Transition report 1996

Infrastructure and savings

Economic transition in eastern Europe and the former Soviet Union

Progress in transition

Infrastructure for transition

Promoting savings

Macroeconomic performance

European Bank
for Reconstruction and Development

Guide to readers

Country groupings

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)
CPI	consumer price index
CSFR	Czech and Slovak Federal Republic
ECE	Economic Commission for Europe
ECMT	European Conference of Ministers of Transport
ECU	European Currency Unit
EFTA	European Free Trade Area
EIU	Economist Intelligence Unit
EU	European Union
FDI	foreign direct investment
FYR	Former Yugoslav Republic
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
IFC	International Finance Corporation
IFI	international financial institution
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
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
OECD	Organisation for Economic Cooperation and Development
Phare	Poland and Hungary: Aid for Economic Restructuring (EU)
PPP	purchasing power parity
SMEs	small and medium-sized enterprises
UN	United Nations
VAT	value added tax
WTO	World Trade Organisation

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Infrastructure and savings

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Foreword

The purpose of this Report, the third in an annual series, is to chart the progress of transition from the command to the market economy and to identify and analyse the challenges of the coming years in the countries of eastern Europe, the Baltics and the CIS. The special focus of this year's Report is the change, during the period of market-oriented transition, in the role and character of physical infrastructure and of household and enterprise savings.

It is the EBRD's task to help promote the transition in all 26[1] of its countries of operations. The EBRD does this as a participant investor with a private sector focus. It works with its partners on projects that are financially sound, move the transition forward, and would be unlikely to emerge or function well without its intervention. In this sense, it works as an investor on the frontiers of the transition process. It is therefore of great importance for the EBRD to study the process and how it moves forward, to share its analysis with its partners, and to adapt its activities to the circumstances and stage of transition in each country. Thus the series of *Transition Reports* has an investment perspective. While the Report is about the region (rather than the EBRD), it draws extensively on the EBRD's unique experience as an investor in all its countries of operations.

The process of market-oriented transition has yielded markedly different experiences in different countries. Together with the diverse initial economic and political conditions in the various countries, these experiences have shown clearly that any generalising across countries or country groups requires caution. While some generalisations are essential to any conceptual analysis, it remains crucial for investors, policy-makers and researchers to look closely at the problems and experiences of each country individually. The EBRD is in a special position, with its direct experience as an investor throughout the region, to contribute to this country-level analysis and to the comparative analysis of country experience.

The transition has now been in progress for between three and seven years in most countries of the region. The comparative analysis of this experience, which is at the heart of the Report, now covers a long enough period and sufficiently many countries to provide real insights both into the process of change itself and into the challenges that have arisen, and are arising, at different stages of transition. We are no longer, as analysts, facing the beginning of an unprecedented process. The process may be unprecedented, but it is now a long way from its beginning.

The past 12 months have seen continued progress in the transition in most countries in the region. Building a new system, with its methods of working, skills, institutions and governance, is a lengthy and difficult process. It involves disruptions and disagreements, and competition between different interest groups. The workings of the associated political processes cannot always be expected to result in smooth and unhesitating advance towards the market economy. From a historical perspective, it is likely that the pace of progress will be seen as remarkably rapid in much of the region. However, the legacies of the many decades of the command economy cannot be overcome in only a few years and there are major tasks to be accomplished in taking reform forward, even in those countries of the region that have advanced the most in transition.

1 Bosnia and Herzegovina became the 26th country of operations in June 1996.

Many essential tasks in the transition, such as price and trade liberalisation and the privatisation of small-scale enterprises, which could (and should) be carried out quickly, are close to completion in many (but not all) countries. However, some of the more difficult tasks at the heart of the transition, such as enterprise restructuring, the rehabilitation and rebuilding of infrastructure, and the building of strong financial and legal institutions, have a long way to go.

The special topics of this year's Report are the building of a market approach and new institutions for infrastructure and savings. The infrastructure of central planning was oriented to the peculiar production patterns and priorities of that system and paid little attention to economic costs, environmental conditions, or to the demands and preferences of producers and consumers. Put simply, it was uneconomic and uncommercial. Accordingly, its commercialisation and restructuring are central to the transition. Financial intermediation also played only a limited role under the old regime. The need for financial intermediation has grown sharply during the period of market-oriented transition, as enterprise savings have become a less important source of investment finance. The creation of new savings instruments and institutions, as well as the strengthening of linkages between savings institutions and providers of investment finance, are, therefore, central parts of the transition.

As in previous years, we have made an effort to combine cross-country studies with detailed analysis of the reform process country by country. We have opted this year to concentrate the country-specific descriptions of the reform process at the end of the Report to add to the user-friendliness of the publication.

The assessments and views expressed in this *Transition Report* are not necessarily those of the EBRD. The responsibility for them is taken by myself on behalf of the Office of the Chief Economist. While we have attempted to be as up to date as possible, the "cut-off" for revisions to most of the draft chapters was early August 1996.

Nicholas Stern

Chief Economist
2 October 1996

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The Report was prepared mainly by the staff of the EBRD's Office of the Chief Economist, with important contributions from the Banking Department and the Office of the General Counsel. The editorial team consisted of Kasper Bartholdy, Steven Fries and Nicholas Stern. The principal authors of the chapters are shown below.

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The collection of material on legal reform in Chapter 2 (including Box 2.1 and the sections on law in the indicators at the back of the Report) was coordinated by Wayne McArdle, with the contribution of other lawyers of the EBRD's Office of the General Counsel. Timothy Murphy prepared Box 2.4 on issues associated with the measurement of environmental developments. Luisa Affuso, Roger Stiegert and Maria Vagliasindi contributed to the work on infrastructure; Peter Falush to that on contractual savings instruments; and Rika Ishii to that on macroeconomic performance.

Overall responsibility for the tables and indicators at the back of the Report rested with the EBRD's country economists. Tables were prepared on Albania and Slovenia by Francesca Pissarides; Armenia, Azerbaijan and Georgia by Thierry Malleret; Belarus by Jose Carbajo and Egbert Jöhrens; Bosnia Herzegovina and Bulgaria by Hans Peter Lankes; Croatia and FYR Macedonia by Andrew Tyrie; the Czech Republic, the Slovak Republic and Ukraine by Julian Exeter; Hungary and Turkmenistan by Kasper Bartholdy; Kazakstan, Romania and Uzbekistan by Kyunghwan Choi and Cristof Rühl; Kyrgyzstan by Vanessa Glasmacher; Estonia and Latvia by Tanya Normak; Lithuania by Rika Ishii; Moldova by Carlo Sdralevich; Poland by Steven Fries; and Russia by Ivan Szegvari.

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Part I
Progress in transition

Progress and challenges in transition: key themes of the Report

1

1.1 Introduction

The process of transition towards a market economy got under way in central and eastern Europe between 1988 and 1991 and in the Baltic states and the CIS from 1992.[1] The experience is now sufficiently extensive and varied across countries to allow a comparative analysis which provides both lessons about the process itself and about the challenges in the years ahead. Indeed, one of the most important lessons is that there can be, and have been, different paths to a market economy, just as there are many forms of the market economy itself. At the same time there are important common features of well-functioning market economies and of effective transitions. The purposes of this and previous *Transition Reports* are, first, to describe and analyse the transition process, second, to draw broad policy lessons from that analysis and, third, to provide a more detailed analysis of selected issues which are central to the transition.

Part I provides, as in previous years, a review of recent progress in market-oriented transition throughout eastern Europe, the Baltics and the CIS. While great strides have been made in most countries in the region, the challenges that remain are persistent and difficult. In particular, restructuring and institution building are, on many important dimensions, in their early stages throughout the region. In Part II the Report turns its attention to the commercialisation of infrastructure. Commercialisation refers to the organisation of firms on commercial principles, with independent and responsible management paying close attention to revenues, costs and market demands. Part III, in its description of the evolution of savings during the process of transition, demonstrates the extent to which households have replaced enterprises as the main source of domestic savings in much of eastern Europe, the Baltics and the CIS. Part III also provides a detailed discussion of new contractual savings instruments. The Report concludes in Part IV with an overview of macroeconomic developments and a discussion of prospects for growth and inflation in the years ahead, emphasising the very different experiences of the countries in the region.

As in the Reports of previous years, the focus of this Report is on the economic transition, i.e. the process which leads to the establishment of a market economy. This process has implications for, and is intertwined with, profound political and social changes. While these changes are not the primary focus of the analysis provided here, they are emphasised in many of the discussions contained in the Report, including this chapter.

Transition and development are different concepts. The latter concerns the advancement of the standard of living, including education, health, command over resources, and economic and political rights. Transition and development are, however, very closely inter-related. Central to the commitment to transition is the commitment to the advancement of development, which should be the consequence of transition. However, there are costs and potential victims in the transition and it is important that policy is designed to alleviate the social strains and difficulties which will inevitably occur. The 1995 Report focused in this context on mortality and life-expectancy in the transition and this year's Report provides (in Annex 2.1) a brief discussion of the distribution of income and wealth. This year's Report also introduces into the discussion of the measurement of transition the very important issue of progress in overcoming the environmental legacy of the old regime (see Section 1.5).

1.2 Transition: progress, problems and tasks ahead

Part II evaluates progress made over the past year in market-oriented transition across eastern Europe, the Baltics and the CIS. It is immediately clear that it is difficult to make generalisations which are valid for the entire region. A distinction is made, therefore, between countries at advanced stages, countries at intermediate stages, and countries at early stages of transition. Since the European Bank for Reconstruction and Development (EBRD) first introduced country-by-country indicators of progress in market-oriented reform (in the *Transition Report* 1994), a number of countries have passed from early to intermediate and from intermediate to advanced stages of transition. However, these groupings are used in the *Transition Reports* mainly to assist the discussion of economic experiences and should not be used with rigidity for other purposes. It is important to keep in mind the many dimensions of transition and the different experiences of individual countries within each grouping.

Most countries in the region have carried out comprehensive liberalisation of prices, foreign trade and currency arrangements. Most small-scale enterprises in the region have been privatised, but progress with large-scale privatisation, enterprise restructuring, financial sector reform, and other areas of structural change varies considerably between countries. Overall, the pace of structural change is now slower than it was in the first half of the 1990s.

[1] The economic transition from the command to the market economy began in earnest in the late 1980s with the three-year programme of market reforms in Hungary, the Balcerowicz reforms in Poland and the Markovic reforms in Yugoslavia. The end of the Soviet bloc as an integrated economic unit was marked by the historic meeting of the Council for Mutual Economic Assistance (CMEA or Comecon) in Sofia in January 1990 and its decision that trade should be conducted in hard currency and be based on world market prices from 1991. The Soviet Union itself collapsed as an entity following the unsuccessful coup attempt of August 1991 (by the end of that year Gorbachev had resigned as President and the Soviet Union ceased to exist) and in October 1991 the President of Russia, Yeltsin, announced a drastic economic reform programme, under the Gaidar team.

This is mainly because reform efforts that were "easier" to implement were undertaken in the early years of systemic transformation, leaving a core of difficult tasks for subsequent years. Many of these will be very challenging and will require a long time to complete.

The countries that have reached advanced stages of transition in the region are all in central Europe (Croatia, the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia) and the Baltics (Estonia, Latvia and Lithuania). While these countries form a convenient grouping for some parts of the discussion, it must be remembered that they vary greatly in the way in which their market-oriented transition has developed. In these countries, most price-setting has been freed from administrative interference, and foreign trade is relatively open. They have privatised most small enterprises and have, in most cases, made considerable progress with the privatisation of larger companies. Markets tend to function reasonably well in these countries, but there are major exceptions, typically including housing markets and capital markets.

To a large extent these countries are market economies and their structural reforms have been substantial and swift. However, they continue to suffer from basic deficiencies compared with a well-functioning market economy, and many of these deficiencies date back to the region's history as a command economy. In particular, enterprise restructuring, strengthening of financial institutions, commercialisation of infrastructure and environmental clean-up have a long way to go. In many areas of economic activity, effective and transparent corporate governance and appropriate standards of business conduct have yet to be firmly established.

Enterprise restructuring remains a huge task throughout the region. The old regime generated a peculiar industrial structure and a capital stock totally unsuited to a market economy. It was strongly biased towards heavy industry; with units which were excessively large. Enterprises were not oriented to consumers, were wasteful of energy and labour, and were environmentally unsound. It will take considerable time to overcome these deficiencies, which apply to a very large part of the capital stock.

Substantial further challenges remain, even in countries at advanced stages of transition, in terms of commercialising infrastructure, establishing environmental standards and alleviating inherited environmental problems.

The construction and consolidation of financial institutions – crucial to a market economy – has proved particularly challenging. Throughout the region, two-tier banking systems were created in the early years of the reform process, as new financial institutions for the enterprise sector were separated from the monobanks. A few of these commercial banks have subsequently been privatised, mainly in the more advanced countries. Most countries have seen the emergence of new private banks, and a few have seen the establishment of local branches or subsidiaries of foreign banks. However, even within the latter group of countries, many of the largest commercial banks remain in state hands, and many (private as well as state-owned) banks continue to struggle with large stocks of non-performing assets. For the region as a whole, the ability to appraise credit is being acquired only gradually, and other skills and methods of work are in formative periods. This is not surprising. The success of banking and other financial activities depends greatly on experience. It also depends on macroeconomic stability and on the establishment among potential borrowers of a track record, of managerial ability, and of accounting skills. All of these are emerging only gradually.

Macroeconomic shocks, inexperience in lending and inadequacies in banking supervision have already led to a number of banking crises in parts of the region, including in countries at more advanced stages of transition. Economic uncertainty has led to unwillingness among the banks to lend for the long term. In addition, severe strains have been imposed on banks, enterprises and the government by the – austere but necessary – tightening in monetary and fiscal policy. This has placed strong restrictions on the availability of investment finance required for the establishment of a new market-based industrial structure in the economies of the region. The multilateral development banks, including the EBRD, have played a leading role in providing longer-term and equity finance in the region.

All the problems that are faced by the countries at more advanced stages of transition are present and more acute in countries that are at the early or intermediate stages. Many of the milestones which more advanced countries have passed remain to be achieved by countries at less advanced stages of reform.

In terms of market liberalisation, most countries have freed the bulk of their prices from administrative control and have opened up domestic production to competition from imports. However, over the past year, a few countries at the intermediate stages of transition have taken steps backwards in the reform process by reintroducing selective price controls or by backtracking on convertibility of their currency.

In most countries at intermediate stages of transition there has been considerable progress in small-scale and mass privatisation. Large-scale privatisation is, however, far from completion, and banking reform is in its infancy in many countries in the CIS and south-eastern Europe. To the extent that large-scale privatisation has taken place, it has often lacked transparency. While this problem is more severe in the countries at intermediate stages of transition, it is far from absent in the countries at more advanced stages. It has sometimes created deep resentment because it appears in some countries to have involved high financial returns to management insiders and those with political influence. It has also at times resulted in weak corporate governance for newly privatised enterprises. These problems have compounded the difficulties of establishing standards of business conduct in the transition economies.

It is encouraging that many countries have reached the intermediate stages of transition or gone beyond this stage. Nevertheless, there is still a group of countries (Azerbaijan, Belarus, Tajikistan

and Turkmenistan) for which progress in the transition has been very slow. In these countries, most major economic activity remains under tight central control, and the development of entrepreneurial activity has been hindered. Nevertheless, even in these countries there are some signs of small-scale entrepreneurial activity, indicating a potential for more comprehensive market development if the most important obstacles were to be removed.

1.3 Building a new role for the state

A central challenge in the transition is the redefinition and reconstruction of the activities of the state. This involves a shift from state control of the whole political and economic system towards an emphasis on state support for democratic procedures, freedoms and a well-functioning market economy. At a minimum, if the market economy is to work well, the state must provide for law and order, macroeconomic stability, and the basic legal and institutional infrastructure for a market. However, it should not stop there. Some basic partnerships between the state (or municipalities) and the private sector are essential for a market economy. Such partnerships are particularly essential in infrastructure – a central topic of this year's Report. The state must also help ensure the functioning of financial and capital markets which are central to the savings issues examined in Part III of this Report.

The role of the state must, however, go beyond ensuring that markets function well, if the transition to the market economy is to provide increasing living standards for the community as a whole and, in particular, for the poor. A broad strategy to deliver the kind of growth which will reduce poverty can be described in terms of three elements. First, the government must provide the conditions for market-oriented growth by advancing structural reform along the dimensions that are described in Chapter 2. Second, the government must provide the conditions which will ensure a good standard of education and health in the population as a whole so that individuals may participate in the market process by earning their own living. This is not, of course, the same as saying that the state itself must provide all education and health services. The state is, however, likely to have to play a role in the regulation and financing of such services.[2] Third, there should be some protection for those who are unable to participate by earning their own living. This can be achieved by creating a social safety net.

The three elements outlined above can be analysed as follows. First, institutional arrangements are at the heart of each of the three elements. Second, the three elements are inter-related – for example, successful market-oriented growth depends on health and education, and a safety net allows participants to take some of the market risks involved in growth and transition. Third, health and education are elements of standard of living and goals in themselves as well as intermediate "inputs" into the process of growth and change.

The challenge of redefining the role of the state in these areas is significant, as the following examples illustrate. In general, tax administration is weak. This corrodes civic responsibility, increases the likelihood of corruption, endangers macroeconomic stability and weakens the crucial functions of the state. There are heavy pressures on the financing of pension systems, and constructing the right kind of safety net is proving very difficult. Moreover, in some cases the relationships between state and industry are disturbingly close, with "favoured" deals in privatisation programmes to management insiders. There are often allocations of special privileges to individuals and companies, and laws are weakly enforced in many cases. In addition, some governments appear to be finding difficulty in upholding promises on tariffs in infrastructure and on environmental aspects of investments. These challenges are faced by countries at all stages of transition. If the problems become too severe, they can begin to undermine political support for the market-oriented transition (see Section 1.4).

There is an important role for international financial institutions (IFIs) in helping the state to develop its new role. They can play a part both in institution-building and in setting standards of government and business conduct in the state and private sectors throughout the region. As outside players committed to transition and development in the region, they have long-term relationships with the transition countries. Thus they can build trust and understanding and make a contribution far beyond the value of the financial resources they provide. Because of their large exposure to the transition countries, the IFIs have an incentive to push for macroeconomic stability. They have an ability to enforce conditionalities on state activities ensuring that a sound policy environment is maintained, that the right institutions develop and that political support for the transition is sustained.

1.4 Establishing democracy

The collapse of the old regime was accompanied not only by a commitment, on the part of the governments of the region, to move to a market economy, but also by a commitment to introduce multiparty democracy in place of a one-party state. Hence a political transition has accompanied the economic transition in the countries of the region. The two are closely intertwined.[3] Article 1 of the Agreement Establishing the EBRD explicitly states that the Bank should help foster transition "in countries committed to and applying the principles of multiparty democracy, pluralism and market economics". Accordingly, the EBRD carefully reviews the political developments in the countries where it operates. It is likely that the speed of establishment and the robustness of democratic systems in most countries of the region will be regarded as remarkable in years to come. Although the democratic process has seen the electorate in a number of countries express concern over the disruption and stresses of transition, there have been few reversals of either political or economic reforms.

By and large, democracy has taken root in much of the region. Second parliamentary or presidential elections may be regarded as a more impressive test of democracy than the first. Many countries have indeed seen several elections. Incumbent parties have not always been re-elected and there have been orderly changes of government. Important examples in large countries in the region were the presidential elections in Russia and Poland in 1996.

2 Health is more strongly influenced by lifestyle and by public programmes (for example, to improve the water supply and immunise the population) than it is by health care services.

3 See also Chapter 1 of the *Transition Report* 1995.

In both cases there was a strong contest. The result was a change of power in Poland and no change in Russia. In neither case has there been a reversal of either political or economic reforms.

However, the path leading towards a solidly constituted democracy can be both long and uneven. As argued in the 1995 *Transition Report*, this path will depend crucially on the success of the reforms of the economic transition. In several former Soviet republics and Balkan countries, reform has been managed by leaders who were already in charge under the former regime, and in some of these countries the pace of reform has been considerably slower than in other transition economies. In many countries of the region, political and economic progress have been hampered by ethnic conflict.

The transition process has also imposed considerable costs in terms of standard of living throughout the region. Some countries have seen serious deterioration in life expectancy and mortality rates, and in many countries there have been increases in inequality and poverty.[4] The deterioration in standards of living for large proportions of the population may constitute a political threat to transition. This may be particularly serious when juxtaposed with the appearance of individuals with large fortunes, some of which are associated with corruption and dubious practices.

1.5 Overcoming the environmental legacy

Environmental degradation was pervasive in the old regime. An emphasis on production targets and a focus on heavy industry implied neglect for the environment, producing an unpleasant and dangerous legacy. Prominent among the sources of environmental damage was a profligate attitude to power and energy – prices for these products were ludicrously low and usage wastefully high. Ironically, local legislation appeared to set high environmental standards, but this was substantially ignored. The origin and scale of the problem make the environment a major transition issue.[5]

Options for productive investment in support of environmental improvements tend to grow as countries advance in transition. The "right" legislation must be in place and enforced and there must be effective monitoring. Only then will the market place provide incentives for firms to carry out investment and controls in support of environmental improvement. The improvement in environmental regulation in the countries of eastern Europe and the Baltics has been brought about partly by the objective of membership of the European Union. This involves the gradual adaptation of regulatory regimes to match those prescribed by the EU for its member states.

Overcoming the environmental legacy will require changes across the board in both production and consumption – in particular in factories, water supply, mineral extraction and transportation, and domestic heating. Many of these changes can be promoted by adjusting prices for power and energy to levels that take account of real resource costs and other expenses. There will also be a need for investments to alleviate earlier damage. The types and magnitude of the necessary environmental spending will no doubt be examined by the European Union in the preparations for the accession of new member states.[6] Investments on the scale required cannot, however, be carried out at once, and much of the investment must be part of the normal replacement cycle for capital goods and building structures.

1.6 Transforming the infrastructure

Efficient, reliable and user-oriented infrastructure is a basic ingredient of a well-functioning market economy. The infrastructure which was inherited from the command system by the countries of eastern Europe, the Baltics and the CIS was poorly suited to the market economy in terms of its physical make-up. The capital stock embodied in infrastructure was heavily influenced by the priorities and methods of the old regime. These involved facilities embodying the special priorities for heavy goods production, scant concern for the preferences of the consumer, excessive specialisation and economic integration across countries of the region for reasons of political control, limited concern for economic costs, and indifference towards the environment.

For example, the railway infrastructure was oriented towards the provision of services for an uneconomical production structure which required the hauling of raw materials and outputs over very long distances with negligible regard for costs. The road system catered poorly for the private car.[7] The telecommunications system used outdated technology, and very few households and businesses had access to the system. Water supplies were inefficient and unreliable, and the method of disposal of waste water and other products was environmentally damaging. Electricity production and usage was wasteful, with harmful consequences for the economies of the region as a whole and for the environment in particular. Unfortunately, large endowments of oil and gas within the region coexisted with a profligate economic system, which showed limited regard for economic costs.

The transformation of infrastructure is a crucial element of the transition.[8] One of the central tasks of the market-oriented transition, therefore, is to encourage a more commercial approach to infrastructure and the environment. This involves the introduction of cost-consciousness and demand-oriented production as well as more careful pricing of services. Commercialisation can help to

4 See, for example, *Transition Report* 1995 (Chapter 2), the 1996 *World Development Report* and Annex 2.1 of this Report.

5 See, for example, Stern (1996).

6 An early study (1993) for six countries (Bulgaria, the Czech Republic, Hungary, Poland, Romania and the Slovak Republic) estimated environmental investments of ECU 91 billion, or 15-20 per cent of GDP, to bring them up to EU standards. Environmental Resources Management (1993), based on estimates by IFO Institut fur Wirtschaftsforschung, Munich. See Chapter 4 of *Transition Report* 1995, p.80.

7 It is not the intention to suggest that advanced market economies have dealt well with road policies but simply to note that car ownership in eastern Europe, the Baltics and the CIS was curtailed and there was little response to consumer demand.

8 See, for example, Stern (1996).

overcome losses and unlock access to private finance, thereby alleviating further pressures on heavily strained public finances. It will also improve the efficiency of infrastructure investments and services.

Commercialisation does not, however, automatically involve private ownership of infrastructure. In some sub-sectors the argument for private provision is stronger than in others. In telecommunications, for example, the factors which led to a natural monopoly have been largely removed by technological change, and the thin inheritance of infrastructure in telephony from the old regime has left a need for major new investments. Such investments and services can be competitively provided by the private sector. For roads and railways, the case for private ownership is perhaps more controversial, but even in the case of continued state-sector ownership, many private contributions can be made in terms of, for example, build-operate-and-transfer projects[9] or the contracting-out of certain services.

Whatever the degree of commercialisation or private participation, responsible regulation of infrastructure will be required. A fundamental challenge for infrastructure regulation is to establish the boundaries between competition and regulation. Where competition is not possible and regulation is required, it must be implemented in a way which is both predictable and allows a reasonable return on investment if private finance is to be attracted to these sectors. Credible regulation often requires independent yet accountable regulatory institutions, particularly in the context of transition.

IFIs can play a very important role in generating the conditions for a more commercial infrastructure. In the public sector they can ensure that structures for project finance provide efficient allocations of risk. They can draw on their experience to provide independent advice and technical support (in many cases restructuring of infrastructure is a one-off exercise for a country whereas IFIs can draw on many relevant experiences from elsewhere). IFIs can provide guidance and covenants on the right kind of pricing so that resources are allocated efficiently and drains on the public purse are avoided. For example, they help stiffen government resolve against populist temptations to underprice.

In private infrastructure the involvement of an IFI has still further advantages. Their long-term relationships with both governments and the private sector, and their independent stance, allow mutual confidence to develop among the partners. This confidence is essential for long-term transactions. The involvement of an IFI in a private infrastructure transaction may allow, therefore, an investment to come to fruition, when in its absence lack of trust may prevent the investment from taking place.

1.7 Savings behaviour and savings institutions in transition

Part III of this Report is devoted to savings. The mobilisation and allocation of household savings had a negligible role to play in the command economy, with the bulk of savings accumulated by enterprises and the government. The level of savings could, at least in principle, be controlled centrally (by depriving households of expenditure). Financial intermediation played a limited role as the government could (again, in principle) direct investment wherever it wished. High levels of centrally planned industrial investments (yielding low returns) were thus matched by a high level of planned savings.

As transition has progressed, the matching of savings and investment has now been increasingly left to market forces. The generation of institutions for mobilising and allocating savings is an issue at the heart of transition. Its importance is underlined by the sharp decline in domestic savings early in the transition period.

The transition economies have financed, and will continue to finance, their investment mainly from domestic savings. To adapt the economic structures to the market-oriented environment, there is a substantial and urgent need for investment, and thus savings, while the fiscal constraints on public sector investment and savings are severe.

The process of market-oriented transition has seen a major shift in the composition of aggregate domestic savings. The public sector has been replaced in many countries by the household sector as the dominant source of savings. However, in contrast to advanced market economies, the range of financial instruments and institutions through which these savings can be accumulated remain limited. For example, contractual savings (pensions and life insurance) constitute only a very modest share of household savings in the transition economies. They may come to represent an important new area of policy focus over the coming years. The reasons extend beyond the need to raise the aggregate level of savings. New contractual savings instruments can also offer a major expansion of individual choice, which is integral to consumer sovereignty and thus to the whole idea of the market economy.

It is important, however, not to lose sight of the importance of public sector savings. Tax revenue has dropped and expenditure pressures have been great in recent years in most of the transition economies. Fiscal deficits have been controlled in many countries despite these pressures, but at great cost in terms of payments to public servants and the erosion of public services in, for example, education and health. It is unlikely that constraints on expenditure conducted in this way can, or should, be maintained over the medium term.[10] The advancement of tax administration and tax compliance will be a crucial part of the drive to increase public savings. This issue was treated extensively in the 1994 *Transition Report*, and should be recognised as a high priority for economic policy throughout the region.

[9] In such a project, private entities take the financial risks and bear the costs involved in the construction of a facility against a right to operate the facility (and sell the associated services) after construction for a pre-specified period. At the end of this period, the private entities transfer the facility to the state (or municipality).

[10] See, for example, Cheasty and Davis (1996).

1.8 Trends in the macroeconomy

Progress towards macroeconomic stability continues in most of the region. Growth remains strong in much of eastern Europe, and positive growth is emerging in some of the smaller CIS countries. A few countries in the region are now seeing unemployment decline and employment increase. However, the macroeconomic picture for the region as a whole is somewhat less favourable now than it was at the time of publication of the *Transition Report Update* in April 1996. Overall growth for eastern Europe and the Baltics has slowed from 1995's impressive level, and the output decline in the largest CIS countries in the first half of 1996 has been substantially larger than anticipated.

A few countries in eastern Europe have seen inflation rebound strongly over the past half-year. This may influence investor perceptions of the risks that are associated with investments in these countries. Recent setbacks in both stabilisation and reform in some countries emphasise the need for investors to evaluate the investment climate carefully country by country since the process of market-oriented transition and macroeconomic stabilisation is not in all cases going to be smooth or move only in one direction.

For most of the countries in eastern Europe and the Baltics a weakening of economic growth in western Europe and a strong expansion in domestic demand has led to deteriorating trade balances, although tighter fiscal policies have helped improve the trade balance of a few east European economies. However, Russia experienced a strong trade surplus in 1995 and in the first half of 1996, partly on account of increases in world prices for its main export products. Increased financial and macroeconomic stability and continued progress in reform led to a sharp increase in capital flows to the region in 1995, primarily from private sources. The flow of foreign direct investment in 1995 almost doubled from a year earlier, but it continued to be concentrated in the Czech Republic, Hungary, Poland and Russia.

Many countries in the region have seen sharp real currency appreciation in recent years. In general, however, rapid growth in labour productivity has helped to offset the influence of real currency appreciation on competitiveness. Indeed, available figures would indicate that the profitability of export activity has strengthened substantially in some of those countries that have seen the greatest deterioration in their trade balance.

1.9 Concluding remarks: main themes of the Report

The Report embodies a number of key themes:

Progress in transition

- Transition continues to advance throughout the region but at a slower pace. The more striking advances in the last year have been made in countries at intermediate stages of transition, particularly in the implementation of mass privatisation. The financial sector remains problematic throughout the region, with insolvency of banks occurring in countries at all stages of transition. The transition has been slowed in some countries by political pressures and a few countries have seen some backtracking on reform over the past year.
- Countries at more advanced stages of transition are now grappling with the difficult problems of restructuring, strengthening of financial institutions, building a more commercial infrastructure and overcoming the environmental legacy of the old regime. These are tasks facing all countries at advanced stages of transition, and their magnitude underlines the conclusion that the transition is not a process that can be completed in only a few years.
- While the data on incomes and purchasing power have to be treated with caution, available data indicate that transition and macroeconomic difficulties have been accompanied by rising inequality in most countries and by rising poverty in a number of places.
- Although democracy in the region is relatively new, it has demonstrated its resilience. There have been second elections and peaceful and democratic changes of power. However, in some countries slow reform is associated with power remaining in the hands of those who were in control under the old regime.
- The IFIs will continue to have a special role to play. In particular, they can help support and generate the private investment which will be at the heart of the transition process. In doing so, their contribution goes far beyond the provision of financial resources. Their long-term and independent relationships with both governments and the private sector mean that their participation helps unlock and expand private investment flows from both domestic and foreign sources.

Infrastructure for transition

- The inherited infrastructure has been badly distorted by the misplaced priorities of the old regime, which showed regard neither for the demands of users nor for the environment. In some sectors (telecommunications, water and waste water and, increasingly, road transportation) the capacity is very weak in relation to the demands that would be expected in a market economy. Other sectors (electric power and railways), however, must adjust to falling demand.
- The level and composition of infrastructure tariffs in the region reflect neither the costs of service delivery nor the financial constraints on government. While the need for tariff reform is clear, political and social considerations have led to a slow pace of change. Countries at more advanced stages of transition have made the greatest progress in this area.
- The reform of infrastructure requires commercialisation. This involves attention to cost control and revenues (for which enforcement of tariff reforms and collection are basic) and a strong demand-orientation. Commercialisation also creates opportunities for private financing of investment in infrastructure. This form of infrastructure finance is playing an important role worldwide and is expanding in some countries in eastern Europe and the Baltics.
- Commercialisation of infrastructure must be supported by effective government regulation. This is a particular challenge in the transition economies, where there is no recent history of commercially oriented regulatory institutions. Careful consid-

eration must be given to designing independent yet accountable institutions, which can serve to underpin competitive provision of infrastructure services. A credible framework for setting tariffs must be established where competition is not possible. Market mechanisms can promote investment for environmental improvements provided appropriate standards are enacted and enforced.

Promoting savings

- During the transition, the need for investment, and therefore savings, is vital. Aggregate domestic savings have fallen dramatically from the very high levels achieved (and wastefully used) under central planning. Households have replaced enterprises as the dominant source of domestic savings. The strive for reform of financial institutions and markets must include policies that serve to strengthen the saving opportunities for households and the efficiency with which savings are used. Public savings must also be raised, and enhanced tax administration and compliance will be crucial.

- An important part of the transition is to expand the range of financial instruments and institutions through which households can accumulate savings. Although they are in the early stages of development in the region, contractual savings, such as life insurance and pensions, are beginning to expand the range of choice in financial services. Life insurance and private pensions can also help to reinforce the transition by promoting the development of local capital markets (and therefore corporate governance) and by facilitating the reform of state pension programmes.

Macroeconomic overview

- Growth has been strong during the past three years in eastern Europe and the Baltics, and the rate of output decline has gradually decreased in the CIS. In the first half of 1996, growth remained high in eastern Europe and the Baltics, but slightly lower than the 5 per cent recorded for 1995. Half of the CIS countries recorded positive growth in the first half of 1996, but output continued to decline in the largest CIS countries, Russia and Ukraine.

- The economies of the region have the potential to grow in the medium to long term at "east Asian" rates (see *Transition Report Update* 1996). The realisation of this growth will require sound policies and long-term commitment to the development of essential institutions (including savings and infrastructure institutions). It is encouraging that these policies and commitments are present in many countries of the region.

- Inflation is coming down in most countries but the strains on public expenditure are severe in parts of the region. Some countries are facing a risk of either a relapse or erosion of basic government activities or both.

- The fiscal priorities differ across the region. Broadly speaking the relative priorities are for tighter control of expenditure in more advanced countries and for increasing tax revenue in less advanced countries.

The situation on both the reform and macroeconomic fronts (as well as initial conditions)[11] varies greatly across countries. Any analysis of the investment climate and of reform measures should therefore take very careful account of country-specific factors.

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[11] See *Transition Report* 1995, Chapter 1.

Progress and challenges in market-oriented transition

2

2.1 Introduction

The broad picture

The economies of eastern Europe, the Baltics and the CIS have been transformed during the 1990s. Market-oriented systems have replaced the old command economies. In most countries of the region, more than half of GDP is now generated by the private sector. The governments in the bulk of the region have comprehensively liberalised prices, external trade and currency arrangements, and privatised small-scale economic units. Many have also privatised a substantial share of their larger enterprises.

Most of the governments and central banks in eastern Europe began the implementation of tight fiscal and monetary policies between 1989 and 1991, alongside comprehensive price and trade liberalisation and removal of restrictions on entry for new companies. This forced enterprises to adjust both to new competition and to a very substantial reduction in their access to subsidised finance from state budgets and banks. The Baltic countries (Estonia, Latvia and Lithuania) followed suit in 1992 soon after gaining independence. Most of the countries in eastern Europe and the Baltics have subsequently implemented comprehensive privatisation schemes and initiated reforms in the financial sector.

Most CIS countries have also tightened fiscal and monetary policies and liberalised markets. Three of these – Russia, Kyrgyzstan and Moldova – adopted structural reform and tentative stabilisation policies in 1992-93. Russia was the first to liberalise prices and trade. Kyrgyzstan and Moldova were the first to embark on serious macroeconomic stabilisation. Since 1994, markets have been liberalised, and financial policies tightened, in a number of other CIS countries, including Armenia, Georgia, Kazakstan, Ukraine and Uzbekistan. By now, only Azerbaijan, Belarus, Tajikistan and Turkmenistan remain at the early stages of market-oriented reform.

Outstanding challenges

Despite impressive advances in market-oriented reform, further major challenges lie ahead in much of the region, including in those countries that have moved the furthest in their market-oriented transition, such as those that have become members of the OECD (the Czech Republic, Hungary and Poland) and are prospective members of the European Union.[1]

In enterprise restructuring much remains to be done, although significant progress has been made, especially in the CEFTA region and the Baltics. Progress made to date reflects primarily the progressive elimination of budgetary and off-budget subsidies and greater enterprise autonomy. The replacement and upgrading of the capital stock has begun more recently, with a recovery in investment levels in a few countries, following sharp declines in earlier years. The scale of the restructuring problem inherited from the old regime is vast, and the adaptation of production patterns and methods to the conditions of a market economy will take many years. Access by private investors in the region to long-term finance for investment remains limited.

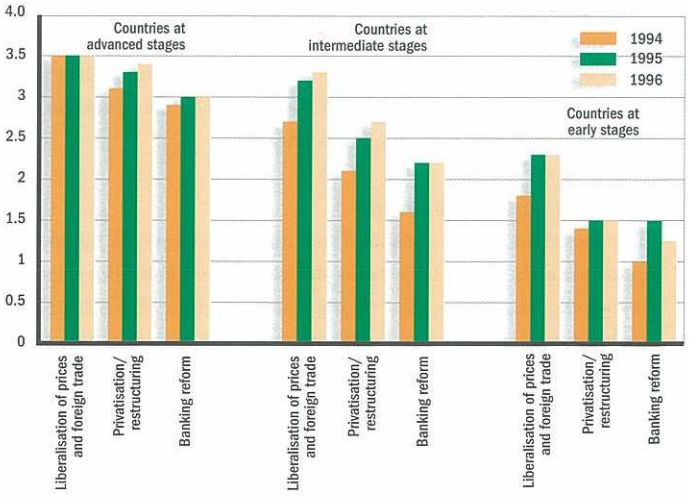
All transition countries also still face other substantial challenges of reform – for example, in the areas of banking supervision, the development of banking skills, capital market development, competition policy, labour market regulation, social security, secured transactions and broad areas of the legal structure. The ownership transformation has in some places, including most countries in the CIS, been focused on industry and services, while leaving the organisational structure in agriculture largely unchanged. Some key prices, notably those for energy and housing, are still centrally controlled in many countries at levels that fail to cover production costs (in the case of energy) or clear the market (in the case of housing).

Developments over the past year

Systemic changes in the region have been more gradual in the most recent 12 months than they were in the early part of the 1990s (see Chart 2.1 and Table 2.1). This is to a large extent because the focus of further reforms in much of the region has shifted from relatively "easy-to-implement" market liberalisation

Chart 2.1

Progress in reform across the region



Note:
The columns represent the average scores attributed to a particular group of countries for progress along the specified dimensions of reforms. The scores were taken from Table 2.1 of the *Transition Reports* from 1994, 1995 and 1996. Higher scores represent greater progress in transition – see Table 2.1 for a detailed explanation.

[1] Ten countries have applied for membership – all of the countries in eastern Europe and the Baltics, except Albania, Croatia and FYR Macedonia.

towards comparatively challenging institutional change, including the privatisation of large-scale enterprises and the reform of financial institutions and markets.

Bulgaria has in fact, reintroduced certain price restrictions over the past year while Romania and Uzbekistan have introduced new curbs on currency convertibility. These are some of the rare examples of significant steps backwards in reform – steps that will hopefully turn out to be of only a short duration.

Three themes stand out from the detailed discussion below of recent progress in privatisation across countries in the region. The first is that privatisation of utilities and transport have gained prominence in some of those countries that have reached the more advanced stages of transition. This is particularly true of the Czech Republic, Estonia and Hungary.

The second theme concerns the advance of "mass privatisation"[2] in countries at intermediate stages of transition. The vast majority of these countries have begun to implement mass privatisation schemes. Implementation was already well advanced in Russia, Kyrgyzstan and Moldova by the middle of last year. Since then, Albania, Armenia, Georgia, Kazakstan, Romania and Ukraine have advanced substantially with implementation of their voucher-based mass privatisation programmes, and Bulgaria has been approaching the implementation stage.

A third theme that emerges from this chapter is that the financial sector remains a problem spot throughout the region. The past year has seen a number of large banks become insolvent, even in countries at the more advanced stages of transition. Large bank failures have taken place, for example, in the Czech Republic, Kyrgyzstan, Latvia, Lithuania and Russia. Looking ahead, carefully designed financial market regulation and development will be required to underpin the continued growth in finance to enterprises from "outsiders" (in the form of loans and equity, as opposed to retained earnings). Outside providers of finance may be crucial to enterprise restructuring, not only on account of the investment that they help finance but also through the pressure they may exert on the management of the borrowing companies.[3]

The concept of transition

The *transition* from a command to a market economy is the movement towards a new system for the generation and allocation of resources. It involves the change and creation of institutions, including enterprises and legal structures. *Stabilisation* policy, on the other hand, aims to achieve a low and predictable rate of inflation and to prevent unnecessary fluctuations in output and employment through the use of fiscal and monetary policy instruments. These concepts differ from the concept of economic *development*, which refers to the enhancement of the standard of living of individuals. Central to the definition of the standard of living are command over resources, education and health.

Both transition and stabilisation policies ultimately aim to promote growth and development. They do so partly through their joint influence on the level and composition of investment (see Box 2.2 on page 16 for a discussion of some aspects of this influence). For transition to be successful (in the sense that it helps promote development), it must be accompanied by stabilisation. For example, one of the primary objectives of privatisation – which is an important component of transition – is to subject enterprise managers to pressure from owners that have a direct economic interest in the financial performance of the companies. This objective may be undermined by loose fiscal and monetary policy, especially by "soft" government management of enterprise subsidies or by easy access for commercial banks to central bank refinancing to cover "soft" lending to enterprises. Thus, tightening of fiscal and monetary policy management has been an important determinant of the degree of enterprise financial discipline that has been achieved, working in this respect alongside efforts by governments to expand the role of private ownership, to create effective bankruptcy and insolvency regimes, and to strengthen the degree of market competition.

Key elements of transition: summary indicators

The remainder of this chapter presents an account of progress made in market-oriented transition in eastern Europe, the Baltics and the CIS, with a focus on developments over the past year. The discussion in the sections below is organised around Table 2.1, which summarises the position of the EBRD's countries of operations in their transition from their centrally planned past to their future of private ownership and free markets. A comprehensive factual presentation, country-by-country, is provided in the Transition indicators at the back of this Report (Box 2.3 on page 22 provides a separate commentary on developments in Bosnia and Herzegovina).

The indicators in Table 2.1 focus on four basic aspects of the transition: enterprises, markets, financial institutions, and the law and its application. The choice of these aspects is at the heart of the analysis of the transition process. But not all elements which are key to the transition process are amenable to "summary by indicator". This is true, for example, of the building of institutions (beyond those referred to in the indicators), environmental developments (see Box 2.4 on page 27), and the role and functions of government (see Chapter 1). They are no less important simply because they are difficult to measure.

The four basic elements for the set of indicators were selected for the following reasons. The transition is a move from a command to a market economy with private production and well-functioning markets. The atoms of a market economy are *enterprises* and households. The former is the basic unit of production and the focus of private investment. An essential question for the indicators of transition is, therefore, how far enterprises have moved into private hands and how far their functioning and production structures have adapted to the market. Enterprises and house-

[2] The term "mass privatisation" denotes the distribution across most adult individuals in a particular country of ownership to the country's formerly state-owned large-scale enterprises.

[3] See Chapter 8 of the *Transition Report* 1995.

Table 2.1

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

(see classification system for transition indicators overleaf)

Countries		Enterprises			Markets and trade			Financial institutions		Legal reform
	Private sector share of GDP in %, mid-96 (rough EBRD estimate)[2]	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	75	2	4	2	3	4	2	2	2	3
Armenia	50	3	3	2	3	4	1	2	1	3
Azerbaijan	25	1	2	2	3	2	1	2	1	2
Belarus	15	1	2	2	3	2	2	1	2	1
Bulgaria	45	2	3	2	2	4	2	2	2	4
Croatia	50	3	4*	3	3	4	2	3	2	4
Czech Republic	75	4	4*	3	3	4*	3	3	3	4
Estonia	70	4	4*	3	3	4	3	3	2	4
FYR Macedonia	50	3	4	2	3	4	1	3	1	3
Georgia	50	3	4	2	3	3	2	2	1	2
Hungary	70	4	4*	3	3	4*	3	3	3	4
Kazakstan	40	3	3	2	3	4	2	2	2	2
Kyrgyzstan	50	3	4	2	3	4	2	2	2	2
Latvia	60	3	4	3	3	4	2	3	2	4
Lithuania	65	3	4	3	3	4	2	3	2	2
Moldova	40	3	3	2	3	4	2	2	2	3
Poland	60	3	4*	3	3	4*	3	3	3	4
Romania	60	3	3	2	3	3	1	3	2	3
Russian Federation	60	3	4	2	3	4	2	2	3	3
Slovak Republic	70	3	4*	3	3	4*	3	3	3	3
Slovenia	45	3	4*	3	3	4*	2	3	3	3
Tajikistan	20	2	2	1	3	2	1	1	1	2
Turkmenistan	20	1	1	1	2	1	1	1	1	1
Ukraine	40	2	3	2	3	3	2	2	2	3
Uzbekistan	40	3	3	2	3	2	2	2	2	3

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.

2 The "private sector shares" of GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity. Here the term "private companies" refers to all enterprises in which a majority of the shares are owned by private individuals or entities. The roughness of the EBRD estimates reflects data limitations, particularly with respect to the scale of informal activity. The EBRD estimates may in some cases differ markedly from available data from official sources on the contribution to GDP made by the "private sector" or by the "non-state sector". This is in most cases because the definition of the EBRD concept differs from that of the official estimates. Specifically for the CIS countries, official data in most cases refer to value added in the "non-state sector" – a broad concept which incorporates collective farms as well as companies in which only a minority stake has been privatised (see also Annex 2.1 of the 1995 *Transition Report*).

Classification system for transition indicators[1]

Transition element	Category	Description of the category
Large-scale privatisation	1	Little private ownership.
	2	Comprehensive scheme almost ready for implementation; some sales completed.
	3	More than 25 per cent of large-scale enterprise assets in private hands or in the process of being privatised (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance.
	4	More than 50 per cent of state-owned enterprise and farm assets in private ownership.
	4 *	Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.
Small-scale privatisation	1	Little progress.
	2	Substantial share privatised.
	3	Nearly comprehensive programme implemented.
	4	Complete privatisation of small companies with tradable ownership rights.
	4 *	Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.
Enterprise restructuring	1	Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
	2	Moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
	3	Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (e.g. through privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).
	4	Substantial improvement in corporate governance, for example, an account of an active corporate control market; significant new investment at the enterprise level.
	4 *	Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.
Price liberalisation	1	Most prices formally controlled by the government.
	2	Price controls for several important product categories, state procurement at non-market prices remains substantial.
	3	Substantial progress on price liberalisation: state procurement at non-market prices largely phased out.
	4	Comprehensive price liberalisation; utility pricing which reflects economic costs.
	4 *	Standards and performance typical of advanced industrial economies: comprehensive price liberalisation; efficiency-enhancing regulation of utility pricing.
Trade and foreign exchange system	1	Widespread import and/or export controls or very limited legitimate access to foreign exchange.
	2	Some liberalisation of import and/or export controls; almost full current account convertibility in principle but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates).
	3	Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.
	4	Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of customs duties for non-agricultural goods and services; full current account convertibility.
	4 *	Standards and performance norms of advanced industrial economies: removal of most tariff barriers; membership in WTO.

Classification system for transition indicators[1]

Transition element	Category	Description of the category
Competition policy	1	No competition legislation and institutions.
	2	Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms.
	3	Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.
	4	Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.
	4 *	Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.
Banking reform and interest rate liberalisation	1	Little progress beyond establishment of a two-tier system.
	2	Significant liberalisation of interest rates and credit allocation; limited use of directed credit or interest rate ceilings.
	3	Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.
	4	Significant movement of banking laws and regulations towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.
	4 *	Standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with BIS standards; provision of full set of competitive banking services.
Securities markets and non-bank financial institutions	1	Little progress.
	2	Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities.
	3	Substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (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		See Box 2.1.

[1] The classification system is simplified and builds on the judgement of the EBRD's Office of the Chief Economist. More detailed descriptions of country-specific progress in transition are provided in the Transition indicators at the back of this Report. The classification system presented here builds on the 1994 *Transition Report* and may be refined further in future editions.

Box 2.1

Legal reform – Survey on investment laws

The Table on the right provides an assessment of progress made to date in legal reforms that help to foster investment. The assessment was made on the basis of a survey conducted through the distribution of questionnaires to Ministers of Justice, selected private law firms and academics and other experts familiar with investment laws in the countries of the region. Private sector lawyers were selected on the basis of their expertise in advising on local law issues, often in the context of the EBRD's own investments. This is the second time the EBRD has conducted such a survey of investment laws. The results of the first survey were published in the 1995 *Transition Report*. To ensure comparability, the questionnaires for 1995 and 1996 were identical (the only exception being the addition in this year's survey of a section on the creation of security over immovable and moveable property).

The Table does not purport to be based upon a comprehensive survey of all investment-related laws and regulations. For example, it does not evaluate tax rules, although these will be relevant to investment decisions. Much of the material which forms the basis of the Table is not readily verifiable and reflects subjective assessments by survey respondents. 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 of this survey and the resulting analysis is to give an impression of how conducive the laws in the region are to fostering investment, care must be taken in reading and interpreting the Table.

The Table provides a numerical assessment (as of July 1996) of how conducive the laws of the countries of the region are to fostering investment. The laws of each country have been scored on the basis of two criteria: 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 the text below.

The overall scores in 1996 reveal an accelerated pace of legislative reform in the region, which is most noticeable in the areas of capital markets and foreign investment regulation. In addition, several countries have reformed or are in the process of reforming their civil codes. Several of the countries have also been reforming laws governing the exploration and exploitation of natural resources.

It appears that greater efforts are being made in many countries in the region to encourage the availability of secured credit through the introduction of secured transactions laws. For example, Hungary introduced greater flexibility in the area of secured transactions through amendments to its Civil Code in 1996. These amendments incorporate key elements of the EBRD's Model Law on Secured Transactions.

Effective implementation and enforcement of these new laws and regulations will require countries in the region to devote more resources to the proper administration and enforcement of laws.

Laws fostering investment – 1996

Country score	Extensiveness of legal rules	Effectiveness of legal rules	Overall
Albania	4*	1	3
Armenia	4	3	3
Azerbaijan	2	2	2
Belarus	1	2	1
Bulgaria	4	4	4
Croatia	4	4*	4
Czech Republic	4	4*	4
Estonia	4	4*	4
FYR Macedonia	4*	2	3
Georgia	2	2	2
Hungary	4*	4	4
Kazakstan	2	2	2
Kyrgyzstan	3	2	2
Latvia	4*	3	4
Lithuania	2	2	2
Moldova	3	3	3
Poland	4*	3	4
Romania	4	3	3
Russian Federation	4*	2	3
Slovak Republic	3	4	3
Slovenia	2	4*	3
Tajikistan	2	2	2
Turkmenistan	1	1	1
Ukraine	2	4	3
Uzbekistan	4*	2	3

Classification system for the legal transition indicators

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 improvement.
	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 generally 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, administration or judicial support of the law is often inadequate (e.g. substantial discretion in the administration of laws, few up-to-date registers).
	4	The law is reasonably 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 the average (rounded down) of the scores given for the two indicators.

holds interact in *markets*. The indicators in Table 2.1 summarise how these markets function, their openness, and how far competitive practices and cost-reflective pricing are supported and achieved.

The role of *financial institutions* in an "ideal" market economy is to collect and channel financial savings to those uses that will contribute most to welfare, and to provide an efficient clearing and settlement system. This role is essential to the functioning of a market economy. Market-driven banks compete to attract savings by offering the highest deposit rates that are consistent with their cost structure and revenue stream. At the same time, they compete to lend to creditworthy customers by offering the lowest lending rates that will cover overhead costs and interest payments on deposits.[5] If they are to be sound and governed by market principles, they must enforce repayments and thus also impose hard budget constraints on enterprises. They also provide links between savers and investors and bridge the present and future through borrowing and lending activities. For these reasons the indicators in Table 2.1 attempt to capture how the financial institutions function in terms of ownership, their contributions to corporate governance in the enterprise sector, competition between them, their contribution to enterprise restructuring, and the range of instruments and services that they provide.

A further key element of market-oriented transition is reform of the legal system, both of the laws and their implementation. Table 2.1 includes an indicator for the extensiveness and effectiveness of legal rules on investment. This indicator is based on a comprehensive survey conducted among selected private law firms and other experts familiar with investment laws in the region (see Box 2.1).

The intention with Table 2.1 is not to judge the economies of eastern Europe, the Baltics and the CIS relative to a "perfectly functioning" market economy but rather to compare achievements in the creation of market structures with the characteristics of real economies that function "reasonably well". Neither is it the intention to propose or define a unique end-point for the transition – there are many possible forms of a market economy which can function reasonably well. The criteria adopted here focus on enterprises, markets and their underpinning. The indicators have been developed primarily to guide the EBRD in the development of its operations in pursuit of market-oriented transition.[6]

Table 2.1 does not attempt to gauge political transition (which is discussed briefly in Chapter 1). As was emphasised in last year's *Transition Report*, the processes of political and economic transformation are closely related. Indeed the EBRD is committed to working only in those countries that show a commitment to the principles of pluralism and multiparty democracy. But while democracy can support the functioning of market economies[7] it is not a necessary condition for their existence.

The framework for a well-functioning market economy, however, goes well beyond the issues captured in the indicators. A well-functioning market economy requires business, management and accounting skills. It also requires standards of conduct which allow the mutual confidence necessary for efficient transactions to take place. It requires the building of market-oriented relationships between businesses and workers. It requires an entrepreneurial culture. All these aspects of behaviour, organisation and relationships take time to establish. They are of great importance, as is the role and functioning of the state (see Chapter 1). That these issues are not included in the indicators does not reflect a judgement on their relative importance but rather difficulties of measurement.

It is becoming increasingly challenging to provide a description of progress in transition which is valid for the entire region. To facilitate the discussion in Sections 2.2–2.5 below, a distinction is made between (i) "countries at advanced stages of transition", (ii) "countries at intermediate stages of transition", and (iii) "countries at early stages of transition". The key used for allocating countries to groupings has been the total of "scores" for each country in the 10 columns of Table 2.1 (after converting the observations in the first column into scores from 1 to 4). It should be noted that any weighting of factors underlying a mapping between the countries of the region and the three country groupings will inevitably involve a degree of subjectivity and will ignore those aspects of transition that are not covered by the table. Moreover, the stipulation of an exact cut-off between groupings will necessarily involve a measure of arbitrariness. The mapping is not a scientific exercise. The country groupings serve mainly to help organise the discussion. The intention is not to imply that the sum of scores in a row of Table 2.1 represents a uniquely "correct" measurement of a country's progress in transition.

2.2 Countries at relatively advanced stages of transition

The countries that have reached the more advanced stages of transition are the member countries of CEFTA (the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia), Croatia and the Baltic states (Estonia, Latvia and Lithuania). These countries have pursued comprehensive market-oriented reform since the late 1980s or early 1990s. GDP in all of these countries, apart from Slovenia, is generated mainly from the private sector. The same may be true for Slovenia in the very near future as the implementation of the country's comprehensive privatisation programme advances further. All of these countries, except Croatia, have so-called "Europe Agreements" with the EU (although ratification has been held up in the case of Slovenia), and all have applied for membership of the EU. The Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia are all members of the World Trade Organisation. During the second half of 1995, the Czech Republic became the first transition economy to join the OECD, followed during the first half of 1996 by Hungary, and more recently by Poland.

5 The EBRD requires all its operations to contribute to the transition process (see Chapter 7 of the 1995 *Transition Report*).

6 See e.g. Stern and Stiglitz (1996).

7 See the article on "Banking reform in central and eastern Europe" in the *EBRD Economic Review*, July 1993.

Privatisation

A number of the countries that are now at advanced stages of transition began implementation of comprehensive privatisation of industrial enterprises and farms in the early 1990s. The most extensive privatisation programmes have been implemented in the Czech Republic, Estonia and Hungary. Having privatised most industrial enterprises, these countries are now focusing their further privatisation efforts on banking and infrastructure and on selected industrial companies that were kept out of earlier privatisation rounds on the grounds that they were thought to be of "strategic" importance. In agriculture, Croatia, Poland and Slovania already had a predominance of privately owned production units prior to the initiation of wide-ranging market reforms. The other countries in CEFTA and the Baltics have, during the 1990s, pursued comprehensive "individualisation" of farm collectives and (at a slower pace) privatisation of state farms.

The Czech government, which completed the so-called "second wave" of the country's comprehensive mass privatisation scheme in March 1995, embarked towards the end of 1995 on direct sales of "strategic" companies. The first and second waves of privatisation combined the use of conventional cash-based sales with the transfer of shares for vouchers, which had been distributed to all adult citizens. The more recent efforts have focused exclusively on trade sales[8] and have over the past year involved the sale of minority stakes in the main telecommunications and petrochemical companies. The period since early 1995 has seen some consolidation of ownership among many of those enterprises that participated in the first and second waves of mass privatisation. This consolidation is commonly known as the "third wave". An active role in this process has been played by the Investment Privatisation Funds. Each of these is limited by law to holding less than 20 per cent of the ownership in any individual enterprise but a recent amendment to the Investment Law has permitted these Funds to transform themselves into holding companies and take majority stakes in the enterprises. A number of large, domestic companies have also played a major role in the ownership consolidation, while certain foreign purchasers have taken strategic stakes in companies. One of the triggers of more rapid consolidation of ownership during the second and third quarters of this year has been an amendment to the Commercial Code which was passed by the Czech parliament in April. The amendment requires any shareholder taking a majority stake to offer to buy out other shareholders at the average market price prevailing over the preceding six months. Although the amendment was passed in April, it took effect only three months later, spurring a surge in take-over activity in the intervening period.

Box 2.2

Progress in transition and the demand for investment finance

The interaction between progress in transition and the demand for investment finance is crucial to the EBRD. The objectives of the EBRD are defined as follows:

"In contributing to economic progress and reconstruction, the purpose of the Bank shall be to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the central and eastern European countries committed to and applying the principles of multiparty democracy, pluralism and market economics."[1]

Beyond the EBRD itself, the analysis of transition is of key importance to a broad category of providers of investment finance for the countries of eastern Europe, the Baltics and the CIS. Demand for their services is intimately linked to the progress made by these countries in market-oriented reform.

Of course, the demand for investment finance in the individual country is not a function only of progress made in transition. A number of other variables also play a role, including stabilisation policies, resource endowment, the political system and stability, economic structure, history, and general developments in other countries (including their trade and investment policies). However, for the countries of eastern Europe, the Baltics and the CIS, progress in transition is likely (under current circumstances) to be one of the dominant factors.

Demand for investment finance in the private sector tends to be comparatively modest in countries at the early stages of transition. The private sector tends, at these stages, to be small, and private investors often find it difficult to predict regulations, property rights, prices, exchange rates and domestic consumption. They may also be strongly limited by government restrictions and bureaucracy as well as by problematic supply conditions for crucial inputs. Demand for investment finance from countries at the early stages of transition will therefore tend to come from the sovereign sector or from companies engaged in natural resource development.

As countries progress in transition, demand for investment finance rises. The regulatory environment gains credibility, the private sector expands, price signals become less distorted, and positive economic growth is likely to emerge.

In countries that move towards advanced stages of transition and stabilisation, still greater certainty about macroeconomic trends and the regulatory environment will gradually elicit an increase in the supply of capital from a variety of sources. However, capital markets remain cautious until the policy changes have become firmly established. Once they have been established, the supply of investment funding can grow sharply (as indeed it has over the past year in some east European and Baltic countries). This growth, however, may be heavily focused on certain market segments, leaving other important segments – for example, companies with reasonable long-term prospects which are in need of restructuring – with little access to investment finance.

Until the credibility of government financial and reform policies in eastern Europe, the Baltic countries and the CIS becomes entrenched with a firm track record, private investors will seek to share their risks with other suppliers of capital, such as banks and international financial institutions (including the EBRD). This will apply in particular to investors in sectors that are heavily dependent on government action (such as private infrastructure and regulated industries). During this phase of growth and further advancement of the transition, investors may continue to suffer from the immaturity of local financial institutions and capital markets. Indeed at present, the lack of longer-term finance continues to constrain investment and restructuring even in those countries that are most advanced in transition.

[1] Article 1 of the Agreement Establishing the European Bank for Reconstruction and Development.

[8] The term "trade sales" will be used throughout this chapter to refer to sales of state assets for cash or on credit terms to "outsiders". The term is used to distinguish such transactions from sales of state assets for privatisation vouchers or coupons that have been distributed to large segments of the population for a nominal fee or for free, and from sales for cash or credit to "insiders" (in the form of incumbent employees or managers).

Estonia and Hungary both implemented privatisation of most of their industrial state-owned enterprises in the years leading up to 1995-96, emphasising (in contrast to the Czech Republic and the Slovak Republic) primarily sales to strategic investors. Both Estonia and Hungary have focused over the past year on the privatisation of utilities and transport.

The Hungarian government implemented a major round of privatisation of utilities towards the end of 1995, attracting record levels of foreign direct investment. This involved, among other things, the sale of a 37 per cent stake in the main Hungarian telecommunications company to a joint venture between Ameritech and Deutsche Telecom, raising the total stake of this joint venture to 67 per cent. It also involved the sale to foreign investors of large stakes (either majority stakes or large minority stakes with options to expand the ownership share) in all six regional electricity distribution companies, in two power generating companies and in six regional gas distribution companies (shares in these companies were purchased mainly by German, Italian, Austrian and French utilities). Other major privatisation transactions completed in Hungary during 1995 include the sale by the state of a minority stake in MOL (the main oil and gas importer/producer) and a majority stake in Budapest Bank to the EBRD and GE Capital (of the US). Further sales of shares in MOL are expected to reduce the government share to 25 per cent before the end of 1996.

The Estonian government has, during the first half of 1996, sold 49 per cent of the shares in the national airline to the private Danish carrier Maersk Air, and 17 per cent to Baltic Cresco Investment Group. The government has also sold the state insurance enterprise to a local private insurance company this year, and is in the process of privatising the state fuel company. The government's privatisation agenda for 1997-98 includes the sales of the state railways, Tallinn Port and Estonian Telecoms.

Both Lithuania and the Slovak Republic started large-scale privatisation years ago through the sale of company shares for vouchers (combined with sales of assets for cash) but have now switched to an emphasis on trade sales (either for cash or with a schedule for delayed payment). In Lithuania the first voucher-based privatisation stage, which favoured incumbent workers and management, was completed in June 1995, leading to the privatisation of about one-third of state-held enterprise assets. A second, cash-based round of privatisation has started. In June 1996 the Lithuanian parliament passed legislation which will permit the sale of up to 30 per cent of the government's stake in some previously excluded strategic enterprises in energy and transport. In the Slovak Republic the first voucher-based "wave" of the large-scale privatisation programme was completed in 1993, prior to the break-up of the Czech and Slovak Federal Republic. A second exclusively cash-based phase of privatisation started in 1995 and has involved predominantly management buy-outs. The government of the Slovak Republic has not as yet embarked vigorously on the commercialisation of infrastructure or on the sale of its majority stakes in some of the country's main banks.

In Latvia, Poland, Croatia and Slovenia large-scale privatisation has lagged behind other areas of reform. However, progress is now under way in all four countries. During the period from 1994 to the middle of 1996, the Latvian government sold 101 medium-sized to large companies, with much of the ownership being sold for vouchers that had been distributed to all citizens (and the remainder being sold for cash). In February 1996, the government authorised the privatisation (using both sales for vouchers and international tenders) of virtually all large enterprises that remain state owned (more than 200), including the largest shipping and energy companies. The Latvian government has also decided to sell a stake in the local state-owned gas company, which handles both imports and distribution.

Poland's long-delayed mass privatisation scheme has now reached the implementation phase. The scale of the programme is modest, with shares in only 512 companies distributed to the so-called National Investment Funds (NIFs) out of the total about 4,500 enterprises that remain in state ownership. About 1,470 enterprises have been privatised through the use of other methods (cash-sales to outside investors or management buy-outs).

Fifteen NIFs were formed in Poland in 1995. Management of the NIFs has been contracted out via international tenders, and in most cases is now in the hands of international consortia. There have been reports, however, of conflicts in recent months between the politically appointed supervisory boards of the NIFs and the selected management companies. Shares in the NIFs are to be floated on the Polish stock exchange within the next year. Vouchers, which will subsequently be convertible into shares in the NIFs, are currently being sold to the population for a nominal fee. In each participating company, 33 per cent of the shares are owned by a designated "lead NIF", about 2 per cent by each of the remaining 14 NIFs, 25 per cent by the Polish Treasury and 15 per cent by employees (who have received their shares free of charge).

In Slovenia 588 out of 1,549 large socially-owned enterprises have completed their privatisation plans and are awaiting registration in the courts. Privatisation of another more than 500 Slovenian state-owned enterprises is expected before the end of 1996. As in Poland, mass privatisation in Slovenia has been much slower than originally intended. The Privatisation Law was passed in November 1992. Implementation began in the first quarter of the following year. Under the mass privatisation scheme, "ownership certificates" have been issued to all Slovene nationals. The value of each ownership certificate is linked to the age of the citizen. The companies have all been invited to draw up their own privatisation plans, and have been permitted to distribute up to 20 per cent of the ownership to incumbent employees. A further 40 per cent of the shares in privatised companies have been transferred to three funds under state management. By September 1996, three-quarters of the 1,549 participating companies had obtained preliminary approval for their plans from the Privatisation Agency and about 700 had obtained final approval. In practice, implementation has been dominated by employee/management buy-outs. In more than a quarter of the privatised companies, employees have

acquired the ownership of more than 60 per cent of the shares, and the average share of employee ownership in participating companies is expected to be close to 50 per cent.

In Croatia, a new privatisation law, approved by parliament in February 1996, also embraces the concept of voucher privatisation, albeit on a more modest scale than the voucher programmes listed above. The Croatian programme foresees the distribution of vouchers to 300,000 people (mainly displaced people and war veterans) who may use them to bid for shares from a list of enterprises which is currently being drawn up by the Ministry of Privatisation. Until now, privatisation in Croatia has mainly taken the form of management buy-outs. About half of Croatia's industrial enterprises have been privatised in this manner.

Enterprise restructuring

Successful enterprise restructuring depends not only on privatisation but also on the structure of control and the financial constraints that are imposed on the enterprises. An important first step is the imposition of product market discipline through the introduction of competition. This has been achieved to a significant degree in all of the CEFTA and Baltic countries and in Croatia through market liberalisation (as discussed in detail below), and through tight credit policies and elimination of budget subsidies (see Chapter 8). In some countries these measures have been accompanied by enforcement of anti-monopoly and bankruptcy policies. Privatisation may also have played an important role, to the extent that the new owners have helped strengthen the pressure on management to improve the performance of the enterprises.

The managers of enterprises in all of the CEFTA and Baltic countries and in Croatia have found themselves exposed to increased competition, a reduction in access to "soft" finance, and changes in the structure of enterprise ownership. These changes have put pressure on the managers of "old" enterprises to embark on the first stages of restructuring, involving an adjustment in the use of labour, and the adaptation of the volume, design and composition of outputs.

One indicator of the extent to which restructuring has taken place is the quantity of output per worker in the manufacturing sector. For example, this measure of labour productivity rose in Hungary and Poland by between 7 and 18 per cent each year between 1992 and 1995 (see Chapter 8). This productivity increase reflects a combination of (i) shedding of surplus staff, (ii) greater effort and skill per worker, (iii) renewal and expansion of the capital stock, and (iv) improvements in the organisation and management of capital and labour. The distribution of the observed productivity increases across these factors is unclear but it would appear intuitively plausible that the shedding of staff would have been the dominant source in 1992-93, whereas the other factors would have played a gradually increasing role in the subsequent years.

The governments of a number of countries in CEFTA and the Baltics have been helping the enterprises advance with "financial restructuring" by inducing the banks to engage in the renegotiation of non-performing loans. Such financial restructuring may help potentially viable companies to continue operations. Nevertheless, progress in so-called "deep restructuring", involving substantial new investment in "old" companies, has been held back by the continued inefficiency of the financial sector even in the countries that are at the most advanced stages of transition (see below).

While market liberalisation and privatisation have promoted the initial stages of restructuring throughout CEFTA, Croatia and the Baltics, enforcement of bankruptcy has typically played less of a role. Estonia, Hungary and, more recently, Poland are the main exceptions. In these countries the number of bankruptcy cases has been substantial.

Estonia's bankruptcy legislation was introduced in September 1992. Under this legislation, more than 450 companies have entered into bankruptcy proceedings. Such proceedings have been completed for, *inter alia*, about 20 medium-sized to large state companies and a number of banks. Bankruptcy proceedings against another 20 large companies (and against many smaller ones) are currently being processed.

In Hungary very demanding bankruptcy legislation was introduced in 1991. The new rules forced enterprises with claims that were more than 90 days overdue to declare themselves bankrupt. The rules also required agreement from a large majority of creditors for any out-of-court settlement to be made. As a result, 9 per cent of Hungarian industrial enterprises (representing one-third of employees in the industrial sector, 24 per cent of industrial output and 35 per cent of total exports) had been registered as being in bankruptcy or liquidation by September of 1992.[9] Viable companies were forced into bankruptcy (or opted voluntarily to take this step in order to obtain respite from creditors), and the massive number of cases created congestion in the courts. Amendments were introduced in 1993 to stem the excessive wave of bankruptcy cases. The amendments eliminated the automatic trigger (i.e. the 90-day rule) and allowed a qualified majority of creditors to decide on out-of-court restructuring. This has helped reduce the number of bankruptcies and liquidations without removing the discipline that is associated with strict implementation of a reasonably transparent bankruptcy regime.

In Poland the 1992 Law on the Financial Restructuring of Enterprises and Banks required the nine state-owned commercial banks to enter into debt restructuring negotiations with those enterprises whose loans had been declared non-performing by independent auditors, leading to conciliation agreements with a large share of these enterprises and liquidation or bankruptcy for at least a quarter of them.

The phase-out of direct subsidisation for state-owned companies and farms has been an important component of the imposition of product market discipline. An extreme example is the government

[9] See the *EBRD Annual Economic Review* 1992, p.8.

sector in the former Czechoslovakia whose expenditure on subsidies to enterprises, farms and consumers in 1989 amounted to the equivalent of 25 per cent of GDP.[10] By 1995, subsidies accounted for "only" about 3 per cent of GDP in the Czech Republic and 4 per cent in the Slovak Republic.[11] In most countries the bulk of the subsidy cuts took place in the first years of reform, alongside radical liberalisation of prices and foreign trade. Implicit subsidisation in the form of soft credits channelled through the banking systems was cut back sharply at the same time.

An integral part of these efforts has been a dramatic drop in state support for agriculture in all of the countries of CEFTA since the mid-1980s, except in Slovenia, where government support for agriculture is comparable to that in the EU.[12] In the Baltic countries, state support for agriculture has been cut sharply since the early 1990s.

The Czech Republic, Hungary and Poland now have far lower levels of explicit or implicit subsidisation of agriculture than do the countries of the EU. Possibly the most reliable aggregate measure of this development is the precipitous decline during the first half of the 1990s in the "producer subsidy equivalent" (PSE) which measures the difference between prices received by farms (after taking into account both direct budgetary support and the effects of import tariffs and quotas) and prices quoted for the equivalent products in world markets. The evolution in the PSE over time shows (according to data prepared by the OECD) that much of the drop in support to agriculture was concentrated in the years prior to 1990 (at least in Hungary and Poland – this was not the case in the Czech Republic where subsidisation continued to drop in subsequent years).[13]

Expressed as a share of the price received by the farms, the PSE fell gradually between 1986 and 1990 from 69 per cent to 53 per cent in the Czech Republic, from 46 per cent to 26 per cent in Hungary, and from 43 per cent to -20 per cent (implying a net tax on farmers) in Poland. In the years between 1990 and 1994 the PSE level continued to fall every year in the Czech Republic, ending the period at 20 per cent. In Hungary the level dropped to 11 per cent in 1992 but bounced back to 16 per cent in 1993 and 20 per cent in 1994 (the latter reflected in part a large increase in import tariffs but also a modest increase in the level of direct support from the state budget for the farm sector). In Poland the PSE level rose every year between 1990 and 1994 to peak in the latter year at 21 per cent. Thus, the PSE level stood at about 20 per cent in 1994 in all three countries. For comparison, the corresponding measure in 1995 was 49 per cent in the EU, 77 per cent in Japan and 78 per cent in Switzerland.[14] Within the OECD area the only countries that have lower PSE levels than those seen in the CEFTA area are New Zealand (5 per cent in 1995), Australia (9 per cent) and the United States (15 per cent).

Market liberalisation

Outstanding elements of *price reform* in countries that have reached the relatively advanced stages of transition include the increase in remaining administered prices to ensure cost recovery in energy and infrastructure. For example, while current levels of electricity tariffs typically cover operational costs, they often fail to cover medium-term investment requirements and environmental costs. Electricity tariffs in transition economies are generally well below the levels in the OECD. More importantly, the structure of tariffs does not reflect the long-run marginal cost of supply (including environmental costs). Residential tariffs in many transition countries are substantially lower than industrial tariffs. In west European countries residential tariffs tend to be twice as high as industrial tariffs, partly because the tariff for end-users tend to include an element of indirect taxation (for further details see Chapters 3 and 4).

Hungary has made more headway towards a rational utility pricing structure than the other transition countries. Full cost recovery for electricity and gas is required by Hungarian law to be achieved by the end of 1996, at which point a fixed formula is to be introduced, linking utility price growth to the evolution in the producer price index and the exchange rate. The aim is to allow producers and distributors a reasonable profit as long as they manage to achieve a satisfactory rate of productivity growth. This pricing regime was a crucial precondition for attracting serious investor interest in the privatisation in December 1995 of state-owned power generating companies and electricity and gas distributors. In order to move prices towards cost-recovery levels, Hungarian prices for electricity and gas have been increased in a series of large jumps over the past two years. The last jump before the switch-over to the fixed price formula had originally been planned for October 1996. However, in late August the government decided, controversially, to postpone this price jump until January 1997.

Liberalisation of *foreign trade* is at an advanced stage throughout CEFTA, the Baltics and Croatia. All CEFTA countries are members of (and all Baltic states as well as Croatia are negotiating accession to) the World Trade Organisation (WTO). In addition, all CEFTA and Baltic countries have Europe Agreements with the EU, providing for free trade in the majority of industrial goods (for details see Chapter 8, *Transition Report* 1994, and Chapter 11, pp. 176-77 of the *Transition Report* 1995).

