laws are often conflicting, as in a number of countries where some new laws were inspired by a variety of foreign models and often embody conflicting policies or legal concepts. Sometimes there exists, in Lithuania, for example, no clear codification of the basic principles of commercial and civil law.

Where the technical drafters of the law are not legally trained, unclear laws often result. For example, in some Central Asian countries laws are rarely prepared by legally trained personnel and are often based on old Soviet models. Where laws are drafted by Western consultants, concepts unfamiliar to the host country are sometimes crudely transported.

Public dissemination of laws

While most countries in the region publish their parliamentary laws, albeit with varying degrees of timeliness and quantity, not all executive decrees are published and few judgements can be obtained from public registers. It is common practice in Russia, for example, for legal opinions issued in the context of investment transactions to contain qualifications which exclude all laws that have not been made public.

In most of the countries of eastern Europe, new laws are usually published within a month whereas draft laws are not always published. In certain CIS countries, it is not unusual for laws to be first published more than six months after being enacted. In many countries, official reporting of judicial decisions remains rudimentary. Annotated statutes showing relevant cases, common in countries having a longer established legal reporting tradition, are largely unheard of. Even in many law libraries basic investment laws are hard to find.

The availability of legal advice

Foreign investors and a significant number of local investors routinely seek advice to learn what the legal rules are, how they apply to them, how their interests can best be organised and protected within the existing legal rules, and how their rights can be enforced.

International investments are being increasingly entrusted more fully to local lawyers in countries (such as the Czech Republic, Hungary, Poland and Slovenia) where an independent profession is well established, and capable of delivering legal services in an international working language and to international standards. A good measure of the quality of local practitioners is the extent to which foreign investors are willing to have them appointed as arbitrators to resolve investment disputes (in countries such as Bulgaria, the Czech Republic, Hungary and Poland).

In a number of the countries of the region, particularly the Caucasus republics, there are few private sector lawyers working independently of the government and capable of providing comprehensive advice. Throughout the CIS, legal advice is generally available, although it can be expensive or inadequate to meet demand. In many more countries in the region, local lawyers are not technologically equipped to compete with their international counterparts operating locally. The legal work on a large investment in Armenia or Kyrgyzstan, for example, will probably be undertaken almost entirely from abroad, with local lawyers providing services only in respect of such issues as security under local law.

Effective administration

The role of the state

Poorly administered laws result in delays or uncertainty, thereby increasing transaction costs for the investor and undermining the positive impact of an otherwise favourable legal regime. Company registration and the granting of special licences by governmental bodies are areas where administrative delays may affect the effectiveness of investment laws.

Registers exist in many east European countries for company shares and property where the accuracy of the records in the registry and the average time needed to create a limited liability or joint-stock company is generally less than two months. Although almost all countries of eastern Europe do have systems enabling the establishment of registers for land and security interests, the register files in many countries are inaccurate.

Generally, across the CIS, there is no adequate system for registers, or they are incomplete or outdated. Another impediment is the requirement to pay fees on the notarisation or registration of the security instrument. These fees often bear no relationship to the administrative costs incurred in providing the service but are more akin to a tax, sometimes levied at excessive rates, and especially against foreigners.

Box 6.2

Survey on investment laws

The material provided in Annex 6.1 and for most of this chapter is drawn from the results of a survey conducted among ministers of justice, selected private law firms, and academic and other experts familiar with investment laws in the countries of the region. An important part of the survey involved the use of questionnaires[1] completed to a good standard by private sector lawyers (usually two or three law firms for each country). These lawyers were selected on the basis of their expertise in advising on local law issues, often in respect of the EBRD's own investments.

The content of the first column of Annex 6.1 has been reviewed for accuracy by other lawyers, including the EBRD's own legal staff. Nonetheless, it is not a comprehensive survey of all investment-related rules. For example, it does not evaluate tax rules, although these will be relevant to investment decisions. The material in the second, third and fourth columns of the table, much of which is not readily verifiable independently and reflects subjective assessments by survey respondents, has not been reviewed. Similarly, the information and views provided by respondents were not always consistent, and the EBRD has been selective in using material provided by the survey. While the purpose is to give an impression (as of July 1995) of how conducive the laws in the region are to fostering investment, care must be taken in reading and interpreting Annex 6.1.

Responses were organised into the four categories discussed in sections 6.1 and 6.2: (i) the extent to which legal rules affecting investment approximate those that are generally accepted internationally; (ii) the clarity and accessibility of the law; (iii) the extent to which the law is well supported administratively; and (iv) the extent to which the law is well supported judicially. The categories were then weighted, with 50 per cent being allocated to category (i) and 50 per cent being allocated to categories (ii), (iii) and (iv) combined (with equal weighting). The scoring was audited for reasonable assurance of overall accuracy by referring to the relative completeness of all questionnaire responses and, where possible, obtaining independent opinions on the accuracy of selected items in category (i).

[1] The most comprehensive questionnaire, to law practitioners, asked for responses to 59 questions, broken down into 6 main parts. The first part asked for identification and detailed information on the most important laws which permit and regulate investment, foreign and domestic, direct and indirect, and other basic information on investment-related law, such as whether limited liability companies can be created and owned by foreigners, taxation, the rules on compensation in the event of expropriation and the need for government approvals for investment. The second part asked questions related to the quality of legislative drafting, the regularity with which they are published and their accessibility (along with court decisions on them) to practitioners. The third part asked for information on the judicial process: the qualifications of judges, the availability of written reasons for decisions, the right of judicial review of administrative action and the enforceability of arbitral awards by the courts without a re-examination of the merits of the case, amongst others. A fourth section asked questions relating to the quality of the administration, the appointment, size and quality of the civil service, and the extent to which statutory prescribed registers for land or shares exist and whether they were up to date. A fifth section asked questions relating to the availability of comprehensive and independent legal advice: for example, the degree of legal training, the affordability of legal advice and the existence of a mandatory professional code of ethics. A final section asked respondents to assess the public's belief in the extent to which various facets of the law were respected.

Certain laws provide for the priority registration of security interests of lenders in respect of assets or capital of borrowers. The utility of such laws, however, is sometimes compromised by the absence of registers or by the incompleteness of records resulting from the failure of the government to appoint a registrar or to provide staff and other means to maintain an up-to-date register. In Kyrgyzstan, for example, the law on pledge provides for publicly accessible information to be maintained on registers established

by various municipal and regional authorities. Because of a lack of funds, however, no effective registers have been established. One consequence is that lenders are unable to verify independently whether an asset has already been pledged to a third party.

The quality of the civil service

The civil service does not always have the resources to discharge its obligations fully. To some degree these problems exist throughout the region. They are particularly problematic in some countries of the CIS, where the administrative discretion of the civil service is often wide, vaguely circumscribed and arbitrary in scope. The administration may be further weakened by poor recruitment and promotion systems. In some cases, civil servants or judges are not remunerated in accordance with legally prescribed standards.

Investment-related crime and enforcement of the criminal law

Laws designed to foster investment can also be undermined by the failure to enforce the criminal law adequately, whether it is laws against criminal damage to physical property, against corruption, money-laundering, tax evasion or extortion. In a few countries, the level of corruption seriously erodes investor confidence (see Annex 6.1). The enforcement of criminal laws is also reported in some countries as being sometimes selective and politically motivated.

Judicial enforcement

Effective and independent judiciary

An effective and independent judiciary is essential to ensuring the certainty and predictability of legal rights. This is particularly true where one party to a dispute is the government or derives power from it. For the laws to function fully, the courts must be able and prepared to rule against the government and to review improper government action and, if necessary, rule against the government. For example, if an investor is refused an export licence by a government official exercising a statutory discretion on unreasonable grounds, the investor must be able to rely on the courts to check such abuse. Here judges play a crucial role. They must be independent of the government and not easily removable if they are to discharge their functions impartially. In the countries of eastern Europe, respondents to the survey reported the public's belief that courts would enforce the legal rights of private parties against state parties, while the opposite belief generally prevailed in most of the CIS countries.

Judges must be not only relatively free from political influence but also financially independent. In eastern Europe, judicial support for investment law is hindered by the relatively low salaries of judges, which tend in some cases to be only two or three times those of unskilled factory workers. In some CIS countries, where relative salaries are also low, judges sometimes receive less than the prescribed levels of pay.

Enforcement of foreign adjudicative decisions

An effective judiciary must also be willing to recognise and enforce foreign judgements and foreign arbitral awards rendered in investment disputes without re-examining the merits (in those circumstances where the law permits such recognition and enforcement). Most of the countries of the region do not recognise foreign judgements, but many are required by their treaty obligations to enforce foreign arbitral awards covered by the 1958 New York Convention.

In eastern Europe, foreign arbitral awards are generally recognised and enforced without a re-examination of the merits. In other countries of the region, even if such awards are recognised, there is often a lack of an effective mechanism to enforce the award.

6.5 Concluding remarks

Law makes a major contribution to the fostering of investment. It provides the rules as well as the conditions and mechanisms capable of ensuring that investment laws achieve their purpose of improving the environment in which investment decisions are made and in which investments succeed or fail. This chapter has provided an overview of the laws on investment operating in the countries of the region and has sought to gauge their effectiveness by providing a view of how clear and accessible investment law is and how adequately it is supported administratively and judicially.

Several themes emerge from the survey.

With few exceptions the countries of eastern Europe have made greater progress than those of the CIS both in adopting legal rules fostering investment and in applying and enforcing them. The Czech Republic, Hungary and Poland are the most advanced, with most of the rest of eastern Europe and Estonia also having made considerable progress.

Despite a great deal of legislative activity, few countries of the region have investment rules that closely approximate international standards. Those countries whose laws come nearest are Bulgaria, the Czech Republic, Hungary, Poland, Russia and the Slovak Republic. The Czech Republic, for example, does not generally distinguish between foreign and local investors, thus meeting the international standard of "national treatment" (although this approach may not preclude discriminatory exceptions applying to foreign investors). Legal rules furthest from international standards on investment are found in Albania, Azerbaijan, Tajikistan and Turkmenistan. There may be many explanations for this regional pattern. History may play a part: the most extensive laws are often found in countries with a long, but until recently dormant, market-oriented legal tradition. More extensive laws are also found in countries with avowed EU membership aspirations. Countries having particularly large, or readily accessible, markets tend also to have better legal rules than small, relatively isolated economies.

Most countries have made more progress in enacting law than ensuring its effectiveness. Only three countries, Croatia, Estonia and Slovenia, appear to have made greater progress with enforcement than legislation.

In many countries, laws that closely approximate international standards on investment are severely compromised by being unclear, inaccessible or poorly supported administratively or judicially. Few countries dedicate the necessary economic resources to ensuring that investment laws are adequately supported administratively. This is reflected, for example, in the lack of the financial and logistical support necessary to implement legal requirements regarding registration of proprietary interests, pledges of assets and company registration. The level of judicial support, although generally better than the administrative support accorded to investment law, is frequently weak. Courts in most countries appear to lack the resources, training and experience, to handle complex investment disputes adequately. The type of institutional change required, as for many other aspects of transition, takes time to achieve.

For law fully to contribute to an environment conducive to investment, both foreign and domestic, adequate processes and institutions must be in place to ensure its clarity, accessibility and enforcement. Only then can laws affecting investment achieve their purpose.

Annex 6.1
Laws of the region: conduciveness to fostering investment

	How extensive are the legal rules fostering investment?	How clear and accessible is the law affecting investment?
Albania	Laws exist regulating both domestic and foreign investment. Laws regulating the use of indirect investment vehicles, such as securities or investment funds, are limited. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits, whether in the form of dividends or otherwise, may be expatriated freely, and no licence is necessary to export fully convertible currencies. Albanian entities are required to have a licence to hold foreign bank accounts. No governmental approval is required in respect of most investment proposals. Where private property is expropriated, compensation is not required to be granted on a basis that at least approximates market value.	Laws are drafted by legally trained personnel. Laws drafted by foreign consultants are considered usually to be well adapted to the needs of the country. Legal rules regulating investment are prescribed mainly by the legislature. The full texts of laws are published, but with delays of up to six months. Important court decisions and draft laws are not usually published or accessible by practitioners. Comprehensive legal assistance is available on investment matters but mainly from foreign lawyers practising locally. Where available, the cost of legal assistance is generally affordable to local investors.
Armenia	Laws regulating both domestic and foreign investment exist. Land ownership by foreigners is not permitted. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. Companies are required to create and maintain share registers. Most foreign investment proposals are not subject to governmental approval, except for security and health reasons, and apply to both national and foreign investment proposals alike. No licence is necessary to export fully convertible currencies. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. Laws drafted by foreign consultants are considered usually to be well adapted to the needs of the country. Laws affecting investment are prescribed mainly by the legislature. The full texts of laws are regularly published and draft laws are usually accessible to practitioners. Reportedly, many laws are also available on a computer database. Comprehensive and independent legal assistance on investment matters is available to private sector clients, but from a very limited number of lawyers. Where available, the cost of legal assistance is generally affordable to local investors.
Azerbaijan	Laws regulating both domestic and foreign investment are limited. Ownership of land by foreigners is not permitted. Laws regulating the use of indirect investment vehicles, such as securities or investment funds, are limited. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. Most foreign investment proposals do not require governmental approval. Where private property is expropriated, compensation is required to be paid, although not at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. Laws drafted by foreign consultants are considered to be usually well adapted to the needs of the country. Laws affecting investment are prescribed both by the legislature and the executive. The full texts of laws are published, although sometimes six months after being passed. Important court decisions and draft laws are not usually published or accessible by practitioners. Little legal assistance is available to private sector clients on investment matters. Where available, the cost of comprehensive legal assistance is often prohibitive for local investors.
Belarus	The ownership of land by foreigners or foreign-owned local companies is not permitted. Laws regulating the use of indirect investment vehicles, such as securities or investment funds, exist, but the activities of all funds were suspended by presidential decree in March 1995. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. No rules exist prohibiting insider trading in securities of publicly listed companies. A licence is necessary to export fully convertible currencies. Most foreign investment proposals require governmental approval. Where private property is expropriated, compensation is not required to be paid at the time of the expropriation being carried out.	Investment laws are usually drafted by legally trained personnel. Where investment laws are prepared by foreign consultants, they are not considered to be always well adapted to local needs. Laws affecting investment, particularly indirect investment, are often issued by executive decree. The full texts of laws are published, but sometimes six months after being passed. Important court decisions and draft laws are not usually published or accessible by practitioners. Comprehensive legal assistance, at least in Minsk, is available to private sector clients on investment matters. Where available, the cost of legal assistance is generally affordable to local investors.
Bulgaria	No governmental approval is required for most investment proposals in the country. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. Although the ownership of land by foreigners is not permitted, foreign-owned local companies may own land, except land intended for agricultural use. Laws regulating the use of indirect investment vehicles, such as securities or investment funds, have recently been enacted. Rules concerning the pledging of assets are principally aimed at protecting debtors over creditors, although Bulgarian banks benefit from a more favourable regime in this respect. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to the needs of the country. The full texts of laws affecting investment are published, usually within one month of being passed. Draft laws are accessible by practitioners. Important court decisions are usually published or accessible by practitioners, but are not usually published within 12 months of being issued. Sophisticated legal assistance on investment matters is available, at least in Sofia, but is not always affordable to local investors.

How well supported administratively is investment law?	How well supported judicially is investment law?	
While the law provides for the registration of security interests, registers do not always exist. Where they exist, records are usually at least six months out of date. Limited-liability companies or joint-stock companies may be created in less than one month. No organised stock exchange exists. The size and quality of the civil service in Tirana is considered insufficient for the role attributed to it by the law. Criminal laws, in particular those relating to the protection of property and corrupt practices, are viewed as not extensively policed.	While private parties generally believe that courts would recognise and enforce their legal rights against other private parties, they do not believe that courts would enforce such rights against state parties. Remuneration of a judge of a court of first instance is twice that of an unskilled factory worker. A commercial case may usually be heard on its merits in less than six months in Tirana. While foreign arbitral awards are required to be recognised, there is a lack of a clear enforcement mechanism.	**Albania**
While recently enacted law provides for the registration of security and ownership interests in specified tangible property, registers do not always exist. Limited-liability companies and joint-stock companies may be created in about three weeks. Two organised stock exchanges exist. Governmental approval of foreign investment proposals may take up to three months. The size and quality of the civil service in Yerevan is considered insufficient for the role attributed to it by the law. Criminal laws, in particular those relating to the protection of property and corrupt practices, are viewed as not extensively policed.	Private parties generally believe that courts would not recognise and enforce their legal rights against state parties. Courts are considered to have neither the experience nor the human resources to handle complex investment disputes. Parties usually wait between six months to one year for a commercial case to be heard on its merits in Yerevan. Foreign arbitral awards are not required to be recognised and enforced by the courts without a re-examination of the merits.	**Armenia**
While the law provides for the registration of security and ownership interests, certain prescribed registers do not exist and others are not current within 12 months. No organised stock exchange exists. The size and quality of the police force in Baku is considered insufficient for the role attributed to it by the law. Cases involving corrupt practices, including bribery of public officials, are not considered to be routinely investigated and prosecuted.	Private parties generally believe that courts would not recognise and enforce their legal rights against state parties. Courts are considered to have neither the skills nor the human resources to handle investment disputes. Foreign arbitral awards are not required to be recognised and enforced by the courts, at least not without a re-examination of their merits. No locally incorporated company has been declared bankrupt in the past year.	**Azerbaijan**
While the law provides for the setting up of a system to register pledges of assets granted by way of security and ownership interests, registers do not exist or are outdated. Limited-liability companies and joint-stock companies may be created in less than two months. The issuance of a licence to export fully convertible currencies may take up to three months. An organised stock exchange exists. The size and quality of the state civil service in Minsk is considered insufficient for the role attributed to it by the law. The public reputedly considers that the exercise of administrative and judicial discretion is sometimes arbitrary. Criminal laws, in particular those relating to the protection of property and corrupt practices, are viewed as not extensively policed.	Private parties reputedly believe that courts would not always recognise and enforce their legal rights against state parties and are sometimes reluctant to protect their interests judicially. Courts are reported as sometimes falling under the sway of the executive. The average annual salary of a judge of a court of first instance is twice that of an unskilled factory worker and legally prescribed standards relating to the remuneration of judges are not always met. Parties usually wait for less than six months for a commercial case to be heard on its merits in Minsk. Courts are considered to have neither the skills nor the human resources to handle investment disputes. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits. No locally incorporated companies are reported to have been declared bankrupt in the past year.	**Belarus**
While legally prescribed registers for interests in respect of land or security exist, there is no requirement to maintain registers to record security interests in movable assets. Records contained in land registers are usually current within 1-3 months but are not centralised. Limited-liability companies and joint-stock companies may be created in less than two months. An organised stock exchange exists: legislation regulating it was passed in July 1995. The size of the state civil service in Sofia is considered sufficient for the role attributed to it by the law. Criminal laws, in particular those relating to the protection of property and corrupt practices, are viewed as not extensively policed.	The salary of a judge of a court of first instance is twice that of an entry-level primary school teacher and one-tenth the average earnings of private practitioners. Private parties reputedly believe that courts would recognise and enforce their legal rights, including against state parties, although rules restricting or delaying foreclosure procedures limit judicial action aimed at protecting interests of creditors. An appellate court system has been introduced recently. The financial and administrative support of the courts is regarded as inadequate. Parties usually wait for up to two years for a commercial case to be heard on its merits in Sofia. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.	**Bulgaria**

	How extensive are the legal rules fostering investment?	How clear and accessible is the law affecting investment?
Croatia	Laws exist regulating the ownership of land by foreigners or foreign-owned local companies. Draft laws on securities and on investment funds are under preparation. Senior management of investment vehicles can consist wholly of foreign nationals, except with public unlimited companies. Profits may be expatriated freely and are not generally subject to any withholding tax. The transfer abroad of fully convertible currencies is subject to governmental approval. Most foreign investment proposals do not require governmental approval. Where private property is expropriated, compensation is required to be paid, although not at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to the needs of the country. The full texts of laws affecting investment are published, usually within one month of being passed, although draft laws may not always be accessible. Important court decisions are usually published or accessible by practitioners within 12 months of being issued. Sophisticated legal assistance is available, at least in Zagreb, and is generally affordable to local investors.
Czech Republic	Laws exist regulating the use of both direct and indirect investment vehicles, such as securities or investment funds. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be repatriated freely. Land ownership by foreigners is permitted through locally created companies. There exist rules prohibiting insider trading in securities of publicly listed companies. Usually, no licence is required for the export of fully convertible currencies. Most foreign investment proposals do not require governmental approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. The full texts of laws affecting investment are published within one month of being passed. Draft laws are not always published. Important court decisions are usually published or accessible by practitioners within 12 months of being issued. Sophisticated legal assistance is available, at least in Prague, and is generally affordable to local investors.
Estonia	Laws regulating the use of indirect investment vehicles exist, regulating investment funds activities and the issuance of securities. Limited-liability companies and joint-stock companies may be wholly owned and managed by foreigners. Profits may be repatriated freely. Land ownership is permitted, including by foreigners or foreign-owned local companies. Usually no licences are required to export fully convertible currencies. Most foreign investment proposals do not require governmental approval. Investment in banks requires central bank approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation.	Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to local needs. The full texts of laws affecting investment are published within one month of being passed. Draft laws are not always published. Important court decisions are usually published or accessible by practitioners within 12 months of being issued. Comprehensive legal assistance is available, at least in Tallinn, and is generally affordable to local investors.
FYR Macedonia	Laws exist regulating both domestic and foreign investment, including the creation of limited-liability companies or joint-stock companies. Laws exist regulating the use of indirect investment vehicles and the issuance of securities. Foreigners may establish and own wholly limited-liability companies and joint-stock companies. Profits may be expatriated freely. There is no operational stock exchange. Private ownership of land by nationals is permitted. Foreigners can own houses and business premises but not urban land. Where land may be leased from the state, leasehold rights may not be assigned to third parties. Rules regulating the pledging of assets are principally aimed at protecting debtors over creditors. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. The full texts of laws affecting investment are published within one month of being passed. Draft laws are not usually published. While constitutional and supreme court decisions are regularly published or accessible to practitioners within one month of being issued (depending on the frequency of the publication of the Official Gazette), decisions from lower courts are not usually published. Comprehensive legal assistance is available, although from a limited number of lawyers, but is generally affordable to local investors.
Georgia	Laws exist regulating both domestic and foreign investment, including the creation of limited-liability companies or joint-stock companies. Limited-liability companies and joint-stock companies may be wholly owned by foreigners only. Profits may be expatriated freely. Foreigners or foreign-owned local companies may not own land. Shareholders of a company may be required, for reasons other than fraud, to contribute more than their fully paid-in capital at the time of the bankruptcy of a company. Most foreign investment proposals do not require governmental approval, although the transfer abroad of fully convertible currencies is subject to central bank approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. Laws affecting investment are often issued by executive decree. The full texts of laws are published, although with several months' delay. Important court decisions are not regularly published or accessible by practitioners. Comprehensive legal assistance on proposed investments is rare, but, where available, is generally affordable to local investors.

How well supported administratively is investment law?	How well supported judicially is investment law?	
Legally prescribed registers for the registration of interests are mainly limited to immovable assets. Records contained in land registers are usually current within six months. Limited-liability companies and joint-stock companies may be created in less than one month. Governmental approval for the transfer abroad of full convertible currencies is generally issued in less than one month from the date of application. Investors generally feel that the issuance of governmental approvals is sometimes arbitrary. An organised stock exchange exists. The size of the police force in Zagreb is considered sufficient for the role attributed to it by the law, although criminal laws, particularly those relating to the protection of property and the prohibition of corrupt practices, are viewed as not extensively policed.	Private parties generally believe that courts would recognise and enforce their legal rights, including against state parties. The average annual salary of a judge of a court of first instance is approximately three to four times that of an unskilled factory worker. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Parties usually wait for up to two years for a commercial case to be heard on its merits in Zagreb. Reportedly, the ability of the courts of first instance to handle investment disputes has, over recent years, been undermined by a drain of human resources towards private practice. Locally incorporated companies have been declared bankrupt in the past year.	**Croatia**
Legally prescribed registers for interests in respect of land or security exist, but are mainly limited to real estate and company shares. Records contained in land or share registers are usually current within three months. The registration of limited-liability companies and joint-stock companies may take up to three months. Career civil servants are stated to be appointed or promoted principally on the basis of merit rather than declared political allegiance. An organised stock exchange exists. The size and quality of the state civil service in Prague is considered insufficient for the role attributed to it by the law. Cases involving corrupt practices, including bribery of public officials, are considered to be routinely investigated and prosecuted.	Private parties generally believe that courts will recognise and enforce their legal rights, including against the state. Courts are viewed usually to have the skills to handle investment dispute matters but still lack human and administrative resources to ensure a smooth administration of justice, particularly in respect of company registration requirements. Parties must wait for up to three years for commercial cases to be finally determined by a court of first instance, in major commercial centres such as Prague. The remuneration of a judge of a court of first instance is three times that of an entry-level primary school teacher, although it is the stated intention of the government to increase the remuneration of the judiciary. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Several locally incorporated companies have been declared bankrupt in the past year. Bankruptcy proceedings are often lengthy.	**Czech Republic**
Legally prescribed registers of interests in respect of land and security exist. Records contained in land or share registers are usually current within one month. Limited-liability companies and joint-stock companies may be created in less than two months. No organised stock exchange exists. Career civil servants are stated to be appointed or promoted principally on the basis of merit rather than declared political allegiance. The size and quality of the police force in Tallinn is considered insufficient for the role attributed to it by the law. Cases involving corrupt practices, including bribery of public officials, are viewed as routinely investigated and prosecuted.	Private parties generally believe that courts will recognise and enforce their legal rights, including against the state. Courts are viewed usually to lack the human and administrative resources to handle complex commercial disputes. The remuneration of a judge of a court of first instance is three to four times that of an entry-level primary school teacher. Parties must usually wait six months to one year for an investment dispute to be heard on its merits. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.	**Estonia**
Registers of proprietary or security interests exist, but are mainly limited to land and other immovable assets. Records are reported to be unreliable and outdated. Limited-liability companies and joint-stock companies may be created in less than one month. A backlog in registration of companies is expected to be experienced when a new law on companies comes into force in autumn 1995, requiring existing companies to re-register. The size and quality of the state civil service, including the police force, is considered sufficient for the role attributed to it by the law. Cases involving corrupt practices, including bribery of public officials, are not considered to be routinely investigated and prosecuted.	Private parties generally believe that courts would recognise and enforce their legal rights against another private party where the litigation is considered to be minor. However, private parties do not believe that courts would recognise and enforce their legal rights against state parties. Courts are viewed usually to lack the skills or the resources necessary to handle complex investment disputes. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.	**FYR Macedonia**
No system exists for the registration of pledges of assets granted by way of security or for the registration of interests in respect of land. Registers, where in existence, are usually at least several months out of date. Limited-liability companies and joint-stock companies may be created in less than one month. Central bank approval for the transfer abroad of fully convertible currencies may take up to one month to be obtained. No organised stock exchange exists. The size and quality of the state civil service, including the police force, is considered insufficient for the role attributed to it by the law. Cases involving corrupt practices, including bribery of public officials, are considered not to be routinely investigated and prosecuted.	Private parties generally believe that courts would not recognise and enforce their legal rights, whether against a state party or another private party. Courts are viewed usually to lack the skills or the resources necessary to handle complex investment disputes. While foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits, such enforcement remains generally untried in practice. No locally incorporated company has been declared bankrupt in the past year.	**Georgia**

	How extensive are the legal rules fostering investment?	How clear and accessible is the law affecting investment?
Hungary	Laws exist regulating both domestic and foreign investment, as well as the use of indirect investment vehicles such as investment funds and securities. Foreigners may establish and wholly own limited-liability companies and joint-stock companies. Profits may be expatriated freely. There exist rules prohibiting insider share dealing of publicly listed companies. Land ownership is permitted, although foreigners may own land only through local companies. Agricultural land may be owned only by Hungarian private nationals. Most foreign investment proposals are not subject to governmental approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Investment laws are drafted by legally trained personnel. The full texts of laws affecting investment are usually published within two weeks of being passed. Draft laws affecting investment are not usually published. Reports of important court decisions are usually published or accessible within 12 months of being issued. Legal rules regulating investment are prescribed mainly by the legislature. Sophisticated legal assistance is available on investment matters, at least in Budapest, and is generally affordable to local investors.
Kazakstan	Laws regulating both domestic and foreign investment exist. Laws regulating the use of indirect investment vehicles, such as securities or investment funds, exist. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. Private ownership of land is prohibited, whether by foreigners or nationals. Most foreign investment proposals do not require governmental approval, except for large-scale investments, such as natural resources projects. Where private property is expropriated, compensation is required to be paid, although not at the time of the expropriation being carried out.	Investment laws are drafted by legally trained personnel. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to local needs. Legal rules regulating investment have been prescribed mainly by the executive since the suspension of the legislature. The full texts of laws and decrees affecting investment are usually published within one month of being signed, although some decrees are not published. Draft laws may be accessible by practitioners. Important court decisions are not always published or accessible by practitioners. Sophisticated legal assistance on proposed investments is available but is not generally affordable to local investors.
Kyrgyzstan	Laws regulating both domestic and foreign investment exist. Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. The management of limited-liability companies or joint-stock companies may not wholly consist of foreign nationals. Profits may be expatriated freely. Private ownership of land is prohibited, whether by foreigners or nationals, although the right to use land for a period of up to 49 years exists. Most foreign investment proposals must be registered with the relevant authorities and may require governmental approval. Where private property is expropriated, compensation is required to be paid, although not at the time of the expropriation being carried out.	Investment laws are drafted by legally trained personnel. Where investment laws are prepared by foreign consultants, they are considered to be generally adapted to the local needs. Legal rules regulating investment are prescribed both by the legislature and the executive. The full texts of laws passed by the legislature are published, although may not be readily accessible. Presidential decrees affecting investment are not always published. Draft laws are usually accessible to practitioners. While some supreme court decisions are published in newspapers or accessible to practitioners, decisions of lower courts are not regularly published. Legal assistance in respect of investment matters is available and is generally affordable to local investors, although local law firms may not yet have the skills necessary to handle complex investment matters.
Latvia	Indirect investment, such as securities or investment funds, is not specifically regulated. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. While foreigners or foreign-owned local companies are prohibited from owning land, they are permitted to lease it. Most foreign investment proposals do not require governmental approval. The transfer abroad of fully convertible currencies does not require government approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to local needs. The full texts of laws affecting investment is generally published within one month of being passed. Draft laws affecting investment and most important court decisions are generally accessible to practitioners. Independent and comprehensive legal assistance is available, at least in Riga, and is generally affordable to local investors.
Lithuania	The use of indirect investment vehicles, such as the issuing of securities and investment funds, is not specifically regulated. Rules exist prohibiting insider share dealing of publicly listed companies. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. Although foreigners or foreign-owned local companies are prohibited from owning land, they are permitted to lease it for up to 99 years. The export of fully convertible currency is not subject to government approval. Most foreign investment proposals have to be approved by the government. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are not always drafted by legally trained personnel, and they are often unclear, or impose conflicting requirements. Where investment laws are prepared by foreign consultants, they are considered not to be generally well adapted to the local needs. Legal rules regulating investment are prescribed mainly by the executive. The full texts of laws affecting investment are generally published within two weeks of being passed. Draft laws affecting investment and most important court decisions are generally accessible to practitioners. Important court decisions are not always published or accessible to practitioners. Independent and comprehensive legal assistance is available, at least in Vilnius, and is generally affordable to local investors.

How well supported administratively is investment law?	How well supported judicially is investment law?	
Where a statute provides for the registration of proprietary or security interests, registers do exist, but are often not current within 12 months. The registration process for limited-liability companies or joint-stock companies may take up to three months. An organised stock exchange exists. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.	Private parties generally believe that courts would recognise and enforce their legal rights against another private party or a state party. The average annual salary of a judge of a court of first instance is three to four times that of an entry-level primary school teacher. Courts are viewed as usually possessing the skills necessary to handle investment disputes, but lack the human and administrative support to ensure an efficient administration of justice. Parties usually wait for up to two years for a commercial case to be finally determined by a court of first instance. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year. The Court of Arbitration attached to the Hungarian Chamber of Commerce is held to possess both the human and financial means to handle complex investment disputes to near-international standards.	**Hungary**
Registers for ownership interests exist, but are mainly limited to immovable assets. Where registers exist, records accessible by the public are at least six months out of date. Limited-liability partnerships and joint-stock companies may usually be created within two months. A stock exchange was recently established. Civil servants are stated as being appointed or promoted principally on the basis of their declared political allegiance. The size and quality of the state civil service, in particular that of the police force, is considered insufficient for the role attributed to it by the law. Criminal laws, particularly those relating to corrupt practices, are viewed as not extensively policed.	The average annual salary of a judge of a court of first instance is twice that of an unskilled factory worker. Judges of the higher courts must be law graduates, but not those of the lower courts. Private parties generally believe that courts would not recognise and enforce their legal rights against state parties. Parties must usually wait six months to one year for an investment dispute to be heard on its merits. Neither foreign judgements nor foreign arbitral awards are required to be recognised and enforced by local courts without a re-examination of their merits. Locally incorporated companies are reported to have been declared bankrupt in the past year.	**Kazakstan**
Legally prescribed registers for security interests often do not exist and when they do they are usually six months out of date. Limited-liability companies and joint-stock companies may be created within about six weeks. A stock exchange was created in late 1994. Civil servants are believed by survey respondents to be appointed or promoted principally on the basis of their declared political allegiance. The size and quality of the state civil service, in particular the police force, is considered insufficient for the role attributed to it by the law. Corrupt practices, including bribery of public officials, are viewed to be quite extensively policed.	Judges may be removed by the President. The average annual salary of a judge of a court of first instance is twice that of an unskilled factory worker. Private parties generally believe that courts would not recognise and enforce their legal rights against state parties. The public perception of the independence of the courts remains to be further demonstrated. Courts are viewed usually to lack the skills or the resources necessary to handle complex investment disputes and are not regarded to be familiar with certain commercial law concepts embodied in local legislation. Few bankruptcies of locally incorporated companies have been reported. Parties must usually wait up to one year for an investment dispute to be heard on its merits. Foreign arbitral awards are not required to be recognised and enforced without a re-examination of their merits.	**Kyrgyzstan**
Where registries in respect of land or security exist, they are usually current within three months. Limited-liability companies and joint-stock companies may be created in less than one month. An organised stock exchange exists. Civil servants are stated to be appointed or promoted principally on the basis of merit, rather than political allegiance. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.	Private parties generally believe that courts would recognise and enforce their rights against other parties, including state parties. The annual salary of a judge of a court of first instance is twice that of an entry-level primary school teacher. Courts are viewed to be generally supportive of laws regulating domestic and foreign investment but often lack the financial and human resources, as well as the training, to adequately handle complex investment disputes. Insufficient budgetary or human resources are considered to be provided by the government in supporting the administration of justice. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.	**Latvia**
No system exists for registering ownership interests or pledges of assets granted by way of security. Limited-liability companies and joint-stock companies may be created within one month. An organised stock exchange exists. Civil servants are stated as being appointed or promoted principally on the basis of their declared political allegiance. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, have been only recently adopted.	Private parties generally believe that courts would recognise and enforce their rights against other parties, but not against state parties. The annual salary of a judge of a court of first instance is five to six times that of an entry-level primary school teacher. Courts are viewed to be usually supportive of laws regulating domestic and foreign investment but often lack the financial and human resources to handle adequately complex investment disputes. A commercial case may generally be heard on its merits in less than six months in Vilnius. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.	**Lithuania**

	How extensive are the legal rules fostering investment?	How clear and accessible is the law affecting investment?
Moldova	Laws regulating both domestic and foreign investment exist. Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. Companies may be wholly owned by foreigners. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated freely. The ownership of land by foreigners is prohibited. Most foreign investment proposals have to be approved by the government where the proposed investment exceeds US$ 250,000. Where private property is expropriated, compensation is not required to be paid at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. Where investment laws are prepared by foreign consultants, they are considered to be generally well adapted to local needs. Legal rules regulating investment are prescribed mainly by the executive. While the full texts of legal rules affecting investment are published within one month of being passed, they are not always widely disseminated. Important court decisions are not always published or accessible by practitioners. Independent and comprehensive legal assistance on proposed investments is rare and, where available, is not generally affordable to local investors.
Poland	Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. Limited responsibility partnerships or joint-stock companies may be wholly owned and managed by foreigners. Most forms of profits, such as dividends, may be expatriated subject to certain conditions (see Annex 2.2). Land ownership is allowed, including by foreigners and foreign-owned local companies, with an appropriate permit. No licence is usually required for the export of fully convertible currencies, except in specific circumstances. Most foreign investment proposals do not require governmental approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature. The full texts of laws affecting investment are published within one month of being passed. Draft laws are not always published. Important court decisions are usually published or accessible to practitioners within 12 months of being issued. Sophisticated legal assistance is available, at least in Warsaw, and is generally affordable to local investors.
Romania	Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. Foreigners may own land through local companies having at least one Romanian shareholder. Senior management of limited-liability companies may consist wholly of foreign nationals. The senior management of joint-stock companies must include Romanian nationals. Profits may be expatriated freely. Most foreign investment proposals require governmental approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the legislature, although the executive is constitutionally permitted to legislate when the parliament is in recess. The full texts of laws affecting investment are published usually within one month of being passed. Draft laws are rarely published. Important court decisions are usually published or accessible by practitioners within 12 months of being issued. Independent and comprehensive legal assistance is available from a limited number of lawyers in Bucharest and is not generally affordable to local investors.
Russian Federation	Laws exist regulating both domestic and foreign investment, although parts of the civil code have yet to be adopted and certain aspects of company law remain unclear. Rules exist regulating indirect investment, but are mainly limited to investment funds and privatisation matters. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Foreigners or foreign-owned local companies may not own land. The leasing of land is generally permitted, although the situation is confused. While most foreign investment proposals do not need to be approved by the Government, transfers to or from Russia of foreign currency (in relation to capital transactions, as opposed to current) are subject to central bank control. In most cases, Russian companies are required to sell to the state 50 per cent of their net foreign currency earnings at a market rate. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are generally drafted by legally trained personnel. Many of the laws affecting investment are issued by means of executive decrees and often are considered to be unclear or to impose requirements conflicting with federal laws. Secondary legislation is rarely adopted. The full texts of laws are usually published within one month of being passed. Important court decisions are not usually published or easily accessible by practitioners. While sophisticated legal assistance is usually accessible on investment matters, at least in Moscow, it is not usually affordable to local investors.
Slovak Republic	Indirect investment, such as the issuing of bonds or the activities of private investment funds, is permitted and regulated. Limited-liability partnerships or joint-stock companies may be wholly owned and managed by foreigners. Foreign-owned local companies may own land. Most foreign investment proposals do not require government approval. Profits, whether in the form of dividends or otherwise, can be expatriated freely, although the transfer abroad of fully convertible currencies is subject to central bank approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. The full texts of laws affecting investment are usually available and published within six months of being passed. While important court decisions are normally published or accessible by practitioners within 12 months of being issued, draft laws affecting investment are not usually published. Independent and comprehensive legal assistance is available (although from a small number of firms), at least in Bratislava. The cost of sophisticated legal assistance on investment matters is usually affordable to local investors.

How well supported administratively is investment law?	How well supported judicially is investment law?	
No generalised system exists for registering ownership interests and pledges of assets granted by way of security. Limited-liability companies and joint-stock companies may be created within two months. An organised stock exchange exists. Civil servants are stated to be appointed or promoted principally on the basis of their declared political allegiance. The size and quality of the state civil service in Chisinau is considered insufficient for the role attributed to it by the law. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.	Private parties generally believe that courts would not recognise and enforce their rights against state parties. The annual salary of a judge of a court of first instance is twice that of an unskilled factory worker. Courts are viewed as often lacking the financial and human resources, as well as the training, to handle adequately complex investment disputes. A commercial case may generally be heard on its merits in less than six months in Chisinau. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.	**Moldova**
Legally prescribed registers of interests in respect of land or security exist. No system exists for registration of security interests in respect of movable assets. Records contained in land or share registers are usually current within three months. Limited-liability companies and joint-stock companies may be created; registration may take two to three months. An organised stock exchange exists. Civil servants are stated to be appointed or promoted principally on the basis of merit rather than declared political allegiance. The size and quality of the state civil service in Warsaw is considered insufficient for the role attributed to it by the law. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.	Private parties generally believe that courts will recognise and enforce their legal rights, including against state parties. Courts are viewed to have the skills to handle investment dispute matters but still to lack human and administrative resources to ensure a smooth administration of justice. Parties must wait for about one year for their commercial case to be heard on its merits by a court of first instance in Warsaw. While the remuneration of a judge of first instance is three times that of an entry-level primary school teacher, it is the reported intention of the state to dedicate further resources to increase the remuneration of the judiciary. The Court of Arbitration attached to the Polish Chamber of Commerce is stated to possess both the human and financial means to handle complex investment disputes approximating to international standards. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.	**Poland**
Legally prescribed registers for the registration of interests in respect of land or security exist. Limited-liability companies and joint-stock companies may be created and registration may take up to two months. A stock exchange is being organised and is scheduled to start operating towards the end of 1995. The size and quality of the state civil service in Bucharest is considered insufficient for the role attributed to it by the law. While the size of the police force is large, criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.	Private parties generally believe that courts would not recognise and enforce their rights against state parties. The annual salary of a judge of a court of first instance is two to three times that of an unskilled factory worker. Courts are seen as often lacking the financial and human resources, as well as the training, to handle complex investment disputes adequately. Parties must wait for up to six months for a commercial case to be heard on its merits by a court of first instance in Bucharest. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits. Few, if any, locally incorporated companies have been declared bankrupt in the past year.	**Romania**
The legally prescribed system for registering pledges of assets granted by way of security is incomplete. Where a statute provides for the registration of interests in respect of proprietary or security interests, registers do not always exist. Where such registers are in existence, records in respect of land or shares are usually six months out of date, at least in Moscow. It may take more than three months for a limited-liability or joint-stock company to be created. An organised stock exchange exists. The quality of the civil service is considered, in certain ministries or agencies, as sufficient for the role attributed to it by the law, but the scope of administrative discretion that may be exercised by governmental agencies is regarded as unclear. Enforcement of criminal laws relating to the protection of property or corrupt practices is viewed as uneven.	Judges may not be removed by the executive once elected. While private parties generally believe that courts would recognise and enforce their legal rights against other private parties in certain cases, they do not have such faith in the court's ability to enforce their rights against state parties. The annual salary of a judge of a court of first instance is three to four times that of an unskilled factory worker. The judiciary is considered as being generally supportive of laws regulating investment, but as often lacking the understanding of certain commercial concepts embodied in those laws needed to handle complex investment disputes. A commercial case may generally be heard on its merits in less than six months, at least in Moscow. Locally incorporated companies have been declared bankrupt in the past year. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits.	**Russian Federation**
Legally prescribed registers for interests in respect of land or security exist, but are mainly limited to real estate and company shares. Records contained in land registers are usually current within one month, while share registers are current within three months. Limited-liability companies and joint-stock companies can usually be created in less than three months. Central bank approvals for the transfer abroad of fully convertible currencies may take up to three months. An organised stock exchange exists. While the size of the police force is considered large, criminal laws relating to the protection of property and corrupt practices are viewed as not extensively policed. Career civil servants are stated as being appointed or promoted principally on the basis of their declared political allegiance.	Judges may not be removed by the executive once appointed. Private parties generally believe that courts will recognise and enforce their legal rights, including against state parties. Parties may wait up to four years for commercial cases to be finally determined by a court of first instance in major commercial centres such as Bratislava. The remuneration of a judge of a court of first instance is five times that of an unskilled factory worker. Courts reportedly lack the financial and human resources necessary to handle complex investment disputes. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits. Very few locally incorporated companies have been declared bankrupt in the past year.	**Slovak Republic**

	How extensive are the legal rules fostering investment?	How clear and accessible is the law affecting investment?
Slovenia	Indirect investment, such as the issuing of bonds or the activities of private investment funds, is permitted and regulated. The senior management of local companies usually may not consist wholly of foreign nationals. Foreign individuals may not own land. Profits, whether in the form of dividends or otherwise, can be expatriated freely. The transfer abroad of fully convertible currencies is not subject to central bank approval. Most foreign investment proposals do not require governmental approval. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are drafted by legally trained personnel. The full texts of laws affecting investment are usually available and published within one month of being passed. Important court decisions are published or accessible by practitioners. Draft laws affecting investment are accessible to practitioners. Independent and comprehensive legal assistance is available, particularly in Ljubljana. The cost of sophisticated legal assistance on investment matters is generally affordable to local investors.
Tajikistan	Laws regulating both foreign and domestic direct investment exist. Laws exist regulating the use of indirect investment vehicles, such as issuing of securities. Limited responsibility partnerships or joint-stock companies may be wholly owned and managed by foreigners. Foreigners are prohibited from owning land. Profits, whether in the form of dividends or otherwise, can be expatriated freely. The transfer abroad of fully convertible currencies is subject to central bank approval. Most foreign investment proposals require government approval, particularly for the exploitation of natural resources. Where private property is expropriated, compensation is required to be paid at the time of the expropriation.	Laws are drafted by legally trained personnel. Legal rules regulating investment are often issued by way of executive decree. The full texts of laws affecting investment are usually published more than six months after being passed. Draft laws are not usually published and accessible to practitioners. Important court decisions are not regularly published. Legal assistance to private parties in respect of investment matters is very limited and may not always be independent from the government. Where available, legal assistance on investment matters is not generally affordable to local investors.
Turkmenistan	Laws exist regulating both foreign and domestic direct investment. Laws exist regulating the use of indirect investment vehicles, such as securities or investment funds. Foreigners may generally not hold more than 49 per cent of the shares issued by a local company and are prohibited from owning land. Nationals (individuals) may own up to 50 hectares of land. Profits may be expatriated freely. The transfer abroad of fully convertible currencies is subject to central bank approval. Most foreign investment proposals require governmental approval.	Laws are not always drafted by legally trained personnel and are often based on Soviet Union or Russian models. Legal rules regulating investment are often issued by means of executive decree. The full texts of laws affecting investment are not always published and ministerial cabinet decrees are not always available. Important court decisions are not usually published or accessible by practitioners. Legal assistance to private parties in respect of investment matters is very limited and may not be independent from the government. Where available, legal assistance on investment matters is not generally affordable to local investors. Local law firms may not yet have the skills necessary to handle complex investment matters adequately.
Ukraine	Laws regulating both foreign and domestic direct investment exist. Indirect investment, such as the issuing of bonds or the activities of private investment funds, is not specifically regulated. Limited responsibility partnerships or joint-stock companies may be wholly owned and managed by foreigners. Profits, whether in the form of dividends or otherwise, can be expatriated freely. The transfer abroad of fully convertible currencies is usually subject to central bank approval. Foreign investment proposals do not require governmental approval, except where approval is required in joint ventures in which state enterprises participate or in respect of key economic sectors identified in laws on foreign investment. Where private property is expropriated, compensation is required to be paid at the time of the expropriation being carried out.	Laws are not always drafted by legally trained personnel. Legal rules regulating investment may be prescribed primarily by the legislature, although in the absence of specific legislation, the executive may also prescribe rules. The full texts of laws prescribed by the national legislature are usually published, although often up to six months after enactment. Legal rules enacted by regional or local governments are rarely accessible to practitioners. While supreme court decisions are usually published or accessible to practitioners, decisions from lower courts are not always available. Draft laws affecting investment are not always accessible to practitioners. Independent and comprehensive legal assistance is scarce. Where available, legal assistance is generally affordable to local investors but is becoming more expensive.
Uzbekistan	Laws regulating both domestic and foreign investment exist. Laws exist regulating the use of indirect investment vehicles, such as securities. Limited-liability and joint-stock companies may be wholly owned and managed by foreigners. Profits may be expatriated. Foreigners and foreign-owned local companies are prohibited from owning land. The transfer abroad of fully convertible currencies is subject to central bank approval. Most foreign investment proposals require governmental approval. Where private property is expropriated, compensation is required to be paid, although not at the time of the expropriation being carried out.	Investment laws are not always drafted by legally trained personnel. Legal rules regulating investment are prescribed mainly by the executive. Executive decrees are not always made public. The full texts of laws affecting investment are usually published within six months of being passed. Draft laws are usually accessible by practitioners. Important court decisions are not always published or accessible by practitioners. Comprehensive and independent legal assistance on proposed investments is available in Tashkent, although from a limited number of lawyers. The cost of sophisticated legal assistance is not generally affordable to local investors.

How well supported administratively is investment law?	How well supported judicially is investment law?	
Legally prescribed registers for interests in respect of land or security exist. Records are usually current within three months. Registration of limited-liability companies and joint-stock companies may take up to six months. An organised stock exchange exists. Career civil servants are stated to be appointed or promoted principally on the basis of merit rather than declared political allegiance. The size and quality of the police force in Ljubljana is considered sufficient for the role attributed to it by the law.	Judges may only be removed by the parliament once appointed. Private parties generally believe that courts will recognise and enforce their legal rights, including against state parties. It is reported that court officials have at times refused to authorise registration of real property interests of foreign-owned Slovenian companies although legally required to do so. Parties must usually wait for one year for a commercial case to be heard on its merits by a court of first instance in Ljubljana. The remuneration of a judge of a court of first instance is twice that of an entry-level school teacher. Courts are viewed as lacking the financial resources necessary to handle complex investment disputes, although practitioners rate Slovene courts highly. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.	**Slovenia**
A generalised system for registering ownership interests or pledges of assets granted by way of security does not exist. Where registers exist, they are often 12 months out of date. It may take more than three months for limited-liability companies or joint-stock companies to be created. Career civil servants are stated to be appointed or promoted principally on the basis of their declared political allegiance. The size and quality of the state civil service in Dushanbe is considered insufficient for the role attributed to it by the law. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as not extensively policed.	Judges sitting on the highest courts are not always required to be graduates in law. Private parties generally believe that courts would not recognise and enforce their rights against state parties. Courts are viewed as often lacking the financial and human resources, as well as the training, to handle complex investment disputes adequately. A commercial case may generally be heard on its merits in about six months in Dushanbe. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits, although this rule remains largely untried in practice. It is unclear whether locally incorporated companies have been declared bankrupt in the past year.	**Tajikistan**
Although there is a law on pledge, registers of ownership interests and pledges of assets granted by way of security rarely exist. Limited-liability companies and joint-stock companies may take up to two months to be registered. No organised stock exchange exists. The size and quality of the state civil service in Ashgabad is considered insufficient for the role attributed to it by the law, although the police force is considered adequate.	Judges are appointed by the President for a five-year term. Private parties generally believe that courts would not recognise and enforce their rights against state parties. The annual salary of a judge of a court of first instance is comparable to that of an unskilled factory worker. Courts are regarded often to lack the financial and human resources, as well as the training, to handle complex investment disputes adequately. Foreign arbitral awards are not required to be recognised and enforced by the courts without a re-examination of their merits. No law on bankruptcy exists.	**Turkmenistan**
Legally prescribed registers for the registration of interests in respect of land or security do not exist or, where they exist, in some cases are at least six months out of date. Limited-liability companies and joint-stock companies can usually be created within two months. An organised stock exchange exists. While civil servants are required to be appointed or promoted on the basis of merit, this rule is stated to be not always observed in practice. The size and quality of the state civil service in Kiev is regarded as insufficient for the role attributed to it by the law. Criminal laws, particularly those relating to the protection of property and the prohibition of money-laundering and corrupt practices, are viewed as insufficiently developed and insufficiently policed.	Private parties generally believe that courts would not recognise and enforce their rights against state parties. The annual salary of a judge of a court of first instance is five times that of an entry-level primary school teacher. Courts are viewed often to lack the financial and human resources, as well as the training, to handle complex investment disputes adequately. A constitutional court does not exist, but is being formed. A commercial case may generally be heard on its merits in less than one year in Kiev. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits, yet there is a lack of an adequate mechanism for enforcing awards. A limited number of locally incorporated companies have been declared bankrupt in the past year.	**Ukraine**
Legally prescribed registers for interests in respect of land or security do not always exist. Where in existence, registers are usually 12 months out of date. Limited-liability companies and joint-stock companies can usually be created in less than one month. An organised stock exchange exists. The size and quality of the state civil service in Tashkent is regarded as insufficient for the role attributed to it by the law. While criminal laws relating to the protection of property are reported to be adequately policed, laws prohibiting money-laundering and corrupt practices are viewed as insufficiently policed.	Private parties generally believe that courts would not recognise and enforce their rights against state parties. Courts are viewed often to lack the financial and human resources, as well as the training, to handle adequately complex investment disputes. A commercial case may generally be heard on its merits in less than one year in Tashkent. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits. Locally incorporated companies have been declared bankrupt in the past year.	**Uzbekistan**

Transition impact of investment projects

7

Transition from a command to a market economy involves the movement towards a fundamentally new system for the generation and allocation of resources. Investment projects play a crucial role in advancing this process of radical change. They help to replace the economically or technologically obsolete stock of capital inherited from the command systems. They expose human capital to previously unfamiliar forms of institutional and production arrangements that are compatible with market development. Furthermore, investment projects can change market structure and functioning and may thereby promote the restructuring of the economic system. The investment project, therefore, can have a direct impact on the transition process. For the EBRD, which is an institution with the goal of advancing the transition through the means of project finance, the "transition impacts" of projects are central to its activities.

Investment is then a key vehicle for advancing the transition. The weakness of capital markets and lack of familiarity with market processes mean that, for transition economies, investment should be fostered. But it is not simply the overall level of investment that is at issue.

Investment projects that are particularly rich in transition impacts will not necessarily receive special priority from the private sector. Private investors will invest to exploit the opportunities created by the new, market-oriented environment only if they expect sufficient financial returns. They do not incorporate the contribution of the investment project to the advancement of the transition process in their calculation of profitability. The investment projects that promise the highest private returns may not always be those with the most significant transition impact. Additionally, the countries of eastern Europe, the Baltics and the CIS have only recently started to develop capital markets. Privately profitable investment that also has high transition impact may not be undertaken by the private sector due to lack of a sufficient supply of credit. Investment activity may therefore be too low in areas that are particularly relevant to fostering the transition process.

Governments and international investors whose objectives include promoting the transition process play a key role both in encouraging investment and focusing their involvement on projects with high transition impact. The creation of efficient financial markets to help overcome credit constraints for the private sector will be a central measure in promoting investment activity.

A prerequisite for fulfilling this task is to have an understanding of which investment projects influence the transition process most strongly. Standard cost-benefit methods, which are implemented by governments or international financial institutions (IFIs) for project appraisal, do not necessarily provide such an understanding. By relying on the assumption of a stable market structure, for the most part, they capture only imperfectly the dynamic aspects of the transition process and therefore do not take account of potentially important transition impacts of investment projects. Furthermore, the specific situation in a country will affect the transition impact of investment. Hence, to assess likely transition impact requires knowledge of both the institutional and economic conditions inherited from the command era and of progress with transition in the different countries in the region.

The focus in this chapter is to examine the contribution of investment projects in advancing transition along two dimensions: the development of competitive market-based interactions, and the advancement of learning and discovery. The first focuses more on the market and the second on the enterprise. Although there is inevitably some overlap, the two categories serve as a useful way of organising the analysis. We shall see that for both dimensions the development of market-based institutions, including markets themselves, are at the heart of transition impact. The discussion of these categories not only serves to contribute to a clearer understanding of the way in which investment projects can support the creation of a market-oriented environment. It also provides the basis for the set of indicators introduced at the end of the chapter, which are a first step towards assessing the transition impact of investment projects in practice.

7.1 Developing competitive market-based interactions

Essential to the transition is the formation of market-based transactions or interactions within and between the enterprise, financial and infrastructure sectors. While in any economy the growth in one firm or sector interacts with growth in other firms or sectors, in well-functioning market economies this process is mediated fairly smoothly through the market system by price signals. Interactions in command economies were for the most part not market-mediated.

In "strategic" sectors (including defence and heavy industry) firms were often highly vertically integrated, with all stages of production located in a single firm (i.e. conglomerate). In other sectors, enterprises were bound together through the planning system. Supply of credit and infrastructure to industrial enterprises was monopolised by state banks and companies and not governed by profitability. These interactions, or linkages, were in general not based on the competitive advantage of alternative suppliers or on broader supply and demand considerations. As a result, most of the linkages inherited from the command economy are incompatible with market orientation.

Sustainable economic growth in the transition economies will require the development of market linkages that are consistent

with private sector development. Failure to establish efficient, competitive linkages, both between enterprises and the financial and infrastructure sectors, and between different enterprises, will block the transition process.

Financial markets play a key role in creating a competitive private sector, enhancing the overall efficiency of the economy and serving as a coordinating mechanism for the market system.[1] The transition impact of financial sector reforms arises both directly, by restructuring bank-enterprise relationships, and indirectly, by facilitating the growth of the new private sector. Enhanced banking skills and investment finance to upgrade and computerise operating systems improve the capacity of banks to monitor loans effectively. In this way access to credit by enterprises operating in the new private sector can be expanded. Credit can be allocated on a market-determined basis, in particular in relation to enterprise performance, which aids expansion of efficient, competitive firms in the economy. However, while the growth of efficient sets of market interactions in the enterprise sector is contingent on the existence of a competitive banking sector, the competitiveness of the banking sector is equally dependent on not having to support large, non-performing state or privatised enterprises. Programmes of bank and enterprise reform are therefore complementary (see Chapter 10).

Since the commercial banking sector was almost completely absent at the beginning of the transition process, the development of financial institutions is a cornerstone in that process. IFIs can play an important role in this area, as exemplified by the Financial Institutions Development Project in Russia (see Box 7.1).

In addition to strengthening the banking sector, there is a need to promote the development of complementary securities markets and non-bank financial institutions in transition countries (see Chapter 10).

Box 7.1

Financial Institutions Development Project, Russia

One of the most far-reaching transformations in the transition process of the Russian economy has taken place in the financial sector. More than 2,000 commercial banks have been created and have taken over many of the commercial banking functions of the former state banks. As these changes predated the enterprise privatisation process, the performance of the new banking sector as effective financial intermediaries became critical for the successful restructuring of newly privatised enterprises and private sector development.

In this context, the World Bank, in cooperation with the EBRD, initiated the Financial Institutions Development Project to contribute to a more efficient mobilisation of financial resources and allocation of bank credit. This project, administered through a Project Implementation Unit established in the Russian Ministry of Finance, focuses on assisting a carefully selected group of 40 Russian commercial banks in the development and arranging of twinning contracts with international banks. These foreign banks provide technical assistance to strengthen banking operations and modernise the bank's computer systems.

The project aims to achieve several goals. Upgrading banking services, modernising accounting practices and enhancing the financial soundness of the core group of commercial banks will lead to intensified competition and demonstration effects, which create a dynamic for improving the quality of banking activities in Russia as a whole. The tighter lending policies of banks will force enterprises to restructure and to establish efficient linkages with trading partners. Lastly, these banks should operate as effective channels for IFI credit lines. The purpose is therefore to restructure interactions within the financial sector, and between the financial and other sectors, so that they operate on a sound market basis.

The transition impact of such projects can be especially strong if they remove major bottlenecks in the institutional infrastructure needed to make such markets function effectively. Private investors are likely to be reluctant to undertake such investments in

Box 7.2

National Registry Company, Russia

In April 1995 the Bank of New York, two Russian companies, the IFC and the EBRD launched a Russian National Registry Company based in Moscow. The Russian shareholders are Nikoil, an investment broker and registrar company for the oil industry, and Uneximbank, one of Russia's largest commercial banks. The main business of the company is to provide an independent share registration and transfer service in Russia that meets the highest professional standards in all areas of registrar operations and administration, and satisfies the requirements of large Russian enterprises. The Bank of New York, in addition to being a shareholder, was awarded the technical services contract to support the development of the company. The company is planned to become fully operational in October 1995.

The project's potential transition impact derives primarily from the role that securities markets are expected to play in the current stage of the Russian reform process and the obstacles that exist to their development. The voucher privatisation generated predominantly insider ownership of privatised enterprises, typically lacking efficient corporate governance, meaningful restructuring strategies and the necessary investment finance. Given the relatively weak and highly vulnerable banking sector, the development of securities markets can be of critical importance for enterprise restructuring and financing. The single most important obstacle to this development has been the inadequate capital market infrastructure, in particular the lack of reliable share registrars. In Russia the only proof of share ownership is an extract from a register which has been typically managed by the enterprise itself. This situation has created fundamental uncertainties regarding shareholders' rights, increased transaction costs and contributed greatly to the fragmentation of the equity market. This project represents the first decisive step to establish transparent and efficient capital market infrastructure and should significantly promote capital market development and stabilisation. The project has also accelerated reforms to develop the related legislative and regulatory framework by helping the authorities to identify a number of critical gaps in this area.

The likely direct and indirect transition impacts encompass strengthening both the capital market itself and the effectiveness of its participants. Examples of the first include transferring special skills, reducing transaction costs and increasing competition in the securities markets. The second category includes diluting the current degree of insider ownership and providing incentives for enterprises to submit to higher standards of financial disclosure, accounting and auditing.

[1] See Stiglitz (1993).

institutional infrastructure on their own, in part because of the uncertainties surrounding the future level of securities market activity, which itself depends on continued progress in reform. This is thus an area where IFIs can play an important role, as illustrated by the National Registry Company project in Russia (see Box 7.2).

The provision of infrastructure services, primarily water, power, transport and telecommunications, is also a prerequisite for dynamic private sector development. These services are critical inputs for almost any production activity, and removing infrastructure bottlenecks can stimulate enterprise development. For example, firms with inadequate linkages to providers of telephones, roads, electricity and so on may not develop even though they have the potential to do so. The highway project discussed in Box 7.3, for example, is likely to provide significant impetus for the development of the private sector in Belarus.

In transition economies, the inherited infrastructure was configured to meet the needs of the command economy, not market-based transactions. These sectors require restructuring in order to service the growing private sector on an efficient and commercial basis. Major infrastructure investments such as the Hungarian Telecommunications project can also promote more balanced regional development (see Box 7.4). In dynamic and uncertain transition environments, where it is particularly difficult to forecast the direction of economic activity in the long run, flexibility and the reduction of fixed-cost elements in infrastructure investments may represent important considerations. In this context, for example, radio and cellular technologies may have some advantages over traditional landline systems for telecommunications.

Box 7.3
Belarus Highway Improvement project

The Belarus Highway Improvement project aims to repair and rehabilitate the Belarus portion of the M1/E30 highway connecting Moscow, Minsk, Warsaw and western Europe. This is the country's most important highway and a vital element of the European transport network. The project's transition impact arises both from the institutional advance associated with the commercial orientation of the organisation and running of the project, and from the direct benefits and linkages it provides.

A newly created entity (Belavostrada) is responsible for maintaining, operating and improving the highway. It is planned to transform Belavostrada from a state enterprise into a joint-stock company to allow for private sector participation and to reduce government spending. User tolls will be introduced, which will provide the primary source of revenue to finance maintenance of the highway and loan repayment. The project contributes to private sector development by supporting the demonopolisation and privatisation of state-owned road construction trusts. The allocation of road work contracts by open tendering will increase competition and improve efficiency in the road construction market.

The project reduces vehicle operating costs, increases average transportation speeds, and introduces better safety standards. It helps to provide an effective domestic transport system and allows an essential input for small and medium-sized enterprises (SMEs) operating countrywide. Additionally, by reducing international border crossing delays, it creates forward linkages to companies involved in the growing market for international truck transportation of high-value goods.

Box 7.4
Hungarian Telecommunications project

At the beginning of the 1990s, the Hungarian telecommunications system compared unfavourably with countries in similar economic circumstances. The general inadequacy of telecommunications services constituted a serious impediment to private sector development. The telecommunications system was particularly inadequate in rural areas, where it was still manually operated. In 1991, the Hungarian Telecommunications Company (HTC), the main provider of telecommunications services, decided to improve the accessibility and quality of its services as well as the overall efficiency of the telecommunications system. HTC engaged in a project which comprised two elements: modernisation and expansion of facilities in Budapest, and replacement of the manually operated system by a fully automated expanded rural telecommunications network.

This project has provided substantial benefits to the Hungarian economy. It supports the efficiency of the private sector by upgrading the quality of a key input to almost any business activity. It also assists the trade sector by permitting linkages to foreign business partners. By promoting balanced regional development, it encourages SMEs to locate outside Budapest and so favours wider linkages and decentralised economic activity.

Despite widespread price liberalisation in most transition economies, prices remain highly regulated in key infrastructure sectors, including energy and critical infrastructure such as water, transport and telecommunications. Particularly damaging is the weak collection of payments from these sectors, which perpetuates soft budget constraints and undermines the market basis for interactions. Weak collection and price distortions slow the restructuring process and undermine rational investment decisions in all sectors. In addition, by reducing profitability, these problems discourage private investment (including privatisation) which could expand and upgrade production and distribution facilities in these critical sectors. Investments that rationalise pricing in these areas thus make a vital contribution to the development of a sound private sector. Examples of such investments are project-related covenants on pricing reform or technical assistance to establish or strengthen market-oriented regulatory institutions.

The linkages created by investment projects help to advance the transition process in an economy. Investment projects create demand for products of other firms which are used in the production process. These have been termed "backward linkages".[2] Higher demand may lead to the establishment of new firms that may not have existed in the absence of the investment project or programme. Investment may therefore act as a stimulus for the creation of a competitive domestic input supply sector. Of course, in a well-functioning market economy it is prices and costs that correctly signal domestic versus foreign sourcing and such sourcing has no special role in project appraisal.

[2] Where new input suppliers are successful in a competitive setting, their success may act as a signal for other firms to enter the sector thus expanding its size. These demonstration effects are discussed in Section 7.2.

But what is at issue here is the establishment of the market interactions that provide the vehicle for such price signalling.

The transition impact of backward linkages created by investment projects is closely related to the extent to which local inputs are utilised. If projects rely on foreign input supply sources, their direct transition impact can be diluted. However, such "leakage" needs to be weighed against potential benefits associated with learning and demonstration effects that can accrue from foreign links. Foreign investment and agencies responsible for diffusing new technology can be instrumental as they demand or provide the know-how for the production of new types of advanced inputs. International trade can also be critical in expanding the set of inputs available to domestic manufacturers. Foreign trade and investment also signal to domestic suppliers the potential market for inputs and thereby promote competitive entry. The key requirement is that there be an effective potential domestic supply.[3] In short, leakages are not necessarily detrimental provided that the project is not "locked in" to foreign input sources, that learning and demonstration effects are substantial, and that the potential domestic supply response is not severely impeded by regulatory or other constraints.

Backward linkages forged by new investment may increase the variety of inputs available to producers. More diverse and advanced inputs in turn allow for the production of more complex goods at competitive costs through "forward linkages".[4] Forward linkages refer to the effects of supplying other enterprises with key inputs. These feedback effects can be crucial in stimulating increases in productivity and technical change at all stages of production and are thus central to the growth process. The Cokoládovny confectionery manufacturer in the Czech Republic is an example of an investment project that has generated many of these types of linkages (see Box 7.5).

The decentralisation of financial responsibility to enterprises through privatisation and restructuring can force them to form more competitive backward and forward linkages. In many countries of the region, mass privatisation has been used as a mechanism to promote industrial linkages that are consistent with market development, open competition and free entry. This task is central to advancing the transition process and will typically require investment finance for capital and technological upgrading as well as substantial technical assistance.

Box 7.6 provides the example of the Russian Mass Privatisation Programme. This shows that the shift to private ownership of enterprises does not by itself ensure that restructuring and market reorientation will take place. Apart from the former East Germany, most large-scale privatisation in the transition economies has occurred through vouchers and insider privatisation to workers or managers or both. There is considerable doubt as to whether either of these privatisation methods has delivered effective corporate governance of enterprises. Governance issues are discussed elsewhere in this report (see Chapter 8), but the concern here is with the implications for restructuring and the creation of market-based interactions, which are a key outcome of the privatisation process. Unless mass-privatisation measures are combined with financial measures to harden enterprise budget constraints and "unbundle" social services from the enterprise, incentives to reconfigure interactions may remain weak (see Box 7.6).[5]

Box 7.5

Privatisation of the Cokoládovny confectionery manufacturer, Czech Republic

The restructuring of the Czech confectionery manufacturer Cokoládovny provides an example of a successful privatisation that has created substantial backward and forward linkages. Multinational sponsors executed a countrywide industrial restructuring programme, and introduced Western-style management in all aspects of the business. Following the restructuring, which included operations, marketing, sales and cash management, the company was listed on the Prague Stock Exchange. The restructuring of this company increased competition in the local market, which in turn will encourage the formation of efficient linkages. New backward linkages, in particular to domestic SMEs providing inputs, have also been forged, leading to growth and competition in the input supply sector. Because of the limited availability of finance for SMEs, the company presently serves as a banker to its distributors. These forward linkages have contributed to the development of an increasingly competitive distribution network. The success of the company, through demonstration effects, has encouraged entry by foreign confectionery and biscuit manufacturers, which intensified competition in domestic markets. Cokoládovny's increasing export orientation has also led to quality upgrading of its product lines.

The growth of the small and medium-sized enterprise (SME) sector can be an important force in the formation of competitive market interactions in the industrial sector. These firms, which are the main source of growth in the private sector in transition economies, compete directly with large state and privatised enterprises, act as alternative providers of inputs and absorb excess labour. They can play a major role in expanding both the number of transactions that are market-based and the competitiveness of market structures. They facilitate the transfer of the factors of production away from the inefficient, planning-oriented state sector and towards the emergent private sector (see Chapter 9).

The development of competitive bank-enterprise linkages is also of central importance to the formation of efficient linkages in the enterprise sector. Hardening the budget constraints of large state and privatised firms forces them to form more efficient linkages both backwards and forwards, since failure to do this will carry financial costs (including possible bankruptcy). Policies that weaken or sever inefficient linkages between state bank and large state or privatised enterprises are critical in this respect, as is

[3] The experience of Japan and other East Asian countries in adapting foreign technical standards and designs, especially for complex and specialised inputs, is of particular relevance here.

[4] See Rodriguez-Clare (1995).

[5] See Earle and Estrin (1994), and Pistor, Frydman and Rapaczynski (1994).

Box 7.6

Mass Privatisation Programme, Russia

The Mass Privatisation Programme (MPP), launched in mid-1992, is a central part of the economic reform programme in Russia aiming at a fast transition to a market economy. It was undertaken in part to set the foundation for a countrywide restructuring of the state-owned enterprise sector. As the first programme of its kind, the MPP was a pilot operation which influenced the policies towards privatisation in other economies in the region.

The programme's first purpose was to introduce clear property rights over enterprises and their assets in a short time. The breakdown of the command system had left many enterprises without clear directives from central authorities, so that establishing unambiguous ownership structures was perceived to be essential to prevent economic standstill. The lack of a regulatory framework for privatisation had led increasingly to the transfer of enterprise ownership from state to private hands through an uncontrolled process of "nomenklatura" privatisations.

Mass privatisation was seen as one way to create a system of linkages between enterprises which was based more closely on efficiency considerations than the structure inherited from the command economy. It aimed to implement a comprehensive change in ownership structure and to ensure the irreversibility of this process. The MPP was also driven by the need to harden links between state enterprises and the central bank as a means of countering the threat of hyperinflation.

The programme specified different privatisation procedures according to enterprise size. It stipulated that large-scale enterprises be transformed into joint-stock companies. Following corporatisation, shares in these enterprises were sold in three steps: closed subscription to employees, public voucher auctions and cash auctions. Each enterprise then had to specify the privatisation method according to three options provided by the programme and this choice had to be agreed by at least two-thirds of the work collective. In effect, this led to workers and managers obtaining majority ownership of enterprises in which they were employed (see Chapter 8).

The MPP was highly successful in achieving a rapid change in the ownership structure of the Russian economy. By September 1994, more than 80 per cent of the workforce of the industrial sector was employed in privatised enterprises. Russia has now more shareholders than any other country in the world. However, there may be a trade-off between speed of privatisation and the depth of restructuring (see Blanchard and Aghion (1995); McMillan (1995)). Insider ownership may have contributed to delaying both internal reorganisation and restructuring of production processes (see Chapter 8). There is also a danger that enterprises, after they have been privatised, inherit the monopoly position from the command economy and therefore may have little incentive to form efficient linkages. Work by Pistor, Frydman and Rapaczynski (1994), for example, shows that many privatised firms continue to receive subsidised state credits. These types of problems are likely to be more severe during early stages of transition, when restructuring is not yet supported by market pressures emanating from price and trade liberalisation and the competitive threat of new private enterprises.

illustrated by the example of Wielkopolski Bank Kredytowy (WBK) in Poland (see Box 7.7). Through privatisation and other means, state banks need to break or restructure relationships with non-performing enterprises and to widen access to viable enterprises in the emerging private sector.

The emphasis so far has been on the development of competitive market-based interactions in the industrial sector. Though this is the pressing issue in most of the countries of the region, agriculture still remains a significant source of employment and output. The collapse of collectively organised agriculture has often ended the provision of essential services such as distribution and processing in the sector, damaging productivity. Box 7.8 illustrates how investments in the Kyrgyz Agribusiness Company (KAC) are designed to promote more efficient commercial interactions in the agricultural sector.

Fragmentation of various countries in the region has made it important to adopt a regional focus in assessing the transition impact of investment. Backward and forward linkages may be regional in scope. This is particularly true for projects that directly promote intraregional trade. Examples include export-oriented investment projects, trade facilitation activities (such as export finance and insurance) and projects involving direct market interactions between enterprises in different countries. There are other types of projects that strengthen interactions across national boundaries in less direct ways, including infrastructure projects (such as coordination of road and rail transport, or power pooling

Box 7.7

Wielkopolski Bank Kredytowy (WBK), Poland

WBK was one of the nine state-owned regional commercial banks created out of the National Bank of Poland in February 1989. In April 1993 it became the first Polish commercial bank to be privatised. The EBRD purchase of newly issued shares provided essential support for the public offering and strengthened WBK's capital base, since no strategic Western investor could be attracted.

Initial restructuring efforts concentrated successfully on improving internal operations and cleaning up the balance sheet. A matching programme of technical assistance executed with the Allied Irish Banks provided quality staff training and advisory services for all aspects of commercial banking. WBK has worked actively with its clients to improve the quality of its credit portfolio, and in the process hardened the budget constraints of its enterprise clients. It has also introduced new financial services to its commercial and retail customers. The development of sound operations led to another capital increase for WBK by the Allied Irish Banks, setting the stage for an expansion of the bank's balance sheet and further improvement in the services provided to its customers.

This project has thus supported privatisation and restructuring of a major bank, expanded finance to private enterprises, and encouraged more efficient commercial links between the bank and its enterprise clients. The transition impact of this investment was magnified by the considerable demonstration effects it generated both within Poland and beyond. Its success encouraged the Polish government to proceed with the privatisation of the other eight regional commercial banks. Increased competition in the banking sector has stimulated the development and implementation of new types of financial instruments. Overall, the project has widened and strengthened the web of market interactions in the Polish economy between the banking and enterprise sectors.

Box 7.8

Kyrgyz Agribusiness Company

In the command era, Kyrgyzstan's agricultural sector was dominated by omnipresent kombinats controlling input supply, extension services, processing and distribution of agricultural products. Trade liberalisation, price reform and the abolition of subsidies led to the dismantling of the kombinat system and left a vacuum in distribution and processing services. The lack of means to sell harvested crops, together with the insufficient supply of funds for working capital, induced a liquidity squeeze among farmers which contributed to a fall in grain yields from a high of 3.5 tonnes per hectare in 1987 to 2 tonnes per hectare in the early 1990s. Lower grain production affected forward-linked industrial processing activities such as the milling, animal feed and livestock industries, and contributed to a worsening in the daily diet. It necessitated grain cultivation of areas with low yield potential and imports of grain, which reinforced the productivity drop and damaged the balance of trade. The crucial role of agriculture in Kyrgyzstan's economy (it accounts for 30-35 per cent of GDP) adds urgency to the need to re-establish input supply, distribution and processing facilities, and provision of working capital finance.

The EBRD, in collaboration with local banks and other foreign sponsors, supports with a loan the restructuring of the Kyrgyz Agribusiness Company (KAC). After successful completion of a pilot, the project will target 25-30 farms of about 50,000 hectares each. The reformed KAC is to offer two key services: crop production support (input supplies to grain farmers, farm equipment, contract harvesting and storage facilities), and a mechanism for final product processing, marketing and distribution. By providing finance for working capital, commercial distribution and food processing facilities, and adequate input supply, this project addresses directly the most pressing post-liberalisation bottlenecks in agriculture. The project will help Kyrgyzstan to exploit its comparative advantage in agriculture and achieve higher levels of productivity. Key transition impacts are transferring technology and management know-how, upgrading agricultural products through improved input applications and cultivation practices, and alleviating the trade imbalance. Furthermore, the creation of the necessary market infrastructure enables both backward-linked activities such as farming and forward-linked operations such as milling and animal husbandry to benefit from agricultural liberalisation.

in electricity supply) and support for domestic banks which finance enterprises involved in intraregional transactions.

7.2 Promoting learning and discovery

Learning and discovery associated with investment are of special importance in transition economies. As with the development of competitive market interactions, investment projects can contribute to these processes by promoting the creation of new market-oriented skills, production techniques and organisation, and institution-building. We may distinguish between learning by doing, where individuals learn by participating in a process, and learning by observing, where individuals extract information from the content and success or failure of another project. We refer to the latter as *demonstration effects*. Projects with strong demonstration effects will play a key role in leading the transition.

Learning is critical in economies where participants are attempting to adapt to market conditions and to "discover" their competitive advantage. Markets represent new phenomena, and a large fraction of the population needs to learn the skills that allow them to operate effectively in these new environments. Market economies are oriented towards the customer in a way that command economies were not. Producers, distributors and retailers have to learn how to identify, generate and respond to demand. Particularly in the financial sector, the establishment of skills, trust and regulation must involve the combination of new working methods, organisation and other aspects of institutional development. This requires experience and takes time.[6]

It is often unclear to investors, managers and workers which production activities or jobs they should be involved in. Investment projects provide the opportunity for different production processes and organisational arrangements to be tested; their success or failure acts as a signal as to where to invest or enter. These demonstration effects lead to the replication of successful production processes and the expansion of profitable sectors. Learning and demonstration effects are of still greater importance in the transition economies than in established market economies.

Most of the countries of the region are characterised by high levels of literacy, numeracy and technical skills. The stock of human capital, however, is not directly compatible with the market approach or with new capital or technology (see Chapter 3).[7] For most workers and managers learning on the job is the most important way of reskilling.[8] For this type of learning to take place on a sustained basis workers and managers have to be constantly acquiring new skills that are compatible with market development. As is illustrated in Box 7.9, IFIs can support this process by, for example, upgrading management skills in medium-sized and large enterprises. Skill and technology acquisition in turn helps firms to produce advanced goods at competitive costs.[9] The production of these advanced goods provides additional opportunities for workers and managers to learn new skills. This process of sustained learning underpins modern economic growth and has been a critical factor in high growth regions such as East Asia.[10] If new skills and technology are not constantly introduced into the transition economies through investment or other means, then the potential of learning to influence growth will be small or negligible. These processes are likely to be particularly rapid in transition economies because the basic literacy, numeracy and technical skills are

6 Much of the transfer of these market-oriented skills will be to those operating, or intending to operate, outside the investment project and in this sense the transition impact extends well beyond the boundary of the project.

7 On the human capital side, the transition economies are at an advantage relative to the developing economies in the sense that the basic investments in literacy and numeracy have already been made. Thus with moderate amounts of reskilling the bulk of the working population should be in a position to participate in economic growth opportunities, whereas some developing economies may take several generations to reach this position. See also the discussion of social indicators in Chapter 2.

8 Expenditures on education also need to be maintained in order to maintain high levels of literacy and numeracy.

9 There are knowledge-based "set-up" costs in beginning new product lines.

10 See Young (1991) and Rodriguez-Clare (1995). Demonstration effects would magnify this process. Successful advanced production processes would be copied, thus increasing the aggregate amount of learning going on in the economy.

Box 7.9

The TurnAround Management (TAM) Programme

The lack of management skills needed to operate in a more market-oriented environment often represents a serious constraint to transition. This problem is particularly pressing for managers in medium-sized and large enterprises who are used to operating in the conditions of a command economy. However, the acquisition of such investment skills is complicated due to the general lack of expertise. Investment in the skill formation of managers by enterprises themselves may not pay off, as trained managers may move on to other jobs. Government programmes to encourage the improvement of managerial skills are rare. Furthermore, governmental agencies are often unaware of the problems faced by enterprises owing to barriers imposed by the existing regulatory environment.

The TurnAround Management (TAM) Programme, set up jointly by the EBRD, the European Union and the United Nations, and supported by the governments of the region, is designed to help develop these important skills. It focuses on senior managers in companies which, if appropriately restructured and managed, have a good chance to succeed in the new market environment. To gear the assistance directly to the needs of a particular enterprise, a TAM team is created. This consists of retired or semi-retired experienced senior managers of successful Western companies and a selected group of senior specialists, who advise on functional skills such as marketing or corporate planning. This team works as close personal advisers to a selected enterprise for a period of (normally) one year.

On the basis of the TAM teams' experience with enterprise management, the TAM programme also informs governments and agencies of the region of the need to develop a more competitive economic environment and set of infrastructure services which will attract new investment, facilitate economic growth and permit restructuring of enterprises into viable business units. This secondary objective recognises the central role for governments in ensuring a competitive marketplace.

present and there are the additional returns arising from learning about and applying market-oriented approaches.

On-the-job learning is more valuable when it occurs in enterprises that embody new competitive production processes.[11] Learning by participating in obsolete production processes has little value either within or outside a firm. Learning effects are therefore strongest when these involve market, organisational and production processes that are relatively new. These considerations underline the potential contribution of foreign direct investment which embodies new methods of work, a market approach and new technological processes, either in the production of inputs or final products. Export orientation in this context can also be valuable because it induces firms to learn about marketing, upgrading quality and cost-efficient production, all of which are essential to allow penetration in foreign markets. It has been one of the central lessons from the growth experience after the Second World War – both in western Europe and East Asia – that the potential for inducing growth through learning is greatest when product markets are heavily export-oriented.

Demonstration effects created by the success or failure of projects help profitable areas of activity to be identified. A central aspect of the transition process is the search for competitive advantage through experimentation, together with the dissemination of the results of this experimentation through demonstration effects. The strength of demonstration effects will be influenced by the competitiveness and stability of the market setting. For these effects to operate effectively, investment projects should not fail for reasons other than competitive disadvantage. Information imparted by the failure of projects will be of little value if potentially profitable investments are unsuccessful due to volatility in market conditions, excessive of unfair regulation or taxation, or the inability to enforce contracts. Enterprises that succeed because they have a monopolistic position in terms of access to credit or inputs are also of little value because their example cannot, or should not, be replicated. Reforms that stabilise prices, remove barriers to entry, rationalise the tax system and establish clear legal guidelines are therefore likely to strengthen demonstration effects by improving the quality of price and profitability signals. It is where conditions are competitive that success (or failure) constitutes a reliable signal of the competitive advantage (or disadvantage) of a given type of project or production process.[12]

Small and medium-sized enterprises stand out as attractive vehicles for testing new production processes. Their small size and low fixed costs facilitate experimentation. They are not hampered by the problems of restructuring obsolete capital or reducing excess employment which characterise the state sector. New entrants are likely to be trying out new production processes and thus can be a potent source of innovation. The type of production activity being demonstrated by SMEs is also usually readily replicable by domestic firms. However, as further discussed in Chapter 9, SMEs can encounter serious problems regarding regulation and licensing, credit access, market access, import and export controls, and taxation. This points to the importance both of assisting SMEs and deregulating the economic environment in which they function.

Replicating investments that embody new organisations, approaches and technology carries much more value than replicating old ideas or processes. Trade in the international market in ideas implies that the set of ideas over which experimentation is taking place is wider and richer than the domestic set. Successful exporting firms provide a powerful signal to other domestic producers about how to compete effectively (for example, how to organise production, maintain quality control and market final output), and about the potential profitability of export activity. Foreign investment and trade can act as a conduit for technology transfer and knowledge spillovers to countries in the region. These types of investment allow domestic firms to benefit from R&D investments and innovation in other parts of the world through replication and imitation.

[11] See Stiglitz (1994). Innovation, though important in some sectors of command economies (e.g. defence), was a fundamentally non-competitive process in the old regime and therefore even technologically advanced products are proving to be commercially unviable.

[12] On the other hand, the value of learning from a given new type of investment project will fall as the number of examples of this type of investment project increases with transition. However, the learning process itself remains important throughout transition and beyond.

In market economies, financial institutions have a central role in generating, sharing and disseminating information connected to the operation of the forces of supply and demand.[13] There are many types of information at issue here, including prices, profits, risks, trading possibilities, market conditions and future economic developments. This leads to a focus on the development of a range of diverse financial institutions, including commercial banks, bond markets, equity markets and insurance markets.

The establishment of these new types of financial intermediaries is essential to allow people to learn the processes and skills that are integral to operating systems of market exchange. Successful introductions of both financial instruments and institutions can then be replicated. However, potential private investors may be discouraged by the inherent riskiness of these types of projects and by the non-appropriability of the returns.[14] Involvement of IFIs in the development of financial markets in transition economies can help to overcome these problems. Box 7.10 shows how the use of an international bond issue by a formerly state-owned bank in Hungary had strong demonstration effects for other banks in the region.

There are complementarities between different aspects of learning in promoting economic growth throughout the region. Investment in reskilling and other forms of human capital formation enables workers to participate in advanced production activities. This increases the value of both on-the-job learning and demonstration effects, which in turn lead to organisational and technological upgrading and the production of even more advanced goods. These dynamic complementarities have been described as "virtuous cycles" and are believed to be behind the high growth rates observed in several East Asian economies.[15] If learning effects are not promoted, for example, if inefficient, obsolete state (or privatised) enterprises dominate industry in the coming years, then a "vicious cycle" could develop. In this case, skills and accumulated human capital erode, leading to production of backward,[16] non-competitive goods which offer little scope for learning, and an economy trapped in a state of limited transition and low growth.

Box 7.10

Bond issue by the Hungarian Foreign Trade Bank

The Hungarian Foreign Trade Bank (HFTB) is one of the country's largest commercial banks. With the establishment of the two-tier banking system in Hungary, it became a full-service commercial bank in 1987. With its focus on international banking and trade finance, and with the cooperation of Western banks, it was well positioned to be the first east European bank to issue a medium-term Eurobond without the enhancement of a sovereign guarantee. The bond was issued in June 1993, with the EBRD as co-lead manager alongside Bayerische Landesbank, and subsequently listed on the Frankfurt and Munich Stock Exchanges.

The bond issue was instrumental in improving the maturity structure of HFTB's liabilities and contributed to its eventual privatisation by establishing its commercial viability. The bond issue also had significant benefits for the economy as a whole. There were clear demonstration effects both in introducing Hungarian and other non-sovereign borrowers to international bond markets and in expanding a new line of business for commercial banks (term lending). This increased their ability to channel financing to east European enterprises on a commercial basis. Proceeds from the issue were also used to finance medium-term lending, which benefited SMEs. If lending to smaller non-state enterprises on a medium-term basis proves successful, then it is also likely to be replicated with attendant strong linkage effects. Lastly, given the specialisation of HFTB in intermediating international trade, its strengthening is a contribution to resolving trade problems in the region.

7.3 Concluding remarks

We have argued that the transition impact of investment may be seen largely in terms of promoting competitive market-based interactions, and learning and discovery. Investment projects that influence the long-run structure of the economy through these effects can have profound impacts on transition and growth. These effects have the characteristic that their benefits extend beyond the returns accruing to the individual investment project or programme. Investment projects that create a competitive market environment also benefit many agents in the economy besides the original investor. There is thus likely to be underinvestment by private investors in such projects, suggesting a role for governments, development agencies and IFIs in the promotion of these types of investment. These financing institutions can also facilitate private sector activity by relaxing the overall credit and infrastructure constraints in a given economy. Involvement is particularly relevant during the early stages of transition when markets are underdeveloped or absent altogether.

It is therefore important to develop an analytic framework for thinking about the transition impact of investment projects, particularly for the EBRD, which has as its mandate to promote the transition and which is focused on project finance as its instrument.[17] The broad structure of such a framework has been presented in this chapter. We argued in Sections 7.1 and 7.2 that the promotion of competitive market-based transactions and of learning and discovery were two important dimensions for any analysis of the transition impact of investment. These different dimensions were illustrated using various government and IFI investment projects.

The analysis suggests that governments and IFIs should tailor their roles, including investment projects, according to the stage of transition and the institutional environment of a country. To conclude, in Box 7.11, we present some early efforts by the EBRD to develop a practical framework designed to assess the transition impact of investment projects.

[13] See Stiglitz (1994).

[14] Private investors do not value demonstration effects because they carry no private benefits, and indeed may have an incentive not to invest in projects with strong demonstration effects as these signals tend to encourage direct competition and the erosion of market power.

[15] See Lucas (1993).

[16] Note that production of technologically advanced goods that are non-competitive (e.g. obsolete military technology) would also lead to small learning and low growth effects.

[17] To ensure effective project lending, it is necessary to assess the transition impact of investment operations both through *ex ante* appraisal as well as *ex post* evaluation. The Project Evaluation Department at the EBRD currently carries out economic performance assessments, including transition impact, of all fully disbursed investment and technical cooperation operations.

Box 7.11

Indicators of transition impact of investment

The objective is to develop a set of indicators identifying key dimensions of the transition impact of investment. We recognise that transition impact is only one component of project appraisal – it should be seen as complementary to conventional cost-benefit analysis, credit appraisal and other relevant criteria. In order to become an effective operational tool for analysis of transition impact of investment the indicators should meet certain requirements. First, the criteria encapsulated in the set of indicators should be fairly comprehensive in encompassing the key dimensions of the transition impact of investment. Second, the indicators should be clearly defined in order to minimise overlap in interpretation and avoid double counting of different dimensions of transition impact. It is also important that transition indicators do not overlap with cost-benefit project appraisal criteria. Third, it should be possible to score investments on dimensions of transition impact within a reasonable time frame and on the basis of readily available project-level information.

The discussion in this chapter of transition impact makes it clear that it is complex and multi-dimensional. Theoretical and empirical difficulties imply that it is not possible to provide precise, plausible quantification of the *impact* of external effects on transition. Instead, qualitative proxies of likely transition impact are developed by identifying channels (dimensions) through which these mechanisms operate. For each investment the strength of each of these channels is examined to give a picture of likely transition impact. Table 7.1 presents a list of indicators for transition impact of investment projects. They represent a first step towards assessing the transition impact of investment projects in operational terms at the EBRD. In line with the organisation of this chapter, these indicators have been grouped into two broad categories: interactions and the competitive environment, and learning and discovery. These distinctions should not be exaggerated, however, since many indicators contain elements from more than one category. The multi-dimensionality of transition impact raises the issue of whether and how to aggregate evaluations across different dimensions. From an analytic perspective, this would require specification of a weighting function which embodies a judgement about the relative importance of different dimensions of transition impact. This is a difficult problem, both because of our incomplete understanding of the dynamics of transition and because the implicit weights would presumably depend both on country-specific conditions and the stage of transition.

Table 7.1

Transition indicators for project appraisal

Competitive interactions and the competitive environment

1 To what extent does the project utilise local suppliers/domestic inputs? (backward linkages, e.g. commodity and services)

2 To what extent are such inputs supplied at non-distorted prices? (backward linkages)

3 To what extent does the project utilise downstream marketing and/or processing activities? (forward linkages)

4 To what extent does the project directly contribute to the formation and expansion of SMEs?

5 To what extent does the project contribute directly to the private sector provision of facilities or services?

6 To what extent does the project contribute to the development of more rational infrastructure pricing, effective collection and/or effective regulation in the sector?

7 To what extent does the project directly improve the competitive environment and/or reduce market distortions in the sector?

8 To what extent does the project involve privatisation or other means of improving effective corporate governance of enterprises in ways that increase market orientation?

Learning and discovery

9 To what extent does the project create or transfer skills relevant to a market economy? (e.g. management, marketing, financial and banking skills, specialised technical skills, etc.)

10 To what extent does the project directly support export-oriented activity, including trade facilitation such as export finance and insurance?

11 To what extent does the project contribute to the development of new financial instruments by local financial institutions?

12 To what extent does the project directly enhance financial intermediation by creating new types of intermediary? (e.g. insurance company, stock market, venture capital company, etc.)

13 To what extent does the project create a new and easily replicable line of activity? (demonstration effects, e.g. in manufacturing or finance)

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Transition report

Part III

Enterprise development

Ownership, governance and restructuring[1]

8

A standard view among academics and policy makers in the early days of the transition process was that faster privatisation would automatically lead to faster restructuring of enterprises. Several years into the transition, the relationship between privatisation and restructuring has proved to be more complex.

First, it is important to recognise that "restructuring" is multidimensional, encompassing: "reactive" policies brought about by the hardening of firms' budget constraints[2] (e.g. labour-shedding, wage reductions, plant closures); strategic aspects, including export reorientation, changes in the mix of products and changes in management structures; and "deeper restructuring", generally involving substantial new investment, that can deliver large improvements in enterprise performance and growth over the long run.

Second, it is now clear that successful enterprise restructuring depends not only upon ownership (e.g. state versus private), but also upon the structure of control and the financial constraints faced. It appears that mass privatisation programmes, which have left control either in the hands of private insiders (employees and/or managers) or diluted among private voucher holders, have so far produced only limited, primarily reactive, restructuring. However, privatisation with dominant outside ownership, especially in the form of foreign direct investment, appears to generate deeper restructuring, which leads to significant performance improvements. In other words, a change of ownership from public to private can no longer be seen as a sufficient condition for comprehensive enterprise restructuring. Attention must be focused also on effective corporate governance and how best to achieve it.[3]

This chapter examines these issues in more detail, concentrating on four countries: the Czech Republic, Hungary, Poland and Russia. This selection was motivated by the relative maturity of enterprise transformation and by the contrasting approaches to it in these four countries. Section 8.1 identifies the main ownership structures that have arisen from privatisation in the four countries. Section 8.2 establishes some relationships between ownership and governance patterns, on the one hand, and restructuring and performance outcomes on the other. Section 8.3 discusses the role of emerging capital markets in facilitating the development of "restructuring-inducing" ownership and governance structures in privatised enterprises.

The analysis indicates that a substantial proportion of firms still remains in state hands; in so far as they do not, insiders for the most part continue to be in control, except in the Czech Republic. This in turn tends to limit the scope for restructuring, caused partly by capital constraints and by the objectives of those insiders. Second, well-functioning capital markets do not yet exist, and even when outside control is significant – as in the Czech Republic – the current institutional relationships (for example, between investment funds, banks and firms) dilute effectiveness. As a consequence, restructuring has been mostly reactive and, to some extent, strategic. The exception is firms with dominant outside investors, especially foreign investors, and to a lesser extent Investment Privatisation Funds (IPFs), which have engaged in significant deeper restructuring.

8.1 Ownership and governance patterns

This section identifies the governance structures that have emerged as a result of the different privatisation processes followed in the Czech Republic, Hungary, Poland and Russia. The term governance structure here refers both to the pattern of shareholding within the firm (its ownership structure) and to the distribution of control rights among shareholders.[4] For example, a privatised firm with dispersed outside ownership (e.g. by individual voucher holders) does not have the same governance structure as a firm with a core outside owner (e.g. a foreign investor). Similarly, a privatised firm whose shares are equally distributed across all employees has a different governance structure from a firm in which the manager has been granted a large proportion of the shares.[5]

The objectives of employees, managers and outside investors vary considerably and, with them, the extent and effectiveness of restructuring. The primary objective of an employee-controlled firm is likely to be first to preserve employment and then to maximise wages, subject to the firm remaining solvent if hard budget constraints are enforced. The hardening of budget

[1] This chapter draws on unpublished surveys done under the auspices of the World Bank and the EU. For Poland and Hungary, the survey data were collected as part of the World Bank Research Project on Enterprise Behaviour and Economic Reform in Central and Eastern Europe, headed by I.J. Singh in collaboration with Alan Gelb. We are very grateful to them for providing these data. Helpful comments were kindly provided by Saul Estrin and Mark Schaffer. The Russia survey was sponsored by the Europe and Central Asia Country Department III, and the Economic Development Institute at the World Bank, for a research project headed by Qimiao Fan. The Czech survey results are drawn from surveys compiled by A. Zemplinerova and funded by an EU ACE project.

[2] That is, the removal of firms' access to soft credits or subsidies.

[3] This important point was made early in the debate on transition by Frydman and Rapacynzski (1994). In the last two years, a number of empirical studies in this area have been completed, based on recently available enterprise survey data (see footnote 1).

[4] For simplicity, in the analysis of different governance structures (see Section 8.1) we do not consider the control rights exercised by creditors. However, the observed hardening of budget constraints and its impact on restructuring even in state enterprises (see Section 8.2) constitute some evidence that creditors may in fact exert influence over the restructuring behaviour of enterprises.

[5] This proportion does not have to be 50 per cent in order for the manager to exert effective control, provided that the other shareholdings are sufficiently dispersed.

constraints has been quite effective in inducing reductions in employment and real wages even in non-privatised enterprises.[6] In addition to preserving their salaries and their jobs, managers may try to establish a reputation *vis-à-vis* the outside labour market, and this would depend on their success at restructuring the enterprise. Thus, more restructuring can be expected to take place in manager-owned firms, compared with employee-owned enterprises. On the other hand, manager control may make transition from inside to outside ownership more difficult (see Section 8.3).

The primary objective of outside investors, whether individual voucher holders, investment funds or foreign investors, is expected to be the maximisation of the long-run value of the firm, subject to the financial and other constraints on the owners. Their ability to restructure will depend on whether they are able to establish control of the firm (which in turn depends to a large extent upon their shareholding concentration). Restructuring will also depend on new finance and expertise, for example to modify the marketing strategy or the product mix delivered by the enterprise, and to modernise the capital equipment. Dispersed individual voucher-holders will typically have only limited ability to induce deep restructuring policies. IPFs, even when they are core owners, may lack the access to finance and expertise, and even the internal governance structure, to implement the appropriate restructuring policies within the enterprises they own. Domestic banks may have better access to finance. Core foreign investors are likely to be strongest on all those dimensions relevant to enterprise performance, namely concentrated shareholding, finance and expertise.

Five main types of governance structure are presented in the following tables and discussed in this chapter:

1. State ownership with control exercised by insiders (managers and employees)
2. Inside ownership with control exercised by employees
3. Inside ownership with control exercised by managers[7]
4. Domestic outside ownership (e.g. individual voucher holders)[8]
5. Foreign investor ownership (foreign individual investor, firm or investment fund).[9]

Table 8.1

Brief overview of privatisation[1]

	Privatisation method	Major players in privatisation	Private sector share in GDP (%)[2]
Czech Republic	mass voucher privatisation	investment privatisation funds	70
Hungary	direct sale to domestic and foreign investors	domestic private companies, managers and foreigners	60
Poland	liquidation mass voucher privatisation (from autumn 1995)	workers and managers	60
Russia	mass voucher privatisation	workers and managers	55

1 Includes partial privatisations.
2 Estimates are taken from Table 2.1 in Chapter 2.

Table 8.2

Composition of ownership in the Czech Republic, by dominant ownership type (in per cent)

	Dominant ownership type[1]				
	State	Insiders[2]	IPFs	Domestic outsiders (excluding IPFs)	Foreign
Number of firms	**60**	**80**	**39**	**57**	**16**
Number of employees[3]	**470**	**75**	**182**	**129**	**212**
Domestic outsiders	**4**	**1**	**76**	**59**	**17**
IPFs	2	0	51	2	2
Individual voucher holders	1	0	22	8	6
Individual investors and companies	0	0	2	33	8
Others	1	1	1	16	1
Insiders	**1**	**97**	**0**	**2**	**0**
Employees	1	35	0	0	0
Managers	0	62	0	2	0
State	**95**	**0**	**19**	**2**	**6**
NPF	62	0	17	2	4
Others	33	0	2	0	2
Foreign investors	**1**	**0**	**2**	**0**	**76**
Other	**0**	**0**	**2**	**36**	**0**

Source
Katsoulacos and Takla (1995). The 1994 Czech survey was based on a random sample of 257 manufacturing firms, and can be used to draw inferences about industrial enterprises in the Czech Republic as a whole. For details, see Zemplinerova *et al.* (1995).

Notes
Figures refer to average percentage ownership shares. Column entries may not add to 100 per cent due to rounding. Zero entry refers to any value less than 1 per cent.
1 Dominant ownership type has a majority stake (greater than 50 per cent), whether concentrated or dispersed among members of that type except for IPFs. Dominant IPF ownership is defined as at least 20 per cent shareholding by IPFs collectively in those firms not otherwise majority-owned. The total number of firms classified by ownership type is 252. The remaining 5 firms were either classified as no dominant owner or unclassified.
2 Insiders includes both employees and managers.
3 Median number of employees.

6 For example, see Pinto *et al.* (1993).
7 Categories 2 and 3 can be distinguished empirically only in the Russia survey. In the others, the number of observations in the categories is too small to be meaningful.
8 In the Czech Republic survey, domestic fund holders and other shareholders are also distinguished.
9 The Russian survey does not separate out foreign ownership.

These ownership structures (and the governance they generate) would be expected to lead to different restructuring outcomes. There follows an overview of privatisation policies and outcomes in the four countries, presenting the available data country-by-country and briefly summarising the type and scale of privatisation implemented in each.[10]

Czech Republic

Privatisation progress

The techniques and decisions most identified with the Czech privatisation programme are the use of vouchers to dispose rapidly of state property, the free entry permitted to privately formed IPFs, and the use of such IPFs as a corporate governance solution to dispersed ownership.[11] Although the Czech programme was quite flexible in terms of choosing between various privatisation methods (e.g. direct sales, auctions, restitutions and voucher privatisation), voucher privatisation turned out to be predominant, accounting for 50.7 per cent of the realised nominal stock value by December 1994 (against 7 per cent through direct sales to outsiders). This in turn has led to the predominance of private outside ownership in the Czech Republic.

Czech legislation imposes a 20 per cent ceiling on a single IPF's ownership of the "total nominal value of securities issued by the same issuer" (Section 24 of the Investment Companies and Investment Funds Act). This ceiling applies only to IPFs and is in part a protection mechanism for minority shareholders. A significant drawback of such ownership restrictions is that they may retard the reselling of shares to IPFs, which in turn would be expected to delay comprehensive restructuring. This 20 per cent restriction can also create a problem of effective supervision, in that a 20 per cent shareholder will have less incentive to monitor the firm than a 50 per cent shareholder.

To summarise, the most pervasive governance structure resulting from the mass privatisation programme in the Czech Republic is outside ownership, either dispersed among private voucher holders or more concentrated with IPFs and the National Property Fund. The incentives and governance structure of the IPFs, and in particular their financial relationship with banks, will greatly influence the restructuring outcome in the privatised sector (see Section 8.3).

Ownership

In the Czech Republic, in firms with dominant insider ownership, employees and managers between them own almost all the shares (97 per cent). The small (median) size of insider-owned firms reflects the fact that *de novo* enterprises are not separately identified in the Czech survey and will be mostly contained in the insider-owned category, in contrast to the surveys for Hungary, Poland and Russia. About 17 per cent of firms in the sample have dominant IPF ownership (as defined in the notes to Table 8.2).[12] It is notable that the IPFs hold a very small stake, only 2 per cent, in enterprises that are under dominant ownership by other (non-IPF) domestic outsiders. This is in sharp contrast to the average 51 per cent holding by IPFs in firms with dominant IPF ownership. This may suggest a focus by IPFs on gaining effective control of enterprises in which they invest. Interestingly, while the IPFs hold only a small stake in domestic outsider-owned firms, domestic outsiders (and particularly individual voucher holders) account for 22 per cent of IPF-dominated firms. Also striking is the fact that foreign investors do not hold any significant stakes in firms other than those with dominant foreign

Table 8.3

Composition of ownership in Hungary, by dominant ownership type (in per cent)

	Dominant ownership type[1]				
	State	Insiders[2]	Domestic outsiders	Foreign	*De novo*
Number of firms	**66**	**12**	**13**	**21**	**27**
Number of employees[3]	**699**	**293**	**74**	**364**	**32**
Domestic outsiders	**0**	**6**	**87**[4]	**7**	**53**
Banks	0	0	7	0	0
Funds	0	0	0	0	0
Companies	0	6	47	4	9
Individuals	0	0	27	3	44
Insiders	**1**[5]	**81**	**2**	**1**[5]	**28**
Employees	0	46	1	0	11
Managers	0	35	1	0	17
State	**95**	**14**	**8**	**21**	**4**
Ministries/financial institutions	79	10	6	13	1
SOEs	16	4	2	8	3
Foreign investors	**3**	**3**	**2**	**71**	**16**

Source
Computed from the 1993 World Bank Hungarian enterprise survey. This survey was based on a sample of 200 manufacturing firms, excluding certain legal forms of organisation. Thus, it should not be used to draw inferences about the ownership composition of the Hungarian manufacturing sector as a whole. Other comparisons across ownership types are valid, however.

Notes
Figures refer to average percentage ownership shares. Column entries may not add to 100 per cent due to rounding. Zero entry refers to any value less than 1 per cent.
1 Dominant ownership type has a majority stake (greater than 50 per cent), whether concentrated or dispersed among members of that type.
2 Insiders includes both employees and managers.
3 Median number of employees.
4 Sub-total differs from sum of the components because sample size varies for each sub-category.
5 Sub-total differs from sum of the components because of rounding.

[10] All of the figures presented in the tables are unweighted averages across enterprises. An analysis using firm-size weighted averages yields somewhat different figures, but the broad conclusions remain intact.

[11] Coffee (1994).

[12] In reading this table, two points should be noted. First, the relatively low proportion of IPF-dominated firms in this table (39/230 = 17 per cent) is largely due to the fact that the sample is not limited to privatised enterprises and includes *de novo* firms (above the minimum cut-off level in the sample of 25 employees). The survey does not separately identify these firms, so they would largely fall in the insider-owned category. This is evidenced by the much smaller median number of employees for insider firms in the Czech table. By contrast, the Hungarian, Polish and Russian enterprise surveys (and the tables in the text) identify *de novo* firms separately. Second, if one restricts attention to privatised firms, the proportion of IPF-dominated firms in the Czech Republic increases substantially. In particular, out of the 1,491 firms that were privatised in the first wave of voucher privatisation, IPFs (collectively) hold more than 50 per cent of shares in 22 per cent of these enterprises. See Laštovička, Marcinčin and Mejstřik (1995).

ownership. By contrast, in Hungary and Poland, foreign firms hold minority stakes in *de novo* (newly-created) firms. While the Czech survey does not distinguish *de novo* firms, they would be mostly included in the insider-owned category.

Hungary

Privatisation progress

Privatisations in Hungary have essentially been implemented through the sale of state property by privatisation agencies. As a legacy of the decentralisation measures introduced under the old system (from the late 1960s and accelerated in the late 1980s), the state has found it very hard to set up a centralised privatisation process or to sell to outsiders without insider cooperation.[13] The current ownership structures of companies is one where foreign owners and domestic outside owners had acquired the majority of sold property by the end of March 1995. Over 30 per cent of total property sold is now in foreign hands. However, the state still holds a large percentage of companies.

Ownership

Outside ownership has been a striking feature of the Hungarian privatisation process, and this is reflected in the enterprise survey data. This feature also characterises *de novo* firms. Well over three-quarters of all *de novo* firms are owned domestically, with the majority of shares held by domestic outsiders. Outside owners, in general, are identified as being other companies and individuals including foreign investors. Also remarkable is the absence of banks and funds as private outside owners in the Hungarian survey evidence. In firms dominated by insiders, employees and managers have roughly equal ownership shares.

Poland

Privatisation progress

In the face of strong resistance from enterprise insiders, successive Polish governments opted for a multi-track approach to privatisation. Polish enterprises were largely free to choose between privatising "by liquidation" and privatising through a direct sale of equity. The former method involved selling the company's assets either to outside investors or to the existing insiders who could then form a new private company. Employees were treated preferentially, both in terms of access to the firm's assets and because only a small proportion of the share price was demanded in cash.

To date, Polish privatisation efforts have resulted in very few enterprises being sold directly to outside investors, domestic or foreign. Privatisations have been mostly through liquidations, which are *de facto* employee buy-outs.[14] Delays in the implementation of mass privatisation have also left a large proportion of the enterprise sectors remaining in "state hands", which in practice has left control with managers and employees.

Ownership

The average combined shareholding of managers and other employees in insider-dominated firms is 88 per cent; that of managers alone is 27 per cent and that of other employees alone is 61 per cent. Employees are also important minority shareholders in foreign and outside-owned firms. In the sample, the state holds on average a quarter of the equity in firms with majority foreign investor ownership. Where the state retains a majority holding, it appears that no dispersion of ownership at all has taken place.

Ownership by funds and banks is still marginal. The average shareholdings of banks and funds in enterprises with dominant outside ownership are only 3 per cent and 8 per cent, respectively. Insiders have very small shareholdings in firms with majority ownership by either domestic outsiders or foreign investors, less than 10 per cent in both cases. As in Russia, *de novo* firms are examples of concentrated ownership and management. Management and "outsider individuals" together own nearly 60 per cent.

Russia

Privatisation progress

Between December 1992 and February 1994, nearly 9,500 large-scale enterprises employing 11 million workers were privatised,

Table 8.4

Composition of ownership in Poland, by dominant ownership type (in per cent)

	Dominant ownership type[1]				
	State	Insiders[2]	Domestic outsiders	Foreign	*De novo*
Number of firms	**122**	**16**	**7**	**8**	**41**
Number of employees	**548**	**273**	**132**	**423**	**68**
Domestic outsiders	**0**	**6**	**79**	**2**	**32**
Banks	0	0	3	0	0
Funds	0	0	8	0	0
Companies	0	1	31	2	7
Individuals	0	5	37	0	25
Insiders	**0**	**88**	**10**	**7**	**31**
Employees	0	61	6	5	8
Managers	0	27	4	2	23
State	**100**	**3**	**11**	**25**	**0**
Ministries/financial institutions	100	0	3	19	0
SOEs	0	3	8	6	0
Foreign investors	**0**	**0**	**0**	**66**	**15**
Others	**0**	**3**	**0**	**0**	**22**

Source

Computed from the 1993 World Bank Polish enterprise survey. This survey was based on a sample of 208 manufacturing firms (minimum employment size of 10) stratified by broad ownership category. Because the ownership composition was fixed by sample design, it provides no information about the ownership structure for manufacturing enterprises in Poland as a whole. The sample under-represents *de novo* firms and over-represents privatised firms. The proportion that is in state ownership is approximately correct. For details, see Belka *et al.* (1994). Other comparisons across ownership types on the basis of the sample are valid, however.

Notes

Figures refer to average percentage ownership shares. Column entries may not add to 100 per cent due to rounding. Zero entry refers to any value less than 1 per cent.

1 Dominant ownership type has a majority stake (greater than 50 per cent), whether concentrated or dispersed among members of that type.

2 Insiders includes both employees and managers.

13 See Stark (1993).

14 See Gomulka and Jasinski (1994).

Table 8.5

Composition of ownership in Russia, by dominant ownership type (in per cent)

	Dominant ownership type[1]				
	State	Workers	Managers	Outsiders[2]	*De novo*
Number of firms[3]	110	140	40	35	45
Outsiders	2	15	9	53	29
Workers	7	63	14	26	5
Managers	2	12	63	14	56
State	89	10	13	12	1
Others	0	0	1	0	9

Source

Earle, Estrin and Leshchenko (1995). The 1994 World Bank Russia survey, on which this table is based, was conducted on a random sample of 439 industrial firms (minimum employment size of 15). Thus, the composition of the sample provides valid information about the ownership structure in the population of industrial enterprises in Russia. For details, see Richter and Schaffer (1994).

Notes

Figures refer to average percentage ownership shares.

1 Dominant ownership type has a majority stake (either greater than 50 per cent or the largest share if ownership is dispersed), whether concentrated or dispersed among members of that type.

2 Includes both domestic and foreign outside ownership, excluding *de novo* firms.

3 The number of firms classified by ownership type is 370. The remaining 69 firms were unclassified.

creating 40 million new shareholders. The Russian mass privatisation scheme was "bottom up", with managers and workers selecting the privatisation process they wished to follow. The hardly surprising result of the scheme is that insiders – workers and managers – hold over 51 per cent of ordinary shares in nearly 70 per cent of all privatised firms. Insider ownership has thus clearly emerged as the dominant ownership structure in Russia.

Ownership

The survey evidence for Russia presented in Table 8.5 is derived from a random survey of 439 enterprises. It therefore provides evidence of the scale of ownership transformation which has taken place. Workers and managers together are now dominant owners in half of all enterprises and in over 75 per cent of these the workers predominate. Despite the large-scale privatisation programme, the state retains a majority stake in about 30 per cent holding of the enterprises in the sample (which are classifiable by dominant ownership type). However, within those firms where the state is no longer the dominant owner, the state's shareholding has fallen to very low levels, at a little over 10 per cent. In *de novo* firms, ownership is concentrated among managers and private individuals (outsiders). Since there may be little distinction between these categories in such firms, it may be said that *de novo* firms are a leading example of owner-managed firms.[15]

Summary

The four countries examined have adopted very different approaches to privatisation, and this has yielded different governance structures within the privatised enterprise sector. Several tentative conclusions, largely confirmed by the evidence presented above, can be drawn about these structures. First, state ownership, with large insider ownership, has remained important in most countries. Second, insider ownership with dominant employee stakes and reportedly managerial control is extensive in Russia, and to a lesser extent in Poland. Third, outside ownership has emerged on a large scale in the Czech Republic, and to a smaller scale in Hungary, but dominant foreign ownership is more common in Hungary and this is more likely to be concentrated ownership with stronger control rights.

8.2 Links between ownership, governance and restructuring performance

This section discusses the relationship between different types of ownership and the consequences that these have for restructuring.[16] Restructuring is influenced by four main considerations: the owners' aims,[17] the distribution of control rights among owners, the availability of new funding and the hardness of enterprise budget constraints.