The CEFTA agreements have removed tariffs on trade between member states in most industrial goods. This complete tariff-removal applies to items that represent about 80 per cent of intra-CEFTA trade in industrial goods. Intra-CEFTA trade in another group of items, representing about 10 per cent of such trade, has until now been subject to import duties at two-thirds of the MFN-level (i.e. two-thirds of the lowest level accorded to developed countries). The members of CEFTA agreed in August

10 For a discussion of difficulties associated with fiscal data for transition economies, see the EBRD *Transition Report* 1995, p.184.

11 See the EBRD *Transition Report* 1995, p.184, and the IMF *World Economic Outlook*, May 1996, p.87.

12 See *Agricultural Policies, Markets and Trade in Transition Economies - Monitoring and Evaluation 1996*, OECD 1996, p.71.

13 See *Agricultural Policies, Markets and Trade in Transition Economies - Monitoring and Evaluation 1996*, OECD 1996.

14 See *Agricultural Policies, Markets and Trade in OECD Countries - Monitoring and Evaluation 1996*, OECD 1996.

1995 to phase out duties for this 10 per cent of intra-CEFTA trade by the end of 1996. Restrictions on intra-CEFTA trade remain in place for "sensitive industrial goods" (textiles, steel and electrical equipment). There are no restrictions on trade in industrial products between the Baltic countries. In the context of the Central European Free Trade Agreement as well as the Baltic Free Trade Agreement (for Estonia, Latvia and Lithuania), participating countries have agreed during 1995-96 to harmonise and reduce duty levels on intra-regional agricultural trade. The CEFTA countries have also agreed to phase out import subsidies in intra-regional trade in sensitive industrial products (textiles, steel and electrical equipment) in two steps before the end of 1996. All CEFTA and Baltic countries as well as Croatia have current account convertibility (and have confirmed their commitment to maintenance of current account convertibility by accepting the obligations of Article VIII of the IMF Agreement).

Financial sector reform

All countries in CEFTA and the Baltics, as well as Croatia, are faced with substantial further challenges in the area of banking reform. Banks continue to play a modest role as providers of investment finance in most of these countries. The ratio of bank assets to GDP in most of these countries is still at a much lower level than in western Europe. Moreover, the ratio of capital to assets continues, on account of the large weight of non-performing loans, to fall short of the Basle standards in some of the largest financial institutions, even in countries in which the state has injected major amounts of new capital into the banks in recent years.[15]

The most severe recent banking crisis in countries at advanced stages of transition emerged in Latvia and Lithuania in 1995 – evidence of the continuing challenge associated with ensuring capital adequacy and sound lending principles for banks in the transition economies. Other countries have seen substantial disturbances in the form of failures of medium-sized or large local banks (notably the Czech Republic in 1996).

In Latvia the activities of more than one-third of the total number of commercial banks were suspended in 1995, including those of Bank Baltija, an institution which prior to the time of the suspension in May 1995 was holding 30 per cent of all deposits in the Latvian banking system. In late December 1995 the Lithuanian central bank halted the planned merger of the country's two largest banks, having discovered during its analysis of the merger that the largest bank was insolvent. The activities of both banks were temporarily suspended, and the Lithuanian government issued guarantees for interbank loans below a certain threshold.

In a somewhat better-regulated environment, private commercial banks have come to play an important role in the banking sectors of the Czech Republic, Estonia, Hungary, Poland and the Slovak Republic on account of both privatisation and entry of new (foreign as well as domestically owned) private banks. Further privatisation and the reduction of state holdings in commercial banks are under way in most of these countries, although there have been implementation delays in some countries. The foreign presence in the banking industry is substantial in the Czech Republic, Hungary and Poland. In June 1996 the Czech Republic ended a moratorium on the issuance of new licences to foreign banks, and in the quest for OECD membership the Hungarian authorities have undertaken to cease before 1998 to insist on case-by-case approval of the opening of branches by banks from other OECD countries.

In the Czech Republic the government is still considering the options for sale of its large minority stakes in the main commercial banks. Hungary's commercial banking law requires the state to reduce its ownership in all banks to less than 25 per cent by 1997. Having privatised several of the main banks over the last year, the Hungarian government is currently negotiating with potential investors for the sale of the remaining two large state-owned banks in an effort to comply with this deadline. In Poland four out of the nine large state-owned commercial banks, which were split off from the central bank when the two-tier banking system was created, have been privatised. In the Slovak Republic (as in the Czech Republic) majority stakes in the dominant banks (except the main savings bank) were privatised in the first wave of mass privatisation. The sale of remaining state shares in these banks, previously scheduled for early 1996, has been postponed. Slovenian legislation enabling bank privatisations to go ahead has yet to be approved, delaying the privatisation of the two largest Slovenian state-owned banks until 1997.

The extent of development of *securities markets and non-bank financial institutions* has differed substantially across countries in CEFTA, Croatia and the Baltics. The evolution of institutions and markets in individual countries has depended heavily on the choice of method of privatisation and on the financing needs of the government sector. Equity prices at the stock markets, especially those in Hungary and Poland, rose sharply during the first half of 1996. The sharp rise was associated with a dramatic increase in turnover on the main stock exchanges in the region.

In the Czech Republic comprehensive voucher-based privatisation has led to a high level of stock market capitalisation. In fact, the stock market capitalisation (42 per cent of GDP at the end of June 1996, including the free market for unlisted securities) is greater in the Czech Republic than in any other economy in eastern Europe, the Baltics and the CIS (see Chart 7.1). Liquidity in the market has been rising over the past year (with the annualised ratio of turnover to capitalisation for listed shares reaching close to 50 per cent during the first half of 1996). There has been some consolidation of ownership of large companies over the past year, facilitated by relatively undemanding disclosure requirements and other elements of weak protection for minority shareholders. A new amendment to the Czech Commercial Code (passed in April 1996) has helped improve such protection by forcing any entity which acquires a substantial minority stake in a company to disclose the terms of the acquisition.

[15] For a detailed discussion of the market structure and performance of the banking sectors, see the *Transition Report* 1995, Chapter 10.

In the Slovak Republic the first round of voucher-based privatisation left the Bratislava Stock Exchange with the second highest ratio of market capitalisation to GDP in the region. While the cancellation of the second round of voucher privatisation has kept the capitalisation ratio in Bratislava substantially below that of the Prague Stock Exchange, the reverse is true of the liquidity on the Bratislava exchange (measured by the ratio of annualised turnover to capitalisation for listed shares) which reached 80 per cent in the first half of 1996.

Despite the existence since 1990 of Hungarian securities regulation that sets comparatively stringent rules for capital requirements for participants in stock trading and for the provision of information by issuers, trading at the Budapest Stock Exchange (BSE), which reopened in 1990, continued until 1995 to be dominated by purchases and sales of treasury bills. This is likely to reflect: (i) the large financing needs during the first half of the 1990s of the central government; (ii) the fact that the dominant method of large-scale privatisation in Hungary has been trade sales to strategic investors (as opposed to the voucher-based method used by the Czech Republic); and (iii) the listing of leading Hungarian companies on stock exchanges in western Europe and the United States. Market capitalisation (in terms of equity) at the BSE remains modest, at about 8 per cent of GDP (in mid-1996), but liquidity has picked up sharply (to an annualised 65 per cent for the first half of 1996) and now matches that of the Bratislava Stock Exchange.

The Warsaw Stock Exchange (WSE) in Poland is, like its Hungarian counterpart, characterised by low levels of capitalisation, reaching only about 5 per cent of GDP in the middle of 1996. It has, however, achieved a level of turnover that is exceptionally strong in comparison with that seen in other CEFTA countries, particularly during the first half of 1996 (as the annualised value of turnover in stocks on WSE exceeded 160 per cent of capitalisation).

Stock-trading remains in its infancy in the Baltic countries and Slovenia, although trading appears to be picking up rapidly in Estonia. Estonia's Tallinn Stock Exchange opened in May 1996. Stock market capitalisation was 8 per cent of GDP in mid-1996. The experience of the initial months of trading points to an annualised ratio of turnover to capitalisation of about 60 per cent. In Latvia, treasury bills dominate domestic capital markets. The market capitalisation for stocks at the Riga Stock Exchange is small, and trading, which started only in 1995, remains insignificant. Capitalisation of the Lithuanian stock market was 5-6 per cent of GDP in the middle of 1996. Market capitalisation at the Slovenian stock market also remained modest, reflecting the comparatively slow progress made to date in large-scale privatisation.

2.3 Countries at intermediate stages of transition

The group of countries at intermediate stages of transition includes the remainder of the east European countries (Albania, Bulgaria, FYR Macedonia and Romania) and most of the CIS (Armenia, Georgia, Kazakstan, Kyrgyzstan, Moldova, Russia, Ukraine and Uzbekistan). The countries at this stage of transition have all moved decisively to strengthen product market competition by liberalising prices and foreign trade and cutting back sharply on government subsidies and on enterprise access to soft credits from the banking system. They have privatised many of their small companies and shops.

Most of these countries are, however, substantially less advanced with respect to enterprise restructuring and reform of financial institutions than the countries of CEFTA and the Baltics. Most of the countries at intermediate stages of transition have embarked on voucher-based mass privatisation schemes but these are still to be completed (except in Russia) and there are in some cases doubts about their influence on corporate governance in the enterprises (especially in countries where large ownership shares are being transferred to the incumbent management). The private sector accounts for about 30-50 per cent of GDP in these countries, except in Albania and Russia, where the GDP-share of private sector is significantly higher. Among the countries at intermediate stages of transition, only Bulgaria and Romania have Europe Agreements, although many others have so-called Trade and Cooperation Agreements with the EU. None of the countries in this grouping is a member of the OECD, and only Bulgaria and Romania among them is a member of WTO.

Serious attempts at market-oriented reform (focused initially on market liberalisation and small-scale privatisation), supported by a tightening of monetary and fiscal policies, were initiated in the early 1990s by the governments of most of the group's east European countries.

Among the CIS countries Russia was the first to embark, in 1992, on implementation of a reform package, involving price and trade liberalisation, small-scale privatisation, and unification of the exchange rate, but the stance of Russian fiscal and credit policies (and thereby financial discipline at the enterprise level) remained loose (and inflation high), partly because of unresolved issues related to the division of responsibility for monetary policy between those republics of the former Soviet Union that were still members of the rouble zone. Kyrgyzstan was the first of the other CIS countries to implement reforms similar to those taking place in Russia. Moldova did the same in 1993, followed in 1994-95 by Armenia, Georgia, Kazakstan, Ukraine and Uzbekistan (all countries which until then had been at the early stages of transition). In terms of financial stabilisation, Kyrgyzstan and Moldova became the pioneers within the CIS in 1993, as evidenced by the sharp drop in their inflation rates in 1994. All the other CIS countries at intermediate stages of transition have subsequently adopted a similar tightening of fiscal and monetary policies (see Chapter 8 for further details).

Box 2.3

Bosnia and Herzegovina

The state of Bosnia and Herzegovina has embarked on two types of economic transition. First, the economy is moving from war-time mode to a peacetime setting. Second, its systemic features are being transformed in a market-oriented direction. The legacy from the former Yugoslavia of an emphasis on social ownership and "self-management" in the enterprises is to be replaced by an emphasis on private ownership and private economic decision-making.

Policies towards economic transition

Systemic reforms were put on hold at the beginning of the war in 1991. Thus in important respects, the current mode of economic management in Bosnia and Herzegovina remains very similar to the old Yugoslav model. The major banks continue to be owned by large enterprises and more than 90 per cent of their assets are non-performing. Meanwhile, the enterprises themselves are "socially owned" and "self-managed", although the various political authorities have intermittently applied direct state control to the enterprise sector during the war. While the Yugoslav model did not allow market forces fully to determine the allocation of labour and capital, domestic and international product market competition were features of the system that distinguished it from the centrally planned economies. As in the other successor states of the former Yugoslavia, this should soften the shock of market-oriented reform.

Plans for market-oriented reforms are being drafted with World Bank assistance. These plans will encompass the legal framework for a market economy and the restructuring and privatisation of the banking and enterprise sectors. Definitive choices have yet to be made by the political authorities but they have generally made a clear commitment to rapid privatisation and broader market-oriented reform. The cash constraint on the state enterprises underlines the need for a substantial role of the private sector in the reconstruction effort.

Institutions of government

In accordance with its constitution, the state of Bosnia and Herzegovina consists of two entities, the Federation of Bosnia and Herzegovina, and Srpska Republic. The Federation, mainly inhabited by Croats and Bosnians, is administratively divided further into cantons. The latter are in turn divided into municipalities. The state of Bosnia and Herzegovina has the right to undertake international obligations and will have institutions that are representing both of the two regional entities. These institutions include the National Assembly, the Presidency, the State Government and the central bank. The first step toward the creation of these supranational institutions was taken on 14 September 1996 when a common presidency and parliament were elected. The competencies of these institutions include foreign trade, customs and monetary policy, the establishment and operation of common and international communication facilities, the regulation of inter-entity transportation as well as air traffic control. The two regional entities will have their own legislative and executive bodies, and will have competence over all other areas of policy, including tax policy.

A functioning *fiscal federalism* is central to the operations of the State and its entities. Ensuring transfers of resources between the regional entities will represent a major challenge. Similarly, the establishment of an open *trade regime* within the territory of Bosnia and Herzegovina without quantitative trade restrictions between regional entities is still far from completion. The completion will require the harmonisation of policies and procedures on external borders. Monetary unification calls for a *common central bank* to be created, with authority to issue a common currency for the whole country. The central bank is to be established in the near future and is to be headed by a foreign national. Some recent progress has been made towards enabling *payment links* between the different currency areas, in particular within the Federation (as opposed to within the country as a whole). Finally, there is a need for *banking supervision* to be harmonised across the territory of the state of Bosnia and Herzegovina to prevent monetary stability from being undermined. A unified supervisory agency for the Federation area was established in June 1996.

Privatisation

Mass voucher-based programmes have been the preferred method for large-scale privatisation in all countries at the intermediate stages of transition, except FYR Macedonia and Uzbekistan.

Albania, Bulgaria and Romania have all moved substantially ahead with comprehensive voucher-based mass privatisation schemes over the past year. In Albania, 97 enterprises out of a total of 400 had been privatised in the voucher-based programme by July 1996. In Bulgaria, vouchers were distributed to the population between January and June 1996. Approximately two-thirds of the vouchers had, by early August 1996, been placed by their holders with one of the 92 licensed investment funds. The first auction under the scheme is scheduled for October 1996 and will involve the sale of 11 per cent of all state enterprise assets. A second round is to follow in 1997.

The Romanian mass privatisation programme has also been advancing. Following the passage of a new privatisation law in March 1995, new privatisation coupons were distributed to the population in August-September 1995. Since then, individuals have been able to subscribe for shares in enterprises on offer in exchange for the new coupons and/or for certificates of ownership (the latter had been distributed to the population in 1992). Almost 90 per cent of the population are participating in the scheme. About 60 per cent of the shares in the country's 3,900 companies are being transferred to the population in this scheme, except in selected companies in which a majority stake is to be offered to strategic investors.

The Russian voucher-based privatisation rounds during 1993-94 led to the ownership transfer for more than 15,000 medium– to large-scale enterprises, employing more than 80 per cent of the industrial labour force. The voucher-based scheme gave particular preference to management and employees and has only to a modest extent resulted in increased performance pressure on management from outside owners. The cash-based second phase of privatisation got off to a slow start in the first three-quarters of 1995. The Russian government revitalised cash-based sales through a variety of schemes in the fourth quarter of 1995. While a number of high-profile sales were undertaken under the so-called "loan-for-shares scheme" (which constitutes one of the schemes of the cash-based second round), the circumstances under which the auctions were held were in some cases the source of significant controversy.

The pace of privatisation in Russia slowed in the first half of 1996, mainly because of uncertainties associated with the political campaigns in advance of the Presidential elections in June. During this period, the government changed its approach to privatisation, replacing the emphasis of the preceding year on speed and revenue-maximisation by a new focus on transparency and on

promotion of enterprise restructuring. In this spirit, the government adopted a new privatisation programme in July 1996. The programme eliminates privileged access to ownership shares previously granted to the workers' collectives. It also expands the rights of the regional authorities in Russia to initiate privatisation, and provides for a more market-based evaluation for enterprises that are candidates for privatisation. The plans of the government foresee the privatisation during the second half of 1996 of several high-profile companies through competitive tendering, including some enterprises in the oil and electricity sectors and the state holding company in the telecommunications sector (Svyainvest). Meanwhile, the government intends to proceed with auction-based sales of state-holding in a number of companies that were only partly privatised in previous privatisation rounds.

In the second-largest CIS country, Ukraine, some 3,500 medium and large enterprises out of the total of 8,000 targeted for participation in the voucher-based mass privatisation programme (initiated in 1995) had been privatised by the middle of 1996. Few of the very large companies have been privatised. The setting of floor prices at voucher auctions has often led to under-subscription of enterprise shares and the need for multiple auctions as a result. The authorities intend to end the voucher scheme in 1996 and continue with cash privatisations.

Voucher-privatisation is proceeding apace in a number of small and medium-sized CIS countries. In Armenia, 626 out of 1,100 targeted enterprises have been privatised in the voucher-based privatisation programme. The process is expected to continue into 1997. In Georgia, 407 out of 1,189 earmarked large and medium-scale enterprises had been privatised in a voucher scheme as of June 1996. In Kazakstan, more than half of 1,700 medium-sized to large enterprises, earmarked for mass privatisation in a voucher-based scheme, had been sold by the middle of 1996. However, the sale of most of the largest companies is yet to begin. A total of five companies with more than 5,000 employees have been privatised. In Kyrgyzstan, 450 out of 900 large state enterprises earmarked for privatisation under the 1994-95 mass privatisation programme have been privatised through a combination of voucher and cash auctions. The Kyrgyz government has approved partial or full privatisation for another 320 enterprises in 1996-97. However, in Kyrgyzstan's first international privatisation tender, involving 13 enterprises in November 1995, the authorities managed to sell shares in only one enterprise. In Moldova, voucher-based mass privatisation was completed in November 1995 with the sale of about half of all state holdings in enterprises. Subsequent cash privatisations have moved forward gradually with about 44 out of 183 targeted Moldovan enterprises being privatised by the end of 1995.

In Uzbekistan, the initial phase of the privatisation programme, initiated in 1994, has resulted in employee/management take-overs of several thousand medium-sized or large companies (accounting for more than a quarter of all such companies). The government has, for the second phase of large-scale privatisation, designed a mass privatisation programme which is centred on a number of so-called "privatisation investment funds" (PIFs), which are expected to be formed by private entrepreneurs. Under the scheme, each citizen will be allowed to purchase from each PIF up to 100 so-called "public privatisation shares" (PPSs), each costing the equivalent of 25 per cent of the minimum monthly wage. The citizen will be able to place the PPS with a PIF of his or her choice, and the PIF will be able to use it to purchase shares from the government. Initially, the government is to offer at least 30 per cent of the shares in 300 companies to PIFs at book value during the second half of 1996, with another fifth of the shares being sold directly on the stock exchange and more than a fifth being allocated to the employees of participating companies. Alongside the preparations for implementation of the mass privatisation scheme, other methods of sales are being used, including cash auctions and sales to strategic foreign investors.

FYR Macedonia is the only country at an intermediate stage of transition that has not embarked on any form of mass privatisation. Instead, more than half of the enterprises (representing at least one-third of former state assets in the enterprise sector) have been privatised through management and employee buy-outs.

Albania and Romania moved rapidly in the early 1990s to privatise most agricultural land. In FYR Macedonia, most agriculture was already in private hands before the country embarked on comprehensive market reforms.

The organisation and ownership regulation for most large farms in the CIS countries at intermediate stages of transition has changed comparatively little since the pre-reform era. In Russia and Ukraine, for example, the vast majority of collective and state farms continue to function as undivided entities and continue to benefit from a substantial amount of subsidisation, sometimes provided by the governments at the regional or local level. There is virtually no functioning market for agricultural land in these two countries.

Only a few break-ups of state farms have taken place in Russia since late 1994, in response to requests made by local offices or farm collectives, following a pilot project involving five farms in the Nizhnii Novgorod Oblast that was initiated in late 1993. In this project the farm employees at all five farms decided to split the farms into smaller "enterprise farms", but none was divided into individual family farms. Since 1990, Russian individuals wishing to establish private farms have been able to apply for land from a stock of uncultivated areas, totalling 630,000 hectares. By the end of 1995 slightly more than half of this land had been allocated. However, the number of individual farms in Russia stagnated in 1994-95 at around 280,000.

Enterprise restructuring

The predominant source of enterprise restructuring in countries at intermediate stages of transition, as in the countries at more advanced stages of transition, has been the tightening of access to government subsidies and soft bank credits, increased scope for import competition, and liberalisation of the rules for establish-

ment of new companies, whereas implementation of bankruptcy legislation has played little role, even where such legislation exists.

In Russia, for example, the level of enterprise and consumer subsidies from the federal budget (including import subsidies, but excluding state-directed credits) dropped from 23 per cent of GDP in 1992 to an estimated 1.6 per cent in 1995.[16] Meanwhile many financial-industrial groups, created by the leading private banks, have begun to push for management changes in companies while providing finance for new investment.

In response to subsidy cuts, import liberalisation and competition from new companies, labour has been shed in the manufacturing sector in many countries at intermediate stages of transition. Employment in manufacturing fell by 7-18 per cent each year in Bulgaria during 1992-95. The same took place in Romania during 1993-95 and in Russia during 1994-95. Labour productivity has been rising sharply (5-14 per cent per year) in Bulgaria and Romania since 1993, and began to rise in Russia in 1995 (after falling markedly in the preceding years). It would appear likely that much of the productivity gain in 1993-94 represented shedding of surplus labour, whereas organisational improvement, and (at least in Romania) renewal of the capital stock may have begun to play a more significant role in 1995.

Market liberalisation

The regime governing the formation of prices and the conduct of foreign trade is very liberal in most of the countries at intermediate stages of transition. Further liberalisation has taken place over the past year. Export taxes and restrictions on current account convertibility, which continued until 1995 to play a role in much of the CIS, have now been phased out in Armenia, Georgia and Russia. Meanwhile, most countries at intermediate stages of transition have been raising some of their utility prices towards cost-recovery levels. Government administration of prices is in most countries largely confined to infrastructure and energy. However, Bulgaria has in the past 1-2 years tightened implementation of regulations for price controls in selected areas (mainly on staple household goods). Meanwhile, Romania and Uzbekistan have, during the course of the first three-quarters of 1996, introduced informal curbs on currency convertibility for trade transactions (for example, in the form of delays in the treatment of applications for currency exchange). These are rare cases of serious backtracking on reform measures implemented in the region since the onset of market-oriented transition in the early 1990s.

In Russia the removal of price controls for domestic oil prices in 1995 largely completed commodity price liberalisation at the federal level, although efforts are still to be made to ensure greater cost recovery in the transport and energy sectors – the government plans to achieve this in the second half of 1996 through the introduction of a system of above-inflation adjustments for industrial tariffs. Prices of natural monopolies continue to be centrally regulated, with adjustments being linked to the evolution of the industrial producer price index. The prices for gas and electricity, as well as railway tariffs, are now at levels that may be covering long-term marginal costs of production. There is, however, a substantial element of cross-subsidisation between customer groups as tariffs for households remain far below those applying to industrial users. The government is planning to phase out such cross-subsidisation in the years ahead. While price liberalisation has been proceeding at the federal level, the application of price regulations at the level of regional governments expanded somewhat in the run-up to the presidential elections.

Utility tariffs, in particular energy prices, have been raised substantially in some CIS countries over the past year to ensure greater cost recovery. For example, the government of Ukraine sharply raised the relative price of electricity for households in two steps in January and July of 1996.

It should be noted that the achievement of cost-recovery pricing is not in all cases sufficient to ensure the viability of the utility companies, as these companies tend throughout the CIS to suffer from poor collection levels. Efforts have been made in Ukraine, for example, to improve collection rates through greater enforcement of the threat to cut off delivery to non-paying customers, but payment arrears to utilities remains a problem.

Liberalisation of foreign trade and the foreign exchange systems is generally well advanced in those CIS countries that have reached the intermediate stages of transition, and all of these countries maintain currency convertibility for the purpose of settlement of foreign trade. Most prohibitive tariffs and barter trade have been abolished. The customs union between Russia, Belarus, Kazakstan and Kyrgyzstan has involved the adaptation of the customs system for extra-union trade in Belarus and Kazakstan to that applied by Russia. The customs union was established in 1995, but Kyrgyzstan has become a member only this year. For Kyrgyzstan, which had previously adopted a very liberal trading regime, the adaptation to the Russian tariffs would lead to a substantial increase in external tariff levels. However, Kyrgyzstan had not by mid-1996 ratified the customs union treaty and had not as yet changed its uniform 10 per cent tariff on imports from non-CIS countries.

The CIS countries are gradually abandoning the use of export taxes and quotas – which are a legacy from the early 1990s. Export taxes and quotas were erected mainly for two purposes. One was to prevent, in 1992 in particular, a major outflow of badly needed domestic production to other countries that remained in the rouble zone. The cause of the need to stem such an outflow was that all countries in the rouble zone for a while were able to issue rouble-denominated credit which (in the absence of trade restrictions) could finance imports from other parts of the zone. Another purpose of export restrictions was to prevent an outflow of goods that were benefiting from heavy price subsidisation (i.e. to prevent an "export of subsidies"), or for which domestic prices had been kept low through other means of government intervention.

[16] Source: "Subsidisation of the Russian Economy", by Liam Halligan, Pavel Teplukhin and Dirk Willer, *Russian Economic Trends*, Volume 5, No.1.

As all the CIS countries now have their own currencies and many have cut price subsidisation drastically, much of the rationale for export restrictions has withered away. Armenia now has no export taxes (and has streamlined import tariffs into a two-band system). In Georgia the system of export licences is being phased out – remaining restrictions on exports are to be abolished in 1996 (and foreign exchange surrender requirements were eliminated at the end of 1995). In Kyrgyzstan all remaining export taxes were abolished in February 1996, but a temporary export duty on grain was introduced in August 1996. Moldova's last remaining export quota restriction (on grain) was eliminated at the end of 1995 (and the maximum import tariff level was reduced to 20 per cent). In Russia, following the elimination of the last export quotas in 1995, export taxes began to be phased out. The final stages in this process involved the abandonment of export taxes on gas in April 1996 and on oil in July 1996. In Ukraine, export quotas and licences now apply only to goods that are subject to so-called "voluntary export restraints", as specified under international agreements (one of these – the Interim Trade Agreement with the EU – came into effect in February 1996). In Uzbekistan the number of export quotas was reduced to four at the end of 1995 and the level of export taxes is to be reduced during the remainder of 1996.

While liberalisation of price formation and foreign trade, as well as progress on privatisation, have helped increase competitive pressures in the markets for goods and services, the legal and administrative framework for prevention of anti-competitive practices is largely missing or at an early stage of development in all of the countries at intermediate stages of transition.

Financial sector reform

The financial system remains fragile in the countries at intermediate stages of transition. Poorly capitalised banks with substantial portfolios of bad claims continue to dominate the financial sector in most of these countries. The largest banks remain state-owned in all countries at intermediate stages of transition, although private banks play a significant role in, for example, Romania and Russia. Romania is the only country within this country grouping in which the government has injected substantial amounts of new capital into the largest banks, and subsequently implemented a tighter supervisory regime.

The *state-owned* banks within this country grouping tend to be plagued by a large number of problem loans, partly as a result of cheap state-directed credits extended to poorly performing enterprises. However, the *private* banks often suffer in the same manner from a substantial non-performing loan portfolio and low levels of capitalisation, after having engaged in their early years of existence in high-risk lending, often in a weakly regulated environment (low capital requirements for new banks, and limited banking supervision by the state). The threat of banking crises has gradually led to a tightening of prudential regulations and strengthened supervisory capacity of central banks, often with assistance from international donors. In some countries this has resulted in a rapid closure of weaker banks. In addition, recapitalisation and restructuring programmes are under preparation in some countries. In Bulgaria and FYR Macedonia, for example, recapitalisation and privatisation of the state banks is under way. The difficulties that face the banks in parts of the region are well illustrated by the recent experience of Bulgaria where macroeconomic uncertainty (see Chapter 8 for details) has intermittently during the first half of 1996 led to runs on the banks' deposit base.

The Russian financial system, which is dominated by private banks (although the largest three are state-owned), is in the process of rapid consolidation and restructuring following an early period of explosive and largely unregulated growth. In late August 1995 the Russian Central Bank intervened to defuse the threat of a serious liquidity crisis in the interbank market which had driven overnight interest rates above an annual level of 1,000 per cent. The Central Bank of Russia is now developing its capacity to deal with troubled banks. Its licensing policy has been tightened significantly and about 350 licences have been withdrawn this year. Special bankruptcy procedures for banks are expected to be adopted by the end of 1996. The core group of the 30-40 largest and best managed banks is evolving into a special quality layer of the banking system.

Securities markets and non-bank financial institutions in most countries at intermediate stages of transition remain small and illiquid, although stock exchanges have been opened in a number of countries. Successful local companies, unable to raise capital in underdeveloped local markets, have in some cases turned to international capital markets for financing. A few leading Russian companies, including Lukoil and Mosenergo, have managed to tap international capital markets by issuing American depository receipts.

The development of securities markets in Russia in 1995-96 has been characterised by buoyant growth of debt markets, very volatile stock markets and improvements in the regulatory and physical market infrastructure. Most of the trading activity is in the domestic bond market, created in May 1993 with the issuance of a short-term government paper. Access for foreigners to the T-bill market was opened up in February 1996 and the remaining restrictions were substantially eased in July 1996.

2.4 Countries at early stages of transition

The state sector remains dominant in Azerbaijan, Belarus, Tajikistan and Turkmenistan. In all of these countries the private sector is likely to account for less than 20 per cent of GDP. Market liberalisation remains far from completion. Foreign trade is heavily regulated, there is only limited currency convertibility for trade transactions, and many prices remain subject to government control. Little privatisation has taken place.

Privatisation

Private entrepreneurship is emerging mainly in the area of consumer services, but there has been little formal privatisation

for large and medium-sized enterprises, or even for smaller enterprises. In Azerbaijan only 20 large enterprises were targeted for ownership transfer under the July 1995 privatisation programme, and planned sales of enterprises with less than 50 workers (started in March 1996) will result in the privatisation of only about 5 per cent of state industrial assets. The government of Belarus adopted in September 1995 a programme for the corporatisation and privatisation of 1,516 enterprises during the course of 1996. In late 1995, the government required all enterprises to re-register; however, a few months later, it suspended the re-registration process. The latter move has effectively halted both corporatisation and privatisation. In Tajikistan the initial process of rapid privatisation was interrupted by the outbreak of civil war in 1992 but the government intends to accelerate privatisation in 1996 in the context of a recently initiated IMF-supported stabilisation programme. In Turkmenistan only four enterprises out of 600 targeted for privatisation in 1996 have been privatised, and not even the shops in the capital are privately run.

Enterprise restructuring

State support in the form of cheap direct credits and budgetary subsidies to state-owned enterprises continues to be widespread in these countries. The state order system (forced sales to the state below market prices) has largely been abolished but the state-owned distribution companies are still dominant in many sectors. Radical restructuring through bankruptcy measures is extremely rare, although bankruptcy legislation exists in some countries at early stages of transition.

Market liberalisation

Some progress has been made in price, trade and foreign exchange liberalisation over the past year in Azerbaijan, Tajikistan and Turkmenistan. New measures have generally included elimination of some price controls for consumer necessities; removal of some quantitative and administrative import and export restrictions and some reduction in the use by state-owned entities of barter in foreign trade (barter has been banned in Turkmenistan for all products other than natural gas). Belarus has had setbacks in reform in a number of areas over the past year. For example, the President decreed towards the end of August 1996 that 75 per cent of the goods on sale in all Belarussian shops must be locally produced. It was announced at the same time that the sales tax on imported goods (presumably from countries outside the customs union) would be raised to 150 per cent from its previous level of 10 per cent.

Highly monopolistic economic structures which emerged after the decades of central planning are largely intact, particularly in distribution and trade. Formally, anti-monopoly regulations and administrative bodies have been set up in all of these countries, except for Turkmenistan, but they have not significantly helped ease entry for new firms. Competition through international trade plays only a modest role.

Financial sector reform

The financial sector in countries at an early stage of transition is dominated by banks owned directly by the state or by state enterprises. Credit allocation tends to favour state enterprises and agricultural entities which are at times able to borrow at preferential rates.

The government of Azerbaijan, and more recently the governments of Turkmenistan and Tajikistan, have been cutting back on the use of directed credits in their efforts to reduce inflation. However, directed credits remain prevalent in Belarus, and the Belarussian government has stepped up direct intervention in the banking system over the past year.

Securities markets are at a very early stage of development in these countries, and the related legal and market infrastructure is scant. In Azerbaijan a Law on Securities and the Stock Exchange has been passed, but no stock exchange has been established as yet. In Belarus a stock exchange exists, but trading is limited to a small number of shares issued by banks.

2.5. Concluding remarks

A general pattern of reform has evolved over the past five years. Most countries in the region have implemented 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 and an effective market economy. These measures involved limited or fairly simple institutional 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 most of the CIS.

A number of countries have largely completed privatisation of companies in industry, and a few have moved on to initiate privatisation or commercialisation of utilities and transport. Another large number of countries – typically those that embarked more recently on serious market-oriented reform – have over the past 1-2 years initiated ambitious privatisation programmes, in most cases with mass participation.

However, the scale of the restructuring problems inherited from the old regime is so vast that the adaptation of production patterns and methods to the conditions of a market economy may take many years. Access for governments and private investors in the region to long-term finance for investment in, for example, infrastructure and environmental improvement, remains minimal. Moreover, even those countries in the region that are most advanced in transition still face other substantial challenges of reform – for example, in the areas of enterprise and farm restructuring, banking supervision, capital market development, competition policy, utility pricing, labour market regulation, social security, secured transactions and broad areas of the legal structure. Much has been achieved but much remains to be done.

Box 2.4

Issues associated with the measurement of environmental developments

The Agreement Establishing the EBRD commits the Bank to "promote in the full range of its activities environmentally sound and sustainable development". Increasingly, work is being undertaken worldwide on the identification of environmental indicators. There is no agreement on a single approach to this task. However, by definition, if "sustainable development" is to be measured, then such indicators are necessary.

The determination and use of environmental indicators is by no means straightforward. If they are to be used to measure change in a particular country or region over time, then it is most important that the monitoring of environmental parameters is undertaken consistently during the time period concerned. This is not always the case in the Bank's region of operations. Changes in national boundaries provide a further complication.

If the indicators are to be used to compare one country or region with another at a particular time, then a distinction has to be made between environmental emissions and environmental quality. Two examples will demonstrate the distinction. Two countries may release the same amount of sulphur compounds into the atmosphere but, because the soils of one country may be sulphur deficient and those of the other already acidified, the environmental impact of the sulphur emissions on the soils of the two countries could be very different. Second, two countries may discharge the same quantities and types of industrial effluents into watercourses. In one case, the dispersion characteristics of the rivers, lakes or seas may be such that this results in relatively little environmental impact; in the other case, the absorptive capacity of the waters may be inadequate and gross pollution may be the result. Inter-country comparisons, like time series comparisons, also raise issues concerning data reliability.

Environmental transition

To develop meaningful indicators of environmental transition is more conceptually challenging than the development of environmental indicators. Environmental transition indicators need to demonstrate something useful about environmental quality over time – transition, by definition, being a dynamic concept – and there needs to be some link to the process of transition to market economies. Some account has to be taken of the fact that some countries had better access to natural resources and were less polluted than others at the time that the transition process started.

One useful concept is that of environmental efficiency. The countries of eastern Europe, the Baltics and the CIS were noted for the profligacy with which they used natural resources and for the large quantities of waste products – solid, liquid and atmospheric emissions – that were generated for each unit of manufacturing output, for each unit of energy produced, and for each kilometre travelled. Economic transition, which ensures that real production costs are reflected in overall economic performance, will, inevitably, improve the efficiency with which raw materials are used and, given appropriate and enforced regulations, should reduce pollution, certainly on a unit of production basis and, hopefully, overall.

Energy and water use intensity, which are discussed in greater detail in Chapter 3 (see Table 3.3 and Chart 3.5), are reasonable measures of environmental efficiency. The electricity intensity (measured as the electricity consumption per unit of output) in most of the countries of eastern Europe, the Baltics and the CIS is above that of the EU. In Central Asia, in particular, it is 3-4 times higher than in the EU.

The countries of eastern Europe, the Baltics and the CIS are, generally, reasonably well provided with renewable water resources on a per capita basis. Some, including the Russian Federation, have substantially better access to water resources than most of the countries of western Europe. Per capita water abstraction varies markedly between the countries of eastern Europe, the Baltics and the CIS; this is also the case in western Europe although the highest figures from many of the transition countries exceed those of any of the countries of western Europe.

The efficiency of resource use should not be the only measure of environmental transition. Meaningful pollution-related indicators are also needed. As explained above, atmospheric and aqueous emissions data can be misleading; pollutant concentration figures are more useful in identifying some environment-related issues. The Table below shows annual mean concentrations of three common air pollutants – sulphur dioxide (SO_2), nitrogen dioxide (NO_2), and total suspended particulates (TSP) – in parts per million for major cities in the EBRD's countries of operations, together with comparisons with selected cities in west European countries for the period 1990-92. A comparison between the figures for cities in the EBRD's countries of operations and the data for west European cities indicates that, at least at the time that the transition process began some six years ago, sulphur and nitrogen dioxide concentrations showed little consistent pattern. However, the total suspended particulate figures in cities in transition countries are twice or three times those typically found in west European cities, with the exception of Athens. All three air pollutants are known to have adverse human health effects under certain circumstances, particularly by affecting the respiratory and cardiovascular systems.

A meaningful comparison of water pollution between countries is more difficult to make than a comparison of air pollution. Whereas, in the case of air quality, sampling sites can be chosen in or near the centre of major cities where there are high population concentrations, in the case of water quality there is a much wider range of parameters to measure and it is more problematic to determine which monitoring sites to choose.

It is anticipated that a future *Transition Report* will examine environmental transition indicators in further detail.

Air pollution concentrations, 1990-92

Country	City	SO_2	NO_2	TSP
Albania	Tirana	23	na	85
Belarus	Minsk	20	37	100
Bulgaria	Sofia	31	53	170
Croatia	Zagreb	39	na	67
Czech Republic	Prague	75	56	84
Hungary	Budapest	44	44	62
Latvia	Riga	4	60	100
Lithuania	Vilnius	na	27	na
Moldova	Chisinau	2	20	na
Poland	Warsaw	30	54	na
Poland	Krakow	47	31	54
Romania	Bucharest	40	36	130
Russian Federation	Moscow	na	76	100
Russian Federation	St Petersburg	5	58	90
Slovak Republic	Bratislava	20	na	58
Slovenia	Ljubljana	50	54	23
Ukraine	Kiev	13	50	100
Ukraine	Odessa	44	97	270
Austria	Vienna	17	38	40
Belgium	Brussels	27	44	24
France	Paris	25	67	43
Germany	Munich	9	49	na
Greece	Athens	36	38	150
Italy	Milan	24	114	70
Sweden	Gothenburg	7	30	5
United Kingdom	Manchester	41	57	21

Source
The statistical compendium for the Dobris Assessment (prepared as part of the Environmental Programme for Europe), Eurostat, Luxembourg 1995.

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Introduction

It is reasonable to assume that in turning towards the market economy the people of eastern Europe, the Baltics and the CIS were, at least in part, motivated by the belief that the transition would eventually result in a higher standard of living. The transition process in itself, by enhancing both political freedom and the economic choices available to consumers and producers, could be seen as providing some of the basic rights which are themselves key elements of standard of living. However, beyond these individual rights, it is the command over material resources (as indicated, for example, by levels of income, expenditure or wealth) and the availability of health and education services, which are usually considered to be the major components of standard of living. Moreover, because the notion of standard of living is a measure of the well being of individuals, an assessment of its evolution cannot be based on aggregate measures (such as changes in average per-capita income) but should involve an examination of distribution across individuals. The *Transition Report* 1995 (Section 2.3) included an assessment of certain aspects of social developments in transition, particularly mortality rates and life expectancy. This annex, instead, focuses on command over resources in terms of the distribution of income and the incidence of poverty.

The figures on income distribution that are quoted here should be interpreted with great caution. While data on income distribution have important shortcomings even in developed market economies, there are particularly severe problems in measuring changes in the real value of income and wealth in countries that have embarked on systemic transition. These problems are present both in using data from the old regime and in the transition period itself. They arise from a variety of reasons. In particular, the fact that scarcities, rationing, and in-kind remunerations and benefits were widespread prior to transition makes it difficult to assess the purchasing power of income and the actual command over resources in the pre-transition period. During the transition this problem is compounded by the significant changes in the availability of new types of goods and services and in the quality of goods and services – changes which are not necessarily captured by prices. Serious problems arise also in the measurement of nominal incomes, since individuals and enterprises now have a greater incentive to conceal incomes for tax avoidance and for other reasons. These difficult problems are faced by statistical agencies which are themselves under pressure and in a state of transition as they try to adapt to a changed environment where government is also playing a very different role.

Despite reservations about the statistics, available figures strongly suggest that both distributional inequalities and the incidence of poverty have increased sharply in many countries in the region during the 1990s. It is important to recognise that, in principle, the movement towards a market system, based on reward-oriented incentives and private ownership, must inevitably involve an increase in inequalities, at least when compared to a system where a commitment to equality is put into practice. There are, however, a number of additional factors – some intrinsic to the transition process and some more country specific – that should influence an analysis of distributional issues in the region. These include macroeconomic developments and policies, the modes of implementation of structural reforms (such as the privatisation procedures and the speed of restructuring), and the type, extent and implementation of social policies.

The substantial declines in output experienced by all the countries in the region can explain part of the fall in consumption and the rise in poverty. However, the different degrees of macroeconomic disequilibrium faced by the various countries at the beginning of the transition process, as well as the different stabilisation strategies followed, may also have had important consequences. Price liberalisation was followed by rapid inflation in countries where a monetary overhang had been accumulating over the years (as in most of the CIS countries, Bulgaria, Croatia and Poland). The acceleration of inflation led to an erosion of both the purchasing power of the accumulated stock of savings and the flow of incomes in countries that did not fully compensate holders of financial assets, or those dependent on transfer payments, for the increase in prices. This drastically reduced the standard of living for various segments of the population, particularly for those dependent on unindexed, or partially indexed, transfers.

The negative consequences of inflation for distribution have been well documented in market economies. However, these consequences may have been more serious in transition countries given the absence of inflationary hedges and the lack of experience of the population in dealing with the problem. Moreover, the adjustment process and the macroeconomic programmes that had to be put in place to stabilise the economy may have had additional negative repercussions in transition countries, given the initial dearth of macroeconomic instruments. The need to implement restrictive fiscal and monetary policies, at a time when output was shrinking and tax revenues falling, led to substantial cuts in public expenditures affecting social spending, the quality and quantity of public services, and the actual payment of salaries in the public sector. In addition, tight credit policies, coupled with significant subsidy cuts, largely constrained the enterprises' access to liquidity resulting in wage arrears and increased unemployment.

While some of the income distribution consequences of these macroeconomic developments could be seen as temporary, and indeed some were ameliorated as inflation receded and better policy tools were developed, there have been some more permanent changes in the distribution of wealth and assets that arose from the ways in which the process of ownership transfer took place. While large parts of the population lost significant fractions of their accumulated assets, some smaller groups have seen their wealth vastly increased. Moreover, at least a fraction of the large gains obtained by some groups have been made in ways which have caused resentment and disenchantment with the transition process. These include certain types of privatisations to management insiders, particularly in the natural resource sector, crime and mafia-related activities.

These developments are of particular concern if one considers the need to maintain a basic public support for the continuation of the reforms. The problem becomes especially acute during the transition since the transition embodies increased transparency in rewards and consumption. It is possible that the growing disparities, because they are more visible, are more disturbing than the preferential treatment and the material benefits that were enjoyed previously by the communist elite. It is also possible that the inability to afford the newly available goods and services may be, to many, more disturbing than the former shortages and the low quality of the most essential commodities. While these effects are difficult to make precise, it is obvious that rising poverty alongside the accumulation of considerable wealth by dubious means can place great strains on public support for the continuation of the transition process.

An important distinction to be made in this context is between distributional inequalities and the incidence of absolute poverty. Although, as mentioned above, it is likely that there will be some increase in income and wealth inequalities as the movement toward a market economy advances, an increase in poverty, in absolute terms, need not necessarily be a corollary of the transition. But if this is to be avoided in the transition, there must be an emphasis in public policies on the alleviation of poverty. As discussed below, such an emphasis was indeed placed by some countries within the context of their reform programme and while adhering to their own budgetary constraints.

In all the countries, data on the distribution of wealth are more scanty and problematic than those on income and expenditure. The challenges to the analysis of the distribution of wealth in transition economies are even more severe. As in other countries, key elements of wealth are housing, land, financial assets, the ownership of enterprises and pension rights. An analysis of the distribution of wealth, and policies towards it, should focus on these elements. There is no doubt, for example, that the form of privatisation, particularly insider privatisation in natural resource sectors, has had a profound impact on the distribution of wealth. So too have policies on the privatisation of housing and land, and they will continue to do so. At present, however, data are too limited to permit extensive analysis.

The rest of this annex discusses some of the available quantitative evidence on shifting income distributions and poverty, describes certain mechanisms adopted by some countries to deal with the problem, and concludes with a short discussion of the relationships between growth and distribution.

Measuring income and its distribution

An evaluation of the impact of transition on real income and its distribution requires, as a first step, a definition of income and the establishment of methods of measurement. Serious conceptual and practical problems are involved. A basic question is whether income should be compared at the individual or at the household level. As it is very difficult to obtain accurate data on the distribution of income within a household, the distribution of total household income (as opposed to the distribution of individuals' income) is frequently used. Data for households have to be treated carefully, taking account of household size and composition (income per capita is often used but it is problematic). Data for individuals, on the other hand, ignore the household context. Earnings by themselves do not provide an adequate measure of total household income because they omit transfers and taxes and some people in transition economies enjoyed – or still enjoy – many non-pecuniary state-financed benefits and subsidies. These non-pecuniary benefits included access to free health services, child-care, education and subsidised housing. Results using expenditure may look very different from those using income – different conceptual and practical problems arise. Any measure of distribution, including the Gini coefficient used below, depends on the underlying definition of income which is chosen (pre- or post-tax and transfer, comprehensiveness of income definition in relation to sources of income, type of data collection procedures, and so on). Most of these problems of data and interpretation are particularly severe for the transition economies. Hence the need for special caution in interpretation.[1]

Distribution before transition

In the 1970s and 1980s there were wide wage differentials in many countries in the region, particularly in the Soviet Union. Moreover, the political elite enjoyed a privileged life-style and a level of real income far in excess of the average per capita level.[2] Nevertheless, a number of studies conclude that overall income distribution (taking into account non-pecuniary benefits and subsidies, but excluding allowances for scarcities and rationing) was more egalitarian in the communist regimes of eastern Europe than in most market economies (Milanovic [1996], Lydall [1968], and Pryor [1973]).

The regimes which prevailed in communist economies differed substantially between countries and over time. While income equality appears to have been a priority for governments in, for example, Hungary and the former Czechoslovakia, it appears to have been less of a priority for governments in the former Soviet Union.[3] The pre-transition distribution of income was more even in the former Czechoslovakia, Slovenia, Hungary and Poland than in other countries in the region.[4] With respect to individual earnings, Atkinson and Micklewright (1992) find that the former Czechoslovakia, in particular, stood out as having a low degree of dispersion in levels of earnings which remained relatively stable from 1960 to 1990. The distribution of earnings and incomes did not always follow the same pattern. During the 1980s the dispersion in earnings in transition economies became increasingly unequal. According to Atkinson and Micklewright (1992) the income distribution of the former Soviet Union was less equal than that of other transition economies. Although per capita income between 1960 and 1990 was more equally distributed in the former Soviet Union than in the UK, this was not the case for the distribution of per capita earnings.

Distribution of income during transition[5]

Although their starting positions differed widely, all transition economies, with the exception of the Slovak Republic, appear to have experienced an increase in income inequality and poverty between 1987-88 and 1993. An indication of this is the evolution of the Gini coefficient, which measures the expected absolute difference in incomes, relative to the mean, between any two persons drawn at random from the population. When the Gini coefficient is zero, everyone earns the same income. When it is 100, one person earns all the income. The average Gini coefficient for transition economies (based on pre-tax income, except for the Czech Republic, Hungary and the Slovak Republic) rose from 0.24 in 1987-88 to 0.32 in 1993-94[6] (indicating an increase in inequality on this measure). The level in 1993-94 is approximately equal to the mean for OECD countries.

The dispersion of the Gini coefficients across countries has increased. In 1993 the observations for Estonia and Russia, at 0.39 and 0.48 respectively, were at the upper extreme. The Gini coefficient rose between 1988 and 1994 by more than 0.1 in Estonia, Lithuania, Moldova and Russia. In Russia the share of total income earned by the top quintile was 20 percentage points higher in 1993 than in 1988. The Gini coefficient for Russia is now similar to the average for middle-income market economies (about 0.4) whereas the Gini coefficients for Bulgaria and Estonia are similar to the average for OECD countries (0.35). These figures, taken together with the very different experiences of GDP per capita across transition countries, suggest a sharp rise in income differentiation not only within the individual country in transition, but also within the transition countries as a group.[7]

Poverty is not a new phenomenon in transition economies. The extent to which it has been affected by reforms is difficult to measure. This is because there was only limited information[8]

1 In the *World Development Report* 1996, for example, the treatment of these issues varies across countries and time periods.

2 See Atkinson and Micklewright (1992 pp.167-70), Morrisson (1984), Gregory and Stuart (1989) and Michal (1978).

3 By way of example, in 1931 Stalin launched an attack on egalitarianism and sought to reward those who chose to acquire skills. See Atkinson and Micklewright (1992, p.37).

4 See World Bank (1996, p.68).

5 See Milanovic (1996, p.57).

6 Much of the data presented in this section comes from World Bank (1996), Chapter 4 on "People and transition".

7 See Milanovic (1996, p.58), Table 4.1.

8 See, however, Atkinson and Micklewright (1992) Chapters 7 and 8 for a discussion and references to a substantial range of publications on this subject.

about poverty prior to transition. Nevertheless, available data indicate that the incidence of poverty has indeed risen since transition began in earnest, and that household size and composition have a direct influence on poverty in transition economies.[9] In Russia, for example, the incidence of poverty is highest among households with three or more children and among households headed by students, single parents or unemployed people.[10] In Hungary, where unemployment benefits are high, only 17.5 per cent of households headed by unemployed people are poor, compared with 63 per cent in Russia (with the poverty line drawn at monthly per capita income levels of US$ 120).[11]

Other factors affecting the incidence of poverty are the level of education and the holding of assets. In Poland a person with little formal education is nine times as likely to be poor as someone with a college education. In Romania this ratio is 50 to one.[12] Property and land ownership are also important factors. People with access to plots of land – in Armenia and Ukraine, for example – have been able to supplement their income by growing and selling vegetables.

The alleviation of poverty

Some governments in transition economies have placed emphasis on the alleviation of poverty and on the equality of income distribution. Hungary, for example, has seen little shift in the distribution of income between rich and poor during the years of transition. The social welfare benefits (pensions, sick pay, family and child allowances) amounted to around 23 per cent of GDP in Hungary in 1994.[13] Partly as a result of this, the greatest medium-term fiscal challenge facing many countries in transition is to reduce budgetary outlays on social security and health, which absorb a large share of government expenditures. Social expenditures will, in most countries, be subject to upward pressure in the years ahead because of foreseeable demographic developments. The number of pensioners for each 100 employed individuals exceeds 55 in a number of countries in eastern Europe, including Croatia, the Czech Republic, Hungary, Poland and the Slovak Republic – and tops 80 in Bulgaria.[14] A number of countries in the region have begun to tackle this challenge. In July 1995 the Czech parliament passed a law which will raise the pension age for men from 60 today to 62 by the year 2007, and that for women from 53-57 today to 57-61 by the year 2007.[15] On 2 November 1995 Latvia introduced a fundamental pension reform, linking benefits more closely to lifetime contributions. Such reforms will help alleviate fiscal pressures but may add to inequality of income.

Distribution and economic growth

What are the implications of rising inequality and poverty for the future growth of transition economies? Some recent studies of political economy suggest that very high levels of inequality may constrain growth by contributing to political and macroeconomic instability, by reducing the efficiency of low-income workers, and by reducing savings and investment (see Birdsall et al [1995], p.497).[16] In particular, savings and investment may be impeded by income inequality where capital market imperfections constrain the savings and investment opportunities to a greater extent for the comparatively poor than for people with a relatively high level of income and wealth.

Empirical evidence from East Asian economies is consistent with the notion that countries with more equal distribution of income have higher rates of economic growth.[17] Data on East Asia indicate that improvements in income distribution coincide with periods of particularly rapid growth. The Gini coefficient fell in each of the high-performing East Asian economies between 1965 and 1990 (see Birdsall et al p.478). However, the extent to which these empirical findings provide information about the relationship between income distribution and growth is not altogether clear. It is difficult to know whether inequality in East Asia has indeed helped raise GDP growth or whether the causality is the other way around. Another possibility is that both growth and inequality have been favourably influenced by a third set of factors. It is likely that widespread public education and health programmes have helped reduce inequality in East Asian countries. Investment in education is a key to sustained growth because it contributes directly to the enhancement of labour productivity.[18]

Experience and analysis have shown that growth alone may take a very long time to make a significant impact on poverty.[19] They have also shown that educational attainment may help both to stimulate growth and to provide for a more equal distribution of income. It is important, therefore, that the educational emphasis and achievements under the old regime are not abandoned in the wake of the severe budgetary pressures of transition. Similarly, public health and health care are important weapons against poverty. So too is a social safety net. An effective tax system is critical not only for macroeconomic stability but also for financing those policies which are crucial to the maintenance and enhancement of the standard of living of those who may otherwise be the victims of the market-oriented transition.

9 See World Bank (1995, p.12).

10 See World Bank (1995) and Milanovic (1996).

11 Measured at purchasing power parity prices for 1990 (i.e. with the local price level adjusted to that prevailing in the United States in 1990). See *World Development Report* (1996, p.69).

12 See World Bank (1996, p.71).

13 See OECD Economic Surveys - Hungary, OECD 1995.

14 See IMF (1994, p.85).

15 The exact retirement age is linked to how many children a woman has had.

16 There is a range of somewhat inconclusive regression-oriented literature which draws a link between inequality and growth in a cross-section of countries. See for example, Alesina and Perotti (1994), Persson and Tabellini (1994) and Brandolini and Rossi (1996).

17 See Birdsall et al (1995) and World Bank (1993).

18 See, for example, Birdsall et al (1995) and World Bank (1993).

19 See J. Drèze and A.K. Sen (1989), Chapter 10.

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Part II
Infrastructure for transition

Inherited supply, market demands and the environment

3

Provision of infrastructure services in centrally planned economies was distinguished from that in market economies in at least three ways. First, services, such as electric power, water and rail freight transport, were abundantly supplied to enterprises as part of a strategy of directed growth involving a mechanical approach to the "required" inputs. This strategy focused more heavily on expanding inputs than on achieving gains in productivity. As a result, infrastructure services were supplied to enterprises with little regard for their costs of production, including consequences for the environment. Second, with an ideological bias in favour of material production and a neglect of services, there was relatively little investment in telecommunications, despite its potential for improving productivity. Third, basic infrastructure services, such as electricity, water and waste water and urban transportation where available, were provided to households for free or for a nominal charge as part of an approach to allocating resources in which basic consumer goods and services were supplied at prices below costs.

The transition to a market economy thus has profound effects on infrastructure. The provision of infrastructure services must adapt to recognise costs, to meet new market demands and to address concerns for the environment. Tariff levels and structures must adjust to ensure a more socially efficient allocation of infrastructure services and to guide new investment decisions throughout the economy. In some infrastructure sectors, such as railways and electric power, market adjustment involves lower service levels, albeit of greater reliability and higher environmental standards. Other sectors, such as telecommunications and road transportation, must respond to expanding demands. In the old system, infrastructure sectors played a central role in the process of environmental degradation, both through their own production and in their encouragement of wasteful use of resources, particularly electricity and water. Achieving higher environmental standards is an important part of the transition.

This chapter focuses on four infrastructure sectors in transition economies where the imbalances between inherited supplies and market demands and environmental concerns were large and the gaps between administered tariffs and socially efficient prices were wide. The sectors covered are telecommunications, electric power, water and waste water and transportation. To describe supply in infrastructure as inherited refers to the fact that the existing capital stock in infrastructure was, for the most part, put in place under central planning. The flow of new investment has been small relative to this stock, particularly in early and intermediate stages of transition when uncertainty was high.

Assessments of prevailing imbalances in markets for infrastructure services are made in three ways. First, measures of infrastructure network size indicate the extent of inherited supply capacities. Second, changing patterns of demand for infrastructure services relative to GDP or indicators of unmet demands point to the required directions of change in infrastructure supply. Third, tariff levels and structures compared with benchmarks in industrialised and developing market economies identify reform requirements. The chapter also examines the impact of infrastructure on the environment, both under central planning and in the transition towards market principles.

While this chapter aims to characterise key challenges in infrastructure in transition economies, the following two chapters analyse approaches to meeting these challenges. Chapter 4 examines pressures for a more commercial approach to infrastructure and the potential it creates for restructuring infrastructure, including increased investment and access to private finance and greater operational efficiency. Chapter 5 considers government's role in supporting a more commercial approach to infrastructure in the four sectors examined by this Report. This role involves establishing boundaries between competition and regulation in infrastructure and providing effective regulation where competition is not possible.

Before turning to a detailed analysis of infrastructure in transition economies, Section 3.1 briefly examines the ways in which infrastructure can promote the transition. Sections 3.2 to 3.5 analyse the transition-related challenges in telecommunications, electric power, water and waste water and transport. Section 3.6 provides conclusions.

3.1 Infrastructure for transition

Infrastructure has a pervasive influence on the whole economy. Telecommunications, electricity and water are used in the production of virtually every sector of an economy, while transportation is necessary for the distribution of commodities. The quantity and quality of infrastructure services is therefore an important determinant of private sector productivity and output. In fact, there is a strong association between the availability of certain infrastructure – telecommunications (in particular), power, surfaced roads and safe water – and per capita GDP.[1] The relationship involves both the supply side, in terms of the contribution of infrastructure to the generation of higher GDP, and the demand side, as higher incomes in turn generate higher demands for infrastructure services. Infrastructure thus makes an important contribution to expanding output.

[1] See World Bank (1994), Chapter 1.

The impact of infrastructure on transition, however, extends beyond enhancing productivity and output to include the way in which markets and market institutions develop. Many relationships among enterprises and between producers and consumers which were inherited from central planning have not withstood the test of the market, and infrastructure plays a pivotal role in their change. Adequate telecommunications and flexible transportation services, in particular, are necessary for forging new business relationships, including those with trading partners. Infrastructure can also enhance the effectiveness of markets, in particular by lessening the restraining effect of distance on competition.[2]

Promoting higher environmental standards is also crucial to the transition. Infrastructure has a positive impact on the environment largely through waste-water treatment and through an efficient transport network. Raising the effectiveness of waste-water treatment and improving water resource management are major challenges in the region. While problems of urban congestion were to some extent avoided under central planning, the sharp increase in personal transportation in the transition is now raising concerns about them. Infrastructure can also have a negative impact on the environment. The most significant contributors to air pollution in the region are electric power plants, many of which are fired by coal, lignite and oil shale. The safety of nuclear power plants is also a significant environmental concern. Addressing these environmental legacies of central planning is a priority.

3.2 Telecommunications

With a bias towards material production and a neglect of services, central planning placed a low priority on provision of public telecommunications services.[3] Hierarchical network structures reflected concerns for security and bureaucratic control of the economy, with relatively limited access to telecommunications by both enterprises and households. Much of the technology was antiquated (analog rather than digital) and unreliable. While some countries have invested significantly in network expansion in recent years, particularly those taking a commercial approach to the sector, there are long waiting lists for services in much of the region. There is also a definite willingness to pay for services, particularly by business users, despite tariff structures being designed to cross-subsidise household users from the income from business users.

Networks

The size of a country's telephone network is typically measured by the number of telephone lines relative to the size of the population, the so-called network penetration rate. Chart 3.1 shows that the network penetration rates in transition economies are on average similar to those in upper middle-income developing countries with comparable per capita income levels. However, the rates are only between one-quarter and one-half of those in the European Union. The low penetration levels persist despite a belated effort under central planning to place a higher priority on telecommunications services as awareness of their importance to enterprise productivity increased.

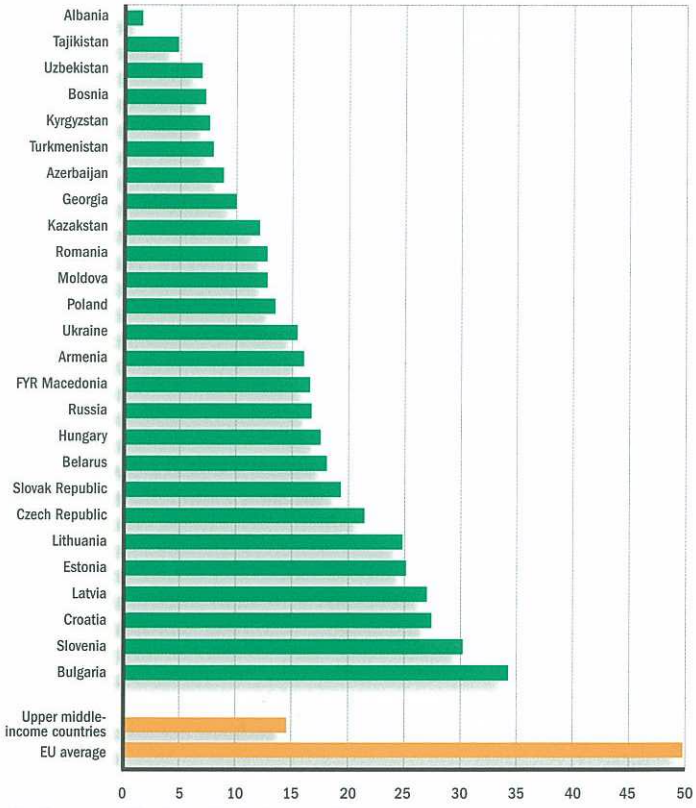
The chart also shows considerable variation within the region. These differences among countries are associated in part with variations in per capita GDP.[4] In part, GDP per capita may serve as an indicator of the extent of a country's rural population, which tended to receive fewer infrastructure services under central planning than urban areas did. It may also reflect the affordability of services in the transition. However, one transition country, Bulgaria, is providing services beyond the level expected from this perspective. This country was a major supplier of telecommunications equipment within the former trading block and pursued a significant expansion of telecommunications under central planning.

While network penetration rates in transition economies tend to be relatively low, at least compared with those in the EU, most countries are currently investing in network expansion, sometimes substantially.[5] The countries with the largest investment in telecommunications networks relative to GNP (at purchasing-power-parity exchange rates) are typically those that have pursued

Chart 3.1

Telecommunications network penetration rates, 1994

Main telephone lines per 100 of population



Source: International Telecommunications Union.

2 See Aghion and Schankerman (1996).

3 See International Telecommunications Union/OECD (1992, 1994a) and Campbell (1995) for analyses of telecommunications in transition economies.

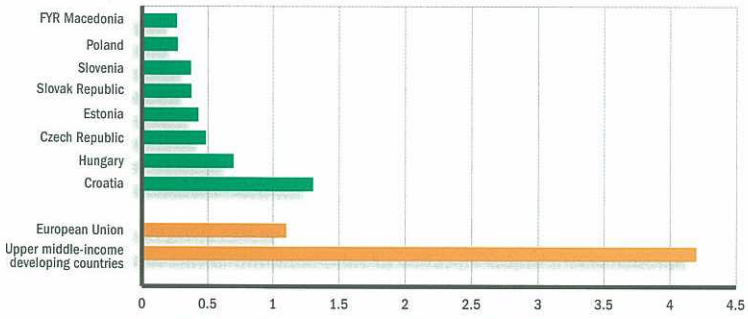
4 See International Telecommunications Union/OECD (1994a).

5 Davies et al. (1995) examines key technological options in expanding telecommunications networks in transition economies.

Chart 3.2

Telecommunications network expansion, selected countries, 1994

Investment in per cent of GNP at purchasing-power-parity exchange rates



Sources: International Telecommunications Union and World Bank.

a commercial approach to the sector (see Chart 3.2). These countries either have opened telecommunications to private sector participation, as in the Czech Republic, Estonia and Hungary, or have strengthened the commercial orientation of public utilities, as in Croatia, FYR Macedonia, Poland and Slovenia.

In terms of quality, inherited networks are burdened with a high percentage of outmoded equipment and high fault rates. The information on faults per number of main lines, a standard measure of service quality, is incomplete for the region. For those countries where data are available, the average is 45 faults per 100 main lines in 1994, compared with an average rate of 34 for upper-income developing countries and 13 for those in the EU. The recorded fault rates in the region, however, range widely, from 10 (Latvia) to 95 (Romania).

The most effective route to increasing service quality is the installation of digital exchanges, and there are extensive efforts being made to replace the most unreliable equipment. The extent to which main lines are connected to digital exchanges is rapidly increasing in some countries, with several (Croatia, Hungary and Slovenia) reaching about two-thirds of the EU average.

Waiting lists and cellular services

Official waiting lists show that between 1 and 8 per cent of the population of transition countries are on a waiting list for network access, but the demand for telephone connections is in all likelihood considerably higher. The average expected waiting time for services is three years, compared with an average of one year in upper middle-income developing countries and less than one month in the EU (see Chart 3.3). With such long waiting times in transition economies, there may well be a significant number of discouraged potential subscribers who have not yet joined the queue for services.

Development of cellular networks in transition economies provides one example of customers' willingness to pay for quick access to reliable services. This willingness is particularly true of businesses and high-income households. While the cellular network penetration rates in transition economies are still comparatively small, the growth rates in the number of subscribers are considerable in some countries. In Estonia, Hungary and Slovenia, these network penetration rates have reached levels which approach those in Belgium, France and Spain. This level of demand has been achieved despite the fact that charges for cellular services are substantially above both those for fixed services in the region and those for cellular services in the EU. Surveys of business users in the region confirm this willingness to pay for quick access to reliable telecommunication services.[6]

Tariffs

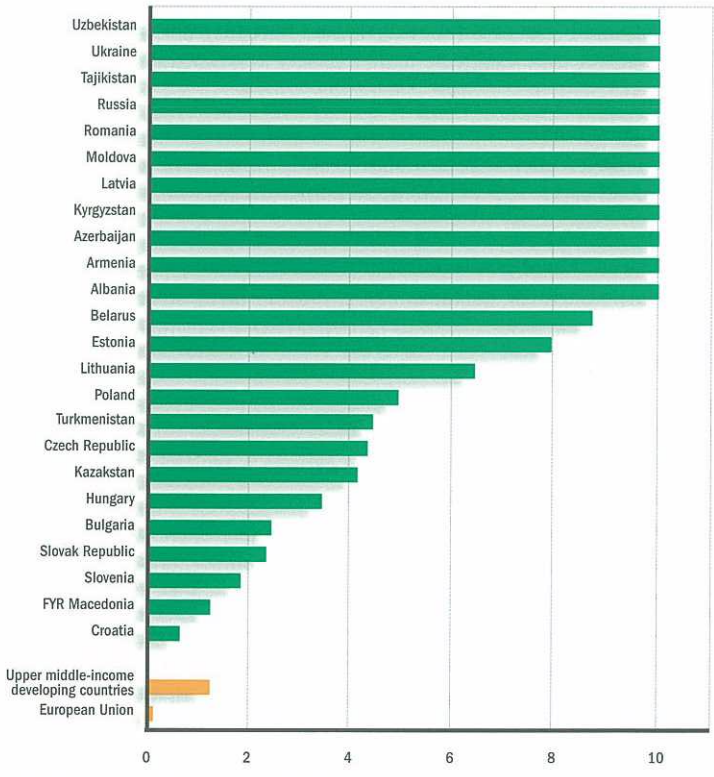
The tariff structure under central planning consisted of subsidised but limited services for households (local calls were largely unmetered and free) while high charges were levied on enterprises for long-distance and international services. However, this tariff structure does not reflect the cost of services, for which the distance of a telephone call is not the dominant factor. The major component of service cost is connection to the network itself.

While detailed data on long-distance and international tariffs are not available, average monthly subscription charges for households and businesses provide some indication of tariff levels and structures. Chart 3.4 shows average monthly subscription charges for both household and business consumers for countries in the

Chart 3.3

Average waiting times for connection to telecommunications services, 1994

In years



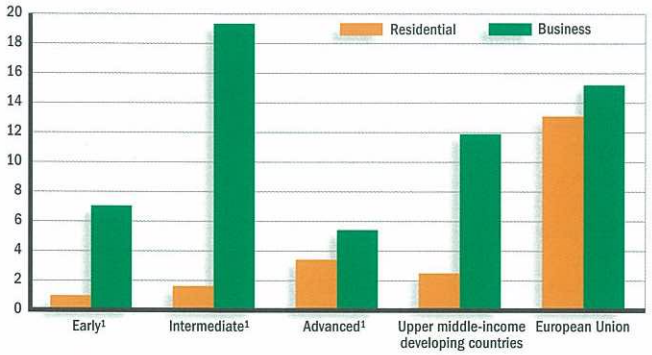
Source: International Telecommunications Union.

6 See International Telecommunications Union (1994b).

Chart 3.4

Average telecommunications tariffs by countries' stages of transition, 1994

Monthly subscriptions in US dollars



Source: International Telecommunications Union.

1 Average of countries for which data are available.

region grouped by their stages of transition.[7] A comparison across these stages reveals how tariff levels and structures have evolved during the transition. As a rule, those countries at more advanced stages of transition have adjusted tariff structures to allow for more balanced charges between households and businesses and have raised the overall level of tariffs. An exception to this rule is the very high tariffs levied on business users in countries at intermediate stages of transition. Nevertheless, tariff levels in countries at advanced stages of transition remain below the average for household and business users in both upper middle-income developing countries and those in the EU.

Tariff rebalancing raises a number of difficult issues. The first is the impact on households paying for the full cost of services. Those countries in the region that have gone the furthest in rebalancing the structure of tariffs and raising their level are also those with higher per capita incomes. Second, there are benefits to all users as more subscribers join the networks. A case may be made, therefore, for subsidising new subscribers, particularly where the density of networks is low, as in transition economies. However, the argument for subsidising access is weaker where there are long waiting times for new connections. In such circumstances, the priority should be on speeding up connection times. Third, competition in international services is beginning to erode the current cross-subsidisation of services. While very high international tariffs continue to provide the bulk of revenues for dominant service providers, the advent of advanced international call-back services, the Internet, and other services are placing strong competitive pressure on international tariffs worldwide.

Together with tariff rates and collection efforts, telephone usage determines the revenue performance of the service providers. In some countries at more advanced stages of transition, dominant telecommunications operators have raised revenue per line substantially. Those countries with the highest revenue per line, in the range of US$ 300 to US$ 400 in 1994, include Croatia, the Czech Republic, Estonia, Hungary, Poland and Slovenia. In comparison, the average revenue per line in the EU is US$ 881, while that in upper middle-income developing countries is US$ 641. The relatively low levels of tariffs in much of the region limit the extent to which internal cash flows and private finance can be raised for new investments.

Summary

Low network densities compared with those in the EU (but comparable with those in upper middle-income developing countries), long waiting times for access to services and clear willingness of some users to pay for access to the service illustrate the significant shortage of telecommunications services in the region. The structure of tariffs falls relatively heavily on businesses and more lightly on households, and the overall level of tariffs remains low in most countries. The need for investment in this sector to expand capacity and to improve service quality is substantial. In the EU, investment in telecommunications in 1994 amounted to about 1 per cent of GNP (at purchasing power exchange rates), while in upper middle-income developing countries the figure was 4 per cent. With investment financing requirements in this range, the necessary expansion in networks will not be achieved without recourse to private finance. However, unlocking this finance will require a commercial approach to telecommunications and credible reform of tariff structures. These issues are taken up in Chapters 4 and 5.

3.3 Electric power

Lenin stated: "Communism is Soviet power plus the electrification of the whole country".[8] Accordingly, central planning in the former Soviet Union and eastern Europe placed a high priority on abundant supplies of electric energy for material production and household consumption. Electricity supply was shaped primarily by quantitative planning requirements, with little attention to costs. With this history, electricity intensity per unit of output in transition economies remains well above levels in industrialised market countries. At the same time, tariffs for electricity generally remain well below levels that are consistent with cost recovery. The structure of tariffs is often inverted in the sense that residential tariffs are below those for industrial users, even though the cost of supplying services is less for industrial users than for households. The electric power sector is a major source of air pollution in the region, particularly in those countries that rely on coal, lignite and oil shale as the primary energy source. Also, nuclear plants in some countries raise important safety issues.

Generation and networks

The installed generation capacities in the countries of eastern Europe, the Baltics and the CIS were designed to meet electric energy requirements prior to the transition. Since demand has declined in most transition economies since 1989, the installed capacity now exceeds present requirements in the region as a whole and in most individual countries. However, many thermal

7 See Chapter 2 for a discussion of measuring stages of transition and the classification of countries.

8 Report of the Eighth All Russia Congress of Soviets on the work of the Council of People's Commissars, 1920.

plants in transition economies are comparatively old and often not well maintained. In addition, the coal and lignite used in these plants are often below the quality for which the boilers of existing power plants were designed. As a result, the effective capacity of power plants is often below their design levels.

The electric power systems in the region are also inefficient in the sense that they use larger amounts of primary energy per kilowatt hours (kWh) of electric energy output than do the power supply systems in industrialised market economies. The overall thermal efficiency of coal- or lignite-fired power stations in the transition economies is usually below 30 per cent and in many cases only in the 20 to 25 per cent range. This compares with thermal efficiencies of about 35 per cent for modern coal-fired plants in the EU and up to 50 per cent for gas-fired combined cycle plants. Furthermore, technical transmission and distribution losses in power supply systems of transition economies are often in the order of 10 per cent of net generation and sometimes as high as 15-20 per cent, whereas in western Europe they are usually between 4-9 per cent.

The structure of power generation by primary energy source varies greatly among transition economies, as it does among industrialised market economies (see Table 3.1). Among those countries that rely heavily on thermal generation, Estonia uses mainly high-sulphur oil shale, while hard coal and lignite together account for 94 per cent of power generation in Poland. Natural gas is the single most important primary energy in the power sector of Moldova, the Russian Federation and Uzbekistan. Two nuclear reactors accounted for 77 per cent of total electricity generation in Lithuania, while the share of nuclear plants in Bulgaria, Hungary and the Slovak Republic is also substantial. Hydroelectric power accounts for over 90 per cent of generation in Albania and Kyrgyzstan.