Economic analysis suggests several outcomes. First, firms remaining in state hands will have the least incentive to restructure. None the less, the hardening of budget constraints may induce some reactive restructuring in those firms, mainly in the form of real wage cutting and some labour shedding. Second, insider-owned firms will go somewhat further than state-owned firms when deciding wage and employment reductions or plant closure. This is because they can exert less pressure on the government, and also because of the increased authority of managers motivated by both profit-maximisation and career concerns. Third, to the extent that deeper restructuring requires additional capital, it is most likely to occur in firms with outside ownership concentrated in the hands of investors with access to finance (such as foreign investors or well-financed domestic institutions). Only such an investor is likely to have both the incentives and the financial ability to incur the new investments involved in deeper restructuring.

The performance of firms (measured by indicators of profitability, growth in sales or labour productivity) should accordingly be highest in outside-controlled firms. Insider-owned firms, especially when controlled by managers, should come second, and state firms "in limbo" should presumably come last. In other words, the initial labelling of governance structures from 1 to 5 given in Section 8.1 should be inversely related to restructuring

15 There are two reasons the distinction between manager and outside individual ownership is unclear in such firms. First, especially in small *de novo* firms, the survey may not distinguish well between the managerial and ownership role of the entrepreneur. Second, the outside individuals holding shares are likely to be family or friends who exercise more influence than dispersed outsiders.

16 There is one important caveat that needs to be borne in mind in interpreting the survey data. There may be a systematic "selection" that affects which types of privatised enterprises fall into different dominant ownership categories. This is probably most serious with respect to insider-owned firms. It is typically the case that management and employee buy-outs involve substantial leveraging (large debt finance) because of the limited assets available to insiders. Insiders would only choose to buy (and banks would only finance) firms with sufficiently high and stable net income capable of covering the debt servicing costs. Thus, insider privatisation may be more likely to occur in the more profitable enterprises. This point is recognised in the recent literature, but the empirical importance of such "selection" has not yet been identified.

17 As will be argued in the following two sections, these aims are themselves influenced by the economic environment, in particular by the state of labour and capital markets.

Table 8.6

Indicators of enterprise restructuring and performance in the Czech Republic, 1993

	Dominant ownership type				
	State	Insiders	IPFs	Domestic outsiders (excluding IPFs)	Foreign
Number of employees	470	75	182	129	212
Profit/sales (%)	3.7	6.1	4.1	2.4	11.4
Reactive restructuring					
Real wage (% change) 1991-93[1]	10.3	8.2	6.1	5.1	44.0
Employment (% change) 1991-93	-23.8	-8.3	-24.2	-14.5	-2.8
Sales (% change) 1991-93	-30.8	-4.1	-33.6	-26.0	3.2
Labour productivity (% change) 1991-93	-15.4	4.0	-12.0	-6.2	1.2
Strategic restructuring					
Exports/sales (%) 1993[2]	20.4 (27.8)	12.0 (20.8)	20.0 (27.6)	20.0 (27.7)	45.0 (46.5)
Exports/sales (%) 1991	12.3 (17.7)	4.7 (14.5)	8.0 (16.4)	4.0 (14.0)	15.0 (24.3)
Deep restructuring					
Investment/sales (%) 1991-93[3]	1.1 (4.2)	0.7 (2.1)	1.1 (2.0)	1.0 (2.9)	2.1 (3.8)
Technology and equipment investment (% total investment) 1993[4]	76.0	80.0	76.0	80.0	79.5

Source
Katsoulacos and Takla (1995). For details, see Table 8.2.

Note
Figures in the table are median values, which are used instead of averages because of "extreme" values.

1 All growth rates in this table are cumulative for the period 1991-93 because the Czech survey only provides data for 1991 and 1993.

2 Exports here includes CMEA exports. Figures in parentheses are unweighted averages.

3 The Czech survey only provides cumulative investment for 1991-93. The figure in the table is estimated as the ratio of cumulative deflated investment to cumulative deflated sales for 1991-93.

4 Percentage of total enterprise investment directed at technology and equipment.

Table 8.7

Indicators of enterprise restructuring and performance in Hungary, 1993

	Dominant ownership type				
	State	Insiders	Domestic outsiders	Foreign	*De novo*
Number of employees	699	293	74[1]	364	32
Profit/sales (%)	0.9	0.3	2.3[1]	0.2	4.4
Reactive restructuring					
Real wage (% change) 1992-93	1.6	-12.9[1]	-26.3[1]	20.6[1]	-6.3
Employment (% change) 1992-93	-12.1	-7.4[1]	-14.3[1]	0.0	6.9
Sales (% change) 1992-93	-5.2	-9.9	-25.3[1]	16.5	17.1
Labour productivity (% change) 1992-93	5.1	-6.7	11.4[1]	22.2	15.2
Strategic restructuring					
Non-CMEA exports/sales 1993 (%)[2]	12.0 (22.9)	19.6 (37.1)	23.0 (22.7)	10.0 (31.5)	0.0 (18.3)
Non-CMEA exports/sales 1989 (%)[2]	10.0 (17.8)	2.3 (12.9)	0.0 (11.4)	10.0 (20.5)	0.0 (6.2)
Deep restructuring					
Investment/sales (%)[2] 1993	0.6 (2.1)	0.2[1] (0.5)	1.1[3] (2.4)	1.1 (5.7)	1.1[3] (1.6)
Firms introducing major new technology (%)[4]	13.9	16.7	23.1	42.9	34.6

Source
Computed from the 1993 World Bank Hungarian enterprise survey. For details, see Table 8.3.

Note
Figures in the table are median values, which are used instead of averages because of "extreme" values.

1 Computed on the basis of between five and ten firms.

2 Figures in parenthesis are unweighted averages.

3 Computed on the basis of fewer than five firms.

4 Percentage of enterprises in each dominant ownership category reporting major investment in new technology within the last two years.

activity and performance. The firms with the most outside ownership should have restructured most deeply and performed best. The performance of firms in the Czech Republic, Hungary and Poland broadly appears to confirm this relationship (Russia, which started privatisation later, has not been included). Tables 8.6-8.8 provide indicators on restructuring and performance for the firms surveyed, including profitability, the growth in wages, employment, sales and labour productivity, export orientation, investment and new technology adoption.

Restructuring and performance

Reactive restructuring

Reactive restructuring is likely to be most clearly reflected in the form of labour shedding and real wage cuts. The tables show that all but one ownership types are shedding labour. Indeed, somewhat surprisingly, the extent of labour shedding appears (from Tables 8.6-8.8) to be largest in state-owned enterprises (SOEs), presumably reflecting the hardening of their budget constraints which impinge most severely on that ownership category. The exception is the Czech Republic, where dominant IPF-owned and state firms have reduced employment to about the same extent. Real wages are falling, except for foreign firms and for all ownership categories in the Czech Republic. That foreign-owned firms increased real wages on average can be explained by the foreign-investors' incentive and financial ability to attract or keep high-quality workers. In marked contrast to

Table 8.8

Indicators of enterprise restructuring and performance in Poland, 1993

	Dominant ownership type				
	State	Insiders	Domestic outsiders	Foreign	*De novo*
Number of employees	548	273	132[1]	423[1]	68
Profit/sales (%)	-0.7	5.5	3.5[1]	-3.2[1]	2.6
Reactive restructuring					
Real wage (% change) 1992-93	-0.5	0.6	-3.8[1]	14.6[1]	-0.8
Employment (% change) 1992-93	-5.5	-0.7	0.8[1]	-5.5[1]	13.6
Sales (% change) 1992-93	5.0	12.5	10.0[1]	19.8[1]	30.0
Labour productivity (% change) 1992-93	14.4	28.2	2.4[1]	33.4[1]	28.1
Strategic restructuring					
Non-CMEA exports/sales 1993 (%)[2]	6.5 (18.7)	0.0 (4.7)	0.0[1] (4.7)	8.7[1] (15.0)	0.0 (16.1)
Non-CMEA exports/sales 1989 (%)[2]	5.0 (10.4)	1.0 (6.3)	0.0[1] (5.0)	8.4[1] (12.5)	0.0 (9.9)
Deep restructuring					
Investment/sales (%)[2] 1993	1.2 (2.4)	2.8 (4.1)	0.0[1] (6.3)	5.8[1] (6.2)	2.6 (5.8)
Firms introducing major new technology (%)[3]	51.6	75.0	71.4	87.5	73.2

Source
Computed from the 1993 World Bank Polish enterprise survey. For details, see Table 8.4.

Note
Figures in the table are median values, which are used instead of averages because of "extreme" values.

1 Computed on the basis of between five and ten firms.

2 Figures in parentheses are unweighted averages.

3 Percentage of enterprises in each dominant ownership category reporting major investment in new technology within the last two years.

all other ownership types, *de novo* firms are increasing employment, which reflects the strong growth experienced by those enterprises.

Strategic restructuring

No clear-cut pattern emerges from the data in Tables 8.6-8.8. A majority of the *de novo* firms in Hungary and Poland, as well as insider- and domestic outsider-owned firms in Poland, do not export to non-CMEA countries (as indicated by the zero median values). As might be expected in a relatively small and increasingly open economy, it appears that in Hungary all dominant ownership types increased the ratio of exports to sales in the period 1989-93. Curiously, in Poland export reorientation appears more common among state-owned enterprises. In the Czech Republic the reorientation of exports is significantly larger in foreign-owned firms and IPF-controlled firms, compared with SOEs and non-IPF outsider-owned firms (presumably with more dispersed shareholding).

Deep restructuring

The investment to sales ratios shown in the tables indicate that foreign-owned firms have been most active in new investment. In Hungary this is particularly striking, while in Poland a generally high investment rate is maintained in all dominant ownership categories except state firms. In the Czech Republic, investment is stronger in foreign firms and lowest in insider-dominated firms, while no systematic differences in investment patterns can be identified between SOEs, insider-owned firms, and non-IPF outside-owned firms. A strikingly large percentage of firms, of all ownership types and in all countries, reported introducing major new technology within the past two years. In Hungary and Poland, the lowest performers in this dimension of restructuring were firms with dominant state ownership.

Performance

As shown by the tables, there are clear differences in some dimensions of enterprise performance across ownership types. Sales growth is nearly twice as high for majority foreign-owned and *de novo* firms than for the other ownership categories both in Hungary and Poland. The differences in labour productivity growth are also quite sharp. In Poland, labour productivity growth is again highest in foreign-owned and *de novo* firms, at about 30 per cent for 1992-93. This is much higher than in domestic outsider-owned and state firms, but insider-owned firms also do well. In Hungary, there is much stronger labour productivity growth in foreign-owned, *de novo*, and domestic outsider-owned firms (in that order) than in the other two categories. It is particularly striking that foreign-owned and *de novo* firms achieve this productivity while increasing employment.

There is no clear-cut pattern across ownership categories in the indicator of enterprise profitability. This is probably due both to the difficulties in measuring profitability accurately (including accounting properly for differences in tax regimes; see Chapter 4) and to the likelihood that insider privatisation was positively related to the profitability of the enterprise. In Hungary, *de novo* firms appear to be doing best, followed by domestic outsiders, whereas in Poland domestic insiders perform best, followed by domestic outsiders and *de novo* firms. In the Czech Republic, profitability is highest in outsider-owned firms with majority stakes held by foreign investors.

There are at least three explanations for the superior performance of *de novo* firms. The first and most elementary explanation is that ownership and management are concentrated in such firms, minimising the incentive ("agency") problems that arise when they are separated, as in most other enterprises.[18] A more compelling explanation is that *de novo* firms typically involve new, market-oriented human capital, which accounts for their superior performance. This is an example of the "selection" process referred to in note 16: entrepreneurs (former workers or managers)

[18] However, this hypothesis fails to explain why *de novo* firms perform distinctly better than dominant manager-owned firms in Russia (the only survey with enough information to distinguish the latter meaningfully). In fact, manager-owned firms are more similar to worker-owned firms than they are to *de novo* enterprises in terms of performance.

Table 8.9

Summary of restructuring outcomes

	Reactive restructuring	Deep restructuring
Czech Republic	High in IPF- and other domestic outsider-owned and state-owned firms	Highest in foreign-owned and lowest in insider-owned firms
Hungary	High in all types of companies	Higher in foreign- and domestic outsider-owned and *de novo* firms. Lower in insider- and state-owned firms
Poland	Significant labour shedding in state- and foreign-owned firms	High in foreign-owned and *de novo* firms, uneven in domestic outsider- and insider-owned firms
Russia[1]	No difference across types of firms	Little deep restructuring across all types of firms

[1] The currently available survey data do not allow any sharp distinctions in restructuring activity across ownership types. See the discussion in Earle, Estrin and Leshchenko (1995).

with such skills are more inclined to create new firms in the first place.[19] The third explanation is that *de novo* enterprises are not burdened with the initial challenge of restructuring, including shedding existing workers and reorienting production.

Summary

There were three propositions, based on economic analysis, suggested in the introduction to Section 8.2. First, all firms are expected to engage in some form of restructuring, if only because of the hardening of enterprise budget constraints. Second, restructuring would be primarily reactive (i.e., limited to reductions in real wages and/or employment), except in firms with concentrated outside ownership where deeper restructuring was expected (e.g., with a foreign investor or, possibly, IPFs if they hold concentrated stakes). The third proposition was that more reactive restructuring would take place in insider-owned firms than in state firms "in limbo". Table 8.9 provides a short summary of the findings.

While the first two propositions appear to be enjoy some support from the available data, there is no clear evidence that more reactive (or strategic) restructuring is taking place in insider-owned firms as compared with state-owned firms.

The findings in this and the previous section are preliminary and should not be over-interpreted. Privatisation has only recently been achieved and, even where restructuring has occurred, it is too early to expect systematic and strong evidence of this in the observed changes in performance. This caveat is relevant for all of the countries examined here. It is particularly relevant for Russia which, partly for this reason, was excluded from the performance section of the survey.[20]

Despite these caveats, the relationships between ownership, governance and restructuring discussed in this section have important policy implications. First, in countries that have not yet engaged in mass privatisation programmes, the design of the privatisation scheme should be aimed at producing governance structures conducive to deep restructuring. Much can be learned from the "models" provided by the Czech, Hungarian, Polish and Russian experiences, not least that privatisation which leads to insider control or dispersed outside ownership may not be sufficient to achieve these aims. Second, privatisations are likely to be much more effective where complementary macroeconomic policies and institutional reforms that facilitate comprehensive enterprise restructuring are also put in place. The next section elaborates this point, focusing on the impact of labour market conditions and emerging capital markets on both the evolution of governance structures and the restructuring behaviour of privatised enterprises.

8.3 Capital markets and effective corporate governance

The first two sections have provided some tentative evidence to suggest that mass privatisation programmes to date may not yet have generated ownership structures that are conducive to effective corporate governance and deep restructuring. There are, however, other factors influencing the implementation of such restructuring. A buoyant labour market can facilitate restructuring by providing alternative activity, and new private sector start-ups can be an important source of such alternative opportunities (see Chapter 9).

An active labour market can play an important role in promoting the dilution of insider control of privatised firms. In choosing to sell their shares, insiders will take into account the prospects for re-employment. Even if they do decide to sell, they will demand a premium to reflect the possibility of an unemployment spell or unattractive earnings prospects, and this will reduce the amount of trading in shares that occurs. By reducing this premium and encouraging insiders to trade their shares, buoyant labour markets can facilitate changes in the ownership pattern that deliver more effective corporate governance. In the Czech Republic, Hungary and Poland, labour market conditions are improving in many respects, largely due to strong growth of new private enterprises. Available information does not indicate any clear improvement in labour market conditions in Russia. On this basis, the insider positions in Hungary and Poland are more likely to be unwound if good labour market prospects persist, but this appears unlikely to be an effective mechanism in the short term in Russia.

[19] While this explanation is plausible, there is no systematic evidence yet to support it. For discussion and preliminary evidence, see Barberis, Boycko, Schleifer and Tsukanova (1995); and see Richter and Schaffer (1995).

[20] The available survey evidence for Russia indicates that only limited reactive restructuring has taken place, and there is no evidence linking it to dominant ownership type. Moreover, there is no correlation between the form of dominant ownership and rankings by managers of the importance of different dimensions of restructuring (such as reducing employment, wages, social benefits, etc.). See Earle, Estrin and Leshchenko (1995), and Fan and Fang (1994).

In any event, the evolution from insider to concentrated outsider ownership will require well-functioning securities markets to facilitate share trading. This section of the chapter briefly summarises some of the main economic issues involved in assessing whether such secondary markets are likely to bring about changes in ownership that improve governance. The analysis focuses on whether restrictions on secondary trading in shares are significant enough to inhibit restructuring, the incentives of insiders and investment funds to trade, and on whether the emerging capital markets are sufficiently well developed for this purpose (see Chapter 10).

Incentives for trading in shares

The distinction made throughout this chapter between insider and outsider ownership is static. Neither initial insider nor diluted outside ownership should be treated as a final outcome. In principle, shareholders of all types can trade their shares and thereby alter the composition of ownership. However, the optimal amount of reselling of shares, and thus eventually of restructuring, may not automatically take place. This may not occur because of restrictions on the tradability of shares and because of limitations on the incentives of current owners to trade.

There are some restrictions on incumbent shareholders in privatised enterprises in selling their shares and on market transactions. Management and employee buy-outs in Hungary and Romania involve restrictions on the tradability of shares, at least until the debts associated with the transactions have been repaid. In the Czech Republic, restrictions on tradability stem from the legal structure of the investment funds that intermediated the allocation of most vouchers in the two phases of privatisation. These funds have largely been converted to unit trusts from joint-stock companies, a legal form that helps to protect the fund managers from the threat of take-over. Restrictions on the tradability of shares of privatised enterprises pose serious obstacles to markets for enterprise control and thus to restructuring.

Insider-owned firms

Insider privatisation might not lead to a desirable level of resale of shares. There is first the "free-rider problem", a major source of inefficiency of the take-over mechanisms implemented in Western countries. Unless constrained to do so because of liquidity problems, no small worker-shareholder will find it profitable to sell his or her shares to an outside investor before the restructuring process brought about by outside privatisation has been completed because it is the restructuring itself which is likely to increase the value of the firm. Furthermore, the price at which worker-shareholders will agree to sell their shares might make it unprofitable for potential outsiders to purchase a controlling stake in the firm.

Second, workers might be more reluctant to sell their shares to an outsider if they anticipate they might lose their jobs as a result of restructuring following outside privatisation. This fear of losing their jobs could, in principle, be used by incumbent management to impede take-overs by outsiders. However, in deciding whether or not to sell shares, individual worker-shareholders are aware of having only a negligible influence on the overall success or failure of the outside takeover process and therefore on the probability of losing a job. Hence, in the absence of coordinated decision-making by insiders, bids by outsiders are unlikely to be blocked effectively. In addition, there have been many cases of manager-owners manipulating the resale process, both directly through threats of dismissal of workers and through illegal refusal to record ownership changes in shareholder registers, and indirectly by withholding information about the firm. A recent survey showed that only 10 per cent of Russian voucher funds reported having regular access to financial data on companies in which they hold large equity stakes, 36.8 per cent reported having casual access to information and 12.5 per cent reported having no information at all.[21]

Investment funds as owners

Investment funds have been used as part of mass privatisation programmes to foster effective outside ownership and governance of privatised enterprises. Their role has been particularly significant in mass privatisation programmes, where the scale and, in some cases, speed of implementation raised concerns about the quality of post-privatisation ownership structures. Such funds have featured prominently in the Czech Republic and, to a smaller extent, in Poland and Russia. However, the inherent risk of this approach to solving the governance problem at the enterprise level is the possibility of simply recreating the same problem at the level of the investment funds. In other words, for the investment funds to perform an effective governance role, they must themselves be subject to effective control by their shareholders.

There have been two approaches to fostering the development of investments funds in the context of mass privatisation programmes. One relies on private initiatives to establish the intermediaries, while in the other the state oversees the formation of the funds.

In Russia and the former Czechoslovakia, the governments created the legal and regulatory framework necessary for the operation of the investment funds and then allowed their relatively free formation. In both countries, there was a rapid formation of large numbers of investment funds: 516 in Russia and over 420 active funds in the former Czechoslovakia. In both countries the top 10-20 investment funds account for the bulk of funds' overall shareholdings. In the Czech and Slovak Republics, about 70 per cent of vouchers issued are in the hands of the investment funds. The main investment funds are themselves indirectly owned by the major banks.[22] The Russian investment funds have played a much smaller role, mobilising about 6 per cent of the vouchers allocated to households, and the majority of these funds do not have close ties with banks.

[21] See Pistor, Frydman and Rapaczynski (1994).

[22] The close and reciprocal ownership ties between the investment funds and banks itself raises some concern about the governance and performance of funds.

The approach to the formation of privatisation intermediaries in Poland was very different. The Polish mass privatisation programme is being implemented through 15 investment funds for which the state has selected the management teams by international tender. The allocation of the 413 enterprises to these funds is being implemented through a series of selection rounds in which each fund manager can select individual firms to be included in the fund's portfolio. The selection procedures ensure that effective control will be exercised by one "leading" fund and that the remaining shares in each enterprise will be held on a broadly diversified basis among the other funds. Once the enterprise shares have been fully allocated to the investment funds (scheduled for November 1995), Polish citizens will receive shares in the investment funds for a small fee. The shares of the investment funds are to be listed on the Warsaw Stock Exchange within two years, which would then allow investors to rebalance their stakes in the various funds. The Polish approach to mass privatisation relies upon extensive oversight by the government to achieve effective ownership and control of both the participating enterprises and of the investment funds themselves. To the extent that these goals have been achieved, however, the cost in terms of delay due to extensive political controversy and opposition has been considerable. The scheme was first proposed in 1991, but adopted only in 1995.

The experience in the region thus points to a choice between the "Czech (or Russian) approach", that is, the rapid creation of investment funds that play a significant role in privatisation (in particular through their affiliation with banks and the use of their branch networks), and the "Polish approach", which is based on the careful structuring of investment funds by the state to ensure effective governance of both enterprises and funds. While the evidence on the effectiveness of the two approaches is sparse, there is some indication that the Czech approach may have somewhat limited the potential effectiveness of the funds as a source of enterprise governance. A recent study of the share price performance of Czech and Slovak enterprises found that, while the stock market valuation of enterprises is higher for firms with concentrated outside ownership, this premium is largely lost if that outside owner is an investment fund.[23] This may be due to the limited ability of investment funds to exercise effective control under existing voting rules in "enterprise charters". It may also reflect an unwillingness by the funds to exercise effective governance due to the potential conflicts of interest between the banks and their affiliated investment funds. On the other hand, the Polish approach also poses problems – the greater state involvement raises the considerable risk of delay.

The development of more liquid secondary markets for shares can also facilitate the concentration of outside ownership in enterprises. The volume of securities market activity, both on-exchange and off-exchange, has expanded rapidly in the Czech Republic, Hungary, Poland, Russia, the Slovak Republic and Slovenia (see Chapter 10). However, these markets remain relatively illiquid compared with those in advanced industrial and high-growth East Asian countries. While liquid and properly regulated securities markets can facilitate an efficient reallocation of ownership and control of enterprises, a legal framework which safeguards property rights in securities is also required in order for this to proceed on a significant scale (see Chapter 6).[24]

8.4 Concluding remarks

The analysis of the early evidence on privatisation and restructuring of former state-owned enterprises in the Czech Republic, Hungary, Poland and Russia yields several important findings. First, the mass privatisation programmes have led, for the most part, either to insider ownership (by workers and managers) or dispersed outsider ownership, at least initially. Second, on the whole the same kind and extent of "reactive restructuring" (involving reductions in real wages and employment) have taken place in state-owned, insider-owned, and dispersed outsider-owned enterprises, mainly as a consequence of the hardening of enterprise budget constraints. This finding underlines the importance of macroeconomic stabilisation, price and trade liberalisation, and reform of banks and other financial institutions as means of enforcing market-oriented financial discipline on enterprises. Third, there is some suggestive evidence that effective corporate governance is necessary to deliver "deeper restructuring", and particularly new capital investment. It seems that more such restructuring may have been undertaken by firms with concentrated outside ownership, especially those owned by foreign investors and, to a smaller extent, firms controlled by investment funds or banks.

These findings have policy implications both for countries that have already implemented mass privatisation programmes and for the design of privatisation schemes in transition countries where a large proportion of enterprises remain in state hands. In the former case, further improvements to corporate governance may require the evolution of more concentrated outsider ownership of enterprises. This in turn depends on the development of strong and liquid capital markets to facilitate the resale of shares by insiders, and on active non-bank financial institutions (including investment funds) participating as investors and potential core owners in those markets. Appropriate institutional and regulatory infrastructure will need to be put into place to support these capital markets. Some limited progress has already been made on these issues in the region (see Chapter 10).

For the majority of countries in the region, which have not yet undertaken comprehensive privatisation, the analysis in this chapter underlines the importance of improving the design of privatisation schemes to deliver more effective enterprise governance, as well as strengthening governance of the investment funds involved in the privatisation programme.[25] It is becoming clear, as

[23] See Claessens (1995). The positive impact of concentrated outsider ownership on the share prices of privatised enterprises is also documented by van Wijnbergen and Marcinčin (1995).

[24] In Russia, for example, the only evidence of share ownership is the physical register of an enterprise. The enterprise manager often controls this, directly or indirectly. The management of at least one Russian enterprise has, apparently legally, deleted the name from its register of a shareholder who was suspected of mounting an acquisition bid.

[25] This may involve a broader range of instruments, including shares with differentiated control rights (such as voting and non-voting shares) and leasing rights for employees and managers.

economic analysis suggests, that the choice of the method of privatisation has a significant impact on corporate governance and hence restructuring. This choice appears to influence both the depth and the pace of restructuring, at least initially. It is too early to tell whether the apparent divergence of restructuring outcomes will be sustained in the long run. Much will depend on the maintenance of hard budget constraints through competition in product and banking markets, and the parallel development of capital markets with sufficient liquidity and transparency to deliver restructuring. The economic performance and viability of enterprises, and thus the prospects for successful transition and growth, will depend critically on whether effective, market-oriented restructuring takes place.

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Small and medium-sized enterprises

9

In a well-functioning market economy there is no *a priori* reason for encouraging any particular type of enterprise or activity. The market provides the guidance. However, there are two reasons why small and medium-sized enterprises (SMEs)[1] deserve special attention in the context of transition. The first is that they generate economic benefits, beyond the boundary of the individual enterprise, that are not reflected fully in the enterprise's own profitability ("positive externalities"). These benefits are likely to be especially strong in economies undergoing radical transformation, where experimentation, learning and adaptability are particularly important. The second reason is that SMEs were severely discriminated against in centrally planned economies and continue to operate under a number of handicaps and restrictions during the transition. If effective policies to remove these restrictions are put in place, SMEs can become an engine for transition and growth.

Before the rise of communism, SMEs played a vital role in the economies of eastern Europe. In the early 1930s over two-thirds of the labour force of the former Czechoslovakia and Hungary were employed in SMEs. However, by 1989 they accounted for less than a third of employment in these countries, and the average enterprise size had grown to about 2,000 workers, compared with an average of only seven workers in the European Union.

The creativity that characterises SME development posed a fundamental threat to command economies. SMEs were often actively suppressed, or outlawed, as the antithesis of central planning. Squeezed into peripheral economic activities, they survived, often informally, despite the overwhelming bias in favour of large state-owned enterprises (SOEs). The restrictions placed on SME activity often limited entrepreneurship to illegal activities. This served to increase political antagonism to SMEs and to compound the negative image and the difficulties facing private entrepreneurs. SMEs continue to suffer from negative biases in government policy and from discrimination in the regulations and incentives that govern enterprise formation and growth. To realise the social and private benefits offered by SMEs, the systematic bias in favour of large enterprises must be replaced by a "level playing field" on which all forms of business activity are treated equally by the state, particularly with respect to taxation and the regulatory framework.

SMEs have played a particularly important role in periods following economic and political dislocation. In West Germany, for example, the development of SMEs was integral to post-war recovery, and in OECD and developing economies SMEs are credited with providing the dynamism that underpinned the recovery in employment and output in the 1980s. SMEs may be the first to suffer during downturns, but they can also be the first to seize on improved opportunities. The motivation and flexibility of SMEs in responding to economic opportunities can be a stabilising influence. SMEs provide alternative employment options for workers threatened by unemployment in the process of enterprise restructuring. Moreover, SMEs tend to recruit from SOEs, and in so doing facilitate the rationalisation of the public sector.

The discussion of their role in transition is organised as follows. Section 9.1 (and Box 9.1) provides a summary of the evidence on the formation and growth of SMEs. It draws on available surveys and research, and examines their particular contribution to transition. Section 9.2 examines the constraints facing SME development, which often include discriminatory taxation and regulation, macroeconomic instability, and shortage of capital and suitable skilled labour. Section 9.3 concludes by examining the scope and limitations of policy reform in assisting SME development.

9.1 SMEs in transition

The analysis of the role of SMEs in the transition economies is frustrated by the virtual absence of reliable information. The problems of measurement and the lessons that may be drawn from comparative perspectives are summarised in Box 9.1. This box shows that, in general, the contribution of SMEs to output and employment rises as the transition advances. In all OECD economies, SMEs account for over half of employment and output and the bulk of private sector activity. Through their constant search for new market opportunities SMEs provide a competitive challenge underpinning market economies.

The special role of SMEs in the transition to a market economy partly derives from the positive "spill-overs" or externalities they generate. These include the benefits that new entrants offer by invigorating markets, providing innovative products and introducing processes that challenge existing production patterns. SMEs are the seed-bed for the emergence of competitive (and the destruction of uncompetitive) larger firms. The greater the number and more fertile the ground, the more dynamic the economy.

SME growth in transition economies is dominated by the entry of new small firms. In the Czech Republic and Poland, where relatively good empirical evidence is available, the transition period

[1] In transition economies the legal definition of SMEs tends to have a lower ceiling than in OECD countries, reflecting the fact that the majority of SMEs were very young at the time the legislation in transition economies was drafted. The ceiling for medium enterprises is generally 500 employees in OECD countries but 200 in transition economies; this chapter uses the latter definition. According to Eurostat, the ceiling for small enterprises is 49 and for micro-enterprises nine employees.

Box 9.1

Measuring SMEs

Analysis of the formation and growth of SMEs in transition economies is difficult because of a lack of reliable information. The available information is summarised in Annex 9.1. Interpreting the data is hazardous. Official data typically cover only registered enterprises, excluding the informal sector, which in transition economies may be large (for example, in Hungary it is estimated at 26 per cent of GDP, in Bulgaria 17 per cent of gross value added, and in Estonia 35 per cent of private sector activity).[1]

The official data also fail to identify inactive enterprises, which are very numerous in some countries. For example, an EBRD survey of Bulgarian SMEs in 1995 found that only 20 per cent of registered private enterprises in manufacturing were active, while the rest had gone bankrupt, relocated, changed their activities, or had never operated as enterprises, but simply registered as an indication of intent or for other reasons. Registration requirements vary greatly. In Albania, enterprises are no longer required to register at all. In most of Central Asia registration does not include any measure of firm size. High-inflation environments make measuring firm size by asset value or sales problematic. Employment is the most reliable basis for measurement, but this can be misleading if it is not differentiated by economic sector. For example, within the service sector 20 employees is relatively large, while in the manufacturing sector it is relatively small. Unfortunately, only Belarus, Russia and Slovenia provide sectoral breakdowns of their enterprise census data.

These limitations lead to both an under-reporting of unsuccessful firms and to a failure to measure success, in that as firms grow they are not reregistered. Meanwhile, firms that are very successful cease to appear on the register of SMEs as they become large enterprises. In transition economies, relatively few enterprises would have already exceeded the ceiling for SME classification. Overall, official statistics provide at best a rough indication of the structure and growth of the SME sector.

Table 9.1 shows that, in general, countries in the earlier stages of transition display the lowest share of employment in SMEs (Belarus, Kyrgyzstan, Tajikistan) and, as is to be expected, SMEs are more important in the more advanced transition economies (the Czech Republic, Estonia, Poland) and OECD countries. Equally, as is indicated in Annex 9.1, countries in the earlier stages of transition tend to have the weakest institutional environment for SMEs (Belarus), while the more advanced countries (the Czech Republic, Hungary, Poland) have a more comprehensive policy framework for SMEs. The sectoral distribution of SME activities also reflects the wider economic context. Initially, SME activity is concentrated in the retail and commercial sectors but, as the transition proceeds, a significant SME presence is established in manufacturing. In countries where this has happened, such as Poland, the evidence suggests that SMEs (particularly newly created, or *de novo*, private firms) in the manufacturing sector provide the "engine of growth" for the whole economy.

[1] One would expect that nearly all of informal sector activity is associated with (private and state) SMEs. See Annex 2.1 in Chapter 2 for a discussion of the sizes of the private and informal sectors.

has been marked by a sudden surge of small-scale start-ups. The SME sector is already a strong domestic force for economic development.[2] In all transition economies, the average size of SMEs is related to the number of years private sector activity has been legal in the country.

[2] See, for example, Belka *et al.* (1994).

Table 9.1

Comparative perspectives

Country	Percentage of employment in SMEs
Belarus	6
Croatia	30
Czech Republic	37
Estonia	45
FYR Macedonia	37
Georgia	58
Hungary	24
Kyrgyzstan	3
Poland	23
Romania	27
Russia	10
Slovak Republic	23
Slovenia	19
Tajikistan	2
EUR 12	69
Belgium	72
France	69
Germany	64
Italy	80
Japan	73
UK	76
USA	53

Sources
Globalisation of Economic Activities and the Development of SMEs, Country Reports, Enterprises in Europe, EBRD *Transition Report* 1994.

Note
The table covers those countries for which relevant data are available.

Small firms contribute importantly to experimentation with new ideas and products. The prospect of uncovering the best ideas is increased as more of these ideas are tried. They are best tried on a small scale at first so that successful ideas can be revealed, imitated and diffused. From an individual point of view, it may be better to wait and be an imitator of a successful idea rather than to pioneer and risk failure and the loss of one's savings. This disincentive to enter the market is offset, however, by the fact that, between the time of success and imitation, the successful entrant will enjoy a special market position that compensates for the risk taken. This incentive is particularly great in transition economies where the upside potential of a successful venture may be relatively high, given both the likely lack of close competitors in any given product or service market and the large number of possible markets that new firms can choose to enter.

Given the immature state of product markets in transition economies, new ideas often take the form of untried market niches and/or speculative trading, as well as the adoption of new advanced technologies to enhance existing products or services. Here, the temporary monopoly and other advantages that a successful new entrant can hope to enjoy can be a strong incentive, overriding the inclination to wait and imitate a rival firm's successful venture. SME formation has in part been based on transplanting existing products and services on offer in the West, with the necessary modifications and adjustments to meet the

consumer requirements in a transition economy. Uncertainty as to tastes and incomes of customers, and the suitability of the product, mean that experimentation can have strong returns, and SMEs provide a test-bed.

For privatised retail businesses in the Czech Republic, Hungary and Poland, post-privatisation investment was found to be highest in cases involving the entry of a new entrepreneur, unrelated to pre-privatisation performance.[3] In transition economies, since small firms will naturally locate in promising new market niches, they are likely to take away market share from the typically older and staler products offered by state-owned enterprises. This also has the benefit of increasing competition and consumer welfare in the short term by extending the range of products available, bringing the mix of products closer to consumer tastes and lowering prices. In the longer term, SMEs advance the transformation process in state-owned enterprises by hardening their budget constraint through product market competition.[4]

For an established firm, which might already hold a very large market share, the introduction of any new lines of business is bound to displace some of the profits being earned on existing lines and therefore the incentive for making improvements may be lower. However, a willingness to make radical and rapid responses is at a premium in transition economies where business opportunities appear and disappear with great speed. That SMEs are flexible is indicated by evidence that when new firms register in eastern Europe, they list a wide range of often unrelated business activities, which may suggest a prior determination to keep options open and try new approaches where old ones fail.

The high volatility of small firms in terms of entry, survival and growth reflects the nature of the risks and uncertainties facing SMEs. There is a steep learning curve associated with understanding risks and making judgements regarding location, product specification and management. In the early years, this leads to a large number of failures and also explains the high growth rate among survivors who have, on average, made better choices.[5]

The emergence of entrepreneurial small firms in distribution and retailing can, by breaking monopolistic trading structures, enhance the productivity of domestic firms and create an atmosphere conducive to the entry of foreign firms. In Russia, for example, even though a private commercial sector has developed, the state-owned sector still plays a major role in the supply of inputs and outputs.[6] The broadening of the private sector dilutes the concentration of economic power and reduces the risk of rent-seeking.

A major problem in the transition is the mismatch between existing and market-compatible skills. By providing opportunities for employment to employees and managers of state-owned enterprises, SMEs mitigate the employment losses that are inevitable in the process of restructuring. The evidence suggests that private firms in transition economies tend to recruit from the state sector, rather than from the pool of unemployed.[7] Thus, even if SMEs do not generate any net new jobs, they reduce the erosion of human capital by providing alternative employment opportunities for relatively skilled workers. This role of the private sector, and SMEs specifically, is likely to be more important in the early and middle stages of transition when the state sector is still dominant.

In the small-scale privatisation of enterprises that are labour-intensive, the key asset of value that has been transferred to the private sector is typically the premises in which the business is located. One survey of the Czech Republic, Hungary and Poland found that 70 per cent of privatised firms did not take over any movable assets from their predecessors. To the extent that privatisation in this context represents a simple "conveyance of ownership or user rights in real estate", the distinction between privatised firms and start-up businesses becomes blurred.[8] In other countries, such as in the former Soviet Union, privatisation contracts have often included the tied sale of any remaining assets and an enforced continuation of the old line of business, sometimes reducing the value of the land and fixed assets. Earlier surveys indicated that, in the first years of transition, *de novo* SMEs bought their equipment second-hand from SOEs.[9] More recent surveys show that the average age of the capital stock of start-up SMEs has dropped considerably, suggesting rapid modernisation and a higher level of investment.[10] The surveys also show, as summarised in Box 9.2, that there are significant differences between SMEs that are created *de novo* and those that are spin-offs from SOEs.

Given the imperfect nature of capital markets in transition economies, there is often a reliance of start-up SMEs on funding by friends and relatives of the entrepreneur. The small firm sector then creates an incentive for savings that might not otherwise occur.[11] This arises from the fact that the banking sectors in these countries do not typically offer very attractive rates on consumer deposits, and banks also tend to be biased against lending to the

[3] Earle *et al.* (1994).

[4] This is one of the important lessons from the transition experience in China during the last decade. SMEs have played a key role in forcing state-owned enterprises to restructure by providing effective competition in domestic product markets (and increasingly, export) markets. See Jefferson and Rawski (1994).

[5] This "learning" model of firm growth and survival was originally presented in Jovanovic (1982). The idea has been developed extensively and tested empirically in the more recent literature. See, for example, Cabral (1995), Evans (1987a,b), Hall (1987), Dunne *et al.* (1989), and Acs and Audretsch (1993).

[6] Sheppard (1994), p. 189.

[7] Boeri (1995) provides statistical evidence for Bulgaria, the Czech Republic, Hungary, Poland and the Slovak Republic for 1991 and 1992.

[8] See Belka *et al.* (1994); Gomulka (1994); Earle, Estrin and Leschchenko (1995); and Earle *et al.* (1994).

[9] See Webster (1992), and Webster and Charap (1993).

[10] See Earle and Estrin (1995) and Richter and Schaffer (1995). See also the evidence on *de novo* firms in Chapter 8.

[11] See Arrow (1995).

Box 9.2

Comparing start-ups and spin-offs

The overwhelming majority of new firms are created *de novo*.[1] By entering sectors where sunk costs are lower, they also tend to reduce their risks; this is an explanation for the concentration in Poland, Russia and a number of other transition economies of *de novo* entry in the retail trade and service sectors. In transition economies, in addition to the creation of new firms, a considerable portion of new entry may occur through the process of unbundling or *spin-off* of state-owned enterprises.[2] This involves the break-up of larger, formerly state-owned enterprises into smaller, privately run firms. In addition, the privatisation of former state-owned small enterprises (such as bakeries or restaurants) leads to the change of ownership status of SMEs.

The relative size of the *de novo* part of the private sector is affected by the stage of transition of the country. It is generally larger in countries that allowed some private sector activity prior to transition than in countries which did not. For example, in Russia it is much smaller than in those countries that initiated their transition earlier (the Czech Republic, Hungary, Poland). In Poland, spin-offs from state enterprises barely contributed to the formation of the private industrial sector, whereas in the Czech Republic, Hungary and Kazakstan spin-offs were particularly important in the earlier stages of transition due to large-scale enterprise restructuring.

Profitability is notoriously difficult to assess, in part because firms tend to "hide profits" (hence the self-declared loss-makers can be very profitable firms). Russian investment figures point to robust growth, with a higher percentage of start-ups investing (85 per cent) or expecting to do so in the future (62 per cent), compared to their spin-off counterparts (57 per cent and 32 per cent respectively). Much of this investment is debt financed, with a high percentage of start-ups and spin-offs benefiting from a bank loan (64 and 74 per cent, respectively, in the study of Russia) . Although spin-offs rely more heavily on bank loans, the terms offered by banks to start-ups appear to be better than those offered to their privatised/state sector counterparts. This has important implications for policy, discussed below.

In terms of performance, the study of Russia indicates that the *de novo* SMEs recorded an increase in real sales of 17 per cent in 1994 over 1993, versus a drop of 5 per cent recorded by privatised and state-owned SMEs. In terms of capacity utilisation, *de novo* firms operate at a much higher level than privatised and state-owned firms. Striking differences are also recorded as far as employment growth is concerned (30 per cent growth in the last year for start-ups versus a 13 per cent decline for privatised and state-owned SMEs), which partly reflects labour shedding connected with the restructuring of the latter group. Twice as many privatised and state-owned firms than start-ups report excess employment.

In Russia, over 20 per cent of start-ups and 9 per cent of state-owned, privatised SMEs reported that they need more workers. The presence of a high vacancy rate (8 per cent of employment) in *de novo* firms (versus 2 per cent of employment in privatised and state-owned SMEs) points to growth and expansion. Both start-up and spin-off SMEs attributed their high vacancy rates to the lack of qualified applicants; whereas two-thirds of privatised and state-owned SMEs blamed their inability to pay attractive wages as the main reason for vacancies, only one-third of the *de novo* firms identified this reason.

Spin-offs have not yet been the focus of extensive investigation, despite the fact that, in countries such as former Czechoslovakia, Hungary and Kazakstan, massive break-ups of SOEs took place even before the government formulated a privatisation policy. In 1990 in former Czechoslovakia, there were 700 private enterprises employing more than 25 workers; by mid-1992, 2,000 enterprises belonged to this category, with a substantial part of the difference composed of the break-up of state enterprises. The government played a passive role in this process and it may be argued that the decision to split from a parent company was taken by the managers of the spun-off enterprises in the expectation of a benefit, although not necessarily of a pecuniary nature. In the Czech Republic, the evidence indicated that the spun-off enterprises do not generally outperform their parent SOEs. The performance of the parent SOE was nevertheless enhanced by the unbundling, so that this remains the preferred option to the previous status quo. Start-ups outperform the whole set of state and privatised enterprises (including spin-offs).[3]

[1] The available data on private sector enterprises (including SMEs) are not usually broken down according to the way enterprises were created, so we cannot easily compare the characteristics (including size and performance) of spin-offs, start-ups and enterprises privatised as a single unit.

[2] These proportions vary across countries. Johnson and Loveman (1994) found that the rapid growth in the Polish private sector stemmed more from the entry of new firms than privatisation. In the Czech Republic privatisation was more significant, with about 19,000 of the 68,000 trade and services establishments sold off in the small-scale privatisation programme (Earle *et al.* 1994, p. 63).

[3] Lizal, Singer and Svejnar (1995).

more risky and less established entrepreneurial establishments. Friends and relatives often have private knowledge of the abilities of entrepreneurs which make them more amenable than commercial banks to lending funds to these firms. Thus, these individuals save more than they would have saved if they had only the option of depositing funds with commercial banks. In the more advanced transition economies, where investment funds specialising in privatisation vouchers are present and the banking sector is more developed, this savings effect is likely to be lower since access to more risk-diversified sources of savings that offer sufficiently high (risk-adjusted) rates of return will be available. To the extent that SMEs remain outside the traditional state credit ring, their demand for finance will continue to provide an impetus for the development of a commercial banking sector.

9.2 Constraints facing SMEs

Surveys of the Czech Republic, Hungary, Poland and Russia in the very early years of transition showed SMEs to be subject to a common set of constraints, many of which are associated with transition itself.[12] The following discussion draws on these surveys.

Among the most significant obstacles to the formation and growth of SMEs were the high level of taxes, the frequently changing regulatory environment, delinquent payment by SOEs, weak demand for domestic products, instability created by high inflation and credit-related problems. More recent surveys reveal a different set of constraints, suggesting that these evolve with the transition process. For example, reforms of the taxation system have reduced the extent to which taxes are seen as a constraint. Delinquent payments and weak demand also became less of a problem as the transition has advanced because, whereas initially SMEs were tightly linked with SOEs, alternative networks and

[12] References to the surveys are provided above (see Belka *et al.* (1994); Earle and Estrin (1994); Gomulka (1994); Lizal, Singer and Svejnar (1995); Richter and Schaffer (1995); Webster (1993a, b); Webster and Charap (1993); and Webster and Swanson (1993).

products were gradually established. As transition progresses, SMEs depend less on large SOEs in order to purchase inputs of production and sell their own products. Similarly, whereas at the beginning of transition almost all firms utilised cast-off, obsolete equipment from SOEs, more recent research has shown that the average age of equipment utilised by privately owned SMEs has decreased substantially, reflecting the growth in investment and innovation.[13] Macroeconomic factors also appear as less important constraints on SME activity over time because, as the transition progresses, economic stabilisation reduces inflation and economic uncertainty.

Firms generally relied on their own savings and private sources for starting up and then, once they were established, appeared to have access to short-term (less than one-year) bank loans. The high level of interest rates, rather than access to credit, is regarded by them as a constraint that constitutes an obstacle to growth and investment. SMEs reported that they first had to identify a niche in the market in which high returns could be obtained before they could take out a loan and pay the high interest rates. Overcoming this obstacle requires improvements in the banking sector but it will also require changes in enterprise behaviour. The underreporting of profits and turnover for tax avoidance purposes penalises SMEs' borrowing, as does their failure to register ownership of assets.

Except in Russia, where less than half the firms surveyed had received a short-term loan, the dearth of longer-term financing, rather than the availability of short-term credit, appears to be a constraint. Start-up capital in Russia, more than in other countries, was mostly provided by own savings and advance credit from customers.[14] In other surveyed transition economies, SMEs had access to short-term loans but longer maturity loans were available to SMEs only in the Czech Republic and Hungary. In the Czech Republic, four out of five loans had a duration longer than one year and in Hungary one-third of entrepreneurs had received long-term loans.

Many firms highlighted the constraints connected with the functioning of the labour market. Vacancies appear to be difficult to fill. Skilled workers are difficult to find. Labour mobility is poor and the lack of job centres or similar structures makes it difficult to mobilise workers who live far away from the vacancy location. Such constraints, although not peculiar to SMEs, nevertheless can have a more immediate and severe effect on SMEs and are less easily circumvented by them.

In the early stages of transition, SMEs are particularly constrained by hostile social environments. Private entrepreneurial activity was regarded as anti-social behaviour and seen to be at the expense of other members of the community and derived from connections to the "nomenklatura" and/or illicit activities. This hostile perception of entrepreneurs provides a considerable psychological barrier to the entry and growth of the SME sector. It dissipates, however, as social acceptance of the market deepens and a critical mass of entrepreneurs who provide peer support is established.

Other constraints that are associated with a relatively early stage of transition include those relating to the macroeconomic climate of the individual country, to gaps and imperfections in the regulatory environment, to the state of the local infrastructure and to the domestic economic environment in general. The flexibility of SMEs allows them to adapt to difficult conditions imposed by substandard infrastructure or imperfections in the regulatory environment. Nevertheless, their performance and efficiency are diminished by the hostile environment, particularly in so far as this disadvantages newcomers and weak enterprises that have neither the internal resources nor necessary networks to overcome obstacles. Large firms can use non-market mechanisms to internalise many of the technical, legal and commercial functions that they need to conduct business. SMEs, by contrast, lack the resources and diversity and so are forced to rely more on external sources for these services. This implies transaction costs. The less developed the external services, the higher the transaction costs to the SME, suggesting that the competitive disadvantage for SMEs will be greater at earlier stages of transition.

The social and many other constraints on SME development appear to be associated with the early stages of transition and are overcome as the transition evolves. In the first phases of transition, the enterprises themselves and the economic and institutional environment as a whole are immature, and levels of uncertainty are acute. During this phase, SMEs face a formidable array of obstacles, many of which diminish over time as enterprises learn by doing and as the foundations of a market economy are laid. SMEs are particularly susceptible to the uncertainty that characterises the first phases of transition and, unlike large enterprises, do not have the experience, internal resources or leverage to compensate for many of the weaknesses apparent in the external environment. Their lack of resources and influence can make them fragile but their small size and agility gives them compensating advantages in an uncertain world which demands the rapid adoption of innovatory practices and products.

The establishment of a mature market economy requires the establishment of a level playing field where SMEs may have access to inputs, goods, services and capital markets on a similar basis to large firms. Past practices that favoured large firms mean that specific policies are required to facilitate SME development. Centrally planned economies tended to marginalise the activities of SMEs, and countries in the initial stages of transition tend to be dominated by large SOEs. This domination by large firms is mirrored in the capital markets, where access to credit can be

[13] The average age of equipment in SMEs (weighted by value) varied between eight and 10 years in eastern Europe (the Czech and Slovak Republics, Hungary and Poland), and between 10 and 20 years in Russia. See Webster (1993a, b); Webster and Charap (1993); and Webster *et al.* (1993).

[14] See citations in the preceding footnote.

based on historically determined working practices and networks that closely link state banks with state and other large enterprises.

In the context of transition, all the problems of uncertainty facing Western firms exist. In addition, SMEs are faced by a wide range of new sources of unpredictable factors which potentially affect their activities. These include uncertainty over macroeconomic factors (such as future price levels, exchange rates and fiscal policy), the absence of a stable legal infrastructure, and competition issues (such as government policy towards horizontal and vertical integration, entry barriers and restrictive trade practices). To the extent that this uncertainty is greater than in market economies, one would expect the growth and survival patterns of firms in transition, and particularly small and start-up firms in transition, to be more turbulent than in developed market economies.

9.3 Directions for policy reform

Policies in support of SME development in OECD countries tend to be based on specific targets or local priorities, often partly non-economic in origin. For example, in many OECD countries, support for SMEs is considered to be a means of enhancing inner-city or minority group employment, by offering jobs to the long-term unemployed. The policies may also have purely economic objectives based on "externalities" arguments, for example encouraging the development of particular segments of the economy, such as high-technology companies. In transition economies, the objectives of SME policies go beyond those in the OECD countries because the level of discrimination against SMEs has been more acute and because SMEs provide externalities that are of special significance in the transition process. In particular, the success or failure of SMEs provide demonstration effects that are stronger in transition economies than advanced market economies, and the growth of SMEs can ease the burdens of subsidy and adjustment associated with large and obsolete state-owned enterprises.

The most important policy reforms that facilitate SME development, whether in OECD or transition economies, are those that influence the overall enterprise environment. Macroeconomic stabilisation and price reforms that bring stable and freely determined market prices are essential to ensure correct signalling and to reduce the uncertainty facing SMEs. Trade reforms, which allow domestic prices to reflect international competitiveness and which end the effective protection of the status quo, will foster sustainable SME development. The government framework for business and for enterprise restructuring and a commitment to privatisation are also vital as, taken together, they determine the potential for private sector development. SME development is facilitated by a stable legal system that allows newcomers to compete with established firms on the basis of a transparent set of rules and without fear of intimidation. Corruption, nepotism and crime tend to discriminate against newcomers and smaller, weaker firms, and thus to stifle competition.

By giving priority to overall economic management and to laying the foundations for a market economy, governments in transition economies are simultaneously providing the appropriate seed-bed for SME development. Within the context of the probable need to reduce overall levels of public spending, measures taken by governments to reform social expenditures and refocus infrastructure investments can benefit the whole economy and not least SMEs. For example, the demand for a skilled workforce is met through improved education, mobility problems are eased by the provision of housing, communications are facilitated by improvements to the regulatory framework for telecommunications, and the social cost to the firm of health benefits and pensions is eased by improved provision of social services. Without economy-wide policy reforms, narrowly targeted micro policy reforms in favour of SMEs will be frustrated.

By assisting in the development of the basic financial and service institutions of the market economy, governments (and supportive international agencies) render great assistance to SMEs. They also avoid the pitfalls of many schemes which support SMEs through intricately targeted interventions and subsidies. Programmes that are defined by bureaucrats and not those in business, and that protect well-connected but often less efficient entrepreneurs from the market, have been failures. In transition economies, therefore, it is critically important not to recreate a culture of public selection, subsidy and dependence in which efficient businesses are taxed to finance less successful ones.

For external agencies, such as IFIs, there are particular difficulties in seeking to intervene at the micro level: just as entrepreneurs and experts in transition economies have an inadequate knowledge of Western market economies, Western experts and entrepreneurs only have a partial knowledge of the business environment and the constraints and opportunities in transition economies. The risks for Western agencies of inappropriate policy design are therefore especially significant in the SME area where, even in the mature OECD economies, policy successes are elusive and tend to depend on extensive groundwork and local knowledge and participation.

Policies to support SMEs should be tailored according to the ranking of constraints to their development. These will reflect the stage of transition as well as the initial conditions in each country. A knowledge of the severity of the different constraints is necessary to allow government policy makers, IFIs and others to focus their efforts. However, there is virtually no recent evidence that ranks these constraints.

SME-specific reforms may include measures to assist in the financing of SMEs and the provision of "one-stop" business centres, networking and the establishment of commercial associations, or the provision of suitable locations with the appropriate utilities to encourage the establishment of SME clusters, for example business parks.

Financial sector activities may include the establishment of specific credit lines for SMEs, facilitating equity participation and reinforcing the capacity of the financial sector to appraise and

Box 9.3
The EBRD and SMEs

There are various forms of EBRD support for SMEs:

1. equity participation in investment and venture capital funds, and investment or commercial banks that are either regional or country-specific
2. funding of local banks which are used for local lending under guidelines established by the EBRD
3. co-financing with local banks or local offices of foreign banks, with project preparation, evaluation, monitoring and supervision delegated to the co-financing bank.

By the end of 1994, the EBRD had contributed ECU 382 million towards projects, with a total value of close to ECU 1 billion, covering SME development in most of its countries of operations. Bank lending resulted in on-lending for over 700 subprojects, with an average unweighted value of around ECU 260,000. In the medium-sized enterprise category this was mainly accounted for by equity participation, and in the small category (below ECU 500,000) by lending to banks that then provided about 500 beneficiaries with loans averaging ECU 116,000. Micro-loans averaged around ECU 2,300 and benefited 115 enterprises.

The approach of the EBRD to supporting SMEs tries to take into account the stage of transition and the ability of the local financial intermediaries to assume key responsibilities. In the early transition economies, because of the weakness of the intermediaries, "apex" lines are generally provided with government guarantees. Examples of such loans include the loans to National Banks in Kazakstan, Ukraine and Uzbekistan for on-lending to local banks for financing small and medium-sized projects. Given the early stage of development of the banking systems in these countries, the projects are characterised by a high degree of risk which is mitigated by sovereign guarantees. In more advanced stages of transition, government guarantees are generally not required and the EBRD can perform the role of a finance wholesaler, reaching SMEs through carefully identified financial intermediaries. Examples of such credit lines include those arranged with the SKB Bank in Slovenia, and the Estonia and Latvia Investment Bank projects.

Regional or country-specific venture capital and investment funds cover the full range of transition economies, with the demand for these funds increasing as the transition progresses. The funds make independent decisions about the projects they invest in, although the main investment criteria are consistent with the EBRD's overall investment policy. The size of each investment varies from fund to fund and is typically in the range of US$ 100,000 to US$ 2 million, so that the funds support mainly SMEs.

Institution building is one of the main goals of the EBRD's SME programmes; a notable example is the **Russia Small Business Fund (RSBF).** This Fund was initiated by the EBRD and the G-7, with expected contributions of US$ 150 million from the G-7 matched by US$ 150 million of the EBRD's ordinary capital resources. A major objective is to bring within the scope of the formal finance system firms whose financing needs had not been previously met by the banking system, notably "micro-enterprises" and small firms requiring investment capital. These firms face numerous barriers to obtaining formal sector finance to meet their needs – lack of credit history, lack of "bankable" collateral and, for those firms requiring medium-term inputs for investment purposes, an absence of available funds with more than a three-month maturity. Because banks have little or no experience of lending to these target groups, substantial technical assistance funds are necessary for training and implementation of such programmes.

The RSBF has three main products: Small Loans (up to US$ 75,000), Micro-Credit (up to US$ 25,000), and Small Equity. In addition, it increasingly provides business advisory services. The loans are extended to firms employing up to 50 people (20 in the case of Micro-Credit) that are majority-owned by Russian residents and under private ownership and control. Micro loans generally start out short term (average is 5 months) and, as the borrower establishes a repayment record, subsequent loans can be larger and extended to terms of up to two years. Small Loans are generally 2-3 years.