The transmission system of the former Soviet Union was dominated by the Integrated Power System (IPS), which consisted of six large interconnected regional grids covering the more densely populated parts of the Soviet Union. This system is technically still in operation, although the newly independent countries now operate their own dispatch centres and the volumes of electric energy exchanged between countries have been reduced, as each participant tries to be self-sufficient in electricity.[9] However, imports and exports are significant relative to consumption and production in a few countries, such as Estonia, Kyrgyzstan and Lithuania (net exports), and the western region of Kazakstan and Latvia (net imports). The power grids of the former communist countries in eastern Europe were also synchronised with the IPS. However, in 1992 Poland, Hungary, the Czech Republic and the Slovak Republic formed an association aimed at making a joint simultaneous connection with the continental west European grid, to which they were joined in 1995.

Table 3.1

Production of electricity by primary energy source, 1994

	Total production *GWh*	Thermal	Nuclear *(in per cent)*	Hydro
Transition countries				
Albania (1993)	3,450	3	0	97
Armenia	5,658	38	0	62
Azerbaijan	2,400	0	0	100
Belarus	–	0	0	0
Bulgaria	38,133	56	40	4
Croatia	8,174	40	0	60
Czech Republic	58,705	75	22	3
Estonia	9,151	100	0	0
FYR Macedonia	5,511	87	0	13
Georgia	–	0	0	0
Hungary	33,486	58	42	0
Kazakstan	–	0	0	0
Kyrgyzstan	12,499	6	0	94
Latvia	4,440	26	0	74
Lithuania	10,055	16	77	7
Moldova	8,228	97	0	3
Poland	135,347	97	0	3
Romania	55,136	76	0	24
Russia	875,942	69	11	20
Slovak Republic	24,740	32	49	19
Slovenia	12,681	37	36	27
Tajikistan	–	0	0	0
Turkmenistan	–	0	0	0
Ukraine	202,994	60	34	6
Uzbekistan	47,000	86	0	14
Eastern Europe[1]	375,363	74	16	10
Baltics[1]	23,646	50	33	17
CIS[1]	1,154,721	67	14	19
European Union	2,267,240	51	35	14
United States	3,473,616	72	20	8

Source: International Energy Agency.

[1] Average of countries for which data are available.

Changing demands

In 1994 the electricity intensity of output, as measured by the consumption of electric energy per unit of GNP at purchasing-power-parity (PPP) exchange rates, was twice as high in eastern Europe and the Baltics as in the EU (see Chart 3.5). The electricity intensity in the CIS was even greater, exceeding that in northern America by a factor of two.[10] The electricity intensity in northern America is about 50 per cent greater than that in the EU, reflecting differences in costs of primary energy (including transport costs) and in energy taxation.

Variations in electricity intensity among the transition economies are significant, as they are among the industrialised market economies. The Central Asian countries and Azerbaijan, which are rich in primary energy resources, show on average higher electricity intensities than much of eastern Europe and the Baltics.

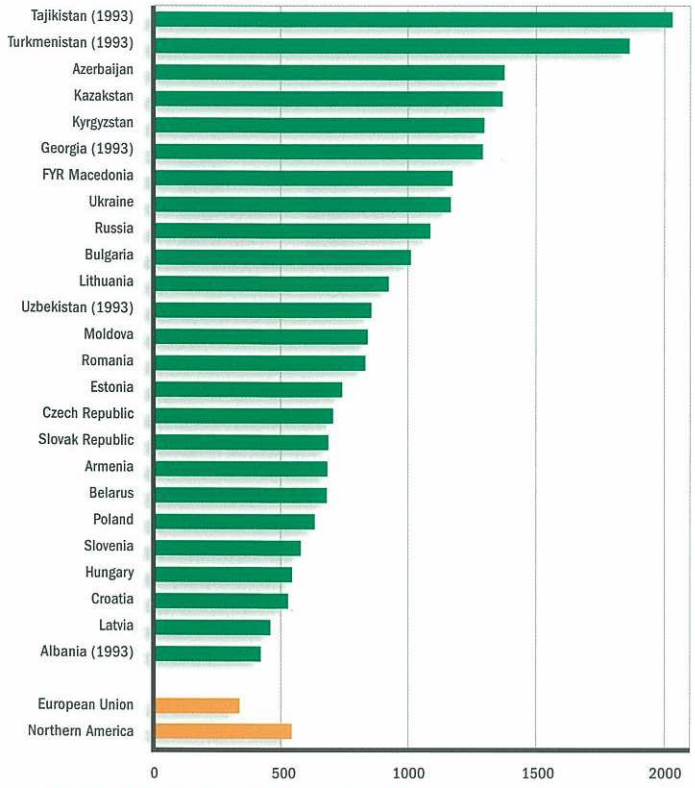
[9] Although this may be politically understandable, it is often not efficient.

[10] Northern America refers to Canada and the United States.

Chart 3.5

Electricity intensity of output, 1994

Electricity consumption per US$ 1,000 of GNP at PPP exchange rates



Sources: International Energy Agency and World Bank.

Two countries in eastern Europe and the Baltics which have relatively high energy intensities (Bulgaria and Lithuania) also rely heavily on nuclear power generation.

In the EU, industry typically accounts for between one-third and one-half of total electricity demand, with households and small-scale commercial users each accounting for about half of the remainder. In transition economies, particularly in the CIS, industry's share of electricity consumption was typically higher at the beginning of transition. In 1990, for instance, industry accounted for 60 per cent of electric energy demand in Russia[11] and 65 per cent of the demand in Ukraine,[12] reflecting the priority attached to abundant supply of power for material production. Much of the high energy intensity of the transition economies can be attributed, therefore, to industry.

Since 1989, consumption of electric power has declined in all countries in the region, with the exception of Kyrgyzstan. The cutbacks have been the greatest in the Baltics, where electricity consumption has fallen by over 30 per cent. In the CIS and eastern Europe the declines have been 22 per cent and 16 per cent respectively (see Chart 3.6). The fall in energy consumption matches the decline in real GDP in eastern Europe as a whole as well as in most countries of that region. However, in the CIS and the Baltics, GDP has fallen much more than electricity consumption. This may reflect in part the difficulties in measuring real output, particularly in the CIS, where statistical coverage of the new private sector is often weak.

While industrial consumption of electric energy has declined substantially in the region, households in transition economies consumed more electric energy in 1994 than in 1989, despite the fall in disposable incomes over the period. The reasons for the increase in residential electricity consumption include the improved access of households to electrical appliances and in some cases a switch from coal and oil to electricity for heating – for example, in cases where primary energy prices have increased relative to effective electricity tariffs.

Tariffs

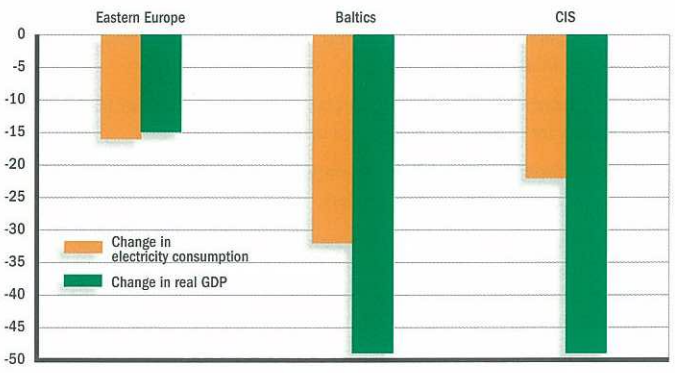
Electricity tariffs should be set at a level which aims to ensure the financial viability of power utilities and to encourage efficient use. Financial viability requires an adequate return on invested capital, with depreciation based on appropriately valued assets. Efficiency in distribution demands that tariffs reflect the cost of supply, including the external costs associated with electricity generation. It is important to recognise that households are more costly to supply than large industrial consumers per unit of electricity. Reasons for this include the higher distribution costs to households and the fact that households contribute much of the peak-load demand, which is normally supplied by the generation capacity with the highest marginal costs.

In most advanced industrialised countries, power utilities are typically financially profitable, although questions are raised as to whether electricity tariffs fully reflect costs, including those associated with pollution and decommissioning of nuclear power plants. In the EU, electricity tariffs average 7 US cents per kWh for large industrial users and 15 US cents per kWh for households. These tariff rates include indirect taxes. The comparable tariffs in northern America are 4 US cents per kWh and 7 US cents per kWh respectively. In other words, industrial tariff rates are between 45 and 55 per cent of those for households in industrialised market economies.

Chart 3.6

Change in electricity consumption, 1989-94

In per cent



Sources: International Energy Agency and EBRD.

[11] See International Energy Agency (1995).

[12] See International Energy Agency (1996).

In gauging the appropriate level of tariffs in transition economies, differences in the costs of primary energy among transition economies, partially reflecting costs of transporting primary energy, must be taken into account. In Russia, Kazakstan and Turkmenistan, fuel costs, which account for a significant proportion of power supply costs, are below those of both eastern Europe and the EU. This difference reflects in part the abundant supply of natural gas, the cost of which is likely to be below the export price (see Box 3.1). In addition, natural conditions allow the exploitation of hydroelectric power at relatively low cost in several CIS countries, such as Kyrgyzstan and Russia. Since the economic costs of fossil fuels and hydroelectricity are also relatively low in northern America, a comparison is drawn between the electricity tariffs there and those in the CIS. Also, as the economic costs of primary energy in eastern Europe and the Baltics are similar to those faced by EU utilities, tariff levels in these two regions are compared. In 1994, the average tariff level in the CIS was about one-half of the level in the United States. Similarly, the average level in eastern Europe and the Baltics was approximately 50 per cent of the average level in the EU.

The level and structure of electricity tariffs in transition economies also varies with progress in transition. Those countries at early and intermediate stages of transition (primarily CIS countries) still have tariff structures which are inverted, in the sense that charges to industrial users are above those for households. In addition, their tariff levels are low in relation to both those in the EU and the United States (see Chart 3.7). Those countries at advanced stages of transition (primarily in eastern Europe and the Baltics) have begun to rebalance their tariff structures between households and enterprises and to raise their levels.

Box 3.1

Trade in natural gas

Some countries in the region produce substantial amounts of natural gas, including Kazakstan, the Russian Federation and Turkmenistan, a significant proportion of which is exported to western Europe. In particular, 10 per cent of Russian gas production is exported, accounting for nearly 25 per cent of western Europe's gas consumption. The domestic price of natural gas, however, is likely to remain below central and west European levels not only because of the transport cost component, but also because of restrictions to the export of the very large volumes of gas potentially available. The volume of exports through the Russian pipeline system to western Europe, eastern Europe and the Baltics is limited by:

- the capacity constraints of existing pipelines and their strategic control by Russian interests;
- the desire of western European countries to limit supplies from Russia for reasons related to the security of supply; and
- the interest of the Russian Federation in restricting exports so as not to depress international prices.

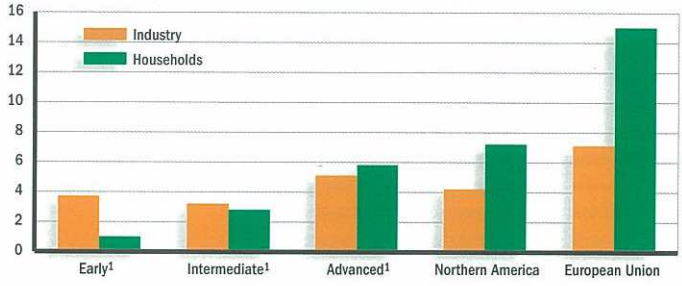
As a result, the economic price of natural gas in Russia and other countries with large gas reserves in Central Asia is likely to remain below the net price of gas from European markets in the near and medium term.[1]

1 See Gray (1996).

Chart 3.7

Electricity tariffs by countries' stages of transition, 1994

In US cents per kWh



Sources: International Energy Agency.

1 Average of countries for which data are available.

With low and inverted tariffs, reflecting in part past use of electricity as a mechanism for distributing benefits and resources under central planning, it is important to recognise that untargeted subsidisation of electricity can be a regressive measure. This adverse effect arises to the extent that higher-income households consume more electricity than do lower-income households, not only on a per capita basis but also as a proportion of income.[13] Thus, it can be more effective to support low-income households with targeted social security benefits.

Within the sector, the provision of a basic or life-line service for households at subsidised tariffs rates can also help to ease the impact of tariff increases on those who are unable to afford cost-reflective tariffs. One way to fund this subsidy is to charge progressively higher tariffs for those who consume greater amounts of electricity.

In contrast to district heating, water supply and waste-water disposal, the technical conditions to charge customers individually for the electricity they consume are available in most transition economies, since electricity meters are widely installed. However, not all electricity consumption in the region is actually metered, billed and paid for on time. "Non-technical" losses, largely theft by way of illegal connections and corruption among meter readers, are common in several countries. Some utilities have difficulty issuing bills on time for metered consumption, and often customers are unwilling or unable to pay for their consumption once a bill is received. Mechanisms for enforcing payments are also weak, with an unwillingness to disconnect users for non-payment. As a result, arrears to power utilities account for a significant share of total payment arrears in many transition economies, with state-owned enterprises and government organisations often incurring the largest liabilities. The discrepancy between effective electricity tariffs in the region and those in industrialised market economies is likely, therefore, to be even larger than is indicated in the above chart.

As a result of low effective tariffs, the demand for electric energy is higher in transition economies than it would be if tariffs reflected

13 See Freund and Wallich (1996).

costs.[14] Not only is this situation inconsistent with the goal of improving demand-side efficiency, the low tariff levels are also an obstacle to mobilising private finance for electricity investments (see Chapter 4). While increased tariffs and improved collection would initially represent additional expenditure for enterprises and households, these steps would make measures aimed at energy efficiency more attractive, easing the longer-term impact on real incomes.

The environment and nuclear safety

At the start of transition, the power sector contributed substantially to the poor air quality in a number of countries in the region. In 1990, sulphur dioxide emissions from power plants exceeded EU levels on a per capita basis by a factor of nine in Bulgaria, seven in Estonia and six in the area of what is now the Czech Republic (see Table 3.2 and Box 2.4). In these three countries local coal, or oil shale in the case of Estonia, is the primary energy source for power generation, and power generation accounts for the bulk of total sulphur dioxide emissions from all sources.

Since there are no consistent data available on the development of emissions, particularly of sulphur dioxide, since 1990, it is difficult to assess the change in air quality in the transition. Indications are, however, that any improvements to date are limited primarily to the effects of reduced thermal power generation. Strict environmental standards have so far tended to be enforced only for new power plant investments. However, where stricter environmental legislation applies also to existing plants, it is likely to be the driving force behind major power sector investments over the coming years, as for example in the Czech Republic and Poland.

The first generation of Soviet-designed RBMK (Chernobyl-type) and VVER 440/230 nuclear reactors are considered unsafe, primarily because they do not have a secondary containment structure. Reactors of these types are presently in operation in Armenia, Bulgaria, Lithuania, Russia, the Slovak Republic and Ukraine. In Lithuania, two Chernobyl-type reactors account for about 80 per cent of total electricity generation, while in Bulgaria and the Slovak Republic the share of the VVER 440/230 reactors in electricity generation is around 20-25 per cent of the total.

Table 3.2

Emissions of sulphur dioxide in selected countries, 1990

	SO_2 from power plants		Power plants as per cent of total SO_2 emissions
	1,000 tonnes	*kg/capita*	
Bulgaria	1,453	173	72
Czech Rep.	1,163	113	62
Estonia	217	141	79
Hungary	430	42	48
Lithuania	105	28	47
Poland	1,589	41	49
Romania	903	40	69
Slovak Rep.	243	46	45
Ukraine[1]	1,690	33	65
European Union	8,600	23	50

Sources: EU Commission and International Energy Agency (1996).

1 Includes emissions from fuel refining and processing.

Fossil-fuel power plants have higher variable costs per kWh of output than hydroelectric and nuclear plants, particularly since fuel costs have increased sharply to near international levels for importing countries since 1989. Where demand for electricity has fallen, utility companies have tended to reduce generation from fossil-fuel plants and to continue using hydroelectric and nuclear plants to the extent possible. As a result, the share of nuclear plants in electricity generation has increased in Bulgaria, Lithuania and Ukraine. Only in Russia has nuclear power generation declined, largely for technical reasons related to the availability and operation of the nuclear plants.

Summary

The main legacies in the power sector are high electricity intensities of output, existing overcapacities of supply facilities albeit needing maintenance and renewal, poor environmental performance and, in some countries, nuclear safety concerns. The inadequate level, structure and collection of tariffs hinders demand-side efficiency and makes private investments in more efficient equipment unattractive. Furthermore, as cash-strapped utility companies are often primarily concerned with the immediate need to purchase fuel to meet demand, they do not have sufficient funds to finance measures aimed at improving the environmental performance and, in some cases, nuclear safety.

3.4 Water and waste water

Although most countries in the region have adequate water resources, an intensive use of water in production and a neglect of the environment under central planning have seriously degraded the quality of this resource in some areas. Water usage by industry and agriculture pushed depletion beyond sustainable levels in parts of the region, while insufficient regard was paid to management of waste water. The provision of piped water and of waste-water facilities for households was free in the former Soviet Union, while tariffs for these services in eastern Europe were at a nominal level under central planning. Tariffs levels and structures for water continue to reflect this history, although those countries at more advanced stages of transition in eastern Europe have witnessed significant real increases in water tariffs in recent years.

Piped water

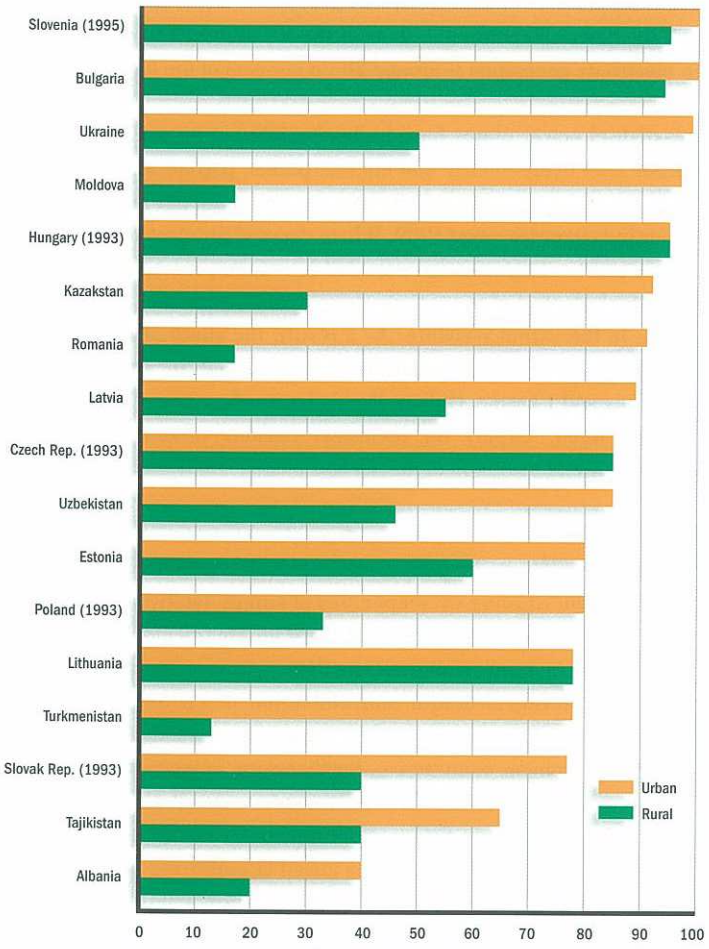
Available data on access to piped water point to significant variation across countries, both within eastern Europe and the former Soviet Union (see Chart 3.8), with two countries having relatively

14 The impact of the low tariffs on demand depends on the price elasticity of demand, which is smaller in the short term than in the long term, when power consumers can adjust the number and type of electrical appliances, production processes and even the location of electricity-intensive industries. Price elasticities within transition countries are difficult to estimate, as the price effects are particularly difficult to distinguish from structural changes in the demand pattern caused by other factors.

Chart 3.8

Proportion of urban and rural population in households connected to piped water supply (1990)

In per cent



Sources: WHO (various years) and Nelson and Sljvijic (1995).

low access to piped water: Albania and Tajikistan. Similarly, within countries, there is often wide variation between urban and rural households in terms of access to piped water. However, in rural areas with sparse populations a decentralised approach to water provision is often more efficient than piped water supply, and this indicator does not capture the extent to which there is access to clean water through wells. It is reported that Russia has relatively high access to piped water, with 75 per cent of the total population and 95 per cent of the urban population connected to piped water supplies.[15]

The extent of connections to piped water, however, is not necessarily equivalent to water delivery, with rationing occurring in some parts of the region. Service interruptions where they occur are due to three main factors: weaknesses in the physical infrastructure, such as leakages and equipment failures; ineffective demand management; and poorly managed or inadequate water resources.

Ageing piped networks often result in leakages, and estimates of water losses for systems in the region where available range from 25 per cent (Lithuania) to 70 per cent (Albania). In comparison, estimated leakages from piped water supplies in industrialised market economies average about 20 per cent.[16] The second factor contributing to service shortages is the lack of effective demand management. The extent of metering varies widely across the region. In most countries of the region, industrial users are metered, but the extent of metering for apartment blocks and individual housing varies widely. Third, the push for growth under central planning was based not only on the accumulation of physical capital, but also on heavy use of available natural resources. The extensive use of water for irrigation in some countries, particularly in Central Asia, and for industrial processing has depleted water resources or damaged their quality.

The quality of water is also important. The most recent region-wide data on water quality are based on analyses conducted around 1990.[17] The analysis showed that water quality in the former Soviet Union measured according to national standards was poorest in parts of Central Asia and the Baltics and Azerbaijan, due primarily to chemical sources of contamination. The extent to which water quality failed to comply with national chemical standards arose largely from the intensive use of fertilisers and pesticides in agriculture, particularly for cotton production in Central Asia, of chemicals in industry, and to a lesser extent naturally occurring minerals in water resources.

Of the more than 3 million people living in areas adjacent to the Aral Sea, only 3 per cent have access to piped water supply, with the remainder supplied from wells providing extremely poor-quality water according to chemical and biological indicators.[18] In six countries – Belarus, Bulgaria, Hungary, Lithuania, Romania and the Slovak Republic – some water sources are highly contaminated with nitrates used in fertilisers.[19] Industry is an equally important contributor to water pollution. In the Ural region of Russia 33 per cent of non-ferrous smelters and 25 per cent of other metallurgical plants discharge directly into rivers without any form of treatment available.

Water demand

Some countries in the region use large volumes of water. In the Baltics, Caucasus and Central Asia, in particular, annual water use of some countries is more than 2,000 cubic metres on a per capita basis (see Table 3.3). In comparison, northern America's per capita use of water is just under 2,000 cubic metres, while in the EU it is about one-third of the level in northern America. Some countries in the region thus use water intensively relative not only

[15] See MDIS (1993), an independent consultants report.

[16] See Foreign Investment Advisory Service (1996).

[17] See World Health Organisation (various years).

[18] High and increasing infant mortality rates, increased morbidity from tuberculosis, oesophageal cancer, cardiovascular and blood diseases, and diseases of the digestive organs have been linked to the poor quality of water supply in this area. See WHO (1995a), p.458.

[19] See WHO (1995a), p.187.

Table 3.3

Annual per capita water use, 1989

In cubic metres

	Households	Agricultural and industrial	Total
Armenia	149	996	1,145
Azerbaijan	90	2,158	2,248
Belarus	94	200	294
Bulgaria (1988)	43	1,501	1,544
Estonia	105	1,992	2,097
Georgia	156	586	742
Hungary (1991)	59	601	660
Kazakstan	92	2,202	2,294
Kyrgyzstan	82	2,647	2,729
Latvia	110	152	262
Lithuania	83	1,107	1,190
Moldova	60	793	853
Poland (1991)	42	279	321
Romania (1994)	91	1,044	1,135
Russian Federation (1991)	134	656	790
Tajikistan	123	2,332	2,455
Turkmenistan	64	6,326	6,390
Ukraine	108	565	673
Uzbekistan	165	3,965	4,130
European Union[1]	79	454	583
Northern America[1]	266	1,470	1,736

Source: World Resource Institute (1996).

1 Most recent year available.

to their population size, but also to the overall level of economic activity. The potential for more efficient use of water thus appears considerable in some countries.

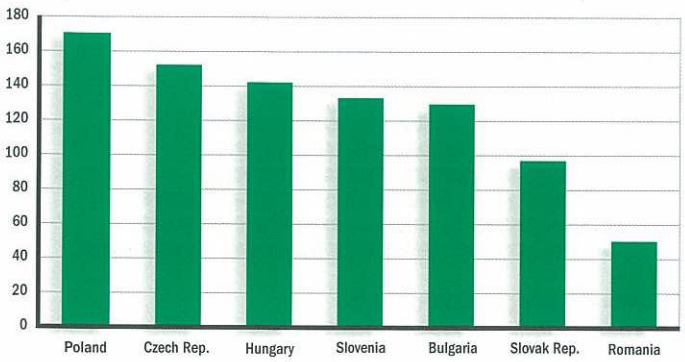
Water tariffs

Under central planning, water and waste-water sectors relied on governments for significant funding, particularly for capital investment. Charges were kept low to convey benefits to households and to encourage production by enterprises. In the transition, responsibility for the provision of water and waste-water services has largely been devolved to municipalities (if not already done so under the old system), while the flow of central government funds has been sharply reduced in most countries. Many municipalities, however, have not raised tariffs sufficiently to cover operating and capital costs. These changes have led to substantial cut-backs in maintenance and investment.

Chart 3.9

Change in household water charges,[1] 1990-94

In per cent



Source: UNICEF (1995).

1 Adjusted for inflation.

National data on changes in water tariffs in real terms between 1990 and 1994 are available for a few countries in eastern Europe, although these figures in all likelihood conceal considerable variation within the countries (see Chart 3.9). One development reflected in these figures is that those countries in eastern Europe that are at more advanced stages of transition have tended to raise water rates in real terms for households by more than those at intermediate stages of transition.

As with other infrastructure sectors, the balance between household and industrial water tariffs also tends to fall more heavily on industry, despite the fact that households account for much of the peak loads for which the systems must be designed. Based on a small sample of water tariffs in the region, the ratio of industrial to household tariffs in 1995 was on average five to one, but ranged widely from one to 20. The relative burden on industry tended to be heavier in the CIS than in eastern Europe.

Effective tariff reform also requires extension of metering if more efficient water use is to be encouraged. This is beginning to occur in countries such as Hungary and Poland. In addition, non-payment for services remains a problem in some parts of the region, and there is often an unwillingness to disconnect enterprises and households for not paying. Lastly, it must be recognised that the pricing of water should reflect not only the costs of treatment and delivery, but also the scarcity value of this natural resource.

Waste water and the environment

In eastern Europe, available data indicate that between one-half and three-quarters of households are connected to sewerage systems, with part of the variation reflecting the extent of rural populations. For many rural households, decentralised systems for collecting and treating waste water are often more efficient than centralised systems.[20] In Russia the sewerage connection rate is 60 per cent for the country as a whole, and 85 per cent in urban areas; similar rates are found in Ukraine.[21]

With respect to treatment facilities, a 1993 survey of five eastern European countries concluded that the level of waste-water treatment was poor.[22] Only 50 per cent of waste water at that time received secondary treatment, and the average efficiency of the treatment systems was 70 per cent relative to their performance potential. Many of the treatment plants were compromised by design flaws, outdated equipment and inadequate monitoring and control systems.

20 See Somlyody (1994) and Nelson and Sljivic (1995).

21 See MDIS (1993).

22 See Somlyody (1994).

The effectiveness of water treatment throughout the remainder of the region is difficult to gauge directly. However, certain health indicators provide an indication of sanitation conditions. A deterioration in the biological quality of drinking water can be associated with the higher incidence of certain types of infectious diseases (cholera, typhoid fever, hepatitis A, gastrointestinal and several parasitic diseases). Data on the standardised death rate from infectious and parasitic diseases suggest that water quality may have fallen during the transition in some parts of the region.[23] While in eastern Europe this health indicator has remained constant or improved slightly during 1989-93, there was a significant deterioration in this indicator between 1992 and 1993 in the Baltics and the CIS.[24] While weaknesses in waste-water collection and treatment may well have been a contributing factor, the deterioration in this indicator may reflect a shortage of medical supplies and a deterioration in public health conditions.

Summary

The main challenges with respect to water and waste-water infrastructure are to maintain and improve existing piped systems and to upgrade the effectiveness of waste-water treatment facilities. Investment in waste-water collection and treatment facilities in industrialised market economies has averaged 1 per cent of GDP over the past 20 years, and the investment needs in the transition economies are substantially greater.[25] The level and structure of tariffs must also be adjusted to reflect more closely costs of service provision. Those countries at more advanced stages of transition have made greater progress in reform of water tariffs. With respect to the environment, water quality in the region has been damaged not only by inadequate waste-water treatment, but also by industrial and agricultural practices. In fact, a number of comprehensive water resource management programmes have been initiated during the past few years at regional level – for example, in the Danube River Basin, Baltic Sea and Black Sea.

3.5 Transportation

The evolution of transport networks in centrally planned economies, as in market economies, was influenced by country size and geography, settlement patterns and population density. These features differ substantially among the countries of eastern Europe, the Baltics and the CIS. However, central planning had a profound impact throughout the region on the composition and location of production and on the effective priority placed on personal mobility. In particular, the strong emphasis on heavy industry and the neglect of transport costs in location decisions led to very intensive use of rail freight services, especially in the former Soviet Union. Passenger services and personal transportation were limited in comparison. In both freight and passenger transport, central planning placed greater emphasis on the level of services than on their qualitative aspects, such as flexibility, logistics, reliability and safety. The environmental implications of transport policies and projects also received low priority. As a result, inherited transport networks in the region have several distinguishing features: a high share of railway services; low levels of motorised transport; low-quality services for both passengers and freight shippers; and safety and environmental problems. As with other infrastructure sectors, there are also significant price distortions in transportation.

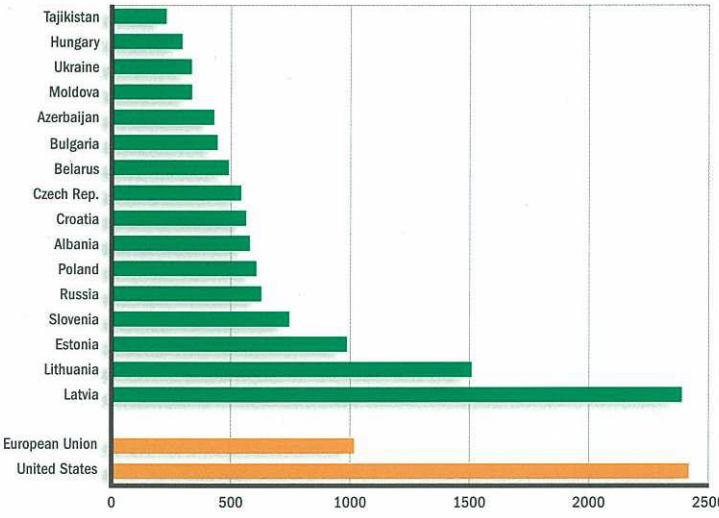
Road and rail networks

Characteristics of transport networks in the region are relatively well-developed railways and limited road systems. The intensive use of railways reflected the central planning emphasis on primary and heavy industries, which created transport requirements for

Chart 3.10

Rail network densities 1993

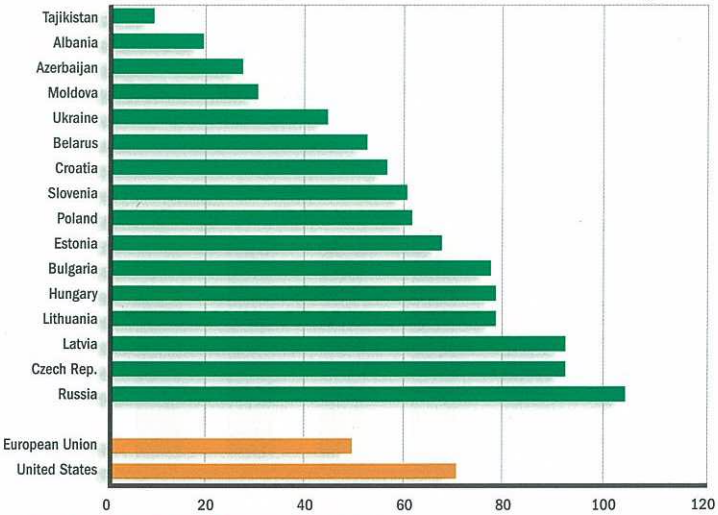
Kilometres of rails per 100,000 of population



Source: International Road Transport Union (1996).

Road network densities, 1993

Kilometres of roads per 100,000 of population



Source: International Road Transport Union (1996).

[23] World Health Organisation (1995b).

[24] Similarly divergent trends in a range of social indicators were reported in EBRD (1995) Chapter 2.

[25] See Somlyody (1994).

bulk commodities. Moreover, industrial production and location decisions gave inadequate weight to transport costs, establishing overly centralised and vertically integrated production facilities and thereby generating an artificially high transport requirement. The capacity and cost advantages of railways over long distances and for bulk cargoes meant that this transport mode was well suited to the freight requirements of central planning. In most countries in the region, railways also provided a high share of passenger transport, not only for long-distance traffic but also for commuter and regional travel. Alternatives were in short supply. Low car ownership, limited bus services and poor roads all added to rail use.

The densities of transport networks are typically measured in relation to a country's population or to its land area. Chart 3.10 provides the densities of railways and roads in the region in relation to population. Two broad features stand out. First, the rail densities are high compared with those in the EU and United States. For example, the Russian rail network density in relation to population is about 50 per cent greater than that in the United States; although, if the densities were calculated in relation to land area, they would be broadly similar. Many countries in eastern Europe and the Baltics also have relatively high rail densities, and their land sizes are roughly comparable to those in the EU.

Second, the road densities in relation to population of most countries in the region are substantially less than those in the EU and the United States. Those countries in the region with high road densities are in the Baltics, which occupied a strategic location within the former Soviet Union.

The quality of the transport networks reflects a number of factors, including their initial design. For example, in the Baltics the major trunk roads run east to west rather than north to south. The trunk roads in the former Soviet Union were also designed for lower vehicle weights than in the EU. This is consistent, though, with the traffic tasks which they had to perform in the past. With respect to railways, design standards are less exacting than those in the EU. However, most rail lines have adequate speeds and are of a sufficient standard for the majority of rail freight services currently provided. Partly as a result of the greater use of rail for bulk freight, passenger speeds are generally lower than on main lines in the EU, offering less competition to emerging road coach and medium-distance airline services. Upgrading existing railway lines to provide higher passenger train speeds in order to compete with road services, however, would involve major investments in track realignment, resignalling, power supply, safety systems and rolling stock.

Another important dimension to the quality of infrastructure is maintenance and renewal. Here, piecemeal evidence points to considerable neglect. In Russia, the extent of rail track subject to speed restrictions, for example, has doubled since 1988 to stand at 20 per cent of the network,[26] while about 25 per cent of tracks in eastern Europe are estimated to be in unsatisfactory technical condition.[27] The latter often serve as major trunk routes for new trading patterns. However, many secondary and branch rail lines with low traffic were probably maintained to excessively high economic standards in the past. With respect to trunk roads, an estimated 38 per cent of the system in Russia requires upgrading or reconstruction, and an additional 25 per cent is in need of resurfacing.[28]

Changing demands

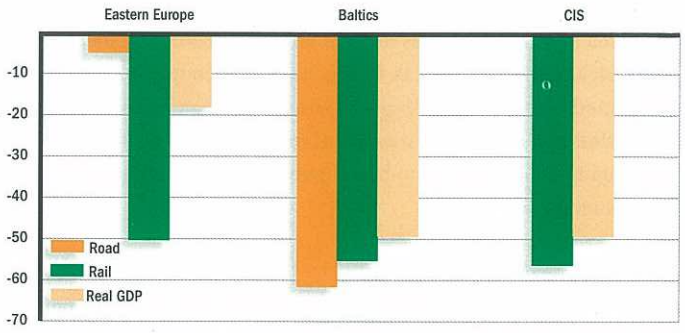
High volumes of freight transport in relation to output characterise transport activities inherited from central planning, with the sector being heavily dominated by rail. In 1988 freight intensity of output in the former Soviet Union (measured in terms of tonne-kilometres of domestic freight per dollar of GDP at purchasing power parity exchange rates) was nearly five times that in the United States.[29] Freight intensity in east European countries were similar to those in the United States, but well above those in the EU. The freight intensity of EU output is about one-third of that in the United States.

In the transition the demand for transport services has changed dramatically. There has been a sharp reduction in overall freight volumes, especially on the railways. Between 1989 and 1994 rail freight volumes declined about 50 per cent in eastern Europe, the Baltics and the CIS (see Chart 3.11). This decline is greater than the fall in real output in these economies, particularly in eastern Europe, pointing to a reduction in the freight intensity of output. However, the trends in road haulage in the region are more diverse. In eastern Europe road haulage fell by 5 per cent from 1989 to 1994, indicating that the proportion of freight carried by road transport has increased. However, in the Baltics road haulage has declined by more than rail. Only very limited data on road haulage in the CIS are available, and these figures point to substantial declines in the initial years of transition.

Chart 3.11

Change in freight transport: 1989 vs. 1994

In per cent



Sources: World Bank Railway Database, ECMT (1996a) and EBRD.

[26] See EBRD (1993a).

[27] See Foreign Investment Advisory Service (1996).

[28] See EBRD (1993b).

[29] See EBRD (1993c).

It is instructive to compare this experience with EU railways, which have faced decades of increasing competition from road haulage and of declining heavy industries. Rail freight transport measured in tonne-kilometres in the EU has declined by about 22 per cent over the last 25 years, while the railways' share of the freight market share has halved to about 15 per cent.[30] The loss of rail freight traffic in eastern Europe, the Baltics and the CIS has had the effect, therefore, of compressing decades of gradual market-driven change in the EU into a few years. The organisation, management structures and operating methods of the railways in the region, however, are very similar to those in the EU 20 years ago. Railways in eastern Europe and the Baltics need to reform at a faster rate and more successfully than EU railways in order to secure an effective long-term role in freight transport.

Even if rail transport is successful in restructuring, road transport can be expected to carry an increasing share of total freight traffic for three main reasons. First, the shift in composition of output away from lower-value bulk commodities towards higher valued products and the location of new production facilities which takes account of transport costs will lead to a fall in the transport intensity of output. Second, with the shift towards higher-value products, road will become more competitive for freight transport in terms of cost and service compared with rail. Third, the road haulage sector will be operating in the private sector and will tend to be more responsive to customer demands. This outlook presents an infrastructure challenge both for road infrastructure providers and competing rail networks.

Changes in the scale and nature of demand for passenger travel also drive infrastructure needs. There has been a sharp increase in automobile registrations in the region, albeit from low levels. Personal mobility, measured by annual kilometres travelled per capita, was significantly lower in the centrally planned economies than in the EU. In eastern Europe and the Baltics the number of registered vehicles is now between 20 and 30 per cent above its pre-transition levels. Limited data from the CIS point to increases in registered vehicles ranging from 15 to 30 per cent.[31] These increases coincide with greater production within the region and liberalisation of imports from the EU, including second-hand vehicles. However, the rising cost of motoring, with fuel prices rising towards market levels, has had the effect of moderating the use of vehicles. Nevertheless, as living standards increase, it can be expected that car ownership will surge. In urban areas in particular this will create environmental pressures and tend to have a damaging effect on surface-based public transport unless policies are pursued to protect it.

Airports and ports

In aviation infrastructure there is an adequate supply of airports, but runways are deteriorating, passenger terminals need upgrading, traffic control equipment needs replacing, and environmental measures need strengthening. Much of the infrastructure required for ancillary activities, such as customs and immigration, air cargo, catering, baggage handing and connecting surface transportation, is lacking compared with market needs.

Similarly, ports are in need of modern, better managed facilities to serve traffic for which sea transport has a significant cost advantage over surface transport, such as dry and liquid bulk cargoes or containerised cargo. There is generally a need for upgrading of existing ports. However, given the right institutional and management change, much of the port infrastructure, such as at St Petersburg and Novorossisk, is capable of handling a substantial increase in traffic without major investment.

Cost-reflective tariffs and prices

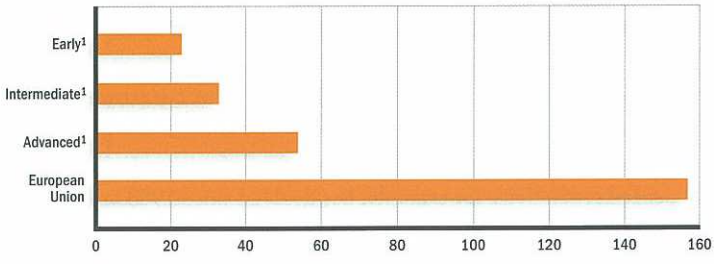
Historically, most railway systems in the region had higher rates of operating cost recovery than their counterpart public railways in the EU, mainly due to the much higher freight traffic intensities arising out of centrally planned production. Despite recent traffic reductions, rail freight still returns a margin above operating costs in many countries in the region, but there is increasing difficulty in earning sufficient revenue to fund renewal of infrastructure. This shortfall is partly due to higher costs, but also to governments requiring, or encouraging, freight services to support passenger services in an effort to cushion the impact of falling household incomes while not impacting on the government budget. The result is a significantly inverted structure of railway tariffs.

In the EU, passengers' fares are about 55 per cent higher than freight rates. In the advanced transition economies, this tariff structure is inverted, with passengers' fares about 55 per cent below those for freight in 1993.[32] The inversion in tariffs is even greater for those countries at intermediate and early stages of transition (see Chart 3.12). These cross-subsidies threaten to overprice freight and prompt its shift to road transport, thereby reducing the resources needed for railway renewal and improvement. Many railways in the region advocate EU policies, which prescribe that loss-making services should be operated under contractual arrangements, including financial compensation from the relevant authorities (municipalities for urban services, regional governments for rural services, and central governments for intercity services).

Chart 3.12

Ratio of average passenger fares to average freight rates, by countries' stages of transition, 1993

(total passenger revenue/passenger km) to (total freight revenue/tonne-km) in per cent



Source: World Bank Railway Database.

1 Averages for countries for which data are available.

30 See Commission of the European Communities (1996).

31 Information provided by DRI/McGraw-Hill from their database.

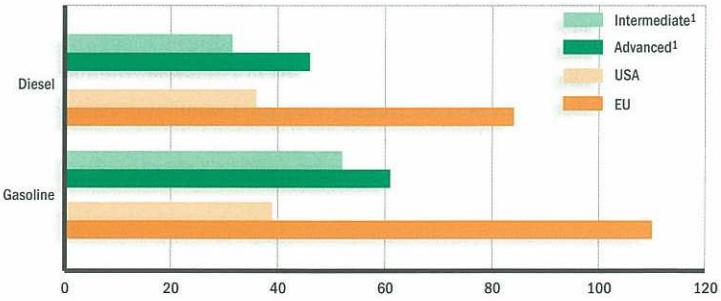
32 See Thompson and Fraser (1996).

Road expenditure has been traditionally financed from earmarked taxes on road users, including taxes on fuels and lubricants. Chart 3.13 provides data on fuel prices in the transition economies, along with those in the EU and the United States. These figures indicate that gasoline prices in countries at advanced stages of transition have already risen above US levels. In countries at intermediate stages of transition, gasoline prices are also above US levels, but diesel prices are relatively low. Nevertheless, fuel prices in the region remain at less than one-half of those in the EU, where fuel taxes are much higher than in the United States.

Chart 3.13

Diesel and gasoline prices by countries' stages of transition, 1995

In US cents per litre



Sources: GTZ, Energy Detente and World Bank.

1 Averages of countries for which data are available.

Safety and the environment

While there are safety challenges for all modes of transport in the region, the largest existing and potential problem, in terms of people at risk, relates to road use. The number of annual deaths in the transition economies due to traffic-related accidents compares unfavourably with that in the EU. In eastern Europe the number of deaths relative to the number of registered vehicles exceeded that in the EU by a factor of three in 1994.[33] A similar difference exists for the number of traffic-related deaths in relation to distances travelled. Fatality rates on Russian roads are between four and five times higher than those in western Europe and the United States.[34] With the increased registration of passenger cars and the projected expansion in road haulage, there is a need to improve safety in the design of both vehicles and roads as well as improve drivers' awareness of road safety.

As with safety, environmental problems beset all transport infrastructure providers. In the railway industry environmental regulations are being strengthened to try to tackle the specific problems of track contamination, the damage caused by lubricants and weedkillers, and the impact of new line construction. Ports and airports suffer from similar kinds of environmental problems as well as the impact of aircraft noise at airports and the effect of spillage on marine life in ports.

The rapid growth in the size and use of vehicles, the average age of vehicles, and the vehicle technology in use have focused attention on the environmental impact from road transport. Air pollution from motor vehicles is now a growing concern in some cities, such as Warsaw, Budapest and Prague. Authorities in a number of east European countries have set emission standards for new vehicles that comply with EU standards, but the main problem remains control of emissions from vehicles already in use, which form the majority of vehicle ownership. Engine retrofitting and the development of well-targeted vehicle inspection and maintenance programmes are cost-effective ways to address this problem.

In order to curb the impact of congestion and air pollution in cities, a balanced urban transport strategy is required. Many urban transport systems in the region have been squeezed by devolution of responsibility to local governments with weak revenue bases, a reduction in central government funding for their operation, and high levels of fare evasion. Many of the region's metro, tram and trolleybus networks suffer a backlog in maintenance renewal, with no resources available for upgrading or system extension. The difficulty of establishing creditworthiness of city authorities has made it difficult for them to raise external funds for urban transport investment.

Summary

The main legacies in the transport sector are a functional mismatch between the components and quality of the transport infrastructure and market demands. In the reorientation of transport services, there has been a sharp decline in demand for freight services, which in eastern Europe has fallen particularly heavily on the railways. Given the shift in composition of output toward higher value-added products and the increased demand for personal transport, there is likely to be a shift towards greater reliance on road services. Estimates of annual investment requirements in east European road and railway rehabilitation and development, including the EU's Trans-European Network initiative, range between 2 and 3 per cent of east European GDP over the next decade.[35] However, the current structure of railway tariffs and fuel taxes runs the risk of encouraging an excessive substitution of road for rail-based services, and this should be realigned. The increased reliance on roads also raises a number of safety and environmental concerns, including increased urban congestion and air pollution.

3.6 Concluding remarks

This survey of the inherited infrastructure capacities, market demands for services and environmental concerns associated with infrastructure point to several common themes. First, there are significant imbalances between supply and demand in most infrastructure sectors. Service provision is clearly inadequate, in terms of either quantity or quality, in the telecommunications and water and waste-water sectors, and is likely to become increasingly insufficient in road transportation. In contrast, the electric power and railway sectors are characterised by excess supply, at least in relation to notional capacities, with each sector having experienced sharp declines in the demand for services in the transition.

33 See ECMT (1996b).

34 See World Bank (1993).

35 See Gaspard (1996). This EU initiative aims to facilitate integration of key European infrastructure networks.

As with many industries in transition economies, infrastructure requires substantial restructuring. This overhaul requires much greater efficiency in the use of existing infrastructure assets. In those sectors where there are significant new demands, investment in additional capacity is also needed. However, in those sectors where inherited infrastructure capacity is adequate, any investments must aim carefully to meet market demands, such as for improvements in service quality and environmental concerns, rather than past central planning priorities. Chapter 4 examines the potential for a more commercial approach to infrastructure to promote this needed restructuring.

The reform and effective collection of tariffs are crucial in both balancing the supply and demand for infrastructure services and achieving the financial viability and accountability of infrastructure service providers. The overall level of tariffs tends to be below that which allows for cost recovery, particularly in the electric power and water and waste-water sectors and, to a lesser extent, in telecommunications. Moreover, the structure of tariffs weighs more heavily on enterprises than on households in all sectors. This reflects the role of infrastructure in allocating benefits and resources under central planning and strong public resistance to rebalancing tariff structures. There is also a significant problem with non-payment for services by both enterprises and households in a number of countries. Tariff reform is an important challenge for government policy, and this issue is considered in Chapters 4 and 5.

Lastly, infrastructure has a strong impact on the environment. Coal, lignite and oil-shale fired electric power plants are a major source of air pollution in the region, and the effectiveness of waste-water treatment is often inadequate. Nuclear safety is also a significant issue in several countries. At the same time, the increased reliance on road transportation in the transition is raising concern about urban congestion and air pollution in some cities. Managing the environmental legacies from central planning and the environmental consequences of the market are important regulatory challenges. Again, these issues are taken up in Chapter 5.

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Commercial infrastructure: pressures and potential

4

The public provision of infrastructure services has been widespread in all economies. This approach is commonly followed because infrastructure consists of, or is at least perceived to consist of, natural monopolies and because unregulated private provision can lead to monopoly pricing or failure to benefit from economies of scale. Infrastructure activities are also seen to be strategic in the sense that they are crucial to the functioning of all economic activity and to everyday lives. Thus, governments have recognised a responsibility for infrastructure and, in many cases, it was assumed that this responsibility implied public ownership and provision. Lastly, infrastructure can have significant spillover effects on the environment, which some have argued can be taken into account only in a system of public ownership.

It is now increasingly recognised, however, that these considerations do not automatically imply that public ownership and provision are the right answer. There is a great deal that can be done through private participation in infrastructure, particularly where there is scope for competition among, or effective regulation of, service providers. Where private participation is not considered possible, governments are taking an increasingly commercial approach to publicly provided services.

This chapter analyses the development of a more commercial approach to infrastructure in transition economies, where there is a pervasive legacy of using infrastructure to distribute benefits and resources under central planning. It examines the main elements of this approach (commercialisation of public utilities, selective private entry and privatisation), how their application varies across infrastructure sectors and stages of transition, and the extent to which this approach is supported by private finance. Chapter 5 considers how governments can support a commercial approach to infrastructure by defining boundaries between competition and regulation in infrastructure and by establishing effective regulation where competition is not possible.

While weaknesses in publicly provided infrastructure in market economies have spurred a search for private alternatives in these countries, infrastructure in transition economies is particularly distorted by decades of central planning.[1] There is a significant mismatch between what remains largely an inherited supply of infrastructure services and new market demands and concern for the environment. Achieving a balance between supply and costs, on the one hand, and market demands and environmental concerns, on the other, will require substantial restructuring, including new investment, more effective management and greater efficiency. Tariff levels and structures also diverge significantly from those that reflect efficiency considerations and fiscal constraints. Tariffs that reflect costs are necessary to guide both market demands for infrastructure services and investment decisions throughout the whole economy.

This chapter examines the potential for commercial infrastructure to help overcome the legacies from central planning in infrastructure and the weaknesses of public provision. It argues that this approach can be instrumental in two ways. The first is to provide some insulation from political influences. The sheltering of infrastructure from excessive political intervention is necessary both to achieve cost-reflective tariffs and to unlock access to private finance for needed investments. Due to severe fiscal strains associated with transition, few governments in the region are in a position to expand public finance for infrastructure, and, in fact, many governments have sharply reduced public investment in the transition. The second is to promote restructuring by selecting the most capable service providers and strengthening their incentives. The selection of managers for infrastructure enterprises under central planning was influenced not only by the distorted priorities of the old system, but also by the way in which bureaucracies operate.

This chapter also examines the relationship between the environment for private investment and the extent of private participation in infrastructure. Development of this environment is measured using the EBRD's transition indictors. This analysis finds a strong relationship between progress in transition and private participation in infrastructure. Lastly, the sources of, and challenges in, private finance for infrastructure in transition economies are examined. Impediments to private finance are identified in part by considering the EBRD's role in financing private infrastructure projects.

Section 4.1 of this chapter considers the strengths and weakness of public and private provision by drawing on available evidence from market economies and by analysing the specific circumstances of infrastructure in transition economies. The second section examines experiences with commercialisation of public enterprises in transition economies and progress in expanding private participation in infrastructure. Section 4.3 analyses the relationship between progress in transition and private participation in infrastructure. The fourth section assesses the potential for, and impediments to, private finance of infrastructure in transition economies. Section 4.5 provides conclusions.

4.1 Public provision and private participation

The strengths and weaknesses of public and private provision of infrastructure services vary across market or regulatory structures and infrastructure sectors. This section brings together available evidence on experiences in industrialised and developing market

[1] See Chapter 3.

economies with these two forms of provision. Infrastructure in transition economies is then examined in view of this evidence.

Considerations and evidence

While competition or effective regulation in infrastructure can exert a strong discipline on firms through strengthened incentives and market selection of service providers, be they publicly or privately controlled, there remain several potential differences between public provision and private participation. These differences arise in two basic ways. The first set of differences arises through the objectives pursued by public and private firms and the constraints they face in their operations. The second set emerges from the potential for public and private firms to influence the market or regulatory structures in which they operate.

The objectives and constraints of public and private firms can differ in a number of ways. Public ownership can divert the objectives of infrastructure enterprises away from commercial principles and well-specified policy objectives towards meeting, in a sometimes haphazard manner, a wide range of political pressures which governments face. For example, public investment in infrastructure is often misdirected, reflecting political rather than economic priorities. The tendency of governments to favour new projects at the expense of maintaining existing infrastructure is one example. Public ownership can also impose constraints which undermine the efficiency of operating and investment decisions. Examples of public enterprises in market economies with overstaffing and weak internal incentives due to limitations on dismissals and pay are legion. Fiscal constraints on public investment can also lead to foregone investment.

Private ownership of firms too can fail to deliver a strong commercial orientation. This weakness often arises in the absence of effective corporate governance or in the presence of monopoly.

The potential for public and private firms to influence market or regulatory structures differs as well. For example, a public firm operating in a competitive market with free entry and exit against a number of private competitors (facing hard budget constraints and similar cost structures) would in principle be unable to survive unless it pursued only the objective of profit maximisation and shed any political or social constraints that impeded its operational efficiency. However, would a government allow a public firm to exit from the industry or would it seek to sustain its operations by softening its budget constraint? The answer depends on the government's objectives and the pressure it faces. A public firm with a soft budget constraint can readily use this advantage to restrict competition.

Another example is government regulation of a private monopoly. In this case, a regulatory institution must stand in the place of the impersonal arbiter of the market in balancing the interests of the private producer against those of consumers. The potential for regulatory institutions to be captured by a private monopoly with substantial resources is considerable, where capture refers to the regulator's loss of impartiality between consumers and producers. As a result, the ability of such institutions to reconcile effectively these pressures and to maintain their impartiality and legitimacy is often questioned.

Evidence from industrialised and developing market countries shows some of the interactions that may occur in practice between ownership, efficiency and market structures. In a competitive market a high-cost producer can in principle remain in the industry only if it can ignore the threat of exit or take-over. Evidence from around the world consistently shows that in competitive markets the relative profitability and operating efficiency of private firms is greater than that of state-owned firms operating in the same markets.[2] These results mean that governments are often willing to tolerate below-market returns on their invested capital in public enterprises or to subsidise their operating costs. These foregone returns or subsidies are mirrored by organisational slack within these enterprises, and it is often the case that public enterprises are run for the benefit of managers and employees and not for that of customers or government.

The evidence on public versus private ownership of firms operating in monopolistic market structures is more difficult to evaluate in terms of cost efficiency, investment, pricing and profitability. To make such judgements, it is necessary to measure carefully the impact of alternative ownership structures not only on producers but also on consumers and governments. A recent set of 12 case studies of privatisation, including a number of firms operating in non-competitive markets, found that in all but one case privatisation yielded overall welfare gains.[3] These benefits came primarily from improved productivity and increased investment following privatisation. They occurred in both non-competitive and competitive markets, in part because the regulatory framework for these particular monopolies were effective both in allowing private firms to operate efficiently and in protecting consumers.

While available evidence points to potential efficiency gains from private as opposed to public ownership, particularly in competitive markets, the effectiveness of governments in regulating private monopolies has a chequered track record.[4] One prevailing view is that small, well-organised groups (frequently producers) tend to benefit more from regulation than large, diffuse groups (frequently consumers). The failure of regulation to achieve the goal of social efficiency contrasts sharply with the benefits from infrastructure deregulation in the United States, particularly in the transportation sector where there is significant scope for competition between modes of transport. Estimates of the benefits from deregulation amount to between 7 and 9 per cent of the output of the formerly regulated sectors.[5]

2 See Vickers and Yarrow (1988) and Vining and Boardman (1992).

3 Galal, Jones, Tandon and Vogelsang (1994) examine the impact of 12 major privatisations in Chile, Malaysia, Mexico and the United Kingdom.

4 See Klein and Roger (1994). Chapter 5 discusses specific regulatory issues related to infrastructure in the transition economies.

5 See Winston (1993).

There are also examples of regulatory failures in the transition economies, where experience with such institutions is largely absent. For example, the initial institutions responsible for regulating natural monopolies in the Russian Federation (Department of Prices in the Ministry of Economy and the Federal Energy Commission) appear to have been dominated by the interests of producers, such as Gazprom (natural gas) and various elements within the government.[6] In other countries in the region, however, consumers of infrastructure services, such as electricity, appear particularly effective in preserving subsidised services.

The evidence from industrialised and developing market economies thus points to the conclusion that private ownership contributes to greater operational efficiency and investment provided that firms face market competition or effective regulation. These benefits arise largely from the strong commercial focus and hard budget constraints achieved under private ownership. However, where competition in infrastructure is not possible, the design of robust regulatory institutions is important to achieving benefits from private participation. This consideration takes on particular significance in infrastructure in the transition economies, where there is no recent history with such institutions.[7]

Infrastructure in the transition economies

While available evidence points to potential benefits from private participation, it is important to identify key factors when deciding on whether to expand private involvement in infrastructure in transition economies. The evidence presented in Chapter 3 shows that infrastructure capacities in transition economies diverge widely from market demands and concern for the environment. As a result, infrastructure must be substantially restructured, requiring new investment, more effective management and greater efficiency. Tariff structures also continue to be heavily influenced by the use of infrastructure as a way of distributing resources under central planning, which encourages inefficient use of services, distorts investment decisions and impairs financial viability of infrastructure enterprises. An important challenge for commercialisation and private participation in infrastructure in transition economies is whether they can help to overcome these key problems.

There are strong arguments for tariff levels and structures that reflect both the economic costs of providing services, including external benefits or costs (e.g., new land use opportunities or pollution) and the financial constraints of governments. Efficiency in the use of infrastructure services is an important social objective, and the main way to achieve it is through tariffs that reflect the incremental economic costs of providing services. Private participation in infrastructure can promote more socially efficient tariffs, by creating a constituency for their implementation.[8]

A more commercial approach to infrastructure, in turn, can help to unlock private sources of finance for investment through greater financial viability. A major constraint on infrastructure investment in transition economies is the lack of access to finance. This impediment arises both from the strains on public finances in the transition and from the continued reliance on infrastructure as a means of distributing benefits and resources to households and enterprises.

Infrastructure in transition economies also requires greater operational efficiency on the part of infrastructure enterprises themselves. This issue is largely the same as with state-owned enterprises in market economies, with the difference that past priorities and the neglect of certain infrastructure sectors under central planning extended not only to investment but also to the allocation of labour skills, in particular technical experts and skilled managers. The selection of enterprise managers was also strongly influenced by bureaucratic and political considerations. As a result, there are considerable variations in the organisational efficiency of existing infrastructure enterprises both across and within sectors. Private participation and market selection can thus play an important role in improving efficiency.

Tariff reform and political influence

Evidence of distorted tariff levels and structures for infrastructure services and effectiveness of tariff collection presented in Chapter 3 reveals an important aspect of an uncommercial approach to infrastructure in the region. It is not easy for governments to overturn the legacy of using infrastructure to control the distribution of resources and of allowing soft budget constraints for enterprises. A new approach involves upsetting consumers with higher tariffs and more determined collection.

Such changes can be facilitated, however, by complementary policies, such as carefully targeted social safety nets. These expenditures, of course, must be funded with taxes which should be designed to create as few distortions as possible. It is likely to be much more efficient to focus policies for the distribution of resources on households rather than on producers. In particular, the efficiency losses associated with raising revenues through value-added and income taxes and targeting social benefits are likely to be much less than those associated with distorted consumption and investment due to the continued transfer of resources through infrastructure. In those countries at more advanced stages of transition such complementary tax and social expenditure reforms are under way.[9]

Within the infrastructure sectors themselves, it is also possible to ensure access to basic services to those most in need. This support can take the form of basic minimum or lifeline services at subsidised rates for those households that cannot afford to pay tariffs that reflect the costs of services.

Even with the implementation of such complementary reforms, overcoming public resistance to cost-reflective tariffs can remain a

6 See Capelik and Wilson (1995).

7 See Chapter 5.

8 This point is similar to the political economy arguments made for privatisation in transition economies. See Frydman and Rapaczynski (1994), Chapter 6, and Boycko, Shleifer and Vishny (1995).

9 See World Bank (1996a), Chapter 4.

challenge. Pressure from both households and enterprises is likely to be particularly strong in the electricity, water and rail transport sectors, where the delivery of services in the past was adequate and the tariffs were low. There is also a history of customers being lax in making payments and of a lack of effort in tariff collection and enforcement.

In telecommunications, however, surveys indicate a high willingness to pay for service access, particularly among business users. Households and enterprises were extensively rationed in their access to telecommunications services under central planning, and popular resistance to cost-reflective tariffs appears to be less than in other infrastructure sectors.

Initial steps towards mitigating political pressure can involve the commercialisation of infrastructure enterprises. Commercialisation refers to reforms in the oversight of, and incentives within, state-owned enterprises in order to simulate the practices of private firms. These changes include legal incorporation and exposure of state enterprises to commercial laws and bankruptcy; selection of an agent with clear responsibilities and accountability for representing the state as the owner of government enterprises; transparent procedures for selecting enterprise managers; and managerial incentive contracts based on performance measures. However, the government still retains considerable discretionary control over state enterprises even with such reforms.

A further instrument for reducing political pressures is to introduce private participation, thereby adding a clear and consistent voice for cost recovery and efficiency in tariffs.[10] Where competition is possible, private participation reinforces and sustains the market's efficiency in setting prices by helping to ensure that all producers face hard budget constraints. Even under effective regulation by government, a private firm is relatively insulated from political influences compared with a public enterprise. This insulation arises from the fact that in order to attract private finance for (generally irreversible) investments in infrastructure assets, governments must first put into place institutions to protect private property rights, including those for credible regulation.

While effective regulation can constrain private enterprises to pursue carefully specified social objectives, their ownership status serves to insulate them from political pressures beyond the contractual terms of the regulations. When government is both the owner of the service provider and regulator, it retains more scope for involvement in directing the activities of infrastructure enterprises. It is, therefore, the respect of private property and contracts that serves to insulate private, albeit publicly regulated, infrastructure enterprises from excessive political influence.

Limited public finances and investment

Fiscal revenues have fallen sharply in the transition, placing a tight constraint on government capital expenditures.[11] Under central planning, the enterprise sector provided the bulk of revenues through a mixture of turnover, profits and payroll taxes. In transition, however, the enterprise sector experienced steep falls in revenues and large losses with abrupt shifts in relative prices, increased competition and sharp output declines. Wages and interest rates were also liberalised, further impairing enterprise profitability. The tax base withered, tax arrears spread and revenues dried up. To provide buoyancy to revenues, tax reforms have been implemented and tax administration improved, although it remains weak with coverage of the emerging private sector a major challenge. As a result of these measures, government revenues as a share of GDP have appeared to stabilise in many transition economies, albeit at significantly lower ratios compared with the pre-transition period.

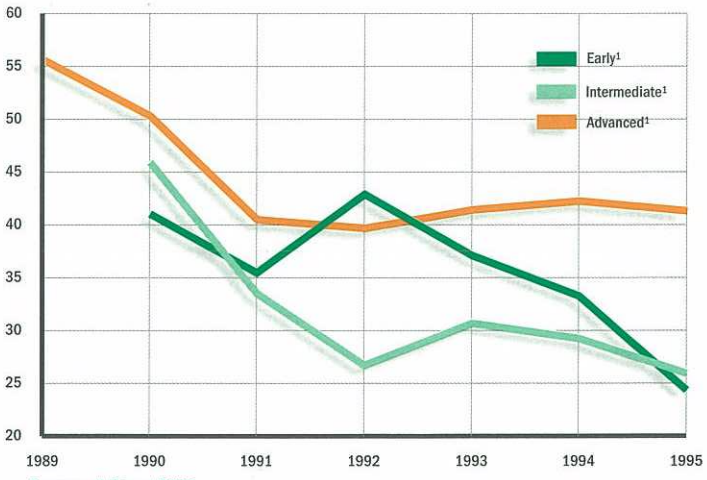
Chart 4.1 shows the government revenue performance of countries grouped by their stages of transition as measured by the EBRD's transition indicators.[12] The countries that have experienced the smallest decline in government revenues relative to GDP are those at advanced stages of transition, followed by the countries that have been the most hesitant reformers and that remain at the early stages of transition. The largest declines have been experienced by those at the intermediate stages of transition. This group includes Kazakstan and the Russian Federation, where reversing the continued deterioration in revenues remains an urgent priority.

When faced with extreme fiscal pressures, governments often defer capital expenditures, and those in transition countries have proved no exception. However, interpreting trends in government capital

Chart 4.1

Government revenues by countries' stages of transition

In per cent of GDP



Sources: IMF and EBRD

1 Averages of countries grouped by stages of transition for which data are available.

10 See Willig (1994) and Newbery (1994).

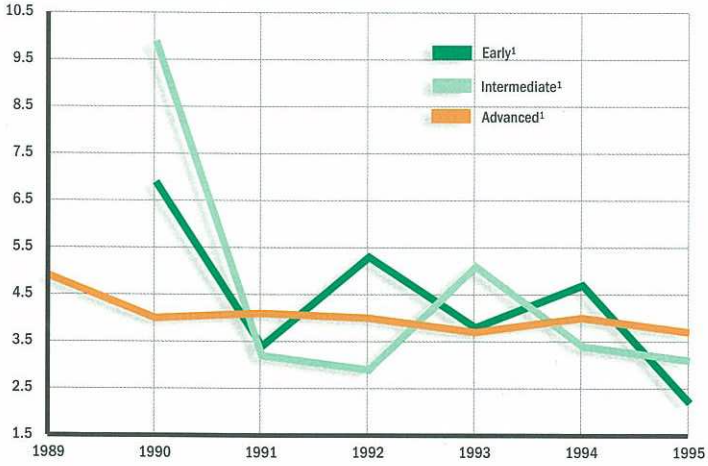
11 See also EBRD (1994), Chapter 6, IMF (1996) and World Bank (1996).

12 See Chapter 2 for a discussion of measuring stages of transition and the classification of countries. Those countries at advanced stages of transition are Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia. Those at intermediate stages of transition are Albania, Armenia, Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Georgia, Kazakstan, Kyrgyzstan, Romania, the Russian Federation, Ukraine and Uzbekistan. Those at early stages of transition are Azerbaijan, Belarus, Tajikistan and Turkmenistan.

Chart 4.2

Government capital expenditures by countries' stages of transition

In per cent of GDP



Sources: IMF and EBRD

1 Averages of countries grouped by stages of transition for which data are available.

Chart 4.3

Government fiscal balances by countries' stages of transition

In per cent of GDP

Sources: IMF and EBRD

1 Averages of countries grouped by stages of transition for which data are available.

expenditures requires a careful understanding of the starting point. Under central planning, the government budget provided much of the funding for investment in both infrastructure and in fixed assets by enterprises, either through budgetary outlays or capital transfers.[13] Even allowing for variations in starting points, capital expenditure by governments continues to fall even in the most recent years (see Chart 4.2). While this decline in government capital expenditure appears less pronounced in countries at more advanced stages of transition, significant falls are still being experienced by countries at earlier and intermediate stages of transition. In most of these countries government capital expenditures in 1995 were between 2 and 3 per cent of GDP.

With sharp cut-backs in government investment, as well as compression of current expenditures, most countries in the region have made some, if not significant, progress toward fiscal stabilisation. Fiscal deficits in countries at advanced stages of transition have fallen to levels below those prevailing in many industrialised market countries, and the levels in countries at intermediate and early stages of transition are only modestly higher (see Chart 4.3). However, expenditure pressures associated with the transition, in particular health care and pensions, and the need to maintain educational standards, will continue to pose challenges for fiscal stabilisation over the medium term. The scope for significant increases in capital expenditures by governments to meet investment needs in infrastructure would appear to be limited without recourse to tax increases (which could deter other types of investment) or to larger fiscal deficits (which could weaken confidence in macroeconomic stabilisation).

Market selection and operational efficiency

Under central planning, certain infrastructure sectors were given higher priority than others and achieved a greater share of the distribution of physical capital among the various sectors. This also applied in the allocation of labour skills, in particular technical experts and skilled managers. For example, the power sector commanded relatively high wages because of the overall priority placed on the sector and attracted many well-trained engineers. In contrast, the telecommunications sector was saddled with relatively low wages and obsolete technology, which tended to discourage skilled personnel from entering this sector. Other sectors that received relatively low priority were waste water (and pollution control more generally), motorways and road haulage.[14] The old system also advanced those who were skilled at manipulating a bureaucracy rather than serving customers.

The opening of infrastructure to commercialisation and private participation would allow for more market-based selection of service providers. This selection process does not mean abandonment of existing infrastructure assets, but rather the introduction of competition to operate and to improve these assets. This competition can take the form of replacing managers of public enterprises through competitive selection or of bidding for concessions to operate existing assets or for licences to provide new services. The privatisation of existing service providers through cash sales can also perform this role. However, voucher and insider privatisations do not lead to market selection, at least in the first instance, though a market for corporate control can emerge in principle for these privatised enterprises.

Lastly, under central planning, infrastructure enterprises were operated in ways which distribute resources not only to end-users but also to workers, particularly through the over-staffing of such enterprises. In the transition, those infrastructure enterprises that face the strongest pressures to rationalise their workforces are those which face declining demands for services, such as in electric power and the railways. As with tariff reform, this

13 Countries in the region differed in the extent to which central planning was reformed prior to 1989 (or 1991 in the Baltics and CIS) by allowing enterprises greater control over investment decisions and use of retentions as a source of finance.

14 See Chapter 3.

rationalisation can be facilitated with complementary policies, such as worker retraining and support for business spin-offs from infrastructure enterprises which are down-sizing.

In summary, the main priorities in infrastructure in transition economies are:

- to move towards more cost-reflective tariff levels and structures to encourage more efficient use of infrastructure services, to guide appropriately investment decisions throughout the economy, and to strengthen the financial viability and accountability of infrastructure enterprises;
- to expand access to private finance through improve financial performance given the fiscal constraints on public investment associated with transition; and
- to promote the restructuring of infrastructure by allow increased market selection of service providers and to promote greater operational efficiency.

A more commercial approach to infrastructure, including greater private participation, is a key instrument for achieving each of these priorities. In particular, private participation in infrastructure can promote more socially efficient tariffs by creating a constituency for their implementation, which can also help to unlock access to private finance.

4.2 Approaches to commercial infrastructure

The commercialisation of public infrastructure enterprises in the transition economies refers to reforms that simulate the business approach of private enterprises while retaining public ownership. These measures aim to promote greater efficiency and improved services from public enterprises. The commercialisation of public enterprises is now proceeding throughout much of the region, and a number of general issues raised by the experiences so far are highlighted below.

Private participation in infrastructure in transition economies is arising in one of two ways. First, selective private entry is made possible through the licensing of new service providers and the awarding of concessions to operate new or existing public infrastructure assets. Second, existing government enterprises can be privatised. Over two-thirds of the 26 countries in the region have allowed selective private entry in at least one infrastructure sector, while seven countries have privatised at least one major infrastructure enterprise.

The pattern of private participation across infrastructure sectors is similar to world-wide trends, indicating the importance of sector characteristics and their ability to support private involvement. However, the telecommunications sector in transition economies has a higher proportion of private sector projects compared with other regions, reflecting the backward state of development of this sector under central planning.

15 See Pannier (1996).

16 See McMillan (1996).

Commercialisation

Successful firms typically have three basic characteristics. They have clear goals which are focused on cost-effective delivery of goods and services to consumers; their managements are autonomous, and both managers and workers are accountable for performance; and they are financially independent. These are inherent characteristics of private firms in a market economy, but they are often absent from enterprises that operate under the control of governments, which must balance a range of economic, political and social objectives.

Governments in many transition economies have used a number of instruments to promote commercial qualities in their infrastructure enterprises, and these measures have been extensively surveyed in a recent study.[15] The most fundamental step is corporatisation, the legal separation of public utilities from government through incorporation. This change serves to establish clear boundaries between a public utility and government, thereby separating ownership from management of the enterprises. In transition economies these two roles were often blurred under the structures inherited from the old regime, preventing the establishment of clear responsibilities and systems for accountability for both managers and those within government who performed an ownership role. Corporatisation can also involve subjecting state enterprises to the disciplines of commercial law and bankruptcy, although this is not always the case in transition economies.

With separation of ownership from management in state enterprises, governments must select an agent to represent it as the owner of these enterprises. This responsibility can reside with particular government ministries, or a separate agency can be established to perform the task. In transition economies, leaving the ownership role with the branch ministries that formerly operated infrastructure enterprises runs the risk of leaving unchanged long-established relationships between ministries and the state enterprises which they formerly operated. Several transition economies – including Hungary, Poland and Russia – have established a separate government agency or ministry to represent the state as the owner of enterprises. However, branch ministries in the transition economies have often maintained considerable influence over the state enterprises that they formerly operated.

Improving the management of infrastructure enterprises typically requires selection of capable managers and introduction of managerial incentive contracts based on performance measures. Under central planning, the selection of enterprise managers was neither competitive nor transparent, and a number of governments in the region have recently begun to adopt more open procedures. However, incumbent managers in some cases have been able to use their inside knowledge and personal connections to maintain their positions. Where selection of managers is made on the basis of fair competition, available evidence suggests that significant gains in performance can be realised.[16] Until recently, performance evaluation and incentives were largely absent in

transition economies. Their effective implementation requires the development of quantitative and qualitative measures of managerial performance and setting of targets that are sufficiently demanding. There is not yet a sufficient track record to gauge their effectiveness in the region.

Available evidence from developing countries on performance-related contracts for public-sector managers, however, reveals that they are often ineffective. A comprehensive survey of government enterprises in developing countries found that implementation of reforms based on performance contracts with public-sector managers had little impact on enterprise performance, including profitability, labour productivity and total factor productivity.[17] Factors behind these disappointing results are the inability of governments to overcome the information advantage of inside managers in negotiating performance contracts, the weakness of rewards and the absence of penalties for poor performance, and the frequent breach of contract terms by governments, including the regulation of infrastructure tariffs according to fair and consistent rules. This latter finding is particularly significant for infrastructure in transition economies, where attainment of socially efficient tariff structures is a priority.

Selective private entry

Selective private entry into infrastructure can take the form either of new operators serving market niches where competitive provision is possible or of concessions to operate public infrastructure assets. The latter approach allows for competition for the right to serve a market where competition in that market is not possible. There are several advantages to expanding private participation in infrastructure in these ways. While these approaches usually require supportive measures to reduce the scope of public utility monopolies, they typically do not require the creation of regulatory institutions or the break-up of dominant utilities; yet they allow for increased competition. The regulatory conditions that are required are usually written into the licence agreements or concession contracts. The use of contracts and the courts, at least as a transitory arrangement, allows for more rapid implementation compared with comprehensive regulatory reform.