The Small Equity component provides investment capital through equity participations, often in combination with debt and various other risk participation instruments. The investments are of up to five years' duration, with a targeted average investment size of US$ 75,000 and a size range of US$ 25,000-200,000. The equity stake is being complemented with business advisory assistance for the Fund's targeted production and service sector firms. In most cases, financing constitutes 25-75 per cent of the total capital of the enterprise after investment, but management control remains in the hands of the Russian owners. The Small Equity component seeks both to invest in local small enterprises and to design effective instruments that can be replicated. In 1995, 2,500 firms are expected to benefit from RSBF loans and investment agreements.

support SMEs. Equity finance for SMEs can provide an important advantage because it reduces the debt service risk. This can be particularly important for small, young enterprises which are going through a learning phase and have volatile revenues. Equity finance in the form of minority holding also preserves control over key decision-making in the hands of the entrepreneur. Equity stakes also confer advantages on financial intermediaries by enabling the financial institutions (both private and public) to share in the upside potential of SMEs. This is especially important because SMEs are characterised by relatively high failure rates together with some successes showing very high returns. By sharing in the potential for high returns, equity finance can permit the financial intermediary to reduce the interest spread on the debt component that is required to cover the commercial risk and the cost of doing business with SMEs. The establishment of funds and other intermediaries for equity finance provide the opportunity to contribute to SME development, both through the provision of capital and by providing access to the technical expertise of the fund managers. The role of the EBRD in supporting equity funds and its other support for SMEs are discussed in Box 9.3.

Policies designed to assist SMEs in OECD economies typically include technical assistance for the provision of a range of services. Training programmes can be particularly useful interventions, although the preliminary evidence from surveys suggests that this has often been poorly matched with entrepreneurs' needs. For example, a World Bank review of its experience concluded: "With few exceptions, Bank-supported SME technical assistance programs implemented by public agencies have failed to achieve their stated objectives. There are some success stories, but many technical assistance programs have been chronically dysfunctional, only partially implemented, subverted their original objectives, or never initiated".[15]

[15] Webster (1991).

To be successful, technical assistance must be tailored to specific local needs and be demand driven, responding to the actual rather than externally perceived needs of the client group. In many cases, training is too sophisticated or inadequately adapted to the requirements and skills of the beneficiaries. A primary objective of the technical assistance is to provide the basic skills needed by new and aspiring businesses to allow them to devise business plans, undertake market studies, assess risk and secure finance. Initial orientation training should be available to aspiring or new entrepreneurs before they commit large amounts of their savings or time to ventures. Further training with industry-specific guidance, which includes information regarding the larger competitive environment, networking with suppliers, exporters and others, and which provides information regarding new technologies, also appears to be highly valued. The centralisation of technical assistance in an SME business centre that provides one-stop information, training and legal and regulatory services has at times proved to be a successful policy initiative in OECD countries. However, the experience in developing countries of one-stop or integrated initiatives is mixed. When skills and resources are scarce, it may be better to draw on specific specialists in areas such as law, accounting or marketing, rather than grouping or attempting to centralise these skills within one SME-focused institution.

9.4 Concluding remarks

In competitive market economies, SMEs flourish. In order to do so in transition economies, SMEs require, first and foremost, sound macroeconomic and competitive market structures. The establishment of the macroeconomic and competitive foundations of a market economy, including measures that reduce barriers to entry, provides the seed-bed in which SMEs will succeed. Special privileges are not necessary and can recreate distortionary practices.

None the less, SMEs have a special role to play in transition economies and they face severe constraints. In some cases, a focused effort can help mitigate those constraints. In attempting to do so, the response of governments and IFIs will need to take account of the stage of transition and have firmly in mind lessons from the mixed record of official support for SMEs in both OECD and developing countries.

The crowded reform agenda and scarce resources in transition economies require that any policy interventions to assist SMEs be well targeted. This requires detailed information regarding the ranking of constraints faced by SMEs in each country, and these constraints will evolve with the transition. Effective policies will have to be adaptive and reflect the particular constraints and the capacity to implement such SME programmes, in order to ensure that they are demand-led and market-friendly.

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Annex 9.1
SMEs in the transition economies

Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes	
Official data: None available as enterprises are no longer required to register. *Additional information:* Evidence of thriving private, small-scale activities in urban areas. The majority of these enterprises are involved in more than one activity, but primarily in retail trade, repair, construction and food-processing. Most small enterprises are financed through remittances from abroad.	No data available.	Decree 938 of June 1993 provides a legal definition of small firms (employing fewer than 50 workers) in the context of privatisation of SOEs. A number of international donors (both national governments and international agencies) are currently engaged in the provision of subsidised credit and technical assistance to SMEs. Regional Business Agencies established with Phare support.	**Albania**
Official data: Enterprise registration requirements do not include information on the number of employees. 13,300 individual businessmen are on the State Register, of whom over 60 per cent operate in the service sector and retail trade and 20 per cent in agriculture.	No data available.	No government policy is specifically targeted at SMEs. However, start-up firms in the manufacturing and agricultural sectors benefit from tax holidays in the first two years. Technical assistance is provided by Tacis, targeted primarily to medium and large firms, rather than to smaller units which are mainly engaged in local retail trade.	**Armenia**
Official data: 44,750 SMEs are currently registered with the Central Statistical Board, 70 per cent of which are private and more than half of which are self-employed entrepreneurs. Most SMEs operate in the service and retail sectors and only 8 per cent in industry. *Additional information:* Many enterprises register for the purpose of one-day transactions (and never deregister) and many of the existing ones are registered for a number of activities. A survey by the SME Development Agency of their members indicated 32 per cent micro-sized, 62 per cent small, and that 60 per cent operated in manufacturing, 50 per cent in trade and 20 per cent in other services. Micro-sized enterprises are on average 3.12 years old, with a turnover of US$ 64,260 (4.17 years and US$ 318,540 for small ones – six years and US$ 1,833,000 for medium-sized ones); over 60 per cent of the sample were registered as sole proprietors and 15 per cent as limited liability companies.	A survey by the SME Development Agency of their members found 60 per cent of employment in small units and 34 per cent in medium-sized firms.	Profits reinvested in machinery, technology and training are tax free. A tax holiday for the first two years of activity is available for SMEs in most productive sectors (three years for small firms). Duty exemptions are available for small joint ventures importing foodstuff from abroad.	**Azerbaijan**
Official data: At the end of 1993, 43 per cent of all registered enterprises were small.	128,000 workers were employed in registered small firms in 1994, 22 per cent of which in the private sector. 154,000 self-employed workers were registered by the end of 1994, 6 per cent of total employment.	A tax-free period of three years for start-up firms and 50 per cent of profits untaxed if reinvested. A state co-funded Business Support Services and Financial Fund for Entrepreneurs provides support services.	**Belarus**
Official data: 460,000 private enterprises registered by mid-1994 (96 per cent of which were micro-sized) and around 8,000 joint ventures with foreigners or foreign firms (mostly engaged in retail trade) – around 6,000 active state-owned SMEs. *Additional information:* A recent survey found that as few as 20 per cent of registered enterprises in the manufacturing sector are active.	No data available.	The Ministry of Industry's Small Business Fund was established in 1991 to assist the setting up of small, completely private firms in industrial production or industrial services. The Fund lends money to small enterprises (with up to 30 employees or Lev 3 million equity) for investment purposes (up to 70 per cent of a project) for a maximum maturity of five years with favourable interest rates. So far, only 12 firms have received loans, and seven firms have been given grants.	**Bulgaria**

	Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes
Croatia	*Official data:* 21,180 SMEs were registered by April 1995, 57 per cent of which were micro-sized, 28 per cent small and 15 per cent medium-sized.	By April 1995, 500,000 workers were employed in registered SMEs, accounting for 30 per cent of total employment. 8 per cent of all employment in SMEs is in micro-sized units, 29 per cent in small firms (65 per cent of which in services and 29 per cent in industry) and 34 per cent in medium-sized units.	A department of the Ministry of Economic Affairs oversees the promotion of the handicraft and small business sector, coordinating its activity with that of other ministries. Financial assistance to entrepreneurs employing fewer than 100 workers is channelled through the commercial banking sector and supported by the Croatian Guarantee Agency for Private SMEs (primarily for investment in fixed material assets). Local assistance programmes are available through municipalities.
Czech Republic	*Official data:* By April 1995, 20 per cent of all registered enterprises were SMEs, 87 per cent of which were micro-sized. 36 per cent of SMEs operate in retail or wholesale trade, 17 per cent in manufacturing and 8 per cent in agriculture. The majority of SMEs are privately owned, of which two-thirds are sole proprietors and one-third limited liability. *Additional information:* Registered enterprises account for 75 per cent of active enterprises. Their size distribution in the manufacturing sector is rapidly approaching that of neighbouring Western economies.	By April 1995, 37 per cent of total employment was in SMEs, 29 per cent of which in micro-firms, 35 per cent in small firms and 36 per cent in medium-sized firms.	Support for SMEs, financed by the Czech National Council Act 28 April 1992, is available in the areas of training, credit subsidies, consultancy and applied research, with priority given to the capital goods sector and depressed areas. In 1993 the introduction of VAT and abolition of tax breaks for new entrants removed some of the incentives for SMEs. In January 1994, new measures were taken to support SMEs, including price-supported guarantees, contribution to interest payments for bank credits and interest free loans for projects involving technology transfer (financial support is provided jointly by Phare and the Czech government).
Estonia	*Official data:* By May 1995, 36 per cent of all registered enterprises were SMEs, including self-employed workers. Of these, 70 per cent are micro-sized and 25 per cent small. 39 per cent of all SMEs operate in retail and wholesale trade and 17 per cent in manufacturing.	By 26 May 1995, 45 per cent of total employment was in the SME sector, 53 per cent of which was in the retail and wholesale trades.	Governmental institutions supporting SMEs are the SME Office at the Ministry of Economy and the Department of Local Government and Regional Development at the Ministry of Internal Affairs. Non-governmental bodies include the Estonian Small Business Association, the Chamber of Commerce and Industry, and the Phare-established Business Advisory Centre. Financial support is channelled through a number of public funds with a new SME Fund established in January 1995. No specific tax incentives are targeted to SMEs. The main legislative instrument is the Law for State Support for Entrepreneurship (30 May 1994).
FYR Macedonia	*Official data:* Nearly 70,000 SMEs were registered by the end of 1994, mostly private, 66 per cent of which were in retail trade, 9 per cent in industry; more than half concentrated in the two largest cities; most SMEs were less than four years old. At the end of 1993 the SME sector was estimated to account for 40-50 per cent of total GDP. *Additional information:* Around one-third of SMEs were reported as being actually active in early 1995.	SMEs account for 37 per cent of total employment. About 10 per cent of the labour force was estimated to be active within the informal sector by the end of 1993.	No data available.
Georgia	*Official data:* None available. *Additional information:* Tacis estimates that 46,000 enterprises are currently active (including the self-employed and primary sector), two-thirds of which are micro-sized and over half of which are in the service sector (30 per cent among medium-sized units). 60 per cent of all SMEs are privately owned.	Estimates by the Tacis-supported Business Communication Service suggest that 58 per cent of the labour force is employed in the SME sector, one-third of which in small enterprises and more than half in medium-sized ones.	No data available.

Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes	
Official data: By January 1995, 99 per cent of all registered enterprises were SMEs, 73 per cent of which are micro-sized, 22 per cent small and 5 per cent medium. 80 per cent of all SMEs are registered as sole proprietors. Nearly all SMEs are private. 40 per cent of all micro-enterprises operate in the trade and retail sectors, 21 per cent in business-related services and 15 per cent in manufacturing. 36 per cent of all medium-sized enterprises operate in manufacturing, 15 per cent in trade and repair and 7 per cent in business-related services.	The 1994 Labour Force Survey found one million workers in SMEs (24 per cent of employment), 21 per cent of whom in units employing between 10 and 19 workers, 22 per cent in units employing between 20 and 50 and 57 per cent in units employing between 51 and 300.	A large number of specialised state funds address the financial needs of enterprises with fewer than 150 employees over a very broad range of activities. Subsidised credit is available both from national and international sources (both bilateral and multilateral), often mediated by local ad hoc foundations. Credit guarantees and export insurance schemes for small enterprises are also available. Technical assistance for small enterprises is available from a number of national private foundations, often financed by the state and Phare. Small entrepreneurs can choose to register either as a "sole trader" or as a "business". Sole traders have no limit on the number of workers employed or on turnover but ownership must be in the hands of a sole proprietor. Corporate legislation does not differentiate between small and large firms. Corporate taxation, both on profit and on value added, local taxes and insurance contributions are the same for small and large firms. Sole traders benefit from simpler accounting procedures and are not required to pay profit tax.	**Hungary**
Official data: 600 medium-sized enterprises – primarily in retail trade – are reported as active. *Additional information:* The vast majority of SMEs were created through the unbundling of state-owned enterprises and are still in state hands.	No data available.	No data available.	**Kazakstan**
Official data: Most recent estimates refer to the end of 1991 and report 4,300 small enterprises under state control (81 per cent of all state enterprises), primarily in the retail trade and service sector. *Additional information:* A labour force survey in 1994 found that 26.6 per cent of industrial establishments employ under 100 workers; that on average these enterprises suffered at least a 30 per cent decline in sales between the end of 1991 and April 1994; that they buy 85 per cent of their input locally and export less than 10 per cent of their output, with a capacity utilisation of 45 per cent. Roughly 60 per cent of such enterprises are private.	Most recent estimates refer to the end of 1991 and report 220,000 workers employed in small enterprises under state control (24 per cent of employment is in the state sector). A survey of Kyrgyz industry found that 3.4 per cent of the total labour force was employed in firms with up to 100 workers in March 1994 (up from 1.1 per cent before reforms). In 1993, 38 per cent of these workers were reported on leave.	No data available.	**Kyrgyzstan**
Official data: No data available. *Additional information:* 46 per cent of all SMEs are micro-sized, 35 per cent small and 19 per cent medium. Micro and small enterprises are mainly in retail and services; medium-sized enterprises in manufacturing. 40 per cent of micro-firms are owned by sole proprietors. Three-quarters of small firms were registered as limited liability. The majority of micro-firms were established after 1991 (but only 55 per cent of medium-sized ones), according to a Phare-funded survey.	No data available.	SMEs have the possibility of not registering for VAT if their turnover is below Lat 10,000. Profit tax reliefs (80 per cent discount on profit tax) and simplified auditing and accounting standards are also offered to SMEs. Subsidised loans (4.5 per cent interest rate per month) and training programmes have been set up by donors including Phare.	**Latvia**

	Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes
Lithuania	*Official data:* 44,700 small enterprises were registered by March 1995, the majority of which are private. 40 per cent of SMEs are registered as involved in more than one sphere of activity, 44 per cent are uniquely involved in trade and 13 per cent in manufacturing.	No data available.	The recently amended Law on Small Enterprises (20 April 1995) grants a tax reduction of 70 per cent for the first two years of operation (50 per cent afterwards) to firms employing up to 50 workers and with an annual income of less than Litas 500,000. The SME Development Programme, approved on 9 March 1995, provides a wide range of services (promotion of SMEs' exports, training, incentives for foreign capital). Six Phare co-funded Business Advisory Service Centres provide counselling and training to start-up SMEs and self-employed.
Moldova	*Official data:* In July 1995, out of a total of 71,000 registered enterprises, 29,000 were registered as individual companies with no more than five employees (a 10-fold increase since 1993), 2,400 as cooperatives, and 14,000 as farms (most of these are small). *Additional information:* Estimates indicate that 57 per cent of active enterprises employ fewer than 200 workers. 23 per cent of all SMEs are micro-sized, 39 per cent small and 42 per cent medium. The majority of active SMEs are in the capital city. 21 per cent reported some activity in agriculture and fishing, 20 per cent in distribution and sales, 9 per cent in construction, 5 per cent in transport and 24 per cent in manufacturing (but multiple activities are common). 10 per cent of all surveyed enterprises were established before 1989.	No data available.	State policies for SMEs are framed within the Law on Support and Protection of Small Business adopted on 20 May 1994. A programme to support private entrepreneurship and small businesses for the 1994-97 period was approved on 26 October 1994. A Small Business Support and Development Fund was created on 21 October 1993 and allocated Lei 128,500 in 1994. Micro-enterprises are not subject to profit tax for the first five years of activity (three years if in the service sector) and pay a reduced tax rate for a further two years if they reinvest at least 80 per cent of the tax loan in the SME activity. Donations to the SME Fund are free from tax up to 1 per cent of total tax bill. Export and import duties are reduced by 50 per cent of the base rate for the first three years after registration. Soft loans (from 25 per cent to 90 per cent of interest rate) and grants are available to SMEs for a three-year period. Further facilities are open to small-scale private farmers.
Poland	*Official data:* By the end of 1993, 1,382,000 micro-sized firms accounted for 93 per cent of all registered enterprises and medium firms accounted for 6 per cent. 19 per cent of micro-sized units operated in industry, 48 per cent in retail trade and 11 per cent in building. 35 per cent of micro-sized units were established between 1971 and 1990 (50 per cent of those engaged in industry). 52 per cent of micro-sized units had one employee *Additional information:* There are currently about two million SMEs operating in Poland, which generate almost 50 per cent of GDP.	By the end of 1993, there were 2,427,000 workers employed in micro-sized firms and 970,000 in medium-sized firms, accounting for 23 per cent of total employment. 55 per cent of employment in micro-sized firms is in the retail trade, 20 per cent in industry and 9 per cent in building. 38 per cent of all workers in micro-sized units are employed in firms created before 1990. Currently, about 60 per cent of total employment is in SMEs.	A policy document, "Small and Medium Enterprises in the National Economy", was adopted by the Council of Ministers on 6 June 1995. The document envisages amendments and changes to legislation favourable to SMEs. A local network system of credit guarantee funds for SMEs will be organised. The amount of budget resources allocated primarily to the credit guarantee fund in 1995 is equal to Zl 25 million. The Polish Foundation for the Promotion and Development of Small and Medium Enterprises is in the process of being established. It will provide information support to SMEs and organise training and education courses for entrepreneurs.
Romania	*Official data:* 98 per cent of all enterprises registered by the end of 1994 were SMEs (including self-employed). 85 per cent of all SMEs are micro-sized, the majority of which are private. 70 per cent of all SMEs are engaged in retail or wholesale trade (21 per cent of medium-sized enterprises) and 11 per cent in industry (25 per cent in manufacturing). *Additional information:* Data on distribution is broadly in line with a survey of small firms where 73 per cent employed up to nine workers, 20 per cent between 10 and 99 and 7 per cent between 100 and 499. 56 per cent of all SMEs surveyed were active in commerce, 22 per cent in industry and 8 per cent in construction.	About one million workers (approximately 20.5 per cent of enterprise employment) are employed in small enterprises (fewer than 200 employees) and 650,000 workers (approximately 12.7 per cent of enterprise employment) are employed in medium-sized enterprises. 57 per cent of SME workers are employed in the private sector, 38 per cent in the public sector and 5 per cent in the so-called mixed sector.	The Romanian Agency for Development with the support of non-governmental institutions (foundations, chambers of commerce, associations) and often with international assistance (primarily Phare) has prepared specific measures to assist SMEs, including a simplified computation of profit tax base for small enterprises, VAT exemption for firms with a turnover below US$ 100,000, deduction of investment costs up to 50 per cent of total profit tax liability, SME credit lines 50 per cent below market interest rate and heavily subsidised technical assistance delivered through SME Development Centres.

Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes	
Official data: 480,000 active small enterprises were reported at the beginning of 1994, one-third of which in retail and wholesale trade, nearly 40 per cent in industry or construction and one-tenth under state or municipal ownership (but nearly one-quarter of units in agriculture). 30 per cent of all small enterprises are registered in the Moscow area. *Additional information:* Recent study of GOSKOMSTAT data found severe underestimation of the number of active small units and put the number closer to one million units. Official estimates ranged from 600,000 (Anti-Monopoly Committee) to 700,000 (Union of Private and Privatised Enterprises).	6,830,000 workers were officially employed in small enterprises at the beginning of 1994, of which a third were in industry, another third in construction and a quarter in state or municipal enterprises. The 1994 ILO Russian Labour Flexibility Survey of 384 enterprises employing 303,000 workers, found 35 per cent of employment in small enterprises (with fewer than 250 workers); labour surplus estimated at 25 per cent; 11 per cent of workforce on leave.	State legislation supporting small enterprises was introduced in early 1993, coordinated by the Ministry of Economy and implemented by several agencies in different ministries. Rb 25 billion were initially set aside as an incentive to small enterprises in the Support Fund for Entrepreneurs (by the end of 1994, only Rb 7.5 billion had been made available). Short-term credit and infrastructure for small enterprises in technical sectors is available within the federal innovation programme. A profit tax holiday is available for small enterprises in the first two years and discounts in the next two years. The tax base is unchanged for the first five years (but other tax incentives were severely curtailed in early 1995). 58 regional or municipal funds supporting SMEs locally were active by early 1995. Technical assistance for entrepreneurs is available through international agencies (e.g. Tacis) and a number of bilateral programmes. Technical assistance for financial institutions is available through the EBRD Russian Small Business Fund. The new federal law, Support of Small Enterprises, came into force on 22 June 1995. The law imposed additional restrictions on the form of ownership of SMEs. Upper limits on the number of employees were changed (these limits differ among industries – the highest limit is 100 employees). The law broadened the rights of small businesses to use accelerated amortisation and introduced some non-tax privileges.	**Russia**
Official data: 35,000 SMEs were registered in 1994, 80 per cent of which are micro-sized and 12 per cent medium-sized. 5 per cent of all SMEs are under some form of state control, 20 per cent with some form of foreign ownership, and they are evenly distributed around the country with 30 per cent in Bratislava. Their average age is three years.	At the end of 1994, there were 425,400 registered SME employees (23 per cent of total employment) but only 14 per cent of all SME workers in micro and small firms.	The Act on the State Support of Small and Medium Enterprises of 3 May 1995 defines a small entrepreneur as a person who employs a maximum of 24 employees, and a medium entrepreneur as a person who employs a maximum of 500 employees. The main forms of support to SMEs are the provision of loans, loan guarantees, reimbursement of interest or part of interest and subsidies.	**Slovak Republic**
Official data: By the end of 1994, there were 28,000 small enterprises (+286 per cent over 1990; +7 per cent over 1993) and 1,158 medium firms (+105 per cent over 1990; -1 per cent over 1993), altogether accounting for 98 per cent of all registered enterprises (13 per cent medium and 81 per cent small in 1990; 4 per cent medium and 94 per cent small in 1993); 42 per cent of small enterprises engaged in business-related services (37 per cent in 1990); 23 per cent in retail and wholesale trade (24 per cent in 1900) and 13 per cent in industry (16 per cent in 1990). Small firms generated 22 per cent of total revenue and 31 per cent of total recorded profit while employing 12 per cent of total capital. Medium sized firms generated 15 per cent of total revenue, 13 per cent of profits and 16 per cent of total capital. *Additional information:* A survey of 156 small firms carried out in 1993 (excluding agriculture) found that 30 per cent had been set-up before 1989 as "craft" enterprises, primarily in the manufacturing sector. Nearly all units set-up after 1989 are private, limited liability companies and primarily in the retail trade and service sector. Nearly 10 per cent of the total are spin-offs.	By the end of 1994, there were 88,350 workers employed in small enterprises (employing fewer than 50 workers) which submitted financial reports accounting for 19 per cent of employment in the enterprise sector (6.1 per cent in 1991 and 17.9 in 1993) and 10 per cent of the labour force. 35 per cent of all workers in small firms are engaged in commerce, 30 per cent in the retail and wholesale trade and 16 per cent in industry. A further 105,000 people registered as self-employed.	The Small Business Development Centre (Ministry of Economy) is the governmental agency that supports SMEs and coordinates international assistance. The implementation of policy measures to support SMEs is in the hands of the Small Business Development Network (co-funded by Ministry of Economy, Labour and Technology and independent Chamber of Commerce and Craft). Main policy measures include profit tax relief for start-ups and small enterprises for the first four years and rebates for the import of foreign machines and raw materials (especially for export-oriented firms). Credit guarantees are arranged through a Fund for SMEs and locally by municipal funds, training and international promotion (primarily through trade fairs), and links with small business associations of neighbouring countries.	**Slovenia**

	Size and characteristics of SMEs	Employment in SMEs	Legislation and support programmes
Tajikistan	*Official data:* No data available *Additional information:* A study carried out in July 1993 found around 3,000 active small enterprises (employing fewer than 200 workers), 60 per cent of which were state-owned, 21 per cent producing consumer goods (14 per cent among privately owned private firms) and 14 per cent in retail trade (35 per cent among privately owned private firms). A further 4,300 persons are self-employed, more than half of whom in consumer goods production. 40 per cent of all enterprises are in the Leninabad region.	Roughly 40,000 employees in small sector by mid-1993, 62 per cent of which in state-owned units, a third in consumer goods production and over a quarter in construction.	No data available.
Turkmenistan	*Official data:* In 1993, 9,000 SMEs were registered, of which 3,000 were privately owned. In addition, 300 retail and small-scale production facilities operate within the parastatal Turkmenistan State Cooperative Alliance. In 1995, 21,000 private companies were officially registered.	No data available.	No data available.
Ukraine	*Official data:* Nearly 80,000 small enterprises (employing on average fewer than 200 workers) operated at the end of 1994. Privately owned enterprises accounted for 43 per cent of all small firms, 50 per cent of sales and 53 per cent of profits. Collectively owned small enterprises accounted for 51 per cent of all small firms, 42 per cent of sales and 40 per cent of profits. 42 per cent of all small firms are engaged in commerce, 16 per cent in industry and 15 per cent in construction.	The 1994 ILO Ukraine Labour Force Survey of 350 enterprises employing 370,000 workers found 27 per cent of all workers in units with up to 250 employees. One-third reported excess labour force in spite of 6 per cent of reported employees being on partially paid leave and employment cuts of roughly 8 per cent over the previous year. Capacity utilisation declined over previous years by around 60 per cent. Wages and earnings are higher in SMEs than in other enterprises.	Government support measures focus on newly established firms and newly privatised ones (most of which are small). Tax exemptions have recently been withdrawn. A number of programmes targeted to small business and credit and technical assistance are funded by international agencies.
Uzbekistan	*Official data:* 60,000 small scale enterprises were privatised by the beginning of 1995. By mid-1993, the construction and retail trade were the two most significant SME activities. On 1 April 1995, there were 1,348 small enterprises. 1,472 small enterprises (with fewer than 300 employees) and 291 medium (300-1,000 employees) are scheduled for privatisation in 1995.	No data available.	A Presidential Decree dated 5 January 1995 simplifies registration procedures for start-up firms (mostly small), provides tax incentives for start-ups and new investment (but not on value-added taxation) and channels 50 per cent of privatisation income to support SMEs (subsidised credit and loan guarantees). A recent survey of small entrepreneurs, however, found that none had ever had access to these funds. On 26 July 1995 the Agency for Insurance Protection of Private Enterpreneurship and Small Business was created together with the Fund for Support of Private Enterpreneurship and Small Business Support (partly funded through receipts from privatisation and from the Employment Assistance Fund, and partly by domestic and foreign donors).

Developing financial institutions and markets

10

The financial sectors in eastern Europe, the Baltics and the CIS must perform two vital roles in the transition toward a market-oriented economy: the mobilisation and allocation of savings and the exercise of financial discipline over enterprises. This chapter assesses progress in reform and development in the region, gauging the capacity of the financial sectors to perform these roles. The analysis proceeds along two largely separate strands: one examines the transformation of banking and the other the emergence of securities activities. Consideration is given both to the role of government and its effectiveness, and to the performance of financial institutions and markets themselves. Although banking and securities activities are analysed separately, potential interactions between these two spheres are also suggested.

Information on the financial sectors in 12 countries in the region provides the analytical basis for this chapter.[1] These countries form a representative cross-section of those in the region in terms of both starting points and progress in transition. The role of government in the financial sector is assessed by examining the laws and regulations applied to banking and securities activities, as well as their enforcement. The performance of financial institutions and markets is gauged by measuring the scale of banking and securities activities relative to the overall size of the economy in which they take place. Market structure and profitability in banking are also examined.

10.1 Financial reform and development

Under central planning, a single state bank effectively performed both commercial and central banking functions.[2] This "monobank" typically played a passive role in the allocation of credit, providing book-entry credits to state enterprises for investment projects approved under the central plan. Since credit could only be created and spent with government approval, this lending by the monobank was not guided by the opportunity cost of funds or by the ability to repay. Moreover, there were virtually no securities markets and the only non-bank financial institutions were a few state insurance companies.

The comparatively marginal and tranquil existence of bankers in the region changed abruptly with the introduction of market reforms. Two-tier banking systems were created, separating central and commercial banking functions. The newly created state-owned commercial banks gained more autonomy in credit allocation decisions. At the same time, however, the enterprise sector experienced considerable upheavals, with liberalisation of prices and trade, cutbacks in state procurement and the collapse of intra-regional trade. Many outstanding loans soured and the quality of new lending became difficult to judge. In addition, the reforms necessary to impart clear incentives for the prudent management of state banks and new private banks took time to implement, allowing the initial spate of bad loans to proliferate in many countries.

Despite the initial setbacks, headway has since been made in overhauling the banking systems in the region. Many countries have enacted legal and regulatory frameworks for banks that draw upon international standards. Procedures for working out bad loans have been implemented in a number of countries in eastern Europe, while others in the Baltics and the CIS have relied on high inflation and negative real interest rates to shrink the asset quality problem. In some eastern European countries, the authorities have recapitalised state-owned commercial banks, raising their capital ratios towards minimum international standards while committing to their privatisation. The actual pace of privatisation of state banks has been slow, however. Some countries, particularly in the Baltics and the CIS, have allowed the extensive, if not excessive, creation of new private banks. Regardless of the chosen reform path, the scale of lending by banks, particularly to the private sector, remains small relative to the size of the economies in which they operate.

Securities activities in the region are typically less developed than banking. The authorities in a number of countries have moved to create the basic legal and regulatory framework for securities activities. Development of the securities markets themselves, though, has been largely shaped by broader developments, in particular the nature of privatisation programmes. In those countries that have pursued a selective approach to privatisation and to listing companies on the stock exchange, such as Poland, the capitalisation of the market remains small relative to the size of the economy, but the liquidity of the stocks is high relative to total capitalisation. In those countries that have pursued mass privatisations, such as the Czech and Slovak Republics, the total stock market capitalisation is high relative to the size of the economy, but the liquidity of these markets is low relative to their total capitalisation. The lack of market liquidity in those countries that pursued mass privatisation programmes can pose a serious impediment to the post-privatisation restructuring of enterprises (Chapter 8).

[1] The countries are Belarus, Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Poland, Romania, Russia, the Slovak Republic, Slovenia and Ukraine.

[2] Kornai (1992) contains an overview of banking under central planning.

10.2 Challenges ahead

The relatively small scale of the financial sectors in the region poses a potentially serious impediment to enterprise restructuring and investment finance, especially in view of the emerging recovery in demand and growth in most of the region. The further development of banking and securities activities requires both the continued transformation of the role of government in the financial sector, particularly in enforcing laws and regulations in this area, and the strengthening of the financial institutions and markets themselves.

The particular priorities in individual countries depend on the reform paths being pursued. In eastern Europe, where the emphasis has been on transformation of state banks, a barrier to sustained progress is the difficulty in their privatisation, which is necessary to strengthen incentives in the sector and to attract the resources required for expansion. In the Baltics and the CIS, new private banks have gained significant market shares following a period of liberal entry. However, the risks in these banking systems are considerable, and their consolidation will require careful management. Indicators of bank profitability point to healthy returns once the asset quality problems are resolved, reflecting in part the small scale and concentration of these markets. This suggests that banks will be able to attract the financial and staff resources required for their expansion and possible deconcentration, although support from the EBRD and other IFIs can accelerate this process both by assisting governments to transform their role and by investing in banks to strengthen their operations. One form that this investment can take is technical cooperation. Since securities activities in the region remain in their formative stages, the building of institutional infrastructure for these markets is required, along with improvements in the amount and quality of financial disclosure, greater protection of shareholder interests, and more transparent markets. Since securities activities are undertaken largely in the private sector, support from the EBRD and the IFC can play an important role in strengthening these institutions and markets.

10.3 The transformation of banking

The importance attached to the transformation of banking in transition economies reflects its fundamental role in a market economy, providing not only finance for investments by enterprises and financial discipline over their operations but also vital transaction services for commerce and securities activities.[3] This section on banking is divided into two parts: the first is on the changing role of government, while the second focuses on the concentration, relative size and profitability of banks.[4]

Changing role of government

The changing role of government in banking involves a number of dimensions, apart from the basic creation of a two-tier banking system and credit market liberalisation (Chapter 2).[5] These include the introduction and strengthening of prudential regulation and supervision, recapitalisation and privatisation of state banks, and policies toward entry and exit of private banks. Some countries in eastern Europe have attempted to move along these various dimensions in a deliberative manner, while others in the Baltics and the CIS have engineered a more rapid break with the past by allowing a period of liberal entry of new private banks as very high inflation reduced the size of state banks and former state banks.

Reform of prudential regulation and supervision

Most countries considered in this chapter have moved to enact a basic framework for prudential regulation, which aims to provide incentives for the prudent management of banks and to limit specific types of risk exposures.[6] Given the bad loan problems in most countries, capital adequacy standards and rules on the classification of assets by quality and on the provision against identified loan losses have assumed a particularly important role. Other regulations that take on added significance in transition economies are limits on concentrated or connected lending and on equity investments.

Capital adequacy regulations have been introduced throughout much of the region. Belarus, Bulgaria, the Czech Republic, Estonia, Latvia, Hungary, Poland, Romania, the Slovak Republic and Slovenia have introduced regulations that draw upon the Basle Committee or EU standards for capital adequacy (Table 10.1). In some countries, such as Bulgaria, the Czech Republic, the Slovak Republic and Ukraine, these standards are being phased in over a fixed period to allow for a smooth adjustment by banks. Procedures for classifying assets and for making specific provisions against doubtful and unrecoverable loans have also been introduced in most of the countries. However, there remain in some of these countries significant departures from Basle Committee or EU standards in the definition of regulatory capital, as well as scope for discretion in application of loan classification and provisioning rules. Effective supervision is required to ensure that asset quality is accurately reflected in financial accounts.

[3] King and Levine (1993) and Blommestein and Spencer (1994).

[4] A number of studies have begun to examine the evidence on performance of the financial systems in eastern Europe. See, for example, Abel and Szekely (1994), Dittus (1994), Dittus and Prowse (1994) and Hrncír (1994).

[5] A legal reform vital to the banking development is the law on secured transactions. See Chapter 6, as well as the 1994 *Transition Report* and Baer and Gray (1994).

[6] The Group of Banking Supervisors from Central and Eastern European Countries, which is supported by the Basle Committee on Banking Supervision, provides a forum for the development of basic principles of banking supervision in the region and for technical assistance in this area. See BIS (1995).

Table 10.1
Prudential regulations for the banking sector

	Capital adequacy ratio	Classification of non-performing assets	Limits on large exposures	Limits on equity investments
Belarus	An 8 per cent standard calculated in broad accordance with international rules as the ratio between a bank's capital and its risk-weighted assets.	The National Bank has a five-category risk classification of loans, in relation to the risk on the investment rate of return and the possible partial loss of asset value. There is no classification of non-performing loans.	Maximum risk exposure to a single borrower may not exceed 30 per cent of a bank's own funds (25 per cent in case of shareholders of the bank); total large exposures portfolio may not exceed 800 per cent of own funds.	A bank's investment in the capital of enterprises is limited to an amount equal to 15 per cent of the bank's own equity.
Bulgaria	An 8 per cent standard for the ratio of total capital to risk-weighted assets, and 4 per cent for the core capital ratio.	Loan classification system includes three classes of asset quality and levels of provisions: doubtful (group A) at 20 per cent, doubtful (group B) at 50 per cent, and uncollectable at 100 per cent.	If a large loan exceeds 25 per cent of the shareholder's equity, the bank must form a special credit reserve to cover the risk of the overexposure to the client, to an amount equal to the excess. Banks are required to notify the BNB within 15 days of being exposed. Total large loans may not exceed eight times shareholders' capital.	Banks need authorisation by the Bulgarian National Bank in order to invest in more than 10 per cent of the equity of a non-financial enterprise. Investments exceeding this limit should be brought in line within three years.
Czech Republic	Since the end of 1993, a transitional solvency ratio of 6.25 per cent drawing upon BIS rules has applied. Banks must reach the target ratio of 8 per cent by the end of 1996.	Regulation on classifying loans and provisioning against doubtful assets establishes five categories: standard, watch, substandard, doubtful and loss.	Exposures to any counterparty or group of economically connected counterparties may not exceed 40 per cent in capital since the end of 1993 and 25 per cent from the end of 1995.	Certain restrictions and conditions are imposed on equity investments with the aim of limiting their size and maintaining transparency of equity holdings in bank and non-bank institutions connected with the investing bank.
Estonia	An 8 per cent standard for the ratio of own funds to risk-weighted assets.	Since December 1993, the Bank of Estonia has required banks to write off loans that are more than 159 days overdue. The Bank has also issued a directive on the assessment of loan quality and the constitution of reserves which were replaced by the relevant provisions of the 1995 Credit Institution Law.	The maximum total exposure to a single customer or connected counterparties is 25 per cent of own funds. Where supervision is not on a consolidated basis, the maximum ratio is 20 per cent. There is also a 20 per cent limit of total lending to managers, employees and shareholders of the bank. Total large exposures may not exceed 800 per cent of own funds.	A regulation issued on 26 July 1994 imposes restrictions and conditions on certain types of loans and investments in equity participations.
Hungary	The 1991 Banking Act prescribes that an 8 per cent weighted asset risk reserve ratio be reached by the end of 1994.	The 1991 Banking Act prescribes that non-performing loans be classified as doubtful, substandard and bad, with regard to delay in repayment and to the financial state of the borrower. Provisions varying from 20 to 100 per cent are accordingly mandated. Banks are allowed to accumulate loan loss reserves over a period of three years and to provision on pre-tax, rather than post-tax, profits.	A large loan is defined as the total amount of placements to a single borrower which exceed individually or on aggregate 15 per cent of the adjusted capital of the financial institution. The total amount of large loans cannot exceed eight times the adjusted capital. The total amount of loans extended to a single borrower cannot exceed 25 per cent of the adjusted capital.	Financial institutions may generally not hold a direct or indirect proportion of ownership in an enterprise exceeding 40 per cent and 15 per cent, respectively, of their adjusted capital. Also they can hold more than 51 per cent ownership only in other financial institutions, similar businesses or activities related to the bank's own activities. In the latter case, ownership cannot exceed 60 per cent of the adjusted capital of the owner financial institution.
Poland	The solvency ratio was established on the basis of BIS standards with some slight adjustments to allow for country-specific circumstances. An 8 per cent standard for the ratio of risk weighted to assets to own funds applies.	Loan quality is appraised with regard to the borrower's overall financial position and delays in repaying the loan. Loans are classified as substandard, doubtful and loss, when the delay is respectively 1, 3 or 9 months. Provisions respectively of 20, 50 and 100 per cent are then required.	Under an amendment to the Banking Act, proposed in May 1994, total large exposures (i.e. of amount over 10 per cent of bank's own funds) may not exceed 800 per cent of own funds.	The Banking Act prescribes a ceiling of 25 per cent of own funds to investment in securities and other companies' equity. Treasury Bonds are exempt.

Table 10.1 (continued)
Prudential regulations for the banking sector

	Capital adequacy ratio	Classification of non-performing assets	Limits on large exposures	Limits on equity investments
Romania	An 8 per cent standard applies to the ratio of own funds to risk-weighted assets. Own funds includes both core capital and supplementary capital (largely subordinated debt).	Banks must classify their assets and make specific provisions on the following basis: standard at 0 per cent, watch at 5 per cent, substandard at 20 per cent, doubtful at 50 per cent and loss at 100 per cent.	Loans to a single borrower and bank staff may not exceed 20 and 5 per cent of own funds respectively. All exposures above 10 per cent of own funds must be reported to the National Bank. The total of large exposures may not exceed 800 per cent of own funds.	An investment in a non-bank company may not exceed 20 per cent of that company's capital.
Russia	Commercial banks are required to satisfy the following minimum requirements: a 4 per cent ratio of bank's capital to assets; a 4-5 per cent ratio of bank's capital to bank's risk-weighted assets.	Instruction 17 of the Central Bank sets five categories of risky assets: pass, watch, unsatisfactory, charge-off and lost.	Commercial banks must satisfy a minimum ratio of one-borrower exposure to bank's capital of 0.5-1.0, which does not apply in the case of loans secured by tangible collateral or third-party guarantees.	At present there are no limits on equity investment of banks into other companies.
Slovak Republic	Since the end of 1994, a transitional ratio of risk-weighted assets to capital of 6.75 per cent applies. Banks must reach the ratio of 7.25 per cent by the end of 1995 and the final target ratio of 8 per cent by the end of 1996.	NBS has issued a regulation on the classification of bad, doubtful and non-standard loans. The classifications are based on past due status. Banks are required to make quarterly reports on their liquidity positions as measured by matching assets and liabilities of similar maturities. The matching of maturities of assets and liabilities may be regulated. Banks are required to establish measures to ensure liquidity in Slovak and foreign currencies.	Commercial banks are required to submit monthly reports on the credit exposures of debtors representing more than 10 per cent of the bank's capital. The credit exposures of the 10 largest debtors cannot exceed 25 per cent of the bank's adjusted capital. Banks are required to reduce any inherited exposures that exceed the new limits to 40 per cent by the end of 1993 and to 25 per cent by the end of 1995. Banks are required to report large exposures to particular sectors of the economy.	Banks may not enter into transactions with their major shareholders if such transactions would limit the bank's activities with other lenders. Investments of a participative nature are not allowed to exceed 25 per cent of the bank's capital. Banks can acquire capital interests of up to 10 per cent of a company's capital. Transfers of more than 15 per cent of a bank's basic capital must be approved by NBS.
Slovenia	Capital adequacy is measured as the ratio of capital to risk-weighted assets, the minimum requirement for which is 8 per cent, in line with BIS standards.	Bank must classify assets into five categories according to the likelihood of repayment, ranging from A (no problem expected) to E (365 days overdue). On this basis, banks must set specific provision against the identified potential loss: 10 per cent for claims in class B, 25 per cent for those in class C, 50 per cent for those in class D, and 100 per cent for those in class E.	A large exposure is defined as an overall exposure (loans, other claims and guarantees) to a single borrower in excess of 15 per cent of a bank's capital. The overall exposure to a single borrower may not exceed 25 per cent of a banks capital. Loans to a bank's directors, managers and owners in excess of certain threshold must be reported to the central bank.	A bank's equity investment in another bank or non-bank company may not exceed 60 per cent of that company's capital. Holdings in any one non-banking company may not exceed 15 per cent of the bank's capital without central bank approval.
Ukraine	The present capital to assets adequacy ratio is 8 per cent. Assets are risk weighted. The major difference as of May 1995 between the Ukrainian legislation and the Basle rules is the interpretation of the terms used. An example of this is the treatment of on and off balance sheet items. There is also some obscurity about the treatment of foreign exchange holdings by the NBU.	In a new regulation of January 1995, banks are required to provision for possible credit losses. The provision amounts are zero for a standard credit, 5 per cent for satisfactory credits, 30 per cent for marginal credits, 80 per cent for doubtful and 100 per cent for irretrievable credits. Only irretrievable credits will be directly written off against profits for the year.	Large exposures are debts to a single borrower that exceed 10 per cent of the bank's own funds. This includes 50 per cent of any off balance sheet exposure. The first guideline is that large exposures should not exceed eight times the bank's own funds. Breaches of this ratio result in first a doubling, and then a tripling, of the solvency ratio. The upper limit on credit to any single borrower is set at 40 per cent of own capital, but is expected to be reduced to more conservative levels, such as 20 per cent.	

Sources: BIS (1995), EBRD, IMF and World Bank.

Restrictions on large exposures to a single borrower (or economically connected group of persons or entities) range from 20 per cent of a bank's own funds in Romania to 40 per cent in Ukraine. In addition, some countries impose a tighter ceiling if the large exposure is to a person or entity connected with the bank (director, manager, employee or shareholder). The Basle Committee recommendation and the EU Directive call for a single large exposure limit amounting to 25 per cent of a bank's capital. The strict enforcement of large exposure limits is particularly important in transition economies because of the close ties between enterprises and (former) state banks and the widespread ownership of banks by enterprises in some countries.

Restrictions on equity holdings typically take one of two forms. The first limits equity investments to a percentage of a bank's capital and reflects the need for portfolio diversification and limits on high-risk exposures. The second restricts equity investments to a share of the investment company's capital, which serves to limit controlling ownership stakes by a bank in non-bank entities. These regulations can have a significant impact in shaping the role of banks in enterprise restructuring and privatisation, for example by determining the scope for debt-equity swaps.[7]

While well-conceived regulations are important, they do not ensure that the prudential regulations achieve the objective of a safe and sound banking system. Realisation of that objective requires adequate supervision of banks to monitor compliance and to enforce the applicable laws and regulations. Effective bank supervision, in turn, hinges upon the development of staff and the provision of accurate information to the regulatory authorities.

A significant challenge for implementing effective supervision is to attract and to train bank examiners. In Hungary and Poland, where there are large numbers of small savings and cooperative banks, the ratio of bank examiners to the number of banks ranges from about 1:4 to 1:3. In the Czech Republic, which has fewer banks, the ratio is around 1:1. The comparable ratios for France and Germany, which also have large numbers of small banks, are around 1:5. The ratio is 3:5 in the United Kingdom, where there are fewer banks. However, these simple comparisons do not take into account the considerable variation in supervisory staff skills and financial accounting and reporting systems among the countries. The regulatory authorities in these countries have also implemented training programmes in banking supervision, which in many cases have received considerable bilateral and multilateral support.[8] However, throughout most of the region, much remains to be done in terms of both recruiting and training supervisory staff.

Apart from adequate staff resources, the other basic input into banking supervision is the financial accounts of banks, which in turn rely on those of the enterprises to form the credit assessments of commercial lending. The accounting practices in much of the region, however, still reflect in part the information requirements of central planning rather than those of depositors and banking supervisors, creditors and other outside investors in banks and enterprises. Under central planning, accounting was designed to enable the government to control the allocation of credit and production in quantitative terms. In banking, there were no accounting standards for bad loans, while enterprise transactions were scored on a cash rather than an accrual basis, so the calculation of profits was not comparable to international standards. While considerable efforts have been made in the region to adapt accounting practices and financial disclosures, the demands for accurate financial information by banking supervisors, creditors and outside investors in enterprises have yet to be fully satisfied.[9]

Overall, while prudential regulations in banking have developed towards international standards, and continue to do so, the capacity to enforce these regulations has expanded at a slower pace. Early weaknesses in regulations and continued gaps in their enforcement have allowed a number of banking troubles to emerge in the region. More effective enforcement will require the sustained development of supervisory staff skills, recruitment of additional staff, and improvements in accounting standards. Moreover, the regulations themselves must be broadly consistent with the stage of development of the banks. If the gap between regulations and banking conditions becomes too great, either the regulations will be ignored or the banks will be forced to adjust in a way that diminishes their role in financing investment. Transitional standards have been used in some countries, such as Bulgaria, the Czech Republic, the Slovak Republic and Ukraine, to ease the adjustment of banks to international standards, while retaining a firm commitment to them.

Recapitalisation and privatisation of state banks

While effective prudential regulation and supervision aim to prevent banking troubles from emerging, an important aspect of the incentive framework for banks is the regulatory authorities' approach toward bank recapitalisation or closure if difficulties do arise. Instilling discipline while recapitalising state banks in eastern Europe has proven to be particularly challenging, however.[10] Governments were essentially unlimited liability shareholders in the dominant state banks, and the behaviour of bank managers was not, at least in the first instance, the primary cause of the bad loan problem. Moreover, the fiscal consequences can curb the scope for direct bank recapitalisations, leading to partial recapitalisation and in some cases to heavy reliance on the inflation tax.

[7] The appropriate role of banks in enterprise restructuring and privatisation has been the subject of extensive debate. See, for example, Corbett and Mayer (1993), and Claessens and Pohl (1994).

[8] EU-Phare and the World Bank have provided extensive support for the development of banking supervision in eastern Europe and the Baltics, while in the Baltics and the CIS the IMF has taken a lead in coordinating assistance. On the latter, see Zulu *et al.* (1994).

[9] The OECD has served as a focal point for technical cooperation on accounting issues. See OECD (1991, 1993 and 1994).

[10] Fries and Lane (1994) and Aghion, Bolton and Fries (1995).

There have been two broad approaches to direct bank recapitalisation, both of which aim to create the conditions under which discipline can be imposed should future difficulties arise. One approach focuses on creating strong incentives for the commercial operation of banks through full recapitalisations, efficient frameworks for resolving bad loans and commitments to bank privatisation. In this approach, the extent of a bank's loan losses is broadly ascertained through an independent audit or other means of verification, with the recapitalisation of a bank designed to restore its capital adequacy after writing down these loans. To resolve the debt overhang in the enterprise sector and to enhance the recovery of problem loans, the approach strongly encourages the work-out of bad loans through direct negotiations between creditors and debtors or through legal bankruptcy proceedings. This is often supported by a commitment on the part of the government to the bank's privatisation, in which its managers may be invited to participate as owners. Following privatisation, any bank failure in principle could be handled in a more conventional way,

Box 10.1

Approaches to the recapitalisation and privatisation of state banks

There follows here a summary of several bank recapitalisation and privatisation programmes in the region, expanding upon the description provided in Annex 2.2 in Chapter 2.

Comprehensive approaches

In April 1993, a second attempt to recapitalise the state-owned commercial banks was launched in ***Hungary*** with the aim of raising their capital ratios to the 8 per cent standard in three steps. The targets under the programme were slightly more than zero by the end of 1993, 4 per cent in May 1994 and 8 per cent in December of that year. In the first phase, the capital of eight banks was raised by an amount equivalent to 3.1 per cent of GDP, of which 77 per cent affected the two largest banks. This was largely implemented by the state purchasing newly issued shares with consolidation bonds. The banks that benefited from these recapitalisations were required to enter into consolidation contracts with the state. Under these contracts, the banks committed to preparing modernisation programmes for their own management, ownership (privatisation) and operating systems, and to taking part in reconciliation proceedings with their troubled debtors. This recapitalisation was followed by two additional ones, both of which amounted to about 0.4 per cent of GDP. As a condition for the May 1994 recapitalisation, each bank was required to submit a detailed consolidation programme, which it had committed to prepare in December 1993. The programmes of some of the banks did not fully meet the requirements, and their programmes were delayed.

The second Hungarian recapitalisation programme was preceded by a hastily arranged bail-out of the banks in 1992 which was deliberately partial. This programme covered banks with a capital adequacy ratio below 7.25 per cent, which were given the opportunity to sell their non-performing loans to the government in exchange for so-called loan consolidation bonds. The government verified whether the loans were non-performing. Claims against specific companies were exchanged at varying discounts for government bonds. The incomplete recapitalisation and surge in the financial reporting of bad loans in 1993 as stricter prudential regulations came into force made necessary the second recapitalisation scheme.

The bank recapitalisation and debt conciliation programme in ***Poland*** was implemented in the course of 1993-94. Seven of the nine state banks created from the former monobank received recapitalisation bonds amounting to about 0.8 per cent of GDP in September 1993 to compensate for bad loans identified through independent audits and to raise their capital ratios to meet regulatory standards, while the state savings bank and agricultural bank were partially recapitalised with bonds totalling 0.7 per cent of GDP in December of that year. At the same time, the authorities committed to privatising the nine state-owned commercial banks by the end of 1996. To encourage the banks to pass on the benefits of their capitalisation to the overburdened enterprises, a fixed deadline was set for reaching conciliation agreements between them (April 1994 for the seven state-owned commercial banks). The agreements reached by the seven commercial banks covered 792 enterprises with total non-performing debts amounting to 0.7 per cent of GDP. By April 1994, these banks had reached conciliation agreements on about half of the loans, while a further one-third either resumed debt service payments or were repaid. Most of the remainder were liquidated under court bankruptcy proceedings. As of mid-1995, three of the nine state commercial banks have been privatised.

The Bank Rehabilitation Agency (BRA) in ***Slovenia*** has, since its establishment in 1992, initiated the rehabilitation of three state-owned commercial banks, two of which have been merged. Rehabilitation procedures can involve conditions imposed on bank operations, as well as transferring doubtful assets to the BRA, which seeks to recover on the claims. The Agency then injects capital in the form of government bonds to meet the minimum requirement and takes over ownership of the bank. The final stage of rehabilitation is bank privatisation. The legislation on bank rehabilitation capped the total amount of government funding available for this purpose. The rehabilitation of the three banks in Slovenia has required the issuance of government-backed bonds equivalent to 6.3 per cent of GDP. These bonds, which are denominated in Deutschmarks, yield an 8 per cent return. Not all of the troubled banks' bad loans were transferred to the BRA, however, owing to the fiscal constraint. The BRA attempted to recover on the loans that it did take over through their sale at a discount, debt rescheduling and debt-equity swaps. For those loans that were retained by the banks, at least one institution has set up a work-out unit to manage these assets. The rehabilitation procedures, including the significant reduction in operating costs, appear to have turned around the operating performance of the banks, and their privatisation is now under consideration.

Quick breaks with the past

In ***Bulgaria***, banks were allowed in 1994 to exchange with the government non-performing, policy-directed loans made before the end of 1990 for state bonds. The face value of these debts amounted to 6 per cent of GDP; however, the bonds received by the banks carry below-market interest rates. Work-out units within the banks are required to recover on non-performing loans made after the end of 1990. No state banks in Bulgaria have yet been privatised.

The former ***Czechoslovakia*** initiated the recapitalisation of its banks in March 1991 by creating the Consolidation Bank, the role of which was to take over special credits for inventories that carried low interest rates. These credits amounted to 11 per cent of GDP, but were not necessarily non-performing. The Consolidation Bank has subsequently recovered much of the debt. A second recapitalisation of the banks occurred in October 1991, equivalent to 5 per cent of GDP. About three-quarters of this amount was allocated to the write-offs of non-performing loans to those firms that, according to the banks' appraisal, had a good chance to survive after the bail-out. Since 1991, the role of the Consolidation Bank has gradually evolved to include participation in enterprise restructuring by purchasing debts of enterprises in bankruptcy proceedings at a discount, easing the adverse impact on the creditor banks. Most existing Czech and Slovak banks were privatised in the first round of voucher privatisations in 1992.

with both shareholders and managers exposed to some form of discipline. Examples of this approach can be found in Poland and Slovenia, as well as in the 1993-94 recapitalisation programme in Hungary (Box 10.1).

The second approach to bank recapitalisation aims to creates a quick break with the past by limiting compensation for losses on loans to those that were in some way clearly linked with the previous regime. This approach typically restricts the types of loans on which compensation for losses would be available. This restriction has taken the form of either a cut-off date, so that losses on loans made after a particular point in time would not be eligible, or a restriction to loans made for a particular purpose. Losses on any loans not covered by the scheme remain the responsibility of the bank and must thus be met out of its earnings or capital. In some cases, this clear break with the past has been reinforced by rapid privatisation of banks. The virtues of this approach are the simplicity of conditions imposed on the recapitalisation and the potential speed in implementation. However, it requires that banks either have sufficient capital to absorb any uncompensated loan losses or have the ability to earn their way out of any remaining difficulties. Examples of this second approach can be found in Bulgaria and the former Czechoslovakia (Box 10.1).

There is a serious risk of distorting incentives for prudent and commercial bank operations from inadequate recapitalisation schemes. In this case, even if there is a commitment to privatisation of the troubled state bank, the inadequate recapitalisation could limit the credibility of the commitment, or it could encourage bank managers to take excessive risks to gamble on the payoff from privatisation. For those recapitalisations that attempt to achieve a quick break with the past, the potential for an inadequate recapitalisation is present. Loan losses are unlikely to be confined to particular types of loans or those made before a cut-off date. The potential pitfalls from inadequate recapitalisations are illustrated by the deliberately partial recapitalisation of the Hungarian banks in 1992, which may have contributed to the surge in bad loans in that country in the following year.[11]

In those countries that have pursued a comprehensive approach to bank recapitalisation, with a clear framework for the work-out of bad loans and commitment to bank privatisation to strengthen incentives, implementation of these relatively complicated programmes has been slow, including the pace of bank privatisation. Of the five state banks that have been privatised in Hungary and Poland in 1993-95, four did not require recapitalisation prior to their sale. Thus, only one state bank that has been recapitalised has, in fact, been privatised. Of the five state banks in the region that have been privatised, the EBRD has been a significant investor in three (Box 10.2). The keys to successful and enduring bank privatisations are both high-quality strategic investors and an effective framework of prudential regulation and supervision.

Box 10.2

EBRD support for bank privatisation

Privatisation of banks in transition economics can be complicated by the lack of a qualified strategic investor, such as a reputable foreign bank. While countries in transition usually lack a sufficient base of domestic investors, foreign investors are often reluctant to buy shares in banks due to the overall country risk and uncertainty about their credit portfolios. To facilitate bank privatisation in these circumstances, the EBRD often purchases a comparatively large share in a bank, normally accompanied by a restructuring and training programme and other technical support. Thus, the EBRD's participation helps not only to strengthen a privatising bank's capital base, but also to improve the quality of the bank's operations and to set the stage for private investors.