Scope for competition in the market is created by limiting the extent of the monopoly granted to integrated utilities to those parts that are truly natural monopolies and by allowing competition elsewhere (common examples of the latter are cellular telephony and independent power generation). While those services that are provided competitively do not necessarily require price regulation, they are usually delivered to consumers through existing infrastructure networks; and determining the terms and conditions for accessing these networks can be a difficult issue to resolve. Two basic requirements are that competing service providers have access to the networks on equivalent terms and that consumers are free to choose among competitors.

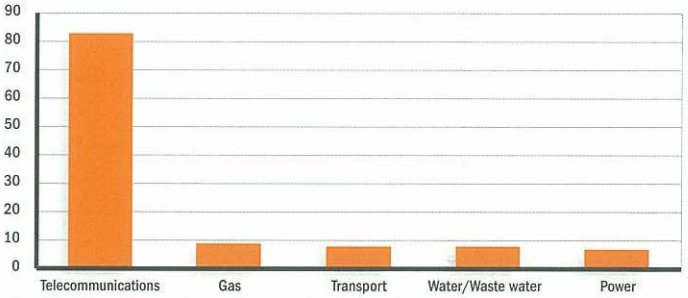
Competition for the market is created through bidding for concessions to operate infrastructure assets for a fixed period. This bidding can help to reveal information about the potential efficiency of alternative private contractors and operators. However, this approach to competition can encounter at least three types of problems. First, the terms of concession are limited to those events that can be reasonably foreseen, and unexpected circumstances can lead to the renegotiation of the concession. Second, the private concession holder may not have an incentive to maintain infrastructure assets, particularly near the end of the concession period. Third, some types of concessions (e.g., operating concessions or leases) do not obligate the concession holder to make investments, thereby limiting some of the benefits from private participation.

In transition economies, selective private entry into infrastructure has been most prevalent in the telecommunications sector (see Chart 4.4). These projects have focused on cellular telephony, specialised networks for data transmission and other business services, and, to a lesser extent, long-distance and international services. In power there are relatively fewer projects involving selective private entry, in part because existing capacity in many of the countries was already large.

Chart 4.4

Selective private entry in infrastructure sectors

Number of projects[1]



Sources: EBRD and World Bank Private Infrastructure Database

1 Projects with awarded contracts or in operation.

Privatisation

Privatisation of infrastructure enterprises can extend the benefits from private participation beyond selective areas of infrastructure to include much of the sector. However, successful privatisation can require two types of institutional change, which may take considerable time to implement. First, infrastructure enterprises themselves may require restructuring to create scope for competition or to enhance their commercial viability. Second, where monopolies are being privatised, effective regulatory institutions must be developed. Private investors must be assured that the approach to setting infrastructure tariffs is transparent and that the institutions responsible for regulation are robust enough to balance fairly the inevitable pressures from governments, consumers and producers.

Some attempts to sell dominant infrastructure enterprises in Hungary and Russia to strategic investors have failed in part because investors lacked confidence in nascent regulatory arrangements. In Kazakstan, sales in electricity have been quickly achieved, but at low prices. Building the necessary regulatory insti-

17 See World Bank (1996b), Chapter 2.

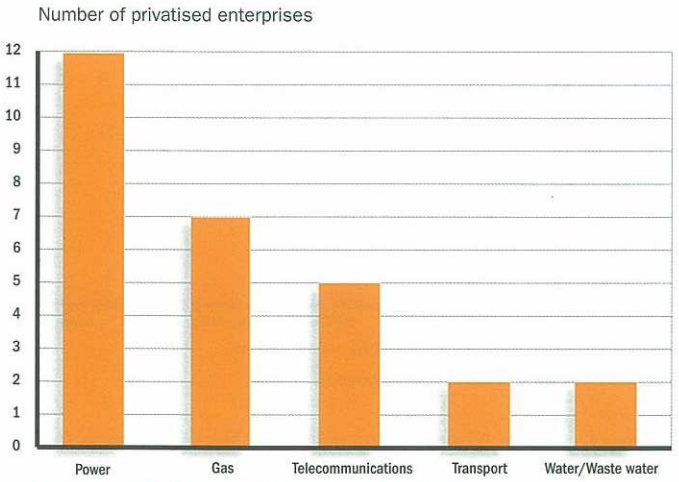
tutions takes time and there can be beneficial interchanges between potential private investors and government over their design.[18]

One form of infrastructure privatisation which has also proceeded quickly is privatisation through vouchers in the Czech Republic and Russia. These countries have distributed minority stakes in major telephone, electric power and gas utilities as part of their mass privatisation programmes. In the Czech Republic, however, this initial distribution has been followed by the cash sale of additional shares in the dominant telephone provider to strategic investors.

The complete privatisation of infrastructure enterprises through vouchers could well compromise potential benefits from private participation, however. Due to resulting weaknesses in corporate governance, it may fail to deliver deep restructuring, investment and access to private finance (see Box 4.1). Voucher privatisation of infrastructure enterprises in the absence of effective regulation also risks creating a constituency in favour of monopoly provision and may require the government to compensate shareholders for interference with property rights acquired through voucher schemes.

Chart 4.5

Cash privatisations in infrastructure sectors



Sources: EBRD and World Bank Private Infrastructure Database

The cash privatisation of infrastructure enterprises, including sales of minority stakes, in transition economies has been most prevalent in the telecommunications, power and gas sectors (see Chart 4.5). Estonia, Hungary, Kazakstan and Latvia have sold at least minority stakes in dominant telecommunications enterprises to strategic investors. The Czech Republic has also sold a minority stake in its dominant telecommunications operator to a group of strategic investors, following the partial voucher privatisation. Hungary, Kazakstan and Poland have privatised major electricity or gas enterprises, with Hungary separating electricity generators, transmission grid and regional distributors prior to their cash sale.

Total cash investments by strategic investors in major infrastructure privatisations in the region amount to US$ 6 billion. This represents 20 per cent of cumulative foreign direct investment in transition economies from 1990 to 1995.

[18] See Chapter 5.

Box 4.1

Privatisation and deep restructuring

While continued public provision imposes a significant financial constraint on infrastructure investment, private participation does not necessarily ensure restructuring, investment and access to private finance. For these, the form of private ownership and the effectiveness of corporate governance are important determinants in the transition economies. The various approaches to privatisation in the region have led to a range of ownership structures for private firms. Under some approaches to privatisation, such as the voucher privatisation programme in Russia and privatisation "by liquidation" in Poland, workers and managers become the controlling owners of their enterprises. In this case, the objectives of firms are not necessarily focused on profit maximisation, and there can be strong pressures to maintain employment or to raise wages.

Other approaches, such as the voucher privatisation programme in the Czech Republic, can lead to dispersed outside ownership when mechanisms for corporate governance are new and untested. Weak corporate governance effectively allows insiders to control firm operations. In the transition economies, concentrated outside ownership may be required to induce a strong focus on maximising profits, at least in the period before any market for corporate control develops. Some strength of corporate governance, together with a focus on profits, are required both for undertaking long-term investments and for generating the confidence of potential creditors and other outside investors.

Available evidence presented in Chapter 8 of the 1995 *Transition Report* suggested that in transition economies effective corporate governance in the form of concentrated outside ownership is necessary to deliver significant investment.[1] Drawing upon enterprise surveys, the analysis considered the relationship between ownership structures (state, insider, and dispersed outside and concentrated outside ownership) and various measures of enterprise performance. The indicators included those related to defensive restructuring driven by hard budget constraints, such as changes in real wages, employment and labour productivity as well as those indicating deeper restructuring, such as investment in new plant and equipment.

The main findings on the basis of this evidence were that, while indications of defensive restructuring through reductions in employment and real wages were found across many forms of ownership (the state, insiders, dispersed outsiders and concentrate outsiders), only those enterprises with concentrated outside ownership undertook significant investment. However, on the basis of this finding, it is not possible to say whether the lack of investment by firms subject to what are judged to be less effective ownership structures (in the context of transition) is due to the absence of effective incentives or the lack of access to finance. The two, of course, can be related. It is also important to recognise that ownership structures are not static and that there are strong incentives for a market for corporate control following some forms of privatisation.[2]

[1] EBRD (1995), Chapter 8.

[2] See Chapter 4 of the 1994 *Transition Report*.

Sectoral composition of private participation

The sectoral composition of private participation in infrastructure in transition economies parallels that in other regions (see Chart 4.6). Much of this participation occurs in the telecommunications and electric power sectors, measured in terms of number of projects, largely because in these sectors there is some scope for competition in the markets for these services and there are reason-

ably well developed regulatory arrangements to support this competition.[19] However, the balance between the number of projects in these two sectors is reversed in the transition economies, reflecting the relatively greater investment needs in telecommunications than in electric power.

One sector in which the region appears to be lagging is transportation, where there have been a substantial number of projects world-wide involving concessions for the construction (or upgrading) and operation of airports, motorways and ports. However, there appears at this point limited scope for a completely commercial approach to toll motorways in transition economies, because their financial viability has yet to be established. However, the external benefits from new roads (e.g., new land use opportunities) provide an economic justification for government subsidies that can enhance their commercial viability. In the rail sector, privatisation of infrastructure is also made difficult, as it is in EU countries, by the limited ability of train operations on many lines to pay full track costs: only one country in Europe, Great Britain, has privatised its rail network. However, there are medium-term prospects for privatising freight and passenger train operations, but this first requires industry restructuring.

4.3 Private participation and progress in transition

Like other forms of private investment, private participation in infrastructure requires a supportive environment. The relevant features of this environment go beyond issues of competition and effective regulation. In transition economies, the development of this environment is measured in part by indicators of progress in transition. Investors in privatisations of infrastructure enterprises, as well as those in infrastructure projects involving selective private entry, will typically require a sound legal framework for private transactions and share ownership, access to finance and material inputs, a stable macroeconomic environment, and a credible regulatory framework and reliable tax regime which will allow an assessment and limitation of risks and a market return on the investment. Satisfaction of these requirements requires progress in transition.

The EBRD's transition indicators embody many of the key factors determining the extent to which an effective environment for the private sector has been established.[20] In the early stages of transition, when major structural reforms have yet to be undertaken, or even in the intermediate stages when many of the consequences of reforms have yet to become apparent, commercial risks are often high. Relative prices can remain volatile and the creditworthiness of business suppliers and customers can be difficult to ascertain. Those countries at more advanced stages of transition tend to have a much more stable environment for investment, as well as greater progress in macroeconomic stabilisation.[21] In fact, survey evidence shows that foreign investors' perceptions of investment risks tend to decline with progress in transition.[22]

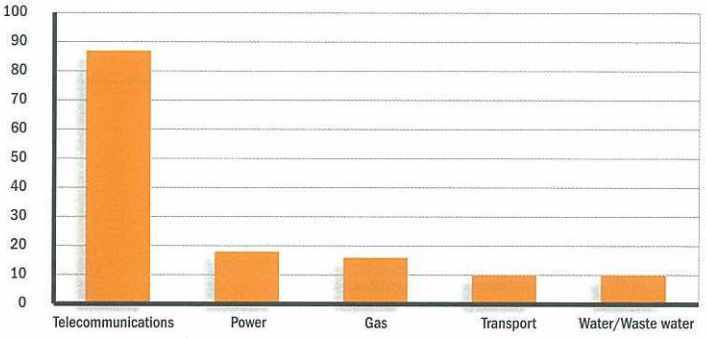
In transition economies, private participation in infrastructure exhibits a strongly positive relationship with progress in transition (see Chart 4.7). This correlation holds for both cash privatisation of infrastructure enterprises and for selective private entry. The positive correlation exists for potential projects as well as those

Chart 4.6

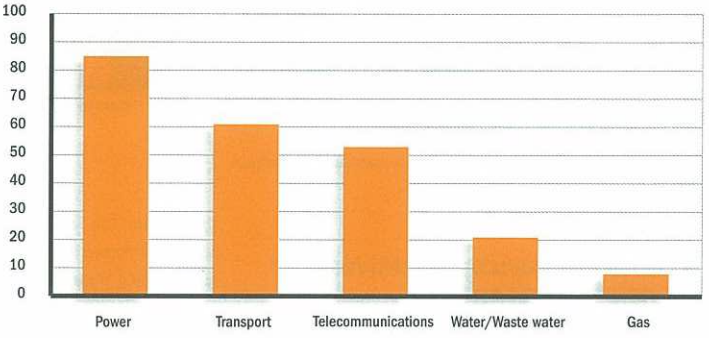
Sectoral composition of private participation in infrastructure by region

Number of projects with completed contracts or in operation plus number of privatised enterprises

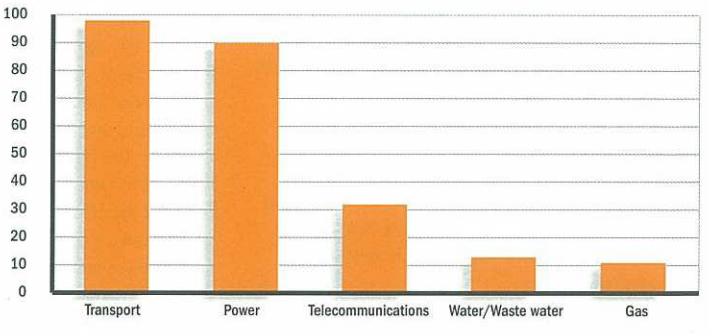
Eastern Europe, the Baltics and CIS



East Asia



Latin America



Source: EBRD and World Bank Private Infrastructure Database

[19] See Chapter 5.

[20] See Chapter 2.

[21] World Bank (1996a), Chapter 2, argues that progress in transition is necessary for control of fiscal and quasi-fiscal deficits and macroeconomic stabilisation.

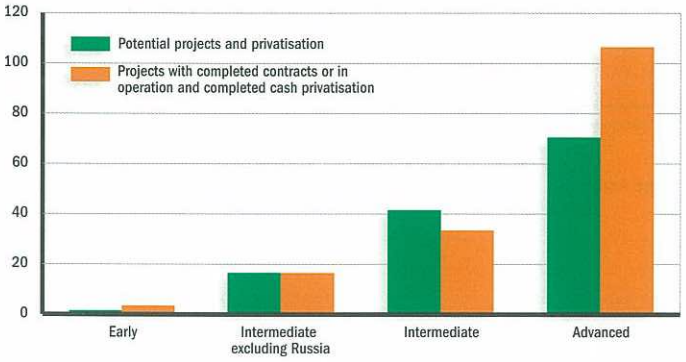
[22] See Lankes and Venables (1996).

that are already operational, reinforcing the point that progress in transition contributes to and facilitates private participation in infrastructure. The strength of the relationship also highlights the particular importance of a stable environment for private investment to infrastructure where many investments are large and irreversible.

Chart 4.7

Private participation in infrastructure by countries' stages of transition

Number of projects and privatisations



Source: EBRD and World Bank Private Infrastructure Database

4.4 Mobilising private finance

While commercial infrastructure can serve to expand access to private finance for needed infrastructure investment in the transition economies, the extent of private infrastructure finance in the region has lagged behind that in other parts of the world. Innovations in international capital markets have helped to foster the recent world-wide expansion in private financing of infrastructure, particularly the rapid development since the late 1980s of project finance and of international capital flows through securities markets. However, the impact of these innovations has only recently been felt in transition economies.

Project finance allows a sponsor to raise funds secured primarily by the cash flows and assets of a particular entity, which often takes the form of a newly established company.[23] In infrastructure, this technique is often used to support the selective entry of private service providers, such as those with licences to provide new services or concessions to operate public infrastructure assets. Because these entities typically have little or no financial track record, this financing technique relies on the clear definition and allocation of project risks to ensure that incentives are strongly linked to performance and that risks are clearly allocated and well managed. Project finance thus serves an important purpose beyond

Box 4.2

Project finance, incentives and risk management

Private infrastructure projects require from sponsors strong commitments to their successful implementation and operation. A sponsor is an investor with a long-term strategic interest in the project, which is reflected in a significant, if not majority, stake in the project company. This equity stake must be long-lived and not clawed back through contracts and fees. Such an enduring commitment is necessary to generate the confidence of creditors and outside equity investors. However, sponsors seek to achieve a balance between creating this confidence and sharing risks with creditors and outside equity investors.

Private infrastructure exposes sponsors and investors to a number of risks that require careful management. The keys to their effective management are clear assessments, careful allocation of risks among the parties involved according to their ability to manage the risks and strong incentives for their mitigation by these parties. The nature of these risks can vary considerably over the project cycle, from initial development, construction and start-up to full-scale operation, calling for carefully designed and often complex project structures.

During the development phase of a project, two main risks are the rejection of the project proposal by government or affected public groups and the failure of the sponsor to obtain sufficient financing for the project. By establishing transparent selection procedures for project concessions with public participation, a government can reduce uncertainty in project development. This requires clearly designed concessions and evaluation criteria and their consistent implementation.

The construction and start-up phase is typically the riskiest of the project cycle. Since lenders rarely assume completion risk, this is usually allocated to the project's sponsors, contractors and equipment suppliers and insurers. The risks of cost over-runs, completion delays and failure to complete to required specifications can be managed by using fixed-price, fixed-date, turnkey construction contracts, with specified penalties for performance failures and bonuses for over-performance. However, for projects with significant uncontrollable risks, there can be some sharing of them among the parties involved. Risks can also be hedged by obtaining commercial insurance or state guarantees against events beyond the control of the project sponsor or contractor, by including cost contingencies and by building in some excess capacity.

Once a project has passed the start-up phase, there are a number of operational and market risks that will affect the financial performance of the project. Those specific to the project include: availability and cost of inputs; technical performance of the project itself; non-payment risks (which are particularly high in transition economies due to the history of soft budget constraints and low prices); foreign exchange risk arising from the mismatch between local currency revenues and foreign financing; and environmental and regulatory risks associated with the tariff adjustments and licensing. Some of these risks can be managed through long-term supply contracts for inputs, guarantees on operational performance from the contractor and local currency financing.

There are also a number of economic and political risks to which projects are exposed. The EBRD and other multilateral development banks (MDBs), based upon their unique standing with governments, are typically well placed to bear and to mitigate these risks, including the risks of foreign exchange inconvertibility and of expropriation, and those from changes to regulatory policies, such as the failure to adjust politically sensitive tariffs in line with agreed schedules and the arbitrary revocation of licences. Indeed, regulatory risks are of overwhelming importance to sponsors and investors in private infrastructure projects. Since the risks that MDBs have an advantage in mitigating are well-specified events, guarantees against these particular risks are a valuable instrument through which MDBs can participate in private infrastructure projects. The EBRD has used specific-risk guarantees in combination with standard project finance (debt and equity) in supporting a number of private infrastructure projects.

[23] World Bank (1994), Chapter 5, and Nevitt and Fabozzi (1995) provide detailed discussions of project finance, including its purpose, structures and instruments.

Table 4.1

International bank loans to private infrastructure projects by region, 1990-95

	1990		1991		1992		1993		1994		1995	
	US$m	No. of companies	US$m	No. of companies	US$m	No. of companies	US$m	No. of companies	US$m	No. of companies	US$m	No. of companies
Africa	0	0	428	1	13	1	142	2	172	3	41	3
Asia	1,062	12	1,105	12	1,890	23	6,409	34	5,825	53	10,280	105
Eastern Europe, the Baltics and CIS	0	0	7	1	177	2	442	13	649	14	1,821	19
Latin America	467	7	1,061	14	490	10	1,448	19	2,391	34	3,622	37
Total infrastructure	**1,529**	**19**	**2,601**	**28**	**2,570**	**36**	**8,441**	**68**	**9,037**	**104**	**15,764**	**164**

Sources Euromoney Loanware and IFC

simply providing funds. The process of raising project finance imposes considerable discipline on the project's structure. It thus performs a role similar to effective corporate governance in privatisations, establishing incentives and monitoring performance. Box 4.2 describes some basic techniques of project finance.

Traditional sources of debt financing for private infrastructure projects are the major international banks and export credit agencies, which have developed considerable expertise in project finance. The major international banks have substantially increased their financing of private infrastructure projects in developing countries over the past several years, and in 1994-95 this expansion spread to eastern Europe, the Baltics and the CIS (see Table 4.1). Much of this financing has been concentrated in the telecommunications sector and, to a lesser extent, gas pipelines. While the major international banks are very active in project finance, they face several constraints. The first is their exposure limits, making complicated loan syndications necessary for large infrastructure projects. Banks are also limited by the maturity of their deposits and the long economic lives of infrastructure projects. The longest international bank loans are typically 7-12 years, while many infrastructure projects require financing well beyond 12 years to avoid refinancing risks.

In terms of investment time horizons, institutional investors, such as pension funds and insurance companies, can provide a better match for infrastructure financing than that provided by commercial banks. However, these institutions tend to be averse to risks and require the careful structuring of projects. A number of institutional investors have begun to finance private infrastructure projects through investment funds that specialise in private infrastructure in developing countries. These funds can offer a mix of financial instruments, including secured and subordinated debt, equity and bridge financing to cover the riskiest phase of the project cycle (construction and start-up). While at least 16 such funds have been established on a global basis with the potential to invest over US$ 10 billion, only two have been set up to invest in private infrastructure in eastern Europe, the Baltics and the CIS, both with backing of either the EBRD or International Finance Corporation. The potential investment capacity of these two funds is US$ 150 million.

One way to gauge the nature of financial impediments to private infrastructure in the transition economies is to consider the types of financing provided by the EBRD for such projects. A fundamental operating principle of the EBRD is to provide financing only when alternative sources of funds are not available elsewhere on reasonable terms and conditions.[24] In other words, the EBRD is restricted to providing finance for viable projects only when the market and other sources of funds are unable or unwilling to provide the necessary capital. The EBRD's ability to fund such projects while observing sound banking principles arises in part from the segmentation of international capital markets (with respect to certain sectors and countries) and the capabilities and unique standing of the Bank itself. The inherent weaknesses of the domestic capital markets in the transition economies also create a potential role for the EBRD in mobilising local currency finance for private infrastructure projects.

The aggregate capital structure for all of the EBRD's private infrastructure projects reveals that overall the projects are financed with 43 per cent in debt and 57 per cent in equity (see Table 4.2). Within the capital structure of EBRD-supported projects, it is noteworthy that the Bank's share of financing is significantly greater for debt than for equity. Direct lending by the EBRD accounts for 38 per cent of total foreign debt, while its loan syndications among international banks account for a further 27 per cent. The EBRD thus either directly provided or helped to mobilise 65 per cent of all foreign debt financing for the private infrastructure projects it supports.

With respect to local currency debt, the EBRD has helped to mobilise financing through the use of guarantees to support domestic bond issues. There has been relatively little domestic bank financing of private infrastructure in Bank-supported projects, reflecting the dominance of short-term lending by local banks in most transition economies. Developing domestic sources of debt financing for infrastructure projects remains a priority, particularly since most infrastructure services are non-tradable and should be financed in local currency from a risk-management perspective. The emergence of life insurance and, to a lesser extent, private pension funds in the transition economies represents an important potential source of local

[24] Agreement Establishing the European Bank for Reconstruction and Development, Article 13 (vii).

Table 4.2

Capital structure of EBRD-supported private infrastructure projects

	ECU billion	% of instrument	% of total
Total financing	4.8		100.0
Debt	2.1	100.0	43.2
Foreign			
Foreign commercial banks	1.0	45.7	
Of which: EBRD syndications	0.6	27.3	
EBRD	0.8	38.3	
Other	0.2	8.7	
Local	0.1	7.3	
Equity	2.7	100.0	56.8
Foreign			
Private foreign sponsors	1.4	52.4	
EBRD equity	0.2	8.3	
Other	0.0	1.1	
Local	0.2	5.6	
Retained earnings	0.9	32.5	

Source: EBRD

currency finance for infrastructure projects, which has yet to be tapped in a substantial way.[25]

The EBRD has also taken an important role in mobilising equity finance, being the only significant source of portfolio equity for the projects. While strategic investors must contribute the bulk of the equity in private infrastructure projects from the viewpoint of incentives and project management, outside equity can also form an important component of capital structures. There are so far relatively few institutional sources for portfolio equity investments in private infrastructure projects in the region.

While an examination of projects that have been initiated reveals some information about financing constraints, it is also important to consider experiences from EBRD projects that have lapsed. Two points can be drawn from this experience.

First, in the EBRD's experience, a number of projects have failed to advance because of the perceived high costs of both the interest margins and the time required to negotiate and document often complex projects. As a result, several of those proposed for private participation have been abandoned or undertaken on a sovereign basis. However, the view that private financing is more expensive than sovereign-guaranteed loans requires careful consideration. Simple comparisons of borrowing costs between private finance and sovereign loans reveal wide spreads in interest rates. However, the cheaper cost of sovereign loans must be weighed against the risks of project failure to which governments are exposed and the inefficiencies that can arise from the inadequate management of these risks. In particular, sovereign loans typically submerge the difficult risk management and incentives issues that are the intense focus of highly structured private finance. The assumption of project risks by the government typically leads to a weakening of incentives to manage these risks effectively, which is reflected in the relatively poor performance of public versus private infrastructure projects. The incentive and efficiency benefits of private markets apply just as strongly, and perhaps more strongly, to capital markets as to other areas of economic activity.

Second, it must be recognised that private finance of a project does not preclude a role for public support in the same project. There are some types of infrastructure projects where it is difficult to achieve financial viability on a strictly commercial basis, but where the economic returns to the projects may be high. Such a divergence between financial and economic returns can arise, for example, in the case of some transport sector projects, for which there are often external benefits. In such cases, the challenge is to find ways of blending public subsidies with the benefits of private finance. A key to progress in this area will be to develop financial structures that are simpler and less costly, but that do not compromise their important disciplining role.

4.5 Concluding remarks

In transition economies, infrastructure must be substantially restructured to meet market demand and concern for the environment. Tariff levels and structures are also heavily distorted by the use of infrastructure under central planning as a way of distributing benefits and resources to households and enterprises. The main challenges for commercial infrastructure are thus:

- to move towards more cost-reflective tariff levels and structures to encourage more efficient use of infrastructure services, to guide appropriately investment decisions throughout the economy, and to strengthen the financial viability and accountability of infrastructure enterprises;
- to expand access to private finance through improved financial performance given the fiscal constraints on public investment associated with transition; and
- to allow increased market selection of service providers and to promote greater operational efficiency.

This chapter argues that commercial infrastructure can help to meet these challenges in two ways. First, it can help to insulate infrastructure from excessive political influence and create a constituency for tariff reform. Second, this approach can serve to improve the selection of service providers and to strengthen incentives within infrastructure enterprises. Available evidence from industrialised and developing market economies suggests that the move towards private participation where there is competition or effective regulation, in particular, can yield significant gains in terms of operating efficiency and investment.

Much of the private participation in infrastructure has occurred through selective entry into areas where competition is possible

[25] Chapter 7 examines the development of local life insurance and private pension funds in the region.

and regulatory arrangements to support this participation are reasonably well developed. Privatisation of existing infrastructure enterprises has proceeded more slowly. This form of private participation can require two types of institutional change: the restructuring of enterprises before their privatisation and the creation of effective regulatory institutions.

The infrastructure sector with the most extensive private participation is telecommunications. This concentration of activities is consistent with both the specific challenges in the transition economies and with the world-wide pattern of private participation in infrastructure.

This chapter also examined the relationship between the environment for private investment, as measured by the EBRD's transition indicators, and private participation in infrastructure, since a key challenge in infrastructure is investment. This analysis finds a strong relationship between progress in transition and private participation in infrastructure.

Lastly, the sources of and impediments to private finance in support of commercial infrastructure in the transition economies were examined, in part, by considering the role of the EBRD in financing private infrastructure projects in the region. This analysis points to a shortage of long-term debt, both from international capital markets and domestic financial systems in the region, and of portfolio equity.

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Regulation and competition in infrastructure

5

As with many industries in transition economies, infrastructure requires substantial restructuring. Chapter 4 points out that a commercial approach to infrastructure can promote its restructuring. Commercial infrastructure provides some insulation against the excessive political influence over unreformed state enterprises and creates a constituency for tariff reform. Strengthened financial performance and accountability and greater access to private finance for infrastructure investment are important aspects of restructuring. Commercial infrastructure can also improve selection of service providers, strengthen incentives and boost operational performance. This approach to infrastructure involves commercialisation of state enterprises, private entry into selective areas of infrastructure, or privatisation. In each case, however, commercial infrastructure must be accompanied by effective regulation or competition.

A fundamental task in the regulation of infrastructure is to determine where the boundaries between regulation and competition are to lie. In the last decade or so there has been a fundamental change in the thinking of policy-makers in industrialised and developing market economies.[1] Whereas infrastructure used to be considered a natural monopoly virtually in its entirety, there is now seen to be scope for competition to play a significant part in infrastructure provision.[2] This development owes something to changing technologies, such as gas turbine generation allowing electricity to be produced efficiently at a lower scale, or cellular telephony, which has already demonstrated the potential for competitive provision in 11 transition economies. However, this change of approach is due principally to the realisation that it is possible to restructure the industries concerned so that there is at least functional separation and even separation of ownership between activities, according to their potential for allowing competition. Thus, electricity generation (which is potentially competitive) can be separated from high-voltage transmission (which is a natural monopoly). This in turn can be separated from local distribution, where there are elements of natural monopoly alongside the potential for limited competition.

The introduction of competition where possible is desirable because it avoids the high costs imposed by regulation. These costs arise in at least two ways. First, and most simply, regulation requires considerable economic and sectoral expertise, which is scarce in any society, and particularly so in those emerging from the era of central planning. Skilled and experienced personnel are hard to recruit and retain,[3] and effective regulation needs to make efficient use of this scarce resource as well as the substantial resources sometimes spent by firms in dealing with regulatory matters. Second, and more fundamentally, regulation is costly in another way. By continuing to allow the state discretion to intervene in the outcome of economic processes, an additional dimension of uncertainty is added to the calculations of private investors whose confidence in the future will be critical to providing the capital requirements of transition.[4] For both of these reasons, competition where possible is preferable to unnecessary regulation.

Competition in infrastructure can also promote better operational and financial performance by service providers. For example, competitive pricing combined with the threat of bankruptcy for loss-making firms eliminates much of the scope for inefficiency within both publicly and privately owned firms. Competitive market entry and exit also perform an important role in selecting which firms provide the services demanded by consumers. Thus, if an incumbent (public) enterprise is not among the most efficient potential producers, opening the sector to competition can serve to change the composition of the industry. Finally, competition can reveal information about the comparative performance of firms operating in the same sector, particularly where there are private firms and performance measures are available from published accounts or share prices. This information can be used to improve incentives within both public and private firms.

The scope of competition and that of necessary regulation, however, depends on the state of technology and the provision of alternative services, both of which are constantly changing, particularly in the transition economies. For example, the falling cost of radio transmission is likely to make access to local telecommunications potentially competitive in the near future. The rapid expansion in road haulage and personal transportation are posing greater competitive challenges to the dominance of railways in transportation. These examples underline the difficulties in foreseeing the potential problems for a system of regulation and the need for any regulatory system to have the flexibility to respond to unforeseen developments. However, flexibility also has a cost. Investors need reassurance that the profitability of their investments will not be compromised by future regulatory decisions that might lower prices or increase standards to court political popularity, exploiting the fact that capital investments, once "sunk", cannot move elsewhere. Typically, investment in infrastructure is extremely capital intensive, has a long lead time and subsequent operating life, and once made cannot change either its function or its location. The "sunk" nature of investment in infrastructure makes it particularly vulnerable to fears about adverse regulatory decisions in the future.

1 An analytical framework for understanding these changes, and evidence for the UK economy, are given in Armstrong et al. (1994).

2 See World Bank, 1994.

3 See Fingleton et al., 1996, for evidence on the experience of competition agencies in central Europe.

4 See Chapter 4.

Given the need for flexibility, the most challenging task for regulation, therefore, is not that of deciding what to do at any moment, but of determining who should have what powers at some time in the future to decide what should be done. This choice may consist either of allocating powers to some party or parties or of determining a procedure whereby existing rules may be changed. It is in an important sense a task of constitution-making rather than merely policy-making. Sometimes the constitution-making task is extremely difficult even if it is easy to see what policies are needed. For example, it is clear in most transition economies that tariffs for electricity should be raised to levels that reflect some appropriate measure of costs. It is far from clear, however, which regulatory arrangements are the best for convincing potential investors in electricity-producing assets, or in assets using electricity, that tariffs will continue to reflect costs over the lifetime of the assets concerned. The credibility of chosen policies is as important as their intrinsic merit, and credibility is in large part a constitutional matter. The fact that credibility may be threatened by political uncertainty is of particular importance in transition economies, precisely because these countries have seen major changes in political regimes and have not had time to develop the relative stability and institutions that investors require.

Section 5.1 examines issues in the design of regulatory institutions, given the absence of such institutions in the region up to now. Section 5.2 examines in detail the scope for competition and the requirements for effective regulation in each of the main infrastructure sectors covered by this Report: telecommunications, electric power, water and waste water, and transportation. Section 5.3 summarises the main issues concerning regulation and competition in infrastructure.

5.1 Design of regulatory institutions

The experience of regulation in market economies has cast light on a number of crucial questions that need to be faced in regulatory design. First, what should be the relationship of regulatory institutions to other branches of government, particularly when providers of services are state-owned? Second, how geographically and politically decentralised should regulation be in a particular sector? Third, how should regulatory tasks be allocated between different institutions? Lastly, what powers and instruments should regulatory bodies have?

There are a number of reasons why it is desirable – especially in transition economies – for regulatory functions in infrastructure to be institutionally separated from other functions of government. They all arise from the fact that effective regulation may conflict with other pressures upon government. It is only where regulatory functions can be exercised with reasonable independence and transparency that it is possible to be confident that they will be exercised well. Independence does not mean lack of political accountability, but it does imply that such accountability is best exercised periodically and according to reasonably clear terms of reference for the institutions concerned. Moreover, credible regulation often requires the use of powers of investigation and punishment that may be politically acceptable only where there is visible accountability exercised over the use of these powers. Establishing accountability may be an essential prerequisite, therefore, to granting these institutions the powers that they need to function effectively.[5]

Two particular reasons for institutional separation stand out. First, government is subject to constant pressures to satisfy particular interests, while coherent policies for infrastructure require an especially long-term perspective. When government ministries are both the service provider and tariff-setting authority, they tend to keep tariffs low, and adjust them erratically according to the ebb and flow of pressure from users of services. This tendency is particularly strong given the history of the transition economies, where infrastructure under central planning served as a means of directing resources to, and influencing the decisions of, households and enterprises. Clear rules for tariff-setting and independent regulatory institutions that exercise the discretion which is required in implementing these rules are much more likely to result in a coherent and effective outcome. Second, only the establishment of regulatory institutions that are separate from the interests of the service provider can put credible pressure on the latter to improve performance, particularly where the entrenched interests of workers and incumbent managers contribute to inefficiency, corruption or low-quality provision.

While effective regulation requires institutional separation, at which level of government (local, regional, national or even supranational) should regulatory power lie? Where natural monopolies exist at the local or regional level rather than the national level, decentralisation of regulation becomes possible, as with the local provision of water and waste-water services in some countries. Different levels of regulation have a comparative advantage in addressing different kinds of problems. Decentralised regulation has the major advantage that regulators can adapt their policies more closely to the circumstances and needs of the particular locality or region, and they will tend to be more accountable to the political process in that area.

Local regulatory institutions, however, can be more vulnerable to corruption or more generally to "capture" by special interest groups. In particular, decentralisation can weaken the effectiveness of regulatory institutions where there is a significant shortage of specialist expertise, as in the transition economies. Sometimes decentralisation can also cause fiscal problems for local jurisdictions, either because it weakens the ability of poorer jurisdictions to receive transfers from richer ones, or because there may have been decentralisation of responsibilities without decentralisation of revenue-raising powers. The latter problem has been particularly acute in the Russian Federation in recent years.

Decentralisation can also cause problems where it is important to coordinate the policies of different jurisdictions because policies adopted in one jurisdiction have a significant impact on conditions in another. In such circumstances centralised regulation is often

[5] See Neven et al. (1993), Chapter 5, for a review of some of these arguments.

more appropriate. Centralisation is particularly important where there are major environmental impacts or network connections between regions – as when a river flows between them, or transport infrastructure in one affects the costs of external trade originating in the other. Thus, while certain regulatory objectives in a sector may be better pursued through decentralisation (tariff-setting in water), others may be better served through a centralised approach (environmental protection). The need for some centralisation or coordination in infrastructure regulation poses a particular challenge where a previously existing federation has broken up, as in the case of the former Soviet Union.

On the division of powers between different regulatory institutions, one question is whether there should be separate regulators for each sector. Another is whether different regulatory objectives – the management of environmental considerations, the policing of anti-competitive behaviour, the setting of tariffs – should be managed by different institutions. Given the scarcity of specialist expertise, pooling resources where there are common problems makes sense. In some areas, such as energy or transport, there may be an important interaction between regulatory policies which means that it is important to determine them together: rail tariffs need to be set jointly with policies on pricing and taxation of road transport; and electricity pricing both influences and is influenced by the costs of alternative forms of power and of fuel. However, transparency and accountability may require separation of functions so that responsibilities are not confused – for example, to avoid the achievement of politically expedient goals, such as low pricing, at the expense of equally important ones, such as control of pollution.

Finally, the instruments used by regulators can have an important bearing on the design of regulatory institutions. One approach to price regulation is to allow service providers to charge prices that covers costs, including a market rate of return on invested capital. This approach, widely used in the United States, is often referred to as rate-of-return regulation. An alternative approach is to set a price ceiling for services, allowing the service provider to earn a higher profit by improving performance and controlling costs. This approach, first applied in the United Kingdom, is often referred to as price-cap regulation. Viewed over time, though, the distinction between the two becomes less sharp, as price caps are periodically adjusted with a view to the profits earned by service providers. Nevertheless, one advantage of price caps, which is important in transition economies, is to economise on resources required to monitor regulated industries, because they encourage service providers to reveal potential cost savings. It is noteworthy that US regulatory agencies typically have much larger specialist workforces than their price-cap counterparts.

The credibility of price caps can be difficult to sustain, however, since the earning of profits from productivity gains and cost savings can generate pressures for tighter prices caps. This problem is potentially significant in transition economies, where there is no recent history of regulatory institutions. To encourage investment, price caps must be at a level that allows a market return on invested capital and must not be subject to overturning by political whim. Rate-of-return regulation can thus have an advantage in reassuring investors.[6] However, the benefits from this increased credibility must be weighed against the additional information costs incurred in supporting rate-of-return regulation.

5.2 Tailoring reforms to sectors and challenges

The needs and circumstances of the infrastructure sectors vary widely, between countries, between sectors and even between different activities in the same sector. This means that the fundamental issues highlighted here – the balance between competition and regulation, the trade-off between regulatory intervention and credibility, the degree of independence, the appropriate levels of decentralisation and specialisation of regulation and the choice of regulatory instruments – have to be resolved in varying ways. The sector-by-sector analysis outlined below draws lessons from Chapters 3 and 4 on what challenges the infrastructure sectors currently face and on approaches towards commercial infrastructure, and goes on to examine the ways in which competition and regulation are beginning to respond to the developments.

Even across the wide diversity of country and sectoral experiences it is possible to discern some common priorities, even if these vary in urgency and the degree to which they are already being addressed. First, distortions need to be removed in both the level and the structure of tariffs in order to encourage efficiency in resource use and to attract private-sector investment in expansion and modernisation of the infrastructure stock.[7] Second, there needs to be an opening of service provision to competition in those areas where it is appropriate and feasible to do so. This liberalisation can and should proceed relatively rapidly. For it to be credible, private participation, or at least commercialisation of public utilities, may be needed to remove the tendency for state-owned enterprises to use the public purse to underwrite anti-competitive behaviour. Third, regulatory institutions that are transparent, independent and accountable need to be established in areas where competition is impossible or seriously imperfect. In practice, this means as a first step the institutional separation of regulation from service provision, a reform that has yet to be undertaken in most infrastructure sectors in most transition economies. The building of effective regulatory institutions requires considerable time. They do not need to be large, but they do have to be of high quality and subject to effective leadership. The initial steps toward their creation should not be delayed.

Telecommunications

Challenges

The evidence in Chapter 3 indicates that the overwhelming priority in telecommunications is investment in new capacity and improvement of the quality of existing capacity. Given fiscal constraints, the bulk of this investment must come from the private sector, and much of the private finance of infrastructure in the transition

[6] See Ordover, Pittman and Clyde (1994).

[7] See Chapter 4.

economies has so far flowed into this sector. There is ample evidence that the willingness of users to pay for new telecommunications capacity will continue to exceed the costs of providing this capacity for the foreseeable future. However, there is at present a significant imbalance between the low tariffs for local calls and the high tariffs for trunk and international calls, which creates a danger that new investment may be distorted towards long-distance traffic at the expense of local networks.

The challenge for regulation in this sector centres, therefore, on investment. Most importantly, a framework must be established in which investors are confident that they will recoup the costs of the sizeable investments required, together with enough of a reward to compensate for the risks involved. Here, there is an important trade-off: the more secure and credible the regulatory framework, the lower the risk premium investors will require, so that paradoxically a framework which guards against the danger of excessively tight restrictions on prices may be able to elicit higher investment and consequently lower prices in the long run. To ensure that this investment is directed to those parts of the network where returns are genuinely high, existing distortions in tariff structures must also be removed. Finally, telecommunications operators need to be given incentives to respond to these investment opportunities and to use profits to finance future investment.

Table 5.1

Telecommunications sector

Services legally open to private entry	
(number of private entrants)	
Cellular telephony:	Albania (1), Belarus (1), Bulgaria (2), Croatia (2), Czech Republic (3), Estonia (3), FYR Macedonia (1), Hungary (3), Kazakstan (1), Latvia (2), Lithuania (3), Poland (3), Romania (1), Russian Federation (9), Slovak Republic (1), Slovenia (2), Ukraine (2) and Uzbekistan (1)
International long-distance services:	Ukraine (1)
Domestic long-distance services:	Poland, Russian Federation and Ukraine (1)
Local services:	Hungary (16),[1] Kyrgyzstan, Poland (14), Russian Federation and Ukraine
Privatisation of dominant operator	
(share of private ownership)	
	Czech Republic (49 per cent), Estonia (49 per cent), Hungary (67 per cent), Kazakstan (49 per cent), Latvia (49 per cent) and Russian Federation (49 per cent)
Regulatory institutions	
Separate telecoms department within ministry:	Czech Republic[2] and Slovak Republic[3]
Separate telecoms authority:	Hungary and Latvia (for tariffs)[4]
Anti-monopoly office:	Poland[5]

Sources: EBRD and World Bank.

1 Of the 54 local telephone companies, concessions to operate 16 of these companies have been awarded to consortia that do not include the dominant Hungarian telephone operator, MATAV.

2 Ministry of Communications retains authority for licensing new service providers. Authority for resolving disputes over the terms of inter-connection with the fixed network remains unclear.

3 Telecommunications office within the Ministry of Transportation, Posts and Telecommunications is responsible for monitoring service quality, while the Ministry itself is the licensing authority. The Ministry of Finance sets tariffs.

4 Telecommunications office within the Ministry of Economy proposes tariffs and issues licences for private networks and services, but final decision on tariffs rests with the Ministry of Finance.

5 The Telecommunications Law established an independent Tariff Council to set tariffs, while the Ministry of Transport and Communications is responsible for overall telecommunications policy, radio frequency management, mobile licensing and relations with international telecommunications organisations.

In facing these challenges, a number of crucial policy issues for the sector need to be resolved. First, in which parts of the sector is competition desirable? Second, in those parts in which competition is desirable, should there simply be free entry, or should the authorities regulate a given number of competing operators? Third, what is the appropriate pace of market liberalisation? Should it take place as fast as possible so that the benefits of competition are quickly achieved? Or is there a case for a more gradual approach, so that the lure of monopoly profits in the short term acts as a spur to investment? Finally, where there remains a degree of monopoly power, what is the appropriate structure of regulation?

Scope for competition

In market economies there has been increasing competition in many parts of the telecommunications sector. The manufacture of equipment is a potentially competitive activity like any other, and in the transition economies this activity has long been separated from the telecommunications operators. The provision of enhanced services and cellular telephony to the final customer can be undertaken by rival operators, provided access can be assured on appropriate terms to the physical transmission network. Competition in cellular telephony has already been introduced in 11 transition economies (see Table 5.1). Although the fixed network has long been considered a natural monopoly, even this structure is changing, for a number of reasons. First, local radio links (which are not subject to significant scale economies) may soon be sufficiently low-priced to replace fixed links. Second, the falling cost of fibre-optic transmission, as well as the fact that telecommunications services can be bundled with other services, such as cable television or electricity distribution, means that the cost disadvantages of duplicating parts of the main network may be small compared to the overall value of the services provided and to the potential benefits from competition.

Competition in the core telecommunications services (local, domestic long-distance and international services) remains limited. In the great majority of countries, there is still a monopoly telecommunications operator, usually a government enterprise that is both owned and regulated by a government department or ministry. Partial privatisation of the state operator has taken place in five countries (the Czech Republic, Estonia, Kazakstan, Latvia and the Russian Federation) and majority private ownership has been achieved in only one (Hungary). However, this privatisation has only in some cases been accompanied by general liberalisation,

although this is sometimes promised for the future. The move towards liberalisation is most extensive in local services, where in Poland, Hungary, Kyrgyzstan, the Russian Federation and Ukraine local authorities have legally opened local networks to competition. Poland, the Russian Federation and Ukraine have also legally opened long-distance telephony to competition, but only Ukraine has allowed private entry in long-distance and international services through an operating concession.

It is ironic that there should be fewer countries with competition in international and long-distance than in local services, since local access is one part of the sector where the natural monopoly argument remains the strongest. However, the openness to competition in local services is less marked in practice than it looks on paper, for it is here that sizeable investments are required to raise the level of access to the network. The inversion of the tariff structure also makes local services less profitable to the incumbent operator and new entrants compared with domestic long-distance and international services. In Poland, for example, over 70 licences have been awarded for private entrants into local services, but only 14 have initiated operations. Those that have done so are also obliged to create new local infrastructure networks rather than build on the existing network of the dominant operator – a system which is good for maintaining competitive pressure on the dominant operator, but at the cost of considerable duplication.

While it is undoubtedly easier to introduce competition in areas of new technology, such as cellular telephony, where there are fewer entrenched interests at stake, in the rest of the sector difficult questions arise about the appropriate pace at which competition should be introduced. There are at least two reasons why phased competition is desirable. It allows both for an initial period of monopoly profit as an incentive to investors and for a period of learning and adaptation to new conditions. In Hungary, for example, under the terms of the sale of the 30 per cent stake in MATAV (the state operator) to a Deutsche Telekom/Ameritech consortium in 1993, MATAV will enjoy a monopoly position for eight years. Similarly, in Estonia the partially privatised operator, Esti Telefon, was given an eight-year exclusive right to provide long-distance services. By contrast, the partial privatisation of the Latvian operator Lattelekom in January 1994 involved a monopoly right for a period of 20 years (subject to some limited rights of competition in enhanced services and the establishment of private networks). The comparison with Estonia and Hungary suggests that such a lengthy period may be an unnecessarily long time to wait for the benefits of liberalisation. With only a distant prospect of competition, there may be limited incentive to invest now in new capacity and service improvements.

The gradual introduction of competition may refer not only to the period of time but also to the extent of competition envisaged. For example, in mobile telecommunications an initial duopoly may provide a better incentive than complete liberalisation for rapid extension of network coverage in the initial phase of investment. Complete liberalisation might encourage all competitors to concentrate their network coverage only on major population centres. However, at least limited competition in cellular telephony should be introduced where possible to help spur investment and to keep some check on profits, as the experience with Centertel in Poland illustrates (see Box 5.1).

International evidence on the value of phased competition for fixed-link telephony is difficult to assess conclusively, but it seems reasonable to suggest that it is most appropriate where the requirement for network investments is high, as in most transition economies. However, even where phased competition in the market is appropriate, it is desirable to ensure that there is competition for the market – for example, through the award of licences by competitive tender. The main difficulty with phased competition, however, lies in ensuring that the timetable for liberalisation is credible. Granting monopoly or duopoly rights creates interest groups with a powerful incentive to resist further liberalisation.

Effective regulation

For those activities that remain monopolies, the structure of regulation is of great importance. Only in Hungary, Latvia and Poland has there been the establishment of independent regulatory powers. In the great majority of transition economies, regulation of prices is still carried out by a government ministry, sometimes the same ministry that continues to have responsibility for ownership and management of the sector's assets. The fact that such a ministry is also subject to considerable political pressure has contributed to maintaining tariffs for local services below cost-recovery levels.

Box 5.1

Cellular telephony in Poland

In 1991 a joint venture between Poland's state-owned telecommunications operator, Telekomunikacja Polska SA (TPSA), with 51 per cent of the equity, and Ameritech and France Telecom, with 24.5 per cent each, established Centertel, the country's first provider of cellular telephone services. The EBRD provided debt financing for the venture. Centertel was granted a licence to develop and operate a country-wide, analog cellular network for 25 years. The participation of TPSA was in part intended to facilitate fair conditions for interconnection charges, while the licence granted Centertel the freedom to set tariffs. It was anticipated that competition would emerge from the licensing of two digital cellular operators. However, their start up was expected to be delayed until 1996 pending withdrawal of the Russian army, which occupied the radio frequencies. By the beginning of 1996 Centertel had 82,000 subscribers and reported a net profit of US$ 62 million on turnover of US$ 174 million. At the insistence of the majority shareholder, Centertel paid out nearly US$ 60 million in dividends, despite a provision in the EBRD loan agreement that the profits be funnelled back into investment. The EBRD subsequently called the loan. Also, in early 1996 the Polish government awarded the licences to operate two digital cellular systems to rival consortia, although Centertel had been promised one of these.

The case illustrates two important issues. First, when liberalisation is delayed (even though unavoidably in this case), monopoly provision of cellular telephone services can be very profitable in the context of widespread shortages of fixed-link access to telephone services. There would appear to be scope for two if not more cellular service providers in these markets. Second, if a monopoly is granted, it should be limited in time and supported with a requirement in the licence that the profits are funnelled back into investment.

In the Russian Federation the effectiveness of regulation is further hampered by the fragmented organisation of the telecommunications system and its control. There are 85 regional operators, which are owned by the republics concerned and a monopoly operating long-distance (between the republics) and international services. The Ministry of Posts and Telecommunications has overall responsibility for the industry, but the regional republics have considerable effective control over the publicly owned operators in their regions. The unsuccessful attempt by the Russian government to sell a share of a newly formed holding company of all the regional operators to foreign investors in 1995 points to the potential problems that regulatory uncertainty can create in attracting private participation. Similarly, the slow progress made by a joint venture between Deutsche Telekom, France Telecom and Rostelekom, the Russian domestic long-distance and international operator, to build a fibre-optic trunk network linking major cities may have been due in part to the uncertain legal and investment climate in the country.[8]

Poland has adopted a different policy, with responsibility for price regulation in the hands of the Anti-Monopoly Office (AMO). This approach has avoided, to some extent, the difficulties seen elsewhere of excessive protection of state-owned firms. Indeed, the AMO has ruled against the state-owned operator on several occasions. However, in its implementation a number of issues emerge. First, the Ministry of Communications issues permits for new service providers, but remains the owner of the dominant operator. Second, the legal framework for the terms of access to the fixed network remains unclear. Third, despite the AMO's efforts, the tariff structure still discourages investors from entering the market for local services, where licensing is more liberal. There are also more general issues raised by relying on AMOs to regulate telecommunications tariffs. While it is undoubtedly beneficial to have regulation carried out separately from a Ministry of Communications, assigning the responsibility to a general competition authority tends to confuse the tasks of creating competition and regulating prices in its absence. Many transition economies need to establish clearly the principle that competition policy is not merely price control in disguise, and allowing competition authorities to retain price control powers makes establishment of that principle more difficult. Also, there is no good argument for the pooling of expertise, since the nature of the training and skill required to regulate telecommunications is very different from that of more general anti-trust policy.

The main challenge of providing a credible assurance to investors is one with which all countries in the region are still grappling. Uncertainty over political developments and the consequent credibility of any proposed regulatory arrangements for the sector has proved very costly in some countries (such as the Russian Federation). In Hungary some attempt has been made to overcome regulatory uncertainty by making use of the provisions of contract law. The concession granted to MATAV in 1993 offers an eight-year monopoly in the supply of long-distance and international services, and in 29 of the country's 54 local districts. This monopoly is conditional on performance targets with respect to the rate of growth of installed exchange lines. It is also conditional on a price-cap formula that allows retail prices to rise by 7.5 per cent per annum in real terms, and this is reviewed every four years (by the Minister for Transport, Telecommunications and Water Management). Although the terms of this review are clearly potentially politically charged, the fact that it must take place only after four years represents a constructive attempt to use the greater certainty of the contract law to mitigate the vagaries of regulatory politics in the interests of creating greater certainty for investment. In some transition economies contract law is as uncertain as regulatory politics, but the solution seems well-adapted to the Hungarian circumstances. As shown in Chapter 6 of the 1995 *Transition Report* and Chapter 2 of this Report, Hungary along with Bulgaria, Croatia, the Czech Republic, Estonia and Poland have relatively effective legal frameworks for investment, including contracts.

Summary

The priorities in telecommunications can be summarised as follows. First, the regulation of prices, the granting of licences and the determination of conditions of access to fixed networks need to be placed in the hands of a regulatory body that is separate from the ownership and management of any state assets in the sector, and preferably insulated from day-to-day political pressures while remaining periodically accountable. Second, distortions in tariff structures need to be removed to create incentives for private investment. Privatisation provides a valuable way to increase the state's commitment in this process, particularly in local networks to increase access to telecommunications services. Third, a credible timetable needs to be established for liberalisation in the sector in international, domestic long-distance and local services. The precise pace of such liberalisation may vary with local circumstances, but long delays in introducing competition should be avoided. Enhanced services and cellular telephony should be quickly liberalised where this opening has not already taken place.

Electricity

Challenges

The immediate challenge is to provide electricity tariffs that reflect costs and to enforce payment by electricity users. This measure would lead to a long-term decline in the electricity intensity of the transition economies from the current high levels documented in Chapter 3. It would be wrong to conclude, however, that the region's power generation capacity is likely to meet power needs adequately in the medium term, particularly where there is a strong recovery in economic output.

Much of the current capacity is in very poor condition due to years of inadequate maintenance. In addition, the capacity has such low levels of energy efficiency that it is uneconomic at world fuel prices or it is highly polluting. Many generating units will have to be closed, and many more upgraded or retro-actively fitted with pollution control mechanisms. In some respects, therefore, the

8 See Armstrong & Vickers (1996).

need to encourage new investment raises similar issues in electricity as in telecommunications. However, there is also the serious additional constraint that tariffs have historically been held very low and may be politically much more difficult to raise. Nevertheless, establishing tariffs that reflect costs remains an immediate priority. Users of electricity must make current investment decisions in the knowledge that they will face tariffs reflecting the true cost of electricity production to the economy.

Since the prices of tradable forms of energy, such as oil and natural gas, have already been raised to international levels throughout much of the region, enterprises and households may tend to substitute subsidised electricity for the more expensive alternatives over time. Tariff reform is thus necessary to ensure that adequate incentives are in place for investments that use the most appropriate form of energy and that save energy altogether. Furthermore, credible environmental regulation of electricity needs to be in place, and tariffs must reflect the costs of regulated environmental standards. Regulation must also ensure that risks of power system failure or of incidents at nuclear power stations are adequately controlled. Finally, there is major scope for improved efficiency in the management of existing assets in the sector. The significance of private sector participation involves, therefore, both the provision of improved management of inefficient plant and the supply of new investment.

Tariff reform

Firms are the electricity users that have the greatest medium-term potential for investment in energy-saving techniques, and the establishment of cost-reflective tariffs for them is therefore urgent. However, in most countries the discrepancy between prices and costs is greatest for households, with their low average income limiting the scope for closing this gap quickly. Some progress has been made in raising tariffs in recent years (usually because of fiscal pressures), although there remains a considerable way to go, particularly in the countries at early and intermediate stages of transition.[9] Households are responsible for much of the peak energy demand (which is supplied from generation units with the highest marginal costs and often with the most polluting plant). It is uncertain how sensitive household demand is to prices, but there may be substantial efficiency gains to be made from better management of demand from households. Given the legacy of low tariffs in transition economies, as well as the potential importance of electricity in household budgets, the challenge is to find ways of structuring tariffs so that they are perceived as fair as well as efficient.

In some parts of the region the payment record of both households and firms is poor (Albania and Ukraine, for example) and there are sometimes significant system losses due to theft. Unfortunately, these problems may make raising tariffs more difficult, since higher real prices may encourage greater non-payment. However, provided that the legal powers exist to enforce payment (notably by denying access to persistent non-payers), and provided that the basic tariff structures are perceived as fair, rising real tariffs provide improved incentives for distribution companies to devote resources to ensuring collection.

The perceptions of fairness are important, however. First, raising household electricity tariffs to cover costs fully would have a significant impact on the real incomes of households (unlike with telecommunications charges). While there is evidence that this impact is not regressive on average, some poor households would be severely affected. It is important, therefore, to ensure that other tax-and-benefit policies are implemented to minimise the impact on poor households. High inflation sometimes makes it difficult to maintain steady real values of pensions and other welfare payments, and in these circumstances there is a good case for various kinds of "lifeline" tariff, with low charges for consumption up to a certain level and substantially higher charges thereafter. Such systems have the advantage that they can be targeted and therefore can have a limited overall budgetary impact. They can also be implemented by the service providers themselves, so they are less prone to become a vehicle for politically induced fluctuations of the kind that can play havoc with long-term investment decisions.

Second, factors other than the overall income distribution may affect the perceived legitimacy of electricity charges, and therefore the willingness of customers to pay. For example, in Albania the high levels of non-payment (up to 70 per cent) owe something to previous government policies that encouraged households to switch towards electrical appliances when real prices for electricity were low. Similarly, if large and well-connected state-owned enterprises fail to pay their bills and are not cut off (as has happened in a number of countries, including the Russian Federation and Ukraine), there will be severe resentment if smaller enterprises or households are penalised for non-payment. This suggests that policies to improve payment need to be introduced broadly and systematically so that burdens are perceived as being fairly shared.

There is in addition significant scope for energy savings in transition economies to help offset the impact of real tariff increases on consumer bills, as households and enterprises switch to less costly energy sources or invest in energy-saving technology. One approach to energy saving is through energy service companies, which develop small and medium-sized energy efficiency investments. These constitute the bulk of investments related to energy conservation on the demand side. Energy service companies are typically paid through contractual arrangements that convert customers' savings from reduced energy costs into a revenue stream. Such companies have become well-established in northern America and western Europe over the past decade and the concept is now being developed in transition economies with the support of the EBRD.

Privatisation in the electricity supply industry has a particularly important role in providing an incentive for, and a test of, the credible establishment of economic tariffs.[10] Hungary provides a good example of such a process at work, in that the government's efforts

[9] See Chapter 3.

[10] As has been argued by Newbery (1996a).

to privatise electricity distribution companies in 1992-93 failed to meet its expectations of sales values because investors lacked confidence in the future regulation of tariffs. These problems were addressed by establishing a more credible tariff policy, and eight electricity companies successfully privatised in early 1996 (see Box 5.2). By contrast, the inclusion of 30 per cent of the main vertically integrated company in the Czech voucher privatisation scheme and of 49 per cent of the Russian companies in similar schemes has involved no such pressure for improved regulation.

This does not mean that privatisation is impossible prior to the establishment of cost-based tariffs. The sale of an integrated regional monopoly and a large power station to foreign investors has been reported in Kazakstan, albeit at low prices that reflect the high risks involved in taking on loss-making enterprises in an uncertain business environment. However, this approach avoids addressing regulatory issues that will become important in the future and can involve the loss of valuable public revenue.

Elsewhere in the region there has been some private sector involvement in the construction and upgrading of generation capacity subject to power purchase agreements with municipalities or other power users. This approach points to the possibility of introducing competition in a sector which is still overwhelmingly loss-making, and where state ownership is likely to remain the norm for some time to come.

Box 5.2

Privatisation of electric power in Hungary

In January 1992 the Hungarian power sector was reorganised under a holding company, Magyar Villamos Müvek Rt. (MVM), with 15 subsidiaries: eight for power generation, six for distribution and one as the national grid. Through the State Holding Company, the government owned virtually all the shares in MVM, while MVM in turn owned 50 per cent of the subsidiaries, with the State Property Agency (SPA) holding most of the remainder. The role of the State Holding Company was to retain in government control those enterprises in which the government had a strategic interest, while the mandate of the SPA was to sell its holdings as quickly as possible. The SPA attempted to sell through trade sales 15 per cent of each of the six electricity distribution companies in November 1993. However, the government considered that the tender offers were too low, and then consolidated the ownership structure of the sector by transferring the holdings of the SPA to the State Holding Company.

The regulatory framework for electric power was finalised only after the failed privatisation attempt in a law passed in April 1994, under which the Hungarian Energy Office was created. The Office was given the authority to issue licences where there was a natural monopoly and to propose maximum tariffs, while the Minister of Trade and Industry retained responsibility for setting tariffs. In July 1995 after a series of negotiations between the Energy Office and the government, a decree was issued containing a series of price increases up to 1997 and a medium-term framework for setting tariffs. This framework for tariffs is designed to allow an 8 per cent return on capital.

The six regional power distribution companies and two generators were partially privatised in December 1995, with up to 49 per cent of the shares in each of the companies sold to foreign strategic investors in a public tender. In March 1996 retail tariffs were increased in line with the decreed formula. However, the government has postponed announcing any further increases from 1 October 1996 to 1 January 1997.

Scope for competition

There has been significant restructuring in the sector even without privatisation, with considerable separation of distribution companies both from each other and from the grid, and some separation of generation as well (see Table 5.2). In some countries, such as the Russian Federation, this restructuring involves basically the creation of regional monopolies (distribution, regional transmission and generation are vertically integrated, and the national grid provides the means for trade between these monopolies; the grid also has large shareholdings in the regional companies). Since the distribution companies may be able to pass on their costs of generation to the customer, the presence of the grid provides no real incentive to generate electricity efficiently. Elsewhere, there is potentially a more competitive structure in which generation, transmission and distribution are fully separated in order to break up both generation and distribution into separate operating companies. Armenia has five generating companies, Hungary eight, Poland 35 and Ukraine six. It can be argued that at least the larger countries (the Czech Republic, Hungary, Poland, Romania, the Russian Federation and Ukraine) should eventually be able to privatise a sufficient number of separate generation companies to ensure reasonable competition (a minimum of five companies is a reasonable rule of thumb).[11] However, the short-term prospect for competition in the market for power generation is limited by the lack of financial viability of the sector with current tariff levels and structures.

In the meantime, the unbundling of the electricity sector provides scope for competition in the right to supply the market through bidding for long-term contracts, provided access by private suppliers to the grid can be ensured on non-discriminatory terms.[12] This approach relies on long-term "take-or-pay" contracts with independent power producers, which ensure vigorous competition for contracts, but which provide weaker incentives for efficiency improvements after contracts have been signed. Although distribution cannot be a competitive activity, except for supply of retail services to certain large customers, separation of distribution companies from each other at least provides for accounting transparency and consequently makes it easier for price regulation to be based on comparative cost or "benchmark" information.

Effective price regulation

As with telecommunications, an important early task is to separate regulation from the state's responsibilities of owning and managing assets in the sector. There has been a variety of approaches adopted by transition economies, as Table 5.2 indicates. In some countries, prices are regulated by a branch of government that is separate from the energy ministries, although in such circumstances it is important to ensure that issues of safety and quality of service are

11 See Newbery (1996a).

12 See Bacon (1995) and Besant-Jones (1996).

not neglected. In Hungary and the Russian Federation a separate regulatory authority for energy as a whole has been established. It is too early to tell how effectively these agencies will be able to function, since it is unclear whether they will be able to operate with real autonomy. For example, the Federal Energy Commission in the Russian Federation is the successor to an earlier body that was widely criticised for having few powers and no real independence, since it was composed mainly of industry representatives. It has now been restructured to have consumer representation and has been granted enhanced powers to gather information, but the effectiveness of these changes has yet to be tested.

Table 5.2

Electricity sector

Comprehensive unbundling
(number of enterprises)

Generation:	Armenia (5), Hungary (8), Poland (35), Ukraine (6)
Distribution:	Armenia (53), Belarus (6), Czech Republic (8), Hungary (6), Poland (33), Russian Federation (72), Slovak Republic (3), Ukraine (27)

Independent power generators
(number of projects) Hungary (3), Czech Republic (1)

Privatisations[1]
(number of privatised enterprises)

Integrated utilities:[2]	Czech Republic (1),[3] Kazakstan (1),[4] Russian Federation (1)[5]
Generators:	Hungary (3), Kazakstan (1), Poland (1)
Distributors:	Czech Republic (8),[6] Hungary (6), Russian Federation (72)[7]

Regulatory institutions

Separate department within ministry:	Armenia,[8] Belarus, Bulgaria,[9] Georgia, Lithuania,[10] Ukraine[11]
Separate energy authority:	Hungary, Russian Federation
Anti-monopoly office:	Kazakstan, Kyrgyzstan

Sources: EBRD and World Bank.

1 Including partial divestiture.

2 Including regional integrated utilities.

3 CEZ (Czech Power Company) (high-voltage transmission and some generation) partially privatised using vouchers.

4 Regional integrated utility, Almaty.

5 RAO EES Rossii (Russian Joint Stock Company for Electric Power and Electrification) (high-voltage transmission and some generation) partially privatised using vouchers and through direct sales to insiders.

6 Partially privatised using vouchers.

7 Partially privatised to insiders, with the remaining shares owned by the integrated utility, RAO EES Rossii (high-voltage transmission and some generation).

8 State Committee on Prices deals with tariff issues; an independent regulatory authority is to be established.

9 Committee on Energy, which reports to Council of Ministers.

10 Establishing an Independent Regulatory Agency. As an interim step the government has established an Energy Pricing Council, which submits proposals to the Cabinet.

11 An independent regulatory authority is to be created as part of the 1995 reorganisation of the Ministry of Power.

There is also the issue of whether the energy sector should be regulated as a whole rather than through separate regulators for electricity, gas and other energy forms. The case for an integrated approach may be strongest in those parts of the former Soviet Union where natural gas is in plentiful supply, but where international trade in gas is limited by security concerns in importing countries and the inadequacy of pipeline facilities. This means that domestic prices for natural gas should diverge from export prices for some time to come, contrary to the standard economic considerations for internationally tradable commodities. It is important, therefore, that the choice of techniques and the location of plant in electricity generation is made on the basis of coherent long-term decisions about the prices not only of electricity but also of different kinds of fuel. This task could be made easier by an integrated approach to regulation for the sector as a whole. However, a single regulatory agency could be particularly vulnerable to capture by special interests, especially in resource-rich countries.

The environment and nuclear safety

Different issues arise with respect to environmental and safety regulation. Electricity generation is a major source of airborne pollution, especially sulphur dioxide, nitrogen dioxide and carbon dioxide. The first two of these have both local and cross-border impact, and carbon dioxide emissions are a matter of global concern. It is clearly important that electricity generation should be carried out in a manner that takes account of the environment, and that users should face the additional costs that concern for the environment will entail. The issue, therefore, is to decide which form of regulation is most likely to ensure that this happens.

Regulation by an energy ministry which continues to own the assets of the industry or to be closely identified with the industry's interests is certainly undesirable. Environmental regulation is often expensive and will tend to be resisted within the industry itself. The alternatives are regulation by either a general environmental agency or by whichever agency is charged with regulating other aspects of electricity. The advantage of the former is that it enables an integrated and coherent approach to be adopted to overall environmental regulation. It also ensures that the political difficulties faced by the industry in raising tariffs do not provide an incentive for lax enforcement of environmental standards. An associated risk, however, is that regulation becomes excessively strict because of the agency's wish to justify itself and to enlarge its own budget. For transition economies where there are high levels of pollution in the power sectors, this risk is probably smaller.

Given the shortage of resources which might attract investment in the region, it is essential that reductions in polluting emissions are achieved efficiently. The experience of environmental regulation in market economies has shown that traditional command-and-control methods can sometimes be very inefficient.[13] More innovative regulatory instruments, such as tradable emissions permits, which ensure a given level of emissions reduction by those plants which can do so at the lowest cost, are potentially of

13 See Newbery (1990).

particular value in transition. They can be much simpler to operate than command-and-control methods because they require less detailed information on the part of the regulatory authorities.

Regulation of nuclear safety poses particularly difficult problems since it is often the most dangerous plants that provide cheap base-load power and which national authorities are most reluctant to close down. As the accident at Chernobyl indicated, nuclear safety has important cross-border implications. The effectiveness of this regulation is therefore an entirely proper matter for international negotiation and concern.

At their 1992 Summit, the G-7 countries offered those countries in transition a multilateral programme to improve safety in their nuclear power plants. This initiative was to comprise immediate measures in operational safety, short-term technical improvements based on safety assessments, and enhancement in regulatory regimes. It was also to create the basis for longer-term safety improvements by considering the scope for replacing less safe plants by developing energy sources and by improving energy efficiency. The G-7 also advocated setting up a multilateral mechanism to help implement this initiative, and in 1993 it proposed that the EBRD establish a Nuclear Safety Account (NSA) to receive contributions from bilateral donors to be used for nuclear safety projects in the region. The EBRD administers the NSA, which has several projects under implementation in the region.

Summary

The overall priorities in the power sector are therefore threefold. First, tariffs reflecting costs need to be established for both households and firms. Second, complementary policies need to be put in place to improve collection rates, to promote investments in energy conservation and to ease the adverse impact on the poor. Third, strong and independent institutions need to be established to regulate tariffs, environmental pollution and nuclear safety. Only when progress is made in these three areas is there likely to be significant private investment in improving existing capacity in the sector.

Water and waste water

Challenges

The available evidence on the condition of water and waste-water infrastructure in the region presented in Chapter 3 points to significant investment requirements to improve the condition of the existing piped water networks (particularly to reduce leakage) and to upgrade sewerage and waste-water treatment facilities. The important policy issues that arise in water and waste water are fourfold. First, how can competition be introduced into this sector? Second, to what extent should tariffs be raised, and how does this depend on progress in the introduction of metering? Third, what policy reforms in other sectors are required to reduce organic and inorganic pollution of water resources? Lastly, what is the appropriate structure of price and quality regulation in the water sector, and how can the efficient management of assets in this sector best be encouraged?

Scope for competition

Of all the infrastructure sectors, water and waste water are the areas in which there is least scope for competition in the traditional sense. The costs of the transmission network are inevitably a large proportion of the overall value of the resource, and there are significant scale economies and economies of density in building pipelines (as in the construction of other forms of water storage and transmission, such as reservoirs and canals). There may be other processes in the technology of water management that are less characterised by scale economies (parts of the sewage treatment process, for example). However, there are important benefits to which these processes give rise, and in the absence of some mechanism whereby private suppliers could appropriate these benefits, conventional competition is unlikely to work. Sewage plants could not compete to offer a cleaner environment to the final consumer, but this does not mean that there is no role for competition. However, it must be competition for the right to supply the market under a concession contract from the government (often termed franchise bidding in the water and waste-water sector) rather than competition in that market. Some of the terms of such concessions (service prices or quality standards, for example) must be determined by regulation rather than by the suppliers themselves, but competition to meet these terms is still essential. For example, water companies may compete to supply services of a given quality at the lowest service price, or a given quality at a given price at the lowest subsidy.

Implementation of this approach to competition for the market, however, raises a number of difficult issues. First, evaluating bids for complex services such as these requires a degree of experience often lacking at the local government level, even if consultants are hired specially for the purpose. Given the relative strength of engineering skills in the region, engineering criteria tend to dominate economic and financial considerations. Second, franchise bidding for an existing water or waste-water network is more problematic than a bidding for a build-operate-transfer project involving, for example, a new treatment plant. Uncertainty over the existing condition of the buried assets leads to high risk premiums in the bids, and the greater likelihood of future contingencies adds instability to the contract. Third, it is not an easy matter to put all non-price factors on an equal basis so that price alone can be the determining criterion in the evaluation. Negotiations will usually play an important role after the selection of one or more preferred tenderers. Fourth, frequent rebidding is the best way to maintain market pressure. However, this is not easy to accomplish in the case of water and waste-water infrastructure because of the existence of long-term assets and the problems involved in their valuation at hand-over. There is also a strong incumbent advantage that greatly reduces competition.

This is not to say that franchise bidding is not a valuable approach for the provision of water and waste-water infrastructure. The advantages it offers over a system of perpetual licences and regulation by permanent commission are considerable. However, careful consideration must be given to the supporting

administrative, legal and regulatory framework to ensure that concession contracts will be enforced by a competent court system. Hungary has already enjoyed some success in attracting the participation of private sector (including foreign) companies in this way (see Table 5.3).

Table 5.3

Water and waste-water sector

Municipal water and waste-water enterprises	
Operating concessions or leases: *(number of projects)*	Czech Republic (2), Hungary (1), Lithuania (1) and Poland (1)
Concessions to operate: *(number of projects)*	Hungary (3)

Sources: EBRD and World Bank.

In circumstances where private sector management expertise would be valuable for the sector, but where regulatory uncertainty is a significant disincentive to private investment, the granting of operating concessions or leases (which differ from concessions in that they require no capital investment) can provide a fruitful form of public-private partnership. This approach has been followed in four transition economies (the Czech Republic, Hungary, Lithuania and Poland). One advantage of such arrangements is that competition may be increased. Without the need to amortise long-term assets, it becomes possible to rebid the contract on a more frequent basis, perhaps as often as every five years. A major disadvantage, of course, is that the need for private sector financing is usually one of the major objectives of local governments in the first place. The absence of capital commitment by the private sector also requires closer and more detailed monitoring than would be necessary under a concession contract, especially to make sure that adequate maintenance is carried out on the assets of the sector. However, high-powered incentives can still be created for management to achieve efficiency improvements, by linking rewards explicitly to the cost savings achieved.

Effective price regulation

A distinguishing feature in this sector is the trade-off between centralisation and decentralisation in regulation, which influences the selection of regulatory approaches and institutions. The local nature of services argues strongly in favour of placing primary responsibility for them at the local government level (with an exception being made for certain environmental and water-resource aspects) so that service providers will be accountable to local groups, and services will reflect local needs. However, there will be a need for regulators to scrutinise the costs of service providers and consequently for a considerable degree of financial, economic and administrative expertise, which is often lacking at the local level. In addition, the level of regulation that is needed to inspire investor confidence requires both great expertise and independence of opinion.

One of the major challenges in transition economies is to work out the details of regulatory mechanisms and institutions for water and waste water, taking into consideration the political and administrative culture of each country. The special difficulty during the transition is that, given the legacy of a command economy and strong centralisation, it is all too easy for central government regulation to become overly bureaucratic and insensitive to local conditions. For this reason, solutions may be favoured that involve contracts combined with supervision by independent, non-governmental groups. Their efforts, however, could be supported by central governments in information gathering and analysis. Because of the relatively large number of separate service systems in each country that can be used as a means of comparison, benchmark pricing has considerable potential in this sector, although it will take some time to develop robust methodologies.

It is important to emphasise the need to attain clarity in the regulatory framework, since the assurance of a credible and remunerative tariff structure over the medium term is as important in ensuring private sector participation as it is in the case of electricity. The establishment of cost-based tariffs has another important virtue. Not all users are metered (especially in the household and small business sector). Cost-based tariffs can encourage the voluntary adoption of metering by users who wish to economise on the use of this scarce resource. This is a matter of particular urgency in industry and agriculture, where the intensity of water use is frequently well above levels in market economies. Raising tariffs may help, therefore, to establish the principle that water is no different from any other goods, as well as making metering appear the friend of the user rather than the imposition of the state. The same principle operates here as in the case of electricity: linking tariff increases to conservation measures makes both the increases and the conservation appear more reasonable and more legitimate than if either is undertaken separately.

The environment

The Aral Sea problem illustrates one of the most significant predicaments in water resource management, namely the extent to which water quantity and quality depend on the management of other sectors of the economy, notably industry and agriculture. Excessive diversion of river water for agricultural use was responsible for a decline of 40 per cent in the surface area of the Aral Sea and a fall in its volume by 65 per cent between 1960 and 1989.[14]

Both industrial and agricultural production can make large claims on water resources (and usually pay well below the costs of these resources). Both can also involve processes with high levels of pollution that damage the quality of the water for the rest of the population. More than in any other infrastructure sector, therefore, the quality of services is affected by regulatory decisions taken in other sectors. For example, agricultural policies encourage intensive farming which results in an increase in the nitrate content of water that runs through arable soil; typically price support for agricultural output is not matched by measures to raise the price of

[14] See Gleick (1993), Table F.20.

chemical inputs. The poorly regulated discharge of industrial effluent damages water quality to such a degree that any subsequent intervention in the provision of water services is unable to reverse the damage. It is often far more cost-effective to use regulation to prevent water pollution occurring in the first place than it is to intervene to clean it up after it has occurred.

These considerations suggest that there is a strong case for regulation of environmental issues affecting the water sector and that this should be carried out by a separate body concerned with overall environmental policy. Given the way in which pollution of water sources can cross regional and municipal boundaries, this suggests that environmental regulation needs to be carried out at a national level, although regulation of the service delivery can be and often is the responsibility of lower levels of government. Many transition economies have made water service the responsibility of municipal government. However, the means by which municipalities can be given incentives to take into account the cross-border impact of their policies remain to be fully developed, though several regional water resource initiatives are under way, including in the Danube River Basin, Baltic Sea and Black Sea.

Summary

Overall, the policy priorities for the water and waste-water sector are threefold. The first is to encourage private sector involvement in management and service delivery through competition for the market. Second, tariffs that reflect costs must be established, not only to strengthen the financial viability of service providers but also to encourage metering and other investments in water conservation, especially by agricultural and industrial users. The third priority is to ensure that these costs take account of the effect that water use – by industry and agriculture, for example – has on the availability and quality of water for other users. In particular, polluters of water must pay the full cost of the damage they inflict. These priorities will be best assured by the establishment of independent and transparent regulatory institutions, although their structure and composition may differ from that in telecommunications and electricity given the local nature of the natural monopoly.

Transport

In transport, considerations of overall system capacity, which are extremely important in telecommunications, are less significant than the geographical and functional mismatch between the components and quality of transport infrastructure and likely future demand. As trade patterns in transition economies reorient towards existing market economies, there is a need for new and expanded westward links, by road, rail, sea and air. Rail use (relative to GDP) is still very high in comparison with industrialised market economies, but has declined sharply in the transition. The changing market share in favour of road transport reflects the more diversified composition of production in the transition. In addition, transport networks are often in poor condition and not as effectively managed as they could be. Major investments are required in maintenance and in upgrading the quality of existing infrastructure in line with market demands, and more effective management is required.

To find the right balance between competition and regulation in the transport sector, two interrelated questions need to be addressed. First, what is the scope for competition in transport? Second, what quantity and type of regulation is needed, and more generally, what role should governments play?

The scope for competition in transport depends largely on the specific characteristics of individual modes of transport and on the existence of alternative modes which can provide competitive services in the same markets. The distinction between competition *within* the market and competition *for* the market is particularly important in this sector. Competition in the market can take place between firms in the same mode of transport – intra-modal competition – or between firms in different modes (road or rail, for example) competing in the market for the same service, namely transport between two points. Competition for the market takes place when different firms compete for the right to provide a service for a given period of time (urban bus franchise) or to build and operate infrastructure under a concession agreement (toll motorway concession). Transport modes differ regarding the potential scope for each type of competition, and the extent of institutional and financial restructuring that first needs to be undertaken.

Government strategic planning and regulation have important roles in transport infrastructure investment. These roles reflect the influence of transportation on many aspects of economic activity and social life and its impact on land use and the environment. These considerations mean that uncoordinated and unregulated private investment cannot be expected to respond adequately to the needs of the economy and society as a whole.

Competition within the market

Competition within the market is usually more feasible and desirable for the supply of transport services than that of transport infrastructure. Certain services, such as road haulage, inter-city coach services and air transport, can be opened up fairly fully to competition, and experience in market economies provides valuable lessons. In transition economies there has been extensive privatisation and liberalisation of road haulage, often as part of a process of divesting of services by large vertically integrated enterprises. Hungary and Poland, for example, liberalised and privatised their road haulage services from existing local public enterprises and own-account fleets. Because of the large number of these privatised service enterprises, as well as the lack of significant economies of scale in such activities, this has resulted in *de facto* liberalisation of haulage markets. However, obstacles to entry remain significant in some countries. These include difficulties in obtaining operating licences, or preferential contracting policies by state authorities. There has been less progress in liberalisation of inter-city bus transport.

Although deregulation of road haulage, inter-city bus services and air transport in market economies has not been free of problems, existing evidence strongly suggests that general restrictions on entry into these markets serve no useful purpose, and that the

amount of institutional restructuring required prior to open competition is minimal.[15]

Introducing competition among train-operating companies is more complex. It can require a large amount of enterprise restructuring, regulatory frameworks for gaining fair access to tracks, mechanisms for allocating capacity, and new contractual frameworks between infrastructure owners and operators to ensure safe and reliable services. There are basically three ways in which railways can be restructured, and each creates different potentials for competition. The first is to put the railway infrastructure under the direct management responsibility of the main passenger or freight operator which uses it and to charge other operators which might also use it for access. The second is to establish infrastructure as a separate internal business within an integrated railway and then to create an internal market with the freight and passenger division. The third approach is to establish the infrastructure business as a separate corporation, so that commercial relationships with the freight and passenger operating companies are formalised in legal contracts. Each of these approaches aims to create scope for competition by unbundling vertically integrated railways, and each has advantages and disadvantages which vary with the particular circumstances of the railway. EU directives require the second approach, and they may be strengthened in due course to require the third. However, EU countries, with the exception of Great Britain, have not embraced the notion of competition among railway operators.

Most countries in transition have recognised the need to adapt their railways to the market economy. Some are in the planning stages of reform, and a few have begun the process of vertical unbundling. The latter countries include Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Russian Federation, and Slovenia (see Table 5.4). In comparison with railway restructuring in western Europe and other industrialised countries, the envisaged pace of change is very rapid, given the extensive use of railways under central planning and the sharp decline in demands for their services in the transition. These plans must recognise the impact of strong competition from other modes of transport, but there remains the need to continually reappraise productivity targets, equipment utilisation and unit cost levels.

Table 5.4

Transport sector

Functional separation of state railways:[1]	Bulgaria, Czech Republic, Hungary, Poland, Romania, Russian Federation[2] and Slovenia
Concessions for ports and airports: *(number of projects)*	Hungary (1), Kazakstan (1) and Turkmenistan (2)
Motorway concessions: *(number of projects)*	Hungary (2), Poland (bidding stage) and Romania (bidding stage)
Regulatory institutions: *(separate motorways authority)*	Hungary, Poland, Romania

Sources: EBRD and World Bank.

1 The functional separation of railways involves establishing separate operating units within the state railway along functional lines, typically, freight haulage, passenger services and infrastructure (tracks, signalling, stations).

2 Commitment under the 1995 Statement of Modernisation Strategy and Commercialisation Principles for Russian Railways.

The fact that vertical unbundling of infrastructure and service operations can create scope for competition within the market applies to other modes of transport as well. For example, the joint operation and management of airport and airline services in transition economies is a practice inherited from the integrated structures of the past, and is a system which hampers competition. There are no financial or operating reasons to maintain airports and airline operations together. If anything, this may provide opportunities for cross-subsidy, which should be avoided. Moreover, there is ample scope for introducing competition in airline services and to a lesser extent in airport management. After the US experience with deregulation, the scope for introducing viable competition in the provision of commercial aviation services is no longer in doubt. Recent developments show that regional airlines can successfully compete with nationally established airlines. There are useful lessons in these developments for countries such as the Russian Federation and the Central Asian republics, where airline services are vital for long-distance travel. Airports represent a case where ownership of infrastructure can be successfully separated from the running of airport services, such as runway maintenance or baggage handling, with the possible exception of air traffic control.

Competition for the market

Competition for the market can provide for private participation and efficiency gains in many areas of transport infrastructure provision and management, such as road and rail track maintenance, the construction and operation of toll motorways, airport terminals and port berths. Through competitive bidding for the right to provide and/or manage a given infrastructure facility or support service for a period of time, or to undertake a particular investment, it is possible to achieve significant cost reductions and service quality improvements. In the Russian Federation, for example, competitive bidding for road maintenance works was introduced in 1994, leading to increased competition in the selection of contractors and to a reduction in costs per unit of lane-kilometre of road upgrading work being contracted.[16] Likewise, open tendering for major road works is becoming common practice in Romania as part of the restructuring of the road sector, including the construction industry and the Ministry of Transport.

Concessions to build and operate parts of the transport infrastructure can also attract private participation and new investment into the sector. Toll motorway concessions have been granted in Hungary and are at the bidding stage in Poland and Romania (see Table 5.4). In principle, the use of tolls means that such concessions can involve 100 per cent private finance. However, traffic flows in most road corridors in the region are not yet sufficient to bear the full cost of upgrading to high-standard, dual-carriageway,

15 See, for example, Morrison and Winston (1986), McGowan and Seabright (1989), and Thompson and Whitfield (1995).

16 see Bousquet and Queiroz (1996).

segregated highways. Nevertheless, motorways typically have social rates of return well in excess of their private rates of return because of their contribution to reducing congestion and accidents and creating new land use opportunities, although in some circumstances they may impose significant environmental costs of their own. Where private rates of return are inadequate to make the project independently viable, this suggests that public-private partnerships, in which the state contributes a subsidy in recognition of the social benefits thereby created, may make an important contribution to mobilising investment finance in this sector.

Concessions for other elements of the transport infrastructure (airports and ports) can work in similar ways to those discussed above for the water sector. Four such concessions are in operation in three transition economies (see Table 5.4).

Regulation

The nature of necessary regulation depends very much on the nature of prevailing and potential competition. When inter-modal competition is strong and there are no artificial barriers to entry into the market, there appears to be little reason for price regulation. While the safety aspects of road and air transport usually need specialised regulatory expertise, evidence from market economies suggests that, provided the conditions for granting licences to operators are reasonably clear and non-discriminatory, and that an appropriate safety regime is properly enforced, regulation of the general process of competition in the provision of these services can be left to competition agencies.

Even in the presence of strong inter-modal competition, however, the relationship between modes of transport is complex and will require some coordination as well as competition. For example, the development of airports requires consideration of road and rail links; the scope for seaports to handle container traffic depends on the quality of rail links as well as on the presence of container terminals inland. For these reasons, decisions about the location of infrastructure investment requires regulatory supervision by local and/or national planning authorities. However, since these decisions usually have significant consequences for the profitability of existing service operators, such authorities can come under strong pressure to favour established operators against new entrants. A strong presumption in favour of competition and rights of new entrants is therefore appropriate.

When there is competition for the market, some amount of regulation is necessary to monitor compliance with the concession agreements signed between the public authorities and the private concessionaires. In addition, it is necessary to have an arbitration authority, which does not need to be a specialised one, to resolve disputes that may arise between the parties in cases of non-compliance. It is essential to ensure the independence of these regulatory bodies as well as to limit their proliferation. In Hungary, Poland and Romania independent authorities have been established to oversee the toll motorway concession (see Table 5.4).

Government credibility and consistency is vital to encourage private participation in transport infrastructure investment. The cancellation of toll road projects after the private sector has committed significant resources to the projects has occurred in some countries in the region, and such reversals will undoubtedly make it difficult to attract investment in similar projects in future.

In some transport sub-sectors, government will continue to play an active role due to inherent obstacles to efficient resource allocation posed by the fact that prices faced by alternative competing modes do not reflect true social costs. This is the case in urban transport, where basic economic principles suggest that pricing may require government subsidies to operators to support public transport, which is needed to reduce urban congestion and pollution levels. The degree of subsidy required will also depend on the complementary policies adopted with respect to taxation of private transport. For example, if congestion pricing could be adopted for roads, private car transport would become significantly more expensive, and public transport could compete without the need for large subsidies. Although market economies have been slow to consider the adoption of congestion pricing for roads, this is no reason for transition economies not to learn from earlier experiences.

Summary

The policy priorities for the transport sector are fourfold. First, the infrastructure needs to adapt to a likely long-term shift from rail to road, both by providing appropriate road infrastructure and by restructuring the railways to benefit from their comparative advantage and to reduce their dependence on state aid. Second, competition needs to be introduced or extended in areas where it is feasible, such as road haulage, air transport and inter-city bus services. Third, competition for the market needs to be implemented to ensure a more commercial approach and greater responsiveness to customer demand in areas as diverse as urban bus transport and the management of airports, where competition in the market cannot work directly. Fourth, effective regulation of environmental impact (including congestion and accident risk) needs to be undertaken to ensure that the growth in demand for transport services does not reduce the productivity of urban centres and the quality of city life.

5.3 Concluding remarks

Although the particular problems and priorities in infrastructure vary from sector to sector, a number of common themes emerge. Three in particular deserve to be highlighted here. First, competition for the right to supply the market is possible and important throughout the infrastructure sectors – in particular where competition in the market is either impossible or likely to be achieved only in the medium to long term. Competition in the market can be quickly achieved in some activities, as illustrated by the cases of cellular telephony and road haulage, although the scope for competitive provision in telecommunications extends well beyond cellular services. But elsewhere there are many services, such as electricity generation, water and waste water, airports, ports and

toll motorways, where competition for the market has the potential to increase efficiency and encourage private investment in infrastructure in transition economies and thus to promote its restructuring.

Second, establishment of tariff levels and structures that reflect both costs and fiscal constraints is necessary to encourage efficiency in the use of infrastructure services, to direct appropriately investment throughout the whole economy and to unlock finance for much needed investments in infrastructure. The use of infrastructure as a mechanism for distributing benefits and resources to households and enterprises has no coherent rationale. However, public resistance to tariff reform is often strong. Use of complementary policies, such as those that encourage energy efficiency or water conservation and that target subsidised services to the poor, however, can ease the impact of tariff reform and facilitate its implementation.

Third, independent yet accountable regulatory institutions are needed to oversee competition for the market, to guard against the abuse of monopoly power and to take into account the environmental impacts of infrastructure, such as pollution and urban congestion. There is no recent history with independent regulatory institutions in transition economies, and only limited progress has so far been achieved in the establishment of regulatory institutions that are separate from the government ministries which oversee infrastructure sectors. Given the time required to establish effective institutions, the initial steps towards their creation should not be delayed. Key considerations in the design of regulatory institutions, including boundaries between competition and regulation allocation of regulatory responsibilities, are provided in the summaries for each of the four infrastructure sectors discussed above.

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Part III
Promoting savings

Savings in transition

6

Economic growth requires rising stocks of productive inputs, encompassing all physical assets, personal skills and knowledge (human capital) together with effective use of these assets. Net investment augments domestic physical assets, while expenditures on education and training develop human capital. While the 1995 *Transition Report* focused on the determinants of fixed investment in the transition, this chapter focuses on domestic savings because of their dominant role in financing physical capital formation. Human capital formation is a vast and vital subject requiring separate treatment.[1] While access to foreign savings can ease the constraint of domestic savings on investment and growth, historically sustained high rates of investment and growth have not been achieved without strong domestic savings.[2] This relationship holds for the financially open industrial and rapidly growing developing countries.

Since domestic investment has been and will continue to be financed mainly from domestic savings in transition economies, sustained high rates of growth require high levels of domestic savings. This surplus needs to be channelled into the most productive investment opportunities. The experiences of the formerly centrally planned economies demonstrate the importance of both the effective intermediation of savings into investment and the selection of those projects with the highest returns. Despite East Asian levels of investment and educational attainment, growth in the planned economies faltered with the returns to investment declining to very low levels in the 1970s and 1980s.[3] In the transition, the productivity of investment appears to have improved somewhat, but aggregate domestic saving and investment rates have fallen sharply. The re-establishment, maintenance and enhancement of economic growth in the transition period will require substantially increased domestic savings, still more effective intermediation of domestic and foreign savings and productive investment.

The rapidly growing East Asian economies demonstrate that high domestic saving and investment rates can help fuel growth. The importance of savings to growth is further reinforced by more systematic evidence on market economies, both industrialised and developing. High-growth economies usually have high rates of saving. In principle, there can be two-way causality between savings and growth (from savings to growth *and* from growth to savings), and both savings and growth can be influenced by further factors, such as the nature of the political system, social and cultural norms or international technology transfers.[4] A recent study of household savings suggests that higher growth will produce only small increases in aggregate saving rates.[5] This result is consistent with the view that the positive correlation between aggregate savings and economic growth should be attributed primarily to a positive causal effect of savings on growth.

Most transition economies have witnessed a sharp decline in domestic saving rates. This decline has been accompanied by a dramatic shift in the composition of savings towards households and away from enterprises and the general government. This chapter examines factors behind both the decline in aggregate savings and the shift in their composition, as well as the interaction between these two developments. In addition, because of the dominant role of households in wealth accumulation in a market economy and their growing importance in transition economies, the chapter considers the main determinants of household savings and identifies policies which could support greater household wealth accumulation.

The decline in aggregate savings is in large part an outcome of the transition process itself, which eliminated the mechanisms for the accumulation of savings in command economies. The price liberalisation and deep recessions that followed the abandonment of central planning reduced enterprise profitability and thereby enterprise savings. Government savings have also decreased in most transition economies, for both cyclical and structural reasons. This fall reflected a combination of reduced revenues, with a recession-induced decline in the main tax bases and a worsening of tax administration, and of increased expenditure on social security payments and interest on the public debt. Household saving rates rose from their typically very low levels under central planning but not by enough to offset the collapse of enterprise savings and the reduced savings (or increased dissaving) by governments. This chapter examines a number of factors which help to explain why household savings did not offset these declines more fully.

It is expected that domestic savings will strengthen with progress in transition and there is already some indication of this tendency. Improving enterprise profitability is boosting enterprise savings. Economic recovery and fiscal stabilisation measures are reducing government budget deficits and increasing public savings (reducing public dissavings) but this may be fragile. Household savings too can be expected to increase as current income continues to recover.

1 See Laporte and Schweitzer (1994) and World Bank (1996), Chapter 8.

2 See Feldstein and Horioka (1980), Deaton (1989) and World Bank (1993).

3 See Bergson (1987), Ofer (1987) and Easterly and Fischer (1994).

4 The empirical relationship between GDP growth and savings has been extensively researched. Recent studies by Masson et al. (1996) and Ogaki et al. (1996) have found a direct positive association between GDP growth and private savings. Aghevli et al. (1990) estimated that a once-and-for-all increase of 10 percentage points in the saving rate would raise the average growth rate of real per capita GNP by 1.2 percentage points a year.

5 See Paxson (1996).

Several measures could be undertaken to reinforce the tendency towards greater household savings and to improve the efficiency of the allocation of household savings. Moving (gradually and probably only part of the way) from the existing pay-as-you-go or unfunded social security retirement schemes towards a fully funded system with individual accounts is one set of reforms under active consideration in a number of countries. Privatising some of the hitherto collectively insured income risks (health, disability and unemployment) may stimulate precautionary savings. The benefits from a higher domestic saving rate and any other efficiency gains would of course have to be weighed against possible adverse distributional consequences of such policies. The measures required to improve the allocation of savings and the quality of intermediation are familiar but sufficiently important to bear restating: improving the asset menu available to households (see Chapter 7), enhancing the supervision and regulation of the financial sector, ending any remaining financial repression, and abandoning institutions, policies, regulations and practices that artificially depress real interest rates. Large-scale financial instability in the banking sectors of many transition economies undermines the financial intermediation process as a whole. Restoring financial stability thus becomes a precondition for improved private savings performance.

6.1 Savings under central planning

The centrally planned economies had very high saving and gross investment rates, indeed significantly higher than in the industrialised market economies. The desire of the political leadership of planned economies to "catch up" with industrial and market economy levels of economic activity, and the system of economic planning produced policies based on the belief that centrally specified growth rates could be achieved by forced savings and directed capital accumulation.[6] This relentless drive for expansion and hunger for investment was reflected in very high rates of saving and investment, with savings being much the passive partner in the savings-investment duo. In other words, investment rates were specified and savings adapted to them by diktat.

The growth record associated with extensive capital accumulation was disappointing throughout the planning period, however. Even when output growth was high, during the early decades of central planning, factor productivity and changes in it were poor. Growth reflected mainly increased inputs of physical capital, labour and natural resources. Moreover, returns to investment went into steep decline between the 1950s and the 1980s. In this period the share of gross investment in GNP doubled from 15 to 30 per cent, as planners attempted to boost fading growth rates. However, the return to investment fell sharply, as did the growth rate of output. Poor efficiency in distribution under central planning was probably chiefly responsible. The diminishing returns to investment may have also been exacerbated by the lack of technical progress in the absence of competition and by the bias of the planners in favour of capital goods that were poor substitutes for labour, thereby exacerbating rather than mitigating the growing relative shortage of labour.[7]

Another striking feature of savings in centrally planned economies (particularly before their partial reform in the 1970s and 1980s) was that enterprise savings were relatively high and household savings low compared with those in market economies.[8] In as much as official statistics were meaningful, they suggested that the general government sector tended to be in fiscal balance, except towards the end of central planning. Planners set input and output prices so that enterprises in aggregate earned substantial surpluses, which were then reallocated to fund planned investment through a complex and often highly discretionary system of taxes and transfers. There was little incentive for households to save, since employment was virtually guaranteed and the state provided social security benefits which eliminated the need to save for a "rainy day" or for retirement and there was little access to durable consumer goods, the purchase of which would have required accumulated savings. There was also only a limited range of financial instruments which households could use to accumulate wealth, primarily domestic (and foreign) currency and deposits in state savings banks.

Since households had little incentive or ability to save, the savings which they did accumulate have been described as involuntary or "forced" due to the unavailability of many types of consumption goods. In practice this was true in the sense that consumption was controlled.[9] However, increased trade and financial links with industrial economies during the 1980s raised household consumption aspirations and made it increasingly difficult for planners to postpone consumption, and aggregate savings and investment ratios began to taper off in the second half of the decade. Planners also recognised that high rates of investment were not producing the expected results in terms of economic performance.[10] At the beginning of transition, past forced savings were reflected in a monetary overhang in the hands of households. Most of this overhang was eliminated by the initial jump in the price level and the subsequent high rates of inflation accompanying price liberalisation.

6.2 Aggregate savings performance

Gross saving rates in transition economies were around 30 per cent of GDP at the start of transition in the late 1980s and early 1990s. This rate was above the world average, above the average saving rate achieved by the industrialised market economies and above that achieved by the developing countries as a group.

6 Kornai (1992) refers to the tendency of central planners to see a virtual one-for-one relationship between an increase in fixed capital investment and economic growth.

7 See Weitzman (1970) and Easterly and Fischer (1994).

8 Household savings in Hungary, for example, averaged less than 5 per cent of GDP during 1985-89, compared with industrialised market economies in which saving rates were typically above 10 per cent of GDP over the same period.

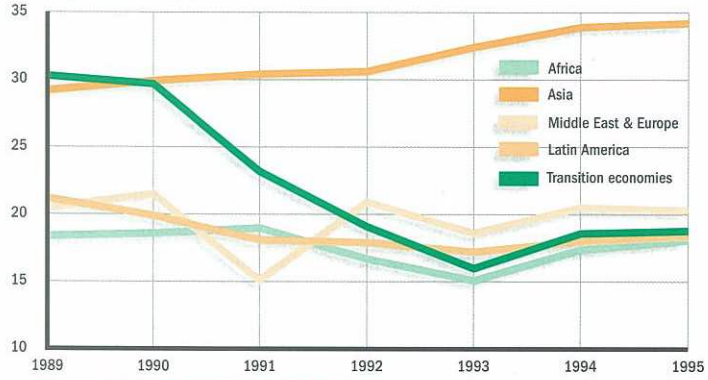
9 See, for example, Conway (1995) and Temprano (1995). However, the non-availability of consumer goods (say because of rationing) will not lead to forced saving if the following two conditions are satisfied: (1) the non-availability is expected to be permanent and (2) work is voluntary. If consumer goods are not available today and are not expected to be available in the future either, households would reduce work effort rather than building up useless financial wealth. The saving arose under central planning partly because there generally was some positive probability of being able to acquire consumer goods in the future and because attendance at work was effectively compulsory (although effort was open to choice).

10 See Ickes (1993).

Chart 6.1

Domestic savings in transition and developing economies, by region

In per cent of GDP

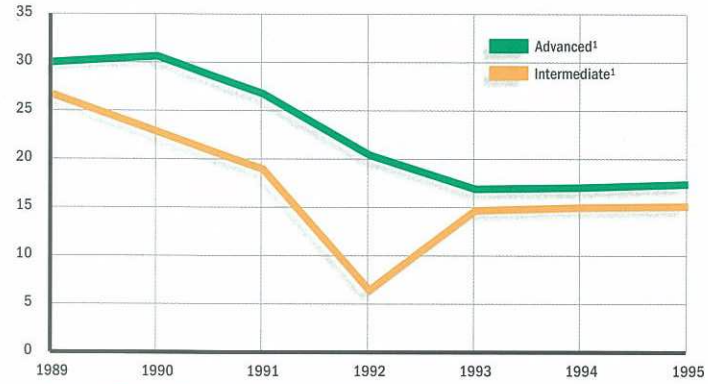


Source: IMF *World Economic Outlook*, May 1996.

Chart 6.2

Domestic savings by countries' stages of transition

In per cent of GDP



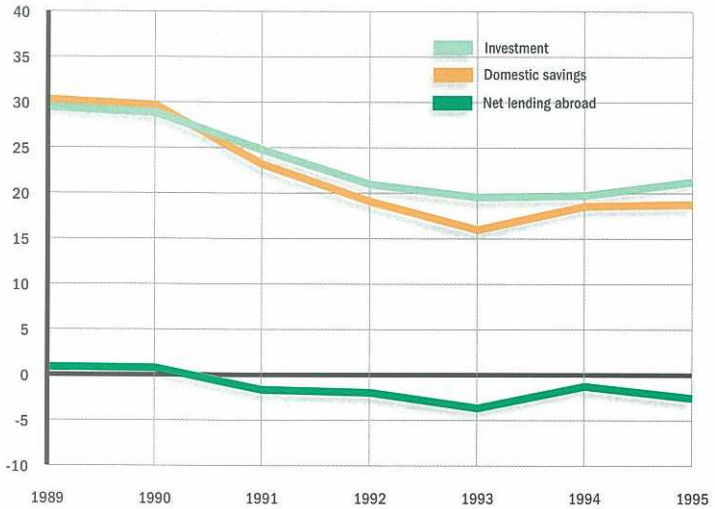
Source: IMF *World Economic Outlook* database.

1 Average of countries, grouped by stages of transition, for which data are available.

Chart 6.3

Savings and investment in transition economies

In per cent of GDP



Source: IMF *World Economic Outlook*, May 1996.

Indeed it was comparable, as Chart 6.1 shows, to the gross saving rate achieved in recent years by fast-growing Asian economies, although it reflected centrally planned investment rather than decentralised savings decisions.

In the initial stages of transition, however, the gross domestic saving rate began to decline, falling – at first gradually to 29 per cent of GDP in 1990 but then declining sharply to just 18 per cent in 1995. Savings in transition involved the shift from centralised investment to decentralised savings as the economic system moved from central planning to market principles. The current saving rate for transition economies is lower than the average world saving rate of 23 per cent of GDP and compares unfavourably with the fast-growing developing countries in the Asia region which by 1995 had raised their saving rate to 35 per cent.

Chart 6.2 depicts the trend in savings by countries at different stages of transition, where a country's stage of transition is measured by the EBRD's transition indicators presented in Chapter 2.[11] It shows that saving rates have declined in all transition economies but, having reached a low during 1992-93, saving ratios are recovering in those countries at advanced and intermediate stages of transition.

It is a major concern that the saving ratio has declined so dramatically in nearly all of the transition economies. The inherited capital stock is of poor quality and not well-oriented to the needs of the market economy (see Chapter 3). There is a continuing need, therefore, for high levels of domestic savings to finance investment in the transition. With more efficient financial intermediation and a better selection of investment projects, there may not be a need for pre-transition saving rates in order to support reasonable growth rates, especially if enhanced creditworthiness permits greater access to foreign saving. However, saving rates of around 23 per cent (the world average) would provide better growth prospects than the 18 per cent rates actually generated in 1995. Unless there are significant capital inflows, the steep decline in the savings share of GDP will have negative consequences for investment. Chart 6.3 shows the very close correlation between domestic savings and investment in transition economies. This feature can be expected to persist throughout the transition and beyond, although the more successful transition economies can expect to gain increased access to international financial markets.[12]

6.3 Composition of domestic savings during the transition

The decline in the aggregate domestic saving rate is due mainly to reduced savings in the enterprise sector and, to a lesser extent, to a reduction in government savings. The share of household savings as a fraction of household disposable income has been rising, but not by enough to offset fully the declines in the other sectors.

11 See Chapter 2 for a discussion of measuring stages of transition and the classification of countries. Those countries at advanced stages of transition are Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic and Slovenia. Those at intermediate stages of transition are Albania, Armenia, Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Georgia, Kazakstan, Kyrgyzstan, Romania, the Russian Federation, Ukraine and Uzbekistan. Those at early stages of transition are Azerbaijan, Belarus, Tajikistan and Turkmenistan.

12 See Chapter 8.

Government savings

Government savings (the excess of current government revenue over public consumption expenditure) are measured by adding the government budget balance to the capital investment undertaken by the government. The transition economies have been characterised by large government deficits at the initial stages of transition, which have recently begun to decline, particularly in countries at more advanced stages of transition, as fiscal discipline has been imposed and maintained. Nevertheless, in 1995 governments of nearly all of the transition economies ran budget deficits which ranged between 2 and 6 per cent of GDP. In general, countries at an early stage of transition are experiencing higher government and financial deficits, partly the consequence of the large losses which enterprises experienced in the sharp output declines, and drops in revenue, while initially public spending remains high. Deficits in countries at more advanced stages of transition are lower.[13]

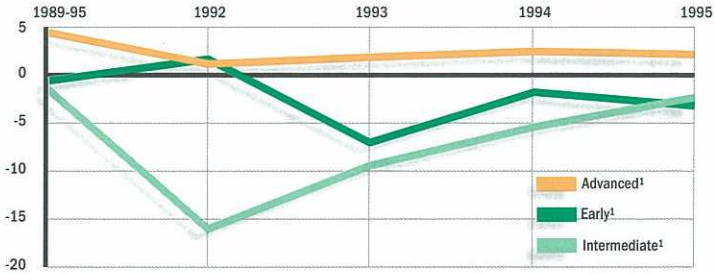
Government capital expenditures have fallen sharply since the start of transition. Part of this decline reflects the elimination of capital transfers from governments to enterprises for funding fixed investment, with the decentralisation of both investment and financing decisions. However, rationalisation of general government fixed investment was also required, given the distorted priorities for infrastructure and other types of investment under central planning.[14] That being said, government investment has declined in countries at all stages of transition, falling to 4 per cent of GDP in countries at advanced stages of transition and to 2-3 per cent of GDP in countries at early and intermediate stages.

The data on the general government deficit and public investment point to a significant reduction in government savings by those countries at advanced stages of transition and a swing from savings to dissavings by governments of countries at the intermediate and early stages of transition (see Chart 6.4). In 1995 average government savings were 2 per cent of GDP for countries at advanced stages of transition and around minus 2 per cent for countries at intermediate and early stages of transition.

Chart 6.4

Government savings by countries' stages of transition

In per cent of GDP



Source: IMF and IMF *World Economic Outlook*, May 1996.

1 Average of countries, grouped by stages of transition, for which data are available.

Enterprise savings

While relatively detailed information is available on government savings in the transition economies, there are much less extensive data on the savings of enterprises. The trend in enterprise savings in the transition is pieced together, therefore, from our knowledge of enterprise savings under central planning and of developments during the transition.

Under central planning, enterprises accumulated a significant share of domestic savings and served as the main base for taxation, including turnover taxes and a form of profits tax.[15] It is not surprising that enterprise profitability weakened initially in the transition, given severe recession, the large swings in relative prices, the opening to external competition and the emergence of domestic competition. However, reported enterprise profits were often distorted early in the transition by high inflation, and in particular by the accounting treatment of inventories and the depreciation of physical assets.[16] Reported profitability of enterprises should be considered, therefore, along with indicators of their internal cash flows, to provide an additional indicator of operating profits. Table 6.1 shows survey data on the profitability and cash flows of large enterprises in five countries in the region

Table 6.1

Profitability and cash flows of large firms, weighted by employment, during transition

	Year	Profitable In per cent of total	Positive cash flow	Cannot service all debt	Cannot pay all wages	Cannot pay all suppliers	Total (%)
Bulgaria	1992	20	2	35	32	10	100
	1994	34	9	30	23	5	100
Czech Republic	1992	60	13	7	13	7	100
	1994	81	11	4	3	1	100
Hungary	1992	59	6	15	14	6	100
	1994	68	12	8	11	2	100
Poland	1992	32	19	20	13	16	100
	1994	51	14	6	21	8	100
Slovak Republic	1992	61	17	7	9	6	100
	1993	71	15	3	9	2	100
United Kingdom	1993	93	5	1	1	–	100

Source: Pohl et al. (1996).

13 See Chapter 4 for a more detailed discussion of fiscal balances and government investment in the transition.

14 See Chapter 3.

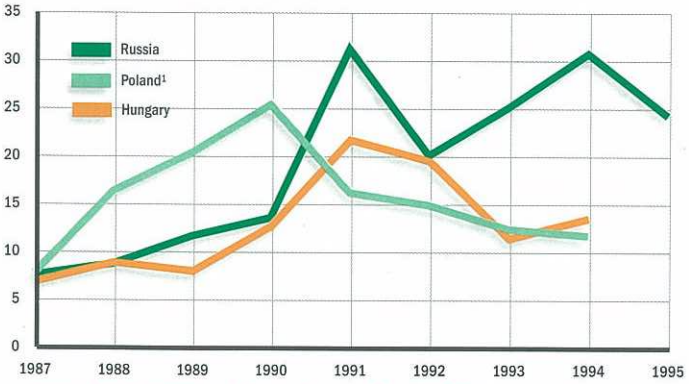
15 In Hungary, enterprises saved 68 per cent of income in 1985-89, compared with the 5 per cent saving rate of households.

16 See Chapter 5 of the 1995 *Transition Report*.

Chart 6.5

Household saving rates in selected transition economies

In per cent of disposable income



Source: IMF, IMF (1995) and *Russian Economic Trends* (1995).

1 There is a statistical break in the series between 1990 and 1991.

(Bulgaria, the Czech Republic, Hungary, Poland and the Slovak Republic). These data clearly show that by 1992 the profitability of large enterprises was seriously impaired, and many had insufficient cash flows to meet obligations to suppliers, workers and creditors. Given the profitability of enterprises prior to the start of transition, it is reasonable to conclude that enterprise profitability deteriorated sharply initially in the transition, although in some cases brief opportunities existed for the exploitation of monopoly power.

Just as the transition "shock" and ensuing recession severely weakened enterprise profitability, progress in transition and macroeconomic stabilisation can be expected to contribute to its recovery. This expectation is confirmed by the above survey results. These results point to clear improvements in enterprise cash flows and overall profitability in the Czech Republic, Hungary, Poland and the Slovak Republic between 1992 and 1993-94. In addition, large enterprises in Bulgaria also experienced some improvement in cash flows and profitability. However, the overall financial performance of enterprises in Bulgaria, which made slower progress in transition, remained well below that of enterprises in the countries at more advanced stages of transition.

Household savings

Reliable measures of household savings in the transition economies are as difficult to obtain as those for enterprise savings, with the compilation of data by economic sector still weak in many countries. Also, high inflation causes a number of measurement problems, in particular in capturing the erosion in the real value of financial assets and liabilities by high inflation. Savings as conventionally measured exclude capital gains and losses on existing holdings. That being said, measured household savings relative to GDP is likely to have risen in the transition for two reasons. First, the share of household income in GDP is likely to have risen as enterprise profitability fell. Second, households raised their rate of saving out of disposable income from the very low levels that prevailed under central planning, in part driven by an increased precautionary motive for savings as the uncertainty over future earned income and public pensions increased.

Time series data on household saving rates from before 1989 to 1994 are available for Hungary, Poland and Russia (Chart 6.5). These data point to a rise in saving ratios from about 8 per cent of disposable income in 1987 to the range 12-25 per cent in 1994. The increase in saving rates reflects both an increased motivation and ability for households to save in the transition. The specific factors contributing to increased household saving are discussed below. Lastly, some of the recorded decline in enterprise savings and increase in household savings may be due to investment by small-scale private ventures being counted as increased household savings, as statistics on enterprises are collected typically for larger (and often state-owned) firms.

Summary

Available evidence points to dramatic shifts in the composition of savings in the transition. A sharp, initial decline in enterprise profitability has been only partially offset by an upturn in household savings. At the same time, government fiscal performance

Box 6.1

Savings in Hungary

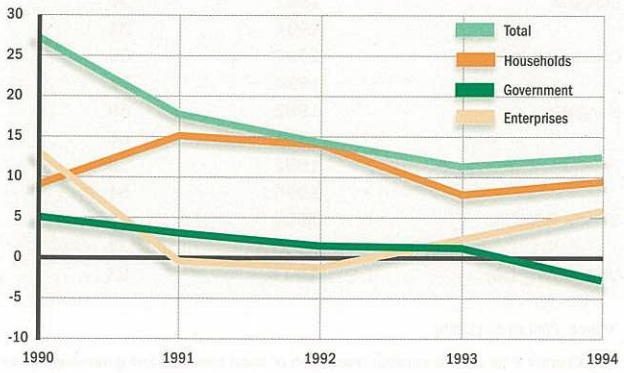
The Hungarian case is a good illustration of what may be considered the broad pattern of savings in transition. The chart below shows how the household saving rate in Hungary increased sharply at the beginning of the transition period in 1990-91 and how this partially cushioned the economy against the decline in saving in other sectors, especially the enterprise sector.

In 1990-91 households developed a greater incentive to save. The means to save was also greater. There was an increase in the share of income going to households, as wage indexation and increased social welfare contributions by employers reduced enterprise profits. High saving in this period may also have been a response to inflation and associated capital losses on the stock of private wealth. After 1991, Hungarian household saving rates declined and within a two-year period the household saving rate had halved before rebounding moderately in 1994.[1] The decline in household saving was a key factor in the deterioration of the aggregate savings-investment balance in 1993.

1 Unique country-specific factors may also exercise a significant influence on saving at times. For example, the Hungarian government removed the subsidy on mortgage repayments in 1991 and created an incentive to accelerate payments with early-payment discount. Therefore, household savings rose steeply in that year with an inevitable subsequent fall.

Composition of domestic savings in Hungary

In per cent of GDP



Source: IMF (1995).

deteriorated, with pronounced cut-backs in public investment easing the impact on government savings.

As the transition progressed, the strong shift in the composition of non-government savings was slightly reversed as enterprise profitability recovered. This general pattern is well represented by the experience of Hungary, for which detailed saving data by economic sector are available (see Box 6.1).

6.4 Does aggregate savings depend on the sectoral composition of income?

A key question both for the interpretation of the savings data and for economic policy is whether the aggregate saving rate depends on the composition of income between households, enterprises and the government. Another way of phrasing the issue is: does a redistribution of income among these three sectors affect the aggregate domestic saving rate? This question can be broken up into two parts. First, does the aggregate domestic saving rate depend on the distribution of income between the government and the non-governmental sector (the combined household and enterprise sectors)? The second question concerns the effect on the private saving rate of a change in the distribution of income between enterprises and households. This chapter takes the view that a decrease in government savings can be expected to lower aggregate domestic savings, although less than one-for-one. Redistribution of income from the enterprise to the household sector is likely to reduce the aggregate private saving rate, with enterprise savings falling by more than household savings increases.

Government versus non-governmental savings

Consider a decrease in public savings brought about through a decline in tax revenues – for example, with a temporary cut in taxes. Current and future public consumption and monetary policy are assumed to remain unchanged in the sense that the loss of tax revenues now means that there will be a future tax increase (equal in present discounted value to the current tax cut) to cover the shortfall. The current loss of tax revenue thus redistributes lifetime disposable income to the old from the young and to the generations currently alive from future generations yet to be born. The net effect on household consumption today is likely to be positive because those who benefit from the current fall in the tax burden are unlikely to consider fully the consequences of the inevitable future tax increases. The key point is that effective concern by the current generations for their own wealth and well-being is greater than their concern for that of future generations. Public consumption is unchanged by assumption, so total domestic savings (private plus public) decrease.

The empirical evidence is inconclusive as to the precise degree to which non-governmental saving behaviour offsets changes in government savings, but there is some suggestion that changes in public savings are likely to elicit opposite but less than equal changes in private savings. A recent study of industrialised market economies found a substantial offset of changes in the government fiscal position from private savings, averaging 60 per cent. This implies that changes in government savings can have a significant impact on total domestic savings, but that the decrease in government savings is likely to be accompanied by only a partially offsetting increase in household savings.

Enterprise versus household savings

Enterprises in transition economies have traditionally had a much higher propensity to save than households. If a difference in the saving propensity persists into the transition period (even though it may be smaller) the distribution of income between households and enterprises will have important implications for the aggregate saving rate.[17] Many transition economies have experienced a sharp redistribution of income from enterprises to households since the onset of reforms. Several factors have contributed to this. The indexation of wages and pensions has meant that enterprise costs have continued to rise while profits have contracted, reducing the amount of after-tax profit which may be invested. Furthermore, enterprises are contributing a higher proportion of the cost of social security than households. For example, in the Czech Republic employers' social security contributions amount to 37 per cent of the wage bill, compared with 13 per cent for employees. In Hungary, employer-paid social insurance contributions increased from 43 per cent of the wage bill in 1989 to 51 per cent in 1993, largely to cover unemployment compensation. This redistribution of income has resulted in relatively higher household income and savings but, because households have a lower saving rate than enterprises, the aggregate saving rate has declined in all transition economies.

In principle, the saving decisions of households and enterprises are jointly determined. Households are either indirect claimants on enterprises through government ownership, or direct claimants through the ownership of shares in privatised enterprises. In an ideal world, a rise in retained earnings would increase the stock-market value of the enterprise and hence household wealth would be the same as it would have been if the firm had distributed the profits in the form of dividends. Hence, it should make no difference to aggregate savings whether profits are retained by enterprises or distributed to households in the form of dividends (or higher wages). A rise in government enterprise savings should have the same effect, provided that the proceeds are efficiently allocated or re-invested and provided current generations act altruistically *vis-à-vis* future generations. In such circumstances, the enterprise is a veil.

For the veil to be perfect, however, requires efficient capital markets and effective corporate governance.[18] Even in the advanced market economies, there are many features of the economic mechanism which cause the corporate veil to be imperfect. These include, among others, distortions in the tax system, the existence of bankruptcy risk in the presence of limited liability, the presence of liquidity constraints and cash-flow constraints that

[17] Household income refers to household disposable income after taxes and transfer payments. Enterprise income is retained earnings of the enterprise sector after taxes, social security contributions and dividends and equals enterprise savings.

[18] In the case of state-owned enterprises it also requires the effective intergenerational altruism referred to earlier.

affect households and enterprises differently, and the pursuit by enterprises of managerial objectives other than maximisation of shareholder value. All these features are present to an even greater extent in transition economies than in industrialised market economies. In such circumstances the distribution of profits to households in the form of dividends has the potential to reduce aggregate savings, because severely liquidity-constrained households are less likely to save out of household disposable income than enterprises are out of retained enterprise earnings, because retentions by definition equal enterprise savings.

6.5 Determinants of household savings

In the transition, households will become the primary source of domestic savings. In general, the main determinants of household saving behaviour are the changing structure of the family and the desire and the capacity to ensure a smooth pattern of consumption over the life cycle of individuals and to insure against unpredictable fluctuations in income. The range of financial instruments and their returns are also important in mobilising household savings for domestic investment. In principle, saving rates could also respond to the expected after-tax rate of return on savings, but empirically no significant effects are found. The composition of savings is, however, sensitive to rate of return differentials among competing savings instruments. Sufficiently high uncertainty about the rate of return on savings (e.g. due to serious instability in the banking sector) may also depress savings.

Life-cycle saving behaviour

Life-cycle and permanent income theories of consumption and savings imply that the level of consumption depends on long-term expected income and does not respond significantly to transitory fluctuations in current income. For example, individuals save to ensure adequate consumption during retirement or dissave (e.g. by taking out student loans) to obtain a college education when they are young. Household savings are therefore assumed to follow a pattern over the life cycle whereby there is dissaving during the early part of the life cycle and most savings are done during the middle years of life, followed by dissavings during retirement. This has important implications for savings at the aggregate level. The first is that the demographic profile of an economy will have a significant effect on the saving rate. If there is a high proportion of retired people and other dependants, in relation to the working population, aggregate savings are likely to be relatively low. Conversely, a high number of workers in their peak earning years in relation to dependants should mean a high saving rate. Second, policies that affect permanent income are presumed not to affect the saving rate from long-term expected income, as they are translated into corresponding changes in consumption, whereas events that affect only current income but not permanent income are reflected in the saving rate.

The life-cycle and permanent income theories do, however, have important limitations which may be of particular significance in transition economies. The degree to which households are able to spread consumption over their life-time depends on their ability to borrow and lend, and in transition economies financial markets are often poorly developed. Liquidity constraints may reduce households' ability to spread consumption over the life cycle. Even with well-developed financial markets, future labour income, which is the largest component of wealth for many individuals, cannot be attached by creditors in the event of default and therefore provides poor collateral for consumption loans. With underdeveloped financial markets, even tangible assets may be hard to collateralise. This makes borrowing against future labour income, in order to spread consumption over the life cycle, problematic and costly or even impossible.

Transition can be expected to affect life-cycle savings in three ways. First, if it raises long-term expected income while temporarily reducing actual income (as would be the case during the deep recessions characterising the early stages of even the most successful transitions), this will tend to lower saving rates. Second, to the extent that confidence in the ability of the state's social security retirement schemes and other state pension schemes to provide for an adequate standard of living during one's retirement is undermined by the transition, private savings for retirement can be expected to increase.[19] The demographic structure of the transition economies is also changing (in the direction of a larger proportion of retired people and a higher dependency ratio) in a way that puts downward pressure on aggregate saving rates. Third, the constraints on the ability of the households to borrow in the transition economies may make consumption particularly responsive to changes in current income. These life-cycle effects on savings pull in different directions and it is not yet clear what the net effect will be. Nevertheless, policy-makers will need to take careful account of these three effects on savings in considering measures to promote household savings.

Precautionary savings

Uncertainty can be expected to exert a strong influence on saving behaviour, with the propensity to save out of permanent income increasing with the uncertainty attached to the future income stream. Precautionary saving behaviour is especially pronounced when strong household aversion to low consumption interacts with an inability to borrow when income is low. This combination can induce households to build up financial wealth to a relatively stable target level so as to hedge against future income uncertainty.

The rise in household savings in the transition economies must in part be attributable to the precautionary motive. This is because many transition economies, especially those at the early stages of transition, are suffering from high and uncertain inflation, declining aggregate output and increased unemployment. In addition, there has been an important permanent change in the need for households to insure privately against a whole range of income risks that had previously been insured collectively.

The responsibility for funding the social safety net has been shifted from state enterprises to the general government and households. As a result of this shift in social provision away from

[19] See Chapter 7 on contractual savings.

the enterprise sector, the general government budgets for health and social welfare have increased significantly in many of the transition economies, often to levels that are viewed as unsustainable. It is therefore to be expected that the years to come will see a further shifting of the burden of social security and risk bearing onto households. Hence, the precautionary motive for savings is likely to become an important reason for increased household savings in the transition and may be expected to result in the accumulation of a stock of financial assets by an increasing number of households in order to insure against future uncertainties. While there is some suggestive evidence, it is, however, difficult to be confident about the precise magnitude of the impact of precautionary motives on saving behaviour by households during the transition thus far.

6.6 Policies to promote domestic savings

Fiscal policies

Both theoretical considerations and available empirical evidence suggest that total domestic savings can be raised by increasing government savings (reducing dissavings). For the advanced transition countries, current government expenditures as a share of GDP are at or above the average level in industrialised market economies. An important element in these high levels are overextended and poorly targeted pension and social security programmes (see below). In these countries there could be an important contribution to government savings (as well as to macroeconomic stability and efficiency) from curtailing expenditures in general and reforming these programmes in particular. For a number of countries at the intermediate and early stages of transition, the ratio of revenues to GDP have declined to dangerously low levels and the priority should be to expand the tax base and to improve tax administration.

The relative burden of taxation on enterprises and households can also have an impact on aggregate savings by shifting the balance between after-tax enterprise profits and disposable household income. Enterprises are more likely to save than households, and shifting the burden of taxation from enterprises to households will therefore raise total private savings, even if the total tax burden on the enterprise and household sectors combined remains the same. Higher retained earnings will boost enterprise investment as the cost of internal finance to the enterprise is lower than the cost of external finance.

A number of countries in the region have trimmed corporate profits tax rates in order to release cash flows for investment. Given the current budgetary pressures faced by governments in many transition economies, it may not be immediately feasible to make significant cuts in corporate profits taxes without severely compromising government revenue. However, increasing the efficiency of tax administration and particularly increasing the coverage of informal sector activities would enable more revenue to be collected. Household incomes, in particular, are supplemented by informal sector earnings. Increasing the efficiency of administering household income taxes, in particular, should widen the tax base and enable higher revenue collection, thereby helping to shift the balance of taxation more towards households. In industrialised market economies, around two-thirds of revenue comes from personal income taxes and social security contributions, with corporate income tax playing only a minor role.[20]

Social security reform

Unemployment, created by recession and enterprise restructuring, has raised the requirements for social security expenditure in most transition economies. Current social security expenditure, including pensions, which comprises between 25 and 35 per cent of GDP in most transition economies and up to 50 per cent in some, is fiscally unsustainable. In comparison, in industrialised market economies transfer payments are typically around 20 per cent of GDP. Measures are gradually being introduced to tighten eligibility criteria and to means-test benefits.[21] There are also moves to shift some of the burden of social security expenditure to households.

Reductions in government expenditure on social security are likely to strengthen the incentives for private savings. Whereas previously households in transition economies relied on government provision of social security, some of the onus of this expenditure is shifting to the private sector. Studies of social security arrangements in the United States have shown that the public provision of social insurance has the effect of depressing household savings, particularly of low-income households.[22] It is argued that increases in social security reduce the perceived need to save to ensure adequate consumption in retirement or in the event of unemployment. This effect is stronger for the poor because social security benefits are a larger proportion of low-income households. Also, because state-funded benefits are usually means-tested, the accumulation of wealth by low-income households is actually penalised.

Public pension reform

The increasing burden of pension expenditure, combined with low levels of private and public savings, is poised to create substantial difficulties for the future financing needs of the governments of transition economies. As discussed more extensively in Chapter 7, ageing populations in many of the more advanced transition economies in particular are putting a heavy burden on state pension expenditures, and low fertility will exacerbate these problems in the future. This burden is likely to increase if early retirement provisions become more generous, if the tendency for people to live longer (recently reversed in a number of transition economies) resumes or if there are other demographic, legal or regulatory developments which reduce the ratio of workers to dependants. The tendency to index-link pensions when government revenue is declining in real terms is also putting pressure on the budget. One way to curtail the growing expenditure on pensions is to discourage early retirement. Another is to tighten the regulations for people continuing to work while they receive a state pension.

20 See Burgess and Stern (1993).

21 Means-testing benefits, while it reduces demands on the budget, has the negative effects of creating or enhancing disincentives to work and save, and of worsening 'poverty-traps'.

22 See Kotlikoff (1989) and Hubbard et al. (1995).

The way in which pensions are financed also has important implications for aggregate saving behaviour. Many transition economies currently have a pay-as-you-go system which requires workers and their employers to pay contributions through their taxes to the current generation of pensioners. Such a system does not perform well with the current demographic profile of transition economies, which typically have a high number of dependants to workers, unless there is very high productivity growth. Under a fully funded pension scheme, however, a stock of financial assets is accumulated to pay future obligations so that cumulative aggregate contributions plus investment returns are sufficient at any time to cover the present value of future obligations. Moving from a pay-as-you-go system to a well-managed, fully funded, mandatory, defined-contribution scheme, in which people have clearly identifiable individual accounts with pension funds, would also raise the saving rate of the young and the stock of private financial wealth. However, this would carry a high cost for at least one generation, which would have to pay for the pensions of their parents and save for their own "funded" schemes at the same time.

6.7 Concluding remarks

This chapter has covered the key determinants of savings at the household and aggregate level in transition economies. The picture which emerges is that aggregate saving rates have shown a dramatic decline during transition and there is some risk of a further decline unless policies are implemented to reverse this downward trend. In some part, the decline in saving rates is likely to reflect the fact that, due to unprecedented declines in real per capita incomes, current income is likely to be significantly below permanent or long-term expected future income.

As economic growth begins to recover, saving rates should recover somewhat. In addition, a redistribution of income from the household sector to the enterprise sector (through profit retention and wage restraint) and to the government (through higher tax collections) can be expected to raise gross domestic savings. However, it is also clear that governments need both to adopt more ambitious policies to restrict their own current spending and to implement policies to promote private savings and to encourage its effective intermediation into productive domestic capital formation. It is hard to visualise effective measures for promoting household savings that do not involve intergenerational redistribution from the old to the young and from the present to future generations.

As the transition economies adapt their inherited social commitments to the market economy, households must take on a large role in domestic savings at a time when the necessary institutional structures for savings in a market economy are only now starting to be built in many countries. Development of some of these institutions and instruments, in particular those for life insurance and private pensions, is the subject of Chapter 7.

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Mobilising household savings: life insurance and pension funds

7

Economic transition is about establishing markets and building the institutions to support them. Among different markets, those for income security in old age and in life contingencies have received relatively little attention during the first years of the transition as shorter-term concerns have dominated the agenda. Life insurance and pension funds belong to those elements of market economy that take considerable time to develop, because of their close dependence on financial stability and on the emergence of institutions that bolster confidence and capital market efficiency. However, once the early challenges of transition have been tackled, the potential benefits of a dynamic contractual savings sector deserve increasing attention, especially since governments can play an important, active role in promoting the growth of the sector.

Beyond their direct contribution to widening consumer choices and to peace of mind, contractual savings have the potential to advance reforms in other areas. Two such areas are reviewed in this chapter. First, an institutionally strong pension fund and life insurance sector can supplement state-sponsored pension schemes and over time support their reform. This social dimension of contractual savings could be timely and helpful in transition economies, in many of which social insurance systems are struggling and improved protection of vulnerable strata such as the elderly and the disabled is gaining in priority. The discussion of public pensions reform in transition economies and its implications for contractual savings is briefly reviewed in Section 7.4 of this chapter.

Second, pension funds and life insurance institutions can be important participants in the financial markets. On the one hand, they require some minimum level of soundness and liquidity of financial markets for their operation. On the other hand, they are uniquely able to lengthen the time-horizon of household savings and, by investing in assets of long maturity, they are able to deepen and widen capital markets with attendant benefits for capital formation. In addition, their financial "clout" may enable them to stimulate a range of financial innovations and institutions that support the equitable and efficient operation of capital markets, many of which would also benefit other market participants. The interaction between contractual savings and capital markets is covered in Section 7.5.

Before turning to this discussion of broader benefits from contractual savings for the transition process, Sections 7.1 and 7.2 first provide perspectives on the future growth of the sector and evidence on current developments. There is reason to believe that there is substantial latent demand for contractual savings products, though expansion to levels seen in the advanced industrial economies will take time. While conditions vary between countries, contractual savings in transition economies are still very much in their infancy. Nevertheless, small private life insurers have begun, in various countries, to challenge the former state monopolies, while the more advanced transition economies are experimenting with private pension schemes.

One of the key areas limiting the growth of contractual savings in many transition economies is the underdeveloped state of government regulation of the sector, particularly regarding effective supervision. In some countries, scandals involving speculative investment vehicles have undermined the public's trust, a crucial ingredient in the demand for long-term savings instruments. Government has a key role to play in improving confidence by putting in place effective means of consumer protection, and in stimulating demand through a tax treatment which, at least, does not penalise such savings. A discussion of the government's role in regulation and an overview of the present state of affairs - which is very diverse across countries - is provided in Section 7.3. The Annexes to this chapter contain a detailed, country-by-country presentation of the legal frameworks for life insurance and private pension funds.

7.1 Contractual savings and the economic transition

The demand and supply of instruments for contractual savings are subject both to macroeconomic developments and to the emergence of markets and market-based institutions. All transition economies have passed through a period of great macroeconomic uncertainty and extensive structural change. As uncertainty gradually diminishes, the appetite for longer-term financial contracts is likely to increase (even though lower uncertainty can dampen aggregate savings, as discussed in Chapter 6). At the same time, the structural change that characterises the economic transition also implies high productivity of capital and consequently the potential for rapid economic growth. Since evidence suggests that the demand for contractual savings products in established market economies tends to increase more rapidly than income, the growth of the contractual savings sector is likely to be even higher than that of GDP.

These consequences of price stability and growth are not unique to the transition process. However, there are also three important reasons why progress in transition, in a more narrow sense, could shift preferences in favour of contractual savings products. First, voluntary contractual savings expand opportunities for consumer choice. Savings instruments on offer under central planning were generally limited to basic banking products, primarily savings deposits. While life insurance was generally available, its terms were unattractive and the product range very limited. Private pension funds were unknown. Liberalisation may therefore transform the latent demand for a more diverse range of financial products into effective demand by establishing the necessary markets.

Second, contractual savings represent the long-term end of financial intermediation. The matching of long-term liabilities with appropriate assets continues to be very difficult and costly - or offer very low returns - even in the most advanced transition economies. As long as the securities markets, and the know-how, institutions and legal frameworks to support them, remain underdeveloped, long-term contracts will tend to be much riskier than shorter-term forms of savings. Ineffective consumer protection (regulation and supervision) further raises perceived risks and increases the appeal of retail banking products which are felt to carry implicit or explicit government guarantees.[1] As the transition advances, progress in these areas should gradually make contractual savings products more attractive. In fact, as Section 7.5 suggests, the development of the contractual savings industry and of capital markets in the region can mutually reinforce each other.

Third, the transition economies had - and some continue to have - state pension systems that were more comprehensive and generous, but also much more costly, than those of countries at comparable income levels. The incentive to purchase contractual savings products under these conditions, with other factors held equal, is likely to be lower than in other middle-income countries. The collective insurance of risks limits the need, while high payroll taxes reduce the scope, to provide for income security on an individual basis. Transition partly implies shifting responsibilities away from the state and to the individual, and contractual savings are key instruments for managing the increased personal responsibility for risks.[2] To the extent that social insurance is slimmed down - by design or *de facto* for lack of funds - contractual savings would take over some of its functions.

In spite of these factors, which point to latent unmet demand and a growing role for contractual savings as the transition progresses, it would seem unrealistic to expect a rapid expansion within a few years to levels seen in advanced market economies. Improvements in some of the key areas limiting demand, including institutional weaknesses (of providers and regulators) and the underdevelopment of capital markets are by their nature long-term propositions. There are also a variety of factors which are likely to slow down the supply response to increased demand in the short term. These include the weakness of insurance distribution systems, such as brokers, agents and retail banking networks (through the combined provision of banking and insurance services) and the significant capital needs for business expansion.

7.2 Development of contractual savings

The volume of contractual savings in transition economies varies substantially across countries, but tends to be small. Private pension plans have emerged in only a handful of countries. Life insurance, which was provided by state-owned institutions under central planning, shows more activity, but remains well below levels in industrialised market economies. However, there is evidence of rapid growth in both forms of savings.[3] Developments are far from homogeneous across the region, but closely mirror differences in the general progress of market-oriented transition.

Life insurance

Table 7.1 presents indicators of the development of life insurance, with premium revenues serving as a proxy measure for the extent of service provision. Since the structure of insurance products varies between countries, aggregate data provide only a partial picture of the trends. One case where the volume of premiums collected can be somewhat misleading is the Russian Federation. A majority of policies concluded in Russia in 1994 and 1995 had maturities of less than one year, representing salary substitutes motivated primarily by tax advantages. After changes in legislation early in 1996 this market collapsed. The evidence presented in the following should be read with this in mind.

The importance of life insurance differs greatly among countries. There is some evidence of a positive link between progress in transition and the volume of premiums as a share of GDP (the insurance penetration ratio). In Table 7.1, countries have been listed in declining order by their stage of transition in 1995.[4] Where data were available insurance penetration in 1995 varied from 0.02 per cent of GDP in Uzbekistan to 0.8 per cent in the Czech Republic. Among the more advanced transition economies, the Czech Republic, Hungary and Poland, for instance, have relatively large insurance penetration ratios, but in Estonia this ratio is comparatively small. The average for advanced industrial economies was more than 4 per cent in 1994, while developing countries showed a very differentiated picture, with insurance penetration ratios generally lower in Latin America than in the transition economies and higher in East Asia.

While the sector continues to be small, its growth rate between 1993 and 1995 has surpassed that of GDP in 10 of the 15 countries for which data covering this period were available. In the Russian Federation, for instance, the ratio of premium income to GDP grew by a factor of $2^1/_2$ between 1993 and 1995, in the Czech Republic and Hungary it grew by a factor of $1^1/_4$, and in Belarus by a factor of 9. Sketchy evidence on the pre-transition period suggests that there was a sharp drop in insurance penetration rates in the early 1990s. In Romania, life insurance premiums had all but vanished by 1993 after having reached a GDP-share of 0.3 per cent in 1990. Total insurance penetration (including non-life classes) in the Russian Federation fell from 2.9 per cent to 0.8 per cent of GDP in the same period. Table 7.1 thus suggests a rapid "rebound" after 1993.

1 However, liabilities of former state life insurance monopolies may carry similar implicit guarantees, and the more advanced transition economies have introduced policyholder compensation funds.

2 The debate over the extent of public versus private responsibility for old-age income security is certainly relevant but controversial in many market economies as well.

3 Some forms of life insurance - e.g. term life and whole life - do not represent savings in the traditional sense of accumulating assets over time; they do, however, represent savings in an actuarial, "probabilistic" sense.

4 Information on progress in transition for 1995 rather than 1996 has been utilised to better coincide with the date of the information presented in Table 7.1. The ranking is derived from the unweighted average of transition indicators presented in the 1995 *Transition Report*, Table 2.1.

Table 7.1

Indicators of the development of life insurance

Country	Insurance penetration rate (premiums in per cent of GDP) 1993	1994	1995	Premiums collected in 1995 (US$ m)	(In per cent of region total)	No. of providers Total	Of which: state controlled	Premiums per provider (US$ m)	Insurers' market shares (In per cent) Top 5	Foreign [2]
Czech Republic	0.64	0.72	0.80	353	8.3	15	0	23.5	99.0	6.50
Hungary	0.53	0.60	0.66	287	6.7	12	0	23.9	88.0	99.50
Poland	0.57	0.60	0.63	764	17.9	13	1	58.7	99.5	4.90
Estonia	0.14	0.11	0.09	4	0.1	5	1	0.7	99.0	<1.0
Slovak Republic	0.58	0.54	0.53	72	1.7	11	1	6.5	99.0	–
Slovenia	0.36	0.50	0.72	129	3.0	9	na	14.4	93.1	–
Croatia	0.11	0.76	0.17	–	–	na	na	–	–	–
Lithuania	0.27	0.95	0.17	13	0.3	15	1	0.9	99.3	
Latvia	0.34	0.30	0.40	18	0.4	12	1	1.5	97.2	–
Bulgaria	0.60	1.82	–	–	–	30 [1]	1	–	–	
Moldova	–	–	0.48	8	0.2	17	na	0.5	–	–
Russia	0.25	0.40	0.61	2,541	59.6	2,700 [1]	130 [1]	0.9	29.5	–
Romania	0.02	0.03	0.04	14	0.3	14	3 [1]	1.0	27.7	–
Albania	–	–	0.80	16	0.4	1	1	16.2	–	–
Uzbekistan	–	–	0.02 [1]	1	–	52 [1]	1	0.0	–	–
Ukraine	0.27	0.54	0.12	41	1.0	600 [1]	6	0.1	–	–
Belarus	0.04	–	0.33 [1]	30 [1]	0.7	40	1	0.7	65.7	–
Kazakstan	–	–	0.07 [1]	11 [1]	0.3	53 [1]	na	0.2	–	–
Total/Average	–	–	–	4,262	100	–	–	–	–	–

Comparator insurance penetration rates Country	Premiums in per cent of GDP	Year
Canada	2.73	1994
France	5.24	1994
Germany	2.7	1994
Italy	1.13	1994
Japan	6.49	1994
UK	6.64	1994
USA	3.98	1994
OECD	4.26	1994
Argentina	0.1	1988
Brazil	0.12	1988
Chile	1.77	1990
Korea	8.56	1989
Malaysia	1.36	1989
Mexico	0.49	1989
Pakistan	0.39	1987
Singapore	1.69	1990
Thailand	0.83	1989
Turkey	0.16	1990

Sources: Transition economies: calculated on the basis of data provided by the national authorities.
OECD countries: OECD *Insurance Statistics Yearbook* 1987-94.
Developing economies: UNCTAD *Statistical Survey on Insurance and Reinsurance Operations in Developing Countries, 1983-90.*

1 Life and non-life.

2 1993, except Poland 1st half 1994; source: Sigma (1995).

The Russian Federation had by far the largest share of aggregate premiums collected in the region, measured in US dollars, with almost 60 per cent (however, note the caveat above). Adding the Czech Republic, Hungary, Poland and Slovenia, these five countries accounted for around 95 per cent of the life business.

In many countries the number of operators in the life insurance field appears out of proportion with the volume of premiums collected. Entry was facilitated by very low minimum capital requirements which were often not adjusted with inflation (see Section 7.3). As a consequence, in 1995 average premiums collected per provider surpassed US$ 1 million in only six of the 16 countries for which data were available. Apart from Albania, the average size of insurers in the advanced transition economies of eastern Europe is by far the largest. Evidence on market concentration in Table 7.1 and correspondence with insurance supervisory authorities, however, suggest that many registered life insurers are in fact dormant or near-dormant. The top five companies account for the vast majority of written policies in most countries except Russia and Romania.

The former state legal monopolies over insurance have been eliminated in all countries. In many, state providers have been majority privatised (the Czech Republic, Estonia, Hungary) or are in the process of privatisation. The privatisation of Poland's large former state monopoly company PZU Zycie - which has a share of 95 per cent of the life market[5] - has been complicated by its serious capital deficiency (a solvency margin below 5 per cent).[6] In the Slovak Republic, the state continues to hold approximately 50 per cent of the former monopoly Slovenska Poistovna. While these companies still dominate the market in most countries, their market share is being eroded by the entry of private competitors.

While foreign insurers have entered most markets in eastern Europe, their operations generally represent little more than footholds. An exception is Hungary, where foreign insurers dominate. However, from low levels, foreign insurers' market share has been growing quickly in the Czech Republic and Poland. Market entry by foreign providers has been restricted in Bulgaria[7] and in Romania.[8] In the CIS their participation has so far been negligible because of an unsettled regulatory environment and a restriction to minority shares in joint ventures.

Private pension funds

Unlike life insurance, private pension funds are new to the economies in transition, with no precedent in the pre-transition period. As discussed below, their emergence is closely bound up with the provision of old-age pensions under social insurance schemes. Despite decades of collective savings for retirement, a culture of private provision for old-age income is slowly evolving.

Table 7.2

Pension Funds

Country	Number of funds	Number of Members (1,000)	Total assets *(in per cent of GDP)*
Czech Republic	44	1125	0.14
Hungary	212	247	0.16
Russia	1,000	na	0.03
France	–	–	3.4
Germany	–	–	5.8
Italy	–	–	1.2
Japan	–	–	44.7
Switzerland	–	–	79.5
The Netherlands	–	–	88.5
United Kingdom	–	–	79.4
United States	–	–	59.1

Data from June and July 1996. End 1993 data for comparator countries.

Source: Correspondences with supervisory authorities and De Ryck (1996).

Only three countries in the region have passed laws dealing specifically with the establishment and operation of pension funds, and in three others laws have been drafted. Table 7.2 provides some information relating to these countries.

Private pension funds are significant only in the Czech Republic and Hungary, although even there the share of assets in GDP remains quite small. Nevertheless, a remarkable number of funds have been set up in the short period since legislation was passed, covering more than one million people in the Czech Republic (approximately one-quarter of the working population) and 250,000 in Hungary. In comparison, western European private pension plans achieved coverage ranging from 5 per cent in Italy to 48 per cent in the United Kingdom (voluntary schemes), to between 80 and 100 per cent in Denmark, the Netherlands and Switzerland (where schemes are mandatory or quasi-mandatory).[9] Assets in the Hungarian funds reached approximately Ft 6.6 billion (US$ 47.3 million) at the end of 1995 against Ft 446 million one year earlier. Funds in the Russian Federation have been operating in a legislative vacuum, and have as a consequence been unable so far to attract significant contributions. Anecdotal evidence suggests that many of these funds have assets under management equivalent to only a few thousand dollars. In comparison, at end-1993 pension fund assets in the Netherlands, Switzerland, United Kingdom and United States represented between 60 and 90 per cent of GDP, while in Belgium, France, Germany, Italy and Spain (where state-pension systems dominate) they represented between 1 and 5 per cent only.[10]

There are interesting structural differences between the Czech and Hungarian pension funds. Whereas personal plans are characteristic of the Czech Republic, the market in Hungary is dominated by

5 Falush (1996).

6 The solvency margin is, in its simplest form, defined as the ratio of (shareholder and free) capital over (technical and other required) reserves.

7 A new insurance law is expected to be approved in 1996 which will permit foreign entry from 2002 (see section 7.3).

8 Only joint ventures are permitted.

9 Apart from the mandatory versus voluntary nature of schemes, coverage ratios are influenced by the sectoral make-up of an economy, tax treatment, the gender distribution of the labour force, the importance of part-time employment and other factors.

10 De Ryck (1996)

sectoral and employer-based funds (which each attract around 40 per cent of all fund members). Approximately 60 per cent of the contributions to Hungarian funds are provided by employers, who are attracted by allowances on corporate income and social security taxes.[11] In the Czech Republic, the net tax effect for employers appears to be neutral, which may may explain why they are less likely to set up workplace funds.[12] In both countries, only defined-contribution pension plans were on offer, whereas defined-benefit plans dominate in western Europe.[13] This difference may reflect the need for a greater degree of sophistication in financial markets to provide defined-benefit plans (for example, indexed instruments).[14]

7.3 Regulation and supervision of contractual savings

Governments in the region can make, and in some countries have already made, important contributions to the development of contractual savings by establishing supportive legal and regulatory frameworks and by clarifying the tax treatment of these instruments. The rationale for regulation is both economic and, at times, political.[15] Economic reasons for regulation are rooted in consumer protection. Contractual savings involve payments today for benefit promises in the future, sometimes decades away. Since individual claimants cannot be expected to monitor the financial soundness of contractual savings institutions, governments help to ensure that companies will be around to honour their obligations (solvency regulations, prudential requirements). While there is a solid case for financial regulation, it should aim for a sensible trade-off between risk mitigation and returns to savers. There is little gain from "safe" investments if they have yields that are insufficient to cover needs in contingencies and old age.

A second economic reason for regulation derives from a lack of familiarity and understanding of these products. Contracts are often complex, and by setting product and disclosure standards, regulators seek to ensure consumer fairness. Government action is further motivated by the knowledge that a functioning contractual savings sector can reduce pressures on state pensions. This is one of the reasons why contractual savings are sometimes supported by tax benefits. Finally, there may be broader political objectives involved in regulation when investment guidelines give a heavy preference to government securities or to domestic over foreign investments.

The legislation covering contractual savings institutions is outdated in some of the transition economies, and unsettled in most of them. Consistency of existing laws with other commercial legislation remains mostly untested. Legislation on pension funds has been passed in only three countries (the Czech Republic, Hungary and the Slovak Republic). Where pension funds have been set up in others (Bulgaria and the Russian Federation), they operate in a legal vacuum and with considerable uncertainty. As legislation is reformed over the coming years, existing blueprints from market economies can provide only a partial guide.[16] The management of contractual savings during the transition process is in many ways more complicated than in stable market environments. Challenges include institutional weaknesses such as the shortage of experience of local providers, regulators and consumers. At the same time, underlying asset and liability risks are high. In addition to the immaturity of capital markets, asset-liability management and product pricing are further hampered by the negative impact that the economic transition has had on demographic mortality and morbidity in some countries.[17] This makes statistical tables based on past trends to be of only limited value.

The considerations detailed above suggest that the initial regulatory regime should be tilted towards prudence and based on a level of complexity consistent with available skills. As discussed below, on the basis of legislative evidence, tight investment restrictions appear to have been imposed in most countries of the region.

The key objective for governments should be to build up strong and capable regulatory authorities, preferably independent from yet accountable to governments, with the discretion that would allow them to respond to changing conditions. The fact that many of the aspects of the contractual savings business are in a state of flux, with sophistication gradually increasing, suggests that regulations that are sensible today may be less so in the future. The legislative and regulatory framework should be flexible enough to reflect such improvements – for example, by allowing an increasingly wider range of permissible investments. Clearly, a restrictive regulatory regime may trade-off significant portfolio yields for the intended gain in safety. Where "safe" assets, such as government paper, carry low or negative real rates of interest, this may be a very high price to pay. This dilemma is sharpened by the relative youth of life insurance and pension plans (that is, the maturity of liabilities tends to lie far in the future); in these circumstances, real return strategies based, for instance, on equity and real estate would generally receive preference over income strategies involving more liquid, finite-term securities and deposits.

Current regulatory regimes

Outlines of the present regulatory framework and legislative drafts for life insurance and pension funds in the region are presented in the tables in the Annexes.[18] For ease of reference, key cross-country comparisons are contained in Tables 7.3 to 7.5. A number of features are worth highlighting.