For example, the EBRD took part in the privatisation of Wielkopolski Bank Kreditowy (WBK) in 1993 (see also Box 7.7). WBK was one of nine state-owned commercial banks created from the National Bank of Poland. Before privatisation, WBK had increased its private sector loans from zero to 40 per cent of exposure by value and had also begun the task of reserving against its non-performing credits; loan reserves amounted to almost 30 per cent of gross customer credits. None the less, at the time of privatisation no single strategic investor wanted to take the lead. Two western European banks indicated interest, but were not prepared to invest because of their view of the risks involved. The EBRD injected new capital into WBK, acquiring a 28.5 per cent stake of the bank's enlarged capital, and was then instrumental in implementing a comprehensive restructuring and technical cooperation programme.

In 1994, Magyar Külkereskedelmi Bank Rt. (MKB or Hungarian Foreign Trade Bank) was the first Hungarian commercial bank to be privatised. MKB is the fourth-largest Hungarian bank in terms of total assets, but first in terms of its capital ratio. It is a full-service commercial bank that targets multinationals, joint ventures and blue-chip Hungarian companies. MKB managed to avoid the severe problems that faced other Hungarian banks after implementation of banking and bankruptcy reforms. In the unfavourable lending environment of the past few years, it has limited its lending and provisioned heavily against bad loans. MKB was considered the only Hungarian bank able to attract foreign investors in the immediate future. Bayerische Landesbank, a major German institution, showed a strong interest in MKB. However, Hungarian legislation requires reduction of the state ownership to 25 per cent plus one share, and Bayerische Landesbank was not able to take alone the full commitment necessary to privatise the bank. Together, Bayerische Landesbank and the EBRD diluted the state's direct shareholding to the required level. Prior to MKB's privatisation, the EBRD had supported an international bond issue by the bank (see also Box 7.10).

The EBRD also participated in the privatisation of Bank Prezemyslowo-Handlowy w Krakowie (BPH) in early 1995. The bank's credit process, organisation and information system had all been significantly improved since 1989 as a result of staff efforts and technical assistance from a major Dutch bank, ABN-AMRO. Again, however, with the absence of a strategic investor, and under difficult conditions in the local and other emerging markets, the privatisation of BPH could not have been carried out successfully without EBRD support. The EBRD purchased a large proportion of shares in BPH through a stand-by agreement before the offering, boosting the confidence of other potential investors in the bank. As a condition for the stand-by arrangement, the management board and bank council of BPH agreed to a policy statement with the EBRD on additional measures to improve the bank's operations.

[11] Bonin and Schaffer (1995).

Liberal entry and exit of private banks

A number of countries in the region have, at least for a period, allowed the liberal entry of new private banks to help transform banking. This strategy partly reflected the aim of reducing the role of the state banks through not only their eventual privatisation but also the emergence of viable private banks.[12] These new institutions, in principle, can provide a source of competitive pressure on the state banks to hasten the transformation of the sector. However, the entry of banks must be disciplined by adequate minimum capital and licensing requirements. The liberal entry of banks will almost inevitably raise the issue of how to manage exit from the industry.

For example, in the former Czechoslovakia and Poland a substantial number of new private banks were licensed in 1990-92 (43 and 60, respectively). At that time, the minimum capital requirements for banks were quite low and the granting of new licences liberal. As a result, while many new banks were established, a significant proportion of these were weakly capitalised and poorly managed. The emerging difficulties in some private banks led the authorities in both the Czech Republic and Poland to tighten significantly the entry conditions for private banks in 1993-94, including the substantial increase in minimum capital requirements and the eventual suspension in granting new banking licences. There is now an ongoing process of consolidating troubled private banks in both countries. Despite the large number of private banks in these two countries, their share of domestic banking remains quite small relative to that of the state institutions.

Estonia and Latvia have relied even more extensively on the entry of new private banks. Between 1989 and 1992, 42 commercial banks were established in Estonia. Entry was much facilitated by the erosion of minimum capital requirements through the high inflation of 1991-92, when three-quarters of the new banks were established. Most of these banks were small and weakly capitalised. The turning point in Estonian banking occurred in late 1992, when the authorities simultaneously closed the three largest commercial banks in response to a growing liquidity crisis. One of the Estonian banks was liquidated and the other two were merged, with depositors receiving only an equity claim on a fund designed to recover on assets. There were subsequent failures of a number of smaller private banks in early 1993 largely due to connected lending. Many of these banks were closed or merged, halving the number of banks in the system. Banking troubles resurfaced in Estonia in mid-1994 with the failure of two more banks, again due to extensive connected lending and, in one case, over-aggressive expansion. The two banks were merged and sustained as a going concern with government support.

The number of private banks in Latvia also expanded rapidly following the initiation of banking reforms in 1992 and reached 58 by the end of 1993. All but three of these banks were privately owned. Prudential regulations and licensing procedures were tightened significantly in 1994, including stricter minimum capital requirements and professional standards for bank managers. The authorities in 1994 revoked the licences of several banks, and stepped up their surveillance of many others. In the initial months of 1995 a further 10 banks either went bankrupt or lost their licences, and in May the government, at considerable expense, took over Banka Baltija, a private bank which had grown rapidly to become the largest in the country. A cocktail of weak capitalisation, aggressive expansion, widespread connected lending and high-risk loans to finance commodity exports from Russia led to the bank's collapse.

Some countries in the CIS have also relied extensively on the liberal entry of new private banks to help transform the banking systems. In Russia, the number of commercial banks has proliferated since the start of reforms, reaching almost 2,600 by mid-1995. However, most of these banks are quite small, with over 40 per cent of them having capital of less than Rb 500 million (less than ECU 100,000). While the largest three banks are formerly state owned, with their prominence sustained in part by their continued role in channelling directed credits, a number of private commercial banks are gaining significant market positions.[13] The total assets of each of the seven largest private banks now amount to about one-third to one-half of the total assets of the two smaller former state banks. The Financial Institutions Development Programme (FIDP) in Russia, which is supported by the World Bank and the EBRD, is aimed at creating a group of sound and commercially effective private commercial banks to form the new core of the banking system. The core components of the FIDP, which is restricted to those banks meeting certain financial criteria, are twinning programmes with foreign banks, investments in information technology and other operational equipment and assistance to the Central Bank of Russia on regulatory reforms (see Box 7.1 in Chapter 7).

In Ukraine and Belarus, there has been a rapid expansion in the number of newly created private banks, some of which have achieved significant shares of the domestic markets. In Ukraine the number has risen to over 220 by mid-1995. While all but two of these institutions are owned by non-governmental entities, most of the larger banks remain under the influence of the state or state enterprises. The savings bank and foreign trade banks remain state owned, while the three former state banks have retained their ties to particular economic sectors.[14] However, five private banks have grown rapidly, and the total assets of each of these banks are now about one-quarter to one-third of the size of the smaller state and former state banks. In Belarus, the number of banks expanded rapidly in 1994 with the liberal licensing policy of the National

[12] Phelps *et al.* (1994).

[13] The three largest banks in Russia are the Sberbank (savings), Vneshtorgbank (foreign trade) and Agroprombank.

[14] The former state banks are Prominvest (industry), Ukraina (agriculture) and Ukrosotsbank (housing and cooperatives).

Bank, reaching 52 by mid-1995. While the banking system is dominated by the specialised former state banks, the assets of each of the two largest new private banks now exceed those of the smaller former state banks.

To summarise, a number of countries in the region have allowed a period of liberal entry of new private banks to help transform their banking systems. In some cases, this entry has not been disciplined by adequate minimum capital and licensing requirements, although most countries have now moved to tighten these entry conditions. As has happened in the Czech Republic, Estonia, Latvia and Poland, a consolidation of the new private banks in some of the CIS countries will almost inevitably be required.[15] The management of any financial distress will require a careful balancing of concerns about financial stability and protection of household deposits against possible adverse impacts of support for banks on public finances and monetary control. This trade-off can become more difficult to manage as private banks gain a more prominent role in the domestic financial systems. If government support is provided for a troubled private bank that is perceived as too big to fail, it is important that the conditions imposed by the authorities on the bank's shareholders, managers and depositors create strong discipline. For those countries that do choose to rely heavily on new private banks to transform their banking systems, it is crucial that their entry into the market is disciplined by minimum capital and licensing requirements and that these banks are subject to adequate prudential regulation and supervision.

Market structure and profitability in banking

Three distinguishing features tend to characterise the structure and performance of banking in transition economies: the high concentration of banking markets, which is often a direct legacy from the structure of pre-reform banking; the relatively small scale of banking in most countries, which has been largely caused by high inflation and banks' limited capacity to expand their balance sheets in real terms; and the adverse impact of asset quality problems on bank profitability. Nevertheless, there are indications that the industry has the potential to become profitable and to attract the resources necessary for its expansion.

Market structure

The high level of market concentration in many countries stems from the way in which two-tier banking systems were created. Typically, this reform has involved splitting the monobank into several large banks, which are specialised by activity (such as savings banks for household deposits, and foreign trade banks), by key economic sectors (such as agriculture, industry and mining) or by geographical region. The extent of entry of new private banks has also had an impact on market concentration.

Table 10.2

Concentration of banking markets in selected countries in transition

Shares of total banking assets held by top banks and top five banks, by ownership

	State	Former state (privatised)	Private banks	Total
Belarus				
Top banks	5	62	21	88
Top five banks	0	54	21	75
Czech Republic				
Top banks	4	67	0	71
Top five banks	0	65	0	65
Hungary				
Top banks	54	8	6	68
Top five banks	49	8	6	63
Latvia[1]				
Top banks	6	0	24	30
Top five banks	6	0	21	27
Poland				
Top banks	66	5	0	71
Top five banks	66	0	0	66
Romania				
Top banks	74	0	5	79
Top five banks	74	0	0	74
Russia				
Top banks	21	6	16	43
Top five banks	21	6	6	33
Slovak Republic				
Top banks	36	40	3	79
Top five banks	36	40	3	79
Slovenia				
Top banks	52	37	0	89
Top five banks	48	22	0	70
Ukraine				
Top banks	11	59	12	82
Top five banks	11	59	0	70

Sources

BREE Ltd, EBRD and World Bank.

Notes

Ownership classification: A state bank is defined by state ownership of at least 51 per cent of shares by the state (direct or indirect). Former state banks are privatised state banks. Private banks are banks that have never been state-owned.

Figures in the table are shares of total banking assets in a given country. The figure for the top banks is the sum of the asset shares of banks with individual asset share of more than 3 per cent. The figure for the top five banks is the sum of the five largest banks, ranked by asset share.

1 In 1994, four of the largest Latvian banks failed or were taken over in conditions of illiquidity. The reported figures are computed excluding the four banks that failed.

[15] The temporary halt to lending in the Moscow interbank market in late August 1995 is an illustration of the fragility of the Russian banking system.

Table 10.3

Outstanding bank claims (as percentage of GDP)

	1990	1991	1992	1993	1994
Bulgaria					
Total claims	148.5	127.5	120.3	–	–
Claims on private sector	15.9	7.2	5.4	–	–
Czech Republic					
Total claims	–	–	–	89.0	94.8
Claims on private enterprises	–	–	–	55.9	64.7
Former Czechoslovakia					
Total claims	78.9	77.3	106.9	–	–
Claims on private sector	6.2	6.2	10.7	–	–
Estonia					
Total claims	–	65.5	11.5	13.7	15.6
Claims on private enterprises	–	18.8	6.9	10.5	13.2
Hungary					
Total claims	77.0	79.8	72.5	72.3	62.8
Poland					
Total claims	22.2	32.5	32.1	28.0	32.8
Claims on private enterprises	2.9	10.9	11.4	6.4	11.9
Romania					
Total claims	79.7	68.0	35.3	28.1	21.2
Russia					
Total claims	–	29.6	28.2	18.5	13.3
Slovak Republic					
Total claims	–	–	–	76.9	63.0
Claims on private sector	–	–	–	34.9	26.9
Slovenia					
Total claims	–	22.6	18.0	30.0	31.6
Ukraine					
Total claims	–	–	55.0	14.0	18.0
Bank claims in industrial countries					
France					
Total claims	107.1	106.4	106.3	101.5	100.1
Claims on private sector	97.1	97.3	97.3	93.0	83.3
Germany[1]					
Total claims	117.6	118.6	124.4	134.5	140.2
Claims on private sector	95.2	96.7	99.1	106.7	110.2
Portugal					
Total claims	82.3	86.5	90.2	–	–
Claims on private sector	46.7	50.5	54.5	–	–
Spain					
Total claims	105.2	102.8	100.9	98.2	104.3
Claims on private sector	70.0	71.6	70.9	70.7	69.5
United Kingdom					
Total claims	122.6	120.2	120.4	119.4	118.1
Claims on private sector	117.1	115.3	114.7	112.3	109.6

Sources

IMF, *International Financial Statistics*, National Bank of Hungary, Central Bank of Slovenia, Government of the Russian Federation, *Russian Economic Trends* and *Ukrainian Economic Trends*.

Notes

Estimates for 1994 except [1] (= actual values).

The market structures in banking in much of the region are highly concentrated, with the exception of Russia. Market shares accounted for by the top five banks in Belarus, Czech Republic, Hungary, Poland, Romania, Slovak Republic, Slovenia and Ukraine ranged from 63 per cent to 79 per cent in 1994 (Table 10.2). In contrast, the market shares of the top five banks in Latvia and Russia are 27 per cent and 33 per cent, respectively. The high market concentration in a number of east European countries reflects the continued dominance of state banks and former state banks. There are no new private banks among the major banks in these countries. Moreover, many banking markets in that region are segmented along industrial sector or geographical lines, in which case the aggregate concentration ratios understate effective market power. The banking markets in Latvia and Russia are distinguished by their low concentration, reflecting the impact of high inflation on the size of the state banks and former state banks and of liberal policies toward the entry of new private banks (see above).

Another distinguishing feature of banking systems in much of the region is their small relative size. In some countries in eastern Europe (Poland, Romania and Slovenia), the Baltics and the CIS, high inflation and negative real interest rates have limited the relative size of bank credits. The ratio of domestic credit to GDP in these countries was roughly between 20 and 40 per cent in 1994, and even less in previous years (Table 10.3). With the easing of inflation and transformation of banking, there has been some recovery in bank credit, but the relative size of the systems remains small. However, in Bulgaria, the Czech Republic, Hungary and the Slovak Republic, where (in the last three countries at least) periods of high inflation have been avoided, the ratio of total domestic credit to GDP ranges between 70 and 120 per cent. In advanced industrial countries the share ranges from 90 to 120 per cent.

Not only is the scale of bank credit relatively small, in most countries of the region the dominant share of the outstanding bank credits is to the government and state enterprises (Table 10.3). The ratio of outstanding private sector credits to GDP in Bulgaria, Estonia, Poland and the Slovak Republic ranges from close to zero per cent to less than 30 per cent. Only in the Czech Republic does the share of private sector credit approach levels found in industrial countries, reflecting the impact of the mass privatisation programme. The comparable shares in some advanced industrial countries range from about 60 to 110 per cent of GDP.

In the Czech Republic, however, the bulk of bank lending, 73 per cent in 1993-94, had a maturity of 1 year or less (short-term lending), with 18 per cent having a maturity of between 1 and 4 years. In terms of the outstanding stock of bank credits, there is a significantly higher proportion of medium- and long- term credits, but, in view of the composition and volume of new lending, most of these credits must have been made prior to the reforms. In advanced industrial countries, only about 20 per cent of

Table 10.4

Inputs in banking

Country	Employment per 100,000
Bulgaria	178
Czech Republic	517
Estonia	408
Hungary	266
Poland	337
Slovenia	481
Industrial countries	
France	704
Portugal[1]	605
Spain	631
United Kingdom[2]	640

Sources
BREE Ltd and OECD, *Bank Profitability, 1984-93.*

Notes
1994 figures for transition economies.
1993 figures for industrial countries.

1 All banks.

2 Commercial banks only.

Table 10.5

Bank profitability (selected banks)

Percentage of balance sheet totals, average 1990-93

	Income	Operating expenses	Provisions	Pre-tax profit
Bulgaria	1.0	0.5	0.2	0.3
Czech Republic	4.9	1.1	2.0	1.5
Hungary	7.1	4.8	3.1	0.0
Poland	8.3	2.0	2.4	3.9
Romania	7.2	1.3	2.5	3.4
Russia	3.9	1.6	0.4	1.9
Slovenia	7.4	3.3	5.8	-1.7
Industrial countries (commercial banks)				
France	2.1	1.5	0.5	0.1
Germany	3.2	2.0	0.6	0.6
Portugal[1, 2]	5.5	2.8	1.5	1.2
Spain[1]	4.7	2.8	0.8	1.0
United Kingdom	4.7	3.1	1.1	0.5

Sources
BREE Ltd and OECD, *Bank Profitability, 1984-93.*

Notes
Savings banks are excluded.

1 All banks.

2 Excludes 1990 figures.

outstanding bank credits have short-term maturities.[16] The capacity of Czech banks to finance fixed investment by private enterprises thus remains seriously constrained by the maturity structure of bank lending, and this feature characterises most countries in the region.

The scarcity of banking services in the region can be gauged not only by examining bank outputs such as loans, but also by the scale of inputs to the provision of bank services. For example, employment in the banking industry ranges from about 170 to 520 per 100,000 of population across the region (Table 10.4). The comparable figures in some advanced industrial countries range from 600 to over 700. This rough comparison makes no allowance for differences in banking skills across countries. Since total employment in banking in the region has grown very rapidly in recent years, and since these employees typically must learn the necessary skills on the job, quality-adjusted banking inputs are probably more scarce than the basic employment figures would suggest.

This analysis of the concentration and scale of banking activities in the region points to markets that are dominated by a handful of banks, but the scale of these banks is small relative to the size of the economies in which they operate. These market structures create conditions under which the exercise of market power becomes possible. This can retard the provision of banking services through high net interest margins and lack of innovation, in the absence of competitive discipline from entry of new banks.

Bank profitability

Selective data on bank profitability is available from a bank rating agency specialising in eastern Europe, the Baltics and the CIS, which compiles this data from the annual reports of selected banks.[16] Most of the annual reports have been subject to an independent audit, and many comply with international accounting standards. The countries covered by the agency include Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, the Slovak Republic and Slovenia. While the data do not cover all institutions, they include for most countries the major commercial and savings banks as measured by their total assets. Apart from Russia, the data typically include the major state-owned commercial and savings banks in each country, along with the better-performing private banks. In Russia, the agency covers only the top-performing private banks.

The financial performance of the selected banks in the region has been dominated by asset quality problems (Table 10.5). In Slovenia, the reporting banks provisioned at an average rate of about 6 per cent of total assets in each of the years 1990-93, and 2-3 per cent in the Czech Republic, Hungary, Poland and Romania. In Bulgaria the average provisioning rate was less than 1 per cent of total assets over the years 1990-93, but a loan conciliation scheme was implemented in 1994 which is likely to have boosted provisions. The typical loan loss provision rate in advanced industrial countries is no more than 1 per cent of total assets.

While loan loss provisions have been considerable, the net interest and other income of banks have also been quite high, with Hungarian, Polish, Romanian and Slovene banks earning between

16 The figures quoted in the text are taken from the Czech National Bank and Borio (1995).

17 The Agency is BREE Ltd, which is based in Cyprus.

7 and 9 per cent of total assets over the period 1990-93. To some extent, the high average income margins reflect periods of high inflation (1990-91 in both Poland and Slovenia and 1992-93 in Romania), when net interest margins typically widen, partly to preserve the real value of banks' capital. The income of banks in the Czech Republic and Russia have averaged between 4 and 5 per cent of total assets. The income of banks in advanced industrial countries is typically in the range 2 to 5 per cent of total assets.

The operating expenses of banks in Hungary have been the highest among those in the region, averaging about 5 per cent of total assets over the period 1990-93. In Poland and Slovenia, bank operating expenses have averaged 2-3 per cent. The average figure for the Czech Republic is rather low, but operating costs have increased steadily over the period, exceeding 2 per cent per cent of assets in 1993. The average operating expenses of Bulgarian and Romanian banks are low, possibly reflecting shortfalls in staff levels and experience. The operating expenses of banks in advanced industrial countries are typically in the 2-3 per cent range.

Two considerations thus point to the potential profitability of banking once the asset quality problems have been resolved, at least among the major institutions in these markets. The net interest and other income of the banks is relatively high, although this may reflect in part the impact of high inflation. Except for Hungary, operating costs appear to be in line with or below those observed in some advanced industrial countries. The concentrated market structures, small scale and high margins in banking in the region point to the need for new entry, including by foreign banks, which can bring much needed technical expertise. However, this new entry must be disciplined by adequate minimum capital requirements and effective prudential regulations.

10.4 The emergence of securities activities

The securities exchanges and non-bank financial institutions in transition economies have the potential to complement the banking sector in mobilising and channelling domestic savings to investment and in imposing financial control on enterprises.[18] A wide range of institutions actually make up a securities market, including the physical or electronic exchanges and their market-makers, clearance and settlement organisations, agents for the issuers of securities (share registrars and transfer and payment agents), and agents for investors (depositories, custodians, proxy services and brokers). Effective regulations are also required to ensure an organised and stable environment for securities activities. These include rules governing the eligibility to issue and to list securities, such as those on financial disclosures, and prohibitions on insider trading. Moreover, investors in securities often rely on vehicles such as investment companies, pension funds and insurance companies, which are typically subject to some prudential regulation.

A number of countries in the region have moved to enact the basic laws and regulations for the creation of securities and the exchanges on which they trade, as well as for the trading of these instruments (Chapter 2). The legal framework necessary to support extensive securities activities extends, however, beyond the narrow confines of securities laws to include reforms in areas such as property rights, bankruptcy and company law (Chapter 6).

Formation of securities markets

The development of securities markets in the region has so far been shaped largely by the nature of privatisation programmes. The formation of securities markets began in 1990-91 with the re-establishment of exchanges in Bulgaria, Croatia, Hungary, Poland and Slovenia. The implementation of mass privatisation programmes in the Czech and Slovak Republics propelled the reopening of the Prague and Bratislava Stock Exchanges in 1993. Similarly, in Lithuania the National Stock Exchange was established in 1993 to support the voucher privatisation programme. In Russia, the completion of the first phase of mass privatisation in mid-1994 fuelled the development of securities activities on a number of exchanges which had been established in the early 1990s, primarily for the trading of commodities. Latvia opened a stock exchange in mid-1995.

In Hungary, Poland and Slovenia, the institutions that make up a securities market have been able to develop in step with the expansion of the markets. This reflects a selective approach to privatisation and demanding disclosure requirements, which have limited the rate of increase in listed equities. In the Czech Republic, Slovak Republic and Russia, however, the mass privatisation programmes have contributed to a surge in equities that has outstripped the capabilities of the market to handle them. In the Czech Republic, the liquidity of the organised market remains low, in part because of problems in trade settlement and non-transparent trade on the organised exchanges. Also, an estimated 80-90 per cent of all share transactions take place outside of the organised exchanges in the Securities Centre, which was originally established to register securities holders. In Russia, the mismatch between volume of securities and capacities of the markets to handle them is even greater, and there are fundamental weaknesses in the systems for the registration of shares and for the clearance and settlement of trades. The EBRD and the IFC are supporting projects in these areas to help develop institutions for securities markets (see Box 7.2). The weak legal protection of shareholder interests and securities fraud are also significant problems in Russia and elsewhere.

Role of government, self-regulation and financial disclosure

Those countries that have at least modest levels of cash-based securities activities, either in the form of new issues or of trading in outstanding securities, have typically enacted a range of regulations and rules applied to securities activities (Table 10.6). These include regulations governing financial disclosure requirements for publicly offered securities and investor protection codes related to insider trading. Such regulations are complemented by listing requirements imposed by the exchanges themselves.

[18] Levine and Zevros (1995), for example, provide empirical evidence of a positive and significant impact of development of securities activities on growth (see also Box 5.2).

The quality of financial disclosure is determined not only by regulatory requirements but also by accounting practices. As with banking supervision, a critical input into the investment decisions of investors are the accounts of listed companies. The accounting practices of many enterprises continue to reflect more the requirements of central planners than of outside investors. However, the overhaul of accounting practices is under way in most countries throughout the region.

In addition to disclosure and accounting requirements, the state has moved to implement investor protection codes, by making illegal the trade of securities based on information that is not in the public domain. However, the extent of enforcement appears limited.

Performance of securities markets

The role of securities in financial intermediation is typically summarised by three indicators: the ratio of market capitalisation to GNP, the market turnover ratio and the ratio of total value traded to GNP. The market capitalisation ratio typically indicates the extent to which securities markets are used to mobilise capital and to diversify risks, but in transition economies this ratio largely captures progress in privatisation. The market turnover is the ratio of total value of traded equities to their market capitalisation. This measure provides an indication of market liquidity and transactions costs. The ratio of total value traded to GNP indicates the extent of liquidity available on an economy-wide basis.

The Czech and Slovak Republics have achieved, in the wake of their mass privatisation programmes, the highest ratios of stock market capitalisation to GNP in the region (Chart 10.1). The 1994 capitalisation ratio in the Czech Republic is roughly the same as that in France, while the ratio in the Slovak Republic is comparable to those in Germany, Greece and Portugal. The capitalisation ratios in Hungary, Poland and Slovenia are similar to that in China, while Bulgaria lags well behind the other countries. It is particularly noteworthy that a number of fast-growing Asian economies have achieved particularly high ratios of stock market capitalisation to GNP.

The stock markets in the region with relatively high market capitalisation typically have less market liquidity (and vice versa). The Warsaw Stock Exchange compares favourably with the stock markets in France, Germany and the United Kingdom in terms of the ratio of total valued trade to market capitalisation (Chart 10.2). The markets in the Czech and Slovak Republics, however, are relatively illiquid compared with other markets. The exchanges in Hungary and Slovenia occupy the middle ground.

In transition economies, there thus appears to be a trade-off between the scale and speed of privatisation and the liquidity of shares in the privatised enterprises. Moreover, the nature of the trade-off is such that no stock exchange in the region performs satisfactorily when performance is measured in terms of the ratio of total market turnover to GNP (Chart 10.3). The liquidity provided in transition economies is well below the levels achieved in the selected industrial and fast-growing developing countries. This lack of liquidity can significantly restrict the ability of companies to raise capital through securities issues and impede the emergence of a market for enterprise control, retarding growth and restricting the restructuring of enterprises. Empirical studies of comparative long-term growth across countries indicate that it is total market liquidity relative to GNP that is empirically associated with higher long-run growth (Chapter 5).[19]

[19] See Box 5.2.

Table 10.6
Securities markets regulations

	Reporting requirements for listed companies	Investor protection codes	Pricing and settlement systems
Bulgaria	The issuance of and the trading in securities are regulated and controlled by the Securities and Stock Exchange Commission. The Commission also grants and revokes any licences for the conduct of business in the Stock Exchange capacity. For admission of a public offering of securities, a prospectus must be published containing any information about the issuer and the offered securities.	As of end-1994 the First Bulgarian Stock Exchange (FBSE) is in the process of completing rules and regulations to protect investors.	The trading instruments now available are stocks of members, shares of different banks and public joint-stock companies. The exchange is organised along the lines of a traditional open outcry system, assisted by a computerised system. Orders are matched according to their priority (price, time and volume) and the trades are registered automatically by the system. The present system of settlement and clearance is based on physical settlement of individual trades. Commission rates on share transactions are fixed at 2.2 per cent.
Czech Republic	The state exercises supervision over the Prague Stock Exchange (PSE) and the capital markets through the Ministry of Finance. Upon request and submission of appropriate documents, from the issuers, it provides licences authorising the public trading of securities. The business and financial results of the issuers of publicly tradable debt are monitored continuously. An Exchange Commissioner appointed by the Ministry of Finance operates on the Stock Exchange.	The stock exchange maintains a list on information insiders, who are only allowed to buy and sell securities through the exchange with the consent of the exchange management. Under the Czech National Council Securities Act of 1992, any use of confidential information in securities trading is prohibited. Members of the exchange have established a Guarantee Fund that covers the risks arising from exchanged trades. The exchange guarantees compensation and settlement of all trades conducted through it.	The PSE offers two types of trading: computerised and block trading. In computerised trading, the broker brings in all the orders and a pricing algorithm is used to match buy and sell orders. Exchange deals are cleared by the Securities Register, a daughter company of the PSE. Delivery of securities in exchange for cash must occur within three days.
Hungary	Public offers of securities within Hungary may be made pursuant to a prospectus being approved by the state Securities Supervision Board. Before a company can issue shares, permission from the Hungarian securities and supervision and the National Bank of Hungary must be sought. Companies must publish a file with the Bucharest Stock Exchange (BSE) quarterly, semi-annual and annual statements within 30 days of the end of each period. In addition, an annual report must be filed (by 31 May) containing the companies' annual audited statements prepared in accordance with the 1991 Accounting Act, which came into force in January 1992.	The provisions of the new Securities Act, 1990, provide for protection against insider trading. The act allows for the Securities Supervision Board or the state prosecutor to institute proceedings against persons trading in securities using insider trading practices. Minority shareholders have limited rights to bring actions against a company.	Trading is on an open outcry basis. Settlement proceeds using the Central Clearing House and Depository, set up in October 1993, operating independently of the Stock Exchange. Brokerage fees vary depending on the level of service provided, and type of security traded. Typically, fees dealing in shares or investment trusts are in the range 0.5 per cent to 1.5 per cent.
Poland	The Stock Exchange Supervision Board is responsible for the supervision of the Exchange. On the issue of new shares, it is required that an investor issue a prospectus. The prospectus is not a separate document, but is published in two national newspapers.	No law exists explicitly protecting investors. This function is carried out by the government according to miscellaneous regulations. Investors' interest are also protected by the Chairman of the Securities Commission.	All trading is computerised, and orders are entered onto a computer on the trading floor by a stock exchange member who is the specialist in that stock. The specialist is the market-maker, balancing the market if there is an imbalance between buy and sell orders. The trading system ensures liquidity and minimises fluctuations from session to session. Settlement is required by law to take place within one day from the execution of the transaction. All transactions are on a cash basis, and all accounts must have sufficient funds covering at least 80 per cent of the order value. Short selling is not permitted. Commissions vary between 0.75 per cent to 2 per cent, and are not fixed by the Exchange.

Reporting requirements for listed companies	Investor protection codes	Pricing and settlement systems	
At the Moscow Central Stock Exchange (MCSE), a company is required to present the following documents to be listed on the Exchange: a copy of a prospectus, the most recent financial statements, financial statements for the last three years or as many years as the company has been in operation, confirmation from a bank that initial capital has been paid in full, a blank copy of a shareholder's certificate and a short description of the company's investment policy. The Moscow International Stock Exchange (MISE) requires that listed companies comply with disclosure requirements for public offerings laid down by the Russian Federation. On the Siberian Stock Exchange, a listed company is required to present on a quarterly basis its financial report, profit and loss statement, and confirmation of the number of shares outstanding. In December 1991 regulations governing joint-stock companies took effect. The Ministry of Finance has set standards for financial disclosure requirements for the issue of new prospectuses. These regulations are under review. A Securities and Exchange Commission was established in November 1994, subsequently raised to ministerial status.	There is no Russian compensation fund on MCSE, MISE, the Siberian Stock Exchange or the St Petersburg Stock Exchange.	All Russian exchanges use a simple open auction system even though some, especially MCSE, have begun to use electronic trading. Few exchanges have developed satisfactory settlement procedures. Three stock exchanges were chosen to provide central clearing and settlement functions. A central register of owners is being prepared in order to speed up the process of transferring ownership. On the MCSE mutual settlement is carried out on the basis of a trade contract carried out through the clearing house of the Exchange. Each deal must be settled within three days, but special terms for settlement between brokers are possible. On the Siberian Exchange, trades are settled between brokers, and confirmed by written contracts prepared by the Exchange and signed by the brokers. Commission on the MCSE varies between 2 and 5 per cent of the value of the bargain.	**Russia**
Company securities listed on the Bratislava Stock Exchange (BSE) must be accompanied by a prospectus detailing information about the company's operations and financial position. Within 30 days of the end of each quarter, the issuers of securities listed on the main market are obliged to submit quarterly financial statements. The issuers of securities on the junior market are obliged to submit semi-annual financial statements. Listed companies are required to submit annual audited statements.	The Stock Exchange Act of 1992 contains provisions on the use of false or misleading information on the issue of shares. There are also provisions in the Securities Act of 1992 preventing persons who have acquired price-sensitive information from trading in the information to which the security relates.	The trading system initially adopted by the Exchange was open outcry. The present system is electronic with continuous matching.	**Slovak Republic**
The government introduced the Slovene Securities Market Law in January 1994, and the Investment Fund Trust Law was adopted simultaneously. However, as of end-1994, 1988 Yugoslav regulations still apply. Stock exchange listing requires that companies publish a prospectus. Listed companies are obliged to provide semi-annual reports, which must be freely available.	In July 1992 the Exchange established a guarantee fund in order to protect investors against insolvency of stock exchange members. At present only floor trades are covered by the guarantee fund up to DM 0.5 million.	The settlement of stock exchange transactions should be carried out within two working days after the bargain date (or one day, in the case of short-term transactions). An electronic system for settlement began operating in early 1994. Trading is carried out by open outcry and through a screen-based trading system. The total cost of each transaction should not exceed 1.5 per cent inclusive of brokerage fees.	**Slovenia**

Sources: *Euroclear-IFR Handbook* (1995), GT Guide and EBRD.

Chart 10.1

Stock market size (measured by capitalisation)

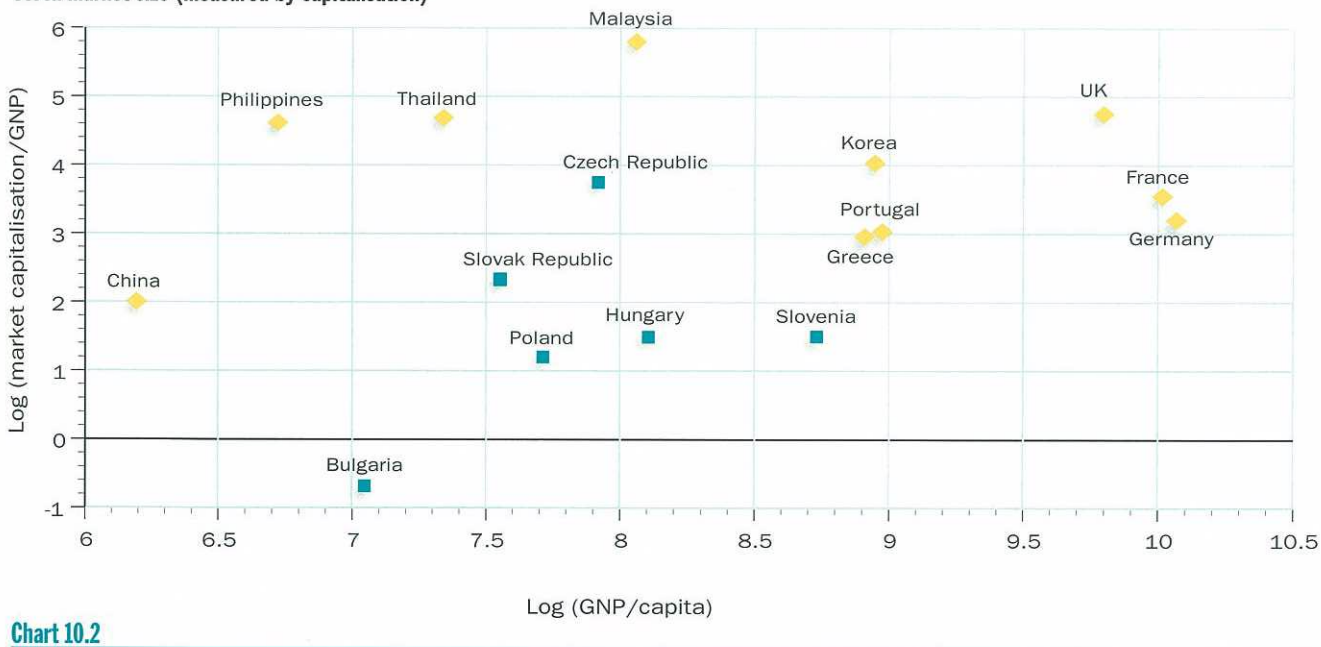


Chart 10.2

Stock market liquidity

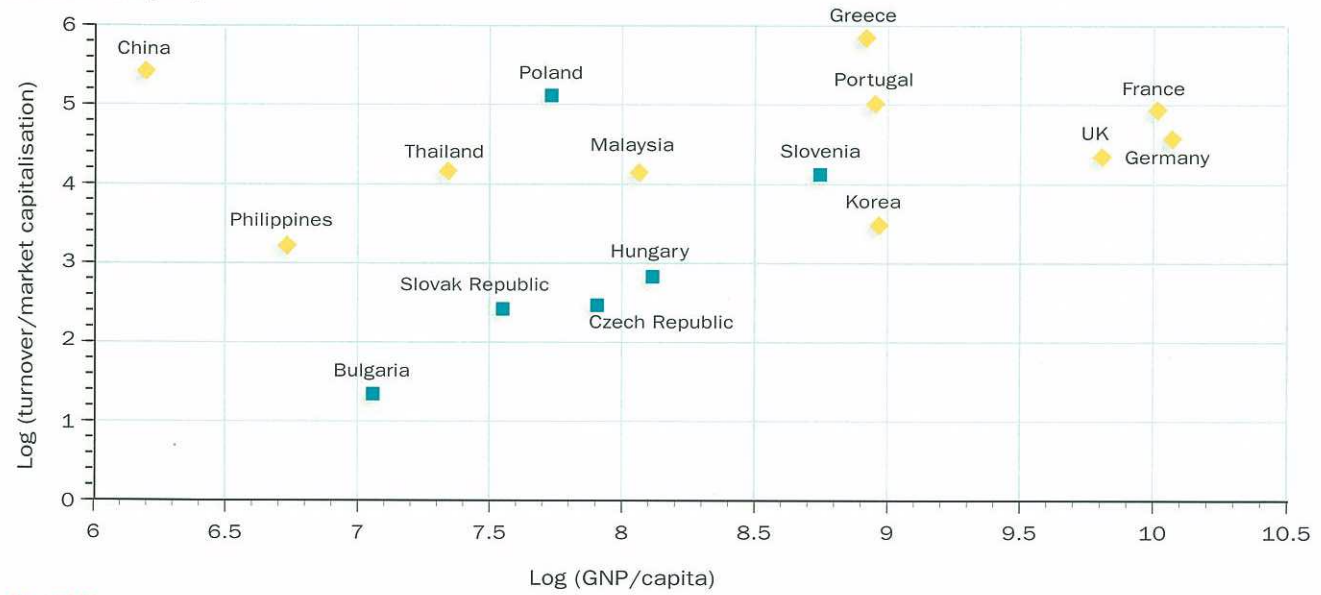
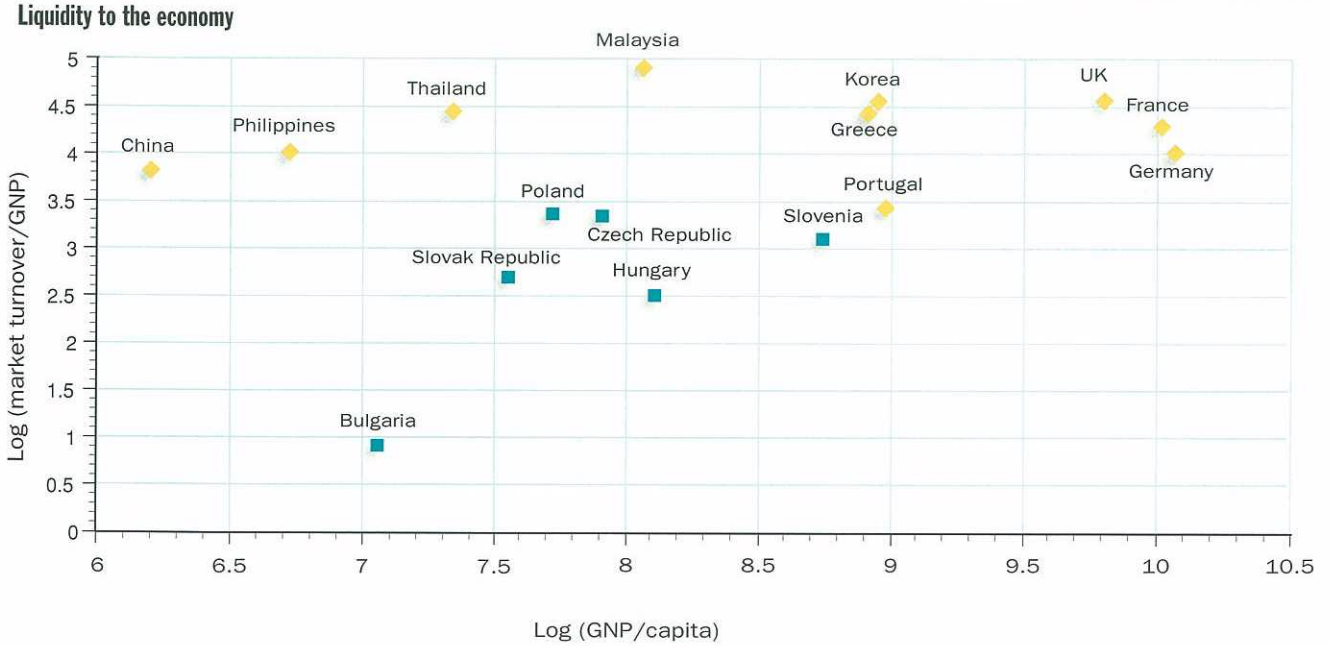


Chart 10.3

Liquidity to the economy



10.5 Concluding remarks

This chapter has shown that the relative scales of banking and securities activities in transition economies are well below the levels in advanced industrial and fast-growing developing countries. Much remains to be done in the region to transform the role of government in the financial sector, with a focus on effective enforcement of laws and regulations, and to strengthen the financial institutions and markets themselves.

Governments in a number of countries in eastern Europe have pursued a measured strategy to transform their role in banking, strengthening prudential regulation and supervision while recapitalising and privatising state banks. Further progress along this reform path will require more stringent enforcement of prudential regulations that approach Basle Committee or EU standards, along with more rapid progress in bank privatisation to strengthen incentives and to attract the resources necessary for the expansion of services. The support of the EBRD and other IFIs for bank privatisation can be instrumental in advancing this process. It must be recognised, however, that movement along this reform path is likely to reduce the capacity of banking systems to bear risks, at least for a period. The Basle Committee EU regulatory standards were designed in the context of advanced industrial countries to reduce risks in banking to low levels and to limit the government's exposure to loss through the official safety net for banks. Stringent application of these regulations in the environment of transition economies may well curb the commercial lending of banks, at least while risks remain high. Development of effective securities markets can help to ease the trade-off between progress toward sound, market-oriented banking and the capacity to intermediate risk capital in the economy.

The transformation of banking in some countries of the Baltics and the CIS has occurred through the extensive entry of new private banks, together with the erosion of assets of the state and former state banks through very high inflation. As the new private banks begin to play a more dominant role in banking markets, the willingness of the authorities to close distressed banks may be constrained by concerns with systemic financial instability. This is illustrated by the recent government bail-outs of large private banks in Estonia and Latvia. If recapitalisations of private banks do become necessary, it is vitally important that the conditions imposed by the authorities on the banks' managers and shareholders impose financial discipline. At the same time, the EBRD and other IFIs can help to strengthen a core of private banks that can serve as the nucleus of a viable banking system.

Banking sectors in the region tend to be highly concentrated and small. At present, the financial performance of banks is dominated by the overhang of bad loans and risks in new commercial lending, but other aspects of banks' financial performance (including net interest margins and operating costs) appear satisfactory, at least for the top tier of institutions in the countries surveyed. As the asset quality problems become resolved, entry into banking should be encouraged, but this must be disciplined by appropriate minimum capital requirements and licensing requirements.

For securities activities, the challenge is to achieve both high capitalisation and liquidity. This will require development of effective regulations and institutions, more accurate and fuller financial disclosure, and greater transparency of trades. The EBRD and other IFIs have an important role to play in fostering the development of the necessary institutional infrastructure, and in supporting the issuance of securities by enterprises in local markets.

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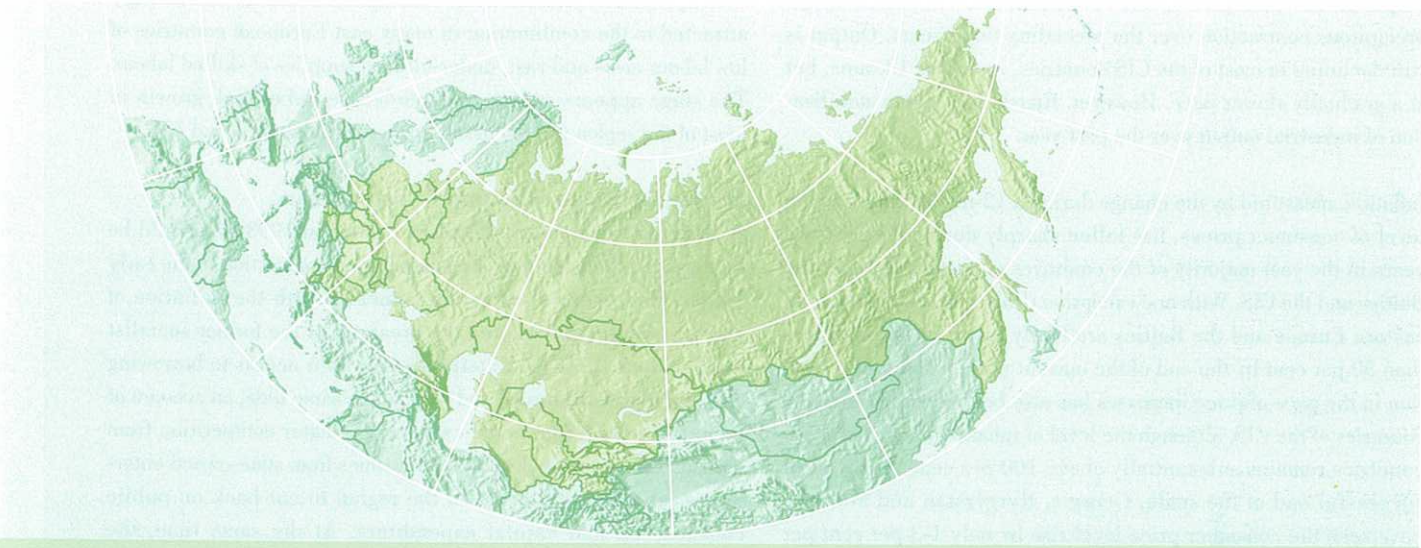
Transition report

Part IV



Macroeconomic overview

Recent economic developments

11

Most countries in eastern Europe and the Baltics recorded healthy output growth during 1994 and the first half of 1995, following a precipitous contraction over the preceding three years. Output is still declining in most of the CIS countries, including Ukraine, but at a gradually slower pace. However, Russia has seen a stabilisation of industrial output over the past year.

Inflation, measured by the change during a 12-month period in the level of consumer prices, has fallen sharply during the past two years in the vast majority of the countries of eastern Europe, the Baltics and the CIS. With one exception (Bulgaria), all countries in eastern Europe and the Baltics are likely to see inflation of less than 50 per cent by the end of the current year. A sharp deceleration in the pace of price increases has also been recorded in many countries of the CIS, although the level of inflation in most of these countries remains substantially above 100 per cent. At the most successful end of the scale, Georgia, Kyrgyzstan and Moldova have seen the consumer price level rise by only 1-3 per cent per month during the first seven months of 1995.

These developments are discussed in further detail in the remainder of this chapter. The commentary on output and inflation is accompanied by a discussion of trends in productivity, employment and cost competitiveness, and by a review of developments in foreign trade, with a particular focus on relations between the European Union and countries in eastern Europe. Much of the supporting data is presented in tabular form in Annex 11.1.

11.1 Eastern Europe and the Baltic states

Output developments

On current trends, 1995 looks set to become the third consecutive year of positive aggregate GDP growth for eastern Europe and the Baltics. The economies of Albania, the Czech Republic, Estonia, Poland, the Slovak Republic and Slovenia are each expected to grow by 3½-6 per cent for 1995. Positive growth, albeit somewhat more modest, is expected in all the remaining economies of eastern Europe and the Baltics. The private sector, which is expanding rapidly (see Annex 2.2), has become a more important influence on aggregate economic growth than the shrinking state sector. Positive growth reflects increases in productivity (discussed in further detail below) and has not been accompanied in any country, except in the Czech Republic in 1994, by an expansion in aggregate employment.

Non-residential investment began to pick up in 1994 in many countries (see the more detailed discussion of investment trends in Chapter 3). The increase in investment has primarily been concentrated on machinery and equipment. Rising investment reflects growing confidence in the stability of the macroeconomic and regulatory environment. It may also reflect export opportunities associated with deepening links with the EU. With greater macroeconomic stability, domestic and foreign investors are increasingly attracted to the combination in many east European countries of low labour costs and vast, under-utilised supplies of skilled labour. The stage appears set for an extended period of high growth in most of the region (as discussed further in Chapters 3 and 12).

Recent increases in output in perspective

Positive growth in most of eastern Europe in 1993-95 should be seen against the backdrop of a sharp output contraction in the early 1990s. This output contraction coincided with the initiation of market-oriented reform and the break-up of the former socialist trading block (CMEA). Enterprises saw their access to borrowing and subsidies constrained and were at the same time, on account of import liberalisation, being exposed to greater competition from abroad. The resulting drop in tax revenues from state-owned enterprises forced governments in the region to cut back on public consumption and capital expenditure. At the same time, the collapse during 1990-91 of the CMEA precipitated a drop in demand from the Soviet Union for goods and services from east European trading partners. The disintegration of the CMEA also led to a sharp increase in the price for energy deliveries from the Soviet Union (and later from Russia) – deliveries that had previously been made on highly concessional terms.

All of these factors led to sharp shifts in relative prices and in the profitability of production across different subregions and industries. In response, activity that had been rendered unprofitable by the changes in relative prices and the partial phase-out of subsidisation was being cut back swiftly. In this environment of rapid change, great uncertainty and large terms-of-trade losses, the expansion of newly profitable production and investment initially only partially offset the decline in the much larger state-owned enterprise sector. According to official estimates, real GDP for eastern Europe and the Baltics as a whole fell by about 20 per cent between 1989 and 1992.

The summary table on growth in Annex 11.1 indicates that Poland and Slovenia are the only countries in eastern Europe that are close to regaining in full what was lost during the early 1990s. In all other countries in eastern Europe, real GDP levels remain 10 per cent or more below the "starting point". Output in the latter countries is likely to return to the pre-reform levels only (at least) 2-4 years from now – in most cases 7-10 years after the transition process began.

It should be emphasised that the officially measured decline in real GDP between 1990 and 1992 is likely to exaggerate the underlying impact on welfare (as discussed in greater detail in Annex 11.1). First, the underlying quantities of output may be underestimated as statistical offices find it difficult to capture activity in the many new

or reformed productive entities. Second, the quality of output may have improved in ways that are not captured in output statistics. Third, market-oriented reforms have led to a shift in the pattern of output towards goods and services that satisfy demand expressed by consumers and investors in the market-place, rather than demand that is formulated by government planners.

A rarely quoted parallel to the output path now seen in eastern Europe can be found in the economic history of the United States immediately after the Second World War. Between 1945 and 1947, real GDP dropped by a fifth in the United States. The contraction reflected a massive post-war reorientation of demand. As in the case of eastern Europe, the reorientation involved a reduced role for government planners and an increased influence of market forces as the government sharply reduced its demand for military goods and services. The sharp contraction in state absorption allowed private consumption and private investment to grow despite the fall in aggregate output. Real GDP in the US regained its "pre-transition" level (that is, the level seen in 1945) only in 1952, seven years after the onset of "reform".

Inflation and exchange rates

Between the end of 1993 and July 1995 inflation fell sharply in a number of countries in eastern Europe and the Baltics, including Albania, Croatia, FYR Macedonia, Lithuania and Romania. All of the latter five countries saw inflation (measured as the change during 12 months in the level of consumer prices) drop during this period from several hundred per cent to less than 40 per cent (6 per cent in Albania, 2 per cent in Croatia, 28-29 per cent in Romania and 38-39 per cent in Lithuania). Croatian consumer prices actually fell during the course of 1994. Bulgaria has also seen a sharp slow-down in the pace of price increases since late 1994 but continues to experience the highest rates of inflation in eastern Europe, with consumer prices increasing by about 60 per cent during the 12 months to July 1995.

Albania, Croatia, the Czech Republic, the Slovak Republic and Slovenia have been the first to reduce inflation to single digits after the onset of market-oriented transition. Inflation in Poland fell to 27.6 per cent in July 1995, responding favourably to the change a few months earlier to the country's exchange rate system (see details below). Meanwhile inflation rose in Hungary to 31 per cent in July (from 21 per cent at the end of 1994) under the influence of sharp devaluations, increases in utility prices and new indirect taxes (see the Transition Indicators in Annex 2.2), aimed chiefly at containing deficits on the state budget and the current account balance.

A number of countries, including the Czech Republic, Estonia, Latvia, Lithuania and the Slovak Republic, are keeping their exchange rates fixed *vis-à-vis* either a hard currency or a basket of hard currencies. Hungary and Poland are adjusting their exchange rate daily by a fixed pre-announced percentage *vis-à-vis* a basket of hard currencies. In some of these countries, rapid gains in labour productivity in manufacturing have been reflected in sharp wage increases, as described in further detail below. Wage pressures have spilled over into the services sector where productivity may have risen more sluggishly and where wage increases, therefore, may have been reflected in higher output prices.[1] Meanwhile large flows of funds have found their way from lenders and investors abroad into enterprises and banks in eastern Europe and the Baltics. The combination of pressure on wages from high productivity growth in some sectors and large financial inflows from abroad has, together with further adjustment of administered prices (notably utility prices), complicated efforts to reduce inflation in countries pursuing fixed exchange rate policies. Difficulties associated with inflation control may well be reinforced in the Czech Republic, Hungary and Poland by steps currently under way in these three countries to remove some of the remaining balance-of-payments restrictions. Many observers believe such liberalisation will result in further net inflows from abroad and further pressure on the real exchange rate to appreciate (either through inflation or through nominal exchange rate appreciation).

In an attempt to restrain the contribution to growth in the money supply from inflows via the balance of payments, the Polish authorities have gradually reduced the cumulative monthly rate of pre-announced devaluations of the zloty from 1.5 per cent in mid-1994 to 1.2 per cent in July 1995. In May 1995 the Polish authorities widened the band within which the central bank will aim to keep the interbank zloty exchange rate. The new band was specified as ±7 per cent of the central intervention rate, up from previously ±2 per cent.[2] The initial effect of this was a nominal appreciation of the zloty within the new and wider intervention band.

Hungary has moved in the opposite direction, accelerating the pace of nominal currency depreciation during the first half of 1995 (with the backing of fiscal tightening) in response to large current account deficits. On 12 March, Hungary devalued the forint in one step by 9 per cent and introduced a system of daily pre-announced devaluations that would be operative from then onwards. The cumulative monthly adjustment in the central intervention rate was 1.6 per cent until the end of June, and has been 1.3 per cent since then. The Hungarian authorities regard the monthly adjustments of 1.3 per cent as a maximum and intend to lower the rate to 1.2 per cent in January 1996.

Productivity and competitiveness

Between 1991 and 1994, dollar wages in manufacturing rose by a cumulative 77 per cent in Bulgaria, 75 per cent in the Czech Republic, 53 per cent in the Slovak Republic, 33 per cent in Hungary, and 24 per cent in Poland (see Table 11.1). All of these

[1] It is possible, however, that the scope for productivity gains in the near term in some countries in eastern Europe and the Baltics is higher in parts of the non-tradable sector than in industry and agriculture. Parts of the non-tradable sector (such as banking, insurance and telecommunications) constituted a particularly neglected part of the planning system and offer great scope for efficiency gains.

[2] The central intervention rate is stipulated by the central bank and devaluations apply to this rate, rather than to the interbank rate, which is determined as a market clearing rate, subject to central bank participation as a buyer or supplier of foreign exchange.