11 Tax treatment and regulation are discussed below in Section 7.3.

12 Communication by Keith Exall, William Mercer Ltd, London.

13 Defined-contribution plans are essentially savings vehicles providing no guarantee as to the eventual pay-out value of the plans, which can generally be taken out either as a lump-sum or applied to the purchase of an annuity. In defined-benefit plans, the pension income is pre-determined and a lifetime annuity after retirement would be an integral part of the plans.

14 Legislation also favours defined-contribution plans in these countries. Among other things, defined-contribution plans present few problems of portability, which is a significant advantage for labour mobility in a period of great structural change.

15 The discussion of the rationale for regulation draws on Skipper (1993).

16 Appropriate regulation is a much-debated topic in industrialised market economies also; opposing views have, for instance, held up passage of an EC Directive on pension funds.

17 Some of the social costs of transition are analysed in the *Transition Report* 1995, Chapter 2.

18 The information is based on responses by supervisory authorities to a mail questionnaire and on the analysis of the relevant legislative texts where available. Responses were incomplete and the tables should not be viewed as providing a full description of the state of affairs.

Table 7.3

Life insurance cross-country comparison of regulations

Country	Minimum capital requirement (local currency)	(US$ 000) [1]	Numbers of supervisory staff	Reinsurance abroad permissible	Life/non-life activity separation	Cross-border services permissible	Permissible share of foreign ownership	Taxation of premiums, investment income and benefits [2]
Belarus	ECU 150,000	190	40	Yes [3]	No	No	≤49% or branches	DTT [4]
Croatia	DM 1m [5]	674	7	Yes	No	No	Unlimited	DTE [6]
Czech Republic	CZK 70m	2,518	20	Yes	No	No	Unlimited	DTT [7]
Estonia	EEK 12m	983	11	na	Yes	No	Unlimited	TET
Hungary	HUF 250m [8]	1,645	35	Yes	Yes	No	Unlimited	DEE
Kazakstan	40xmin. wage	na	20	Yes	na	No	≤50%	na
Latvia	LVL 600,000	1,083	20	Yes	Yes	No	Unlimited	DEE
Moldova	MOL 50,000	110	10	Yes	No	na	Unlimited	DEE
Poland	PLZ 2m	786	22/64 [9]	Yes	Yes	No	Unlimited [10]	DTE [11]
Romania	ROL 25m	9	na	Yes [3]	No	No	No [12]	TEE
Russia	RUR 150m	29	200	na	No	No	≤49%	na
Slovak Republic	SKK 50m	1,645	6	No	Yes	No	≤45%	DTT [7]
Slovenia	ECU 800,000	1,014	6	Yes [3]	No	No	Unlimited	DTE
Ukraine	ECU 100,000 [13]	127	50	na	No	No	≤49%	na
Uzbekistan	na	na	na	na	No	No	Unlimited	na
Albania [14]	ALL 30m	319	–	na	na	na	≤40% or branches	na
Bulgaria [14]	BGL 200m [15]	1,053	–	na	Yes	na	≤49% [16]	na
Lithuania [14]	US$ 1m	1,000	–	na	Yes	na	na	DEE

Source: Annex 7.1.

1 Average exchange rate for June 1996.

2 "D": deductible; "T": taxed; "E": exempt. First position refers to premiums, second to investment income and third to benefits.

3 Only after exhausting domestic capacity.

4 Investment returns subject to VAT (20 per cent) and profit tax (30 per cent).

5 DM 2m for multiple classes.

6 Investment returns are taxed according to corporate tax.

7 Taxation of 15 per cent on premiums-benefits differential.

8 HUF 100m Organisational Capital and HUF 150m Security Capital for joint-stock life insurance companies.

9 22 members employed in the Ministry of Finance and 64 in the independent supervisory office.

10 An informal limit of 30 per cent is applied.

11 Investment returns are taxed according to corporate tax (45 per cent).

12 Foreign insurers can establish branches for the purpose of conducting business with foreign companies only.

13 ECU 0.5m with foreign participation.

14 Draft of new law.

15 Reserve requirement enters in force in Jan. 1997.

16 After Council of Ministers approval.

Most striking perhaps is the diversity of legislation. In life insurance, cross-country variations may be partly linked to differences in the age of the legislation. Recent laws, especially in eastern Europe, have often begun to be modelled on EU Directives. Minimum capital requirements in life insurance, expressed in a common currency (Table 7.3) range from a negligible US$ 9,000 in Romania to US$ 2.5 million in the Czech Republic, approximately two-and-one-half times the minimum recommended by the European Union. These differences are partly explained by a combination of inflation and lags in the legislative process, but partly also by timing and progress in transition. Many countries appear to have pursued a policy of liberal entry early in the transition process to allow entrepreneurial initiative in the face of a dearth of capital, and subsequently adjusted required capital upwards to filter out non-viable ventures (by forcing them to merge or liquidate).

Another interesting feature concerns market entry by foreign providers (see Table 7.3), an issue of particular importance when countries are small. Domestic monopolies in life insurance have been largely abolished. However, entry by foreign providers is restricted to minority holdings in joint ventures in all CIS countries except for Moldova and Uzbekistan. In contrast, most eastern European countries permit free entry, with legal restrictions only in Albania and Bulgaria (minority shareholdings) and Romania (no foreign providers allowed except branches conducting business with foreign companies). No transition economy permits the cross-border sale of policies.

Restrictions on the investment portfolios of life insurers again differ substantially across economies in transition, as they do in the industrialised market economies. Table 7.4 provides a cross-country comparison.[19] At the liberal end of the scale, Ukraine applies a "prudent man" rule to all asset classes.[20] Hungary, at the other end of the scale, closely circumscribes insurers' investment choices. With few exceptions, restrictions on share portfolios in the transition economies are tighter than in most advanced market economies, while those on real estate are broadly comparable. Another interesting feature are the minimum investment requirements for state bonds imposed by some countries (Belarus,

19 In all countries except Croatia, restrictions apply to technical reserves only, therefore allowing some investment leeway for well-capitalised institutions.

20 The prudent man rule allows insurers to allocate their portfolios without specific restrictions, provided that investments cover liabilities in a prudent way, as judged by the supervisory authority. Consumer protection in this case relies on a significant degree of sophistication of providers and supervisors. Among industrialised market economies, only Spain allows such freedom. See Dickinson and Dinenis (1996).

Table 7.4

Life insurance portfolio regulation

investment limits in per cent of reserves

Country	State bonds	Corp. bonds	Listed shares	Unlisted shares	Real estate
Moldova	≥10	≤40	≤10	≤5	≤40
Russian Federation	≥10	na	na	na	≤40
Bulgaria	≤25	≤25 [1]	≤30	≤15	≤25 [1]
Hungary	≥30	≤10	≤10	≤5	≤20
Slovenia	≥30	≤25	≤10	na	≤30
Belarus	≥40	na	≤15	≤15	≤25
Croatia [2]	≤40	≤40 [3]	≤40 [3]	≤10	≤50 [4]
Kazakstan	≤80	na	na	na	≤20
Czech Republic	unlimited	unlimited	≤10	na	≤25
Estonia	unlimited	unlimited	≤30	≤15	≤25
Latvia	unlimited	unlimited	≤30 [5]	≤30 [5]	≤25
Poland	unlimited	≤5	≤30	≤15	≤25
Ukraine	unlimited	unlimited	unlimited	unlimited	unlimited
Slovak Republic	unlimited [6]	unlimited	≤15	na	≤25
Romania [7]	statute	statute	statute	statute	statute

Albania, Lithuania, Uzbekistan – investment shares to be announced once laws are in force.

For comparison: G-7 countries	Mortgage loans	Other domestic (foreign) debt and debt securities	Domestic (foreign) listed shares	Unlisted shares	Real estate
Canada	unlimited	unlimited (≤10)	≤5–25 (≤10) [8]	≤5–25 [8]	≤10
France	unlimited	≤10 (unlimited)	≤65 (≤65) [8]	≤65 [8]	≤40
Germany	≤50	≤50 (≤5)	≤30 (≤6)	≤10	≤25
Italy	≤50	≤50 (≤50)	≤20 (≤20) [8]	≤20	≤50
Japan	≤50	≤50 (≤30)	≤30 (≤30) [8]	≤30 [8]	≤20
United Kingdom	≤10 [8]	≤10 (unlimited)	unlimited (unlimited)	≤10 [8]	unlimited
United States (New Jersey)	≤60	≤60 (≤5)	≤15 (≤5) [8]	≤15 [8]	≤10

Source: Annex 7.1 for transition economies, Dickinson and Dinenis (1996) for comparator countries.

1 The limit applies to corporate bonds, mortgage loans and real estate as a whole.

2 As a percentage of total assets.

3 The limit applies to listed shares and corporate bonds as a whole.

4 The law is not clear on this item.

5 The limit applies to listed and non-listed shares as a whole.

6 At least 30 per cent of reserves have to be invested in bank deposits.

7 At present investment shares have to be agreed by the Supervisory Authority and written into the company statute. The draft of the new law will prescribe investment shares.

8 For these classes of investment combined.

Table 7.5

Pension funds

Country	Minimum capital requirement	Foreign participation permissible	Taxation[1]	Portability	Investment limits (in per cent of total assets) State bonds and cash (min.)	Other state securities (max.)	Listed shares (max.)	Real estate (max.)
Czech Republic	CZK 20m (US$ 750,000)	Unlimited	TTT[2]	Full no fee	unlimited	unlimited	unlimited	unlimited
Hungary	HUF 20m (US$ 160,000) [3]	Unlimited	EEE	Full with fee	10	30	60	30
Lithuania	TBA	TBA	EET	Full no fee	TBA	TBA	TBA	TBA
Poland	TBA	TBA	EET	Full no fee	10	30	30	10
Russia	na	na	TTT	Full no fee	TBA	TBA	TBA	TBA
Slovak Republic	SKK 30m (US$ 1 m)	na	EET	Full no fee	unlimited	unlimited	na	20

Source: Annex 7.2.

1 "T": taxed; "E": exempt. First position refers to contributions, second to investment income and third to benefits.

2 State subsidy for contributions instead of exemption. Information refers to June/July 1996.

3 The minimum capital requirement of HUF 20m is required for funds established as legal entities separate from the sponsor.

Hungary, Moldova, Russian Federation and Slovenia). While these may be in part motivated by prudence, such restrictions are often meant to ensure a flow of investable funds into government debt markets.[21] Only in six countries do the insurance laws restrict foreign investments, but general exchange restrictions would apply in others.[22] It is an interesting question whether such limits reduce or, in fact, increase the riskiness of portfolios, with real exchange rate volatility traded off against the greater liquidity of foreign assets.

Reflecting differences in liabilities and the implicit real return commitment of pension funds,[23] investment regulation is more liberal in this sector (see Table 7.5). An important difference is that life insurance promises are often fixed in nominal terms while those of pension funds are not. Consequently, instruments with a pre-determined redemption value at maturity are a particularly important tool for the asset and liability management of insurers.

The structure and effectiveness of supervision is difficult to compare across countries. However, correspondence with the authorities suggests that supervisors tend to focus largely on entry requirements for providers. Expertise for solvency assessments in life insurance is often in short supply, and outside some of the more advanced transition economies financial information from providers is often considered to be unreliable. The number of staff of the supervising agencies is, in some cases, low by international standards (see Table 7.3).

Lastly, it is interesting to note differences in tax regimes. Taxation is a key factor determining demand for contractual savings, in particular by companies. However, since it is beyond the scope of this chapter to analyse incentive effects in detail, only a brief description of taxation is provided. In life insurance, premiums are deductible from taxable income up to certain limits in all countries for which the information was available, except Estonia and Romania.[24] While various countries also exempt investment income on the invested reserves and benefits accruing to individuals from taxation, others tax both. Either fiscal income objectives or the aim to provide strong incentives for purchasing insurance appear to have guided taxation in most countries, rather than the application of a consistent principle of tax neutrality (for example, between current and future consumption).

In pensions, taxation differs almost diametrically between Hungary (exemption of contributions paid by corporations, investment income and benefits) and the Czech Republic and Russian Federation (taxation at all three stages). However, the Czech Republic provides direct subsidies for contributions up to a certain level. Laws or draft laws in Lithuania, Poland and the Slovak Republic appear consistent with savings-consumption neutrality in that savings are taxed only once in the contribution-to-benefit cycle.

7.4 Reform of public pensions systems and development of contractual savings

While progress in transition, macroeconomic stabilisation and strengthened government regulation serve to underpin the development of contractual savings, the structure and size of this sector in the long term will be significantly shaped by public pensions and their reform. This is particularly true of the role of private pension funds in the provision of retirement incomes. The wide variation in the size of private pensions in industrialised market economies reflects the profound impact that these policies - in conjunction with taxation - can have in the sector.

Old age and disability income protection under central planning rested on publicly managed pay-as-you-go (PAYG) pensions[25] and on the largely free provision of certain basic goods and services (such as health care, utilities and housing). These pension systems have come under considerable financial strain during the transition process (see Box 7.1). PAYG pensions, particularly in south-eastern Europe and the CIS, often barely cover subsistence levels and there is considerable uncertainty concerning the states' ability to honour their pension liabilities in the future. The former collective insurance against income risks has, in fact, given way to a large degree of private responsibility for ensuring personal income security. The formalisation of this state of affairs, by redefining public and private roles and methods of financing old age security, is under discussion in many of these countries. Proposals, some of which have begun to be implemented, range from slimming down the public PAYG systems to introducing mandatory, privately managed and funded "second pillars", as with recent reforms in Latin America.

Reform proposals

Efforts to reform the public PAYG systems in most transition economies are directed at raising retirement ages, limiting occupational privileges, strengthening the link between contributions and benefits (for example, by lengthening the base for calculating pension entitlement to cover as much as possible of the working lifetime) and establishing clear rules of indexing.[26] These could be supplemented by provisions for voluntary, privately funded pension plans, supported within certain limits by tax incentives or subsidies.

Proposals that are gaining increasing currency in the Baltics, Hungary and Poland, however, would go beyond these reforms in changing the basic nature of mandatory pension provision by placing a large share on a fully funded, and possibly privately

21 Among industrialised market economies, only Japan imposes minimum requirements on state bonds. See Dickinson and Dinenis (1996).

22 In Bulgaria the permission of the Ministry of Finance is required, in Kazakstan foreign investments are limited to 50 per cent of technical reserves, in Lithuania share investments have to be made on the National Stock Exchange, in Moldova less than 15 per cent can be invested in foreign currencies, in Poland foreign investments are explicitly excluded, and the Russian Federation requires 80 per cent of assets to be invested domestically.

23 This commitment is explicit in the case of defined-benefit schemes.

24 In general, deductibility applies only to contracts of a minimum duration.

25 In PAYG schemes, current pension benefits are paid out of current (payroll) taxes without necessarily building reserves except for short-term liquidity. Shortfalls would be covered by budgetary transfers.

26 EC Commission (1996).

Box 7.1

Financial strains on social security systems in the economies in transition

Public pension reform is a vast and much debated topic throughout the world.[1] In many countries, the issue has come to the fore since slackening economic growth and demographic ageing have combined to drive up the rates of contribution needed to sustain PAYG systems, and will do so further on the basis of demographic trends. The problems faced by transition economies represent an extreme and particularly acute version of these tendencies, sharpened by the initial contraction of incomes, the loss of administrative control over income sources and the importance of incentives (and the weight of payroll taxes) in the newly decentralised economic systems. Some evidence of the financial pressures is contained in the adjacent table.

Several points are noteworthy:

Demographic dependency ratios (number of people over 60 divided by the number of those aged 20-59) in many transition economies are comparable to those in industrialised market economies. However, populations in the Caucasus, Central Asia and Poland tend to be younger.

Combined with an inherited nearly universal coverage of pensions systems and often high income replacement ratios,[2] this explains why the share of pensions in GDP in a large number of transition economies is approximately the same as in the industrialised market economies and far higher than in countries of comparable per capita income in Latin America and East Asia.

The share of pensions in GDP, however, varies significantly among transition economies, and tends to be much greater in eastern European countries than in the Baltics and CIS. In some cases, this reflects lower demographic dependency ratios, but more crucially it is a consequence of differences in the real value of pensions.

A large share of pensions in GDP points to a significant financial burden on the active population. This situation is worsened by the large wedge between the demographic dependency ratio and the system dependency ratios (number of contributors to the public pension schemes divided by the number of current beneficiaries). The difference arises from the relatively low general retirement ages and occupation-specific privileges, substantial early retirement as part of enterprise restructuring efforts, and tax avoidance and evasion (by joining the informal sector). A particularly extreme case is Bulgaria, where almost one pensioner is "supported" by each contributor.

While conditions obviously vary between countries, the combination of the above tends to result in: (i) high and increasing contribution rates, further strengthening the incentive for system evasion – payroll taxes to finance public pensions range from 20 per cent in Estonia to 45 per cent in Poland, whereas the highest rate in the European Union (Italy) is 27 per cent; (ii) low pension benefits, placing many pensioners on subsistence incomes and thus reducing the attractiveness and insurance value of the public pensions system; and (iii) increasing recourse to general budgetary revenues, adding to existing fiscal pressures. In their present form, public pensions systems in many transition economies may therefore be unsustainable.

1 There are many publications on the topic. See World Bank (1994), Vittas and Skully (1991) and Arrau and Schmidt-Hebbel (1995) on reforms in developing market economies. Comprehensive pension reforms, generally in the direction of funding and the creation of personal accounts, have been implemented with growing frequency in Latin America (Chile 1981, Mexico 1991, Peru 1993, Argentina and Colombia 1994) and in some industrialised market economies (Switzerland 1985, Australia 1992).

2 The ratio of pension benefits to final (or some average) income.

Public pension systems in transition economies, selected countries

Country	Male retirement age[1]	Demographic dependency ratio[2] (in per cent)	System dependency ratio[3] (in per cent)	Pension expenditures (in per cent of GDP)	Year
Albania	–	17	37	5.9	1994
Armenia	65 [4]	22	34	6.7	1994
Azerbaijan	60	19	–	4.7	1995
Belarus	60	33	49	10.3	1995
Bulgaria	60	37	87	8.0	1995
Czech Republic [5]	60	32	42	9.1	1995
Estonia	60	32	52	6.7	1995
Georgia	60	30	45	11.0	1992
Hungary	60	36	59	10.3	1994
Kyrgyzstan	60	20	34	2.4	1993
Latvia	60	33	51	9.8	1995
Lithuania	60 [6]	30	53	4.8	1994
Moldova	60	26	–	4.1	1994
Poland	60	28	49	14.6	1995
Romania	60	29	62	6.5	1993
Russian Federation	60	31	46	5.5	1993
Slovak Republic [5]	60	32	42	9.9	1995
Slovenia	–	29	54	13.7	1994
Ukraine	60	36	–	8.0	1995
Uzbekistan	60	15	34	2.6	1993
Averages [7]					
Eastern Europe, Baltics and CIS	60.0	30.0	48.3	7.3	
Asia	55.5	15.3	11.4	1.9	
Latin America	60.8	14.9	21.0	2.0	
OECD Countries	64.4	32.9	39.2	9.2	

Source: Fox (1993), The World Bank (1994), IMF, OECD and local authorities.

1 1991

2 Number of people over 60 divided by the number of those aged 20-59, 1990.

3 Ratio of contributors to the public pension schemes over current beneficiaries, 1990.

4 1996.

5 Male retirement age, demographic dependency ratio and system dependency ratio refer to the former Czechoslovak Republic.

6 1994.

7 All averages are weighted except for the system dependency ratio of Asia, Latin America and OECD.

managed, basis with individual retirement accounts. From the point of view of social security finance, the main advantage of such a system lies in the direct link it establishes between individual contributions and benefits. While this link could in principle be achieved within PAYG systems, the greater flexibility and lack of transparency of these tend in practice to prove too great a political temptation. In the short term, lower contributions and higher benefits are politically attractive.

Movement towards fully funded pension schemes would also have an important impact on other parts of the economy. In labour markets, elimination of ex-ante income redistribution, particularly in defined contribution schemes,[27] can lessen the incentive for tax avoidance, which is strong in some PAYG schemes (for instance, by

27 Defined benefit plans, whether on an individual or group basis, have an insurance feature and thus lead to ex-post redistribution of incomes. On an ex-ante basis, redistributive features may be built into occupational defined-benefit plans as part of employer-designed incentives.

Table 7.6

Asset structure of pension funds (1994) and life insurance (1989)

Arranged by increasing portfolio share of equities in pension funds – in per cent

	Share of assets invested in equity		Share of assets invested in fixed income incl. mortgage loans		Percentage of assets invested in real estate		Percentage of assets invested in short term and other investments	
	Pension funds	Life insurance	Pension funds	Life insurance [1]	Pension funds	Life insurance	Pension funds	Life insurance
Germany	11	4	75	88	11	6	3	3
Switzerland	11	6	64	76	16	16	9	3
Denmark	22	11	65	81	9	3	4	5
Japan	29	22	63	44	3	6	5	29
Netherlands	30	na	58	44	10	8	2	18
Belgium	36	14	47	72	7	8	10	7
United States	52	6	36	86	4	3	8	6
Ireland [2]	55	49	35	35	6	8	4	8
United Kingdom	80	56	11	23	6	16	3	5

Sources: Pension funds - De Ryck (1996). Life insurance - Dickinson (1993).

[1] Corresponds to bonds, mortgage loans and other loans.

[2] Data for life insurance refer to 1995; Source: Irish Insurance Federation.

joining the informal sector).[28] In the capital markets, pensions funding could have a rapid and profound effect on the volume and structure of the supply of funds. Under certain plausible conditions, national savings rates would rise, with beneficial effects on investment and the balance of payments (see Chapter 6). Proponents therefore point out that, as a result of efficiency gains and faster accumulation of capital, mandatory funded pensions pillars could stimulate economic growth.[29] It should be noted, however, that experience with these schemes is still limited outside a few developed, primarily "Anglo-Saxon" economies, and the response of economic aggregates has proved to be very hard to identify.

While these arguments may ultimately sway the debate in some countries in favour of the introduction of mandatory funded schemes, there are difficult challenges which would need to be overcome.[30] Chief among them is to ensure that old-age incomes are sufficient and savings are adequately protected. The states' responsibility in this respect is particularly important where schemes are mandatory. Another issue that needs to be addressed is the pace of "transition" from the present system to a funded one.[31] While such reforms are being debated, contractual savings in transition economies will continue to be based on voluntary contributions. To the extent that the institutions which support this sector are built up and strengthened in the process, it will be easier in the future to transfer a greater share of mandatory retirement provision to a privately managed, fully funded basis.

7.5 Contractual savings and financial market development

The growth of contractual savings institutions can contribute to the development of a country's financial markets in important ways, but growth is also dependent on operating conditions in those markets. A number of characteristics set contractual savings institutions apart from other intermediaries and determine both their need for supporting financial services and instruments and their influence on financial market developments. Potential benefits relate to the product and maturity structure of markets, to financial innovations and to institutions supporting financial services. Greater efficiency in financial intermediation, particularly at the long-term end of the market, could enhance growth and facilitate economic restructuring.

Contractual savings and capital market structure

The contractual savings industry can shift the structure of demand for financial assets towards longer maturities. Apart from regulatory requirements and taxation, the selection of long-term portfolios in this sector is primarily a function of the nature of liabilities. The average duration of liability cash flows tends to be – contractually or actuarially[32] – long and relatively firmly predetermined. On the one hand, this time horizon permits investment strategies based on long-term real returns – for example, by taking positions in equity and property. On the other hand, the interest guarantee implicit in many life insurance contracts (and defined

[28] Distortions of labour market decisions in PAYG systems, compared with pensions based on personal retirement accounts, can have various sources. They affect labour demand where minimum wage legislation prevents the cost of payroll taxes from being fully shifted to the worker. They affect labour supply in the formal sector where there are redistributive features built into the pensions formula. For example, in defined benefit PAYG schemes, the relation between real interest rates and wage growth is important. When the real interest rate is higher than the rate of real wage growth, the present value of future benefits can be lower than that of contributions.

[29] A key condition is, naturally, that there are adequate investment opportunities so that the marginal productivity of capital does not fall significantly. This is a complex question which goes beyond the objectives of this chapter (a discussion can be found in Arrau and Schmidt-Hebbel, 1995). The conditions for capital market efficiency, which are related to this issue, are taken up in Section 7.5.

[30] Succinct discussions of the challenges of pension systems reform can be found in Arrau and Schmidt-Hebbel (1995), de Fougerolles (1995) and Diamond (1993).

[31] The basic problem is that current contributors (or tax payers) are doubly burdened under a "transition", first by the need to sustain pensioners who did not have an opportunity to build up personal pension accounts, and second by the need to save for their own pensions. Governments have in fact a large implicit pension liability which needs to be addressed. A good discussion and simulations of "transition" in the transition economies can be found in World Bank (1994) and Fox (1993).

[32] The maturity of whole-life and term-life policies and annuity contracts is actuarially predetermined in the sense that the timing of cash flows can be derived from mortality tables on an expected but relatively certain basis.

Table 7.7

Asset structure of personal sector, 1990

In per cent

	Equity	Bonds	Loans	Deposits [1]	Life insurance and pension funds
UK	12	4	0	29	47
Netherlands	6	8	0	29	54
Germany	6	18	0	48	22
Italy	22	18	0	49	12
France	34	3	0	51	12
Canada	21	6	2	39	28
Australia	17	13	0	34	36
US	19	10	1	30	33
Japan	13	5	0	53	23

Source: Davis (1995).

[1] Liquidity and deposits.

benefit pension plans) exposes them to risks which suggest that contracts be matched by assets of broadly similar duration.[33]

An analysis of the structure of personal financial assets in industrialised market economies reveals that the "indirect" portfolio of households held via pension plans and life insurance policies tends to be far heavier in equities and long-term fixed income securities than direct investment portfolios (compare Tables 7.6 and 7.7). This is quite generally true in spite of sharp differences in the particular choices of long-term instruments across these countries.[34] While the share of personal financial assets in liquid form and in bank deposits ranges from 29 per cent (United Kingdom) to 53 per cent (Japan), short-term investments of contractual savings institutions represent generally less than 10 per cent of their assets. In the United Kingdom, where funded pension plans are particularly prominent, domestic pension funds alone accounted for 34 per cent of all shares listed on the London Stock Exchange in 1993, with a further 17 per cent held by insurance companies and only 18 per cent by individuals.[35]

The particular structure of the balance sheets of contractual savings institutions could have significant benefits for investment and public finance in the transition economies. External funding for enterprise investment is often available only to a select number of "blue chip" companies and even then tends to come only in the form of short-term debt.[36] Wider availability of equity finance would help to reduce leverage and thus sensitivity to short-term shocks. Longer-term finance more generally, via equity and corporate bonds, would reduce refinancing risks for capital investment. A lengthening of the average maturities of capital supply would extend yield curves and, to the extent that yield curves at meaningful maturities are presently defined at all, may make them less steep. If the aggregate volume of financial savings is raised by the greater diversity of instruments available to households this would exert downward pressure on the cost of capital, given that financial markets in the transition economies are not fully integrated internationally. Government debt finance by means of domestic securities could benefit in similar ways.

There are interesting financial complementarities between commercial infrastructure and contractual savings. Investment amortisation periods in commercial infrastructure tend to exceed the current debt maturity frontier in all transition economies by a wide margin. At the same time such investments can offer stable long-term cash flows which are attractive to the contractual savings sector. This issue is taken up in Chapter 4.

Product innovation

Financial innovation refers to the creation of new instruments which repackage financial risks or returns.[37] Given their potential importance, contractual savings institutions can have a significant influence on the creation of instruments that meet their particular requirements, such as protection from the effects of inflation on long-term contracts, liquidity and – at a greater level of sophistication – hedging strategies. Inflation-indexed instruments that prevent the erosion of nominal claims – which have not yet been introduced to the region[38] – could be especially valuable in the environment of the transition economies.[39] The liquidity requirement of contractual savings institutions – referring to rapid marketability at stable values – could also stimulate the securitisation of financial claims.[40]

While some innovations may not be on the immediate agenda in transition economies, the experience of Chile demonstrates that even relatively undeveloped financial sectors can with some efficiency create securities "tailor-made" to suit the needs of contractual savings institutions (see Box 7.2). This increases the marketability of long-term loans backed by real assets and could thus stimulate bank lending to sectors such as housing, commercial real estate and utilities. Chile also permits the issuing of fixed-income CPI-indexed bonds in the secondary market backed by CPI-indexed mortgage loans, provided a bank guarantees the bonds.[41]

[33] Interest rate risk arises if investments are held too short such that interest rates may fall and remain low when funds require reinvestment, or that funds are held too long and increases in rates depress the market value of fixed income securities.

[34] Broadly speaking, differences in portfolio structure are explained by differences in the depth of securities markets, in the structure of liabilities, in regulatory restrictions and in investment culture (Davis, 1995; De Ryck, 1996).

[35] The balance was accounted for by unit trusts (6.6 per cent), foreign entities (16.3 per cent) and other UK based investors (7.9 per cent) (De Ryck, 1996).

[36] See *Transition Report* 1995, Chapters 5 and 10, for evidence on the structure of enterprise funding.

[37] See Davis (1995).

[38] However, in early September 1996, the Bulgarian National Bank announced that it planned to introduce securities whose yields would be linked to inflation.

[39] Inflation-hedging is particularly important where pension promises or pension-related insurance are linked to final salaries. In many industrialised market economies, apart from the United Kingdom, authorities have been reluctant to permit or encourage inflation indexation in the financial markets for fear that this would contribute to inflation inertia. The argument appears to rely primarily on a political economy rationale that unprotected savers would constitute an effective constituency against overly expansionary monetary policies.

[40] Securitisation refers to the pooling of non-liquid assets (such as mortgage or other loans, credit card receivables etc.) as backing for the issuance of tradable securities.

[41] See Arrau, Valdes-Prieto and Schmidt-Hebbel (1993).

Box 7.2

Capital market development in Chile[1]

The Chilean experience shows that the process of capital market deepening is strongly encouraged by the growth of pension funds. In December 1981, seven months after contributions to private pension funds became mandatory, 99 per cent of portfolios (amounting to 1 per cent of GDP) were invested in government debt and bank instruments, including mortgage-backed securities. By December 1991, private pension funds reached US$ 12.2 billion or 32 per cent of GDP. Of this amount, 23 per cent was invested in corporate equities, 16 per cent in corporate bonds, and 12 per cent in mortgage bonds. Additional long-term reserves are kept by insurance companies to back annuity pensions. While certain aspects of the organisation of the Chilean pensions system have been subject to debate - such as the relatively high administrative and marketing costs of funds competing for contributors - its contribution to the development of the capital market is not in doubt.

The strong growth of the capital market was reflected by the following features, as shown in the table in this box:

(i) Stock market capitalisation increased from about 20 per cent of GDP in 1981 to 88 per cent in 1991-92. After a 1991 stock price increase that raised average price-earnings ratios to 14, closed companies have shown a growing trend to go public and to accept standard record-keeping and auditing practices, encouraged by better access to pension fund financing.

(ii) Bonds have been placed directly by large companies into pension funds and insurance companies. The bond market has been improved by a new risk-classification industry, which also classifies bank securities and insurance company annuities.

(iii) The life insurance sector has grown rapidly to provide survivorship and invalidity reinsurance to pension fund management companies and annuity pensions to pensioners of the new system.

(iv) Other institutional investors like mutual (open-ended) funds and foreign investor funds have emerged, increasing the diversity of market participants.

(v) The trading volume of fixed-income securities has grown dramatically, although stock turnover is still low.

[1] Based on Arrau, Valdes-Prieto and Schmidt-Hebbel (1993).

Capital market developments in Chile 1980–92

	Stocks	Fixed income instruments	Stock market capitalisation	Corporate bonds	Mutual funds	Foreign capital country funds	Insurance company reserves	Gross domestic product	Pension funds
	(In per cent of GDP)			(US$ million)					
1980	1.8	0.2	29.9	51	714	–	na	27,600	–
1981	1.1	0.3	20.7	96	681	–	na	32,600	298
1982	0.6	3.3	22.7	415	611	–	584	24,300	876
1983	0.3	5.6	13.3	266	188	–	454	19,000	1,265
1984	0.2	5.8	12.7	203	104	–	515	19,200	1,653
1985	0.3	10.7	13.2	101	125	–	427	16,000	1,743
1986	1.7	25.5	23.9	64	215	–	458	16,800	2,254
1987	2.6	31.1	27.5	149	295	–	566	18,900	2,936
1988	2.8	37.3	30.2	440	375	–	753	22,100	3,644
1989	3.3	48.8	37.6	906	364	106	1,031	25,400	4,998
1990	2.8	50.5	40.5	1,349	479	502	1,313	27,800	7,364
1991	6.0	38.6	88.6	1,889	908	1,023	1,834	31,300	10,773
1992	5.5	60.4	87.6	2,064	910	1,244	2,655	37,700	12,243

Source: Arrau, Valdés-Prieto, Schmidt-Hebbel (1993).

"Architecture" of financial markets

A final and important aspect of financial market development relates to the institutions that inform and facilitate securities transactions and that protect the rights of claimants. Again, the potential contribution of insurers and pension funds derives from their particular needs. Given their limited ability to monitor asset quality directly (compared with commercial banks), contractual savings institutions are dependent on published financial information and third-party credit assessments in order to contain transaction costs. Prudent insurance companies and pension funds have therefore an interest in supporting the development of a wide range of services, such as credit rating, accounting and auditing services.

For reasons of prudence and regulation, contractual savings institutions tend to invest in companies on a portfolio basis and not as controlling investors. Each institution on its own thus tends to have only a modest influence on the issuer or obligor. In some industrialised market economies, the influence of institutional investors has thus been credited with improvements in disclosure standards, listing requirements and other legislation protecting the rights of minority shareholders.[42] Where formal legislation is still lacking, their financial prowess – compared with individual investors – can generate the necessary pressure and incentives for such standards to be implemented. In the process, they may nudge financial markets towards practices that are rule-based (rather than informal) and transparent. Reflecting the portfolio nature of their individual holdings, the contribution of contractual savings institutions to enterprise governance tends to rely more on the threat of "exit" than on "voice", although a more active involvement has been registered in South Africa.[43]

[42] Including for instance protection against insider dealing, pre-emption rights, equal voting rights, and equal rights in take-overs.

[43] See Vittas and Michelitsch (1995).

From a development perspective, it is important to note that most of these factors carry positive externalities. These arise from the fact that other capital market participants may also benefit from them.

Financial market preconditions and positive feedback

While the discussion so far suggests that contractual savings institutions could contribute to financial sector development in the transition economies, there is a problem of sequencing reforms and institutional development. On the dimensions of capital market development distinguished above – the breadth and depth of markets and the quality of supporting institutions – most transition economies still perform rather poorly (see Chapter 2 of this Report and Chapter 10 of the 1995 *Transition Report*). As long as there are few safe and liquid assets to invest in, and the architecture of financial markets remains incomplete – with transaction costs correspondingly high – it is hard for fund managers to build satisfactory risk-return profiles. Risks would tend to rise the greater the volume of funds relative to existing market size. But when funds are small, the positive feedback effects that might arise are limited. There is thus a question of what the minimum conditions are for setting this process in motion, and what investment strategies could be adopted in the present financial settings.

Contractual savings institutions cannot step ahead of the development of competitive banking systems. For their liquidity management, they need to rely on deposits handled with reasonable efficiency, and rapid and large transactions require well-functioning payment and settlement systems operating at low cost. However, deposits alone are a poor basis for long-term investment strategies. Among higher-yielding instruments, well-organised and active markets in government debt, offering a broad range of maturities, would generally be the first to meet the contractual savings sector's criteria for risk, return and duration. Teething problems of domestic securities markets could be altogether side-stepped by investing abroad. However, for significant portions of the portfolio this would be sensible only where real exchange rates have achieved a certain degree of stability. In many countries, restrictions would be imposed by balance of payments policies.[44]

As discussed on a country-by-country basis in Chapter 2 (Annex 2.1), banking systems in the transition economies are generally at an intermediate stage of development. However, government securities issues are still quite uncommon in the region. In 1995 the only countries with a significant volume of new domestic government bond issues of over one-year duration were Bulgaria (which issued new bonds equivalent to 5.9 per cent of GDP), Hungary (2.4 per cent), and the Czech Republic (1.7 per cent). Shorter-term issues are developing rapidly in a wide variety of countries, including, for instance, Albania, Kazakstan, Lithuania, Poland and the Russian Federation. With inflation continuing to fall, and pressure on governments to develop non-inflationary deficit finance, demand by contractual savings institutions could stimulate a lengthening of maturities.

The scope of privatisation in the region and the growing liquidity of stock markets could allow a relatively early role for investments in company shares. Stock market profiles are still influenced by the chosen privatisation mode, with initial capitalisation and the number of listings relatively high in countries such as the Czech Republic, the Russian Federation and the Slovak Republic, which implemented voucher privatisation schemes. As shown in Chart 7.1, the stock market capitalisation in the Czech Republic in mid-1996 compared well with some western European countries. Nevertheless, as activity and share prices have picked up recently in markets such as Budapest and Tallinn (which gave preference to direct sales in their privatisation programmes) and Warsaw (where broad-based privatisation got under way only recently),[45] capitalisation has also risen substantially.[46] Liquidity, as measured by the ratio of turnover to capitalisation, appears to be quite high in some of the stock markets of the region. However, there is evidence that activity is often concentrated in a small number of "blue-chip" shares, while trade in others is limited for reasons such as poor asset quality or a lack of market transparency.[47]

Chart 7.1

Characteristics of share markets in mid-1996 [1]

Source: FIBV 1995 Annual Report, 1996 World Economic Forum, local exchanges

1 Prague and Bratislava, listed shares. Listed and unlisted shares for all other transition economies. Data for non-transition economies refer to 1995.

Bolivia's "capitalisation" programme, elements of which have entered the discussion in countries such as Poland, could provide an additional avenue for pension fund equity investment.[48] The programme entails the transfer of shares in certain valuable assets held by the state (for example, oil and gas sectors and utilities) to pension funds, thus offsetting part of the pension liability of

44 From the perspective of the contractual savings sector's contribution to financial market development, foreign investment would obviously be somewhat counterproductive, but the achievement of safe and sufficient returns for old age and life contingencies should be the principal motive in guiding placement policies.

45 Monthly turnover on the Warsaw stock exchange multiplied almost by a factor of three between 1995 and the first half of 1996.

46 Note that for Prague, Bratislava and Warsaw, as well as all non-transition economies, only listed shares are reflected in Chart 7.1. For other transition economies, the line was hard to draw and both listed and unlisted shares are reflected.

47 The low liquidity of many stocks in Russia appears often to reflect the unwillingness of insiders (among the main beneficiaries of privatisation) to relinquish control.

48 See Sinn and Sinn (1996) for a description of this programme.

governments to previous contributors to the PAYG scheme and making explicit the attribution of assets to earlier "savers". Management control and shares proportionate to the contribution of fresh investment finance are assigned to strategic investors.

This discussion suggests that policies should support a step-by-step build-up of contractual savings, avoiding large demand surges for financial assets but aiming for positive feedback to financial sector development. The Chilean experience, in which a contractual savings sector was built virtually from scratch under difficult macroeconomic conditions, again provides a useful reference (see Box 7.2).

Lastly, could contractual savings institutions destabilise the banking system? Efficient securities markets backed by substantial contractual savings could provide strong competition to the bank loan market. This competition is beneficial for savers and investors but could be problematic where banks are forced to maintain high margins as a result of bad loan portfolios, a common problem in many transition economies. Highly rated borrowers may be driven away from banks and into securities markets, forcing banks into more risky business segments. While these points have to be acknowledged and banks should ready themselves for the competition, developments on securities markets are unlikely to be so fast as to be immediately threatening. In the longer term, the evolution of a new division of labour for banks and securities markets is natural and raises economy-wide efficiency.

7.6 Concluding remarks

Contractual savings have received relatively little attention so far in the discussion of the transition towards market economies. However, a close look at the characteristics of the contractual savings sector and the evidence from other countries suggest that it has significant potential to contribute both directly and indirectly to progress in transition. Key points in this chapter are that contractual savings can facilitate the reform of financially strapped public pension systems in the region, as well as contribute to the development of local capital markets and the institutions which support them. However, effective and enduring contractual savings institutions require effective regulatory frameworks and minimum conditions regarding financial markets. A significant role for contractual savings belongs to more advanced stages of transition rather than earlier ones.

In developing contractual savings, there is an important role for governments and foreign companies and scope for external support from official sources and international financial institutions (IFIs). Governments can contribute to the development of the contractual savings sector above all by protecting consumer interests. This should be supplemented with measures that strengthen property rights and transparency in the capital markets. The participation of foreign providers in building up a contractual savings sector should be sought – rather than hindered as is the case in some countries of the region – since this can help to overcome the shortage of skills, capital and confidence which represent major bottlenecks in the development of the sector. Finally, IFIs and official donors such as the European Union can support this process by providing technical assistance to governments and providers of contractual savings products, and through capital participations in local and foreign contractual savings institutions.

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Albania

Law of
draft

General issues
Life insurance activity started in March 1996. The state-owned Insurance Institute is to be privatised. Insurance companies may take the form of joint-stock companies and mutual insurance companies.

Investment regulation
(Art. 45) Insurers can invest in bank deposits, short and long-term state bonds, listed and unlisted shares, real estate and other. Portfolio restrictions are yet to be announced.

Supervision and disclosure
An Insurance Supervision Committee will be created with the power to grant, suspend and revoke licences; to request from insurers any information and documents necessary for auditing; to conduct on-site inspections; and to impose sanctions. The draft law is fairly detailed on issues such as mergers and divisions, liquidation and rules on foreign companies. (Art. 87) Insurers shall publish systematically documents according to the Insurance Supervision Committee directives.

Market entry
Minimum capital requirement for joint-stock companies is 30m leks. Foreign participation is permitted up to 40% of capital. Foreign companies can obtain authorisation to perform insurance activity through branches. Cross-border services are not permitted.

Taxation
na

Product regulation
Insurers may be authorised to provide supplementary insurance for risk of body injury, accidental death and disability stemming from an accident or death.

Belarus

Law of
13/10/95

General issues
Insurers may be represented by state organisations, joint-stock companies, limited or additional liability companies. Reinsurance abroad is permitted after saturation of the domestic market and with the authorisation of the insurance supervisors. Life and non-life activities are not separated.

Investment regulation
(Art. 36) Investment of reserves shall obey principles of diversification, profitability and liquidity. Insurers can invest technical reserves in the following assets with the following limits: state bonds >40%; municipal bonds <10%; bank deposits <20%; shares <15%; real estate <25%.

Supervision and disclosure
There is an independent State Insurance Surveillance Body (SISB) with 40 staff and an annual budget of US$ 75,000. (Art. 40) The SISB issues, suspends and revokes licences. (Art. 41) It monitors the compliance with the legal requirements and can apply sanctions for violations of the law. It decides upon compulsory liquidation. The SISB determines a solvency margin. (Art. 38) Insurers shall publish an annual audited financial statement in the form and terms set by the SISB.

Market entry
Minimum capital requirement is ECU 150,000. (Art. 6) Foreign participation in domestic insurers is limited to 49%. Foreign insurers can open branches but cannot sell foreign policies. Cross-border services are not permitted.

Taxation
Insurance premiums are tax deductible. Investment return subject to value added tax of 20% and profit tax of 30%. Benefits taxed according to the income tax law.

Product regulation
Actuarial rules for premium calculation are approved by the SISB. Insurers can sell the following policies: pure endowment, pure life, annuity insurance.

Bulgaria

Law of
draft of 01/06/92

General issues
(Art. 9) Life and non-life insurance activity are separated. (Art. 13-16) Insurers may operate as joint-stock companies or mutual societies.

Investment regulation
(Art. 48) Insurers may invest the insurance fund only in Bulgaria and with the following limits: state bonds and other securities guaranteed by the state <25%; bonds of local companies, mortgage loans and real estate <25%; listed shares <30% (<10% of the nominal value of the stock of the acquired company); unlisted shares <15% and only in companies submitting an annual balance sheet. Investments abroad are permitted subject to authorisation by the Ministry of Finance.

Supervision and disclosure
(Art. 25) The Department of Insurance Supervision (DIS) has the power to grant licences after approving a business plan for the first three years of operation; to revoke licences; to resolve on mergers; (Art. 27) to inspect the overall activity of the insurers; to place an insurer in liquidation. It determines solvency margins. (Art. 28) Insurers have to submit to DIS an annual balance sheet together with the necessary enclosures regarding the state of each type of insurance. There has been no insurance supervision to date.

Market entry
The minimum capital requirement is 200m leva (in force from January 1997). Foreign joint ventures with a foreign ownership limit of 49% are permitted after approval from the Council of Ministers. No foreign insurers are permitted to enter the market until 2002. Cross-border services are not permitted.

Taxation
na

Product regulation
na

Croatia

Law of
10/02/94

General issues
(Art. 4) Insurance activity may be performed by joint-stock companies and mutual insurance companies. Life and non-life activities are not separated. (Art. 7) Reinsurance abroad is permitted.

Investment regulation
(Art. 54) Investment in real estate and private shares is permitted up to 50% of total assets with a limit of 10% for any one investment in real estate. Investments in loans secured with mortgages <40% of total assets. Investments in listed shares and other securities such as bonds <40% of total assets.

Supervision and disclosure
The Supervisory Directorate for Insurance Companies (SDIC) employs 7 staff. (Art. 59) The SDIC issues licences after approving a business plan for the first three years of activity; it suspends and revokes licences; it controls the accuracy of annual financial reports; it monitors the compliance of insurers' activity with the law; declares liquidation. (Art. 13) Life insurance companies must appoint a reserve manager. (Art. 60-61) Insurers must publish annual financial reports.

Market entry
Minimum capital requirement DM 1m, increasing to DM 2m if the company covers various classes of insurance. There are no privileges for public insurers. Foreign participation is permitted without limits in domestic companies or through the establishment of a new company. Cross-border services are not permitted.

Taxation
Insurance premiums are tax deductible except when they are paid by employers on behalf of employees. Investment returns are taxed as any other corporate income. Benefits are tax exempt.

Product regulation
Insurers can sell the following policies: pure endowment, pure life, annuity insurance, mixed life insurance.

Czech Republic

Law of
26/04/91.
Amends: 09/12/93; 23/02/94; 29/03/95

General issues
(Sec. 2) Insurance activity may be performed by joint-stock companies and cooperatives. A blocked account with a security deposit has to be opened prior to submitting a licence application. Life and non-life activities are not separated. Reinsurance abroad is permitted.

Investment regulation
(Art. 9 law 1994) Technical reserves can be invested in state bonds; bonds issued by banks; corporate bonds; real estate (<25%); listed shares (<10%); bank deposits, with <15% of bank capital stock for any one deposit; more than 20% of reserves cannot be deposited in any one single bank.

Supervision and disclosure
The Department of Financial Markets Insurance Sector and Pension Funds (Supervisory Authority: SA) in the Ministry of Finance employs 20 staff. (Sec. 17-23) The SA issues, revokes and suspends licences. It can impose fines (Sec. 11) and recommend specific policies to be adopted by the insurers. The SA decides on liquidation and mergers. Solvency requirements are in line with EU directives but not established by the law. (Sec. 15a) Insurers must document their solvency to the SA. Annual financial statements must be published.

Market entry
There is a minimum capital requirement of CZK 70m. Foreign participation is permitted in the form of joint-stock companies with no participation limits. No cross-border services permitted.

Taxation
Insurance premiums are tax deductible. Returns on investment are taxed. A flat 15% tax is paid on the difference between benefits and paid premiums.

Product regulation
Actuarial rules for premium calculation are approved by the SA. Insurers can sell the following policies: pure endowment, pure life, annuity insurance.

Estonia

Law of
11/1992.
Amends: 15/02/95; 13/03/96

General issues
(Art. 24) Insurers may operate as joint-stock companies and mutual insurance associations. Life and non-life activity are separated.

Investment regulation
(Art. 49) Investment of technical reserves can be made in the following assets and with the following limits: state bonds, Bank of Estonia bonds and securities issued by local authorities; corporate bonds; mortgage loans and bank deposits: no limits; real estate (except for agricultural), <25%; listed shares, <30%; non-listed shares, <15%. Investment in non-listed shares is permitted only if investee companies submit their annual reports to the insurance companies.

Supervision and disclosure
There is an independent supervisory authority employing 11 staff. (Art. 60) The Estonian Insurance Supervisory Authority (EISA) has the right to grant, suspend and revoke licences. (Art. 63) It has the right to verify the solvency of companies. (Art. 64) It has the power to demand additional reports other than the annual report requested by the Law on Statistics; to conduct audits on premises. Solvency regulations are in line with EU directives but not established by the law. The Law on Statistics requires insurance companies to report annually to EISA but there is no legal obligation to publish financial statements.

Market entry
(Art. 29) The minimum capital requirement is EEK 12m. There is no restriction on the participation or foundation of subsidiary companies by foreign insurers. Cross-border services are not permitted.

Taxation
Insurance premiums are not tax deductible. Investment returns are tax exempt. Benefits are taxed according to the income tax law. Life insurance companies are taxed at 1% on net collected premiums only.

Product regulation
Actuarial rules for premium calculation are approved by the EISA but no standard tables are yet in force. Insurers can sell the following policies: pure endowment, pure life, annuity insurance, and mixed life insurance where benefits depend on marriage or birth.

Hungary

Law of
01/01/96

General issues
(Sec. 6) Insurers may operate as companies limited by shares, cooperatives or mutual associations. (Sec. 45) Life and non-life activities are separated. Reinsurance abroad is permitted.

Investment regulation
(Sec. 84-89) The law contains detailed prescriptions regarding the investment of assets. In particular (Sec. 86) insurers have to keep >30% of liquid assets in state bonds and domestic securities issued by the central bank. Insurers may keep <25% of liquid assets in bank deposits; <10% in corporate bonds; <20% in real estate; <10% in listed shares; and <5% in non-listed shares.

Supervision and disclosure
The State Insurance Supervising Authority (SISA) employs 35 staff. It is an independent body reporting to the Ministry of Finance. (Part 8) The SISA issues insurance licences after approving a regulated business plan. (Chpt IV) SISA can impose fines, restrict activity, withdraw licences, institute liquidation proceedings. The insurer must employ a senior actuary, legal adviser, head of accounting and internal auditor with high professional experience. (Sec. 92-93) (Schedule 5) The law specifies the method of calculation of the minimum solvency capital. The government regulates the content of the annual report. (Part 10) Special rules apply to the disclosure of insurance secrets in case of suspected drug trafficking, money laundering, terrorism, illegal arms trade.

Market entry
There are two minimum capital requirements: companies limited by shares have a (Sec. 46, 2a) minimum "organisational" capital requirement of HUF 100m and a (Sec. 80, 1a) minimum "security" capital requirement of HUF 150m. Foreign participation is permitted in the form of joint-stock companies or cooperatives with no limits on the foreign shareholding. Cross-border services are not permitted although companies operating in foreign trade can take insurance abroad.

Taxation
Insurance premiums are tax deductible up to a HUF 50,000 ceiling. Investment returns are tax exempt. Benefits are tax exempt.

Product regulation
There are no official actuarial rules for premium calculation set by the SISA, but these have to be agreed by both insurers and SISA through a compulsory licensing system for new products. (Schedule 2) Insurers can sell the following policies: pure endowment, pure life, annuity insurance; life insurance with risk related to marriage and birth.

Kazakstan

Law of
Decree 03/10/95

General issues
The law does not specify the legal form that insurance companies can take, referring instead to the Civil Code. (Art. 8) Reinsurance abroad is permitted.

Investment regulation
(Art. 37) Insurers shall invest insurance reserves with the following portfolio limitations: state securities <80%; real estate <20%; bank deposits <80% with a limit of 50% of total deposits in any one bank; foreign currency and securities in foreign currency <50%. Listed and non-listed shares are not mentioned by the law.

Supervision and disclosure
The State Insurance Authority (SIA) employs 20 staff. (Art. 40) The SIA issues, suspends and revokes licences and monitors the compliance with the normative. No business plan for the first years of activity is required to obtain a licence. (Art. 42) The SIA carries out audits on established reports. On-site inspections are not mentioned by the law. (Art. 38) As a guarantee for solvency, the maximum obligation of an insurer in a single agreement cannot exceed 10% of the amount of the insurer's own resources. Although the law provides that SIA has to audit financial reports it does not establish the compulsory publication of reports.

Market entry
The minimum capital ("the charter fund") requirement is 40 times the minimum wage irrespective of organisational form and type of ownership. Foreign participation is permitted up to 50 per cent of shares. (Art. 11) No cross-border services permitted.

Taxation
Private persons: Insurance premiums are tax deductible. Legal persons: Insurance premiums are not tax deductible and have to be accompanied by a tax payment of 30%. A tax of between 5% and 50% is paid on the difference between benefits and paid premiums.

Product regulation
There are no official actuarial rules for premium calculation set by the SIA due to the lack of actuaries. (Art. 5) Any interest of a citizen or a legal entity may be subject to insurance except for unlawful interests.

Latvia

Law of
08/01/95.
Amended; 24/08/95 (Superv.)

General issues
(Art. 3) Insurers can be joint-stock companies and mutual insurance associations. Life and non-life activities are separated. Reinsurance abroad is permitted.

Investment regulation
(Art. 17) A prudent man rule for investment is accompanied by the following limits: investment in any one single company, <10% of technical reserves; 30% investment limit in listed and non-listed shares; 25% in real estate. No limits are imposed on state bonds, NBL securities and bank deposits.

Supervision and disclosure
The State Insurance Supervision Inspectorate (SISI) within the Ministry of Finance employs 20 staff. (Art. 3, 24 and 26) The SISI issues, suspends and revokes insurance licences. The SISI (Art. 18) determines the solvency margin to be respected by the insurer. (Art. 28) A protection fund compensates 100% of losses in case of insolvency of life insurers. A separate law "On State Insurance Supervision Inspectorate" regulates the supervision activity of the SISI. (Art. 8) Insurers shall provide the SISI with all requested information irrespective of the confidential nature of the documents. Annual financial statements shall be audited by the SISI.

Market entry
Minimum capital requirement of 600,000 lats. The only state company will be privatised and does not enjoy any privileges. Foreign participation is permitted with no limits. Cross border services are not permitted.

Taxation
Private persons: Insurance premiums are tax deductible. Legal persons: Insurance premiums are tax deductible only for contracts lasting more than five years. Investment returns are tax exempt. Benefits are tax exempt.

Product regulation
Insurers are free to sell new products provided they send a copy of the contract to the SISI. No official tables are used for the calculation of premiums and the SISI does not employ actuaries. A new amendment of 07/08/96 in force from January 1997 will require life insurance companies to employ at least one actuary.

Lithuania

Law of
draft of new law

General issues
Insurers may operate as joint-stock companies and mutual insurance associations. Life and non-life activities are separated.

Investment regulation
Reserves may be invested only in government bonds, corporate bonds, mortgage loans, real estate (except agricultural), shares listed in the national stock exchange and bank deposits. Investment limits are to be set by the Ministry of Finance.

Supervision and disclosure
At present the supervision is performed by the Board of Insurance Affairs (BIA) which is to be reorganised into the State Insurance Supervision Institution (SISI) under the new law. The BIA consists mainly of insurance company representatives. The SISI will determine new solvency margins and capital adequacy requirements once operational. Life insurance companies should employ at least one actuary. There are no special requirements for information disclosure at the moment. The new law will require mandatory auditing and publishing of annual reports.

Market entry
Minimum capital requirement of US$ 1m. The State insurance company has monopoly over mandatory insurance. This covers some types of property insurance of legal entities and life insurance of some professions.

Taxation
Insurance premiums are tax deductible up to four times the minimum wage. Investment returns are tax exempt. Benefits are tax exempt.

Product regulation
No official tables are used for the calculation of premiums but in practice such premiums have to be agreed within the BIA. Insurers are free to sell pure endowment, pure life, annuity insurance and other life insurance policies with benefits linked to marriage or birth. Supervision on products is very limited.

Moldova

Law of
15/06/93

General issues
Corporate bodies of any legal and organisational form, established to exercise insurance activities are recognised as insurers. Life and non-life activities are not separated. Reinsurance abroad is permitted.

Investment regulation
Insurers may invest resources with the following limits: government paper >10% of reserves; real estate <40%; bank deposits <40%; non-government securities <40%; loans to policyholders <30%; foreign currency <15%; cash >5%.

Supervision and disclosure
The supervisory office within the Ministry of Finance employs 10 staff. It issues, suspends and revokes licences. It has the duty to control that tariffs are based on sound grounds. It has the power to request information from insurers and auditors. Insurers have to submit detailed quarterly profit accounts and balance sheets. Failure to do so may mean suspension.

Market entry
Minimum capital requirement of MOL 50,000. Foreign participation is permitted with no limits.

Taxation
Insurance premiums are tax deductible. Investment returns are tax exempt. Benefits are tax exempt.

Product regulation
There are no specific restrictions on policy terms and price. Term assurance, health and disability insurance are currently marketed.

Poland

Law of
28/07/90.
Amends 08/06/95

General issues
Insurance activity may be conducted in the form of joint-stock companies or mutual insurance societies. Life and non-life activities are separated. Reinsurance abroad is permitted.

Investment regulation
(Art. 63) Insurers may invest reserves only in Poland and with the following limits: non-state bonds <5%; real estate <25% (<5% for any one single estate); listed shares <30%; non-listed shares <15%; bank deposits <20%.

Supervision and disclosure
There are two bodies supervising the insurance market. The Department of Insurance within the Ministry of Finance employs 22 staff and is responsible for licensing and legislation matters. The State Insurance Supervision Office (SISO) employs 64 staff and is responsible for current supervision. (Art. 82) The SISO shall issue, suspend and revoke licences; inspect insurance activity; attend general meetings. Solvency regulations are in line with EU directives but not established by the law. (Art. 46) The insurer is obliged to report quarterly and annual financial statements to SISO signed by the management and actuary. The insurer shall present to the Ministry of Finance, together with the balance sheet, a calculation of the solvency margin and evidence of the possession of own funds in the amount of the solvency margin.

Market entry
(Art. 39–39a) By law, there is no limit on foreign participation but there is an informal limit of 30%. Full foreign entry is to be permitted after 1999 in the form of branches and agencies. The creation of companies with foreign participation requires the permission of the Ministry of Finance. Minimum capital requirement of PZL 2m. Cross-border services are not permitted.

Taxation
Insurance premiums are tax deductible. Investment returns are taxed according to a corporate tax of 45%. Benefits are tax exempt.

Product regulation
Actuarial rules for premium calculation are approved by the Department of Insurance in the Ministry of Finance and their application is controlled by the SISO. Insurers can sell different types of policies: pure endowment, pure life, annuity insurance or mixed insurance.

Romania

Law of
47/91; 547/91; 136/95

General issues
(Art. 3) Insurers may operate as joint-stock companies and limited liability companies. (Art. 10) There is no separation between life and non-life activities but separate accounting is required. (Art. 6) Reinsurance abroad is permitted after saturation of the domestic market.

Investment regulation
(Art. 20) Insurers can invest part of their capital and reserves in bonds, real estate and bank deposits, subject to limits stipulated in the company statute.

Supervision and disclosure
Within the Ministry of Finance (MoF) the Office for Supervision of Insurance and Reinsurance Activity (OSIRA) grants, suspends and revokes licences. With the observance of the law 136/95, insurers contribute with 0.5% of gross premiums to a Protection Fund managed by the MoF through the OSIRA. OSIRA can call extra-ordinary meetings of shareholders and decide on partial or total termination of activity. Insurers have to publish annual financial reports.

Market entry
Minimum capital requirement of ROL 25m. Foreign insurers can establish branches for the purpose of conducting business with foreign companies only. In all other cases joint ventures only are permitted. (Art. 6) No cross-border services are permitted.

Taxation
Insurance premiums are not tax deductible. Investment returns are tax exempt. Benefits are tax exempt.

Product regulation
Insurers can sell the following policies: with-profits endowment, term assurance, annuities.

Russia

Law of
01/01/93

General issues
(Art. 2) Insurance activity may be conducted in the form of "insurance organisations" or mutual insurance societies. (Art. 28) There is no separation between life and non-life activities although separate accounting is required.

Investment regulation
Insurers may invest total reserves in the following assets and within the following limits: >10% in securities issued by the state and local authorities; <40% in real estate (with a maximum of 50% of total real estate investments in any one investment); <50% in bank deposits (with a maximum of 40% of total bank deposit investments in any one deposit); <10% in foreign currency (for insurers forming reserves in roubles only); >5% in current accounts used for supporting current insurance payments. Not less than 80% of total reserves should be placed in the territory of Russia.

Supervision and disclosure
The State Insurance Supervision Office of the Russian Federation (Rosstrakhnadzor) employs 200 members of staff and it has 18 regional offices. It grants licences after approving a feasibility study and a business plan for the first year of activity. It can also suspend and revoke licences. In the first half of 1996 Rosstrakhnadzor pulled 266 insurance (life and non-life) licences and another 230 licences were suspended. Rosstrakhnadzor determines formats of accounting and reporting; it has the right to request documentation in addition to the annual reports; it can impose sanctions; it controls adequacy of tariffs and solvency of insurers. The minimum solvency ratio (defined by the ratio of total assets over total liabilities) is 5% of reserves for life insurers; for mixed insurers it is 5% of life reserves and 20% of non-life reserves. At present, there is no on-site inspection. (Art. 29) Insurers must publish annual accounts after verification by independent auditors. Rosstrakhnadzor is to be disbanded and its functions assigned to the Ministry of Finance.

Market entry
Minimum capital requirement of RUR 150m. Foreign insurers are only admitted in joint ventures with maximum participation of 49%. No cross-border services permitted.

Taxation
Insurance premiums on short-term policies are not tax deductible for both private and legal persons. Investment returns are taxed at a profit tax of 13%. Benefits are tax exempt only when premiums are paid by beneficiaries.

Product regulation
na

Slovak Republic

Law of
24/1991.
Amends: 25/92; 197/92; 306/95; 136/96

General issues
(Art. 2) Insurance activity may be conducted in the form of joint-stock companies or mutual insurance societies. Life and non-life activities are separated. (Art. 10) A deposit of SKK 1m has to be made when applying for a licence. Reinsurance abroad is not permitted.

Investment regulation
(Art. 13 306/95) At least 30% of reserves must be invested in bank deposits. (Art. 9 136/96) Insurers cannot invest more than 15% of technical reserves in any one bank. Investment of technical reserves is limited to: <25% in real estate; <20% in mortgage bonds; <15% in listed and non-listed shares. Insurers can invest in state bonds, deposit certificates and other securities issued by municipalities and economic institutions.

Supervision and disclosure
The Department of Insurance within the Ministry of Finance is in charge of supervision and employs 6 staff. (Art. 17-21) The Ministry of Finance grants, suspends and revokes licences and verifies the solvency of companies. It can levy fines and suggest corrective measures. The Ministry of Finance (Art. 14a 306/95) has to continuously inspect the legality and regularity of the activities conducted. Solvency regulations are in line with EU directives but not established by the law. On site inspections are not mentioned by the law. Information disclosure is required by the Civil Code and Commercial Law, according to the insurer's legal form.

Market entry
Minimum capital requirement of SKK 50m. (Art. 5 197/92) Foreign insurers are only admitted in joint ventures with 45% as maximum participation. Contracts can be concluded in foreign currency. No cross-border services permitted.

Taxation
Insurance premiums are tax deductible. Investment returns are taxed. A flat 15% tax is paid on the difference between benefits and paid premiums.

Product regulation
Actuarial rules for premium calculation are provided by the Statistical Office. However, insurers are not forced to comply with these rules. Insurers can sell different types of policies: pure endowment, pure life, annuity insurance or mixed insurance.

Slovenia

Law of
11/94

General issues
Insurance activity may be conducted in the form of joint-stock companies or mutual insurance societies. There is no branch separation between life and non-life activities, although separate accounting is required. Reinsurance abroad is permitted once domestic capacity is exhausted.

Investment regulation
(Art. 75) Insurers have to invest >30% of mathematical reserves in government bonds. Insurers may invest mathematical reserves with the following limits: <30% in domestic real estate; <25% in listed bonds; <10% in listed shares with a limit of <1% in any individual investment.

Supervision and disclosure
The Insurance Supervisory Authority (ISA) within the Ministry of Finance employs 6 staff and several consultants on a temporary basis. (Art. 91) The ISA grants licences subject to the approval of a business plan; it also may suspend and revoke licences. (Art. 94) The ISA may inspect on the premises all books, book-keeping documents and other acts. (Art. 99) Insurers shall establish internal supervision in order to continuously inspect the legality and regularity of the activities conducted and are fined for failing to do so. (Art. 71) The solvency margin is set at 4% of mathematical provisions multiplied by the higher of the percentage of own shares over gross annual premiums and 85%. (Art. 72) A life insurance guarantee fund is to be not less than SLT 120m. (Art. 75) Insurers shall keep a regular list of investment by types to be submitted to the ISA twice a year.

Market entry
Minimum capital requirement of ECU 800,000. Majority participation by foreign insurers is possible. No cross-border services permitted.

Taxation
Insurance premiums are tax deductible for policyholders. Insurance companies have to pay 5% tax on collected gross premiums. Investment returns are subject to a profit tax of 25%. Benefits are tax exempt.

Product regulation
Mortality and population tables exist but standards for mathematical reserves are still to be set. The Slovenian Insurance Bureau (Association) has to adopt insurance standards set by the ISA.

Ukraine

Law of
07/03/96

General issues
Insurance activity can be conducted in the legal forms established by the law "on economic companies". Mutual insurers are permitted. Life insurers may not transact in other classes and separate accounting is required. (Art. 44) Foreign citizens and legal persons enjoy equal rights to Ukrainian citizens and legal persons. Reinsurance abroad is permitted.

Investment regulation
(Art. 30) Insurance reserves may be invested in bank deposits, real estate, state and non-state securities and long-term credits according to a prudent man rule.

Supervision and disclosure
The Committee for Supervision of Insurance Activity (CSIA) employs 50 staff. (Art. 16) The CSIA sets requirements for insurance contracts. (Art. 36) The CSIA issues insurance licences after approving a regulated business plan; it establishes the rules for formation and allocation of reserves. The CSIA may impose administrative fines and institute liquidation proceedings. (Art. 34) Insurers shall publish their audited annual balance sheet in the format established by the CSIA. (Art. 32) A Fund of Insurance Guarantees may be set up in the form of a separate legal person.

Market entry
(Art. 29) Minimal statutory fund of ECU 100,000 (ECU 500,000 with foreign participation). Foreign participation is permitted with a maximum participation of 49%. No cross-border services permitted.

Taxation
na

Product regulation
Policy conditions are set by the regulator but official actuarial rules are not enforced due to the lack of actuaries in the CSIA.

Uzbekistan

Law of
06/05/93;
Amended: 26/09/94

General issues
na

Investment regulation
The law does not specify investment limits and almost 100% of reserves are deposited with banks.

Supervision and disclosure
There is no supervisory and licensing body. There is no regulation on minimum reserve requirements. Insurers have to publish annual financial reports.

Market entry
Foreign participation is permitted through branches or joint ventures. No limits on shareholdings are mentioned by the law. No cross-border services permitted.

Taxation
na

Product regulation
na

Source: Country legislation and communication with supervisors.

Czech Republic

Law of
16/02/94

General issues
The law refers to private funds for old age pensions determined on a voluntary defined contribution basis only. Invalidity pensions can be organised also on a defined benefit basis. The pensionable age for an old age pension may be not less than 50 years of age. Participation in more than one pension fund is forbidden. There is full portability after 12 months of contributions.

Investment regulation
Any proportion of the fund can be invested in bonds and shares listed in the stock exchange and real estate. Restrictions on investment apply to any one particular company and share issues. International investments are not precluded.

Fund control, supervision and disclosure
A Board of Directors deals with the day-to-day management of funds. Effective influence of members on fund governance is limited. A supervisory board monitors the activities of the fund. State supervision is guaranteed through the Ministry of Finance which authorises new funds and has the right to attend members' meetings and inspect documentation. Pension funds have to publish financial reports twice a year.

Market entry
There is a minimum capital requirement of CZK 20m to form a pension fund.

Taxation
Pension funds are not subject to VAT or insurance tax. The government supplements contributions with direct transfers. Contributions, investment returns and benefits are all taxed.

Hungary

Law of
01/11/93

General issues
The law on Voluntary Mutual Benefit Funds (VMBFs) covers the provision of both defined benefit and defined contribution schemes. Provision and membership are voluntary. The fund can be paid out at retirement as a lump sum payment or transformed into an annuity. An asset manager may be appointed and 33 funds out of 200 have one.

Investment regulation
Assets in which funds can invest are divided into four classes with equity and property falling into the most hazardous class. Funds worth less than HUF 10m can invest only in the first two classes. Funds worth more can invest in all four classes with the following limitations: >10% in state securities with less than one year maturity and one-year deposits; <30% in other state and National Bank securities and mortgage bonds; <60% in listed shares and bonds, and bonds of more than one year maturity backed by mortgages; <30% in non-listed shares, bonds, security documents issued by municipalities, land and unencumbered property, and member loans.

Fund control, supervision and disclosure
A Board of Directors deals with day-to-day management, control of the fund lies in a General Meeting of members and a supervisory board monitors the activities of the VMBF. State supervision is guaranteed through the Pension Funds Supervisory Committee. This grants licences to new funds after the approval of a financial plan. It has the right to attend members' meetings, inspect documentation, nominate an independent auditor and impose fines. It decides on merger, splitting and liquidation of funds. At the end of the financial year, the Board of Directors has to draw up a financial plan for the following year. An insurance of at least 30% of the book value of the assets must be taken.

Market entry
Funds can be established on a regional, occupational or trade basis with a minimum of 15 members. No minimum capital requirement exists for mutual pension funds. A minimum capital requirement of HUF 20m is required for funds established as legal entities separate from the sponsor. Funds can be foreign owned but must have domestic establishment.

Taxation
Contributions made by employers are exempt from social security tax (42.5%) up to HUF 20,000 per person. Employees can deduct 50% of the total contributions from taxable income up to an annual HUF 100,000. Benefits are tax free after three years of membership.

Lithuania

Law of
draft

General issues
At present there is no law on non-state pension funds. According to the draft law, non-state pension funds will be fully funded, defined contribution schemes with voluntary participation, subject to compulsory participation to the social security system. Pension accounts are fully portable and can be inherited without any restriction during the period of contribution.

Investment regulation
Pension funds may invest only in securities recognised by the Securities Commission. The law will specify relative shares.

Fund control, supervision and disclosure
The Securities Commission will be in charge of granting licences, subject to the approval of a business plan for the first four years of operation. It seems that a separate supervisory authority will not be created. The Securities Commission has the right to suspend, revoke licences and assign a temporary administrator for a suspended pension fund. Pension funds have to submit reports to the Securities Commission twice a year. Reports are public. Once per quarter, the board of a pension fund must submit to all participants information on their accounts.

Market entry
Minimum capital requirements and terms for foreign participation will be determined by the Securities Commission.

Taxation
Employees' contributions are tax deductible up to 15% of salary. Employers' contributions are deductible up to the same percentage of total salaries.

Poland

Law of
draft

General issues
At present there is no law on non-state pension funds. The draft law establishes two types of pension funds: 1) corporate funds and 2) funds open for individual membership. Pension funds will be created on a defined contribution basis and will be voluntary. Full portability is assured. A fund member will acquire the right to obtain pension benefits after reaching the statutory retirement age (60 for men and 55 for women), given at least 10 years membership of the fund. Physical disability represents an exception and entitles to a disability pension until reaching retirement age.

Investment regulation
The law will define the investment policy of the funds along the following lines (suggested guidelines of the draft law in brackets): what part of capital may be invested abroad and in what investments; what minimum part of capital should be invested in state bonds and National Bank securities (>30 – 40%); what minimum part of capital should be held in cash or short-term securities (>10%); what maximum part of capital may be invested in listed shares (<30%); non-listed shares (<5 – 10%); real properties (<5 – 10%); what maximum level of investment in securities of the same issuer would be admissible.

Fund control, supervision and disclosure
The State Pension Fund Supervision Office will be created with the power to issue, revoke and suspend licences; to approve pension plans; to decide on the liquidation of the fund; to exercise current supervision of compliance with the law and statutory principles of investing the fund capital; to make recommendations. A special Guarantee Fund managed by a state supervisory authority will be created in order to cover losses incurred by funds in case of bankruptcy of a bank or an insurer. The capital of the Guarantee Fund will consist of 1%–2% of each pension fund capital.

Market entry
Minimum capital requirements and terms for foreign participation will be determined by the State Pension Fund Supervision Office.

Taxation
Employees' contributions will be income tax deductible up to a percentage to be defined.

Slovak Republic

Law of
01/07/96

General issues
According to the law, pension funds can be established as the result of an agreement between employers and employees (trade unions). The law establishes that accounts are fully portable. Benefits can be withdrawn in the form of a lump sum or as annuities managed by the pension fund.

Investment regulation
Pension funds can invest in the sponsor up to 10 per cent of their assets; in listed shares with a limit of 5 per cent for any one issue; in real estate with a limit of 3 per cent of assets for any one investment and a cumulative limit of 20 per cent of assets. Other asset classes are not restricted by specific maxima.

Fund control, supervision and disclosure
Pension funds are managed by employers and employees, although employees cannot be appointed to the management and supervisory boards. The government of the Slovak Republic has 6 months from the time of application for licensing pension funds with the approval of the Ministry of Finance and the Ministry of Labour. Among the documents to be provided in the licence application there has to be a business plan with a projection for the first years of activity. All documents are public.

Supplementary pension insurance companies are required to create reserve funds at a level of at least 0.5 per cent of their annual income for the purpose of covering unexpected fluctuations in economic operations. The state does not guarantee the solvency of the pension funds but monitors their economic activity and observance of the law. The Ministry of Finance decides on mergers with the approval of the anti-monopoly commission. In case of compulsory liquidation the Ministry of Finance appoints a liquidator and the bankruptcy law is applicable. Pension funds are required to produce annual financial reports and provide the Slovak Statistical Office with all requested information.

Market entry
Pension funds have to be non-state entities with a minimum capital requirement of SKK 30m.

Taxation
Contributions enjoy tax advantages. Employees' contributions are tax deductible. Employers' contributions are considered an expenditure item up to 3 per cent of the wage bill. Investment returns are tax exempt while benefits are taxed at a special rate of 15%.

Source: Country legislation and communication with country supervisors.

Part IV
Macroeconomic performance

Recent economic developments

8

8.1 Introduction

The past three years have seen strong economic growth in eastern Europe and the Baltics and a slowdown of the pace of output decline in the CIS. Growth in eastern Europe and the Baltics remained strong during the first half of 1996, albeit a little lower than the 5 per cent achieved in 1995. Full-year projections for 1996 point to significantly negative growth, however, in Bulgaria, which recorded positive growth in output in 1995.[1] It is likely that the slowdown in east European growth reflects primarily short-term factors, including a drop in recent quarters in western Europe's output growth and import demand, as well as fiscal contraction in a few east European countries. Growth prospects remain strong in the medium to long term for those countries of eastern Europe that have advanced the most in market-oriented reform (see Chapters 2 and 9).

The largest countries in the CIS still await the initial appearance of positive growth but eight of the smaller CIS countries recorded increases in industrial output in the first half of 1996 (compared with the same period of 1995). Despite earlier optimism amongst most forecasters (see Chapter 9), official data indicate that the pace of decline in Russia's real GDP failed to slow during the first half of 1996 from the annualised rate of about 4 per cent seen in 1995, while real GDP in Ukraine in the first half of 1996 was a full 8 per cent below the level one year earlier. However, at least in the case of Russia, both industrial production and oil output have recently flattened, indicating that the trough has been reached.

The current account has deteriorated sharply over the past year in parts of eastern Europe and the Baltics. Some of these countries remain crucially dependent on official assistance from abroad, notably from the IMF, to retain a manageable cushion of foreign exchange reserves. The first half of 1996 saw Bulgaria and Romania suffer from declining levels of reserves, sharp currency depreciation (both in nominal and real terms[2]) and a significant increase in inflationary pressure. Both were able to replenish reserves in the middle of the year (Bulgaria obtained IFI funding and Romania successfully completed two large international bond issues). Nevertheless, the difficulties experienced recently by these countries underlines their continued vulnerability, which they share with many other countries in the region, to policy inconsistencies and to external shocks.

In a number of countries, rising labour productivity has, over the last few years, been offsetting the negative impact on industrial competitiveness of real currency appreciation. Thus, figures on output-prices and unit labour costs indicate that the recent current account deterioration in many countries in eastern Europe has happened alongside an improvement in profitability of production in manufacturing.

The current account deterioration has mainly been the consequence of a sharp pick-up in domestic demand (with the underlying cause of the pick-up differing from country to country), alongside sluggish growth in export demand from the European Union. The few east European countries that have escaped a current account deterioration have done so on account of a substantial tightening of fiscal and monetary policies.

8.2 Growth in eastern Europe and the Baltics, further output contraction in the CIS

Nominal GDP in eastern Europe, the Baltics and the CIS increased in ECU terms by about one-fifth in 1995, and in dollar terms by about one-third.[3,4] A further, albeit probably more modest, increase took place in the first half of 1996. The 1995 increase in dollar GDP was caused exclusively by real currency appreciation. In fact, real GDP for the region as a whole declined slightly in 1995 as strong growth in eastern Europe was offset by GDP declines in the CIS (see Chart 8.1). Real currency appreciation continued in most countries in the first half of 1996, albeit at a slower pace, and with a few reversals, notably in Bulgaria and Romania.[5]

Eastern Europe and the Baltics: continued growth

Eastern Europe is well into its seventh year of market-oriented reform and its fourth year of economic recovery.[6] GDP in eastern Europe and the Baltics as a whole is likely to grow this year, in real terms, by about 4 per cent, only marginally down from the impressive 5 per cent level achieved in 1995. Growth has been held back by the weakness of demand from stagnating west European

1 It should be emphasised that the tables on pages 185 to 209 and the assessment in this chapter of the growth in output rely almost exclusively on current official estimates from the national statistical offices in the region. It is widely recognised that official GDP estimates for many countries overstate the output decline that took place in the early years of transition (for a discussion of statistical issues, see Annex 11.1 of the *Transition Report* 1995).

2 The real exchange rate is a term that has been given a number of different definitions and interpretations. It will be used here to refer to the ratio between the dollar price of a representative consumer-basket of goods and services in the domestic (say, Russian) economy and the dollar price of the same basket in trading partner countries (such as the United States). The term "real currency appreciation" will be used to cover an increase in the real exchange rate, i.e. an *increase* in the dollar value of goods and services in the domestic economy over and above the increase taking place abroad.

3 The average ECU/dollar-rate dropped by about 10 per cent in 1995.

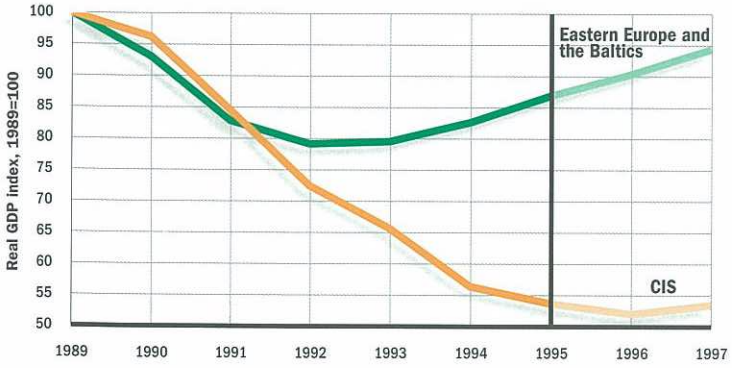
4 For a detailed discussion of the causes of real currency appreciation in the region, see *Transition Report Update*, April 1996.

5 For a detailed discussion of the causes and consequences of real currency appreciation in the region, see the *Transition Report Update*, April 1996.

6 The starting date for reform and for the return to positive growth varies from country to country. Hungary initiated price and import liberalisation in earnest in 1988, and phased in the bulk of its market liberalisation gradually over three years. Poland implemented comprehensive liberalisation of prices and imports in 1990, and the former Czechoslovakia did the same in 1991. Bulgaria and Romania also embarked on market-oriented reform in 1991. The Baltic countries initiated reform in earnest in 1992-93.

Chart 8.1

Real GDP 1989-97: Regional averages



Source: Table 8.1. Data for 1996 and 1997 are EBRD projections.

economies, notably from Germany which has become the main export destination for the central European transition economies.[7] A tightening of domestic demand management policies has also played a substantial role in a few countries (see below).

Activity in the industrial sector remains buoyant in the Czech Republic, Estonia, Poland, Romania and the Slovak Republic. Most of these countries saw industrial output growth of the order of about 10 per cent during the first half of 1996. The output increase has been accompanied in all of these countries by a significant increase in domestic demand and by a deterioration in the trade balance (see also Section 8.4).

Bulgaria and Hungary continue to experience much slower growth than the remainder of eastern Europe. In Hungary a tightening of fiscal, monetary and incomes policy since March 1995 (aimed at reducing the current account deficit from a level of about 9 per cent of GDP in 1993 and 1994) continues to dampen activity and has helped to sharply reduce the current account deficit. The main independent Hungarian forecasting agencies have scaled down their forecast for GDP growth in 1996 to 1–1.5 per cent (from earlier forecasts of 2 per cent). The Bulgarian government embarked on a tightening of fiscal and monetary policy during the first half of 1996 and began in the middle of the year (in the context of a new IMF programme) to implement further fiscal adjustment and closure of major loss-making enterprises. As a consequence of these policies, full-year real GDP in Bulgaria may be substantially lower in 1996 than it was in 1995.

In Latvia and Lithuania, the banking crisis in 1995 (see Chapter 2) has resulted in more restricted access for the private sector to credit from banks (and to money held on deposit). There has also been a cut-back in government investment expenditure. These factors have restrained domestic demand and dampened the pace of real GDP growth, which is now expected in both countries to be within a 0–2 per cent range for the full year 1996.

Only Poland is expected to reach the pre-1990 level of output in 1996 (see Table 8.1). Output in most other countries in eastern Europe and the Baltics is likely to return to pre-1990 levels in two to three years' time. It should be noted, however, that these statements are based on the official data for growth, which are subject to the caveats mentioned in Section 8.1.

CIS: slower decline in output

Output of the largest CIS countries continued to decline during the first half of this year. The official Russian measurement of real GDP dropped 5 per cent in the first half of 1996 (compared with the same period in 1995). Ukraine recorded a decline of 8 per cent. It is now clear that positive full-year growth will at the earliest be achieved in these two countries in 1997, although it remains possible, especially for Russia, that month-to-month changes in real GDP will turn positive during the second half of 1996.

Some of the smaller CIS countries recorded positive growth in 1995 (in the case of Armenia, positive growth was recorded already in 1994), and others saw positive growth emerge during the first half of 1996. Real GDP grew in Armenia at annualised rates of 5–7 per cent in both 1994 and 1995, and both Georgia and Kyrgyzstan recorded modest positive growth in 1995. Turkmenistan and Uzbekistan both saw positive GDP growth in the first half of 1996, following steep declines in preceding years. The relatively early return to positive growth in Armenia should be seen against the background of a particularly sharp output contraction in the preceding years. The reopening of factories has been made possible by a partial revival in 1994 of foreign trading links, including energy supply routes, that had previously been severed due to armed conflicts in the region.

Historical growth data for the CIS should be utilised with caution. For example, the data in Table 8.1, which indicate that real GDP fell during 1990-95 in Russia, Ukraine and some other CIS countries to less than half of the pre-1990 level, probably exaggerate significantly the "true" extent of the output decline. The under-recording of activity in the new private enterprises, the activities of which are likely to be growing fast, is a problem in most transition economies. It is likely to be particularly pronounced in the CIS countries.[8]

8.3 Inflation

Eastern Europe and the Baltics

By the end of 1995 no country in eastern Europe and the Baltics was suffering from annual inflation of more than 40 per cent (see Table 8.2). In fact, inflation fell in 1995 to single digit levels in six countries: Albania, Croatia, the Czech Republic, FYR Macedonia, the Slovak Republic and Slovenia. No country in the region had been recording single digit inflation two years earlier.

7 Real GDP growth in Germany slowed from 3.7 per cent in the second quarter of 1995 (compared to the same quarter one year earlier) to 0.1 per cent in the third quarter, -0.6 per cent in the fourth, and -1.5 per cent in the first quarter of 1996 (according to JP Morgan's *World Financial Markets – Third Quarter 1996*).

8 A detailed discussion of alternative indicators of GDP growth was included in the EBRD *Transition Report* 1995, Annex 11.1.

Table 8.1

Growth in real GDP in eastern Europe, the Baltics and the CIS[1]

	1990	1991	1992	1993	1994	1995 *Estimate*	1996 *Projection*	Estimated level of real GDP in 1995	Projected level of real GDP in 1996
Individual countries				*(Percentage change)*				*(1989=100)*	*(1989=100)*
Albania	-10.0	-27.7	-9.7	11.0	9.4	8.6	5.0	***77***	***81***
Armenia	-7.4	-10.8	-52.4	-14.8	5.4	6.9	6.5	***38***	***40***
Azerbaijan	-11.7	-0.7	-22.6	-23.1	-21.2	-8.3	-3.5	***38***	***36***
Belarus	-3.0	-1.2	-9.6	-10.6	-12.2	-10.2	-5.0	***61***	***58***
Bulgaria	-9.1	-11.7	-7.3	-2.4	1.8	2.6	-4.0	***76***	***73***
Croatia	-8.6	-20.0	-10.0	-3.7	0.8	2.0	5.0	***65***	***68***
Czech Republic	-0.4	-14.2	-6.4	-0.9	2.6	4.8	5.1	***85***	***90***
Estonia	-8.1	-11.0	-14.2	-8.5	-2.7	3.2	3.0	***64***	***66***
FYR Macedonia	-9.9	-12.1	-21.1	-8.4	-4.0	-1.5	3.0	***54***	***56***
Georgia	-12.4	-13.8	-40.3	-39.0	-35.0	2.4	8.0	***18***	***20***
Hungary	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.5	***86***	***87***
Kazakstan	-0.4	-13.0	-13.0	-12.0	-25.0	-8.9	0.5	***45***	***46***
Kyrgyzstan	3.2	-5.0	-19.0	-16.0	-26.5	1.3	2.0	***50***	***51***
Latvia	2.9	-8.3	-35.0	-16.0	0.6	-1.6	1.0	***51***	***52***
Lithuania	-5.0	-13.4	-37.7	-24.2	1.0	3.1	1.5	***40***	***41***
Moldova	-2.4	-17.5	-29.0	-1.0	-31.0	-3.0	4.0	***38***	***39***
Poland	-11.6	-7.0	2.6	3.8	5.2	7.0	5.0	***99***	***103***
Romania	-5.6	-12.9	-8.8	1.3	3.9	6.9	4.5	***84***	***88***
Russia	-4.0	-13.0	-14.5	-8.7	-12.6	-4.0	-3.0	***55***	***53***
Slovak Republic	-2.5	-14.6	-6.5	-4.1	4.8	7.4	5.5	***84***	***89***
Slovenia	-4.7	-8.1	-5.4	1.3	5.3	3.5	3.0	***91***	***94***
Tajikistan	-1.6	-7.1	-29.0	-11.1	-21.5	-12.5	-7.0	***40***	***37***
Turkmenistan	2.0	-4.7	-5.3	-10.0	-20.0	-10.0	0.0	***60***	***60***
Ukraine	-3.4	-9.0	-10.0	-14.0	-23.0	-11.8	-7.0	***46***	***43***
Uzbekistan	1.6	-0.5	-11.1	-2.3	-4.2	-1.2	-1.0	***83***	***82***
Eastern Europe, the Baltics and the CIS	-5.1	-11.7	-10.2	-5.0	-5.6	0.3	0.7	***68***	***68***
Eastern Europe and the Baltic countries[2]	-6.9	-11.0	-4.4	0.5	3.9	5.2	4.0	***87***	***90***
The Commonwealth of Independent States[3]	-3.7	-12.2	-14.3	-9.4	-13.9	-4.8	-3.0	***54***	***52***

1 Data for 1990-95 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1995 are preliminary actuals, mostly official government estimates. Data for 1996 represent EBRD projections.

2 Estimates for real GDP represent weighted averages for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. The weights used were EBRD estimates of nominal dollar-GDP for 1995.

3 Here taken to include all countries of the former Soviet Union, except Estonia, Latvia and Lithuania. Estimates for real GDP represent weighted averages. The weights used were EBRD estimates of nominal dollar-GDP for 1995.

Inflation rose, however, in a number of countries in the region during the first half of 1996. A particularly strong rebound was recorded in Bulgaria and Romania (of a much greater order of magnitude in Bulgaria than in Romania). The increase in inflation was, in both countries, partly the consequence of a precipitous drop in the nominal exchange rate. This was in turn caused in Bulgaria primarily by a substantial weakening in the confidence amongst depositors in the strength of the financial system, as evidenced by a run on many banks since the end of 1995. In addition, there was concern during much of the first half of 1996 about whether the Bulgarian government would reach agreement with the IMF on a new stand-by arrangement and on a complementary arrangement with the World Bank in time to be able to finance large debt-service payments that would be due in July (in practice, the government reached agreement with the IMF and the World Bank in June, leading to a replenishment of the stock of reserves). In the case of Romania, pressure on the exchange rate has in part been a consequence of a loosening of domestic credit policies and political uncertainty associated with the forthcoming elections (scheduled for November 1996). In August, year-on-year inflation reached 141 per cent in Bulgaria, and 44 per cent in Romania. Inflation has also been rising in Albania, as fiscal and wages policies have been loosened. After falling to 6 per cent at the end of 1995, Albania's inflation is now projected by the EBRD to rise to 20 per cent before the end of 1996.

On a much more modest scale, Slovenia also saw an increase in inflation during the first half of 1996. Year-on-year inflation moved from 8.6 per cent at the end of 1995 to more than 10 per cent in July 1996. Croatia's inflation rose marginally to 4.3 per cent year-on-year in July 1996, from 3.7 per cent at the end of 1995.

The Commonwealth of Independent States

Armenia, Azerbaijan, Georgia, Kazakstan and Uzbekistan have all seen inflation fall from more than 1,000 per cent in 1994 to less than 100 per cent by mid-1996. At the most successful end of the

Table 8.2

Inflation in eastern Europe, the Baltics and the CIS[1]

	Retail/consumer prices (end-year)					
	1991	1992	1993	1994	1995 Estimate	1996 Projection
Individual countries			(Percentage change)			
Albania	104	237	31	16	6	20
Armenia	25	1,341	10,996	1,885	32	19
Azerbaijan	126	1,395	1,294	1,788	86	15
Belarus	93	1,558	1,994	1,957	244	61
Bulgaria	339	79	64	122	33	165
Croatia	249	937	1,150	-3	4	5
Czech Republic	52	13	18	10	8	9
Estonia	304	954	36	42	29	24
FYR Macedonia	115	1,935	230	55	9	2
Georgia	131	1,176	7,488	7,144	65	23
Hungary	32	22	21	21	28	22
Kazakstan	150	2,567	2,169	1,160	60	26
Kyrgyzstan	170	1,771	1,366	87	32	27
Latvia	262	958	35	26	23	19
Lithuania	345	1,161	189	45	36	26
Moldova	151	2,198	837	116	24	18
Poland	60	44	38	29	22	19
Romania	223	199	296	62	28	60
Russia	144	2,318	841	203	131	25
Slovak Republic	58	9	25	12	7	6
Slovenia	247	93	23	18	9	10
Tajikistan	204	1,364	7,344	5	1,500	200
Turkmenistan	155	644	9,750	1,330	1,000	250
Ukraine	161	2,000	10,155	401	182	55
Uzbekistan	169	910	885	1,281	117	35

1 Data for 1991-95 represent the most recent official estimates of outturns as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1995 are preliminary actuals, mostly official government estimates. Data for 1996 represent EBRD projections.

scale, Moldova, Georgia and Kyrgyzstan have reduced inflation to less than 30 per cent. Only Tajikistan and Turkmenistan have yet to reduce inflation to a level below 200 per cent. Tajikistan, however, has embarked on an IMF-supported stabilisation programme which may help reduce inflation to a much more modest level over the coming one to two years. Turkmenistan has also tightened monetary policy substantially in the current year.

Inflation in Russia has declined gradually in recent years, from more than 800 per cent in 1993 to about 37 per cent in August 1996 (based on the increase in consumer prices between August 1995 and August 1996). Ukraine has also edged closer towards price stability, albeit somewhat unevenly. After rising by more than 10,000 per cent in 1993 – a 100-fold increase in one year – Ukrainian consumer prices rose by a more modest 400 per cent in 1994 and 180 per cent in 1995. Year-on-year inflation in Ukraine fell to 80.5 per cent in July 1996 (but rose to 82.4 per cent in August, partly on account of an increase in rents for government-owned housing).

8.4 Capital flows and the current account of the balance of payments

Total private and official capital flows

Increased financial stability has helped trigger a sharp rise in inflows of funds from abroad. Figures from the World Debt Tables (published by the World Bank) point to an increase in the gross flow of lending, foreign direct investment (FDI) and portfolio placements into eastern Europe, the Baltics and the CIS to a record level of US$ 45 billion in 1995, up from US$ 31-33 billion per year in 1991-94 (see Tables 8.3–8.5). Preliminary data for the first half of 1996 point to a further increase during this period.

Funding from abroad was boosted in the early 1990s mainly by significant increases in the flow of official finance. Between 1989 and 1991 total gross flows of medium to long-term finance to the countries of eastern Europe, the Baltics and the CIS rose from about US$ 18 billion to almost US$ 32 billion (see Table 8.3). The entire increase during this period was due to a sharp rise in finance from official sources abroad (about US$ 5 billion of which came from the IMF, the World Bank, the EBRD and other multilateral organisations, with the IMF being the dominant single source). Such finance had been negligible until reforms were initiated.

By contrast, the increase in aggregate inflows seen in 1995 was caused entirely by flows from private sources which rose from about US$ 21 billion in 1994 to about US$ 31 billion in 1995 (see Tables 8.3 and 8.4). The percentage increase in such flows (+48 per cent) was much greater for eastern Europe, the Baltics and the CIS than for the group of developing countries as a whole (+5 per cent). The flow of FDI into eastern Europe, the Baltics and the CIS almost doubled in 1995 to about US$ 12.2 billion

Table 8.3

Financial flows to eastern Europe, the Baltics, and the CIS[1]

	1990	1991	1992	1993	1994	1995	1976-1980	1981-1985	1986-1990	1991-1995
	(annual flow in billions of US dollars)						(average annual flow in billions of US dollars)			
Gross medium to long-term flows *(incl. IMF)*	24.1	31.6	32.1	32.5	33.3	45.4	1.6	6.0	18.5	35.0
Official medium to long-term finance	7.1	16.7	13.4	12.0	13.7	17.0	0.5	1.4	3.0	14.6
Grants (excl. technical assistance)	0.6	6.5	5.9	4.8	4.6	4.3	0.0	0.0	0.1	5.2
Loans	6.5	10.2	7.5	7.1	9.1	12.7	0.5	1.4	2.9	9.3
Bilateral	4.8	4.5	2.8	1.9	1.8	1.6	0.2	0.5	1.8	2.5
Multilateral, excl. IMF	1.0	1.9	2.3	3.0	3.1	3.4	0.2	0.4	0.9	2.7
IMF	0.7	3.7	2.4	2.3	4.2	7.7	0.1	0.4	0.2	4.1
Total medium to long-term private flows	17.0	14.9	18.7	20.5	19.7	28.4	1.1	4.6	15.5	20.4
Debt flows	16.6	12.7	14.5	13.9	12.1	14.2	1.1	4.6	15.4	13.5
Guaranteed by government in recipient country	16.6	12.7	13.9	12.3	9.3	9.2	1.1	4.6	15.4	11.5
Commercial bank loans	2.3	1.4	2.2	1.6	2.2	2.8	0.9	3.6	7.7	2.0
Bonds	1.6	1.5	1.5	4.8	3.7	3.0	0.0	0.1	1.2	2.9
Others	12.7	9.7	10.3	5.9	3.4	3.4	0.2	0.9	6.5	6.5
Non-guaranteed	0.0	0.0	0.6	1.6	2.8	5.0	0.0	0.0	0.0	2.0
Foreign direct investment	0.3	2.2	4.2	6.6	6.7	12.2	0.0	0.0	0.1	6.4
Portfolio flows	0.2	0.0	0.1	0.0	0.8	2.0	0.0	0.0	0.0	0.6
Net medium to long-term flows *(incl. IMF)*	11.4	18.4	25.7	25.2	20.7	30.7	1.2	1.8	5.0	24.1
Official net medium to long-term financial flows	6.2	16.1	12.0	10.7	10.4	12.0	0.3	0.8	1.1	12.2
Grants (excl. technical assistance)	0.6	6.5	5.9	4.8	4.6	4.3	0.0	0.0	0.1	5.2
Loans	5.6	9.6	6.1	5.8	5.8	7.7	0.3	0.8	0.9	7.0
Bilateral	4.4	4.2	2.4	1.5	1.3	0.2	0.1	0.2	1.1	1.9
Multilateral, excl. IMF	0.8	1.7	1.9	2.3	2.2	2.0	0.2	0.3	0.1	2.0
IMF	0.3	3.6	1.8	2.0	2.4	5.5	0.0	0.3	-0.3	3.1
Total net medium to long-term private flows	5.2	2.3	13.7	14.5	10.2	18.7	0.9	1.0	3.9	11.9
Debt flows	4.7	0.1	9.4	7.9	2.7	4.5	0.8	1.0	3.8	4.9
Guaranteed	4.7	0.1	9.1	7.0	1.1	1.0	0.8	1.0	3.8	3.6
Commercial bank loans	-4.5	-4.4	-0.4	-0.9	-1.8	-1.2	0.7	0.7	0.1	-1.7
Bonds	1.6	1.4	0.9	4.2	2.6	1.9	0.0	0.1	1.2	2.2
Others	7.7	3.0	8.5	3.8	0.3	0.3	0.1	0.2	2.5	3.2
Non-guaranteed	0.0	0.0	0.3	0.9	1.7	3.5	0.0	0.0	0.0	1.3
Foreign direct investment	0.3	2.2	4.2	6.6	6.7	12.2	0.0	0.0	0.1	6.4
Portfolio flows	0.2	0.0	0.1	0.0	0.8	2.0	0.0	0.0	0.0	0.6
Flows deflated/inflated to the average price level in the US in 1990 *(as measured by the GDP-deflator)*										
Total gross medium to long-term flow	24.1	30.2	30.1	29.8	29.9	39.6	2.7	7.7	20.0	31.9
Total official gross flow	7.1	16.0	12.5	11.0	12.3	14.8	0.8	1.8	3.2	13.3
Total private gross flow	17.0	14.2	17.5	18.8	17.6	24.8	1.9	5.9	16.8	18.6
Total net medium to long-term flow	11.4	17.6	24.1	23.1	18.5	26.8	2.0	2.3	5.3	22.0
Total official net flow	6.2	15.4	11.3	9.8	9.4	10.5	0.6	1.1	1.1	11.2
Total private net flow	5.2	2.2	12.8	13.3	9.2	16.3	1.4	1.2	4.2	10.8
Share of private (nominal) long-term flows in total (nominal) long-term flows							(based on total flows in each five-year period)			
Ratio for gross flows	71%	47%	58%	63%	59%	63%	71%	77%	84%	58%
Ratio for net flows	46%	13%	53%	58%	50%	61%	73%	54%	79%	49%

Source: *World Debt Tables 1996* (published by the World Bank) and EBRD staff estimates.

1 For 1985-94, each item was computed as the sum of observations in the World Debt Tables for the EBRD's 25 countries of operations. The 1996 edition of the World Debt Tables does not include country-by-country tables covering 1995 for the EBRD's countries of operations. The 1995 estimates that are quoted above were derived on the basis of figures quoted in the World Debt Tables for the country grouping labelled "Europe and Central Asia", which includes the EBRD's 25 countries of operations plus Gibraltar, Greece, Malta, and Turkey. Data for Turkey, extending all the way through 1995, are quoted in the World Debt Tables. However, separate country data were not available for Greece, Gibraltar and Malta. The data for Turkey were subtracted from the data for "Europe and Central Asia" to arrive at a series for a revised grouping ("Europe and Central Asia, excluding Turkey"). For this revised grouping, the percentage changes between 1994 and 1995 were computed for all data items (i.e. for each line item appearing in the table above). These percentage changes were then used as the basis for taking the 1994 observations in the table above forwards to 1995. However, for private flows, the "Loanware" information system was used to establish the 1995 estimates.

Table 8.4

Financial flows to all developing countries[1]

	1991	1992	1993	1994	1995	1971-1975	1976-1980	1981-1985	1986-1990	1991-1995
	(annual flow in billions of US dollars)					*(average annual flow in billions of US dollars)*				
Gross medium to long-term flows *(incl. IMF)*	222.0	255.7	321.7	323.8	370.5	36.1	97.5	142.6	165.2	298.7
Official medium to long-term finance	102.6	90.9	90.0	91.5	127.3	14.6	32.1	55.6	73.4	100.5
Grants	37.5	31.9	29.4	32.5	32.9	4.4	9.1	11.9	20.0	32.8
Loans	65.1	58.9	60.6	59.1	94.5	10.2	23.0	43.7	53.3	67.6
Bilateral	26.2	23.7	22.7	21.5	36.4	6.4	12.7	20.7	23.7	26.1
Multilateral, excl. IMF	29.2	28.2	30.9	29.2	32.6	2.5	7.0	14.8	24.1	30.0
IMF	9.7	7.1	7.0	8.4	25.4	1.3	3.3	8.2	5.5	11.5
Total medium to long-term private flows	119.4	164.8	231.7	232.2	243.1	21.5	65.4	86.9	91.8	198.3
Debt flows	76.9	104.2	117.8	117.2	130.8	18.3	59.6	76.2	71.3	109.4
Guaranteed	58.0	69.4	74.8	67.4	74.6	10.7	44.0	60.4	59.9	68.9
Commercial bank loans	16.5	22.3	17.9	20.7	na	6.2	28.1	37.2	28.2	na
Bonds	12.8	13.9	31.0	23.4	na	0.4	2.7	4.1	6.4	na
Others	28.7	33.2	25.9	23.3	na	4.0	13.3	19.1	25.3	na
Non-guaranteed	18.9	34.7	43.1	49.8	56.2	7.7	15.5	15.8	11.4	40.5
Foreign direct investment	35.0	46.6	68.3	80.1	90.3	3.1	5.9	10.7	18.6	64.1
Portfolio flows	7.6	14.1	45.6	34.9	22.0	0.0	0.0	0.1	1.9	24.8
Net medium to long-term flows *(incl. IMF)*	130.2	156.4	209.0	209.0	247.0	25.6	66.1	87.0	75.0	190.3
Official net medium to long-term financial flows	68.7	56.2	54.7	50.2	79.8	11.9	25.5	41.3	41.6	61.9
Grants	37.5	31.9	29.4	32.5	32.9	4.4	9.1	11.9	20.0	32.8
Loans	31.1	24.2	25.3	17.7	47.0	7.4	16.4	29.4	21.5	29.1
Bilateral	13.2	10.8	9.4	6.1	18.9	4.6	9.0	12.4	11.4	11.7
Multilateral, excl. IMF	14.8	12.3	14.3	10.1	12.6	2.0	5.9	11.4	13.4	12.8
IMF	3.1	1.2	1.6	1.6	15.6	0.8	1.5	5.7	-3.3	4.6
Total net medium to long-term private flows	61.5	100.3	154.3	158.8	167.2	13.7	40.6	45.7	33.5	128.4
Debt flows	19.0	39.6	40.4	43.8	54.8	10.6	34.8	35.0	12.9	39.5
Guaranteed	10.4	19.2	23.0	19.0	21.4	6.9	28.1	29.9	12.5	18.6
Commercial bank loans	-3.3	1.9	-2.7	1.8	na	4.8	18.5	20.5	3.5	na
Bonds	10.0	4.6	18.8	14.7	na	0.2	2.2	2.4	1.9	na
Others	3.7	12.7	6.9	2.4	na	1.9	7.4	6.9	7.0	na
Non-guaranteed	8.6	20.4	17.4	24.8	33.4	3.7	6.7	5.1	0.4	20.9
Foreign direct investment	35.0	46.6	68.3	80.1	90.3	3.1	5.9	10.7	18.6	64.1
Portfolio flows	7.6	14.1	45.6	34.9	22.0	0.0	0.0	0.1	1.9	24.8
Flows deflated/inflated to the average price level in the US in 1990 *(as measured by the GDP-deflator)*										
Total gross medium to long-term flow	211.9	239.4	294.9	290.6	322.9	94.0	177.1	186.9	178.5	271.9
Total official gross flow	97.9	85.1	82.5	82.2	111.0	38.1	58.3	72.6	79.3	91.7
Total private gross flow	114.0	154.3	212.4	208.5	211.9	55.9	118.8	114.3	99.2	180.2
Total net medium to long-term flow	124.2	146.5	191.5	187.6	215.3	66.1	120.5	114.9	80.7	173.0
Total official net flow	65.5	52.6	50.1	45.1	69.6	30.7	46.4	54.2	44.9	56.6
Total private net flow	58.7	93.9	141.4	142.5	145.7	35.4	74.1	60.7	35.9	116.4
Share of private (nominal) long-term flows in total (nominal) long-term flows						*(based on total flows in each five-year period)*				
Ratio for gross flows	54%	64%	72%	72%	66%	60%	67%	61%	56%	66%
Ratio for net flows	47%	64%	74%	76%	68%	54%	61%	53%	45%	67%

Source: *World Debt Tables 1996* (published by the World Bank).

[1] World Bank concept of "all developing countries".

Table 8.5

Foreign direct investment

	FDI-inflows in 1994 (in millions of US dollars)	FDI-inflows in 1995 (in millions of US dollars)	Cumulative FDI-inflows 1989-95 (in millions of US dollars)	Cumulative FDI-inflows 1989-1995 per capita (in US dollars)	FDI-inflows per capita in 1995 (in US dollars)	Ratio of FDI in 1995 to GDP in 1995[1]
Albania	53	70	200	63	22	3.5%
Bulgaria	105	100	302	36	12	0.8%
Croatia	98	68	251	53	14	0.4%
Czech Republic	850	2,500	5,481	532	243	5.6%
Estonia	214	204	637	413	132	5.8%
Hungary	1,146	4,453	11,466	1,113	432	10.2%
Latvia	155	160	409	164	64	3.5%
Lithuania	60	55	228	61	15	0.8%
FYR Macedonia	24	14	38	18	7	0.3%
Poland	542	900	2,423	63	23	0.7%
Romania	341	367	879	39	16	1.0%
Slovak Republic	187	180	623	117	34	1.1%
Slovenia	88	150	505	253	75	0.8%
Eastern Europe and the Baltics	**3,864**	**9,221**	**23,442**	**203**	**80**	**2.8%**
Armenia	3	19	22	6	5	1.4%
Azerbaijan	50	206	276	37	28	11.7%
Belarus	10	7	85	8	1	na
Georgia	8	6	92	17	1	na
Kazakstan	635	723	1,831	110	43	3.8%
Kyrgyzstan	45	88	143	32	20	5.5%
Moldova	18	63	95	22	15	3.5%
Russia	1,000	1,500	3,100	21	10	0.4%
Tajikistan	12	13	29	5	2	na
Turkmenistan	100	100	215	54	25	10.6%
Ukraine	91	120	581	11	2	0.4%
Uzbekistan	85	120	287	13	5	1.5%
The Commonwealth of Independent States	**2,057**	**2,965**	**6,756**	**24**	**10**	**0.6%**
Total	**5,920**	**12,187**	**30,198**	**76**	**30**	**1.5%**

[1] Nominal GDP-figures for Tajikistan and Turkmenistan in 1995 were set equal in per capita terms to the 1994 observation for Kazakstan.

(see Table 8.5). FDI inflows into this region accounted for about 13 per cent of all FDI flows to developing countries in 1995, up from slightly more than 8 per cent in 1994.

FDI accounted for more than half of the net private capital flows to the region in 1995. Most of this was received by four countries: Hungary, the Czech Republic, Russia and Poland (although Estonia was running third to Hungary and the Czech Republic in terms of FDI-flows per capita).

Hungary attracted FDI inflows of about US$ 4.5 billion in 1995 (equivalent to 10 per cent of GDP), up from US$ 1.1 billion in 1994. Hungarian balance-of-payments statistics do not distinguish between portfolio flows and FDI.[9] However, portfolio flows to Hungary in 1995 are likely to account for no more than a few hundred million dollars out of the total US$ 4.5 billion. The massive increase in FDI inflows into Hungary reflected sales by the government, especially in December 1995, of shares in electricity and gas distribution, banking and telecommunications (see Chapter 2 for further details).

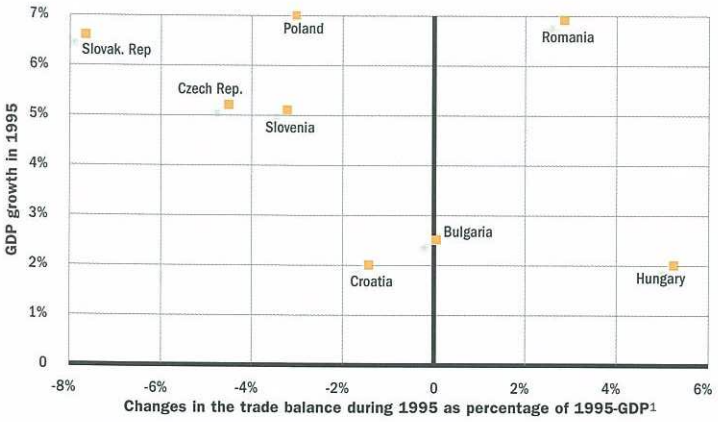
FDI flows into the Czech Republic rose to about US$ 2.5 billion in 1995 (5 per cent of GDP) from US$ 0.8 billion in 1994, helped by the sale of a 27 per cent stake in the local telecommunications company (accounting for FDI inflows of US$ 1.3 billion).

More modest increases took place over this period in Russia (from US$ 1 billion in 1994 to roughly US$ 1.5 billion in 1995) and in Poland (from US$ 0.5 billion in 1994 to about US$ 0.9 billion in 1995). A significant increase was also recorded in the flow of portfolio investment from abroad into Poland (rising from a negligible level in 1994 to more than US$ 1 billion in 1995) whereas portfolio investment flows into the Czech Republic remained at the 1994 level of slightly less than US$ 1 billion.

[9] According to the *Balance of Payments Manual* (fourth edition, issued by the IMF in 1977), "direct investment refers to investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise", whereas the term portfolio investment "covers long-term bonds and corporate equities other than those included in the categories for direct investment and reserves".

Chart 8.2

Large deteriorations in the trade balances of most high-growth countries



Source: The Vienna Institute's Monthly Reports, nos 229 and 225.

1 Annualised difference between two half-year observations, one covering 95Q4-96Q1, and another covering 94Q4-95Q1.

The cumulative flows of FDI into the region since 1989 remain concentrated on a few countries in the region. The main recipients, in per capita terms, have been Hungary, the Czech Republic, Estonia and Slovenia. These four countries are relatively advanced with respect to social stability and macroeconomic stabilisation, and therefore with respect to investor-perceptions of country risk. It is likely, however, that there have been other important influences on the distribution throughout the region of FDI-inflows.[10] One such influence is geographical and cultural proximity to countries that are the main sources of FDI. Within the CIS the level of natural resources of individual countries has already been an important influence and will no doubt continue to be so in the years ahead. Another important factor has been the privatisation strategy in recipient countries. For example, flows of FDI into Hungary and Estonia have been greatly buoyed by the deliberate focus of these countries on sales of state assets to foreign strategic investors (see Chapter 2 for further details). As the figure for FDI inflows into countries of the region was boosted exceptionally in 1995 by the Hungarian sell-off in December of major utilities, the full-year inflow of FDI is likely to be somewhat lower in 1996 than it was in 1995.

Total flows to the region of private finance from international bond issuance by east European governments and enterprises and from borrowing from foreign banks amounted during the first half of 1996 to US$ 7 billion, of which US$ 1.3 billion flowed into Hungary, and US$ 1.1 billion into the Czech Republic. On an annualised basis, this level of inflows is broadly unchanged from the full-year figure of US$ 15.4 billion that was registered in 1995 (out of which a massive US$ 5.6 billion flowed into Hungary alone, and US$ 2.2 billion into the Czech Republic).[11]

The current account of the balance of payments

The current account deteriorated sharply during the course of 1995 and early 1996 in the Czech Republic, Poland, the Slovak Republic, Slovenia and in all three Baltic countries. Most of these countries experienced particularly high growth in 1995 (see Chart 8.2). The combination of high output growth and deteriorating trade balances points to a particularly strong expansion of domestic demand and may in part be the result of capital inflows. It also reflects a rise in investor and consumer confidence in parts of eastern Europe at a time of sluggish growth in the main export markets within the European Union. It does not appear to reflect a deterioration in export competitiveness (see Section 8.5).

In some countries of eastern Europe the direct positive influence on the trade balance of tighter fiscal policy (which has held back domestic demand) and sharp increases in labour productivity has outweighed the negative impulse from a weakening in economic growth in west European export markets. In 1995 the trade balance strengthened, for example, in Bulgaria (marginally) and Hungary – the two countries in eastern Europe with the lowest growth. In all the countries with high growth (except Romania, whose currency had depreciated sharply) the trade balance deteriorated substantially. At least that is the indication that follows from a comparison between, on the one side, data covering the 6 months from October 1995 to March 1996, and, on the other, data covering the 6 months from October 1994 to March 1995 (see Chart 8.2).

Russia's current account has been remarkably resilient to rapid real currency appreciation.[12] Russian balance-of-payments statistics are uncertain, and many different estimates for the trade balance for any particular year can be found in competing statistical publications from Russian government sources and from international financial institutions. However, all available full-year data point to a substantial strengthening of the current account in 1995 and to no substantial change from the 1995-level in the first half of 1996. Among the contributing factors have been a significant improvement in the terms of trade (reflecting rising prices for raw materials), the influence on domestic demand of tighter fiscal and monetary policies, and the gradual reduction in export taxes (see Chapter 2).

8.5 Productivity and competitiveness

Available data suggest that the average dollar wage in manufacturing rose in 1995 by 17–30 per cent in Russia and in each of the six eastern European countries listed in Table 8.6, except Hungary.[13] However, the dollar cost of labour per unit of output rose at a much more modest pace as labour productivity continued to increase strongly. The average wage level in 1995 (see Table 8.7) remains far below west European levels throughout the region.

10 For a more detailed discussion of factors affecting the flow of FDI, see Chapter 4 of the EBRD *Transition Report* 1995, and Chapters 7 and 9 of the EBRD *Transition Report* 1994.

11 The source of these figures is the "Loanware database", which provides information about each transaction. The totals quoted here include some transactions that would be categorised in Table 8.3 as "portfolio flows".

12 Real appreciation implies an increase in the dollar price of consumer goods domestically over and above the increase taking place in partner and/or competitor countries. Real appreciation might, on this basis, indicate that it has become more difficult for domestic producers to compete against products that are manufactured in other countries. However, the use of the real exchange rate as an indicator of competitiveness is problematic. Difficulties of interpretation are discussed in Section 8.5 below.

13 In Russia, specifially, dollar-wages rose sharply during the course of 1995 and were, in the first quarter of 1996, a massive 87 per cent above the level one year earlier.

Table 8.6

Indicators of competitiveness

	1990	1991	1992	1993	1994	1995	1996 (1Q)
Bulgaria[1]			*(percentage change, year on year)*				
Percentage change in:							
industrial gross output	-16.0	-27.8	-15.0	-7.0	4.1	1.6	-2.5
employment in industry	-6.2	-18.8	-15.1	-11.8	-8.8	-6.8	-4.7
wage in industry (expressed in local currency)	20.7	167.7	139.5	51.7	53.9	58.1	23.1
exchange rate (leva per US dollar)	116.7	364.1	28.9	18.4	96.3	23.7	13.0
wage in industry (expressed in US dollars)	-44.3	-42.3	85.7	28.1	-21.6	27.8	8.9
labour productivity in industry (output per employee)	-10.4	-11.1	0.2	5.5	14.2	9.0	2.3
unit labour cost in industry (in US dollars)	-37.8	-35.1	85.4	21.5	-31.4	17.3	6.5
Czech Republic[2]							
Percentage change in:							
manufacturing gross output	-3.5	-26.4	-14.5	-9.9	0.2	7.9	7.5
employment in manufacturing	-3.1	-11.8	-7.5	-6.6	-3.7	-10.4	-2.5
wage in manufacturing (expressed in local currency)	-1.7	16.8	17.6	25.2	16.3	18.7	17.8
exchange rate (Czech Crowns per US dollar)	19.3	64.2	-4.1	3.1	-1.2	-7.8	-0.1
wage in manufacturing (expressed in US dollars)	-17.6	-28.9	22.7	21.4	17.8	28.8	17.9
labour productivity in manufacturing (output per employee)	-0.4	-16.6	-7.6	-3.5	4.0	20.5	10.3
unit labour cost in manufacturing (in US dollars)	-17.3	-14.8	32.8	25.8	13.2	6.9	6.9
Hungary[3]							
Percentage change in:							
manufacturing gross output	-10.3	-21.1	-8.2	3.3	9.3	5.3	-1.4
employment in manufacturing	-10.6	-3.9	-17.1	-12.9	1.9	-5.3	-8.0
wage in manufacturing (expressed in local currency)	22.9	25.6	25.9	24.7	21.5	21.3	22.3
exchange rate (forint per US dollar)	7.0	18.2	5.7	16.4	14.4	19.6	27.3
wage in manufacturing (expressed in US dollars)	14.8	6.2	19.2	7.1	6.3	1.5	-3.9
labour productivity in manufacturing (output per employee)	0.4	-17.9	10.7	18.5	7.3	11.2	7.2
unit labour cost in manufacturing (in US dollars)	14.4	29.4	7.6	-9.6	-1.0	-8.7	-10.3
Poland[4]							
Percentage change in:							
manufacturing gross output	-24.1	-12.3	4.8	12.2	13.7	11.4	9.6
employment in manufacturing	-3.7	-0.4	-10.5	-2.0	-4.7	1.7	-0.2
wage in manufacturing (expressed in local currency)	374.2	63.3	37.7	39.1	38.4	34.6	29.1
exchange rate (zloty per US dollar)	560.2	11.3	28.8	33.1	25.3	6.7	6.2
wage in manufacturing (expressed in US dollars)	-28.2	46.7	6.9	4.5	10.5	26.1	21.5
labour productivity in manufacturing (output per employee)	-21.1	-11.9	17.1	14.5	19.2	9.6	9.7
unit labour cost in manufacturing (in US dollars)	-8.9	66.5	-8.7	-8.8	-7.3	15.1	10.8
Romania[5]							
Percentage change in:							
industrial gross output	-23.7	-22.8	-21.9	1.3	3.3	9.4	5.7
employment in industry	1.2	-5.3	-10.9	-7.0	-7.4	-4.5	-4.3
wage in industry (expressed in local currency)	9.4	125.0	173.5	204.2	131.6	49.2	50.0
exchange rate (lei per US dollar)	40.2	240.6	303.1	146.8	117.8	22.8	37.5
wage in industry (expressed in US dollars)	-22.0	-33.9	-32.2	23.3	6.4	21.5	9.1
labour productivity in industry (output per employee)	-24.6	-18.5	-12.3	9.0	11.6	15.7	10.4
unit labour cost in manufacturing (in US dollars)	3.5	-18.9	-22.6	13.1	-4.7	5.0	-1.2
Slovak Republic[6]							
Percentage change in:							
industrial gross output	–	–	-9.5	-3.7	4.7	8.3	7.1
employment in industry	–	–	-15.8	-4.3	-2.0	4.1	1.5
wage in industry (expressed in local currency)	–	–	16.4	23.1	17.5	15.2	13.8
exchange rate (Slovak crowns per US dollar)	–	–	-4.1	8.8	3.9	-7.1	-0.5
wage in industry (expressed in US dollars)	–	–	21.3	13.1	13.1	24.1	14.4
labour productivity in industry (output per employee)	–	–	7.4	0.6	6.8	4.0	5.5
unit labour cost in industry (in US dollars)	–	–	13.0	12.4	5.9	19.3	8.4

Table 8.6 continued

Indicators of competitiveness

	1990	1991	1992	1993	1994	1995	1996 (1Q)
Russia[7]				*(percentage change, year on year)*			
Percentage change in:							
industrial gross output	–	–	–	-16.3	-22.7	-3.2	-7.0
employment in industry	–	–	–	-2.3	-10.6	-7.5	-6.4
wage in industry (expressed in local currency)	–	–	–	798.2	261.3	144.0	108.4
exchange rate (roubles per US dollar)	–	–	–	346.6	120.9	108.1	11.4
wage in industry (expressed in US dollars)	–	–	–	101.1	63.6	17.3	87.1
labour productivity in industry (output per employee)	–	–	–	-14.2	-13.6	4.7	-0.6
unit labour cost in industry (in US dollars)	–	–	–	134.5	89.3	12.0	88.3
Germany[8]							
Percentage change in:							
unit labour cost (in US dollars)	19.0	1.6	12.2	-2.1	-4.1	13.0	5.1
United Kingdom[9]							
Percentage change in:							
unit labour cost (in US dollars)	14.4	6.1	1.8	-14.6	2.0	6.7	0.2

1 The computation of percentage changes in industrial gross output, employment and wages under the heading "Bulgaria" was based on data extracted from OECD *Short Term Economic Indicators*, No. 3, 1996. Data on exchange rates were taken from *The Annual Report 1994* of the Bulgarian National Bank (BNB), *The Bulgarian Banking System*, issued by BNB in November 1995 and *Bulgarian National Bank Monthly Report*, June 1996. All data quoted on wages for Bulgaria concern wages net of income tax. All data quoted on Bulgarian industrial output, wages and employment concern only the state-owned and cooperative part of the industrial sector.

2 The computation of percentage changes quoted in this table under the heading "Czech Republic" were based on series extracted from OECD *Short Term Indicators*, No. 1, 1996 and data series in *Monthly Statistics of the Czech Republic*, 3.96, of the Czech Statistical Office, *The Czech National Bank Monthly Bulletin*, No. 1, 1996, and *Statistical Yearbook of the Czech Republic 1995*. All data quoted on wages for the Czech Republic concern wages before income tax (gross wages). Percentage changes quoted for 1990-92 cover only enterprises with more than 100 employees: those for 1993 onwards cover enterprises with more than 25 employees.

3 The computation of percentage changes quoted in this table under the heading "Hungary" for the period 1992-96 was based on data from the *Monthly Bulletin of Statistics* (of the Hungarian Central Statistical Office, various issues, including the one from April 1996) and *The Hungarian Statistical Yearbook 1993*. The computation of percentage changes for 1991 and 1992 was based on data supplied directly to the EBRD by the Hungarian Central Statistical Office. Percentage changes for 1990 were computed on the basis of data extracted from *OECD Short Term Indicators, No. 3, 1996*. All data quoted on wages for Hungary concern wages before income tax (gross wages).

4 The computation of percentage changes quoted in this table under the heading "Poland" for the period 1994-96 was based on data from the *Monthly Bulletin of Statistics* of the Polish Central Statistical Office, various issues, including the one from April 1996). Percentage changes for 1990-93 were computed on the basis of data extracted from OECD *Short Term Indicators*, No. 4, 1995. For 1990-93 the quoted percentage changes in wages for Poland concern wages net of income tax: for 1994-96 they concern wages before income tax (gross wages).

5 The computation of percentage changes quoted in this table under the heading "Romania" for the period 1990-96 was based on data from the *Quarterly Bulletin of the National Bank of Romania* (including the issue from the first quarter of 1996) supplemented by the data directly provided by the National Bank of Romania. Percentages changes until 1993 on industrial employment were computed on the basis of data extracted from OECD *Short Term Indicators*, No. 3, 1996. All data quoted on wages for Romania concern wages net of income tax.

6 The computation of percentage changes in employment, wages, and exchange rates quoted in this table under the heading "Slovak Republic" for the period 1993-96 was based on data from the *Monitor of the Economy of the Slovak Republic* (of the Slovak Central Statistical Office, various issues, including the one from April 1996). Percentage changes in the same variables for 1992 were computed on the basis of data extracted from OECD *Short Term Indicators*, No. 3, 1996, as were percentage changes in output for 1992-96. All data quoted on wages for the Slovak Republic concern wages before income tax (gross wages). Percentage changes quoted for 1990-92 cover only enterprises with more than 100 employees: those for 1993 cover enterprises with more than 25 employees: those for 1994-96 cover all industrial companies.

7 The computation of percentage changes quoted in this table under the heading "Russia" for output, wages and employment was based on data from *Russia Economic Trends* (various issues). Data on exchange rates were based on the IMF's *International Financial Statistics*, June 1996. All data quoted on wages for Russia concern wages before income tax (gross wages).

8 The computation of percentage changes quoted in this table under the heading "Germany" was based on data supplied directly to the EBRD by the German Federal Office of Statistics. Data for 1990-95 cover only West Germany.

9 The computation of percentage changes quoted in this table under the heading "United Kingdom" was based on data supplied directly to the EBRD by the UK Treasury.

In five of the countries listed in Table 8.6 – Bulgaria, the Czech Republic, Hungary, Poland and Romania – the quantity of output per worker in manufacturing rose by 9-20 per cent in 1995. More modest labour productivity growth of 4-5 per cent was recorded in Russia and the Slovak Republic.

Such productivity gains are likely to reflect the combination of two separate phenomena. One is the increasing effectiveness of labour on account of a greater effort or skill per worker, reallocation of labour within enterprises, and/or shedding by enterprises of staff who were previously kept on the payroll as a "social support mechanism" (to help sustain full employment). The other phenomenon involves renewal and expansion of the capital stock and improvements in the organisation and management of capital (see Chapter 4 of the *Transition Report* 1995).

While opportunities for labour-shedding may be limited, the other processes that help raise the productivity of labour may in principle proceed at a relatively rapid pace as long as new and old enterprises can maintain technological, educational and managerial progress (for example, by importing production techniques from the West and adapting them to local circumstances). The scope for such progress will be likely to exist as long as there is a substantial gap between the transition economies and the advanced industrialised countries in the effectiveness with which individual factors of production are being used.

Table 8.7

Gross monthly wages in manufacturing

1. Annual average of monthly wages in US dollars, gross of income tax and of employee-part of payroll taxes, net of employer-part of payroll taxes[1]

	1994	1995	1996 (1Q)
Bulgaria[2]	97	109	132
Czech Republic	231	297	306
Hungary	304	309	286
Poland	229	288	308
Romania[3]	113	138	106
Slovak Republic	203	252	251
Russia	105	123	171

2. Annual average of monthly wages in US dollars, gross of income tax and of all payroll taxes[3]

Bulgaria[2]	138	155	187
Czech Republic	316	407	420
Hungary	458	465	430
Poland	339	427	456
Romania[3]	150	183	141
Slovak Republic	280	348	347
Russia	146	172	240

Sources:
The wage levels quoted here are EBRD staff estimates based on the sources that are listed in the footnotes to Table 8.6. Payroll tax levels were extracted from the EBRD *Transition Report* 1995, *Emerging Markets Profiles* (Ernst and Young, September 1995) and from *Bulgaria – Private Sector Assessment*, World Bank, January 1996.

1 For Bulgaria, Slovak Republic and Russia, wage levels quoted here represent monthly dollar wages in industrial sector, rather than in the more narrow manufacturing sector.

2 The wage levels quoted here concern only enterprises in the state-owned and cooperative sector.

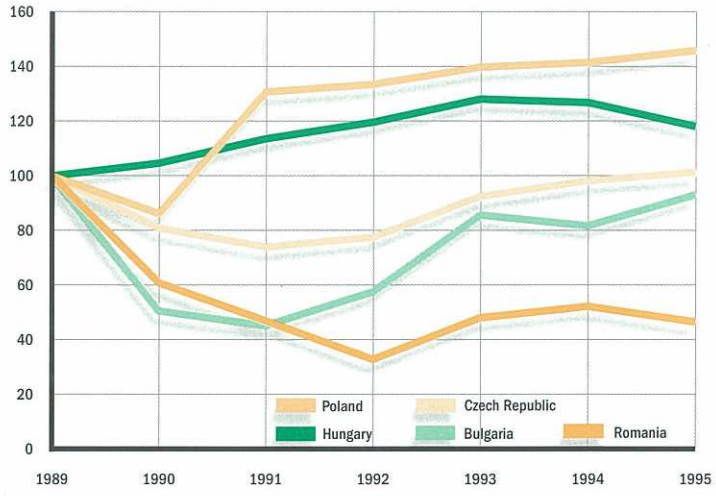
3 The data in this table were computed on the rough assumption that the most recently available estimate of the employer's part of the payroll tax level applied fully in both 1994 and 1995.

Despite productivity gains, Bulgaria, Poland, the Slovak Republic and Russia saw unit labour costs (in US dollar terms) rise in 1995 at a rate that exceeded or was broadly comparable with that recorded in Germany (also in US dollar terms – see Table 8.6, and Charts 8.3–8.5). However, unit labour costs in the Czech Republic and Romania rose in US dollar terms by 4–7 per cent in 1995, a lower rate of increase than that of West Germany (13 per cent). In Hungary, unit labour costs in US dollars fell for the third year running. The main cause of decline in Hungary in 1995 was the tight stabilisation programme which was implemented in March of that year and which included as a key component an active effort by the government to elicit moderation in wage growth.

It should be emphasised that even if reliable data on unit labour costs were available, these would still represent an insufficient 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 (as well as land). Unfortunately, meaningful data on the capital stock, and for capacity utilisation, are not available for the countries in the region. Moreover, sectoral data on real value added for these countries tend to become available only with long lags (up to several years). An attempt to use data on real value added in the computa-

Chart 8.3

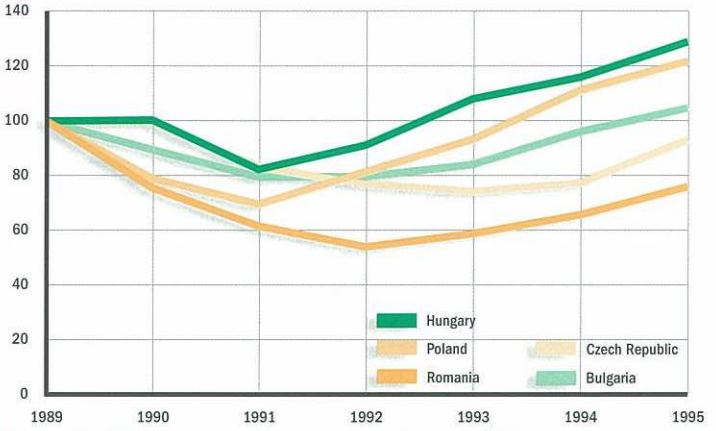
Real exchange rate (CPI-based) against DM (1989=100)



Source: Tables 8.2 and 8.6, and the IMF's *International Financial Statistics* (for German data).

Chart 8.4

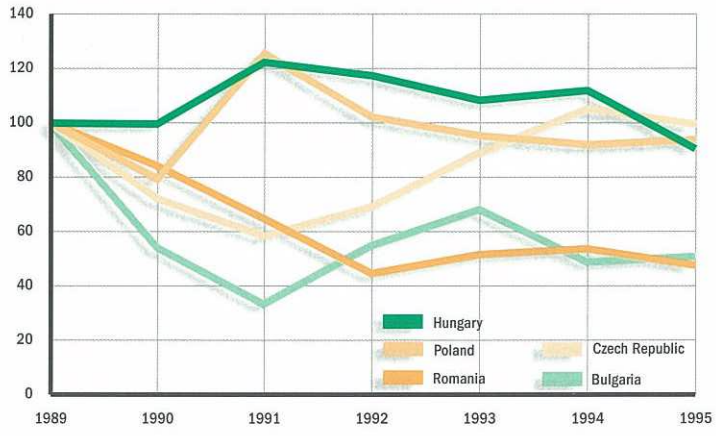
Labour productivity in manufacturing (units of output per full-time employee) (1989=100)



Source: Table 8.6. Covers "industry" rather than "manufacturing" for Bulgaria and the Slovak Republic.

Chart 8.5

Real exchange rate (unit labour cost based) against DM (1989=100)



Source: Table 8.6.

tion of unit labour costs would, therefore, not shed much light on the recent evolution of foreign trading competitiveness.

The profitability in manufacturing in east European countries may have followed a more favourable path in the most recent years than that indicated by the data series for unit labour costs. A comparison between the evolution in unit labour costs (expressed in US dollars) and the evolution in output prices (also expressed in US dollars) would suggest this. When output prices rise more quickly than unit labour costs, the dollar-value of "gross profits" per unit of output (before deducting the cost of depreciation and the cost of material inputs) will rise. Increases in this concept of "gross profits" per unit of output have indeed been emphatic in some central European countries in recent years. Expressed in US dollar terms, Czech industrial producer prices rose in 1995 by 16 per cent (partly on account of depreciation of the dollar *vis-à-vis* the main European currencies) while unit labour costs rose by "only" about 7 per cent. In Hungary the average dollar price of industrial exports grew by 12 per cent, and the dollar price of domestic sales of output from the manufacturing sector rose by 6 per cent. Meanwhile, unit labour costs in the Hungarian manufacturing sector dropped (in US dollar terms) by almost 9 per cent. In Poland, industrial producer prices rose in dollar terms by 18 per cent in 1995, slightly more than the 15 per cent recorded for unit labour costs in the manufacturing sector.

These figures on relative unit labour costs and profitability in manufacturing for 1995 suggest caution in jumping to the conclusion, based on the observed widening of current account deficits in parts of eastern Europe, that there is a growing "competitiveness problem" to the extent that competitiveness is taken to mean profitability of production and investment. In the Czech Republic, in particular, the large current account deficits that have emerged recently are more likely to have been generated largely by an investment boom (and some slackening in fiscal discipline). However, caution is also required in the use of these data as the basis for consideration of competitiveness over future years. First, the quoted figures on profitability ignore the cost of capital which may have risen more sharply than output prices. Second, the sharp increases in productivity in 1995 arose from a combination of rapidly rising output (short-run labour productivity will tend to rise in these circumstances) and labour shedding (which was stronger than in preceding years). Third, sharply rising producer prices can be a short-run phenomenon associated with a boom and lead to some 'pricing out of the market' in the medium term. On the other hand, it is also possible that rising output prices reflect growing quality, and perception of quality, in domestically produced tradeable products. Again, even if the more positive interpretation is correct, maintainance of the profitability gain would require further enterprise restructuring and supporting policies.

8.6 Concluding remarks

The current year has seen a modest decline in the (still high) rate of growth in eastern Europe and little sign of a halt to the output decline in the largest CIS countries. Lower than expected growth throughout the region has been a reflection of short-term effects: tighter fiscal policies and slow growth in the main export markets in western Europe.

The medium-term growth developments are likely to be determined to a much greater extent by the organisation and utilisation of available production inputs, and by the level of high-quality investment in human and physical capital. In this regard, prospects remain bright. The countries in the region have an educated labour force and are moving towards greater macroeconomic stability (albeit with occasional setbacks in some countries). In addition, most of them are moving decisively towards the establishment of market-oriented economic systems which, while welcoming entrepreneurship, subject enterprises to competitive pressure both domestically and in foreign trade. These are factors that have produced high medium to long-term growth in developing countries in other parts of the world, including some of the countries in South-East Asia. There is every reason to believe that these factors can produce the same results in eastern Europe, the Baltics and the CIS, provided that the policy framework adopted by the countries in the region will allow them the flexibility and time to do so.

Annex 8.1 Estimates of GDP per capita at purchasing power parity exchange rates

Most of the country tables on pages 179-203 include estimates of GNP per capita in US dollar terms at purchasing power parity (PPP) exchange rates. These estimates were drawn from the *World Bank Atlas* 1996.

In the computation of PPP-based GDP-estimates, the World Bank divides nominal GNP for each country by the country's purchasing power parity, 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.

A major effort has been mounted internationally in recent years, in the context of the "International Comparison Programme" (ICP), to improve the accuracy of PPP-based GDP-estimates. This exercise, in which Eurostat, the OECD, the ECE and the World Bank are active participants (and to which the EBRD contributes financially), will generate substantial revisions (associated with increased accuracy) to the PPP-based estimates of GDP. Some preliminary results from the ICP exercise are presented in the table below.

To put the estimates into context, it is worth recounting briefly the history of the ICP. The first phase of the ICP was initiated at the end of the 1960s, and was organised mainly by the United Nations' Statistical Office and the University of Pennsylvania with the latter taking the leading role. Phase I, which produced estimates for 1970, had the participation of five European countries (out of a total of 10 countries). Phase II (1973) and Phase III (1975) covered, respectively, seven and 15 European countries. In Phase III, the effort became more regionalised - Eurostat became responsible for organising the comparison for the members of the European Communities. Phase IV (1985) and Phase V (1990), in which the number of participating European countries rose to 18-20, were organised to an even greater extent on a regional basis, with UNSO at the centre with responsibility for worldwide coordination.

The European Comparison Programme (ECP) was initiated in 1979 (within the ICP framework) by the Conference of European Statisticians. Countries participating in the ECP are divided into two groups: Group I contains the west European countries and Group II the remainder of Europe.

The first and second rounds of the ECP coincided with Phases V and VI of the ICP. These rounds produced estimates for 1980 (published in 1985), and for 1990 (published in 1994). The estimates from the second ECP are the basis for the PPP-data for 1994 that were published in the *World Bank Atlas* 1996, and are the ones quoted in the country tables on pages 179-203. The 1990 observations have essentially been extrapolated to 1994 on the basis of observations for real GDP growth, population growth and US inflation.

Of course, some of the countries in eastern Europe, the Baltics and the former Soviet Union did not exist in 1990. PPP-estimates for these countries, as extracted from the *World Bank Atlas* 1996, are based on a substantially weaker data-foundation than are estimates for other countries.

The third and latest ECP was initiated a few years ago. It coincides with, and constitutes a part of, the current Phase VII of the ICP. The third ECP has 1993 as the reference year and provides estimates for 42 countries (based on detailed data for consumption and income patterns in each country). These include a total of 23 countries in eastern Europe, the Baltics and the CIS.

Preliminary results from the third ECP are shown in the Table below, alongside the corresponding earlier estimates, as published in the 1995 and 1996 editions of the *World Bank Atlas*. The ECP-figures are in some cases very different from the "older" estimates, especially for Estonia and Latvia. Revised ECP figures are to be published by the OECD and the World Bank before the end of 1996.

PPP-based estimates of GDP per capita

	PPP-based estimates of GDP per capita in 1993		PPP-based estimates of GDP per capita in 1994 data
	New ECP [1]	*World Bank Atlas* 1995	*World Bank Atlas* 1996
	(in US dollars)	*(in US dollars)*	*(in US dollars)*
Albania	na	na	na
Armenia	na	2,080	2,170
Azerbaijan	na	2,230	1,720
Belarus	4,962	6,360	5,010
Bulgaria	4,193	3,730	4,230
Croatia	3,828	na	na
Czech Republic	8,322	7,700	7,910
Estonia	3,785	6,860	na
FYR Macedonia	na	na	na
Georgia	na	1,410	1,160
Hungary	5,976	6,260	6,310
Kazakstan	na	3,770	2,830
Kyrgyzstan	na	2,420	1,710
Latvia	3,070	5,170	5,170
Lithuania	3,681	3,160	3,240
Moldova	2,215	3,210	na
Poland	4,666	5,010	5,380
Romania	3,698	2,910	2,920
Russia	4,950	5,240	5,260
Slovak Republic	6,299	6,450	6,660
Slovenia	9,234	na	na
Tajikistan	na	1,430	1,160
Turkmenistan	na	na	na
Ukraine	3,310	4,030	3,330
Uzbekistan	na	2,580	2,390

[1] For Bulgaria, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, Slovenia, and Romania, the source of the data in this column was the OECD *Short Term Economic Indicators*, No.3, 1996, p. 142. For the Czech Republic, the source was OECD *Main Economic Indicators*, August 1996, p. 197. For all other countries, the source was OECD *Purchasing Power Parities for Countries in Transition – Methodological Papers* (Paris, 1995), p. 12. and data presented directly to the EBRD by the World Bank.

Forecasts and prospects

9

This chapter presents projections of the growth of output and inflation for the region as shown in the latest estimates (most of which are published) from a number of institutions. The main aim is to provide a summary of forecasters' views of trends in output and inflation for the period up to the end of 1997, although reference is made to medium-term prospects at the end of the chapter.[1]

The forecasts presented in this chapter include those of a number of international organisations – the IMF, the OECD, the United Nations and the European Union – as well as those prepared by the Office of the Chief Economist at the EBRD. They also include those of a number of other organisations which were willing to let us use their forecasts for these purposes. These include two banks, JP Morgan and CS First Boston; the consultants PlanEcon and the Economist Intelligence Unit (EIU) and two research institutes, the Vienna Institute for Comparative Economic Studies and the Kopint-Datorg Institute for Economic and Market Research in Budapest.

On the basis of the "average" results calculated from the forecasts, there is an expectation that economic growth will gradually strengthen throughout the region as a whole, accompanied by further falls in inflation. There is a broad consensus that the general outlook for eastern Europe and the Baltic states is one of continued growth, although at somewhat slower rates than in 1995, a scenario that is likely to extend into the medium term. Inflationary pressures, as measured by changes in the consumer price index, continue to ease. There is, however, a perception among forecasters that for those countries which have now lowered their annual inflation rates to single digits, it is becoming increasingly difficult to achieve further large reductions.

For the CIS countries the expectation of the surveyed forecasters is that the recession is now reaching its trough, and the overall view is encouraging in so far as most of the CIS countries are expected to record positive growth rates in 1997. Much will depend on developments within Russia given the impact that stronger growth in that country can have on CIS trade, both directly by increasing imports from other CIS countries and more indirectly by contributing to a recovery in CIS regional trade. Most forecasters now expect another year of negative growth in Russia followed by a recovery in 1997; the medium-term forecasts presented here project strong growth in Russia for the remainder of the decade. Further substantial declines in the rates of inflation are projected for several CIS countries in 1996. Although inflation is expected to remain at double digit levels in most CIS countries in 1997, the average level of inflation is projected to fall to below 25 per cent in several of them.

All these forecast results are subject to considerable uncertainty. Few of the results are based on detailed econometric models of the economies, owing to the lack of suitable time series for most variables. In addition, and especially within the CIS countries, differences in estimates of output from the shadow economy can lead to differing estimates of GDP, while uncertainty over the extent of barter trade can sometimes lead to very different estimates of trade volumes. Therefore, most forecasters continue to rely on informal techniques to estimate the variables, including the use of judgemental factors.

As with the forecast of any industrial or developing country economy, forecasters will have taken a view on a range of political and economic issues in making their assessments. These will have included the outcome of elections and the prospects for the continuity of policy – for example, the presidential elections in Russia and the parliamentary elections in the Czech Republic in mid-1996. External economic developments will have remained important, including the impact of weaker growth in western Europe on exports from eastern Europe and the extent of the pick-up in trade among the CIS countries. Above all, forecasters need to make a judgement on the macroeconomic pressures that governments will face and how they will respond. The deficit on general government account remains high in some countries, especially in the CIS. In certain cases the deficits have been contained by cutting expenditure across the board, or alternatively by allowing arrears to mount, while longer-term measures, including improving methods of tax collection and more specific targeting of social spending programmes, are formulated and implemented. However, in these circumstances the pressures for some immediate relaxation of policy can be considerable. Within some east European countries the rebound of growth has been so strong that the authorities have had to adjust policy to slow down the growth of domestic demand and to curb the rise in trade and current account deficits. These are measures which will continue to have an impact on growth and inflation over the forecast period.

The estimates from the various forecasting institutions are presented in Section 9.1. Section 9.2 reviews the accuracy of last year's forecasts of growth and inflation for 1995. Medium-term prospects for countries at the more advanced stages of transition are presented in Section 9.3.

9.1 Forecasts of growth and inflation 1996-97

Eastern Europe and the Baltic states

Within eastern Europe the growth rates of the majority of the countries are expected by most forecasters to lie between 3.5 per cent and 5.5 per cent by 1997 (see Tables 9.1 and 9.2). For 1996,

[1] This chapter omits any reference to Bosnia and Herzegovina, for which there are insufficient forecasts. In the tables, estimates from some institutions have been rounded to the nearest whole number or one decimal place.

however, the forecasts show considerable variations in expected growth. For most of the countries that recorded high rates of growth in 1995, including Albania, the Slovak Republic, Romania and Poland, growth is projected by most forecasters to remain strong, albeit slightly below the rates achieved in 1995. In some of those countries where growth to date has been slower, such as Slovenia and Croatia, growth is projected to strengthen throughout the period under review.

One of the possible exceptions to this pattern is the Czech Republic, which recorded strong growth in 1995 and is projected by several forecasters to grow at over 5 per cent in 1996 and 1997. Although there is a broad consensus among forecasters that the growth of output in the Czech Republic will be maintained – this being reflected in the fairly narrow range of forecasts in both 1996 and 1997 – some of the more recent projections have tended to be closer to 5 per cent than to 6 per cent in the light of the measures taken by the Czech National Bank in mid-1996 to contain inflationary pressures.

Differences in the timing of preparation of the forecasts have proved particularly important in the case of Bulgaria. Forecasts that were completed before the conclusion of the Standby Arrangement (SBA) with the IMF and the Structural Adjustment Loan with the World Bank in mid-1996 generally anticipated modest growth of 2 to 3 per cent and inflation of about 30 per cent a year, continuing the gradual improvement in the economy which had been recorded in 1994 and 1995. However, doubts about the likelihood that an IMF programme would be agreed in advance of the maturity of large debt service obligations in July 1996 contributed to sharp falls in both reserves and the currency. The precipitous currency depreciation has been followed in recent months by a strong rebound of inflation. In June 1996 the government reached agreement with the IMF on a programme that involves fiscal tightening and enterprise closures, which looks likely to hold back GDP growth. Most forecasters, therefore, have significantly reduced their forecasts for growth in 1996 and raised their predictions for inflation.

For the Baltic states the surveyed forecasters project GDP growth to strengthen gradually throughout the period 1996-97, although the growth rates are on average projected to be below those expected for eastern Europe. From the average of all projections shown, growth in 1996 is expected to slow in Lithuania as a result of the initial reduction in liquidity following the banking crisis at the end of 1995 and to remain at only modest levels in Latvia, followed by stronger growth in 1997. There are some exceptions to this general view – PlanEcon expects the Baltic countries to grow on average by at least 5 per cent in 1996 and by 7 per cent in 1997.

The projections of strong growth in most of the countries reflect the expectation that there will be further increases in investment and labour productivity as restructuring proceeds. Various factors account for the expectation that growth in a number of countries will decelerate in the near term after the strong performance shown in 1995, although their impact differs between countries. Most countries will have been affected by the slowdown in demand in western Europe, and in particular in Germany, one of the region's main export markets. Domestic demand has strengthened in a number of countries, resulting in a sharp deterioration in the trade and current account balances, as occurred in the Czech Republic in 1995 and in the Slovak Republic in 1996. In both countries the negative contribution to growth from the deterioration in the trade balance will partly offset the strength of domestic demand, while the monetary tightening that the authorities in both countries implemented in mid-1996 to lower inflationary pressures is likely to dampen the growth of domestic demand.

Inflation in Croatia, the Czech Republic, FYR Macedonia, the Slovak Republic and Slovenia is expected to remain at 10 per cent or below throughout the period 1996-97, on the average of forecasts surveyed (see Tables 9.3 and 9.4). This is a reflection of the progress that has already been made in lowering inflation and an assumption that the stance of monetary and fiscal policy will remain anti-inflationary. Only modest falls in inflation in these countries are expected in 1997, mainly because continued growth of domestic demand will put upward pressure on costs and prices, although some countries are likely to have to deal with the monetary consequences of capital inflows. Several countries will also have to make further adjustments in administered prices for energy, housing and transport. Croatia is generally expected to record the lowest annual inflation rate in the region at less than 4 per cent in 1996. The uncertainty which surrounds the forecasts for inflation in 1997 is well illustrated by the Croatian case. The EIU expects a further decline in inflation in Croatia to 3 per cent, whereas PlanEcon projects a sharp increase to over 16 per cent in 1997.

Most forecasters are expecting further declines in inflation for Poland and Hungary, to levels between 17 and 18 per cent in 1997. The range of forecasts is, however, greater in the case of Hungary. In the Baltic states, inflation is projected to fall steadily in Latvia, from 25 per cent in 1995 to an average of a little over 14 per cent by 1997, with PlanEcon projecting a lower rate for 1996 compared with the average. In Estonia inflation is also expected to fall, from 29 per cent in 1995 to around 20 per cent by 1997, although PlanEcon is relatively pessimistic about the extent to which the rate will be lowered in 1996 compared with the average projection. Inflation is also projected to decline in Lithuania, from the 39 per cent recorded in 1995, although the average figure shown in the table is affected by the relatively low estimate for 1997 from the European Union.

As noted above, the most recent forecasts point to a very large increase in inflation in Bulgaria in 1996. Thus, most of those forecasts prepared in August and September, for example those of the Vienna Institute, CS First Boston and Kopint-Datorg, expect inflation in 1996 to average well over 100 per cent. All these forecasters, including the EBRD which projects a smaller increase in inflation this year, nevertheless expect the average rate of inflation to fall somewhat in 1997.