Table 11.1

Indicators of competitiveness

	1990	1991	1992	1993	1994
			(Average percentage change)		
Bulgaria					
Industrial production	-16.8	-22.2	-15.9	-7.0	4.5
Employment in industry	-6.2	-18.8	-15.1	-11.8	-8.8
Wage in industry (expressed in local currency)	20.7	167.7	139.5	51.7	53.9
Exchange rate (LEV/USD)	216.7	210.5	32.2	19.2	100.7
Dollar wage in industry [1]	-61.9	-13.8	81.2	27.2	-23.3
Labour productivity in industry [2]	-11.3	-4.2	-0.9	5.4	14.6
Unit labour cost in industry in US dollars [3]	-57.0	-10.0	82.9	20.7	-33.1
Czech Republic					
Manufacturing production	-3.5	-26.4	-14.5	-9.9	0.2
Employment in manufacturing	-3.1	-11.8	-7.5	-6.6	-3.7
Wage in manufacturing (expressed in local currency)	-1.7	16.8	17.6	25.2	16.3
Exchange rate (CZK/USD)	19.3	64.2	-4.1	3.1	-1.2
Dollar wage in manufacturing [1]	-17.6	-28.9	22.7	21.4	17.8
Labour productivity in manufacturing [2]	-0.4	-16.6	-7.6	-3.5	4.1
Unit labour cost in manufacturing in US dollars [3]	-17.3	-14.8	32.8	25.8	13.1
Hungary					
Manufacturing production	-10.1	-24.0	-4.9	3.2	8.7
Employment in manufacturing	-10.6	-3.9	-15.5	-11.1	0.7
Wage in manufacturing (expressed in local currency)	22.9	25.6	26.6	22.8	20.3
Exchange rate (FT/USD)	7.0	18.2	5.7	16.4	14.4
Dollar wage in manufacturing [1]	14.8	6.2	19.8	5.6	5.2
Labour productivity in manufacturing [2]	0.6	-20.9	12.6	16.0	8.0
Unit labour cost in manufacturing in US dollars [3]	14.2	34.3	6.4	-9.0	-2.6
Poland					
Manufacturing production	-24.1	-12.3	4.8	12.2	14.5
Employment in manufacturing	-3.7	-0.4	-10.5	-2.0	-3.4
Wage in manufacturing (expressed in local currency)	374.2	63.3	37.7	39.1	39.1
Exchange rate (ZLY/USD)	560.2	11.3	28.8	33.1	25.3
Dollar wage in manufacturing [1]	-28.2	46.7	6.9	4.5	11.0
Labour productivity in manufacturing [2]	-21.1	-11.9	17.1	14.5	18.5
Unit labour cost in manufacturing in US dollars [3]	-8.9	66.5	-8.7	-8.8	-6.3
Romania					
Manufacturing production	-18.8	-23.6	-24.3	-6.6	3.7
Employment in manufacturing	0.6	-6.9	-12.5	-7.9	-8.5
Wage in manufacturing (expressed in local currency)	6.6	123.0	166.0	199.6	133.5
Exchange rate (LEI/USD)	43.9	211.9	328.7	146.8	117.6
Dollar wage in manufacturing [1]	-26.0	-28.5	-38.0	21.4	7.3
Labour productivity in manufacturing [2]	-19.2	-17.9	-13.5	1.4	13.3
Unit labour cost in manufacturing in US dollars [3]	-8.4	-12.9	-28.3	19.7	-5.3
Slovak Republic					
Industrial production	-4.5	-17.6	-14.4	-10.2	7.0
Employment in industry	-3.1	-7.8	-15.8	-7.4	-0.3
Wage in industry (expressed in local currency)	3.0	17.8	19.7	18.4	17.0
Exchange rate (KCS/USD)	19.2	63.9	-4.1	8.8	3.6
Dollar wage in industry [1]	-13.6	-28.1	24.8	8.8	13.0
Labour productivity in industry [2]	-1.4	-10.6	1.6	-3.0	7.3
Unit labour cost in industry in US dollars [3]	-12.3	-19.6	22.9	12.2	5.3
Germany					
Unit labour cost in US dollars [4]	18.5	1.3	12.4	-2.1	-4.4
United Kingdom					
Unit labour cost in US dollars [5]	14.4	6.1	1.8	-14.5	1.9

Source
EBRD staff calculations based on data from the "OECD Short-term Economic Indicators No. 2, 1995".
The calculations for Germany and the UK are based on data from the "OECD Main Economic Indicators", June 1995.

1 Measured as the local wage in industry/manufacturing converted into US dollars at the average exchange rate for the year.

2 Measured as industrial/manufacturing output per employee in the industrial/manufacturing sector.

3 Measured as the cost in US dollars of labour used in industry/manufacturing per unit of gross output.

4 Mining and manufacturing wages per unit of output.

5 Total wages and salaries per unit of output.

rates substantially exceed the percentage increases in dollar wages over the same period in EU countries, such as Germany (5 per cent). These increases have caused concern about industrial competitiveness among some observers and governments, although the level of the dollar wage remains modest throughout eastern Europe in comparison with levels prevailing in the EU (see Table 11.2).

Table 11.2

Gross monthly wages in US dollars

(gross of income tax, net of social security tax)

	1992	1993	1994
Bulgaria	–	115	86
Czech Republic	164	200	240
Estonia	47	83	138
Hungary	282	296	317
Latvia[1]	–	77	138
Lithuania[1]	–	37	89
Poland	215	221	241
Russia	28	63	96
Slovak Republic	161	175	196
Ukraine	24	15	30

Source

The data for the former Soviet Union states were taken from PlanEcon August 1995, those for the Visegrad countries were taken from the Statistical Bulletin 1994/4 and 1995/1 (issued jointly by the statistical agencies of the Visegrad countries), and those for Bulgaria were taken from the Bulgarian National Bank Annual Report 1994.

[1] For Latvia and Lithuania the wage levels quoted here refer to the state sector only.

A better measure of competitiveness than the dollar wage is the labour costs (expressed in dollars) associated with production of one unit of output. This concept, referred to below as "unit labour costs", can be expressed as the ratio of labour-related expenses (measured in dollars) to the productivity of labour (the latter term is defined as the number of units of output produced per employee).

Despite the rise in the dollar wage, unit labour costs in dollar terms in manufacturing declined by about 22 per cent in Poland and by 6 per cent in Hungary between 1991 and 1994. This points to a very substantial improvement in labour cost competitiveness for both countries *vis-à-vis* Germany and, especially in the case of Poland, also *vis-à-vis* the United Kingdom. This improvement reflects large increases in labour productivity in Polish manufacturing, amounting to 15-19 per cent per year between 1991 and 1994 (see Table 11.1).

Developments in Romanian and Bulgarian unit labour costs have been dominated to a greater extent by gyrations in the dollar wage. In the case of Romania, the cumulative rate of change of -19 per cent in unit labour costs between 1991 and 1994 was dominated by a drop of 28 per cent in 1992 which reflected rapid currency depreciation (and, correspondingly, a sharp decline in the dollar wage) rather than improvements in productivity. During the course of 1993 and 1994, both stabilisation and structural reform took hold in Romania, and the pattern of labour cost developments came to correspond more closely to that seen in Hungary and Poland, with increases in productivity outstripping increases in dollar wages. In Bulgaria, the exchange rate and hence the dollar wage have fluctuated sharply in recent years, partly in response to changes in market perceptions of the government's commitment to macroeconomic stabilisation. Bulgaria was the only country listed in Table 11.1 in which dollar wages declined in 1994. Compounded by a 15 per cent improvement in labour productivity, this led to a reduction by one-third in unit labour costs, partly offsetting rapid increases in the preceding two years.

In the Czech and Slovak Republics the sharp increases in unit labour costs between 1991 and 1994 reflected rapidly rising dollar wages, far outpacing productivity growth, which in fact was negative until 1994. The increase in dollar wages reflects the fact that wages in local currency increased rapidly, while the nominal exchange rate remained fixed against a basket of hard currencies. Labour productivity movements were driven by the continued weakness of the index for manufacturing output, which started rising only in 1994 in both countries, long after the equivalent indices in Hungary and Poland had begun to increase rapidly. The late and subdued turnaround in recorded industrial production in the Czech Republic may in part be the result of measurement difficulties (the data quoted are based on observations only for enterprises with more than 100 employees), possibly leading to an understatement of labour productivity growth and an overstatement of the rise in unit labour costs (statistical methodological difficulties are discussed in Annex 11.1).

It should be emphasised that even reliable data on unit labour costs would be insufficient as the basis for a precise assessment of changes in competitiveness. Ideally, the applied productivity measure should focus on value added (rather than gross output) and should incorporate changes in the cost and quantity of both labour and capital. However, the analysis of these items is a challenge that lies beyond the scope of this Report. It might appear intuitively plausible that the use, as set out in Table 11.1, of gross output rather than value added leads to an understatement of productivity growth and an overstatement of increases in unit labour costs because the transition process involves large cutbacks in lines of production that subtract rather than add value, so that value added in manufacturing is likely to have fallen less sharply than output. This hypothesis is, however, not always backed by available data. In Hungary, for example, official estimates for real value added in manufacturing point to a drop of 9.3 per cent in 1992 and 2.3 per cent in 1993, whereas the estimates for gross manufacturing output indicate a fall of "only" 4.9 per cent in 1992 and an increase of 3.1 per cent in 1993. To the extent both sets of figures reflect reality, they imply an increase in the use of material inputs per unit of real value added. The reasons for this development are unclear.

Abstracting from these conceptual and statistical difficulties, Table 11.1 does provide at least tentative evidence of solid productivity gains in 1994 in all of the listed countries. Such gains are likely to reflect the combination of two conceptually separate phenomena. One is the shedding by enterprises of staff who were previously kept on the payroll as a "social support mechanism" (to help sustain full employment). This process, which allows a reduc-

tion in employment without a corresponding change in output, will not go on forever. At some point there will be no more "surplus" labour that can be shed without influencing capital requirements or output from the enterprises. It is impossible to know how much surplus labour is left in the enterprise sector.

The other phenomenon involves renewal and expansion of the capital stock, improvements in training, and/or a strengthening of the organisation and management of capital and labour. This process may in principle proceed at a relatively rapid pace for as long as technological, educational and managerial progress can be imported from the West, that is, at least for as long as there is a substantial gap between eastern and western Europe in the effectiveness with which individual factors of production are being used.

Officially measured employment has dropped sharply over the past four years and continued to decline in 1994 in all countries of eastern Europe and the Baltics (except the Czech Republic), despite the fact that output in most countries was increasing at a substantial pace. The scope for shedding of surplus labour may, however, be shrinking rapidly, and it would appear reasonable to expect some increase in employment in a few countries in 1995. In fact, aggregate employment was rising even according to official estimates during the first half of 1995 in the Czech Republic and Poland.

International trade

The foreign trade turnover of countries in eastern Europe grew rapidly in 1994, in particular in the second half of the year. According to estimates from the UN Economic Commission for Europe,[3] aggregate exports from these countries grew last year by 12-15 per cent (in US dollar terms), while imports increased by about 7-10 per cent. Trade between east European countries rose substantially in 1994, after having contracted sharply during the preceding four years. The relatively strong aggregate export growth appears consistent with the indications in Table 11.1 of steady or improving labour cost competitiveness for many east European countries. The combined trade deficit of the east European countries narrowed in 1994 by about a quarter to just over US$ 10 billion. Romania was the greatest single contributor to this improvement (see the country tables in Annex 11.1).

Ten countries in eastern Europe and the Baltics have entered into "Europe Agreements" with the EU. Europe Agreements for Bulgaria, the Czech Republic, Poland, Romania and the Slovak Republic were signed during 1992-93. Agreements for Estonia, Latvia, Lithuania were signed and one for Slovenia was initialled during the spring and summer of 1995. The Europe Agreements aim to further the integration between east European countries and the EU by lowering barriers to trade, establishing a political dialogue, harmonising legislation, cooperating on science and technology, and providing for technical cooperation. The most important aspect of the agreements is the establishment of free trade in industrial goods over 10 years, asymmetrically – with the EU countries in most cases reducing protectionist measures at a faster pace than their east European counterparts. During the course of 1995 and 1996, the EU will abolish all remaining trade barriers on industrial imports, except textiles (this has already been done for the EU's trade with some of the east European countries). Further concessions on trade in agricultural products are applied on a reciprocal basis. The agreements have to be endorsed by the national parliaments of all EU countries before entering into full effect but the trade parts of the agreements become effective (through a so-called "interim agreement") virtually immediately after being signed. The full approval process has now been completed for the first 6 of the 10 Europe Agreements.

The Central European Free Trade Agreement (CEFTA), signed by the then Czech and Slovak Federal Republic, Hungary and Poland in 1992, involves gradual symmetrical liberalisation of trade, most radically for industrial products, during the period until 2001. Slovenia will join CEFTA in 1996. Trade between the CEFTA countries has been expanding in 1994 and 1995, after declining sharply prior to the existence of the CEFTA agreement.

The prospect of accession to the EU

A "White Paper"[4] outlining the steps to be taken within the countries applying for accession was circulated in the spring of 1995 and endorsed by the EU summit in Cannes in June. Accession to the EU for a country of the region would surely be a landmark on the road to establishment of a fully fledged market economy and one may ask whether it would signal the "end of market-oriented transition". The answer will depend on what is meant by the "end of transition". If the latter concept defines the point at which the economies have overcome the legacy of the many decades of the command economy and are now essentially similar to a western European economy then the answer would surely be "no". For even the most advanced countries of the region, the restructuring problems are much too profound to be overcome in just 10 years from the start of transition. The damaging and dangerous environmental and nuclear legacy will still be threateningly present in the year 2000. The financial institutions will still be inexperienced and many of them fragile. Corporate governance is unlikely to be of the quality typically seen in western European countries. The neglect of the infrastructure by the old regime will take much more than one decade to rectify. In all these basic senses the transition will be far from complete even with accession.

There is no doubt, however, that accession would be an important milestone. It would mark full integration into the major relevant trading bloc and thereby overcome permanently any residual barriers to trade in the main export markets. Accession would reduce the risk foreign providers of funds had previously associated with lending to the new members and thus lower the cost of capital to both public and private sectors, although it would not be guaranteed to provide the levels of long-term capital that will be needed for restructuring to proceed at a satisfactory pace. From

[3] UN Economic Commission for Europe (1995).

[4] European Commission (1995).

the point of view of the new members, accession would be likely to enhance access to infrastructural funds, through, for example, the European Investment Bank and the EU Regional and Structural Funds. From the perspective of trade, capital markets, infrastructure investment, and for many other economic and political issues, it will be a profound advance.

To a large extent, pursuing the transition by establishing a well-functioning market economy will involve much the same measures as would be prescribed for preparation for accession. Hence, since the countries seeking accession are embarked on the transition they are already basically committed to the required path for accession. There are, however, specific institutional and legislative measures, including infrastructure requirements (trans-Europe links, for example), the functioning of financial institutions and environmental standards, for which specific accession-oriented investments will be required.

Events internal to the EU will be among the crucial determinants of the timing and conditions for accession to the Union of east European and Baltic countries. The poorer regions of the EU currently benefit from significant aid in the form of regional and structural funds. Subsidies are also allocated on a sectoral basis, most notably through the Common Agricultural Policy (CAP). Integration of the countries of eastern Europe and the Baltics into the EU would have very significant implications for these redistributive policies.

Many of the east European and Baltic countries are suffering from the same problems as the disadvantaged regions of the EU: inadequate transport and other basic infrastructure, a large and comparatively low-productivity agricultural sector, industrial decline and high levels of unemployment. Funding under EU structural policies attempts to overcome these weaknesses and "cohesion" funds are currently provided to four countries which account for 18 per cent of the EU population. The simple extension of these policies to eastern Europe and the Baltics would imply massive transfers of funds over long periods of time. Simply extending the structural policies to these countries would imply roughly a doubling of the EU's structural funds budget, which is estimated to be ECU 35 billion in 1999.

The issues relating to the EU's Common Agricultural Policy are even more uncertain than those regarding structural funds, although the ultimate financial implications are not as large. In 1994, the cultivated area in Bulgaria, the Czech Republic, Hungary, Poland, Romania and the Slovak Republic was equivalent to 38 per cent of the EU total. Without major reform of the CAP, it may be anticipated that the entry of the prospective members would imply that CAP expenditures rise by at least a third. Enlargement without further substantial modification of the CAP may not be feasible both for the internal reasons associated with the budgetary burden and because of commitments made by the EU and the east European countries under the Uruguay Round.

The Inter-governmental Conference of the EU member countries, to start in 1996, will form a major part of the decision-making process for accession. The Conference is unlikely to be complete before the middle of 1997. The outcome of the Conference will have to be ratified by all EU member governments and this may take another one to two years. In addition, as noted, crucial and controversial aspects of the EU's funds and policies may need to be reformed before it would be realistic to expect existing member countries to vote for full accession of east European and Baltic partner countries. Detailed negotiations with each country will be required before the arrangements can be completed. It appears unlikely that all 10 countries with Europe Agreements would join at the same time.

Access of governments and central banks to international capital markets

Before 1995, the only governments or central banks in eastern Europe that had been able to raise funds in international bond markets after embarking on market-oriented transition were those of the Czech Republic, Hungary and the Slovak Republic. The Hungarian authorities have been by far the most active in these markets, raising US$ 4.4 billion in 1993 and US$ 2.5 billion in 1994 to build up reserves, and to cover principal payments on the country's high stock of foreign debt as well as, in 1993-94, current account deficits equivalent to 9 per cent of GDP, far in excess of inflows of foreign capital to the corporate sector (in the form of lending or foreign investment).

Jitters in international capital markets during the months following the Mexican financial crisis in January 1995 subsided during the second quarter of the year. Thus, the National Bank of Hungary (NBH) was able to raise US$ 1.5-2 billion during the first three quarters of 1995 through international bond issues and syndicated loans. A yen issue by the NBH in September carried a maturity of 20 years.

The governments of the Czech and Slovak Republics saw less of a need during the first half of 1995 to issue bonds in international markets, as they were able to add to their stocks of foreign exchange reserves without resorting to foreign borrowing. Although the Czech Republic's current account moved into a deficit of about 3 per cent of GDP in the first half of 1995 after having been in surplus in 1994, this was outweighed by even greater inflows of investment, portfolio placements and direct lending from abroad to Czech-domiciled enterprises and banks.

In July 1995, the Polish government tapped private capital markets for the first time in the 1990s, raising US$ 250 million from a Eurobond issue with five years' maturity. The government had paved the way in late 1994 by reaching agreement with commercial creditors on repayment terms for pre-1991 state debt. The net present value of obligations covered by the agreement was reduced by about 50 per cent. This debt reduction agreement (which complemented a reduction in 1991 by about 50 per cent in Poland's debt to official creditors) led to the elimination of Polish debt arrears and "normalised" the country's relations with external creditors. The issue of bonds in July 1995 was helped not only by

debt reduction but also by the persistently solid Polish fiscal policy record so far during the 1990s, as affirmed by cuts during 1994 and the first half of 1995 in the deficit of the state budget and of the current account. Although official statistics point to a Polish current account deficit of about US$ 0.8 billion for the first half of 1995 (up slightly from US$ 0.6 billion in the first half of 1994), many observers believe that the "true" current account is in surplus, after incorporation of border trading (particularly buoyant on the export side) which escapes official statistics.

Relations with international capital markets also improved for other countries in the region. In May 1995, the National Bank of Romania became a newcomer to the market for syndicated loans (after years of absence), obtaining a one-year loan in the amount of US$ 150 million from a group of Western banks. In August 1995, Latvia raised about ¥4 billion by issuing bonds with a maturity of two years in international capital markets. In September Slovenia concluded an agreement with commercial creditors to assume part of the debt of the former Yugoslavia. This agreement will "normalise" Slovenia's creditor relations and is likely to open the way for international bond issues. Albania agreed in July with commercial creditors on a debt restructuring package, involving a reduction of up to 80 per cent in the net present value of obligations covered by the agreement.

11.2 The Commonwealth of Independent States

Output developments

Over the past year, the pace of output decline has subsided in the largest CIS countries, Russia and Ukraine, following precipitous falls over the preceding three years. In Russia, industrial production during the first half of 1995 was "only" a few percentage points below the level achieved during the first half of 1994. In Ukraine, output was relatively stable during most of 1994 but declined by about 15 per cent in the first quarter of 1995 (from the level in the last quarter of 1994), partly in response to a substantial tightening of financial policies. It remains uncertain for both Russia and Ukraine to what extent output will be reduced by the expected execution of tight credit policies during the remainder of the year. Output in the remainder of the CIS continued to contract in the first half of 1995, except in Armenia where production staged the first substantial rebound seen so far in the CIS (from a very depressed level). According to official estimates, the level of industrial output in Armenia in the first half of 1995 exceeded the level in the same period of 1994 by at least 10 per cent.

The recent output stability in perspective

The output stability in the larger CIS countries follows a severe contraction during the first four years of the 1990s and very sluggish growth in the latter half of the 1980s. The slow-down in growth in the perestroika period in the late 1980s was caused in part by a decline in oil production, resulting from years of inadequate investment in the oil sector, and in part by the use by enterprises of increased budgetary autonomy to switch spending from investment to wage increases. The drop in oil output coincided with a rise in hard currency debt servicing requirements, forcing the Soviet authorities to raise hard currency revenues by exporting an ever-growing share of oil output to the West while compressing the use of hard currency for imports of inputs and machinery. In order to capture badly needed hard currency revenues, oil exports were diverted away from trading partners in the CMEA. In the 1980s, these trading partners would not normally pay for imports from the Soviet Union in hard currency but in the form of deliveries of goods under complicated bilateral barter deals. In response to Soviet cuts in oil deliveries, the Soviet Union's CMEA trading partners cut exports to the Soviet Union. The trading partners were keen to avoid shipping useful resources to the Soviet Union in exchange for non-convertible claims which they would not be able to use to solicit imports of useful goods and services. The resultant drop in deliveries from eastern Europe to the Soviet Union aggravated shortages of inputs and investment goods within the Union between 1988 and 1990.

The Soviet economic climate deteriorated further in 1991. The break-up of the Union led to a disintegration of inter-republican trading links. Partly as a result of this, the all-encompassing influence of the state order system for domestic procurement and distribution of goods and services was eroded before market-based institutions were ready to take over transportation, distribution and marketing of goods and services. Meanwhile, all levels of government throughout the former Soviet Union were forced to cut back on demand for capital goods in general, and for military goods and personnel in particular, adding further to the recessionary forces that had come to dominate the economies of the newly independent states. Ripple effects from these shocks as well as a gradual further disintegration of the old command system and of inter-republican trading links led to further falls in output in 1992, 1993 and 1994. In cumulative terms, real GDP of the CIS countries has virtually halved during 1990-94, according to official estimates (see the summary table on growth in Annex 11.1). While these estimates are likely to overstate the decline there can be little doubt that the contraction has been severe.

The fiscal and monetary policy regime in Russia was tightened in 1994 and the first half of 1995, although this trend was interrupted occasionally by spells of rapid credit expansion. The overall trend towards harder enterprise budget constraints (resulting from the tightening of central bank credit policy) forced most chronic loss-makers to cut production. This helped release labour and financial resources to the fledgling private sector, although open unemployment was kept at a minimal level through the widespread use by enterprises of "unpaid leave" for employees in preference to outright layoffs. While the release of previously poorly utilised resources helped set the stage for a switch in the medium term to sustainable growth, the initial effect may well have been significantly contractionary. Cuts in unprofitable activity are likely to have occurred at a substantially faster pace than the generation of new high value added lines of output, providing part of the explanation for the officially estimated 15 per cent decline in Russian real GDP in 1994.

However, the weight in GDP of the growing non-state sector has expanded substantially over the past 18 months, while that of the

financially troubled part of the "old" enterprise sector has dropped off. This development has gradually brought Russia closer to the point at which even officially registered aggregate real GDP will again begin to grow. Full-year real GDP may still be lower for 1995 than for 1994 but the turnaround is likely to be reached in 1996.

In interpreting these comments, it is important to keep in mind that all quantitative statements made in this section rely on data from the national statistical agencies in CIS countries (see Annex 11.1). There can be little doubt that these data exaggerate the fall in output. Statistical systems in the CIS countries are dependent to an even greater extent than their counterparts in eastern Europe on reporting from large, "old" companies that have contracted most rapidly, rather than the new and more dynamic private entities.

Inflation and exchange rates

Although rates of inflation remain much higher in the CIS than in eastern Europe, most CIS countries have reduced the rate of price increases very substantially over the past two years through much tighter fiscal and monetary policies, in most cases designed in the context of policy agreements with the International Monetary Fund.

The most impressive progress towards price stability within the CIS has been made in Armenia, Azerbaijan, Georgia, Kazakstan, Kyrgyzstan and Moldova. In Armenia, consumer prices rose 27 per cent during the first four months of 1995, after having increased fivefold during the same months of 1994. Azerbaijan's monthly inflation rates, which had hovered between 17 and 28 per cent from August 1994 to January 1995, dropped to a more modest 1-6 per cent range during February-April 1995. In Georgia, consumer prices rose less than 20 per cent during the first half of 1995, after having risen more than 70-fold during 1994. A slightly less dramatic yet still impressive development was recorded in Kazakstan, where prices rose less than 30 per cent during the first five months of 1995 after having increased 10-fold during 1994. More persistent stabilisation policies have been pursued over the past few years in Kyrgyzstan and Moldova, whose 12-month rates of inflation fell gradually during 1994 and the first half of 1995 to reach, respectively, 41 per cent and 22 per cent in July 1995, down from more than 1,700 per cent in both countries in December 1992. The reduction in inflation rates has been reflected in a gradually increasing degree of stability of nominal exchange rates, notably in Kyrgyzstan and Moldova, but also in Georgia, Russia and Uzbekistan.

In Belarus, Russia, Ukraine and Uzbekistan, inflation fell to 4-7 per cent per month in the second quarter, after having risen sharply to much higher levels towards the end of 1994. In the case of Ukraine, there will be a one-off large increase in the price level during the third quarter of 1995 as administrative prices are adjusted. But the monthly rate of inflation is likely to fall back late in the year, assuming the fiscal and monetary policy determination of the government and the central bank is maintained.

Tajikistan had the unique experience within the CIS of a large price level decline in early 1994 resulting from an unintended monetary contraction in the context of the switch from the use of "old Russian roubles" to the use of "new Russian roubles" without establishment of a formal monetary union with Russia (these events are described in greater detail in the EBRD's *Transition Report Update*, April 1995, p. 11). However, the official estimate of the size of the price decline during January-March 1994 has now been revised downwards from 42 per cent to 27 per cent, and increases during subsequent months are currently thought, despite an extremely tight supply of liquidity, to take end-year inflation for 1994 to a positive 5 per cent. A new national currency, the Tajik rouble, was introduced on 10 May 1995. Tajikistan and Turkmenistan are the only countries in the CIS that have experienced a substantial increase in inflation in 1995.

Unit labour costs in Russia

The depreciation of the Russian exchange rate has, over the past few years, fallen far short of the differential between nominal wage increases in Russia and nominal wage increases in trading partner countries. Meanwhile official data for output and employment indicate that productivity continues to decline. Thus unit labour costs (in dollars) in Russia's industrial sector rose by more than 150 per cent in 1993 and more than 80 per cent in 1994 (see Table 11.3). Even if the data underlying these figures overstate the production decline, there can be little doubt that unit labour costs have risen sharply (Annex 11.1 provides a commentary on problems of interpretation of Russian output data). It is important, however, not to exaggerate the consequences of this rise. Monthly wages, at an average of US$ 96 per month in 1994 (see Table 11.2), remain at a very modest level by international standards. Much of the real currency appreciation in the past few years represents an adjustment to the initial "undershooting" of the real exchange rate (below the long-run sustainable level). This undershooting had occurred in the initial reform period in response to highly negative real interest rates (now replaced by rates that are highly positive in real terms) and a perception of high systemic risk (a perception which is likely to have lessened gradually in recent years).

Table 11.3

Indicators of competitiveness for Russia

	1993	1994
	(Average percentage change)	
Industrial production	-14.1	-20.8
Employment in industry	-3.3	-4.8
Wage in industry (expressed in local currency)	838.9	265.8
Exchange rate (rouble/US dollar)	318.9	136.6
Dollar wage in industry[1]	124.1	54.6
Labour productivity in industry[2]	-11.2	-16.8
Unit labour cost in industry in US dollars[3]	152.3	85.9

Source
EBRD staff calculations based on data from the OECD Short-term Economic Indicators No. 1, 1995.

1 Measured as the local wage in industry converted into US dollars at the average exchange rate for the year.

2 Measured as industrial output per employee in the industrial sector.

3 Measured as the cost in US dollars of labour used in industry per unit of gross output.

Trade developments

Data compiled by the UN Economic Commission for Europe point to a modest increase in 1994 in the dollar value of exports from CIS countries to non-CIS countries of about 9 per cent, and an increase in the corresponding import value of about 5 per cent. Russian export growth was slightly below the average for the CIS countries, whereas the remainder of the CIS saw export growth of about 15 per cent.

The aggregate trade balance for the CIS countries *vis-à-vis* the rest of the world was in surplus by about US$ 20 billion in 1993 and US$ 23 billion in 1994. These figures are dominated by very large Russian surpluses (accounting for about US$ 18 billion in 1993 and US$ 20 billion in 1994, according to official estimates).

However, much uncertainty is associated with trade statistics for the CIS countries. The country tables in Annex 11.1 quote a figure for Russia's trade surplus *vis-à-vis* non-CIS partners in 1994 of US$ 12 billion, substantially below the official estimate of the surplus), based in part on the assumption that official customs statistics fail to record a significant proportion of imports, particularly of consumer goods.

Concluding remarks

The picture that emerges from an analysis of GDP data for eastern Europe, the Baltics and the CIS is one of growth in those countries that entered the process of market-oriented transition and macroeconomic stabilisation in earnest around 1989-91, and of gradually diminishing declines in output in those countries that entered the process a few years later.

Progress in the transition process (described in detail in Chapter 2) has been accompanied by advances in the control of inflation, through increasingly active fiscal and monetary policy. The EBRD expects inflation by the end of 1995 to be in the 5-30 per cent range in most of eastern Europe and the Baltics, and close to 100 per cent in large parts of the CIS (lower in some of the smaller CIS countries). In the following chapter these and other EBRD predictions will be compared with forecasts from a large number of other institutions.

Annex 11.1
Selected economic indicators for each country in transition

Statistics

The interpretation of economic indicators: some caveats

The following set of tables provides a summary of macroeconomic developments in recent years in the EBRD's countries of operations. However, many of the series suffer from quality deficiencies. They are mostly based on official national statistics from governments, statistical agencies and central banks in eastern Europe, the Baltics and the CIS. In some cases they are taken from publications issued by other international financial institutions, which in turn rely heavily on official national statistics. A period of fundamental systemic change to a country's economic system tends greatly to increase data inaccuracy. This section discusses some of the difficulties of interpretation and quality that are associated with the data series. (A less comprehensive version of this section was published in the EBRD's *Transition Report Update*, April 1995.)

Statistics for output and value added

Before the market-oriented transition began in earnest in eastern Europe, the Baltics and the CIS, statistics on production volumes were based on information from state-owned companies. Virtually all of these companies were subject to extensive reporting requirements. However, the devolution of activity over the past 4-5 years to myriad smaller, often private, entities has forced statistical agencies in the region to switch towards survey-based methods of data collection, similar to those applied in the West. The change of technique has created great methodological difficulties.

Since 1989, statistical agencies in the region have been gradually phasing out the Material Product System (MPS), the national accounting system that was applied by centrally planned economies and which excluded many services (in the so-called "non-material sphere") from the "Net Material Product" (NMP), its main measure of value added. The aim of these statistical agencies has been to replace the MPS by the United Nations' System of National Accounts (SNA), which establishes the core of the standards that are applied in most OECD countries as well as in many developing countries throughout the world. The most important concept of aggregate value added in the SNA system is the "Gross Domestic Product" (GDP). The use of a simplified conversion between estimates for NMP and GDP during the gradual switch of system has introduced an element of inaccuracy. A number of statistical agencies in CIS countries continue to apply the "old" data collection principles that were originally aimed at production of an NMP-estimate. Some of these countries amend the NMP-estimate in a very rough procedure to arrive at a figure for GDP. The procedure often amounts to simple multiplication of the NMP-estimate by a fixed factor (usually in the range of 1.1-1.3) to adjust for the exclusion from NMP of most value added from the service sector.

One probable result of inadequate statistical coverage of the relatively dynamic, and rapidly growing, private sector is a negative bias in some countries' growth estimates for the initial years of transition. The companies that are most easily monitored are large state-owned enterprises, which are in most cases contracting rapidly. Private companies in the new market-oriented environment may be tempted, mainly for tax reasons, to understate their production. The resulting negative bias in series for growth of real GDP and gross output may be quite large. In some cases the magnitude of the officially measured decline in real GDP does not appear credible. For example, Georgia's real GDP in 1994 was less than 15 per cent of the 1989 level, according to official figures. During the interim period Georgia was also exposed to a sharp deterioration in the terms of trade and suffered a loss of large fiscal transfers from the central authorities of the former Soviet Union. Thus the implication of the official GDP series would be that the average real income in Georgia is now far less than 15 per cent of the 1989-level.

Studies published several years ago with the backing (if not official endorsement) of statistical agencies in Hungary and Poland point to a need for substantial positive revisions to these countries' official data for GDP growth in the early 1990s. These findings have not been reflected in revisions to the data series that are published by the Hungarian and Polish governments. These series may still fail to capture in full the growth in the emerging private sector, especially the informal part of it. This caveat applies to the figures shown in the attached country tables for Hungary and Poland, which reproduce the official data series. Similar caveats apply to the attached tables on most other countries of eastern Europe, the Baltics and the CIS.

A recent study by Dobozi and Pohl suggests that the percentage changes in electricity consumption may be better proxies for percentage changes in "true" real GDP levels than available official GDP-estimates.[5] One underlying assumption is that reported data on electricity consumption are more reliable than official GDP-estimates. Another is that the ratio of electricity consumption to "true" GDP is constant or declining. Their calculations show that, for eastern Europe, the percentage drop in electricity consumption between 1989 and 1994 corresponds fairly well to official estimates of the GDP decline, whereas for the CIS countries the drop in electricity consumption falls far short of the measured fall in GDP (see Table 11.4). A rise in overhead electricity use per unit of output due to declining capacity utilisation and a fall in maintenance investment, would tend to raise absorption of electricity per unit of value added. However, others factors, including higher electricity tariffs and shifts away from heavy industry, would pull towards increased energy efficiency. Dobozi and Pohl find it plausible to assume on balance that the energy intensity of real value added would have changed only a few percentage points over the period covered by their study. Their assumption would imply that the GDP decline has been overestimated in official statistics to a much greater extent in the CIS countries than in eastern Europe and in the Baltics. The "electricity measure" of GDP developments should, however, also be interpreted with care. In some countries there may be solid grounds for refuting the assumption that the relationship between electricity use and value added has remained constant. In particular, certain countries, including Kazakstan and Kyrgyzstan, have

[5] Dobozi and Pohl (1995).

Table 11.4

Growth in power consumption and real GDP[1]

		(Annual change in per cent)					Cumulative change in per cent
		1990	1991	1992	1993	1994	1989-94
Eastern Europe							
Bulgaria	Power consumption	-6.9	-14.4	-6.6	2.3	0.2	-23.7
	GDP estimates	-9.1	-11.7	-7.3	-2.4	1.4	-26.4
Czech Republic	Power consumption	-0.5	-8.9	-2.1	-0.5	3.1	-9.0
	GDP estimates	0.4	-14.2	-6.0	-0.9	2.6	-18.3
Hungary	Power consumption	-2.4	-6.0	-6.8	-4.1	0.8	-17.3
	GDP estimates	-3.5	-11.9	-3.0	-0.9	2.0	-16.6
Poland	Power consumption	-8.1	-2.4	-2.6	2.1	0.8	-10.1
	GDP estimates	-11.6	-7.6	2.6	3.8	5.0	-8.7
Romania	Power consumption	-15.8	-9.4	-8.9	-1.4	-4.0	-34.2
	GDP estimates	-5.6	-12.9	-10.0	1.3	3.4	-22.5
Slovak Republic	Power consumption	-0.8	-7.7	-4.6	-6.3	2.6	-16.0
	GDP estimates	-0.4	-14.5	-7.0	-4.1	4.8	-20.4
Baltic countries							
Estonia	Power consumption	0.5	-3.0	-15.2	-10.1	6.1	-21.1
	GDP estimates	-8.1	-11.0	-14.2	-6.7	6.0	-30.6
Latvia	Power consumption	-0.3	-3.5	-19.8	-18.8	2.5	-35.8
	GDP estimates	2.9	-8.3	-35.0	-15.0	2.0	-46.8
Lithuania	Power consumption	-4.0	-0.8	-22.0	-25.3	-2.4	-45.8
	GDP estimates	-5.0	-13.1	-37.7	-24.2	1.7	-60.4
Commonwealth of Independent States							
Armenia	Power consumption	-14.3	-1.7	-12.7	-33.8	-10.2	-56.3
	GDP estimates	-7.4	-10.8	-52.4	-14.8	5.4	-64.7
Azerbaijan	Power consumption	-0.4	0.4	-15.0	-3.5	-7.9	-24.5
	GDP estimates	-11.7	-0.7	-22.6	-23.1	-21.9	-59.2
Belarus	Power consumption	1.3	0.4	-10.3	-10.0	-11.8	-27.6
	GDP estimates	-3.0	-1.2	-9.6	-11.6	-21.5	-39.9
Georgia	Power consumption	-2.0	-10.2	-20.5	-14.3	-26.0	-55.6
	GDP estimates	-12.4	-13.8	-40.3	-39.0	-35.0	-82.1
Kazakstan	Power consumption	1.3	-3.1	-5.9	-7.9	-14.5	-27.3
	GDP estimates	-0.4	-13.0	-13.0	-12.0	-25.0	-50.2
Moldova	Power consumption	6.5	-4.6	-14.9	-11.3	-12.6	-33.0
	GDP estimates	-1.5	-11.9	-29.0	-9.0	-22.0	-56.3
Russia	Power consumption	-0.4	-2.3	-6.2	-5.5	-8.5	-21.1
	GDP estimates	-4.0	-13.0	-19.0	-12.0	-15.0	-49.4
Ukraine	Power consumption	1.0	-2.2	-6.2	-7.8	-11.7	-24.6
	GDP estimates	-3.4	-12.0	-17.0	-17.0	-23.0	-54.9
Uzbekistan	Power consumption	1.5	-3.7	-6.1	-3.5	-3.6	-14.6
	GDP estimates	1.6	-0.5	-11.1	-2.4	-2.6	-14.6

[1] The data on power consumption were kindly provided by Istvan Dobozi and Gerhard Pohl from the World Bank. The GDP growth rates quoted here were taken from the country tables in Annex 11.1.

pursued a relative price policy which has led to substitution of electricity for other sources of energy.

Data uncertainty pertains not only to output statistics but also to most other macroeconomic data, including measures of consumption, investment, employment and prices. For some countries, indicators of expenditure fail to support the hypothesis that deficiencies in currently available data on production lead to a negative bias in published series for growth in real GDP. For example, data for consumption and investment in Hungary and Poland in 1993 point to significantly weaker GDP growth than data collected from the production side.[6] This may in part be because expenditure data in these countries suffer from an even greater negative bias than the production series. A possible bias of this sort could result from a gradual shift in retail trade away from long-established outlets that tend to underlie retail trade surveys, as well as from rising investment by small enterprises whose activities are difficult to monitor.

A recent study by Gavrilenkov and Koen,[7] focusing specifically on national accounts expenditure data for Russia, argues the exact opposite. Gavrilenkov and Koen report that the Russian statistical agency Goskomstat recently dramatically revised its retail trade series: the new series put the decline in the volume of retail sales between 1990 and 1994 at 1 per cent, down from 40 per cent according to the older series. This revision has not been reflected in the official Russian national accounts in which GDP is estimated primarily on the basis of production data. Gavrilenkov and Koen present an alternative set of GDP-estimates, in which they incorporate the recent revisions to retail trade (by assuming that these revisions should be reflected in corresponding adjustments in the official estimates for private consumption). The decline in real GDP is about 4-7 percentage points less each year (1991-94) in their alternative set of accounts than in the official version of the Russian national accounts.

The following country tables include various measures of GDP or GNP per capita. The common denomination chosen for this concept in the tables is US dollars per capita. The most straightforward way to derive an estimate of GDP per capita is to divide the official nominal GDP-estimate (in national currency) by the size of the population, and then convert it into US dollars using the average exchange rate for the year. However, if the aim is to gauge the country's standard of living, this is a highly problematic approach because a typical consumer basket is far cheaper in eastern Europe, the Baltics and the CIS (measured in US dollars at the official exchange rate) than it is in western Europe, Japan or the USA.

Measures of GNP at "purchasing power parity" (PPP) aim to overcome this problem. The PPP-estimates quoted in the attached tables were taken from the *World Bank Atlas 1995*. In the computation of these estimates, the World Bank has divided nominal GDP for each country by the country's PPP, defined as the number of units of the country's currency that would be required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States. It is far from easy to produce these estimates. Price data for countries in transition are often inaccurate (see below). Moreover, the PPP-estimates are heavily influenced by the choice of goods-basket for which the price comparison is made. For some of the countries of eastern Europe, the Baltics and the CIS, the PPP-based estimates in the attached tables are based on very preliminary information. Future revisions may produce very different figures. The World Bank has initiated a major research effort (to which the EBRD contributes) to improve the quality of PPP-based estimates of GNP.

Data on exports and imports

Some countries in transition produce two different sets of data on exports and imports. One set is derived from customs data for imports and survey data for exports. Another set is based on banking data on flows of foreign exchange: payments for imports and receipts for exports. It used to be thought in countries such as Hungary that banking data were "more reliable" than customs/survey-based statistics. This assessment was formed during the 1980s when data from the large state banks covered most transactions in these economies. Since then the quality of banking statistics has dropped as banks have become gradually more independent, new private banks have emerged and reporting requirements have weakened. This may have reversed the ranking, in terms of relative reliability, of the different sources of statistics.

High inflation

Many countries in the region have gone through a period of very high inflation which has made it difficult to measure relative price changes. High inflation has also made it particularly awkward to deflate correctly nominal data for production, use of inputs, consumption, fixed investment, stock-building and wages. When price increases as well as volumes of production are subject to large swings from month to month, it is difficult to compute a measure of growth in real GDP. Computation of a constant-price estimate for GDP through simple deflation of the annual nominal GDP-figure by a measure of annual average inflation may lead to serious errors. When inflation is sufficiently high, and fluctuates from week to week, even the use of monthly data as the basis for deflation may lead to large errors.

Index number problems

Index number problems have also complicated the interpretation of price (and production) data for eastern Europe, the Baltics and the CIS. An important index issue is the choice of base year. Some countries, including the Czech Republic, have been slow to change the base year for their national accounts. In the Czech case, the national accounts are still presented at constant 1984-prices. Production sectors with much higher relative prices or volumes in pre-reform 1984 than in post-reform 1994 carry an excessive weight in the computation of growth rates for the economy as a whole. Another very important index issue relates to quality improvements. Part of the price increase that has taken place in recent years in eastern Europe, the Baltics and the CIS

6 Bartholdy (1994).

7 Gavrilenkov and Koen (1994).

has been caused by the switch from low-quality, cheap products to high-quality, expensive equivalents. One result is that official price series tend to exaggerate inflation. In some cases, estimates of changes in the production volume may have been derived through deflation of nominal production data by these exaggerated price indices. Such estimates would exaggerate a production decline (or understate a production increase).

Fiscal data

Data from government budgets are sometimes difficult to interpret because of the tradition in many countries of the region of handling many activities of the state and municipalities off-budget. Another problem stems from the fact that chronically loss-making enterprises in some countries are kept alive through their access to credits from the banking system. Such credits may conceptually constitute government subsidies. Where this is the case, it is deceptive to look exclusively to the fiscal accounts for a measure of the underlying budgetary imbalance.

A special difficulty of interpretation pertains to countries with high inflation and a large stock of government debt. A part of the budget deficit in such a country reflects interest payments to holders of claims on the government. A large share of these payments serves only to compensate claimholders for the inflation-induced drop in the real value of their claims. Spending by the government for inflation-indexation of liabilities does not add to the real value of the government's net indebtedness. Therefore, standard concepts of the fiscal deficit, which include expenditures that cover this type of "indexation of the liabilities", may exceed by a wide margin the impact on the ratio of government debt to GDP of the underlying fiscal position.

This makes it difficult to assess the seriousness of a particular deficit, expressed as a percentage of GDP, independently of the government debt stock and the rate of inflation. These factors are crucial to inter-country comparisons of fiscal positions. Similarly, it is important to consider changes in inflation when the path of a particular country's deficit over time is under scrutiny.

Banking reform during transition may also distort the fiscal accounts. In countries where the government effectively guarantees depositors against losses, the "net worth of the state" declines every time bad lending decisions are made by those banks that are covered by the guarantee. Losses associated with such decisions should arguably be accounted for in the state accounts at the time when they occur (although this is rarely possible in practice), rather than at the time when they are reflected in a state-financed bank recapitalisation. If the state injected capital into the banking system in 1994 to cover banking losses accrued over many years this outlay should clearly not be treated as a new budgetary expenditure accruing in 1994. The outlay represents realisation of losses of past years, which should have been treated as expenditure in past years' state budget accounts. The typical practice in eastern Europe (where, for example, the former Czechoslovakia, Hungary, Poland and Romania have injected large amounts of capital into the banks) has been to exclude the banking losses from the fiscal accounts both in the year of accrual and in the year of recapitalisation. The losses do not appear in the fiscal accounts for any year.

An important problem pertains to the interest paid by the state on funds it has used for bank recapitalisation. Banks in need of recapitalisation will typically be paying interest on all deposits while being unable to collect interest on some of their assets. Thus their average interest margin is negative. Prior to recapitalisation, losses resulting from negative interest margins appear only in the books of the banks, not in the state budget. State-financed recapitalisation shifts them from the books of the banks to the accounts of the government. Assume, for simplicity, that the state carries out the recapitalisation by donating to the banks a batch of state bonds. After this, the state will be paying interest on these bonds. One may think of this flow of interest payments as an annual subsidy from the state to the banks to cover losses that derive from the negative interest margin. After bank recapitalisation, these flows are typically treated in the fiscal accounts as state expenditures. This makes perfect sense, but the losses associated with the negative interest margin should also ideally be treated as fiscal expenditures in the accounts for earlier years. The fact that they are not means that official budget data will tend to exaggerate any underlying fiscal deterioration (or underestimate any improvement) in the years after recapitalisation of the banks. The distortion resulting from this problem is probably greater in Hungary, where the state injected capital equivalent to almost 10 per cent of GDP into the state-owned banks during 1992-94, than in any other country in the region.

Concluding remarks

Without pretending to be exhaustive, this section highlights some of the difficulties of interpretation that are associated with the data series that appear in the following macroeconomic country tables. It is emphasised here that the reliability is weak for many series and that many important conceptual issues need to be carefully considered by the user of macro-data for most of the countries of eastern Europe, the Baltics and the CIS.

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Growth in eastern Europe, the Baltics and the CIS

	Real GDP						
	1990	1991	1992	1993	1994	1995 *Projection*	Projected level of real GDP in 1995
Individual countries			*(Percentage change)*				*(1989=100)*
Albania	-10	-28	-10	11	7	6	75
Armenia	-7	-11	-52	-15	5	5	37
Azerbaijan	-12	-1	-23	-23	-22	-15	35
Belarus	-3	-1	-10	-12	-22	-10	54
Bulgaria	-9	-12	-7	-2	1	3	75
Croatia	9	-14	-9	-3	1	2	84
Czech Republic	0	-14	-6	-1	3	4	85
Estonia	-8	-11	-14	-7	6	6	74
FYR Macedonia	-10	-12	-14	-14	-7	-3	53
Georgia	-12	-14	-40	-39	-35	-5	17
Hungary	-4	-12	-3	-1	2	3	86
Kazakstan	0	-13	-13	-12	-25	-12	44
Kyrgyzstan	3	-5	-25	-16	-27	-5	43
Latvia	3	-8	-35	-15	2	1	54
Lithuania	-5	-13	-38	-24	2	5	42
Moldova	-2	-12	-29	-9	-22	-5	42
Poland	-12	-8	3	4	5	6	97
Romania	-6	-13	-10	1	3	4	81
Russia	-4	-13	-19	-12	-15	-3	49
Slovak Republic	0	-15	-7	-4	5	5	84
Slovenia	-5	-8	-5	1	6	6	94
Tajikistan	-2	-7	-29	-11	-21	-12	40
Turkmenistan	2	-5	-5	-10	-20	-5	63
Ukraine	-3	-12	-17	-17	-23	-5	43
Uzbekistan	2	-1	-11	-2	-3	-4	82
Aggregates							
Eastern Europe and the Baltics[1]	-8	-10	-3	1	4	5	88
The Commonwealth of Independent States[2]	-4	-12	-18	-13	-17	-4	48

Note

Data for 1990-94 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on information from the aforementioned sources about developments in the first half of the year. See the caveats in the initial paragraphs of this Annex.

[1] Estimates for real GDP represent weighted averages for Albania, Bulgaria, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. The weights used were national GDP estimates for 1992 converted into common currency at the average official exchange rate for 1992.

[2] Here taken to include all countries of the former Soviet Union, except Estonia, Latvia and Lithuania. Estimates for real GDP represent weighted averages, using the nominal levels of NMP in each country in 1991 as weights.

Inflation in eastern Europe, the Baltics and the CIS

	Retail/consumer prices (end-year)				
	1991	1992	1993	1994	1995 *Projection*
			(Percentage change)		
Albania	104	237	31	16	5
Armenia	25	1,341	10,996	1,885	45
Azerbaijan	126	1,395	1,294	1,788	100
Belarus	93	1,558	1,994	1,875	260
Bulgaria	339	79	64	122	50
Croatia	149	937	1,150	-3	3
Czech Republic	52	13	18	10	10
Estonia	304	954	36	42	22
FYR Macedonia	115	1,935	230	55	10
Georgia	131	1,463	7,492	7,380	25
Hungary	32	22	21	21	28
Kazakstan	150	2,567	2,169	1,160	60
Kyrgyzstan	170	1,771	1,366	87	25
Latvia	262	958	35	26	23
Lithuania	345	1,175	189	45	30
Moldova	162	2,198	837	98	20
Poland	60	44	38	30	23
Romania	223	199	296	62	30
Russia	144	2,318	841	203	145
Slovak Republic	58	9	25	12	10
Slovenia	247	93	23	18	10
Tajikistan	204	1,364	7,344	5	240
Turkmenistan	155	644	9,750	1,100	2,500
Ukraine	161	2,000	10,155	401	150
Uzbekistan	169	910	885	423	155

Note

Data for 1991-94 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on information from the aforementioned sources about developments in the first half of the year. See the caveats in the initial paragraphs of this Annex.

Albania

	1989	1990	1991	1992	1993	1994 Estimate	1995 Projection
Output and expenditure				*(Percentage change)*			
GDP at constant prices	9.8	-10	-27.7	-9.7	11	7.4	6
Industrial production	5	-7.6	-36.9	-44	-10	-2	na
Prices and wages							
Consumer prices (annual average)	0	0	36	226	85	22.6	7
Consumer prices (end-year)	0	0	104	237	31	15.8	5
Average real wages (public sector)	na	na	-6	-45	-1	na	na
Monetary sector							
Broad money (end-year)	14.8	23.4	104	153	74.4	39.5	na
Government sector				*(In per cent of GDP)*			
General government balance (cash basis)[1]	-5.5	-3.7	-44	-22	-16	-14	-13
General government balance (commitment basis)	-9	-15	-31	-22	-16	-13	na
General government expenditure (commitment basis)	56.8	62.1	61.9	47.6	44.6	41	na
External data in convertible currencies				*(In millions of US dollars)*			
Current account (excluding official transfers)	-49	-122	-293	-442	-369	-238	na
Current account (including official transfers)	na	-122	-213	-101	-70	-146	na
Trade balance	-83	-150	-308	-454	-490	-460	na
External debt, net of foreign exchange reserves	0	94.5	497.8	635	655	768	na
				(Percentage change in the US dollar value)			
Exports (data from the balance of payments)	25	-7	-56	-31	60	25.8	na
Imports (data from the balance of payments)	58	4	7	28	15	0	na
				(In months of current account expenditures, excluding transfers)			
Gross international reserves (end-year), excluding gold	12.5	5.9	0.2	0.7	2.3	3.4	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions)	3.2	12.6	12.6	12.6	12.6	12.6	3.2
Employment (percentage change, annual average)	1.9	0.2	-18.6	-27.8	-7.8	9.3	na
Unemployment rate (in per cent of domestic labour force, end year)	na	7.6	8.6	26.9	29	19.5	na
GDP (in millions of lek)	18,681	16,813	16,473	49,519	113,041	166,297	na
The share of agriculture in GDP (per cent)[2]	26	40	44	54	56	56	na
The share of industry in GDP (per cent)[2]	37	37	32	17	14	13	na
Exchange rate (lek per US dollar, end-year)	8	10	25	97	101	95.4	na
Exchange rate (lek per US dollar, annual average)	8	8	14.6	75.1	102.1	94.7	na
Interest rate (lending, 12 months maturity, end-year)	1-2	1-2	8-12	39	30	20	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on information from the aforementioned sources about developments in the first half of the year.

1 Excluding from expenditures due but unpaid interest on foreign debt.

2 Based on national accounts at constant 1990-prices.

Armenia

	1989	1990	1991	1992	1993	1994	1995 Projection
Output				*(Percentage change)*			
GDP at constant prices	14.2	-7.4	-10.8	-52.4	-14.8	5.4	5
Prices and wages							
Consumer prices (annual average)	4.8	10.3	100	825	3,732	5,273	210
Consumer prices (end-year)	na	na	25.0	1,341	10,996	1,885	45
Monetary sector							
Broad money (end year; millions of drams)	na	na	na	na	3,042	23,856	33,886
Government sector				*(In per cent of GDP)*			
Consolidated central government balance (accrual)	na	na	-1.9	-37.6	-48.2	-16.1	-9
Consolidated central government expenditure (accrual)	na	na	-28.0	64.2	68.6	43.7	26
External data in convertible currencies				*(In millions of US dollars)*			
Current account with non-FSU countries	na	na	na	-40.0	-31.5	-15	na
Trade balance with non-FSU countries	na	na	na	-96	-197	-179	na
Exports (data from the balance of payments)	na	na	na	335	165	209	na
to countries outside the FSU	na	na	na	12	29	29	na
to former Soviet republics	na	na	na	323	136	180	na
Imports (data from the balance of payments)	na	na	na	405	392	381	565
from countries outside the FSU	na	na	na	108	226	208	na
from former Soviet republics	na	na	na	297	166	173	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions)	na	3.3	3.5	3.7	3.7	3.7	3.8
Unemployment (in per cent of the labour force, end-year)	na	na	4	19	26	na	na
GDP (in billions of roubles)	9.5	9.7	15.9	59.1	780	na	na
GNP (in millions of US dollars)	na	na	na	na	na	652	na
GNP per capita (in US dollars) at PPP exchange rates[1]	na	na	na	na	2,080	na	na
The share of agriculture and forestry in NMP (per cent)[2]	15	17	26	41	55	na	na
The share of industry in NMP (per cent)[2]	50	45	55	53	32	na	na
Exchange rate (dram/US dollar; end-period)	na	na	na	na	75.0	406	407

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflects EBRD evaluations, partly based on information from the aforementioned sources about developments in the first half of the year.

1 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

2 NMP excludes depreciation and the value added from most of the service sector.

Azerbaijan

	1989	1990	1991	1992	1993	1994	1995 Projection
Output at constant prices				*(Percentage change)*			
GDP	-4.4	-11.7	-0.7	-22.6	-23.1	-21.9	-15
Prices							
Consumer prices (annual average)	na	7.8	106	616	1,130	1,664	425
Consumer prices (end-year)	na	na	126	1,395	1,294	1,788	100
Government sector				*(In per cent of GDP)*			
General government balance	na	na	-5.0	2.8	-13	-18	-2
General government expenditure	na	na	40.7	46.4	58	57	na
External data in convertible currencies				*(In millions of US dollars)*			
Current account	na	na	153	488	2	-179	-125
Trade balance	na	na	60	489	-5	-177	na
vis-à-vis countries outside the FSU	na	na	-42	371	109	-35	na
vis-à-vis former Soviet Republics	na	na	102	118	-114	-212	na
Exports (merchandise)	na	na	395	1,275	716	637	553
to countries outside the FSU	na	na	24	755	347	274	na
to former Soviet Republics	na	na	371	520	369	363	na
Imports (merchandise)	na	na	336	786	721	814	725
from countries outside the FSU	na	na	67	384	238	486	na
from former Soviet Republics	na	na	269	402	483	328	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions)	na	na	na	7.3	7.4	7.5	7.5
GDP in billions of manat[1]	na	1.5	2.7	25.1	157.0	1,636	na
GNP per capita (in US dollars) at PPP exchange rates[2]	na	na	na	na	2,230	na	na
The share of agriculture in NMP (per cent)[3]	na	37.4	41.1	32.5	38.2	38.7	na
The share of industry in NMP (per cent)[3]	na	34.8	37.2	50.5	43.3	37.0	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1994-95 reflect EBRD evaluations, partly based on information from the aforementioned sources about developments in the first half of the year.

1 GDP-figures in roubles for 1989-92 were converted into manat at the rate of 10 roubles per manat.

2 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

3 NMP excludes depreciation and the value added from most of the service sector. Not compatible with previous years due to changes in economic classification of expenditure.

Belarus

	1989	1990	1991	1992	1993	1994	1995 Projection
Output and expenditure				*(Percentage change)*			
GDP at constant prices[1]	8.0	-3.0	-1.2	-9.6	-11.6	-21.5	-10
Consumption at constant prices	na	na	-6.8	-10.2	-6.0	na	na
Investment at constant prices	na	na	4.4	-18.1	-18.0	na	na
Industrial production	na	na	-0.2	-6.0	-11.0	na	na
Prices and wages							
Consumer prices (end-year)	na	na	93	1,558	1,994	1,875	260
Consumer prices (annual average)	1.7	4.5	84	969	1,188	2,220	700
Average real wages	7.8	11.6	-2.8	-14.4	12.2	na	na
Monetary sector							
Net domestic credit (end-year)	na	na	na	1,582	612	1,452	na
Broad money (M3, end-year)	na	na	na	508	928	1,883	na
Government sector				*(In per cent of GDP)*			
General government balance (incl. extra-budgetary funds)	na	na	3.6	-1.6	-8.3	-1.5	na
General government expenditure	na	na	43.9	45.6	51.9	38.1	na
External data							
Current account	na	na	na	3.7	-7.3	-8.4	na
Trade balance							
vis-à-vis countries outside the FSU	na	na	-2.8	5.8	-3.8	6.9	na
vis-à-vis former Soviet republics	na	na	6.3	0.5	-2.5	-13.1	na
Exports (merchandise)				*(In millions of US dollars)*			
to countries outside the FSU	na	na	1,661	1,082	832	1,039	na
Imports (merchandise)							
from countries outside the FSU	na	na	1,957	741	912	621	na
Exports (merchandise)				*(In billions of roubles)*			
to former Soviet republics	na	na	37	380	2,004	3,510	na
Imports (merchandise)							
from former Soviet republics	na	na	32	374	2,278	5,476	na
			(In months of current account expenditures, excluding transfers)				
Gross international reserves of the central bank	na	na	0.0	0.0	0.2	0.4	na
Memorandum items				*(Denominations as indicated)*			
Population (in millions)	10.2	10.3	10.3	10.3	10.4	10.4	na
Unemployment (in per cent of labour force, end-year)	na	na	na	0.5	1.5	2.5	na
The share of agriculture in GDP (per cent)	na	24.2	21.3	23.2	na	na	na
The share of industry in GDP (per cent)	na	38.6	41.0	38.4	na	na	na
GNP per capita (in US dollars) at PPP exchange rates[2]	na	na	na	na	6,360	na	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on information from the aforementioned sources about developments in the first half of the year.

1 Figures are for NMP until 1990, GDP thereafter. NMP excludes depreciation and the value added from most of the service sector.

2 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate, the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Bulgaria

	1989	1990	1991	1992	1993	1994	1995 Projection
Output and expenditure			*(Percentage change)*				
GDP at constant prices	0.5	-9.1	-11.7	-7.3	-2.4	1.4	2.5
Industrial production	-1.1	-16.0	-27.8	-15.0	-7.0	4.1	na
Prices and wages							
Consumer prices (annual average)	6.4	26.3	333.5	82.0	73.0	96.3	68
Consumer prices (end-year)	10.0	72.5	338.9	79.4	63.9	121.9	50
Wages in the state sector (annual average)	8.7	31.7	165.6	103.0	59.0	50.8	na
Monetary sector							
Broad money (end-year)	10.6	16.6	122	43.5	52.9	77.9	na
Government Sector			*(In per cent of GDP)*				
General government balance[1]	-1.4	-12.8	-14.7	-15.0	-15.7	-7.0	na
General government cash balance[2]	na	na	na	-13.0	-10.6	-6.0	-8
General government expenditure (cash basis)[2]	58.4	65.9	45.6	45.4	50.8	43.8	na
External data in convertible currencies[3]			*(In billions of US dollars)*				
Current account (accrual basis)	-1.3	-1.2	-0.8	-1.1	-1.5	-0.1	0.1
Trade balance	-1.2	-0.8	0.0	-0.2	-0.9	0.2	0.4
Gross external debt	9.4	9.9	11.2	12.2	12.6	10.4	na
			(Percentage change in the US dollar value)				
Exports (balance of payments data)	na	-16.7	42.9	5.9	-5.8	11.6	na
Imports (balance of payments data)	na	-22	11.8	10.6	10.6	-13.1	na
			(In months of current account expenditure excluding transfers)				
Gross international reserves (end-year), excluding gold	1.8	0	0.8	1.7	1.2	2.1	na
Miscellaneous items			*(Denominations as indicated)*				
Population (in millions, end-year)	9.0	8.7	8.6	8.5	8.5	8.4	na
Employment (percentage change, end-year)	-2.3	-6.1	-13.0	-8.1	-1.6	na	na
Unemployment (in per cent of the labour force, end-year)	na	1.5	11.5	15.6	16.4	12.8	na
GDP (in billions of leva)	39.6	45.4	135.7	201	299	543	na
GNP per capita (in US dollars) at PPP exchange rates[4]	na	na	na	na	3,730	na	na
The share of agriculture and forestry in GDP (per cent)[5]	11	18	15	16	13	na	na
The share of industry in GDP (per cent)[5]	59	51	48	43	42.3	na	na
Exchange rate (lev per US dollar, end-year)	2.0	7.0	21.8	24.5	32.7	66.5	na
Exchange rate (lev per US dollar, annual average)	1.8	3.9	18.1	23.4	27.7	54.3	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. These data are frequently revised, and we strive to incorporate the latest revisions. Data for 1995 reflect EBRD evaluations, partly based on information from the aforementioned sources about developments in the first half of the year.

1 General government includes the state, municipalities, social security and extra-budgetary funds.

2 Excluding (from expenditures) unpaid due interest amounting to 4.1 billion lev in 1992, 14.5 billion lev in 1993, and 5.4 billion lev in 1994.

3 Balance of payments data.

4 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

5 At current prices.

Croatia

	1989	1990	1991	1992	1993	1994	1995 Projection
Output and expenditure				*(Percentage change)*			
GDP at constant prices[1]	-1.6	-8.6	-14.4	-9.0	-3.2	0.8	2
Industrial production	na	-11.3	-28.5	-15	-6	-3	na
Prices and wages							
Retail consumer prices (end-year)	na	136	149	937	1,150	-3	3
Monetary sector							
Narrow money (end-year)	na	na	na	598	889	110	na
Government sector				*(In per cent of GDP)*			
General government balance[2]	na	na	-5	-4	-1.0	1.7	-0.4
General government expenditure	na	na	39	38	34.6	42.1	48.9
External data in convertible currencies[3]				*(In millions of US dollars)*			
Current account[3]	na	1,053	-589	823	104	103	-1,000
Trade balance[3]	na	-1,168	-536	137	-763	-969	-2,000
Exports[3]	na	4,020	3,292	4,597	3,904	4,260	5,000
Imports[3]	na	5,188	3,828	4,461	4,666	5,229	7,000
				(In months of imports)			
Gross international reserves (end-year)	na	na	na	0.4	1.6	3.2	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions)	na	4.8	4.8	4.8	4.8	na	na
Unemployment rate (in per cent of labour force[4]	na	na	na	12.9	12.8	12.6	12.5
Exchange rate (average, dinars/kuna per dollar)[5]	na	0.011	0.033	0.298	3.588	5.993	na
GDP (in millions of US dollars at current exchange rates)	na	25,343	12,828	9,151	12,490	14,025	17,750
The share of agriculture in GDP (per cent)	na	10.6	10.2	13.2	12.6	na	na
The share of industry in GDP (per cent)[6]	na	30.4	29.7	26.9	26.8	na	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on information on developments in the first half of the year.

1 For 1989, the data refer to GSP, the value-added concept of former Yugoslavia which excludes government, housing, financial services and some personal services.

2 General government includes the state, budget and extra-budgetary funds.

3 For 1990 and 1991 these data exclude trade with Slovenia, FYR Macedonia and Bosnia.

4 Labour force approximated by the number of pension insured individuals plus the number of registered unemployed.

5 Dinars were converted into kuna in May 1994 (when the kuna was introduced) at the rate of 1,000 dinars to one kuna.

6 Including construction.

Czech Republic

	1989	1990	1991	1992	1993	1994	1995 Projection
Output and expenditure			*(Percentage change)*				
GDP at constant prices	1.4	-0.4	**-14.2**	**-6.4**	**-0.9**	**2.6**	**4**
Private consumption at constant price	na	na	**na**	**20.4**	**2.9**	**5.3**	**na**
Gross fixed investment at constant price	na	na	**na**	**8.9**	**-7.7**	**4.4**	**na**
Industrial production	0.8	-3.5	**-22.3**	**-7.9**	**-5.3**	**2.3**	**na**
Prices and wages							
Consumer prices (annual average)	2.3	10.8	**56.7**	**11.1**	**20.8**	**10.0**	**10**
Consumer prices (end-year)	1.5	18.4	**52.0**	**12.7**	**18.2**	**10.2**	**10**
Producer prices (annual average)	-0.7	4.4	**74.7**	**9.9**	**13.1**	**5.3**	**na**
Wages in industry (annual average)	3.2	4.5	**16.7**	**19.6**	**23.8**	**15.7**	**na**
Monetary sector							
Broad money (end-year)	3.5	0.5	26,8	17.3	**20.5**	**21.5**	**na**
Government sector			*(In per cent of GDP)*				
General government balance	-2.8	0.1	-2.0	-3.3	**1.4**	**1.0**	**0**
General government expenditure	64.5	60.1	54.2	52.8	**48.5**	**49.0**	**na**
Foreign Trade			*(Percentage change in the US dollar value)*				
Exports, excluding trade with Slovakia[1]	8.5	10.1	39.2	35.2	**20.3**	**15.4**	**na**
Imports, excluding trade with Slovakia[1]	-1.5	35.0	29.6	46.2	**4.1**	**19.2**	**na**
Exports, including trade with Slovakia[1]	na	na	na	na	**9.8**	**8.3**	**na**
Imports, including trade with Slovakia[1]	na	na	na	na	**1.3**	**14.0**	**na**
			(In billions of US dollars)				
Current account balance, excluding trade with Slovakia	0.4	-1.1	0.4	**-0.3**	**0.5**	**0.4**	**na**
Trade balance, excluding trade with Slovakia	0.4	-0.8	-0.4	**-1.9**	**-0.2**	**-0.7**	**na**
Current account balance, including trade with Slovakia	na	na	na	**0.6**	**0.4**	**0.3**	**-1**
Trade balance, including trade with Slovakia	na	na	na	**-1.0**	**0.3**	**-0.4**	**na**
Gross foreign direct investment, cash	na	na	na	1.0	**0.6**	**0.9**	**na**
Portfolio investment	na	na	na	0	**1.1**	**0.8**	**na**
External debt, net of reserves of the banking system	6.8	7.7	8.3	**8.6**	**3.9**	**2.8**	**na**
			(In months of current account expenditures excluding transfers)				
Gross international reserves of the central bank	1.8	0.7	1.4	1.0	**3.2**	**4.3**	**na**
Miscellaneous items			*(Denominations as indicated)*				
Population (in millions, end-year)	10.3	**10.3**	**10.3**	**10.3**	**10.3**	**10.3**	**na**
Employment (change in per cent)	na	**-0.9**	**-5.5**	**-2.6**	**-1.6**	**1.1**	**na**
Unemployment rate (end of period)	0	0.8	**4.1**	**2.6**	**3.5**	**3.2**	**na**
GDP (in billions of crowns)	758.8	**567.3**	**716.6**	**803.3**	**911.0**	**1,038.0**	**na**
The share of agriculture in GDP (in per cent)	6.3	**8.4**	**6.0**	**5.7**	**6.2**	**5.5**	**na**
The share of industry and construction in GDP (in per cent)	na	**na**	**na**	**45.0**	**39.8**	**39.3**	**na**
GNP per capita (in US dollars) at PPP exchange rates[2]	na	**na**	**na**	**na**	**7,700**	**na**	**na**
Exchange rate (crowns per US dollar, end-year)	14.3	28.0	27.8	28.9	**30.0**	**28.2**	**na**
Exchange rate (crowns per US dollar, annual average)	15.1	18.0	29.5	28.3	**29.2**	**28.8**	**na**
Interest rate (average 3-month inter-bank deposit rate, per cent)	na	na	na	13.8	**13.2**	**9.1**	**na**

Note

Figures in bold type are those for the Czech Republic and figures in normal type are those for the former CSFR. As a rule, data for the Czech Republic are shown for years after 1991 where possible. Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on information from the aforementioned sources about developments during the first half of the year.

[1] Data from the balance of payments, collected on a settlement basis.

[2] PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Estonia

	1989	1990	1991	1992	1993	1994	1995 Projection
Output				*(Percentage change)*			
GDP at constant prices	-1.1	-8.1	-11	-14.2	-6.7	6	6
Prices and wages							
Consumer prices (annual average)	6.1	23.1	210.5	1,076	89.8	48	25
Consumer prices (end of period)	na	na	303.8	953.5	35.6	42	22
Average real wages	na	na	na	-39	6	4.5	na
Monetary sector							
Broad money (M3, end-year)	na	na	312.4	69.4	52.8	30	na
Government sector				*(In per cent of GDP)*			
General government balance[1]	2.8	2.9	4.6	0.5	-1.4	0.9	1
General government expenditure[1]	36.7	32.8	31.8	31.0	33.9	34	na
External data				*(In millions of US dollars)*			
Current account	na	na	570	83	12	-171	-200
Trade balance	na	-250	561	-63	-156	-345	-400
Exports (merchandise)	na	1,843	2,822	457	812	1,305	1,450
to former Soviet republics	na	1,763	2,749	215	342	586	na
to countries outside the FSU	na	80	72	242	470	718	na
Imports (merchandise)	na	2,093	2,261	520	968	1,650	1,850
from former Soviet republics	na	1,887	2,079	266	324	507	na
from countries outside the FSU	na	206	183	254	644	1,142	na
				(In months of goods imports)			
Gross international reserves (end-year)	na	na	na	4.5	4.8	3.3	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions)	1.6	1.6	1.6	1.6	1.6	1.5	na
Unemployment (in per cent of working age population)[2]	na	na	0.1	1.9	2.6	2.0	3.5
GDP (in millions of kroons)	na	na	1,832	14,255	22,845	31,723	42,033
GDP per capita at current exchange rates (in US dollars)	na	na	na	739	1,079	1,525	na
GNP per capita (in US dollars) at PPP exchange rates[3]	na	na	na	na	6,860	na	na
The share of agriculture in GDP (per cent)[4]	na	na	20.1	13.2	11.5	10.5	na
The share of industry in GDP (per cent)[4]	na	na	40.4	32.5	26.3	25	na
Exchange rate (kroons per US dollar, end-year)	na	na	na	12.6	13.8	12.4	na
Exchange rate (kroons per US dollar, annual average)	na	na	na	12.1	13.2	13.0	na

Note

Data for 1989-93 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1994-95 reflect EBRD evaluations, partly based on information from the aforementioned sources about developments in 1994.

1 General government includes the state, local governments and extra-budgetary funds.

2 Officially registered unemployment.

3 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

4 At current prices.

FYR Macedonia

	1990	1991	1992	1993	1994	1995 Projection
Output			*(Percentage change)*			
GSP at constant prices[1]	-9.9	-12.1	-14.0	-14.1	-7.2	-3
Industrial production	-10.6	-17.2	-17.3	-15.9	-9.4	na
Prices						
Retail prices (end-year)	606	115	1,935	230	55	10
Retail prices (average)	na	na	1,691	350	122	50
Monetary sector						
Denar M2 (end-year) monthly average	na	na	15.2	23	3	na
Government sector			*(In per cent of GSP)*			
General government balance	na	-3.6	-7.2	-11.1	-2.6	-3
General government expenditure	na	40.4	36.1	44.3	45.4	na
Central government balance[2]	na	na	-5.6	-7.1	-2	-1
Central government expenditure[2]	na	18.2	19.6	25.8	27.5	na
External data in convertible currencies			*(In millions of US dollars)*			
Current account	-400	-262	-19	-88	-170	-350
Trade balance	-418	-225	-7	-172	-171	na
Exports[3]	1,113	1,150	1,199	1,055	1,068	na
Imports[3]	1,531	1,375	1,206	1,227	1,238	na
External debt (end-year)[4]	828	806	848	828	865	na
Memorandum items			*(Denominations as indicated)*			
Population (in millions)[5]	2.13	2.15	2.17	2.19	2.1	na
Unemployment rate (annual average)[6]	na	18	19	19	19	na
Official exchange rate (denar per US dollar, end of period)[7]	11.3	19.7	1,235.6	44.5	40.6	na
Official exchange rate (denar per US dollar, average)[7]	na	19.6	509.1	23.2	43.3	na

Note

Data for 1990-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on preliminary information from the aforementioned sources about developments in the first half of the year.

1 GSP is the value-added concept of former Yugoslavia which excludes the value added by government, financial and some personal services.

2 Include transfers to extra-budgetary funds. Figure for 1992 refers to end-December. Figure for 1993 is for end-September 1993.

3 Merchandise only. The gradual inclusion of exports to other republics of the former Yugoslavia from 1991 results in a discontinuity in this series for total exports.

4 Estimated stock of debt excluding interest arrears, penalty interest and the FYRM's share of the unallocated debt of the former SFRY. 1994 figure for first nine months only.

5 Figures for 1992-93 do not include refugees (30,000-60,000). 1994 figure reflects June census.

6 These data have recently been revised sharply downwards, reflecting *inter alia* that some of the registered unemployed may work in the private sector.

7 Figure for 1993 expressed in new denar (=100 old denar).

Georgia

	1989	1990	1991	1992	1993	1994	1995 Projection
Output and expenditure at constant prices				*(Percentage change)*			
GDP at constant prices[1]	-4.8	-12.4	-13.8	-40.3	-39	-35	-5
Industrial production	-6.9	-29.9	-24.4	-43.3	-21	-40	na
Agricultural output	-24.3	61.8	-10.6	-34.2	-42	-15	na
Prices							
Retail prices (end-year)	0.9	4.8	131	1,463	7,492	7,380	25
Retail prices (annual average)	na	3.3	79	913	3,126	7,400	250
Monetary sector							
Domestic credit (end-year)	na	na	na	794	2,282	3,000	na
Broad money (end-year)	na	na	na	464	4,319	1,600	na
Government sector				*(In per cent of GDP)*			
Consolidated government balance (cash-basis)	na	na	-3	-28	-34	-17	-7
Consolidated government expenditure (cash-basis)	na	na	33	39	46	24	na
External data				*(In millions of US dollars)*			
Current account	na	na	na	-248	-191	-500	-400
Trade balance	na	na	na	-378	-363	-300	na
Exports	na	na	na	267	360	500	na
Imports	na	na	na	645	723	800	na
Miscellaneous items				*(Denomination as indicated)*			
Population (in millions)	5.4	5.4	5.4	5.4	5.4	5.4	na
Unemployment rate (in per cent)	na	na	na	5.4	8.4	na	na
GNP per capita (in US dollars) at PPP exchange rates[2]	na	na	na	na	1,410	na	na
The share of agriculture in NMP (per cent)[3]	20	37	42	48	46	na	na
The share of industry in NMP (per cent)[3]	44	35	33	33	43	na	na
Exchange rate (millions of coupons per US dollar, end-period)	na	na	na	na	na	1.28	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on information from the aforementioned sources about developments in the first half of the year.

1 NMP for 1989-93. NMP excludes depreciation and the value added from most of the service sector.

2 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

3 NMP excludes depreciation and most of the service sector.

Hungary

	1989	1990	1991	1992	1993	1994	1995 Projection
Output and expenditure							
National accounts at constant prices				*(Percentage change)*			
GDP	0.7	-3.5	-11.9	-3.0	-0.9	2	3
Private consumption[1]	-0.3	-0.8	-5.8	-0.5	1.4	1-2	na
Public consumption[1]	0.2	2.6	-2.7	3.9	30.5	-22	na
Gross fixed investment	8.8	-7.8	-10.0	-2.7	1.7	11-12	na
Exports of goods and services[2]	1.2	-5.3	-15.3	-5.0	-9.5	14.5	na
Imports of goods and services[1, 2]	1.8	-4.3	-8.8	-10.0	24.2	11.7	na
Industrial gross output	-1.0	-9.6	-18.2	-9.8	4.0	9.5	6
Agricultural gross output	-1.8	-4.7	-6.2	-20.0	-6.9	2.4	na
Prices and wages				*(Percentage change)*			
Consumer prices (annual average)	17.0	28.9	35.0	23.0	22.5	18.8	29
Consumer prices (end-year)	18.9	33.4	32.2	21.6	21.1	21.2	28
Producer prices (annual average)	15.4	22.0	32.6	11.5	10.8	11.4	22
Producer prices (end-year)	na	na	24.8	16.6	10.3	14.0	29
Gross monthly earnings per full-time employee	17.9	27.2	33.4	24.7	22.0	24.7	na
Monetary sector				*(Percentage change)*			
Broad money (end-year)	13.8	28.7	28.5	26.8	15.5	13.4	na
Government sector				*(In per cent of GDP)*			
General government balance[3]	-1.4	0.5	-2.2	-5.6	-6.4	-8.2	na
Central government balance[4]	-0.8	0.8	-4.4	-6.9	-6.6	-7.7	-5
General government expenditure[4]	61.0	57.5	58.3	63.4	60.5	na	na
External data in convertible currencies				*(In billions of US dollars)*			
Current account	-1.4	0.1	0.3	0.3	-3.5	-3.9	-3
Trade balance	0.5	0.3	0.2	0.0	-3.2	-3.6	na
External debt, net of reserves	19.2	20.2	18.7	17.1	17.9	21.7	na
Foreign direct investment in cash	0.2	0.4	1.5	1.3	2.2	1.2	na
				(Percentage change in the US dollar value)			
Exports (data from the balance of payments)[5]	17.1	-1.6	45.9	8.3	-19.3	-5.9	na
Imports (data from the balance of payments)[5]	17.8	1.5	51.2	11.1	12.5	-0.8	na
Exports (customs/survey statistics)[5]	na	na	na	5.6	-16.8	20.1	20
Imports (customs/survey statistics)[5]	na	na	na	-2.7	13.2	16.1	10
				(In months of current account expenditures, excluding transfers)			
Gross international reserves (end-year), excluding gold	1.5	1.3	3.8	3.7	5.1	4.9	na
				(In per cent of current account revenues, excluding transfers)			
Debt service	48.8	47.1	34.7	35.5	43.2	55.9	na
Memorandum Items				*(Denominations as indicated)*			
Population (in millions, end-year)	10.4	10.4	10.4	10.3	10.3	10.3	na
Employment (percentage change, end-year)	-0.6	-3.1	-9.6	-9.3	-5.9	-1	na
Unemployment (in per cent of the labour force)	0.3	2.5	8.0	12.3	12.1	10.4	na
GDP (in billions of forints)	1,723	2,089	2,477	2,935	3,535	4,310	na
GDP per capita (in US dollars)	2,803	3,179	3,184	3,607	3,734	3,979	na
GNP per capita (in US dollars) at PPP exchange rates[6]	na	na	na	na	6,260	na	na
The share of agriculture in GDP (per cent)[7]	9.7	9.6	8.6	7.3	6.4	6.6	na
The share of industry in GDP (per cent)[7]	30.1	28.8	25.5	26.4	25.2	25.9	na
Exchange rate (forint per US dollar, end-year)	62.5	61.5	75.6	84.0	100.7	111.6	na
Exchange rate (forint per US dollar, annual average)	59.1	63.2	74.8	79.0	91.9	105.2	na
Interbank interest rate (14-30 days maturity, end-year)	na	na	35.4	15.4	21.8	31.3	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on preliminary information from the aforementioned sources about developments in the first half of the year.

1 Private consumption excludes consumption by Hungarians abroad; includes consumption by foreigners in Hungary. Public consumption and imports for 1993 includes deliveries of military aircraft from Russia as settlement of CMEA-related debts to Hungary. Excluding this item, public consumption grew about 1½ per cent in each of the years 1993 and 1994, while imports grew 13 per cent in 1993 and 19 per cent in 1994.

2 These series incorporate sharp revisions for 1992-93, published in April 1995. The revisions reduce the role of re-exported goods in the figures for both imports and exports.

3 General government includes the state, municipalities and extra-budgetary funds.

4 Comprising the state and extra-budgetary funds. Includes the activities of the State Development Institution from 1990.

5 Balance of payments data are based on banking statistics and are presented on a settlement basis. Since 1993 trends in balance of payments data on exports and imports have deviated markedly from trends observed in partner country statistics, notably OECD trade statistics. Banking statistics have become less reliable over this period as statistical reporting requirements for banks have been loosened. Many observers now find the customs/survey-based series more reliable. Because of a break in the series, customs/survey based data are quoted here only from 1992 onwards.

6 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

7 At constant 1991 prices.

Kazakstan

	1989	1990	1991	1992	1993	1994	1995 Projection
Output				*(Percentage change)*			
GDP at constant prices	-0.4	-0.4	-13	-13	-12	-25	-12
Industrial output	2	-1	-1	-14	-16	-28	na
Agricultural output	-14	16	-9	1	-10	-23	na
Prices and wages							
Retail prices (annual average)	na	4.2	90.9	1,381	1,662	1,880	180
Retail prices (end-year)	na	na	149.5	2,567	2,169	1,160	60
Wages (average monthly wage in tenge)	na	na	na	na	384	3,392	na
Monetary sector							
Broad money (end-year)	na	na	211	391	692	560	na
Government sector				*(In per cent of GDP)*			
General government balance	0	1.4	-7.9	-7.3	-1.2	-6.5	-5
Total expenditure	35.4	31.4	32.9	31.9	24.7	24	na
External data				*(In billions of US dollars)*			
Total trade balance	na	na	na	-1.1	-0.4	0.8	na
Exports	na	na	na	3.5	4.8	3.3	na
Imports	na	na	na	4.6	5.2	4.1	na
Total current account	na	na	na	0.3	0.1	na	na
Trade balance *vis-à-vis* countries outside the FSU	-0.7	-1.2	-1.1	0	0.1	na	na
Exports	1.6	1.3	0.8	1.5	1.6	na	na
Imports	2.3	2.5	1.9	1.5	1.5	na	na
Current account balance *vis-à-vis* countries outside the FSU	na	na	na	0.3	0.1	na	na
Miscellaneous				*(Denominations as indicated)*			
Population (in millions, end-year)	16.5	16.6	16.7	16.9	16.9	16.9	na
Unemployment rate (end-year)	0	0	0	0.5	0.6	1.6	na
Exchange rate (annual average, roubles per US dollar until 1993, tenge per US dollar thereafter)	0.63	0.59	117	222	930	36	na
GNP per capita (in US dollars) at PPP exchange rates[1]	na	na	na	na	3,770	na	na
The share of industry in GDP (per cent)	29.9	21	37.1	46.4	44.3	40.2	na
The share of agriculture in GDP (per cent)	34.8	41.8	34.1	30.4	31.4	38.8	na
Direct investment (millions of US dollars)	na	na	na	100	470	450	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on information from the aforementioned sources about developments in 1994.

1 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Kyrgyzstan

	1989	1990	1991	1992	1993	1994	1995 Projection
Output				*(Percentage change)*			
GDP at constant prices	4	3	-5	-25	-16	-27	-5
Industrial production at constant prices	na	na	0	-27	-25	-30	na
Agricultural production at constant prices	na	na	-10	-6	-9	-15	na
Prices and wages							
Consumer prices (annual average)	na	3.0	85	855	1,209	280	45
Consumer prices (end-year)	na	na	170	1,771	1,366	87	25
Producer prices (end-year)	na	na	288	4,031	1,355	85	na
GDP deflator	na	na	na	na	1,282	299	na
Monetary sector							
Broad money (end-year)	na	na	84	428	180	124	36
Net domestic assets (end year)	na	na	na	761	307	44	37
Government sector				*(In per cent of GDP)*			
Government balance	2.1	0.3	4.6	-17.4	-13.5	-8.4	-12
Government expenditure and net lending	35.9	38.3	30.3	33.9	36.8	32.7	na
Government tax revenue	28.0	26.3	17.1	14.5	13.5	15.5	na
External data				*(In millions of US dollars)*			
Current account balance, excluding transfers	na	na	-136	-61	-256	-194	-200
Official transfers	na	na	na	na	105	76	na
Trade balance	na	na	-136	-74	-159	-96	na
Exports	na	na	3,719	258	335	340	na
to non-FSU	na	na	23	23	112	117	na
to FSU	na	na	3,696	235	223	223	na
Imports	na	na	3,855	332	494	436	na
from non-FSU	na	na	785	15	178	172	na
from FSU	na	na	3,070	317	317	264	na
External Debt	na	na	na	na	295	420	535
Memorandum items				*(Denominations as indicated)*			
Population (in millions, end-year)	4.3	4.4	4.4	4.4	4.4	4.5	na
GDP (in billions of roubles until 1992, in millions of soms thereafter)	7.6	8.3	86	765	5,720	10,700	na
GNP per capita (in US dollars) at PPP exchange rates[1]	na	na	na	na	2,420	na	na
Exchange rate (annual average, roubles per dollar, som per dollar from 1993 onwards)	0.6	0.6	1.8	161.0	6.1	11.0	na
The share of industry in NMP	33.3	31.8	32.9	38.4	30.0	29.5	na
The share of agriculture in NMP	41.7	43.1	45.6	43.0	46.0	43.3	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on information from the aforementioned sources about developments in 1995.

1 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods in the domestic market as one dollar would buy in the United States.

Latvia

	1989	1990	1991	1992	1993	1994	1995 Projection
Output				*(Percentage change)*			
GDP at constant prices	6.8	2.9	-8.3	-35	-15	2	1
Prices and wages							
Consumer prices (annual average)	4.7	10.5	124.4	951.2	109.1	35.7	25
Consumer prices (end-year)	na	na	262.4	958.0	35.0	26.0	23
Real average wage in the state sector (annual average)	na	na	-16.3	-15.7	1.0	12	na
Monetary sector							
Domestic credit (end-year)	na	na	91	304	146	65	na
Broad money (M2, end-year)	na	na	153	170	84	49	na
Government sector				*(In per cent of GDP)*			
General government financial balance	1	2	6	0	1.0	-1.7	-1.6
General government expenditure	51.0	44.0	31	28.2	34.8	38.0	na
External data							
Current account balance	na	na	na	1.8	6.7	-3.4	-3.4
				(In millions of US dollars)			
Exports (merchandise)	na	na	na	831	998	967	1,080
to FSU	na	na	na	396	541	488	na
to other countries	na	na	na	435	457	480	na
of which: re-exports of energy	na	na	na	134	117	na	na
Imports (merchandise)	na	na	na	1,046	1,159	1,367	1,500
Energy	na	na	na	na	525	405	na
from FSU (non-energy)	na	na	na	na	237	244	na
from other countries (non-energy)	na	na	na	na	396	718	na
Gross foreign debt	na	na	na	69	240	370	na
Gross foreign debt (percentage of GDP)	na	na	na	na	11	11	na
Debt service (percentage of exports)	na	na	na	na	2	5	na
Gross reserves (in months of imports)	na	na	na	69	4.4	4.6	na
Exchange rate (lats per US dollar; end of period)	na	na	na	0.843	0.595	0.548	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in million)	2.7	2.7	2.7	2.7	2.7	2.7	na
Unemployment (end-year, per cent of labour force)	0	0	0.1	2.1	5.3	6.5	na
GNP per capita (in US dollars) at PPP exchange rates[1]	na	na	na	na	5,170	na	na
Credit interest rate (in per cent, end-year)	na	na	23	92	67	32	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD assessments, partly based on information about developments in the first half of the year.

[1] PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Lithuania

	1989	1990	1991	1992	1993	1994	1995 Projection
Output				*(Percentage change)*			
GDP at constant prices[1]	1.5	-5.0	-13.1	-37.7	-24.2	1.7	5
Domestic demand at constant prices	na	na	na	-40.5	-28.0	1.3	4
Industrial production[2]	na	na	na	-50.9	-42.7	2.0	6
Prices and wages							
Consumer prices (annual average)	2.1	8.4	224.7	1,020.5	409.2	72	35
Consumer prices (end-year)	na	na	345.0	1,175.0	188.7	45	30
Average real wages	8.1	7.3	-18.3	-32.8	-45.0	8	na
Monetary sector							
Broad money (M2)	14	55	71	351	160	63	na
Government sector				*(In per cent of GDP)*			
General government balance[3]	-3.8	-4.5	5.0	0.5	2.4	-1.5	-1
General government expenditure	53.8	49.2	38.9	37.8	27.9	26.5	25
External data in convertible currencies							
Current account	na	na	na	3.4	-5.7	-3.7	-3
Trade balance	-8.4	-8.8	9.1	3.4	-10.3	-5.4	-4
				(In millions of US dollars)			
Exports (merchandise)	na	na	na	1,145	1,698	1,892	2,300
to countries outside the FSU	na	na	na	557	716	863	na
to former Soviet republics	na	na	na	588	982	1,028	na
Imports (merchandise)	na	na	na	1,084	1,992	2,210	2,700
from countries outside the FSU	na	na	na	341	520	705	na
from former Soviet republics	na	na	na	742	1,472	1,505	na
of which: Energy	na	na	na	na	901	655	na
Net international reserves of the central bank	na	na	na	24	290	482	na
Gross foreign debt	na	na	na	126	345	490	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions)	3.69	3.73	3.75	3.76	3.75	3.73	na
Unemployment (end-year, per cent of labour force)	na	na	0.3	1.0	2.5	4.2	6.6
GNP per capita (in US dollars) at PPP exchange rates[4]	na	na	na	na	3,160	na	na
The share of agriculture in GDP at factor cost (per cent)[5]	27.2	24.9	23.8	28.2	21.0	18.0	na
The share of industry in GDP at factor cost (per cent)[5]	34.5	36.4	36.9	25.4	41.0	38.0	na
Exchange rate (local currency per US dollar, end-year)[6]	na	17.5	113.9	378.9	3.9	4.0	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance, with most of the data for 1993 and 1994 stemming from the IMF. Data for 1995 reflect EBRD evaluations, partly based on information on developments in the first half of the year.

1 Figures are for NMP until 1990, GDP thereafter. NMP excludes depreciation and the value added from most of the service sector.

2 All manufacturing in 1992; state enterprise sector only in 1993.

3 General government includes the state, municipalities and extra-budgetary funds.

4 PPP stands for purchasing power parity. The estimate quoted here for 1993 stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

5 Data for 1993 from WDR 1995, Table 3. The 1993 data are not consistent with the figures given for earlier years. But they are believed to reflect the structure of GDP more accurately than the earlier figures, though the shares of both agriculture and industry in GDP have been declining with the share of services increasing.

6 Roubles per US dollar in 1990 and 1991, talonai per US dollar in 1992, and litai per US dollar from 1993.

Moldova

	1989	1990	1991	1992	1993	1994	1995 Projection
Output				*(Percentage change)*			
GDP at constant prices[1]	8.8	-1.5	-11.9	-29	-9	-22	-5
Prices							
Consumer prices (annual average)[2]	na	4.2	98	1,276	789	327	35
Consumer prices (end-year)[2]	na	na	162	2,198	837	98	20
Government sector				*(In per cent of GDP)*			
State budget balance[3]	2	3	0	-23.4	-8.8	-8	4
State budget expenditures and net lending[3]	na	na	na	43.6	25.9	16	na
External data in convertible currencies				*(In millions of US dollars)*			
Current account	na	na	na	-39	-182	-180	na
vis-à-vis countries outside the FSU	na	na	na	-22	-8	-60	na
vis-à-vis former Soviet Republics	na	na	na	-17	-174	-120	na
Trade balance	na	na	na	-37	-180	-100	na
vis-à-vis countries outside the FSU	na	na	na	-20	-35	-40	na
vis-à-vis former Soviet Republics	na	na	na	-17	-144	-60	na
Exports	na	na	na	868	451	500	na
to countries outside the FSU	na	na	na	185	174	200	na
to former Soviet Republics	na	na	na	683	277	300	na
Imports	na	na	na	-905	-631	-600	na
from countries outside the FSU	na	na	na	-205	-210	-240	na
from former Soviet Republics	na	na	na	-700	-421	-360	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions)	4.4	4.4	4.4	4.3	4.3	4.3	na
GDP (in millions of Moldovan lei)	na	na	na	215	2,131	8,500	na
GDP per capita (in US dollars) at PPP exchange rates[4]	na	na	na	na	3,210	na	na
GDP per capita (in US dollars) at current exchange rates	na	na	na	na	354	460	na
The share of agriculture in NMP (in per cent)[5]	na	na	na	43	42	na	na
The share of industry in NMP (in per cent)[5]	na	na	na	33	42	na	na
Exchange rate (lei per US dollar, average for the year)	na	na	na	na	1.4	4.3	na

Note

Data for 1989-94 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Projections for 1995 should be treated with the same caveats as apply to official estimates and forecasts. They are based on government and EBRD evaluations of expected developments and on official estimates of outturns for 1994.

1 Changes in NMP at constant prices until 1991, GDP thereafter. NMP excludes depreciation and the value added from most of the service sector.

2 Retail prices for 1989-91.

3 Includes republican and local budgets except for the Trans-Dniester region.

4 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

5 NMP excludes depreciation and the value added from most of the service sector.

Poland

	1989	1990	1991	1992	1993	1994	1995 Projection
Output and expenditure				*(Percentage change)*			
GDP at constant prices[1]	0.2	-11.6	-7.6	2.6	3.8	5.0	5.5
Consumption at constant prices	6.1	-11.7	7.2	3.5	5.1	1.2	na
Gross fixed investment at constant prices	-2.1	-10.6	-3.1	2.3	2.9	7.0	na
Export volume	0.1	13.7	-2.4	-2.6	-2.4	na	na
Import volume	1.5	-17.9	37.8	13.9	20.0	na	na
Industrial production	-1.4	-26.1	-11.9	3.9	5.6	13.0	13
Prices and wages							
Consumer prices (annual average)	251.1	585.8	70.3	43.0	35.3	32.2	27
Consumer prices (end-year)	639.7	249.3	60.4	44.4	37.6	29.5	23
Producer prices (annual average)	212.8	622.3	48.1	28.5	32.2	30.1	na
Wages and salaries (annual average)	291.8	398.0	70.6	39.2	33.6	37.0	na
Monetary sector							
Broad money (end-year)	236.0	121.9	47.4	57.5	36.0	38.2	23
Government sector				*(In per cent of GDP)*			
General government balance[2]	-7.4	3.1	-6.5	-6.7	-2.9	-2.5	-3.1
General government outlays[2]	48.8	39.8	48.0	50.7	48.4	50.2	na
State budget balance[3]	-6.1	0.7	-7.0	-6.9	-3.4	-3.0	-3.2
State budget outlays[3]	36.9	32.7	32.7	33.9	32.9	32.4	33.7
External data in convertible currencies				*(In billions of US dollars)*			
Current account balance	-1.8	0.7	-2.2	-0.3	-2.3	-0.9	-1.1
Trade balance	0.2	2.2	0.1	0.5	-2.3	-0.8	-1.0
External debt	40.2	48.9	48.3	48.2	48.7	40.9	na
				(Percentage change in the US dollar value)			
Exports (data from the balance of payments)	4.5	43.4	17.5	9.7	-2.9	24.8	na
Imports (data from the balance of payments)	16.3	17.9	46.9	6.1	17.7	12.0	na
				(In months of imports of goods and non-factor services)			
Gross official reserves (end-year)	3.6	5.5	3.3	3.5	3.0	3.6	na
Memorandum items				*(Denominations as indicated)*			
Population (in millions)	38.0	38.2	38.3	38.4	38.5	38.6	na
Employment (percentage change, end-year)	-0.8	-6.2	-3.9	-3.1	-2.8	-1.5	na
Unemployment (in per cent of the labour force, end-year)	0.1	6.1	11.8	13.6	15.7	16.0	na
GDP (in billions of new zloty)	11.832	59.152	82.527	114.944	155.605	211.500	na
GNP per capita (in US dollars) at PPP exchange rates[4]	na	na	na	na	5,010	na	na
Private sector share of GDP (per cent)	28.6	31.4	45.3	48.2	53.5	56.0	na
The share of agriculture in GDP (per cent)[5]	7.8	8.4	9.3	8.3	7.1	na	na
The share of industry in GDP (per cent)[6]	49.5	43.6	39.2	39.6	37.8	na	na
Exchange rate (new zloty per US dollar, end-year)	0.650	0.950	1.096	1.577	2.134	2.437	na
Exchange rate (new zloty per US dollar, average)	0.145	0.950	1.058	1.363	1.812	2.272	na
Interest rate (re-discount rate, end of period)	136.0	48.0	36.0	32.0	29.0	28.0	na

Sources

Central Statistical Office, Poland; National Bank of Poland; International Monetary Fund; and EBRD staff estimates.

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on information on developments in the first half of the year.

1 An unofficial report published by the Central Statistical Office puts the decline in real GDP between 1989 and 1991 at 5 -10 per cent, significantly below the official figures.

2 "General government" includes the state, municipalities and extra-budgetary funds. The data are compiled on a commitment basis, except for external interest payments which are cash-based.

3 For the period 1988-90 the "state budget" includes central government accounts and accounts of local and regional authorities. The state budget for 1991 and subsequent years includes the central government accounts, the accounts of regional authorities and accounts of several previously extra-budgetary funds. Flows are compiled on a commitment basis, except for external interest payments which are cash-based.

4 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

5 At constant prices. Includes agriculture and forestry.

6 At constant prices.

Romania

	1989	1990	1991	1992	1993	1994	1995 Projection
Output and expenditure				*(Percentage change)*			
National accounts							
Real GDP	-5.8	-5.6	-12.9	-10.0	1.3	3.4	4
Private consumption	0.6	8.0	-16.2	-9.3	-2.0	na	na
Public consumption	1.2	12.7	8.4	1.4	3.0	na	na
Gross fixed investment	-1.6	-35.5	-31.6	4.9	4.7	na	na
Exports of goods and services	-10.2	-39.4	-17.9	-3.0	11.1	na	na
Imports of goods and services	2.9	18.5	-29.6	7.6	3.9	na	na
Industrial output[1]	-5.3	-23.7	-22.8	-21.9	1.3	3.3	5
Prices and wages							
Consumer prices (annual average)	1.1	5.1	174.5	210.9	256.1	131.0	40
Consumer prices (end-year)	0.6	37.7	222.8	199.2	295.5	61.7	30
Wholesale prices (annual average)	0.0	26.5	255.8	191.7	165.0	na	na
Wages (annual average)	3.9	10.6	121.2	170.0	202.1	na	na
Monetary sector				*(In per cent of GDP)*			
Broad money (end-year)	5.3	22.0	101.2	79.6	143.2	100	na
Government sector				*(In per cent of GDP)*			
Central goverment balance (national definition)	na	na	-1.9	-4.4	-1.8	-3.5	-3
General government balance[2]	8.4	1.2	0.6	-4.6	-0.1	-3	-2
General government expenditure[2]	42.7	39.3	40.4	42.2	31.0	na	na
External data in convertible currencies				*(In billions of US dollars)*			
Current account balance	2.9	-1.8	-1.3	-1.7	-1.5	-0.7	na
Trade balance	2.6	-1.8	-1.3	-1.4	-1.1	0.3	na
Gross external debt, net of reserves (end-year)	-1.3	0.6	1.6	2.7	3.5	4	na
				(Percentage change in the US dollar value)			
Exports (data from the balance of payments)[3]	-7.9	-44.0	-1.7	22.9	13.6	28	na
Imports (data from the balance of payments)[3]	17.3	49.9	-10.2	16.3	6.2	5	na
				(In months of current account expenditures, excluding transfers)			
Gross international reserves (end-year), excluding gold	6.0	0.8	1.0	1.3	1.6	2.6	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions, mid-year)	23.1	23.2	23.2	22.8	22.8	22.7	22.6
Employment (percentage change, end-year)	1.3	-1.0	-0.5	-3.0	-3.8	-2.7	na
Unemployment rate (in per cent of the labour force, end-year)	na	na	3.0	8.4	10.2	10.9	na
GDP (in billions of lei)	800	858	2,199	5,982	18,835	47,500	na
GDP per capita (in US dollars) at current exchange rates[4]	2,321	1,649	1,242	852	1,087	1,324	na
GDP per capita (in US dollars) at PPP exchange rates[5]	na	na	na	na	2,910	na	na
The share of agriculture in GDP (per cent)[6]	13.9	18.0	18.5	20.1	21	na	na
The share of industry in GDP (per cent)[6]	52.8	48.2	43.6	44.3	41	na	na
Exchange rate (lei per US dollar, end-year)[7]	14.4	34.7	189.0	460.0	1,276.0	1,767	na
Exchange rate (lei per US dollar, average)[7]	14.9	22.4	76.3	308.0	760.1	1,580	na
Bank lending rate (end-year)[8]	3	3	8-18	52	86	56	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on preliminary information from the aforementioned sources about developments in the first half of the year.

1 For 1988 and 1989: industrial real value added.

2 General government includes the state, local governments and extra-budgetary funds.

3 Balance of payments data; payments settled plus accrued payments due.

4 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

5 Applying the average exchange rate quoted above.

6 At current prices.

7 During most of the period covered in this table, the exchange rate facing individuals has differed from that facing enterprises. The rates quoted here are the officially quoted rates facing enterprises.

8 For 1988-91: The central bank's refinancing rate. For 1992: commercial bank rate on medium-term lending to enterprises. For 1993: average end-year commercial bank rate on lending to enterprises. For 1994: the central bank's average lending rate in October 1994.

Russian Federation

	1989	1990	1991	1992	1993	1994	1995 Projection
Output and expenditure				*(Percentage change)*			
Real GDP	na	na	-13	-19	-12	-15	-3
Real NMP	1.9	-4.0	-11.0	-20.0	-13	-16	-4
Investment at constant prices	4.1	0.1	-11.0	-45.0	-15.0	-27	-10
Industrial production	1.4	-0.1	-8.0	-18.8	-16.0	-21	-6
Prices and wages				*(In percentage)*			
Retail prices (annual average)	2.0	5.6	92.7	1,354	896	302	205
Retail prices (end-period)	na	na	143.9	2,318	841	203	145
Wages (annual average)	9.9	14.8	73.9	1,065	885	269	na
Industrial wholesale prices (annual average)	1.2	3.9	138.1	1,949	na	na	na
Industrial wholesale prices (end-period)	na	na	236.3	3,275	1,007	345	155
Monetary sector				*(Percentage change)*			
Credit to enterprises and households	na	na	127	803	452	242	na
Broad money (end-period)[1]	14.6	17.6	126	643	416	190	na
Government sector				*(In per cent of GDP)*			
State budget balance (cash basis)[2]	na	na	-16.0	-6.9	-5.7	na	na
General government balance (cash basis)[3]	na	na	-31.0	-18.8	-7.6	-9.9	-5.7
External data[4]				*(In billions of US dollars)*			
Current account balance							
vis-à-vis non-CIS countries (incl. gold)	na	-2.5	1.5	-1.7	2.0	5.3	5
Trade balance *vis-à-vis* non-CIS countries (excl. gold)	13.1	10.0	6.4	5.4	10.4	12.3	12
Gross external debt in convertible currencies							
(of the Soviet Union/Russia, end of period)	54.4	61.1	67.0	78.2	86.8	92.8	na
				(Percentage change in the US dollar value)			
Exports to non-CIS countries (excl. gold)	8.5	0.8	-19.8	-16.7	9.0	10.6	15
Imports from non-CIS countries	13.8	7.3	-16.9	-16.8	-12.0	8.2	20
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions, end-year)	147.6	148.3	148.9	148.6	148.3	148.2	148
Unemployment rate (in per cent of labour force, end-year)[5]	0.0	0.0	0.1	0.8	1.1	2.1	3.5
Exchange rate (roubles per US dollar, end-year)	0.6	1.7	1.7	415.0	1,247.0	3,550	na
Exchange rate (roubles per US dollar, average)	0.6	1.7	1.7	222.0	930.0	2,212	na
Refinancing rate	na	na	6–9	80	210	180	na
Nominal GDP (in billion roubles)	573	622	1,130	14,046	162,300	630,000	na
GNP per capita (in US dollars) at PPP exchange rates[6]	na	na	na	na	5,240	na	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, Russian Economic Trends, PlanEcon and the Economist Intelligence Unit. Data for 1995 reflect EBRD evaluations, partly based on preliminary information from the aforementioned sources about developments in the first half of the year.

1 Excluding foreign currency deposits.

2 Official definition of the consolidated state budget.

3 After accounting for import subsidies and extra-budgetary funds.

4 The source of external data used in this table is PlanEcon. There are many difficult conceptual issues associated with Russian balance of payments statistics. For example, estimates from other sources for the current account balance for each of the years 1992-94 differ by up to US$ 4-6 billion from PlanEcon figures. This is because most non-governmental sources, including the IMF, the World Bank and PlanEcon, make discretionary adjustments to official estimates, and because different sources adjust to different extents for overdue (but unpaid) interest (payments as well as receipts), for under-recording of trade and for gold transactions.

5 Officially registered unemployed.

6 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Slovak Republic

	1989	1990	1991	1992	1993	1994	1995 Projection
Output				*(Percentage change)*			
GDP at constant prices	1.4	-0.4	-14.5	-7.0	-4.1	4.8	5
Industrial production[1]	-0.7	-3.6	-17.6	-14.0	-13.5	6.4	na
Prices and wages							
Consumer prices (annual average)	2.3	10.8	61.2	10.1	23.1	13.4	11
Consumer prices (end-year)	1.5	18.4	58.3	9.1	25.1	11.7	10
Producer prices (annual average)	-0.7	4.4	68.8	5.3	17.2	10.0	na
Average wages in industry	3.2	4.5	16.5	20.2	16.8	17.4	na
Monetary sector							
Broad money (end-year)	3.5	0.5	26.8	4.7	18.5	18.8	na
Net domestic assets (end-year)	0.9	5.2	21.9	7.2	14.8	12.4	na
Government sector				*(In per cent of GDP)*			
General government balance	-2.8	0.1	-2	-13.1	-6.7	-3.7	-3
General government expenditure	64.5	60.1	54.2	63.8	49.1	40.7	na
External data in convertible currencies				*(In billions of US dollars)*			
Current account balance	0.4	-1.1	0.4	0.2	-0.4	0.7	0.2
Trade balance	0.4	-0.8	-0.4	-0.7	-0.9	0.1	na
				(Percentage change in the US dollar value)			
Exports (data from the balance of payments)[2]	8.5	10.1	39.2	35.2	-16.9	25	na
Imports (data from the balance of payments)[2]	-1.5	35	29.6	46.2	-12.5	7	na
				(In billions of US dollars)			
External debt	na	na	na	na	3.6	4.3	na
Gross official reserves (end year and excluding gold)	na	na	na	na	0.4	1.7	na
				(In months of imports)			
Official reserves (end year)	na	na	na	na	0.9	3.1	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions, end-year)	5.3	5.3	5.3	5.3	5.3	5.3	na
Unemployment rate (in per cent of labour force, end-year)	0	1.5	7.9	11.0	14.4	14.8	na
GDP (in billions of crowns)	758.8	244.0	280.1	301.1	340.2	398.3	na
The share of agriculture in GDP (per cent)[3]	6.3	8.2	5.8	6.1	6.6	6.1	na
The share of industry in GDP (per cent)[3]	59.6	61.6	63.9	38.0	36.7	37.5	na
GNP per capita (in US dollars) at PPP exchange sales[4]	na	na	na	na	6,450	na	na
Exchange rate (crowns per US dollar, end-year)	14.3	28	27.8	28.9	33.0	31.5	na
Exchange rate (crowns per US dollars, annual average)	15.1	18	29.5	28.3	30.8	32	na
One month average interbank deposit rate	na	na	na	na	17.9	15.6	na

Note

Figures in bold type are those for the Slovak Republic and figures in normal type are those for the former CSFR. As a rule, data for the Slovak Republic are shown for years after 1991 where possible. Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, the UNECE, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD estimates, partly based on the sources mentioned above.

1 Covers only state enterprises until 1991, but includes the private sector from 1992.

2 From 1993, growth rates are for transactions including the Czech Republic from the balance of payments.

3 Share of NMP until 1992 and GDP thereafter. NMP excludes depreciation and the value added from most of the service sector.

4 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Slovenia

	1989	1990	1991	1992	1993	1994	1995 Projection
Output				*(Percentage change)*			
GDP at constant prices	-1.8	-4.7	-8.1	-5.4	1.3	5.5	6
Industrial production	-0.1	-10.5	-12.4	-13.2	-2.8	6.4	6
Agricultural production	-3.3	1.6	-3	-6	-3.7	1.6	na
Prices and wages							
Retail prices (annual average)	1,306	550	117.7	201.3	32.3	19.8	15
Retail prices (end-year)	2,772	105	247.1	92.9	22.9	18.3	10
Producer prices (annual average)	1,413	390	124.1	215.7	21.6	17.7	na
Nominal wages, net of income tax (annual average)[1]	1,141	379	82.5	198.5	52.0	28.3	na
Monetary sector							
Broad money (end-year)	na	na	na	131.6	64.7	47.2	na
Government sector				*(In per cent of GDP)*			
General government balance	0.3	-0.3	2.6	0.2	0.5	-1.0	-0.6
General government expenditure	42.1	49.6	41.1	46.8	49.4	48.8	47
External data in convertible currencies				*(In billions of US dollars)*			
Current account[2]	1.1	0.5	0.1	0.9	0.2	0.5	0.4
Trade balance[2]	0.2	-0.6	-0.3	0.8	-0.2	-0.1	-0.4
External debt, net of reserves[3]	na	na	1.8	1.0	1.1	0.8	na
				(Percentage change in US dollar value)			
Exports (data from the balance of payments)[2]	3.19	20.8	-6	8.1	-9	14.0	10
Imports (data from the balance of payments)[2]	9.9	47.0	-12.6	0.1	5.9	6.2	12
				(In months of current account expenditures, excluding transfers)			
Gross international reserves, excluding gold	na	0.6	0.4	1.9	2.4	3.9	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions, annual average)	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Employment (percentage change, annual average)	-1.1	-3.8	-7.2	-6	-0.5	0.0	-0.5
Unemployment (in per cent of the labour force, annual average)	2.9	4.7	8.2	11.1	14.5	14.6	12.7
GDP (in 10 trillions of dinars up to 1990, in billions of tolars thereafter)	34.8	196.1	349.4	1,005.3	1,435.0	1,800	na
The share of agriculture in GDP (per cent)	4.3	4.7	4.9	4.9	4.5	4.5	na
The share of industry in GDP (per cent)	44.3	38	40.8	37.6	35.4	35.1	na
Exchange rate (tolar per US dollar, end-year)[4]	11.8	10.7	56.7	98.7	131.8	126.5	na
Exchange rate (tolar per US dollar, annual average)[4]	2.9	11.3	27.6	81.3	113.2	128.8	na
Working capital nominal interest rate (end-year)	na	na	562.6	71.6	42.6	38.5	na

Note

Data for 1989-94 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1995 reflect EBRD evaluations, partly based on preliminary information from the aforementioned sources about developments in the first half of 1995.

1 Data for 1989-91 covers only the social sector; starting from 1992 private enterprises employing three or more persons are included.

2 For 1989-91 excluding trade with former Yugoslavia.

3 Excluding non-allocated federal Yugoslav debt.

4 For the period prior to 8 October 1991 (the date of the introduction of the tolar) measured as the multiple of 10,000 dinars that would buy one US dollar. The tolar was introduced at 10,000 dinar per tolar.

Tajikistan

	1989	1990	1991	1992	1993	1994	1995 Projection
Output				*(Percentage change)*			
GDP at constant prices[1]	-2.9	-1.6	-7.1	-28.9	-11.1	-21.4	-12
Industrial production	1.9	1.9	-7.4	-35.7	na	-30	na
Agricultural production	-13.0	-9.2	-9.9	-27.7	na	-3	na
Prices and wages							
Retail prices (annual average)[2]	na	4	112	1,157	2,195	341	120
Retail prices (end-period)[2]	na	na	204	1,364	7,344	5	240
Wholesale prices (annual average)	na	na	79	3,450	4,241	586	na
Average monthly wages	6	10	64	464	672	167	na
Monetary sector							
Broad money (end-year)	na	na	68	579	1,429	159	na
Government sector				*(In per cent of GDP)*			
General government balance[3]	na	na	-16.4	-29.9	-24.7	-6.4	na
General government expenditure[3]	na	na	49.6	65.7	51.7	34.2	na
External data				*(In millions of US dollars)*			
Trade balance total	na	na	na	-54.8	-208.1	-109.1	na
vis-a-vis countries outside the FSU	-3.9	-6.5	0.1	-21.4	-81.1	70.5	na
vis-a-vis former Soviet Republics	-15.4	-9.4	2.1	-33.4	-127	-179.6	na
Exports total	na	na	na	184.8	452.2	512.0	na
to countries outside the FSU	5.2	4.3	2.9	110.8	317.6	399.4	na
to former Soviet Republics	30.7	23.5	28.2	74.0	134.6	112.6	na
Imports total	na	na	na	239.0	660.4	621.1	na
from countries outside the FSU	9.1	10.8	2.8	132.2	398.8	328.9	na
from former Soviet Republics	46.1	32.9	28.2	107.4	261.6	292.2	na
Current account (incl. official transfers)	na	na	na	52.8	206.9	115.8	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions, end-year)	5.1	5.2	5.3	5.6	5.7	5.7	na
Employment (percentage change)	na	3.3	1.7	-3.0	0.1	0.5	na
GDP (in millions of roubles)[4]	4,817	5,490	10,540	64,760	631,162	1,717,974	na
GDP per capita (in US dollars) at PPP exchange rates[5]	na	na	na	na	1,430.0	na	na
The share of agriculture in NMP (per cent)	37.2	38.3	43.9	32.8	na	na	na
The share of industry in NMP (per cent)	26.7	28.6	30.6	45.4	na	na	na

Note

Data for 1989-93 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1994-95 reflect EBRD evaluations, partly based on preliminary information from the aforementioned sources about developments in 1994.

1 GDP from 1991. NMP for 1989-90 excludes depreciation and the value added from most of the service sector.

2 RPI through 1991, CPI thereafter.

3 Includes state budget, pension and employment funds.

4 NMP for 1989-91.

5 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Turkmenistan

	1989	1990	1991	1992	1993	1994	1995 Projection
Output				*(Percentage change)*			
GDP at constant prices	-6.9	2.0	-4.7	-5.3	-10	-20	-5
Price and wages							
Consumer prices (annual average)	2.1	4.6	103	493	3,102	2,400	1,800
Consumer prices (end-period)	na	na	155	644	9,750	1,100	2,500
Government sector				*(In per cent of GDP)*			
Central government expenditure[1]	30.1	43.6	38.2	42.2	19.2	6.2	na
Central government balance[1]	-1.9	1.2	2.5	13.2	-0.5	-1.1	na
External data				*(In millions of US dollars)*			
Current account	na	na	na	na	677	500	na
Current account, cash basis[2]	na	na	na	na	-254	-334	na
Trade balance	na	-249	590	1,140	1,033	949	na
Exports	na	151	1,238	2,149	2,626	2,425	na
Imports	na	400	648	1,009	1,593	1,476	na
Memorandum items				*(Denominations as indicated)*			
Population (in millions)	3.6	3.7	3.8	3.8	3.9	3.9	na
Employment (in millions)	1.49	1.54	1.57	1.57	na	na	na
GDP (in millions of manat)[3]	7	7	17	300	11,000	200,000	na
The share of agriculture in NMP (in per cent)[4]	43	48	46	48	17	na	na
The share of industry in NMP (per cent)[4, 5]	23	16	20	11	39	na	na
GDP per capita in purchasing power terms (US dollars)[6]	na	na	na	3,950	na	na	na
Official exchange rate (manat per US dollar, end-year)	na	na	na	na	2	175	na

Note

Data for 1989-94 are largely estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Figures for 1995 are EBRD staff estimates/projections, partly based on information about developments in the first half of the year.

1 Excludes many government activities. For example, activities of several key ministries are not included in the central government concept.

2 Computed as the difference between the current account and the flow-accumulation of overdue claims on other countries.

3 Based on converting rouble amounts into manat at an exchange rate of 500 roubles per manat for 1989-92.

4 NMP excludes depreciation and the value added from most of the service sector.

5 The methodology used by the Turkmen Statistical Office leads to an understatement of the contribution from natural gas production.

6 PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank's *World Development Report 1994*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Ukraine

	1989	1990	1991	1992	1993	1994	1995 Projection
Output and expenditure				*(Percentage change)*			
GDP at constant prices	4	-3	-12	-17	-17	-23	-5
Private consumption	5	2	-8	-9	-21	-22	na
Public consumption	7	5	19	-17	-26	na	na
Net fixed investment	-2	-32	-79	-37	-23	na	na
Industrial production	3	0	-5	-7	-8	-28	na
Agricultural production	na	na	-19	-9	-2	-16	3
Prices and wages							
Consumer prices (annual average)	2.2	4.2	91	1,210	4,735	891	350
Consumer prices (end-year)	na	na	161	2,000	10,155	401	150
Producer prices (annual average)	na	4.5	125	2,384	3,962	904	na
Producer prices (end-year)	1.7	4.5	163	4,129	9,668	559	na
Average wages (annual average)	na	na	na	1,523	3,850	317	na
Monetary sector							
Broad money (end-year)	na	na	na	921	2,103	465	na
Net domestic assets of the banking system (end-year)	na	na	na	1,280	1,242	476	na
Government sector				*(In per cent of GDP)*			
General government balance[1]	na	na	-13.6	-29.3	-9.7	-9.1	-4
State budget balance[1]	5.8	2.6	-14.1	-30.4	-10.1	-8.6	-3
State budget expenditure[1]	27.3	31.4	41.0	71.9	51.2	49.9	na
State budget revenue[1]	na	na	na	41.5	41.1	44.3	na
External data				*(In billions of US dollars)*			
Current account balance	na	na	-2.9	-0.6	-0.8	-1.4	-1.3
Nonfactor services	na	na	na	na	1.6	1.0	na
Merchandise trade balance total	-9.0	-12.7	-3.4	-0.6	-2.5	-2.4	na
vis-à-vis non-FSU countries	-0.8	-2.6	-2.7	0.5	0.5	0.3	na
vis-à-vis FSU republics	-8.2	-10.1	-0.7	-1.1	-3.0	-2.1	na
Exports total	77.1	74.6	50.0	11.3	12.8	11.8	na
to non-FSU	14.0	13.2	7.3	6.0	5.2	4.7	na
to FSU republics	63.1	61.4	42.7	5.3	7.6	7.2	na
Imports total	86.1	87.3	53.4	11.9	15.3	14.2	na
from non-FSU	14.8	15.8	10.0	5.5	4.7	4.3	na
from FSU republics	71.3	71.5	43.4	6.4	10.6	9.8	na
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions)	51.7	51.8	51.9	52.0	52.1	51.7	na
Employment (percentage change, end-year)	na	-3.5	-1.6	-5.0	-5.9	na	na
Unemployment rate (in per cent, end-year)	0	0	0	0.3	0.4	0.4	na
GDP (in billions of roubles until 1991; in trillions of karbovanetsi after that)	154	165	295	4	153	1,137	na
GNP per capita (in US dollars) at PPP exchange rates[2]	na	na	na	na	4,030	na	na
The share of agriculture and fisheries in NMP (per cent)[3]	28	30.3	30.2	22.5	16	na	na
The share of industry and mining in NMP (per cent)[3]	42.6	41.3	42.4	50.7	52	na	na
Exchange rate (roubles or karbovanetsi per US dollar, average per year)[4]	0.62	0.59	1.74	198	7,629	63,224	na

Note

Data for 1989-94 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Projections for 1995 should be treated with the same caveats as apply to official estimates and forecasts.

1 General government includes the state, municipalities and extra-budgetary funds. The state budget includes direct credits. All balances on cash, not accrual, basis.

2 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

3 NMP excludes depreciation and the value added from most of the service sector.

4 Roubles per US dollar until 1991, karbovanetsi per US dollar thereafter.

Uzbekistan

	1989	1990	1991	1992	1993	1994	1995 Projection
The real economy				*(Percentage change)*			
Real GDP	3.7	1.6	-0.5	-11.1	-2.4	-2.6	-4
Real NMP	3.1	4.3	-0.9	-12.9	-3.5	na	na
Industrial output	3.6	1.8	1.8	-12.3	-8.3	na	na
Agricultural output	-4.3	6.3	-5.2	-7.3	-0.7	na	na
Prices and wages							
Retail prices (end of period)	na	na	169	910	885	423	155
Retail prices (annual average)	0.7	3.1	82.2	645	534	746	325
Wholesale prices	2.1	7.2	147.3	3,275	2,545	1,346	na
Wages (annual average)	6.4	11.2	51.1	612	na	na	na
Monetary Sector							
Broad money (end-year)	na	na	133	470	785	482	na
Government sector				*(In per cent of GDP)*			
Total revenue	35.0	44.9	49.1	31.0	41	43	47
Total expenditure	35.9	46.1	52.7	43.0	61	45	51
General government balance	-0.9	-1.1	-3.6	-12.0	-20	-2	-4
Consolidated fiscal balance[1]	na	na	-4.1	-18.0	-12	-3.6	-4
External data[2]				*(In million of US dollars)*			
Exports	na	na	na	1,424	2,877	3,218	3,500
Imports	na	na	na	1,660	3,255	3,178	3,630
Trade balance	na	na	688	-236	-378.0	41	-130
Current account	na	na	na	-239	-429	-432	-670
Gross external debt	na	na	na	258	1,009	1,462	2,030
Gross international reserves	na	na	na	530	1,020	1,330	1,500
Miscellaneous items				*(Denominations as indicated)*			
Population (in millions, end-year)	20.0	20.5	20.9	21.3	22.0	22.2	na
Investment (in per cent of GDP)	32	32	26	25	24	20	na
Nominal GDP (in billion roubles)	30.7	32.4	61.5	447.2	4,428.1	46,971	na
GNP per capita (in US dollars) at PPP exchange rates[3]	na	na	na	na	2,580	na	na

Note

Data for 1989-93 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund the World Bank, the OECD, PlanEcon and the Economist Intelligence Unit. Data for 1995 reflect EBRD evaluations, partly based on preliminary information from the aforementioned sources about developments in the first half of 1995.

1 Including balance of extra-budgetary funds, gold and foreign currency operations.

2 Consolidated balance of non-FSU and FSU transactions.

3 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1995*. In the computation of this estimate the country's nominal GNP per capita was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one dollar would buy in the United States.

Forecasts and prospects

12

This chapter presents a compilation of forecasts for growth and inflation in the countries of eastern Europe, the Baltics and the CIS. The primary aim is to convey the perception among forecasters of growth prospects for countries in the region.

Section 12.1 presents a sample of predictions for the next two years. For most countries in eastern Europe and the Baltics, GDP is forecast to grow by 3-6 per cent in both 1995 and 1996. For the CIS as a whole, negative growth of 4-9 per cent is predicted for 1995, followed by a turnaround to positive growth of less than 1 per cent in 1996. Most forecasters are predicting further progress towards price stability during 1995 and 1996 throughout the region.

Section 12.3 discusses the accuracy of forecasts for growth and inflation based on comparisons between forecasts and outturns. On the evidence of such comparisons, the ability of forecasters to predict short-term developments in GDP and inflation in eastern Europe and the Baltic countries appears to have improved in 1994. Meanwhile, the precision of their short-term predictions for the evolution of the same variables in the CIS countries appears to have deteriorated dramatically.

12.1 Growth forecasts for 1995-96

Most forecasters expect annual GDP growth in 1995 and 1996 of 3-6 per cent in almost all countries in eastern Europe and the Baltics, with a somewhat lower rate only for Hungary (see Tables 12.1 and 12.2). As the size of the population is expected to remain broadly stable in most of these countries, the rate of growth in real per capita income is expected to be close to the rate of increase in real GDP.

Growth projections of this order of magnitude (i.e. 3-6 per cent a year) may be rationalised with reference to the analysis of medium-term prospects in Chapter 3 and of productivity and unit labour costs in Chapter 11. The central part of the argument presented there is that new investment will add not only to the capacity of productive capital but also to the productivity of "old" capital (notably buildings) and to the scope for efficient usage of the highly educated labour force in the region, much of which is currently under-utilised. This will allow large productivity increases throughout eastern Europe and the Baltics, adding to substantial gains already achieved in 1993 and 1994 (the latter are documented in tables in Chapter 11).

PlanEcon's *Review and Outlook*[1] stands out among the sources quoted at the end of this chapter as the only one whose macroeconomic forecasts for eastern Europe extend beyond 1996. PlanEcon's projections for growth fall within a range of 4-6 per cent per year for the entire period 1996-99 for all of the six largest east European countries. PlanEcon expects the ratio of fixed investment to GDP for each country to remain, during the entire period to 1999, broadly at the level seen in 1994 (about 16 per cent in Poland at the lower extreme, and 26 per cent in the Slovak Republic at the upper extreme). The lower end of this range falls short of the average in OECD countries. Even the higher end of the range remains far below ratios recorded in recent years in the high-growth economies of East Asia.[2] Nevertheless, predictions of relatively high medium-term growth can be supported by the line of argument that was pursued above in the discussion of near-term growth prospects (see Chapter 3). Given the vast supply of under-utilised skilled labour and "old" machines and buildings, it might well be possible to sustain high productivity growth at least until the end of the decade without significant increases in the *quantity* of investment (ratios of fixed investment to GDP). The new investment, however, will have to be market-oriented and of high *quality*.

Moving beyond the assumptions underlying PlanEcon's forecasts, it would appear reasonable to expect investment demand to increase faster than GDP in coming years, assuming that the stability of the macroeconomic and legal environment becomes gradually more entrenched. As set out in Chapter 4, an increase in investment demand is likely to be induced by the potential for high profits associated with the expected productivity gains. The ratio of investment to GDP has in fact risen in recent years in many countries in eastern Europe (again, see Chapter 3). The likelihood of further increases in the ratio reinforces the case for expecting buoyant GDP growth in eastern Europe in the years ahead.

As indicated by the figures in Tables 12.1 and 12.2, forecasters tend to be less optimistic about the near-term prospects for the largest CIS countries than they are about those in eastern Europe. Most of the CIS is currently at an intermediate stage of market-oriented transition and macroeconomic stabilisation (as detailed in Chapters 2 and 11), and a sustained rebound in output is yet to be recorded in the large CIS countries. The timing of such a rebound remains highly uncertain. Forecasters quoted in these tables expect GDP to decline in 1995 by 3-7 per cent in Russia and 5-12 per cent in Ukraine. For 1996, most forecasters expect positive growth of 1-4 per cent in Russia but a further output contraction of 1-5 per cent in Ukraine. For the CIS as a whole (with Russia and Ukraine being the dominant countries in terms of size), this translates broadly into a GDP decline of 4-9 per cent in 1995 and growth of 0-3 per cent in 1996.

1 PlanEcon (1995a, b).

2 It should be noted that ratios of investment to GDP in the early part of the high-growth era in at least some of the Asian Tiger countries were similar to those seen now in eastern Europe. The ratio of investment to GDP has tended to rise during the course of the high-growth period in many of these countries. This supports the argument that the investment preconditions for high growth are present in eastern Europe and the Baltics.

Table 12.1

GDP growth forecasts for 1995 (in per cent)[1]

Eastern Europe and the Baltic states

	Average of forecasts[2]	Range of forecasts[3]	EBRD forecast (September)	OECD forecast (June)	IMF forecast (May)	Project Link forecast (April)	European Union forecast (June)	PlanEcon forecast (June)	Economist Intelligence Unit forecast (September)	Vienna Institute forecast (June)	JP Morgan forecast (September)	CS First Boston forecast (July)	IKC forecast (June)[4]	GKI forecast (September)[5]	Kopint-Datorg forecast (June)[6]
Albania	6.2	0.9	6	–	6.0	–	–	6.9	6.0	–	–	–	–	–	–
Bulgaria	2.3	4.0	2.5	2.0	–	1.0	1.6	5.0	2.0	2	3.0	–	–	–	1.5
Croatia	4.3	5.0	2	–	–	–	–	–	4.0	7	–	–	–	–	3.5
Czech Republic	4.0	1.3	4	4.0	3.8	4.0	4.2	4.8	4.0	4	4.0	3.5	–	–	3.5
Estonia	5.9	1.4	6	–	6.0	–	–	6.4	5.0	–	–	–	–	–	–
FYR Macedonia	-1.0	4.0	-3	–	–	–	–	–	1.0	–	–	–	–	–	–
Hungary	1.4	2.8	3	1.0	0.2	1.8	0.3	3.0	1.5	1	1.3	0.7	–	0.5	2.0
Latvia	2.9	4.0	1	–	4.6	–	–	5.0	1.0	–	–	–	–	–	–
Lithuania	4.8	3.7	5	–	6.7	–	–	4.3	3.0	–	–	–	–	–	–
Poland	5.7	2.3	6	5.5	5.0	4.9	5.0	7.2	5.9	6	6.6	5.0	5.5	–	6.0
Romania	3.4	2.8	4	3.0	–	3.9	2.8	4.8	3.0	2	–	–	–	–	3.5
Slovak Republic	4.7	3.0	5	5.0	4.0	3.7	3.0	6.0	5.7	4	5.5	5.0	–	–	4.5
Slovenia	5.4	3.0	6	–	5.0	–	–	7.0	5.5	5	5.3	–	–	–	4.0
Average	3.8	2.9	–	–	–	–	–	–	–	–	–	–	–	–	–
Commonwealth of Independent States															
Armenia	8.3	6.6	5	–	–	–	–	11.6	–	–	–	–	–	–	–
Azerbaijan	-6.4	17.3	-15	–	–	–	–	2.3	–	–	–	–	–	–	–
Belarus	-10.4	1.2	-10	–	–	–	–	-11.2	-10.0	–	–	–	–	–	–
Georgia	0.3	10.5	-5	–	–	–	–	5.5	–	–	–	–	–	–	–
Kazakstan	-9.5	5.5	-12	–	–	–	–	-6.5	-10.0	–	–	–	–	–	–
Kyrgyzstan	-2.0	6.0	-5	–	–	–	–	1.0	–	–	–	–	–	–	–
Moldova	-0.8	3.5	-5	–	–	–	–	3.5	–	–	–	–	–	–	–
Russia	-4.1	5.0	-3	-5.0	–	-4.4		-2.7	-2.0	-7	-3.5	-3.0	–	–	-6.5
Tajikistan	-5.5	13.1	-12	–	–	–	–	1.1	–	–	–	–	–	–	–
Turkmenistan	-1.2	7.7	-5	–	–	–	–	2.7	–	–	–	–	–	–	–
Ukraine	-8.8	7.0	-5	–	–	–	–	-5.5	-8.0	-10	-12.0	–	–	–	-12.0
Uzbekistan	-3.3	1.4	-4	–	–	–	–	-2.6	–	–	–	–	–	–	–
Average	-3.4	7.1	–	–	–	–	–	–	–	–	–	–	–	–	–

[1] All forecasts in this table were published or reported to the EBRD between April and September 1995 (see also the references at the end of this chapter). There may, for a number of institutions, be a substantial lag between preparation and publication of forecasts. The dates in parentheses indicate in which month the forecasts were reported or published by each institution. The EBRD forecasts were prepared in August and published in October.

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

[3] This column shows the difference between the highest and the lowest of the forecasts.

[4] IKC is the Foreign Trade Research Institute in Poland.

[5] GKI is the GKI Economic Research Company in Hungary.

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

Table 12.2

GDP growth in 1996 (in per cent) [1]

Eastern Europe and the Baltic states

	Average of forecasts [2]	OECD forecast (June 1995)	IMF forecast (May 1995)	Project Link forecast (April 1995)	European Union forecast (June 1995)	PlanEcon forecast (June 1995)	Economist Intelligence Unit forecast (Sept. 1995)	Vienna Institute forecast (June 1995)	JP Morgan forecast (Sept. 1995)	CS First Boston forecast (July 1995)
Albania	5.8	–	5.5	–	–	7.0	5.0	–	–	–
Bulgaria	3.0	2.0	–	3.0	2.1	5.0	3.0	2.5	3.5	–
Czech Republic	4.7	5.0	4.9	4.9	4.5	5.6	4.2	5	4.3	4.0
Estonia	5.5	–	5.3	–	–	7.3	4.0	–	–	–
Hungary	2.5	3.0	1.5	2.4	2.0	4.1	3.0	2	1.9	2.7
Latvia	4.6	–	5.0	–	–	5.8	3.0	–	–	–
Lithuania	4.5	–	4.0	–	–	6.0	3.5	–	–	–
Poland	5.0	5.0	5.0	4.9	5.0	6.5	4.7	5	4.7	4.0
Romania	3.7	4.5	–	3.6	2.0	5.3	4.0	3	–	–
Slovak Republic	4.2	5.0	4.0	4.6	4.0	5.3	5.1	3	4.0	2.8
Slovenia	5.3	–	5.0	–	–	7.0	4.5	5	4.8	–
Average	4.4	–	–	–	–	–	–	–	–	–
Commonwealth of Independent States										
Armenia	8.4	–	–	–	–	8.4	–	–	–	–
Azerbaijan	4.8	–	–	–	–	4.8	–	–	–	–
Belarus	-4.5	–	–	–	–	-3.0	-6.0	–	–	–
Georgia	9.3	–	–	–	–	9.3	–	–	–	–
Kazakstan	0.6	–	–	–	–	4.1	-3.0	–	–	–
Kyrgyzstan	7.8	–	–	–	–	7.8	–	–	–	–
Moldova	6.9	–	–	–	–	6.9	–	–	–	–
Russia	1.6	2.5	–	1.9	–	3.5	3.0	-3	1.0	2.0
Tajikistan	2.8	–	–	–	–	2.8	–	–	–	–
Turkmenistan	3.4	–	–	–	–	3.4	–	–	–	–
Ukraine	-2.9	–	–	–	–	-0.6	-2.0	-5	-4.0	–
Uzbekistan	-0.2	–	–	–	–	-0.2	–	–	–	–
Average	3.2	–	–	–	–	–	–	–	–	–

[1] All forecasts quoted here were published or reported to the EBRD between April and September 1995. The dates in parentheses indicate the month in which the forecasts were reported or published by each institution.

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

12.2 Inflation forecasts for 1995-96

All forecasters expect further advances over the next two years in efforts to control inflation in the countries of eastern Europe, the Baltics and the CIS (see Tables 12.3-12.5 and Box 12.1). Forecasters appear generally to share the optimism expressed in Chapter 11 regarding the determination and ability of governments and central banks in these countries to strengthen monetary and fiscal policy. Consistent with trends observed for the first half of the year (see Chapter 11), forecasters generally expect inflation to fall in 1995 (as compared with 1994) in all 25 countries except Hungary, and to fall from the new level in 1996 (including in Hungary). Average inflation (as defined in Box 12.1) is forecast for all east European and Baltic countries (except for Bulgaria) at levels below or close to 40 per cent in 1995 and at levels below 30 per cent in 1996. For most countries, a gradual decline can be observed in the path of projections moving from the "starting level" of average inflation in 1995, to a lower level of end-year inflation for the same year, and further to a still lower average inflation for 1996.

Inflation is generally expected to be much higher in the CIS than in eastern Europe and the Baltics. The EBRD expects the lowest average 1995 inflation rate within the CIS to materialise in Moldova (35 per cent) and Kyrgyzstan (45 per cent), and the highest in Turkmenistan (1,800 per cent). The EBRD's end-year 1995 forecasts for CIS countries range from 20 per cent for Moldova to 2,500 per cent for Turkmenistan.

12.3 The accuracy of forecasts

Estimated outturns

The measurement of forecasting accuracy depends crucially on the choice of proxy for the "outturn". Nobody knows the true value of the outturns. All estimates of GDP and of aggregate price levels are associated with statistical uncertainty (see Annex 11.1). The data that represent the outturns in the first column of Tables 12.6-12.10 were taken from the country tables in Annex 11.1. The original source of the figure that is quoted as the outturn for a

Table 12.3

Inflation forecasts for 1995 (change in the average consumer price level, in per cent)[1]

Eastern Europe and the Baltic states

	Average of forecasts	Range of forecasts[2]	EBRD forecast (Sept.)	OECD forecast (June)	IMF forecast (May)	Project Link forecast (April)	European Union forecast (June)	PlanEcon forecast (June)	Economist Intelligence Unit forecast (Sept.)	Vienna Institute forecast (June)	JP Morgan forecast (Sept.)	CS First Boston forecast (July)	IKC forecast (June)[3]	GKI forecast (Sept.)[4]	Kopint-Datorg forecast (June)[5]
Albania	13.8	16.0	7	–	11	–	–	23.0	14.0	–	–	–	–	–	–
Bulgaria	67.3	21.8	68	–	–	53.2	75.0	75.0	68.0	65	69.2	–	–	–	65.0
Croatia	1.9	4.0	0	–	–	–	–	–	4.0	3	–	–	–	–	0.5
Czech Republic	9.6	2.5	10	9	8	9.5	10.0	9.6	9.0	10	9.8	10.0	–	–	10.5
Estonia	25.8	2.0	25	–	26	–	–	25.0	27.0	–	–	–	–	–	–
FYR Macedonia	37.5	25.0	50	–	–	–	–	–	25.0	–	–	–	–	–	–
Hungary	27.8	4.5	29	27	28	–	25.0	27.3	28.0	29	28.3	26.0	–	28.5	29.0
Latvia	22.3	6.0	25	–	19	–	–	20.0	25.0	–	–	–	–	–	–
Lithuania	33.8	10.0	35	–	30	–	–	30.0	40.0	–	–	–	–	–	–
Poland	26.7	9.6	27	23	25	21.7	30.0	25.0	26.5	29	27.5	31.3	25.0	–	29.0
Romania	39.6	15.3	40	45	–	29.7	40.0	37.0	35.0	45	–	–	–	–	45.0
Slovak Republic	10.9	2.0	11	10	10	10.5	10.0	11.5	10.6	12	10.5	11.3	–	–	12.0
Slovenia	12.4	11.0	15	–	5	–	–	15.0	13.0	16	13.0	–	–	–	9.8
Commonwealth of Independent States															
Armenia	301.5	–	210	–	–	–	–	393.0	–	–	–	–	–	–	–
Azerbaijan	587.5	–	425	–	–	–	–	750.0	–	–	–	–	–	–	–
Belarus	1,086.7	660.0	700	–	–	–	–	1,360.0	1,200.0	–	–	–	–	–	–
Georgia	769.5	–	250	–	–	–	–	1,289.0	–	–	–	–	–	–	–
Kazakstan	246.7	210.0	180	–	–	–	–	390.0	170.0	–	–	–	–	–	–
Kyrgyzstan	47.5	–	45	–	–	–	–	50.0	–	–	–	–	–	–	–
Moldova	45.2	–	35	–	–	–	–	55.3	–	–	–	–	–	–	–
Russia	167.7	102.2	205	–	–	102.8	–	173.0	200.0	180	181	170	–	–	130
Tajikistan	190.0	–	120	–	–	–	–	260.0	–	–	–	–	–	–	–
Turkmenistan	1,800.0	–	1,800	–	–	–	–	1,800.0	–	–	–	–	–	–	–
Ukraine	355.2	281.2	350	–	–	–	–	421.2	380.0	400	440	–	–	–	140
Uzbekistan	382.5	–	325	–	–	–	–	440.0	–	–	–	–	–	–	–

[1] All forecasts in this table were published or reported to the EBRD between April and September 1995 (see also the references at the end of this chapter). There may, for a number of institutions, be a substantial lag between preparation and publication of forecasts. The dates in parentheses indicate in which month the forecasts were reported or published by each institution. The EBRD forecasts were prepared in August and published in October.

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

[3] IKC is the Foreign Trade Research Institute in Poland.

[4] GKI is the GKI Economic Research Company in Hungary.

[5] Kopint-Datorg is the Institute for Economic and Market Research and Informatics in Hungary.

Table 12.4

Inflation forecasts for 1995

(change in the end-year consumer price level, in per cent) [1]

Eastern Europe and the Baltic states

	Average of forecasts	EBRD forecast (September)	JP Morgan forecast (September)
Albania	5.0	5	–
Bulgaria	52.5	50	33.0
Croatia	3.0	3	–
Czech Republic	9.9	10	9.8
Estonia	22.0	22	–
FYR Macedonia	10.0	10	–
Hungary	29.3	28	30.5
Latvia	23.0	23	–
Lithuania	30.0	30	–
Poland	23.6	23	24.1
Romania	30.0	30	–
Slovak Republic	10.0	10	10
Slovenia	10.3	10	10.5
Commonwealth of Independent States			
Armenia	45.0	45	–
Azerbaijan	100.0	100	–
Belarus	260.0	260	–
Georgia	25.0	25	–
Kazakstan	60.0	60	–
Kyrgyzstan	25.0	25	–
Moldova	20.0	20	–
Russia	144.0	145	143
Tajikistan	240.0	240	–
Turkmenistan	2,500.0	2,500	–
Ukraine	215.0	150	280
Uzbekistan	155.0	155	–

[1] All forecasts in this table were published or reported to the EBRD between April and September 1995 (see also the references at the end of this chapter). There may, for a number of institutions, be a substantial lag between preparation and publication of forecasts. The dates in parentheses indicate in which month the forecasts were reported or published by each institution. The EBRD forecasts were prepared in August and published in October.

Box 12.1

End-year inflation and average inflation – what is the difference?

The "end-year inflation" rate represents the percentage difference between the price level in December of a particular year and the price level in December of the preceding year. The "average inflation" rate measures the percentage difference between the mean of monthly price levels in a particular year and the mean of monthly price levels in the preceding year. The gap between the end-year rate and the average rate can be great when inflation is high.

The "end-year inflation" rate arguably conveys more information about events in a particular year than does the "average inflation" rate. Consider, for example, a country in which prices remain constant throughout the course of year 2. It would probably appear reasonable to most observers to state that inflation was zero in that country in year 2. Consistent with this assessment, "end-year inflation" would be zero. But "average inflation" would not (unless prices had been constant throughout year 1 as well). Developments in Croatia provide a good illustration of this point. The Croatian consumer price index was 3 per cent lower in December 1994 than in December 1993. Therefore, Croatian end-year inflation for 1994 was -3 per cent. Derivation of the average inflation rate for Croatia for 1994 requires computation not only of the average of monthly consumer price indices for 1994 but also of the equivalent average for 1993. It turns out that the average for 1993 was much lower than the average for 1994 because prices rose 12-fold during the course of 1993 before remaining close to the new and higher level throughout 1994. In fact, the average price level in 1994 exceeded the average level in 1993 by 97.5 per cent. The latter figure is therefore quoted in the attached tables as Croatian "average inflation" for 1994.

The two inflation concepts are both useful. They can both, for example, be used to convert a nominal time series into a constant price level. If the aim is to prepare a constant price series for end-year balance sheets, then the "end-year inflation" concept should be used as the basis for deflation of the nominal series. If instead the objective is to convert a time series of nominal flows, such as wages, into constant prices, then data for "average inflation" provide the basis for deflation.

Before a year begins, end-year inflation for that year will be easier to predict than average inflation. This is because average inflation will be sensitive to the (yet unknown) monthly pattern of price increases, whereas end-year inflation will not. Later in the year, however, the balance shifts, because the average rate of inflation will be affected much less than the end-year rate by surprising jumps in monthly prices towards the end of the year.

particular country will in most cases be that country's central statistical office. There are, however, exceptions to this rule. Specifically for Estonia and Turkmenistan, the growth estimates come from the IMF *World Economic Outlook* (May 1995) and differ substantially from estimates quoted by the national statistical agencies. In the case of Estonia, for example, the IMF data point to growth in 1994 of 6 per cent whereas the local statistical agency puts growth for 1994 at -2.3 per cent, but a number of ministries and the central bank find the IMF estimate more realistic than that of the national statistical office.

Another difficulty is that estimates of outturns change over time. Government statisticians often continue to revise data several years after completion of the period to which the data pertain. This may reflect the emergence of new information, or it may be caused by methodological advances. It follows, for example, that the *measured* accuracy of a particular forecast for 1994 might change as late as 1998, as the estimate of the "outturn" continues to be revised.

The accuracy of growth forecasts

Table 12.6 shows "prediction errors" for 1994. All forecasts in the table were prepared or published by the listed forecasting institutions at some point between May and October of 1994. The table includes two columns per forecasting institution. The first of these contains forecasts made in the middle of 1994; the second presents the "errors". For each forecaster, the "error" is measured as the absolute value of the difference between the forecast for growth in 1994 and the estimated "outturn".

The average of all quoted errors on 1994-forecasts for east European and Baltic countries amounted to 1.9 percentage points, down markedly on the equivalent average error on 1993-forecasts (as quoted in the EBRD *Transition Report*, 1994) of 3.7 percentage points. The errors will inevitably tend to decline as the transition economies gradually overcome the initial systemic shocks and

Table 12.5

Inflation forecasts for 1996 (change in the average consumer price level, in per cent)[1]

Eastern Europe and the Baltic states

	Average of forecasts[2]	Range of forecasts[3]	OECD forecast (June)	IMF forecast (May)	Project Link forecast (April)	European Union forecast (June)	PlanEcon forecast (June)	Economist Intelligence Unit forecast (September)	Vienna Institute forecast (June)	JP Morgan forecast (September)	CS First Boston forecast (July)
Albania	12.3	9.0	–	9	–	–	18.0	10.0	–	–	–
Bulgaria	41.4	30.0	–	–	38.5	40.0	60.0	40.0	40	30	–
Czech Republic	8.7	5.0	8	7	8.0	12.0	9.1	7.0	7	9.5	11.0
Estonia	18.7	6.0	–	21	–	–	20.0	15.0	–	–	–
Hungary	20.3	10.5	16	17	–	18.0	20.5	20.0	22	26.5	22.0
Latvia	15.3	9.0	–	11	–	–	15.0	20.0	–	–	–
Lithuania	27.0	5.0	–	26	–	–	25.0	30.0	–	–	–
Poland	20.0	13.0	18	12	16.7	25.0	20.0	20.0	20	23.0	25.0
Romania	29.3	10.0	35	–	30.8	25.0	30.0	25.0	30	–	–
Slovak Republic	9.4	6.0	8	6	9.0	12.0	10.7	10.0	10	9.5	9.0
Slovenia	8.3	8.0	–	3	–		11.0	8.5	10	9.0	–
Average	19.1	10.1									
Commonwealth of Independent States											
Armenia	108.0	–	–	–	–	–	108.0	–	–	–	–
Azerbaijan	410.0	–	–	–	–	–	410.0	–	–	–	–
Belarus	650.0	300.0	–	–	–	–	500.0	800.0	–	–	–
Georgia	411.0	–	–	–	–	–	411.0	–	–	–	–
Kazakstan	82.0	24.0	–	–	–	–	94.0	70.0	–	–	–
Kyrgyzstan	50.0	–	–	–	–	–	50.0	–	–	–	–
Moldova	54.3	–	–	–	–	–	54.3	–	–	–	–
Russia	80.0	40.0	–	–	66.7	–	75.0	80.0	100	98	60.0
Tajikistan	365.0	–	–	–	–	–	365.0	–	–	–	–
Turkmenistan	600.0	–	–	–	–	–	600.0	–	–	–	–
Ukraine	153.3	130.0	–	–	–	–	130.0	100.0	–	230	–
Uzbekistan	330.0	–	–	–	–	–	330.0	–	–	–	–
Average	274.5	123.5									

[1] All forecasts in this table were published or reported to the EBRD between April and September 1995. There may, for a number of institutions, be a substantial lag between preparation and publication of forecasts. The dates in parentheses indicate in which month the forecasts were reported or published by each institution.

[2] The number at the bottom of this column refers to the mean of the average forecasts shown in the column.

[3] This column shows the difference between the highest and the lowest of the forecasts.

enter a period of relative stability. Over the past two years, a large proportion of east European countries appear to have entered a period of stable growth. As a result, the range of realistically feasible growth rates has narrowed. This is likely to be the key source of the observed drop in the average forecasting error.

The average error on 1994-forecasts exceeded 1.9 percentage points in only three of the countries in eastern Europe and the Baltics, namely Latvia, Romania and the Slovak Republic. Growth forecasts were excessively optimistic for Latvia and overly pessimistic for Romania and the Slovak Republic.

For the CIS countries, the average error on all 1994-forecasts was a spectacular 10.2 percentage points. This compares with a more moderate average error of 5.5 percentage points on 1993-forecasts (as quoted in last year's *Transition Report*). Great uncertainty pertains for these countries to both "outturns" and prospects for growth (see Box 12.2).

Comparing the accuracy of growth forecasts from different institutions

Table 12.7 juxtaposes errors on the GDP growth forecasts from different institutions. Two comparisons are being made in the table. One is based on the full set of forecasting institutions quoted in Table 12.6. This comparison involves forecasts only for Bulgaria, Hungary and Poland (denoted as EE3) because these are the only countries for which all the forecasting institutions provided data. On this basis, the EBRD's forecasts come out on top.

Focusing on Russia and the six largest east European countries, Table 12.7 also compares the accuracy for forecasts from those institutions that provide data on all of these countries. On this comparison, the forecasts from PlanEcon were the most accurate. An equivalent assessment could not meaningfully be made in last year's *Transition Report* on the basis of 1993-forecasts as very few institutions were, at that time, covering all of the countries that underlie the assessment.

The accuracy of inflation forecasts

Tables 12.8 and 12.9 gauge the accuracy of inflation forecasts for 1994 from a number of institutions. All forecasts in the table were prepared or published by the listed forecasting institutions at some point between May and October 1994. A general pattern in both tables is that errors grow with the level of inflation. "Average inflation" of less than 50 per cent was recorded in 1994 in eight of the 25 countries listed in Table 12.8 (see Box 12.1 for a discussion of the concepts of "average inflation" and "end-year inflation"). For six of these eight countries, the average prediction error across all forecasting institutions was less than 2 percentage points. For the two remaining countries among these eight, Poland (where inflation exceeded expectations) and Albania (whose inflation was reduced more rapidly than the forecasts would have implied), the error was less than 4 percentage points. Much higher error levels of about 20-25 percentage points were recorded for Bulgaria and Romania, the two countries with the highest inflation in eastern Europe in 1994. Errors on forecasts for the high-inflation countries in the CIS were typically in the order of several hundred percentage points. In consistency with this pattern, the level of forecasting errors for inflation dropped substantially from 1993 to 1994, in tandem with the decline in the level of inflation in large parts of the region (detailed data on the accuracy of forecasts for 1993 were published in the *Transition Report*, 1994, p. 176).

Comparing the accuracy of inflation forecasts from different institutions

Table 12.10 shows the institution-specific average errors on inflation forecasts for the group of countries covered by all institutions providing 1994 forecasts for average inflation. This group of countries includes Bulgaria, the Czech Republic, Hungary, Poland and Romania. On this measure, forecasts for average inflation from PlanEcon and the Economist Intelligence Unit were the most accurate in 1994 (after having been outperformed by those of the Vienna Institute in 1993).

A comparison of inflation accuracy based on simple averages of errors tends to be dominated by developments in high-inflation countries. In the case of the comparison just made, the average errors are dominated by the influence of observations for Bulgaria and Romania. Table 12.10, therefore, also presents a cross-institution comparison based on a data set that excludes observations for these two countries (leaving only observations for the Czech Republic, Hungary and Poland). On this basis, the best averages (that is, the lowest errors) pertained to forecasts from the OECD, the IMF and the Economist Intelligence Unit.

12.4 Concluding remarks

The sampled forecasting institutions expect growth rates for most countries in eastern Europe and the Baltics of 3-6 per cent in both 1995 and 1996. This contrasts sharply with forecasts for the larger CIS countries, for which a further substantial output drop is expected for 1995, followed in 1996 by modest growth (in the case of Russia) or further decline (in the case of Ukraine). However, some of the smaller CIS countries are expected to register positive growth in 1995.

Forecasters generally expect further gradual progress towards price stability in all countries in the region. Inflation for 1996 is widely expected to be below 30 per cent in almost all countries of eastern Europe and the Baltics. Much lower rates are expected for a handful of countries in this group.

Among the forecasters quoted in this chapter, only PlanEcon provides medium-term forecasts for inflation in all of the CIS countries. For 1996, PlanEcon expects inflation (measured as the average price increase) of less than 100 per cent in only three CIS countries: Kazakstan, Kyrgyzstan and Moldova. This would appear somewhat pessimistic given the progress already made with respect to inflation in several other CIS countries (see Chapter 11). Eight of the surveyed forecasting institutions provide predictions for Russian inflation in 1996, ranging from 60 per cent (OECD) at the lower extreme to 173 per cent at the upper extreme (PlanEcon).

Table 12.6

GDP growth in 1994 (in per cent)[1]

Eastern Europe and the Baltic states

	Actual[2]	Average absolute value of error[3,4]	Range of forecasts[5]	EBRD forecast (Sept.)	EBRD error[3]	OECD forecast (July)	OECD error[3]	IMF forecast (October)	IMF error[3]	Project Link forecast (April)	Project Link error[3]	European Union forecast (June)	European Union error[3]	PlanEcon forecast (June/Aug.)	PlanEcon error[3]	Economist Intelligence Unit forecast (June)[1]	Economist Intelligence Unit error[3]	Vienna Institute forecast (June)	Vienna Institute error[3]	JP Morgan forecast (July)	JP Morgan error[3]
Albania	7.4	1.2	3.6	8	-0.6	–	–	8.0	-0.6	–	–	–	–	9.6	-2.2	6.0	1.4	–	–	–	–
Bulgaria	1.4	1.9	3.4	0	1.4	0	1.4	-2.0	3.4	-0.4	1.8	0.5	0.9	1.4	0.0	0.0	1.4	-2	3.4	-1.9	3.3
Croatia	0.8	1.8	5.0	2	-1.2	–	–	1.8	-1.0	–	–	–	–	–	–	2.0	-1.2	-3	3.8	–	–
Czech Republic	2.6	0.7	3.3	3	-0.4	2	0.6	1.5	1.1	–	–	2.5	0.1	4.8	-2.2	3.0	-0.4	2	0.6	2.4	0.2
Estonia	6	1.0	3.0	5	1.0	–	–	6.0	0.0	–	–	–	–	5.9	0.1	3.0	3.0	–	–	–	–
FYR Macedonia	-7.2	3.7	6.7	-8	0.8	–	–	-14.7	7.5	–	–	–	–	–	–	-10.0	2.8	–	–	–	–
Hungary	2	1.2	5.5	1	1.0	1	1.0	1.0	1.0	0.0	2.0	2.0	0.0	5.5	-3.5	1.0	1.0	2	0.0	0.4	1.6
Latvia	2	3.3	10.0	5	-3.0	–	–	4.1	-2.1	–	–	–	–	3.0	-1.0	-5.0	7.0	–	–	–	–
Lithuania	1.7	1.3	3.0	4	-2.3	–	–	4.7	-3.0	–	–	–	–	1.7	0.0	2.0	-0.3	–	–	–	–
Poland	5.0	0.9	3.5	5	0.0	4	1.0	4.5	0.5	4.2	0.8	2.5	2.5	6.0	-1.0	4.0	1.0	4	1.0	4.5	0.5
Romania	3.4	2.8	5.8	0	3.4	0	3.4	0	3.4	1.2	2.2	1.4	2.0	3.8	-0.4	1.0	2.4	-2	5.4	–	–
Slovak Republic	4.8	4.3	7.0	1	3.8	0	4.8	0	4.8	–	–	-3.1	7.9	3.9	0.9	-0.5	5.3	2	2.8	–	–
Slovenia	5.5	1.4	2.3	4	1.5	–	–	4.0	1.5	–	–	–	–	5.3	0.2	4.0	1.5	3	2.5	–	–
Average absolute value of the error, 1994	–	1.9	4.8	–	1.5	–	2.0	–	2.3	–	1.7	–	2.2	–	1.1	–	2.2	–	2.5	–	1.4
Average absolute value of the error, 1993[4]	–	3.7	–	–	–	–	2.9	–	–	–	3.7	–	3.2	–	4.0	–	–	–	4.7	–	1.5
Commonwealth of Independent States																					
Armenia	5.4	4.4	8.8	–	–	–	–	3.0	2.4	–	–	–	–	11.8	-6.4	–	–	–	–	–	–
Azerbaijan	-21.9	13.5	10.7	-15	-6.9	–	–	-6.0	-15.9	–	–	–	–	-4.3	-17.6	–	–	–	–	–	–
Belarus	-21.5	4.0	12.9	-30	8.5	–	–	-17.1	-4.4	–	–	–	–	-19.0	-2.5	-22.0	0.5	–	–	–	–
Georgia	-35	23.4	3.2	–	–	–	–	-10.0	-25.0	–	–	–	–	-13.2	-21.8	–	–	–	–	–	–
Kazakstan	-25	15.4	5.5	-11	-14.0	–	–	-6.0	-19.0	–	–	–	–	-11.5	-13.5	-10.0	-15.0	–	–	–	–
Kyrgyzstan	-27	19.5	4.5	-10	-17.0	–	–	-5.5	-21.5	–	–	–	–	-6.9	-20.1	–	–	–	–	–	–
Moldova	-22	19.2	0.9	-3	-19.0	–	–	-2.2	-19.8	–	–	–	–	-3.1	-18.9	–	–	–	–	–	–
Russia	-15	3.7	4.0	-12	-3.0	-10	-5.0	-12.0	-3.0	–	–	–	–	-11.2	-3.8	-10.0	-5.0	-10	-5.0	-14	-1.0
Tajikistan	-21.4	9.9	6.9	–	–	–	–	-15.0	-6.4	–	–	–	–	-8.1	-13.3	–	–	–	–	–	–
Turkmenistan	-20	15.1	13.2	–	–	–	–	1.7	-21.7	–	–	–	–	-11.5	-8.5	–	–	–	–	–	–
Ukraine	-23	4.7	15.0	-20	-3.0	–	–	-25.0	2.0	–	–	–	–	-20.3	-2.7	-10.0	-13.0	-20	-3.0	–	–
Uzbekistan	-2.6	5.8	3.0	-8	5.4	–	–	-10.1	7.5	–	–	–	–	-7.1	4.5	–	–	–	–	–	–
Average absolute value of the error, 1994	–	10.2	7.4	–	9.6	–	5.0	–	12.4	–	–	–	–	–	11.1	–	8.4	–	4.0	–	1.0
Average absolute value of the error, 1993[4]	–	5.5	–	–	–	–	–	–	–	–	–	–	–	–	6.5	–	–	–	2.4	–	–

1 All forecasts in this table were published or reported to the EBRD in June/July/August 1994 except for the IMF forecast which was taken from the October 1994 *World Economic Outlook*. There may, for a number of institutions, be a substantial lag between preparation and publication of forecasts. The dates in parentheses indicate in which month the forecasts were reported or published by each institution. The EBRD forecasts were prepared in August and published in October.

2 "Actuals" represent the most recent official estimate of outturns for 1994, as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance.

3 What is referred to as "errors" denotes the difference between actuals and forecasts (measured in percentage points).

4 The number at the bottom of this column is calculated as the mean of all the absolute values of the errors shown in this table (i.e. it is not a simple average of the errors in this column). The number for 1993 (taken from the EBRD *Transition Report* 1994) was based on fewer observations than the number for 1994.

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

Table 12.7

Comparison of growth forecasts for 1994 from different institutions[1]

	EBRD error	OECD error	IMF error	Project Link error	European Union error	PlanEcon error	Economist Intelligence Unit error	Vienna Institute error	JP Morgan error
Bulgaria	1.4	1.4	3.4	1.8	0.9	0.0	1.4	3.4	3.3
Czech Republic	-0.4	0.6	1.1	–	0.1	-2.2	-0.4	0.6	0.2
Hungary	1.0	1.0	1.0	2.0	0.0	-3.5	1.0	0.0	1.6
Poland	0.0	1.0	0.5	0.8	2.5	-1.0	1.0	1.0	0.5
Romania	3.4	3.4	3.4	2.2	2.0	-0.4	2.4	5.4	–
Slovak Republic	3.8	4.8	4.8	–	7.9	0.9	5.3	2.8	–
Russia	-3.0	-5.0	-3.0	–	–	-3.8	-5.0	-5.0	-1.0
Average of the absolute error EE3	0.8	1.1	1.6	1.5	1.1	1.5	1.1	1.5	1.8
Average of the absolute error EE6 and Russia	1.9	2.5	2.5	–	–	1.7	2.4	2.6	–

[1] The EE3 group of countries includes Bulgaria, Hungary and Poland. EE6 includes all the EE3 countries plus the Czech Republic, Romania and the Slovak Republic. What is referred to as "errors" denotes the difference between actuals and forecasts (measured in percentage points).

Corresponding to the regional gaps in inflation and growth forecasts, there is a great disparity in accuracy between forecasts for eastern Europe and the Baltics on the one side and the CIS on the other. This is evidenced by data that analyse the proximity to "actuals" of "old" forecasts for 1993 and 1994. Each of the forecasts under analysis was prepared 3-6 months into the year to which the forecasts applied. The average error on forecasts for growth in countries of eastern Europe and the Baltics dropped to 1.9 percentage points in 1994, from 3.7 percentage points in 1993. The corresponding average error for predictions of growth in the CIS countries rose to more than 10 percentage points in 1994 from less than 6 percentage points in 1993. An equivalent disparity between the two regions pertained to the level of errors on forecasts for inflation; these were typically far smaller for countries in eastern Europe and the Baltics than for countries in the CIS. A glance at the evolution in errors between 1993 and 1994 indicates a substantial improvement over time on a broad regional front in the accuracy of inflation forecasts. This is likely to reflect a strengthening of monetary policy management and an attendant improvement in the ability of governments to deliver on their inflation objectives in most countries of the region.

Box 12.2

Forecasting the turnaround in an economy with declining output

Consider the challenge facing a forecaster who has seen output in a particular country, say Georgia, drop by 10 per cent in 1994. Let us assume that the end-1994 output index is 100. Suppose the forecaster is convinced that output in Georgia will at some point abruptly turn around and begin to rise at an annualised rate of 10 per cent.

Suppose further that the forecaster assumes this will happen on 1 January 1996. His or her assumptions would be consistent (ignoring any seasonality in growth) with the output index falling from about 100 at the beginning of 1995 to about 90 at the end of 1995 before rising to about 99 at the end of 1996. The average output level in 1996 would deviate less than 1 per cent from that in 1995. The forecaster will therefore expect 1996 growth to be somewhere between zero and -1 per cent.

Suppose that in practice the turnaround is "one year late", in the sense that output continues to drop throughout 1996 at an annualised pace of 10 per cent before beginning to grow at an equivalent annualised pace on 1 January 1997. In this case the forecaster winds up with an error on his or her growth prediction for 1996 of 10 percentage points, after delivering a prediction that was accurate in terms of the order of magnitude of growth. The error arises solely on account of the forecaster's misjudgement of the timing of the turnaround. This illustrates the particular difficulty that is associated with forecasting of growth in countries that remain in deep recession but are expected to emerge with potentially quite high positive growth rates at some unknown point in the future.

Table 12.8

Inflation in 1994 (change in the average consumer price level, in per cent)[1]

Eastern Europe and the Baltic states

	Actual[2]	Average absolute value of the error[3]	OECD forecast (June)	OECD error[3]	IMF forecast (October)	IMF error[3]	Project Link forecast (April)	Project Link error[3]	European Union forecast (June)	European Union error[3]	PlanEcon forecast (June)	PlanEcon error[3]	Economist Intelligence Unit forecast (June)	Economist Intelligence Unit error[3]	Vienna Institute forecast (June)	Vienna Institute error[3]
Albania	22.6	3.7	–	–	27	-4.4	–	–	–	–	28	-5.4	24.0	-1.4	–	–
Bulgaria	96.3	20.3	75	21.3	81	15.3	52	44.3	65.0	31.3	89	7.3	90.0	6.3	80	16.3
Croatia	97.5	0.5	–	–	98	-0.5	–	–	–	–	–	–	–	–	–	–
Czech Republic	10.0	0.7	11	-1.0	9	1.0	9	1.0	10.0	0.0	9	1.0	11.0	-1.0	10	0.0
Estonia	48	1.7	–	–	47	1.0	–	–	–	–	46	2.0	50.0	-2.0	–	–
FYR Macedonia	122	57.0	–	–	65	57.0	–	–	–	–	–	–	–	–	–	–
Hungary	18.8	1.2	19	-0.2	19	-0.2	20	-1.2	18.0	0.8	16	2.8	19.0	-0.2	22	-3.2
Latvia	35.7	1.8	–	–	36	-0.3	–	–	–	–	35	0.7	40.0	-4.3	–	–
Lithuania	72	4.3	–	–	69	3.0	–	–	–	–	70	2.0	80.0	-8.0	–	–
Poland	32.2	3.8	30	2.2	30	2.2	24	8.2	27.0	5.2	28	4.2	30.0	2.2	30	2.2
Romania	131.0	24.4	170	-39.0	156	-25.0	120	11.0	150.0	-19.0	140	-9.0	150.0	-19.0	180	-49.0
Slovak Republic	13.4	1.9	16	-2.6	14	-0.6	–	–	17.0	-3.6	14	-0.6	15.0	-1.6	16	-2.6
Slovenia	19.8	0.9	–	–	18	1.8	–	–	–	–	19	0.8	19.0	0.8	20	-0.2
Commonwealth of Independent States																
Armenia	5,273	185.0	–	–	5,458	-185.0	–	–	–	–	–	–	–	–	–	–
Azerbaijan	1,664	383.0	–	–	1,281	383.0	–	–	–	–	–	–	–	–	–	–
Belarus	2,220	439.5	–	–	1,621	599.0	–	–	–	–	–	–	2,500.0	-280.0	–	–
Georgia	7,400	2,600.0	–	–	10,000	-2,600.0	–	–	–	–	–	–	–	–	–	–
Kazakstan	1,880	540.0	–	–	1,680	200.0	–	–	–	–	–	–	1,000.0	880.0	–	–
Kyrgyzstan	280	20.6	–	–	299	-20.6	–	–	–	–	–	–	–	–	–	–
Moldova	327	82.0	–	–	245	82.0	–	–	–	–	–	–	–	–	–	–
Russia	302	58.0	450	-148.0	336	-34.0	–	–	–	–	310	-8.0	400.0	-98.0	300	2.0
Tajikistan	341.4	1,158.6	–	–	1,500	-1,158.6	–	–	–	–	–	–	–	–	–	–
Turkmenistan	2,400	792.0	–	–	1,608	792.0	–	–	–	–	–	–	–	–	–	–
Ukraine	891.2	371.8	–	–	1,000	-108.8	–	–	–	–	813	78.2	2,000.0	-1,108.8	700	191.2
Uzbekistan	746	603.0	–	–	1,349	-603.0	–	–	–	–	–	–	–	–	–	–

1 All forecasts in this table were published or reported to EBRD in June/July/August 1994 except for the IMF forecasts which are taken from the October 1994 *World Economic Outlook*. There may, for a number of institutions, be a substantial lag between preparation and publication of forecasts. The dates in parentheses indicate in which month the forecasts were reported or published by each institution. The EBRD forecasts were prepared in August and published in October.

2 "Actuals" represent the most recent official estimate of outturns for 1994, as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance.

3 What is referred to as "errors" denotes the difference between actuals and forecasts (measured in percentage points).

Table 12.9

Inflation in 1994 (change in the end-year consumer price level, in per cent)[1]

Eastern Europe and the Baltic states

	Actual[2]	Average absolute value of the error[3]	EBRD forecast (September)	EBRD error[3] (June)	JP Morgan forecast	JP Morgan error[3]
Albania	15.8	3.0	19	-3.2	–	–
Bulgaria	121.9	47.0	70	51.9	80	41.9
Croatia	-3.0	3.0	0	-3.0	–	–
Czech Republic	10.2	0.1	10	0.2	10	0.0
Estonia	42	0.0	42	0.0	–	–
FYR Macedonia	55	15.0	70	-15.0	–	–
Hungary	21.2	1.5	20	1.2	23	-1.8
Latvia	26.0	1.0	25	1.0	–	–
Lithuania	45	5.0	40	5.0	–	–
Poland	29.5	3.1	27	2.5	27	2.7
Romania	61.7	28.0	90	-28.3	–	–
Slovak Republic	11.7	1.0	13	-1.3	–	–
Slovenia	18.3	2.0	16	2.3	–	–
Commonwealth of Independent States						
Armenia	1,885	–	–	–	–	–
Azerbaijan	1,788	212.0	2000	-212.0	–	–
Belarus	1,875	–	–	–	–	–
Georgia	7,380	–	–	–	–	–
Kazakstan	1,160	260.0	900	260.0	–	–
Kyrgyzstan	87	3.0	90	-3.0	–	–
Moldova	98	22.0	120	-22.0	–	–
Russia	203	88.0	180	23.0	356	-153.0
Tajikistan	5	–	–	–	–	–
Turkmenistan	1,100	–	–	–	–	–
Ukraine	401	51.0	350	51.0	–	–
Uzbekistan	423	177.0	600	-177.0	–	–

1 All forecasts in this table were published or reported to EBRD in June/July/August 1994. The dates in parentheses indicate in which month the forecasts were made by each institution. There may, for a number of institutions, be a substantial lag between preparation and publication of forecasts. The EBRD forecasts were prepared in August and published in October.

2 "Actuals" represent the most recent official estimate of outturns for 1994, as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance.

3 What is referred to as "errors" denotes the difference between actuals and forecasts (measured in percentage points).

Table 12.10

Comparison of inflation forecasts for 1994 from different institutions (change in the average consumer price level, in per cent)[1]

	Actual	OECD error	IMF error	Project Link error	European Union error	PlanEcon error	Economist Intelligence Unit error	Vienna Institute error
Bulgaria	96.3	21.3	15.3	44.3	31.3	7.3	6.3	16.3
Czech Republic	10.0	-1.0	1.0	1.0	0.0	1.0	-1.0	0.0
Hungary	18.8	-0.2	-0.2	-1.2	0.8	2.8	-0.2	-3.2
Poland	32.2	2.2	2.2	8.2	5.2	4.2	2.2	2.2
Romania	131.0	-39.0	-25.0	11.0	-19.0	-9.0	-19.0	-49.0
Average of the absolute error (EE5)[1]	–	12.7	8.7	13.1	11.3	4.9	5.7	14.1
Average of the absolute error (EE3)[1]	–	1.1	1.1	3.5	2.0	2.7	1.1	1.8

1 The EE5 group of countries includes Bulgaria, the Czech Republic, Hungary, Poland and Romania. The EE3 countries are all of these, excluding Bulgaria and Romania. What is referred to as "errors" denotes the difference between actuals and forecasts (measured in percentage points).

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Note that in addition to the references listed below we have relied on extensive communication by fax with some of the forecasting institutions quoted in this chapter.

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