The inflation estimates discussed above all represent the change between two years in the average monthly consumer price level for the year in question. The 1995 *Transition Report* explained the

Table 9.1

GDP growth forecasts for 1996

(in per cent)[1]

Eastern European and the Baltic States	Average[2]	Range[3]	EBRD (August 1996)	OECD (June 1996)[4]	IMF (May 1996)	Project Link (May 1996)[5]	European Union (May 1996)	PlanEcon (June/Aug. 1996)	EIU (June 1996)[6]	Vienna Institute (July 1996)	JP Morgan (Sept 1996)	CS First Boston (July 1996)	Kopint-Datorg (June 1996)[7]
Albania	6.6	4.9	5.0	–	7.0	5.0	–	9.9	6.0	–	–	–	–
Bulgaria	-1.3	13.5	-4.0	2.5	0.0	3.5	2.1	2.3	1.0	-2.0	-5.5	-10.0	-4.0
Croatia	4.0	2.0	5.0	–	5.0	–	–	4.7	3.0	3.5	–	–	3.0
Czech Republic	5.1	1.9	5.1	5.6	5.2	5.5	5.5	5.9	5.0	5.0	5.2	4.0	4.5
Estonia	3.8	4.0	3.0	–	3.1	2.5	4.0	6.5	3.5	–	–	–	–
FYR Macedonia	3.0	0.0	3.0	–	3.0	–	–	–	3.0	–	–	–	–
Hungary	1.6	1.7	1.5	2.0	1.2	2.5	2.1	2.5	1.5	1.5	0.8	1.0	1.3
Latvia	1.6	4.0	1.0	–	2.1	0.3	1.2	4.2	0.6	–	–	–	–
Lithuania	2.2	6.1	1.5	–	1.6	3.3	1.0	6.1	0.0	–	–	–	–
Poland	5.4	1.5	5.0	5.5	5.5	5.8	6.0	5.8	4.9	5.5	5.6	4.5	5.0
Romania	4.4	2.0	4.5	4.0	4.0	5.5	4.5	5.3	4.5	4.0	–	–	3.5
Slovak Republic	5.7	1.5	5.5	5.0	6.5	5.8	5.5	6.0	5.0	6.0	–	–	6.0
Slovenia	3.3	2.5	3.0	5.0	3.0	–	4.4	2.6	3.0	2.5	–	–	3.0
Average	3.5	3.5	–	–	–	–	–	–	–	–	–	–	–
Commonwealth of Independent States													
Armenia	6.8	2.1	6.5	–	6.5	–	–	8.1	6.0	–	–	–	–
Azerbaijan	-2.9	3.9	-3.5	–	-3.8	–	–	-0.1	-4.0	–	–	–	–
Belarus	-4.1	2.5	-5.0	–	-5.5	–	–	-3.0	-3.0	–	–	–	–
Georgia	10.0	6.0	8.0	–	8.0	–	–	14.0	–	–	–	–	–
Kazakstan	0.9	1.1	0.5	–	0.4	–	–	1.2	1.5	–	–	–	–
Kyrgyzstan	3.2	4.2	2.0	–	2.4	–	–	6.2	2.0	–	–	–	–
Moldova	4.7	2.8	4.0	–	4.0	–	–	6.8	4.0	–	–	–	–
Russia	-2.1	6.0	-3.0	1.0	-1.3	0.5	–	-1.8	-1.0	-5.0	-3.7	-2.0	-5.0
Tajikistan	-5.9	10.4	-7.0	–	-7.0	–	–	0.4	-10.0	–	–	–	–
Turkmenistan	3.9	6.2	0.0	–	6.2	–	–	4.9	4.5	–	–	–	–
Ukraine	-6.0	6.9	-7.0	–	-8.0	-3.1	–	-3.6	-5.0	-5.0	–	–	-10.0
Uzbekistan	1.2	6.8	-1.0	–	-1.0	–	–	5.8	1.0	–	–	–	–
Average	0.8	4.9	–	–	–	–	–	–	–	–	–	–	–

1 All forecasts in this table were published or reported to the EBRD between May and September 1996 (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 brackets indicate in which month the forecasts were reported or published by each institution.

2 The numbers at the bottom of these columns refer to the mean of all the average forecasts shown in each column.

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

4 These forecasts were published by the OECD in EO 59 (*Economic Outlook*, 1996, no. 59) in June 1996. However, GDP in the Slovak Republic is projected to grow at 6.0 per cent according to the OECD's *Economic Survey of the Slovak Republic*, published September 1996.

5 This column in this and other tables in the chapter shows forecasts from the United Nations, which unless otherwise stated are from *Project Link World Outlook*. However, forecasts for GDP growth in 1996 are from the United Nations, *World Economic and Social Survey*, 1996.

6 The Economist Intelligence Unit forecast for FYR Macedonia is social product instead of GDP.

7 Kopint-Datorg is the Institute for Economic and Market Research and Informatics in Hungary.

Table 9.2

GDP growth forecasts for 1997

(in per cent)[1]

Eastern European and the Baltic States	Average[2]	Range[3]	EBRD (August 1996)	OECD (June 1996)	IMF (May 1996)	Project Link (May 1996)	European Union (May 1996)	PlanEcon (June/Aug. 1996)	EIU (June 1996)[4]	Vienna Institute (July 1996)	JP Morgan (Sept 1996)	CS First Boston (July 1996)	Kopint-Datorg (June 1996)[5]
Albania	7.2	3.0	9.0	–	–	–	–	6.7	6.0	–	–	–	–
Bulgaria	1.5	9.1	2.0	3.0	–	5.1	1.7	4.8	3.0	2.0	-2.8	-4.0	0.0
Croatia	5.7	3.5	6.0	–	–	–	–	7.5	4.0	5.0	–	–	6.0
Czech Republic	5.1	1.9	5.3	5.8	–	5.9	5.9	5.2	4.7	5.0	4.8	4.0	4.5
Estonia	4.9	5.0	4.0	–	–	–	3.8	8.3	3.3	–	–	–	–
FYR Macedonia	5.0	0.0	5.0	–	–	–	–	–	5.0	–	–	–	–
Hungary	3.2	3.7	3.0	3.0	–	3.6	3.5	5.5	3.5	3.0	1.8	2.0	3.0
Latvia	3.4	4.3	3.0	–	–	–	2.2	6.3	2.0	–	–	–	–
Lithuania	3.8	4.6	4.0	–	–	–	2.5	6.6	2.0	–	–	–	–
Poland	5.1	1.5	5.0	5.0	–	5.3	5.5	5.1	5.2	5.5	5.3	4.0	5.0
Romania	4.3	2.1	3.5	4.0	–	3.1	5.2	5.2	4.5	5.0	–	–	3.5
Slovak Republic	4.7	1.6	4.5	5.0	–	5.3	4.6	5.6	4.1	4.0	–	–	4.5
Slovenia	4.2	1.5	3.5	5.0	–	–	4.6	5.0	4.0	4.0	–	–	3.5
Average	4.5	3.2	–	–	–	–	–	–	–	–	–	–	–
Commonwealth of Independent States													
Armenia	7.0	–	7.0	–	–	–	–	7.6	6.5	–	–	–	–
Azerbaijan	6.1	–	4.0	–	–	–	–	10.4	4.0	–	–	–	–
Belarus	2.6	1.0	2.0	–	–	–	–	2.8	3.0	–	–	–	–
Georgia	11.2	–	10.0	–	–	–	–	12.3	–	–	–	–	–
Kazakstan	3.2	4.5	1.0	–	–	–	–	5.5	3.0	–	–	–	–
Kyrgyzstan	5.6	5.0	8.0	–	–	–	–	5.9	3.0	–	–	–	–
Moldova	5.9	3.8	4.0	–	–	–	–	7.8	6.0	–	–	–	–
Russia	2.0	5.3	3.0	3.0	–	2.0	–	3.3	3.0	2.0	1.5	2.0	-2.0
Tajikistan	-1.6	8.2	-3.0	–	–	–	–	3.2	-5.0	–	–	–	–
Turkmenistan	3.7	2.0	3.0	–	–	–	–	3.0	5.0	–	–	–	–
Ukraine	0.2	6.9	1.0	–	–	1.5	–	2.9	-1.0	1.0	–	–	-4.0
Uzbekistan	2.7	4.1	1.0	–	–	–	–	5.1	2.0	–	–	–	–
Average	4.1	4.5	–	–	–	–	–	–	–	–	–	–	–

1 All forecasts quoted here were published or reported to the EBRD between May and September 1996. The dates in brackets indicate the month in which the forecasts were reported or published by each institution.

2 The numbers at the bottom of these columns refer to the mean of all the average forecasts shown in each column.

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

4 The Economist Intelligence Unit forecast for FYR Macedonia is social product instead of GDP.

5 Kopint-Datorg is the Institute for Economic and Market Research and Informatics in Hungary.

Table 9.3

Inflation forecasts for 1996

(change in the average consumer price level, in per cent)[1]

Eastern European and the Baltic States	Average[2]	Range[3]	EBRD (August 1996)	OECD (June 1996)[4]	IMF (May 1996)	Project Link (May 1996)[5]	European Union (May 1996)	PlanEcon (June/Aug. 1996)	EIU (June 1996)[6]	Vienna Institute (July 1996)	JP Morgan (Sept 1996)	CS First Boston (July 1996)	Kopint-Datorg (June 1996)[7]
Albania	10.8	4.0	13.0	–	12.0	–	–	9.1	9.0	–	–	–	–
Bulgaria	89.3	147.0	95.0	–	73.0	36.4	33.0	58.0	100.0	180.0	98.0	130.0	150.0
Croatia	3.7	1.7	3.5	–	3.0	–	–	4.7	3.5	4.0	–	–	5.0
Czech Republic	8.8	1.3	9.0	8.4	9.0	8.2	8.5	8.5	8.7	9.0	8.9	9.5	9.5
Estonia	25.1	7.4	26.0	–	27.0	–	20.0	27.4	25.0	–	–	–	–
FYR Macedonia	6.0	3.0	4.0	–	7.0	–	–	–	7.0	–	–	–	–
Hungary	22.8	4.5	24.0	–	23.0	19.5	23.0	20.7	24.0	24.0	23.8	23.5	24.5
Latvia	18.8	4.0	19.0	–	21.0	–	18.5	17.0	18.5	–	–	–	–
Lithuania	28.5	2.3	28.0	–	29.0	–	28.0	27.7	30.0	–	–	–	–
Poland	20.9	4.0	21.0	–	19.0	23.0	21.0	20.1	21.0	21.0	22.1	20.0	19.0
Romania	30.1	17.0	40.0	–	23.0	26.1	24.0	33.6	34.0	30.0	–	–	40.0
Slovak Republic	6.7	1.5	7.0	7.0	6.0	7.5	6.5	6.3	6.0	7.0	–	–	7.0
Slovenia	10.0	2.3	10.0	–	10.0	–	8.7	10.4	10.0	11.0	–	–	9.5
Average	21.7	–	–	–	–	–	–	–	–	–	–	–	–
Commonwealth of Independent States													
Armenia	26	11	25	–	26	–	–	31	20	–	–	–	–
Azerbaijan	24	7	20	–	23	–	–	27	24	–	–	–	–
Belarus	70	22	70	–	70	–	–	58	80	–	–	–	–
Georgia	51	4	50	–	50	–	–	54	–	–	–	–	–
Kazakstan	39	1	40	–	39	–	–	38	39	–	–	–	–
Kyrgyzstan	27	10	30	–	20	–	–	29	30	–	–	–	–
Moldova	24	4	25	–	24	–	–	25	21	–	–	–	–
Russia	53	15	45	–	51	55	–	51	52	50	53	53	60
Tajikistan	718	738	700	–	633	–	–	1,138	400	–	–	–	–
Turkmenistan	925	997	500	–	904	–	–	1,497	800	–	–	–	–
Ukraine	95	155	90	–	70	200	–	90	91	80	–	–	45
Uzbekistan	55	16	50	–	49	–	–	65	56	–	–	–	–
Average	175.4	–	–	–	–	–	–	–	–	–	–	–	–

1 All forecasts in this table were published or reported to the EBRD between May and September 1996 (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 brackets indicate in which month the forecasts were reported or published by each institution.

2 The numbers at the bottom of these columns refer to the mean of all the average forecasts shown in each column.

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

4 The OECD's EO 59 (*Economic Outlook*) includes end-year forecasts of the Consumer Price Index for selected countries (see Table 12.5). The average CPI forecasts shown here were taken from the OECD *Economic Survey of the Czech Republic*, published in July 1996, and the OECD *Economic Survey of the Slovak Republic*, published in September 1996.

5 Project Link forecasts are consumption deflators, with the exception of Hungary for which the figure quoted is the Net Material Product deflator.

6 The Economist Intelligence Unit forecast for FYR Macedonia is social product instead of GDP.

7 Kopint-Datorg is the Institute for Economic and Market Research and Informatics in Hungary.

Table 9.4

Inflation forecasts for 1997

(change in the average consumer price level, in per cent)[1]

Eastern European and the Baltic States	Average[2]	Range[3]	EBRD (August 1996)	OECD (June 1996)[4]	IMF (May 1996)	Project Link (May 1996)[5]	European Union (May 1996)	PlanEcon (June/Aug. 1996)	EIU (June 1996)[6]	Vienna Institute (July 1996)	JP Morgan (Sept 1996)	CS First Boston (July 1996)	Kopint-Datorg (June 1996)[7]
Albania	9.4	2.3	10.0	–	–	–	–	10.3	8.0	–	–	–	–
Bulgaria	60.2	71.1	74.0	–	–	28.9	30.0	49.0	65.0	60.0	90.0	100.0	45.0
Croatia	8.2	12.7	6.0	–	–	–	–	16.2	3.5	–	–	–	7.0
Czech Republic	8.4	2.6	8.2	8.0	–	7.4	7.4	7.5	8.2	9.0	8.6	9.5	10.0
Estonia	20.4	4.5	21.0	–	–	–	18.0	22.5	20.0	–	–	–	–
FYR Macedonia	5.5	5.0	3.0	–	–	–	–	–	8.0	–	–	–	–
Hungary	17.6	5.2	17.0	–	–	14.1	18.0	15.6	19.0	18.0	19.3	18.0	19.0
Latvia	14.2	4.3	16.0	–	–	–	14.0	11.7	15.0	–	–	–	–
Lithuania	23.0	6.0	24.0	–	–	–	19.0	23.8	25.0	–	–	–	–
Poland	17.4	1.4	18.0	–	–	18.2	17.0	17.8	18.0	17.0	17.1	16.8	17.0
Romania	29.4	15.0	35.0	–	–	26.0	20.0	32.8	27.0	30.0	–	–	35.0
Slovak Republic	6.9	4.0	6.5	6.0	–	6.0	6.0	7.5	6.3	7.0	–	–	10.0
Slovenia	8.5	2.8	7.0	–	–	–	7.0	9.8	8.5	9.0	–	–	9.5
Average	17.6	10.5	–	–	–	–	–	–	–	–	–	–	–
Commonwealth of Independent States													
Armenia	16	15	14	–	–	–	–	25	10	–	–	–	–
Azerbaijan	17	8	12	–	–	–	–	20	20	–	–	–	–
Belarus	43	12	40	–	–	–	–	38	50	–	–	–	–
Georgia	20	10	15	–	–	–	–	25	–	–	–	–	–
Kazakstan	23	5	20	–	–	–	–	25	25	–	–	–	–
Kyrgyzstan	23	8	20	–	–	–	–	28	20	–	–	–	–
Moldova	16	8	15	–	–	–	–	20	12	–	–	–	–
Russia	27	35	22	–	–	20	–	24	35	30	15	23	50
Tajikistan	250	200	150	–	–	–	–	–	350	–	–	–	–
Turkmenistan	306	150	250	–	–	–	–	268	400	–	–	–	–
Ukraine	43	20	50	–	–	30	–	38	45	50	–	–	45
Uzbekistan	38	19	30	–	–	–	–	49	35	–	–	–	–
Average	69	41	–	–	–	–	–	–	–	–	–	–	–

1 All forecasts in this table were published or reported to the EBRD between May and September 1996 (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 brackets indicate in which month the forecasts were reported or published by each institution.

2 The numbers at the bottom of these columns are calculated as the mean of all the average forecasts shown in each column.

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

4 The OECD's EO 59 (*Economic Outlook*) includes end-year forecasts of the Consumer Price Index for selected countries (see Table 12.5). The average CPI forecasts shown here were taken from the OECD *Economic Survey of the Czech Republic*, published in July 1996, and the OECD *Economic Survey of the Slovak Republic*, published in September 1996.

5 Project Link forecasts are consumption deflators, with the exception of Hungary for which the figure quoted is the Net Material Product deflator.

6 The Economist Intelligence Unit forecast for FYR Macedonia is social product instead of GDP.

7 Kopint-Datorg is the Institute for Economic and Market Research and Informatics in Hungary.

Table 9.5

Inflation forecasts for 1996

(change in the end-year consumer price level, in per cent)[1]

Eastern Europe and the Baltic States	Average	EBRD (August 1996)	OECD (June 1996)[2]	JP Morgan (Sept 1996)	EIU (Sept. 1996)	PlanEcon (June 1996)
Albania	14.2	20.0	–	–	12.0	10.7
Bulgaria	120.2	165.0	40.0	170.0	150.0	76.0
Croatia	5.0	5.0	–	–	3.5	–
Czech Republic	8.9	9.0	–	9.2	8.5	8.7
Estonia	22.0	24.0	–	–	20.0	–
FYR Macedonia	4.5	2.0	–	–	7.0	–
Hungary	20.8	22.0	22.0	19.8	22.0	18.2
Latvia	18.5	19.0	–	–	18.0	–
Lithuania	24.0	26.0	–	–	22.0	–
Poland	19.0	19.0	19.0	18.9	19.0	19.3
Romania	39.3	60.0	25.0	–	35.0	37.2
Slovak Republic	6.3	6.0	7.0	–	6.0	–
Slovenia	10.2	10.0	10.0	–	9.5	11.1
Commonwealth of Independent States						
Armenia	19	19	–	–	–	–
Azerbaijan	15	15	–	–	–	–
Belarus	61	61	–	–	–	–
Georgia	23	23	–	–	–	–
Kazakstan	26	26	–	–	–	–
Kyrgyzstan	27	27	–	–	–	–
Moldova	18	18	–	–	–	–
Russia	33	25	50	23	–	–
Tajikistan	200	200	–	–	–	–
Turkmenistan	250	250	–	–	–	–
Ukraine	55	55	–	–	–	–
Uzbekistan	35	35	–	–	–	–

[1] All forecasts in this table were published or reported to the EBRD between May and September 1996 (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 brackets indicate in which month the forecasts were reported or published by each institution.

[2] In the Slovak Republic, the projection of end-year inflation is 6.0 per cent, according to the OECD *Economic Survey of the Slovak Republic*, published in September 1996.

difference in the information contained between inflation measures that are based on, respectively, the annual average and the end-year (December on December) observations of the consumer price index.[2] There can be marked differences between the two measures, especially when inflation rates are high. Only a few institutions prepare projections for end-year inflation figures (see Table 9.5). In the case of Poland and Hungary, for example, inflation between December 1995 and December 1996 is projected to be somewhere between the forecast for the change in the average price level in 1996 and that of 1997, implying that continuous progress is expected in lowering inflation.

The Commonwealth of Independent States

A number of the CIS countries are projected to record positive growth of output from 1996 onwards, according to the EBRD, EIU, IMF and PlanEcon. This is a sharp contrast with 1995, when most countries recorded negative growth. Armenia is expected to record growth of around 7 per cent a year in 1996 and 1997, while a strong rebound of growth in Georgia to over 10 per cent a year is also projected. For both countries, strong growth reflects in part the reopening of trading routes and production sites that were previously closed as a result of armed conflict in the region. In both Kyrgyzstan and Moldova the growth of output is expected to increase to over 5 per cent by 1997 as a result of the successful implementation of stabilisation policies under IMF programmes and the positive effect of economic reform measures.

For most other countries the expectation of a gradual return to positive growth is a result of greater price stability, facilitating investment decisions; progress with structural reform; and in particular the expectation that Russia, which remains an important market for many of these countries, will achieve positive growth at least from 1997 onwards. Towards the end of 1995 some forecasters were expecting that Russia would record positive growth during 1996. However, political uncertainty in the run-up to the presidential elections, combined with the continuation of the tight monetary stance, contributed to a further period of negative growth in the first half of 1996. Although there is a range of views on the outcome for 1996, most of the recent forecasts project negative growth (with an average of -2 per cent) followed by a recovery with growth of around 2 per cent in 1997.

[2] See 1995 *Transition Report*, p. 216.

Table 9.6

The accuracy of forecasts of GDP growth in 1995 (in per cent)[1]

Eastern Europe and the Baltic States	Actual[2]	Average absolute value of error[3]	EBRD Forecast (Sept)[3]	EBRD Error (Sept)[3]	OECD Forecast (June)[3]	OECD Error (June)[3]	IMF Forecast (May)[3]	IMF Error (May)[3]	Project Link Forecast (April)[3]	Project Link Error (April)[3]	European Union Forecast (June)[3]	European Union Error (June)[3]	PlanEcon Forecast (June)[3]	PlanEcon Error (June)[3]	EIU Forecast (Sept)[3]	EIU Error (Sept)[3]	Vienna Institute Forecast (June)[3]	Vienna Institute Error (June)[3]	JP Morgan Forecast (Sept)[3]	JP Morgan Error (Sept)[3]	CS First Boston Forecast (July)[3]	CS First Boston Error (July)[3]	Kopint-Datorg Forecast (June)[3]	Kopint-Datorg Error (June)[3]
Albania	8.6	2.4	6.0	2.6	–	–	6.0	2.6	–	–	–	–	6.9	1.7	6.0	2.6	–	–	–	–	–	–	–	–
Bulgaria	2.6	0.9	2.5	0.1	2.0	0.6	–	–	1.0	1.6	1.6	1.0	5.0	-2.4	2.0	0.6	2.0	0.6	3.0	-0.4	–	–	1.5	1.1
Croatia	2.0	2.1	2.0	0.0	–	–	–	–	–	–	–	–	–	–	4.0	-2.0	7.0	-5.0	–	–	–	–	3.5	-1.5
Czech Republic	4.8	0.8	4.0	0.8	4.0	0.8	3.8	1.0	4.0	0.8	4.2	0.6	4.8	0.0	4.0	0.8	4.0	0.8	4.0	0.8	3.5	1.3	3.5	1.3
Estonia	3.2	2.7	6.0	-2.8	–	–	6.0	-2.8		–	–	–	6.4	-3.2	5.0	-1.8	–	–	–	–	–	–	–	–
FYR Macedonia	-1.5	2.0	-3.0	1.5	–	–	–	–	–	–	–	–	–	–	1.0	-2.5	–	–	–	–	–	–	–	–
Hungary	1.5	0.8	3.0	-1.5	1.0	0.5	0.2	1.3	1.8	-0.3	0.3	1.2	3.0	-1.5	1.5	0.0	1.0	0.5	1.3	0.2	0.7	0.8	2.0	-0.5
Latvia	-1.6	4.5	1.0	-2.6	–	–	4.6	-6.2	–	–	–	–	5.0	-6.6	1.0	-2.6	–	–	–	–	–	–	–	–
Lithuania	3.1	1.7	5.0	-1.9	–	–	6.7	-3.6	–	–	–	–	4.3	-1.2	3.0	0.1	–	–	–	–	–	–	–	–
Poland	7.0	1.3	6.0	1.0	5.5	1.5	5.0	2.0	4.9	2.1	5.0	2.0	7.2	-0.2	5.9	1.1	6.0	1.0	6.6	0.4	5.0	2.0	6.0	1.0
Romania	6.9	3.5	4.0	2.9	3.0	3.9	–	–	3.9	3.0	2.8	4.1	4.8	2.1	3.0	3.9	2.0	4.9	–	–	–	–	3.5	3.4
Slovak Republic	7.4	2.7	5.0	2.4	5.0	2.4	4.0	3.4	3.7	3.7	3.0	4.4	6.0	1.4	5.7	1.7	4.0	3.4	5.5	1.9	5.0	2.4	4.5	2.9
Slovenia	3.5	1.9	6.0	-2.5	–	–	5.0	-1.5	–	–	–	–	7.0	-3.5	5.5	-2.0	5.0	-1.5	5.3	-1.8	–	–	4.0	-0.5
Average absolute value of the error – 1995	–	2.1	–	1.7	–	1.6	–	2.7	–	1.9	–	2.2	–	2.2	–	1.7	–	2.2	–	0.9	–	1.6	–	1.4
– 1994	–	2.0	–	1.5	–	2.0	–	2.3	–	1.7	–	2.2	–	1.1	–	2.2	–	2.5	–	-1.4	–	–	–	–
– 1993	–	4.9	–	–	–	2.9	–	–	–	3.7	–	3.2	–	4.0	–	–	–	4.7	–	1.5	–	–	–	–
Commonwealth of Independent States																								
Armenia	6.9	3.3	5.0	1.9	–	–	–	–	–	–	–	–	11.6	-4.7	–	–	–	–	–	–	–	–	–	–
Azerbaijan	-8.3	8.7	-15.0	6.7	–	–	–	–	–	–	–	–	2.3	-10.6	–	–	–	–	–	–	–	–	–	–
Belarus	-10.2	0.5	-10.0	-0.2	–	–	–	–	–	–	–	–	-11.2	1.0	-10.0	-0.2	–	–	–	–	–	–	–	–
Georgia	2.4	5.3	-5.0	7.4	–	–	–	–	–	–	–	–	5.5	-3.1	–	–	–	–	–	–	–	–	–	–
Kazakstan	-8.9	2.2	-12.0	3.1	–	–	–	–	–	–	–	–	-6.5	-2.4	-10.0	1.1	–	–	–	–	–	–	–	–
Kyrgyzstan	1.3	3.3	-5.0	6.3	–	–	–	–	–	–	–	–	1.0	0.3	–	–	–	–	–	–	–	–	–	–
Moldova	-3.0	4.3	-5.0	2.0	–	–	–	–	–	–	–	–	3.5	-6.5	–	–	–	–	–	–	–	–	–	–
Russia	-4.0	1.4	-3.0	-1.0	-5.0	1.0	–	–	-4.4	0.4	–	–	-2.7	-1.3	-2.0	-2.0	-7.0	3.0	-3.5	-0.5	-3.0	-1.0	-6.5	2.5
Tajikistan	-12.5	7.1	-12.0	-0.5	–	–	–	–	–	–	–	–	1.1	-13.6	–	–	–	–	–	–	–	–	–	–
Turkmenistan	-10.0	12.9	-5.0	-5.0	–	–	–	–	–	–	–	–	2.7	-12.7	–	–	–	–	–	–	–	–	–	–
Ukraine	-11.8	3.2	-5.0	-6.8	–	–	–	–	–	–	–	–	-5.5	-6.3	-8.0	-3.8	-10.0	-1.8	-12.0	0.2	–	–	-12.0	0.2
Uzbekistan	-1.2	2.1	-4.0	2.8	–	–	–	–	–	–	–	–	-2.6	1.4	–	–	–	–	–	–	–	–	–	–
Average absolute value of the error – 1995	–	4.2	–	3.6	–	1.0	–	–	–	0.4	–	–	–	5.3129	–	1.8	–	2.4	–	0.4	–	1.0	–	1.4
– 1994	–	11.6	–	9.6	–	5.0	–	–	–	1.7	–	–	–	11.1	–	8.4	–	4.0	–	1.0	–	–	–	–
– 1993	–	6.6	–	–	–	–	–	–	–	–	–	–	–	6.5	–	–	–	2.4	–	–	–	–	–	–

1 All forecasts in this table were published or reported to 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 brackets 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 1995, 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).

In Ukraine the severe winter of 1995-96 and the failure to meet all the performance targets of the first Standby Arrangement towards the end of 1995 will have contributed to another year of negative growth in 1996. There is no consensus among the forecasts surveyed as to whether growth will resume in 1997, although three of the latest estimates prepared, those of PlanEcon, the EBRD and the Vienna Institute, anticipate a return to positive growth in that year. In addition to Ukraine, the only other CIS countries that most forecasters expect to experience negative growth in 1996 are Azerbaijan, Belarus and Tajikistan.

Most CIS countries are expected to achieve further substantial declines in their inflation rates in 1996, although the rates forecast for 1996-97 remain high in both Tajikistan and Turkmenistan. If these two countries are excluded, the average level of inflation in the CIS region is projected to fall from 46 per cent in 1996 to 27 per cent in 1997. Inflation, as measured by the change in the average price level, is expected to fall to an annual average of 53 per cent in Russia in 1996 and to below 30 per cent in 1997. Most forecasters expect the other CIS countries to make further progress in lowering inflation from the high levels recorded in the early 1990s. Armenia, Azerbaijan, Georgia, Moldova, and Kazakstan are projected by the EIU, PlanEcon and by the EBRD to see inflation slow to 25 per cent or less in 1997. Much will depend on the continuation of sound monetary policies. This in turn will depend crucially on improvements in tax collection to maintain government revenues as well as the extent to which governments meet some of the inevitable pressures for higher spending. Demographic pressures will necessitate improvements to the targeting of many health, pension and other social benefits if budget deficits are to be contained in the medium term.

9.2 The accuracy of forecasts

Previous editions of the *Transition Report* have emphasised the uncertainty associated with forecasting for transition economies. As noted in the introduction to this chapter, this uncertainty derives from a number of factors, including inadequacies in the methods by which economic activity is measured, the rapid pace of structural change and the general difficulty of anticipating the exact timing of sometimes sharp turnarounds from precipitous output declines to strong growth. This section reviews the accuracy of forecasts prepared in the middle of 1995 for full-year growth and inflation in 1995. When comparing the forecasts from different institutions, it is important to bear in mind the date when each forecast was completed – those produced later in the year can be based on a greater amount of information. In addition, it should be noted that even the "outturns" may be associated with great uncertainty and may be subject to revisions several years after the period to which they pertain. In this section we have used as "outturns" data from the selected economic indicators for each country in transition on pages 185-209. The original source of these figures is, in most cases, statistical offices in the region.

The accuracy of growth forecasts

A summary of the comparison of growth forecasts for 1995 is shown in Table 9.6. All the forecasts were prepared or published between April and September 1995. The table includes two columns for each institution: the first column quotes the forecast of that particular institution; the second contains the "error" defined as the difference between the outturn and their forecast. The average of the absolute value of the errors (i.e. ignoring negative values) is shown at the foot of the table for 1995 as well as for the previous two years.

There was no improvement in the accuracy of forecasts in 1995 compared with 1994 for eastern European and the Baltic states although there was for the CIS countries. The average absolute error for eastern Europe and the Baltic states fell from 4.9 percentage points in 1993 to 2.0 percentage points for 1994, but rose slightly to 2.1 percentage points for 1995. The small decline in the overall accuracy of the forecasts for 1995 was mainly attributable to the tendency for most forecasters to underestimate growth in those countries that achieved the strongest growth increases, such as Albania, Romania and the Slovak Republic. This was reflected in the large size of the average error for these countries. By contrast, forecasters were reasonably accurate in their projection of the 7.0 per cent growth recorded in Poland, partly because 1995 was the fourth successive year of growth in that country. Overall, the level of the errors is considerably less than for the CIS countries. This is mainly a result of the tendency of a number of countries in eastern Europe and the Baltic states to move towards more stable growth paths as transition progresses.

Within the CIS there was a sharp reduction in the value of the absolute error, from 11.6 percentage points reported for the 1994 forecasts to 4.2 percentage points for 1995. Most forecasters accurately predicted that the majority of countries would record another year of negative growth in 1995. There was, however, a tendency to underestimate the extent of the output declines.

The accuracy of inflation forecasts

The accuracy of inflation forecasts is presented in Table 9.7 and follows a similar format to the previous table, with the exception that the average value of the errors has not been calculated. This is mainly because of the large differences in inflation rates between countries in the region. One percentage point error is more significant when inflation is low than when it is very high, but this is not accurately reflected in the average absolute value. The forecasts of inflation were more accurate for eastern Europe and the Baltic states than for the CIS, where inflation was higher and thus more difficult to predict. The main feature which emerges from this table, shown by the number of negative errors for the forecasting institutions, was the tendency to underestimate the extent to which inflation could be brought down. This applies particularly to the CIS, but was also true of certain east European countries where inflation was relatively high – for example, Romania.

A comparison of the accuracy of forecasts from different institutions

Only a few of the surveyed institutions provide projections for growth and inflation for all the countries in the region, although the majority project these variables for the Czech Republic, Hungary, Poland, the Slovak Republic and Russia. Tables 9.8 and 9.9 compare the accuracy of forecasts across forecasting institutions. It should be stressed again that the forecasts were completed at

Table 9.7

The accuracy of forecasts of inflation in 1995 (change in the average consumer price level, in per cent)[1]

Eastern Europe and the Baltic States	Actual[2]	Average absolute value of error[3]	EBRD		OECD		IMF		Project Link		European Union		PlanEcon		EIU		Vienna Institute		JP Morgan		CS First Boston		Kopint-Datorg	
			Forecast (Sept)[3]	Error	Forecast (June)[3]	Error	Forecast (May)[3]	Error	Forecast (April)[3]	Error	Forecast (June)[3]	Error	Forecast (June)[3]	Error	Forecast (Sept)[3]	Error	Forecast (June)[3]	Error	Forecast (Sept)[3]	Error	Forecast (July)[3]	Error	Forecast (June)[3]	Error
Albania	8.0	6.3	7.0	1.0	–	–	11.0	-3.0	–	–	–	–	23.0	-15.0	14.0	-6.0	–	–	–	–	–	–	–	–
Bulgaria	62.0	7.5	68.0	-6.0	–	–	–	–	53.2	8.8	75.0	-13.0	75.0	-13.0	68.0	-6.0	65.0	-3.0	69.2	-7.2	–	–	65.0	-3.0
Croatia	1.6	1.6	0.0	1.6	–	–	–	–	–	–	–	–	–	–	4.0	-2.4	3.0	-1.4	–	–	–	–	0.5	1.1
Czech Republic	9.1	0.7	10.0	-0.9	9.0	0.1	8.0	1.1	9.5	-0.4	10.0	-0.9	9.6	-0.5	9.0	0.1	10.0	-0.9	9.8	-0.7	10.0	-0.9	10.5	-1.4
Estonia	29.0	3.3	25.0	4.0	–	–	26.0	3.0	–	–	–	–	25.0	4.0	27.0	2.0	–	–	–	–	–	–	–	–
FYR Macedonia	16.0	21.5	50.0	-34.0	–	–	–	–	–	–	–	–	–	.	25.0	-9.0	–	–	–	–	–	–	–	–
Hungary	28.2	1.0	29.0	-0.8	27.0	1.2	28.0	0.2	–	–	25.0	3.2	27.3	0.9	28.0	0.2	29.0	-0.8	28.3	-0.1	26.0	2.2	29.0	-0.8
Latvia	25.0	2.8	25.0	0.0	–	–	19.0	6.0	–	–	–	–	20.0	5.0	25.0	0.0	–	–	–	–	–	–	–	–
Lithuania	39.5	6.0	35.0	4.5	–	–.	30.0	9.5	–	–	–	–	30.0	9.5	40.0	-0.5	–	–	–	–	–	–	–	–
Poland	27.8	2.5	27.0	0.8	23.0	4.8	25.0	2.8	21.7	6.1	30.0	-2.2	25.0	2.8	26.5	1.3	29.0	-1.2	27.5	0.3	31.3	-3.5	29.0	-1.2
Romania	32.2	8.0	40.0	-7.8	45.0	-12.8	–	–	29.7	2.5	40.0	-7.8	37.0	-4.8	35.0	-2.8	45.0	-12.8	–	–	–	–	45.0	-12.8
Slovak Republic	9.9	1.0	11.0	-1.1	10.0	-0.1	10.0	-0.1	10.5	-0.6	10.0	-0.1	11.5	-1.6	10.6	-0.7	12.0	-2.1	10.5	-0.6	11.3	-1.4	12.0	-2.1
Slovenia	12.6	2.8	15.0	-2.4	–	–	5.0	7.6	–	–	–	–	15.0	-2.4	13.0	-0.4	16.0	-3.4	13.0	-0.4	–	–	9.8	2.8
Commonwealth of Independent States																								
Armenia	177	125	210	-33	–	–	–	–	–	–	–	–	393	-216	–	–	–	–	–	–	–	–	–	–
Azerbaijan	412	176	425	-13	–	–	–	–	–	–	–	–	750	-338	–	–	–	–	–	–	–	–	–	–
Belarus	709	384	700	9	–	–	–	–	–	–	–	–	1,360	-651	1,200	-491	–	–	–	–	–	–	–	–
Georgia	169	601	250	-81	–	–	–	–	–	–	–	–	1,289	-1,120	–	–	–	–	–	–	–	–	–	–
Kazakstan	180	73	180	0	–	–	–	–	–	–	–	–	390	-210	170	10	–	–	–	–	–	–	–	–
Kyrgyzstan	43	5	45	-2	–	–	–	–	–	–	–	–	50	-7	–	–	–	–	–	–	–	–	–	–
Moldova	30	15	35	-5	–	–	–	–	–	–	–	–	55	-25	–	–	–	–	–	–	–	–	–	–
Russia	190	18	205	-15	–	–	–	–	–	–	–	–	173	17	200	-10	180	10	181	9	170	20	130	60
Tajikistan	635	445	120	515	–	–	–	–	–	–	–	–	260	375	–	–	–	–	–	–	–	–	–	–
Turkmenistan	1,005	795	1,800	-795	–	–	–	–	–	–	–	–	1,800	-795	–	–	–	–	–	–	–	–	–	–
Ukraine	375	67	350	25	–	–	–	–	–	–	–	–	421	-46	380	-5	400	-25	440	-65	–	–	140	235
Uzbekistan	305	78	325	-20	–	–	–	–	–	–	–	–	440	-135	–	–	–	–	–	–	–	–	–	–

1 All forecasts in this table were published or reported to 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 brackets 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 1995, 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 9.8

Comparison of growth forecasts for 1995 from different institutions[1]

	EBRD error	OECD error	IMF error	Project Link error	European Union error	PlanEcon error	EIU error	Vienna Institute error	JP Morgan error	CS First Boston error	Kopint-Datorg error
Czech Republic	0.8	0.8	1.0	0.8	0.6	0.0	0.8	0.8	0.8	1.3	1.3
Hungary	-1.5	0.5	1.3	-0.3	1.2	-1.5	0.0	0.5	0.2	0.8	-0.5
Poland	1.0	1.5	2.0	2.1	2.0	-0.2	1.1	1.0	0.4	2.0	1.0
Slovak Republic	2.4	2.4	3.4	3.7	4.4	1.4	1.7	3.4	1.9	2.4	2.9
Russia	-1.0	1.0	–	0.4	–	-1.3	-2.0	3.0	-0.5	-1.0	2.5
Average absolute value of the error – EE4	1.4	1.3	1.9	1.7	2.1	0.8	0.9	1.4	0.8	1.6	1.4
– EE4 and Russia	1.3	1.2	–	1.5	–	0.9	1.1	1.7	0.8	1.5	1.6

[1] The EE4 group of countries includes the Czech Republic, Hungary, Poland, the Slovak Republic. What is referred to as "errors" denotes the difference between actuals and forecasts (measured in percentage points).

different times, implying not only that more current data would have been available for the later projections, but that quite possibly more accurate estimates of the values of 1995's variables, especially of growth, would also have been available. With these caveats in mind, it is apparent that JP Morgan, PlanEcon and the EIU had the most accurate forecasts of GDP growth for the countries shown. The average absolute error has been calculated for the inflation estimates in the four east European countries in this case, since inflation was lower and more stable. JP Morgan provided the most accurate estimates of inflation followed closely by the EIU.

9.3 Medium-term growth prospects

The evidence of this chapter (and Chapter 8) indicates that the recovery has gained impetus over the past two years and that there are good prospects that it can be sustained. Only three of the institutions surveyed here – the EIU, PlanEcon and Project Link – publish comprehensive forecasts for more than 18 months ahead. Data for selected countries are shown in Table 9.10.[3]

GDP in the east European countries shown in the table is expected to grow at rates between 4 per cent and 5 per cent per year for the remainder of the decade, according to the three forecasts. This partly reflects the assumption made by the forecasters that fixed investment will increase steadily. The main difference between the sets of projections concerns Hungary and the Czech Republic. In the case of Hungary, Project Link predict lower rates of increase in investment, and thus average rates of growth. The converse applies in the case of the Czech Republic. All three forecasters expect positive growth in Russia next year, followed by a strong recovery; the recovery in Ukraine is projected especially by Project Link to be more subdued.

9.4 Concluding remarks

The forecasts surveyed in this chapter provide an encouraging view of the region's prospects. For east European countries and the Baltic states, especially those in the advanced stages of transition, the prospects are for a continuation of growth between 4 per cent and 5 per cent per year for the remainder of the decade, with further falls in inflation. However, demand pressures and in some cases strong capital inflows suggest that monetary policy will have to remain tight to preserve the gains already made in lowering inflation.

Performance in the CIS countries has generally lagged behind that of eastern Europe. This is a reflection of the greater length of time it has taken to implement successful stabilisation policies and the generally slower rate at which reforms have been introduced. There are of course exceptions to this: Armenia and Georgia are projected to record growth in 1996 and 1997 that is even stronger (albeit from a low base) than that achieved in certain east European countries in 1995. Moldova and Kyrgyzstan are also projected to record strong growth in 1996 and 1997. In fact most CIS countries are expected to see positive growth in 1996, which is projected to average 1 per cent for the CIS as a whole. Stronger growth is projected in 1997 – 4 per cent for the CIS as a whole – which partly reflects the return to positive growth in Russia. The average forecasts for the CIS countries assume that there will be further progress in lowering inflation in 1997, although inflation remains at high levels in two countries in the early stages of transition: Tajikistan and Turkmenistan.

The survey of forecast results has emphasised the uncertainty which surrounds these estimates. Even though the accuracy of the growth forecasts for eastern Europe and the Baltic states declined slightly in 1995, this was mainly explained by the underestimation of the strong rebound in growth in certain countries. The error in the forecasts for 1995 was greater for the CIS countries, mainly explained by the continuation of steeper than expected falls in output, although this merely serves to emphasise the difficulty of estimating the turning points. It was also evident that on average the forecasts underestimated the extent to which inflation could be brought down in most CIS countries.

The results indicate that the attainment of more stable paths of growth and inflation depend on a continuation of stabilisation policies to lower inflation, especially given the demand pressures that some countries currently face and the fiscal pressures that most will encounter in the medium term. It will also depend on maintaining high rates of quality investment and utilising in the most productive manner the stock of human and social capital, which is

[3] Both the EIU and PlanEcon publish medium-term forecasts for the majority of the countries in the region.

Table 9.9

Comparison of inflation forecasts for 1995 from different institutions[1]

	EBRD error	OECD error	IMF error	Project Link error	European Union error	PlanEcon error	EIU error	Vienna Institute error	JP Morgan error	CS First Boston error	Kopint-Datorg error
Czech Republic	-0.9	0.1	1.1	-0.4	-0.9	-0.5	0.1	-0.9	-0.7	-0.9	-1.4
Hungary	-0.8	1.2	0.2	–	3.2	0.9	0.2	-0.8	-0.1	2.2	-0.8
Poland	0.8	4.8	2.8	6.1	-2.2	2.8	1.3	-1.2	0.3	-3.5	-1.2
Slovak Republic	-1.1	-0.1	-0.1	-0.6	-0.1	-1.6	-0.7	-2.1	-0.6	-1.4	-2.1
Russia	-15.0	–	–	–	–	17.0	-10.0	10.0	9.0	20.0	60.0
Average absolute value of the error – EE4	0.9	1.6	1.1	2.4	1.6	1.5	0.6	1.3	0.4	2.0	1.4

1 The EE4 group of countries includes the Czech Republic, Hungary, Poland, the Slovak Republic. What is referred to as "errors" denotes the difference between actuals and forecasts (measured in percentage points).

generally acknowledged to be high in relation to income levels. While these are necessary conditions for economic growth, the 1995 *Transition Report* examined the reasons why the productivity of investment might be expected to increase throughout the region.[4] These included the scope for raising productivity through better management and working practices and as a result of technical progress embodied in much of the new capital equipment which will be required as part of industrial restructuring. Foreign direct investment can play an important role in this respect, not just through providing investment finance, but also by transferring technology, providing management expertise and by strengthening corporate governance. In addition, it is also important that government policies create and maintain a favourable market-oriented environment, in which investment decisions can be taken. This requires continued progress with macroeconomic stabilisation and market-oriented reform. Under these conditions, the returns to investment are likely to be enhanced, so that every dollar invested contributes to stronger growth.

Table 9.10

Medium-term growth forecasts

(in per cent, selected countries)[1]

		1996	1997	1998	1999	2000
Czech Republic	PlanEcon	5.9	5.2	4.9	4.5	4.1
	Project Link	5.4	5.9	5.8	5.8	–
	EIU	5.0	4.7	5.0	4.6	4.9
Hungary	PlanEcon	2.5	5.5	5.4	5.4	5.2
	Project Link	2.5	3.6	3.8	3.8	–
	EIU	1.5	3.5	4.5	4.0	4.8
Poland	PlanEcon	5.8	5.1	5.0	3.9	4.5
	Project Link	5.7	5.3	5.0	5.0	–
	EIU	4.9	5.2	5.7	5.1	4.9
Romania	PlanEcon	5.3	5.2	5.1	2.9	4.8
	Project Link	5.2	3.1	4.1	3.7	–
	EIU	4.5	4.5	4.6	4.5	4.7
Slovak Republic	PlanEcon	6.0	5.6	5.1	4.6	3.9
	Project Link	5.8	5.3	4.2	4.4	–
	EIU	5.0	4.1	4.3	4.0	4.4
Russia	PlanEcon	-1.8	3.3	4.4	5.0	5.3
	Project Link	-1.2	2.0	3.9	5.0	–
	EIU	-1.0	3.0	5.0	5.0	5.0
Ukraine	PlanEcon	-3.6	2.9	4.9	5.1	4.6
	Project Link	-3.1	1.5	2.3	3.0	–
	EIU	na	na	na	na	na

1 PlanEcon forecasts were published in June and August 1996, whereas Project Link forecasts were compiled in May 1996 (see the references at the end of this chapter for the sources). Some of the Project Link forecasts for 1996 differ slightly from the estimates from the same institution shown in Table 9.1 for the reasons given in footnote 5 for that table. The EIU forecasts were taken from the latest individual country forecasts, published by the EIU during 1996.

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4 See the discussion on incremental capital output ratios in Chapter 3 of the *Transition Report* 1995.

Transition indicators
Selected economic indicators

Albania

A comprehensive market-oriented reform programme was adopted in 1992. Price and trade liberalisation as well as privatisation of farm land and small-scale enterprises are virtually complete.

Enterprises

Size of the private sector
Official Albanian statistics indicate that the private sector accounted in 1995 for 75 per cent of GDP and 77 per cent of employment. Agriculture, construction, road transport, retail trade and food industry are almost completely in private hands. While private sector activity has spread rapidly in recent years, the almost completely state-owned industrial sector has been decimated. Agricultural production was almost entirely privatised early on in the reform process.

Large-scale privatisation
A new voucher-based Mass Privatisation Programme was introduced in 1995. According to this programme a total of 400 medium-sized or large state-owned enterprises are to be privatised through a system of "unpriced auctions". The programme includes all the 32 large enterprises that were in the original portfolio of the Enterprise Restructuring Agency, when it was established in 1993 to restructure or liquidate these companies. Vouchers are tradable and can be exchanged for shares in enterprises, in any one of the auction centres set up in each of Albania's 37 districts. The value of each enterprise is determined as the total sum of vouchers which individuals bid during the auction period (45 days). A total of 97 enterprises have been sold under the programme as of July 1996. The whole process is expected to be completed by the end of 1998.

Small-scale privatisation
The Privatisation Law (1991) and subsequent amendments regulate the privatisation of small-scale entities (defined as those with less than 15 staff). Small-scale privatisation progressed rapidly already during 1991-92, largely through employee buyouts. 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.

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 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 1996, 98 per cent of state buildings had been privatised (a 1996 law regulates usage rights of remaining state-owned buildings).

Property restitution
According to two laws passed in 1993, former owners and their heirs can claim compensation or restitution for 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
There has been rapid growth of small enterprises in trade, transport and services, partly financed by a large inflow of remittances from abroad.

Enterprise restructuring
Much enterprise restructuring has happened over the past three 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. An Enterprise Restructuring Agency (ERA) was established in 1993 to restructure or terminate the operations of 32 large companies. Most of the large enterprises have by now been broken up in parts. Some parts have been closed down, and the viable ones are receiving management support. Employment in the enterprises in the ERA portfolio has fallen from 51,000 in 1988 to 10,000 in 1995. Those who are laid off from these enterprises are compensated in the form of one year of wages and one year of unemployment benefits. However, this treatment of the unemployed will not be extended to those employees who lose their jobs after privatisation.

A new bankruptcy law was adopted by parliament in October 1995. It defines bankruptcy procedures for all companies (the previous law from 1992 covered only state enterprises) but no bankruptcies have taken place so far.

Markets and trade

Price liberalisation
Price liberalisation has been extensive (the latest prices to be liberalised were those of bread, gas and kerosene in July 1996), but price controls and subsidies (amounting to less than 1 per cent of GDP) still apply for public transport, rail fares, postal tariffs, electricity and the rural water supply.

Competition policy
A competition law was adopted by parliament in December 1995. It introduces procedures for mergers and break-ups of dominant companies. It also establishes a so-called Economic Competition Department under the Ministry of Trade.

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

In May 1995 the structure of custom tariffs was streamlined to three 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 (medicines are exempt from custom duties). Capital goods in production, telecommunications and construction sectors are exempt from import duties (except for office equipment).

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 some capital transactions but not on repatriation of initial capital by foreign investors. Albanian citizens are allowed to hold foreign currencies and maintain foreign currency accounts. The exchange rate is freely determined in the interbank market, which competes with a number of private dealers and foreign exchange bureaux. The central bank is trying to deepen the market by encouraging the banks to play a more active role.

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 US$ 42 per month (at the market exchange rate) in mid-1996.

Interest rate liberalisation
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. There is no formal 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. However, apart from remittances from family/friends who migrated abroad, the main source of outside finance for the private sector is the informal credit sector.

Financial institutions

Banking reform
During 1996, three new laws on the structure of the financial sector were approved by parliament. The first concerns the organisation and the independence of the central bank. The functions of the supervisory board and of the executive board are clearly specified. Members of the executive board are now appointed by parliament, instead of by government. Relations with the government regarding the financing of the budget deficit are clarified by this law so as to fit in with the monetary policy guidelines issued by the central bank. A second law assigns clear responsibility to the central bank regarding the foreign exchange regime, policy, and portfolio management of foreign exchange reserves. In the past, the central bank did not have clear-cut responsibility on these matters which by law had to be agreed with the Ministry of Finance. A third law provides the legal framework for setting up new banks (including co-operative banks, not previously envisaged according to the old system), and the different financial operations they can conduct. On the regulations side, new minimum capital requirements were introduced. A US$ 2 million minimum capital requirement now applies for both domestic and joint venture banks.

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.

None of the established commercial banks has yet been privatised. Two of the three state owned banks are expected to be privatised before summer 1997. In preparation for privatisation, the National Commercial Bank has recently been recapitalised and its capital clearly separated from that of the central bank. Auditing of all the Albanian state banks was carried out in 1995. A law to transform the state banks into joint stock banks and to privatise them has been approved in late 1995. Five partly foreign-owned private banks are currently operating in Albania: the Banca Italo Albanese (joint venture between a branch of the NCB and the Italian Banca di Roma), Dardania Bank (Kosovan owned), the Arab Albanian Islamic Bank (joint venture between a branch of the NCB and a group of Saudi banks), as well as the Tirana Bank (majority owned by the Greek Bank of Piraeus) and the International Commercial Bank (owned by a Malaysian investor), which obtained licences to operate as banks in the first half of 1996. The National Bank of Greece recently obtained the preliminary approval for a licence.

Almost all transactions are still in cash, although a "fixed value personal cheque" was introduced in July 1996. Only short-term lending (up to six months) is available from the banking sector, which is actively financing the public deficit.

Non-bank financial institutions

A law on investment funds has been approved. Funds may purchase vouchers from citizens, and use vouchers to build up an equity portfolio in the privatised enterprises. The first investment fund licence was granted in April 1996 to the foreign-managed Anglo-Adriatic Investment Fund.

A law has been passed regulating the establishment and operation of insurance companies (minimum capital requirement Lek 30m), so as to break the monopoly of the large state-owned insurance company INSIG.

INSIG is an active player in the T-bills auctions, as is the Savings Bank. Together with the Bank, it is trying to set up a Mortgage Bank.

Securities markets and instruments

New securities laws regulating the operation of the stock exchange and transactions with vouchers were adopted in 1996. A stock exchange was established in March 1996. It trades treasury bills (with one month to one year maturity), privatisation vouchers and foreign currency. A special Securities Commission has been appointed to regulate trading activity.

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, have replaced profit transfers by profit taxation and have removed the most notable inefficiencies in the turnover tax system. In 1992 the profit tax rate was set at 30 per cent (additional taxes are payable in certain sectors such as mining and oil), the progressive rates for personal income taxation at 5-40 per cent, and the basic turnover tax at 15 per cent. The latter was replaced on 1 July 1996 by a value added tax, initially set at 12.5 per cent (likely to be increased to 15-17 per cent in 1997). Excise taxes range from 20 to 60 per cent and apply to, for example, tobacco, cigarettes, alcohol and petrol derivatives. Despite the new revenue sources, there has been a very sharp drop in revenues collected from enterprises (this phenomenon was exacerbated during the pre-electoral period in 1996). Some rates increases are likely to take place in the near future (small business tax), together with the elimination of some tax exemptions (import tariff exemption for investment goods). A four-year tax holiday for investment in manufacturing and a 60 per cent tax reduction on reinvested profits are in place.

A new law approved in 1996 states that industrial parks might request "free trade zone status" which would be phased out in a seven-year period from beginning of operations.

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; there is a one-year limit on eligibility for unemployment insurance; and earnings-related unemployment benefits have 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 percentage points paid by the employer, the rest by the employee).

Investment legislation

Extensiveness

Laws exist regulating domestic and foreign investment, directly and, to a limited extent, through indirect investment vehicles. Such investment generally requires no government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners and nationals may, subject to restrictions, own or lease land (see the comments above under "small-scale privatisation"). Security interests over shares and land may be created, require notarisation and, in the case of land, entry in an official register or, in the case of shares, entry into the company share register. Security interests over contracts, receivables and moveable assets are theoretically possible, and require registration; however, registration problems currently prevent enforceable perfection of such interests.

Effectiveness

The full texts of laws relating to investment are published, usually within one month of enactment. Subordinate regulations, decrees, etc. which frequently contain substantive measures relating to investment, are in force although they are generally not published. Draft laws are usually not circulated to practitioners for comment prior to enactment. Public records in share or land registries may be up to 12 months behind current status. Despite requirement for registration, registers do not always exist. Court decisions are not generally available to practitioners. Independent professional legal advice is available. While private parties generally believe that courts will recognise their legal rights against other private parties, they do not believe that courts would enforce such rights against the state. Foreign arbitral awards are not required to be recognised and enforced by the courts, at least not without a re-examination of their merits.

Armenia

Although market-oriented reforms were initiated in January 1992, further progress was delayed due to the conflict in Nagorno-Karabakh and the effective trade blockade imposed on the country. The country's reform efforts regained momentum in 1994 with the support of the IMF. Substantial progress has been made since then both in the area of structural reform and in macroeconomic stabilisation.

Enterprises

Size of the private sector
In 1996, the private sector share in GDP may exceed 50 per cent on account of sharp contraction in the state sector and rapid privatisation in trade, services and agriculture.

Large-scale privatisation
A new phase of privatisation in Armenia began in 1994: a "voucher" privatisation programme was approved which provided for privatisation of both large and small-scale enterprises. 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. As of mid-August 1996, 626 medium and large enterprises had been privatised. The majority of the enterprises were offered by public subscription and a few were sold by auction. There were also employee buy-outs. Furthermore, 10 enterprises have been earmarked to be sold through international tender. The government expects that privatisation will now continue at least until the end of 1997.

Small-scale privatisation
Of the approximately 5,000 enterprises earmarked for small-scale privatisation, 3,238 had been privatised by the end of August 1996. The remaining 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.

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.

Privatisation of housing is now virtually complete.

Property restitution
No property restitution has taken place in Armenia.

Growth of private enterprise
New private enterprises have emerged rapidly, 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 between 1990 and 1994. There were more than 18,000 private enterprises registered in November 1995.

Enterprise restructuring
During 1994-95, substantial financial discipline has been imposed on state enterprises by the elimination of subsidies and cheap credits, the opening up of foreign trade, and the entry of new companies.

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. However, due to lack of provisions for reorganisations and ambiguity over the judicial authority to administer the law, a new bankruptcy law is being drafted. The new law is expected to be adopted by the autumn of 1996. Eleven loss-making enterprises were placed in a restructuring programme in 1995.

Markets and trade

Price liberalisation
Almost all prices have been liberalised: prices remain administered only for bread, urban transport, electricity, hot water, gas, heating, sewage services, garbage collection, state-owned housing, telephone services and irrigation. All administered prices are inflation-adjusted on a regular basis. The tariff for domestic use of electricity was sharply raised to 14 dram (approximately 3.4 US cents) per kWh on 1 January 1996. Direct price control remains in place for flour through the setting of maximum profit margins for flour mills. The only consumer subsidies that remain are on district heating and hot water, which are also under review to better target the vulnerable parts of the population.

Competition policy
In order to improve resource allocation state purchases above US$ 50,000 have been made through competitive tendering since February 1995. The Law on Protection of Economic Competition and the Law on Natural Monopolies are to be submitted to the parliament (by, respectively, the end of 1996 and early 1997).

Trade liberalisation
Armenia has progressively removed most of the regulatory obstacles to external trade. In December 1995, a five-band import tariff structure was streamlined into a two-band structure, with rates of 0 and 10 per cent. Import and export licences are required only for health, security and environmental reasons. There are no export taxes for enterprises but individuals taking goods across the border are taxed a 10 per cent export duty. All bilateral clearing arrangements that existed between Armenia and other FSU countries have been eliminated. Armenia is committed to early WTO accession. Armenia has bilateral free trade agreements with 28 countries. Currently, excise taxes on strong alcohol, beer, grape wine and passenger vehicles discriminate against imports. Equalization of the rates is planned by the end of the first quarter of 1997.

Currency convertibility and exchange rate regime
The dram is fully convertible for current account transactions. Export surrender requirements were eliminated by mid-1995. There are no restrictions on repatriation of profits and capital.

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. The minimum wage was increased by 18 per cent to 720 dram in January 1996.

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. With the abolition of directed credit at the beginning of 1995, credit auctions became the main means for credit extensions to commercial banks.

Financial institutions

Banking reform
A two-tiered banking system was created in 1987-88 in Armenia as in the rest of the Soviet Union. The fragility of the current banking system continues to undermine its role in savings mobilisation and financial intermediation. In August 1996, there were 39 commercial banks operating in Armenia, a significant reduction from the beginning of 1994 (at which point there was 58 resident banks and 14 foreign banks), due to the closure of banks that have failed to meet prudential regulatory standards. According to the mid-1995 data, eight banks (five former state-owned banks and three private banks) accounted for nearly 80 per cent of the Armenian banking system as measured by total assets, while their capital accounted for 60 per cent of the total capital of the banking system. In July 1996, 42 per cent of the loan-assets of the deposit money banks were non-performing.

The Central Bank of Armenia (CBA) began taking decisive moves to strengthen Armenia's banking system in early 1994: minimum capital requirements were increased; banks were required to report daily or weekly to the CBA; and on-site audits and off-site surveillance programmes were developed. In early 1995, it was decided that the capital in each bank should reach at least US$ 350,000 by the beginning of 1997, US$ 600,000 by 1998 and US$ 1 million by the beginning of 2000. In addition, banks are required to comply with the following requirements: minimum capital to risk-adjusted assets ratio of 10 per cent; a minimum liquidity ratio of 35 per cent; maximum exposure to a single borrower of 20 per cent of assets; and maximum household deposit-taking of 9 times capital. International accounting standards for banks were introduced in 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, began operations in January 1996, and was established as a commercial bank in March 1996.

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 underway, but moral hazard and adverse selection issues will have to be dealt with before further progress is made.

Securities markets and instruments
Securities markets are at 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.

The government has been operating a treasury bill market since October 1995. Treasury bills are offered in weekly auctions, in which only banks are allowed to participate. By early September 1995, annualised yields were about 35-40 per cent.

Fiscal and social safety net reform

Taxation
The Armenian tax regime includes the following components: a value added tax (VAT) of 20 per cent, an *ad valorem* excise tax (15-75 per cent), an enterprise profit tax (30 per cent for banks and insurance companies, 70 per cent for casinos and 12-30 per cent for other legal entities), a personal income tax (with rates at 12-30 per cent), a land tax and property tax. Newly established enterprises (including foreign enterprises) are exempt from profit tax for the first two years. Enterprises with foreign investment will receive further favourable tax treatment from the third to the tenth year (30-50 per cent reduction of profit tax). Despite the reform, tax revenues remain low: 41 per cent of expenditures in 1995. VAT and excise taxes as a percentage of total revenue were 28 per cent while enterprise income tax and personal income tax were the major source of tax revenues, totalling 50 per cent of tax revenues in 1995. The government intends to increase tax revenues by broadening the tax base, reducing tax exemptions and strengthening the revenue collection capacity.

Social security
The pressure on pension expenditures due to an ageing population is in itself not a serious problem in Armenia: in 1995, the number of non-working age individuals per actively employed individual in Armenia was 0.8 and population growth averaged 1.5 per cent per annum between 1985 and 1994. Due to other sources of fiscal pressure, social government expenditures (consumer subsidies, pensions, social safety net, health and education) have been sharply reduced from 18 per cent of GDP in 1994 to 8 per cent of GDP in 1995. Given the budgetary constraints, the government has been seeking to target better the most vulnerable parts of the population. In 1996, child allowances will be restricted to children aged 0-6. Pensions accounted for about 65 per cent of total social expenditures in 1995. The new Pension Law adopted in December 1995 provides for the following reforms in the pension system: a gradual increase in the retirement age; a flattening of the pension structure; a delinking of adjustments to the pension level from adjustments made to the minimum wage; and a reduction of payouts to working pensioners. The government plans to submit an Employment Law by mid-1996 which limits the maximum payout period of unemployment benefit to 12 months.

Investment legislation

Extensiveness
Laws exist regulating domestic and foreign investments, including indirect investment vehicles, such as securities or investment funds. Most foreign investment proposals are not subject to governmental approval, except for security and health reasons. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Nationals can, subject to restrictions, own or lease land, while foreigners can acquire property and the right to use land, but there is no law that allows outright ownership of land by foreigners. Security interests over shares and land may be created. Security interests over land require notarisation. Security interests may be created over certain movable assets.

Effectiveness
The full laws are regularly published, and draft laws are usually accessible to practitioners. Reportedly, many laws are also available on a computer database. While recently enacted laws provide for the registration of security and ownership interests in specified tangible property, registers do not always exist. Court decisions are not generally available to practitioners. Independent professional legal advice is available, but from only a very limited number of lawyers. Private parties generally believe that courts would not recognise and enforce their legal rights against the state. Foreign arbitral awards are not required to be recognised and enforced by the courts without a re-examination of the merits.

Azerbaijan

A comprehensive stabilisation and economic reform programme - supported by the IMF - was initiated early in 1995. Good progress has been made with respect to macroeconomic stabilisation. In the realm of structural reforms, progress remains slow and uneven.

Enterprises

Size of the private sector
The private sector may account for about 25 per cent of GDP.

Large-scale privatisation
The legislation for the corporatisation of the large enterprises is being prepared, and vouchers are being printed. Their distribution should be completed by the end of the year, and the first voucher auction is to take place early next year. Foreigners will be allowed to participate in the process, although they will be required to buy an option to do so first.

Small-scale privatisation
Many shops, restaurants, small manufacturing companies, and trade and service units have been leased out and are run as private enterprises.

A new privatisation programme, approved by the parliament in July 1995, envisaged that small enterprises (less than 50 workers) would be auctioned or sold directly to individual workers. This process started on 26 March 1996. By the end of 1996, 2,500 small enterprises should be sold, including small service units, gas stations, shops and bakeries.

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. There is a large number of unregistered active private entities.

Enterprise restructuring
The pre-independence management structure and relationship between enterprises and ministries remain largely intact, supported until mid-1995 by budgetary subsidies and bank credits to enterprises.

Recently, however, some progress has been made. In its efforts to reduce inflationary pressures, the government has, over the past year, cut back on subsidies and directed credits to enterprises. With assistance from EBRD, the government is preparing a Secured Transactions Law and amending the Bankruptcy Law. A presidential decree on payment discipline will also be issued soon.

Markets and trade

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.

In January 1995, the bread price subsidy and the state order system for agricultural products were abolished. Prices for oil and oil products were gradually increased during the course of 1995 to reach world market prices by the end of that year. However, prices for utilities, housing and transport remain controlled at levels that fail to cover production costs.

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 had been removed by the spring of 1995, with the exception of those pertaining to a selection of "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 those commercial banks that are authorised to deal in foreign exchange. Until March 1995, exporters were required to surrender a fixed proportion of their foreign currency earnings at an unfavourable exchange rate. In March 1995, the exchange rate was effectively unified when the government abolished the Unified Foreign Exchange Fund and the rate applied for surrender requirements was aligned with market rates. Capital account convertibility remains limited.

Wage liberalisation
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 and 1996.

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.

New National Bank and Banking Laws were adopted in June 1996. They establish the National Bank as the sole supervisory authority for the whole sector. The minimum capital requirement for new banks has increased to ECU 1.2 million. Prudential regulations were improved in 1995 and 1996. Each bank must have a minimum capital adequacy ratio of 8 per cent, a maximum exposure per borrower of 50 per cent of its own capital, and a maximum foreign exchange exposure of 30 per cent of its capital. A number of smaller banks that have persistently failed to comply with these standards have been closed.

The banking system in Azerbaijan remains weak. To avert a systemic failure, the government has, with the assistance of the World Bank and the IMF, developed a restructuring programme for the three large state banks (Agro, Prominvest, Savings), which are facing the most severe problems.

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

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.

Investment legislation

Extensiveness
Laws regulating both domestic and foreign investment are limited. Most foreign investment proposals do not require government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners cannot own, but may lease, land. Security interests cannot be created over land, but may be created over shares. Security interests over certain moveable assets may be created.

Effectiveness
The full texts of laws are published, although sometimes six months after being passed. Draft laws are usually not circulated to practitioners for comment prior to enactment. While the law provides for the registration of security and ownership interests, certain prescribed registers do not exist. Important court decisions are not usually published or accessible to practitioners. Independent professional legal advice is available, but from a limited number of lawyers. Private parties generally believe that courts would not recognise and enforce their legal rights against the state. Foreign arbitral awards are not required to be recognised and enforced by the courts, at least not without a re-examination of their merits.

Belarus

While progress has been achieved in macroeconomic stabilisation during 1995 and the first half of 1996, there has been slow progress with structural reforms.

Enterprises

Size of the private sector
The private sector is likely to account for only about 15 per cent of GDP. Employment in "transformed" enterprises (joint stock companies, mostly 100 per cent owned by the state) is officially estimated to have accounted for 11.4 per cent of total employment in March 1996.

Large-scale privatisation
In 1993 Belarus launched a privatisation programme to de-nationalise two-thirds of enterprises owned by central and local governments by 2000. In January 1996, however, only 20 per cent of the programme's total (or 1,595 enterprises) had been "transformed" into joint-stock companies, in which the government initially owns 100 per cent of the shares. Genuine privatisation of large state-owned enterprises, with majority ownership and decision-making powers transferred to private investors, has not yet taken place.The 1996 privatisation programme approved in September 1996 comprises 516 enterprises owned by central government. Shares were to be sold to the population for vouchers that had been distributed in 1994 (the number of vouchers transferred to the individual adult citizen was linked to the number of years of employment, his or her age, and the number of children in his or her family). By May 1996, no transactions under this scheme had taken place. A major obstacle has been the rules for registration of enterprises. Registration of enterprises was suspended in early 1996, so that new companies could not be registered. Nor could a change in the ownership structure of old companies be registered. This measure effectively suspended the privatisation process.

Small-scale privatisation
Privatisation of small service units and shops, which accounted for 30 per cent of all "transformed" enterprises in 1995, has been mostly undertaken through auctions and competitive bidding. In 1996, the privatisation process at the local level slowed, with 88 small enterprises being sold or transformed during the first seven months of the year (a total of 415 enterprises were privatised in 1995). By the end of 1995, 47 per cent of the "transformed" enterprises were in the agro-processing sector, 35 per cent in the trade sector and only 4 per cent in industry.

By the end of 1995 about 36 per cent of the total stock of government and public-owned housing had been privatised.

Property restitution
No property restitution has taken place to date.

Growth of private enterprise
As of early 1995, private companies accounted for 19.3 per cent of all companies. A total of 48 per cent of all companies were collectives, 19 per cent were state enterprises, 4.6 per cent

were cooperatives and 2 per cent were joint ventures. 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 been no significant active effort by the government or the banking system to instigate restructuring of state enterprises. There is still government intervention in capital and investment decisions, and in the setting of pricing and production targets. The number of state-owned enterprises has increased by 4 per cent between the end of 1995 and April 1996. About one-third of the enterprises are loss-making.

A major obstacle to enterprise restructuring is the lack of an adequate legal environment that will enable quick bankruptcy declaration and/or liquidation. The Bankruptcy Law, which was enacted in 1992, is ineffective. The government continues to provide financial aid to priority enterprises through tax concessions (tax and import duty exemptions, limitations on tax obligations) and banking measures (earmarked credits).

The collective agricultural sector continues to be a recipient of large subsidies in the form of cheap credits or subsidies to purchase machinery and fuel.

Markets and trade

Price liberalisation
A large share of producer prices were liberalised in early 1992; and the process of price liberalization was mostly completed in early 1995. However, some price controls still apply to consumer products such as meat, dairy products and bread, and administered prices are set for transport, energy and communications. Profit margin restrictions are also applied to essential agricultural products.

As of January 1996, cost recovery in household utilities had reached about 60 per cent, a significant increase from the 12 per cent level of January 1995.

Competition policy
The State Anti-monopoly Committee was established in 1991, and enabling legislation and administrative regulations were approved in 1992-93. The Committee also monitors and regulates monopolistic enterprises. Although the licensing system for the production of a large number of products was abolished, the structure of the economy remains highly monopolistic. Restrictions on trade and distribution among regions are creating regional monopolies in sectors such as transport and domestic trade.

Wholesale trade monopolies were broken up in 1994 and the first half of 1995. Enterprises are subject to investigation only when there is evidence of monopolistic practice. The Anti-monopoly Ministry regulates and monitors natural monopolies and enterprises with no domestic competitors.

Trade liberalisation
In January 1995, a custom union agreement was signed with Russia. The customs union was joined later in 1995 by Kazakstan and in March 1996 by the Kyrgyz Republic. The harmonisation of import and export duties and non-tariff regulations with Russia, which was planned for May 1995 is still incomplete. In April 1996, Belarus declared its intention to follow Russia in the elimination of all non-crude oil export duties.

Harmonisation of import duties with Russia has been broadly maintained since mid-1995 with a few exceptions such as duties for imported cars. Import duty rates range between 5 and 30 per cent. A limited number of products are subject to rates in the 40-100 per cent range.

Currency convertibility and exchange rate regime
In July 1996 the Russian parliament ratified an agreement with Belarus on measures to bring about mutual convertibility between the currencies of the two countries.

Formal administrative controls were reintroduced in the foreign exchange market in November 1995, including the prohibition of interbank trading, and restrictions on the purchase of foreign currency. In April 1996 the Inter-bank Currency Exchange was nationalised and is now under direct control of the central bank (NBB).

In January 1996, a 10 per cent tax on purchases of foreign currency was introduced and exporters were required to surrender 100 per cent of their foreign earnings (with many exemptions granted). In June 1996, the 10 per cent tax was removed and the surrender requirement reduced to 50 per cent.

Wage liberalisation
The 1990 Law on Enterprises allowed for the free determination of wages; however, many enterprises follow adjustments in public sector wages. The minimum wage is set by parliament and is periodically adjusted for inflation; as of January 1996, it was Rb 100,000. A new wage scale for the public sector was also introduced in January 1996, containing 28 grades. Enterprises that receive subsidies must follow the same wage structure as the public sector.

Interest rate liberalisation
Interest rates on loans to industry and commerce were deregulated in October 1994. During 1995, the government reduced the amount of directed credit that was extended at preferential rates. However, between January and March 1996 the NBB again expanded the provision of preferential rate credits through state-owned banks on government recommendations, particularly for housing and agriculture.

Financial institutions

Banking reform
The Law on the National Bank (passed in 1990) and the Law on Banks and Banking Activities (1990) 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. A total of 47 banks have been licensed, mostly during 1994.

The government has continued to intervene in the banking sector. The National Bank (NBB) and commercial banks have been requested to earmark credits to some sectors of the economy, in particular agriculture and housing.

In September 1995, Belarus Bank (a joint-stock bank) was merged by Presidential Decree with the state-owned Sberbank.

As of December 1995, over 83 per cent of the assets of the Belarussian banking system were concentrated in Sberbank (the Savings Bank), Belagroprombank, and the five large former state banks. Foreign and joint venture banks account for less than 1 per cent of all banking assets.

During 1995, banks in Belarus were required to increase their foundation capital to the equivalent of ECU 2 million by January 1996 but only 19 of the 47 banks were able to comply immediately. The minimum size of the foundation capital has been set at ECU 5 million for foreign banks.

New prudential regulations were introduced in early 1996: loans to shareholders and banks' borrowing capacity are restricted to 100 per cent of own capital.

A deposit guarantee fund, with initial capitalisation equal to 0.3 percent of total household deposits, was established in mid-1995. The fund guarantees deposits of up to US$ 2,000.

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 71 insurance companies in Belarus. The insurance market is less concentrated in Belarus than in many other countries in the region, with the top five providers accounting for about 65 per cent of collected premiums. The state insurance company "Belgosstrakh" accounts for 35 per cent of collected premiums. At present, insurance investment returns are subject to a value added tax of 20 per cent and a profit tax of 30 per cent.

There are 34 operating licensed investment funds, holding about 8 million vouchers.

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 shares in 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
State revenues amounted to 30 per cent of GDP in 1995 (34 per cent if contributions to non-budgetary funds are included), compared to 37 per cent in 1994. Statutory tax rates are generally high, although there are many exemptions. The VAT, which accounts for 38 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. Individual income tax accounted for 33 per cent of state tax revenues, with corporate profits tax accounting only for another 1 per cent. The fall in the tax/GDP ratio in 1995 was due to the general economic downturn (lower profits) and tax evasion. Tax arrears accounted for 1.3 per cent of GDP at end-1995 and increased to about 2 per cent in March 1996.

Social security
Despite the steep decline in output (at least 40 per cent since 1991), the official rate of unemployment was only 2.8 per cent as of end-1995. An unemployment rate in the order of 5 per cent is expected by the end of 1996.

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. At the end of 1995, state pension expenditure represented 10.3 per cent of GDP and 19.7 per cent of general government budget. Demographic and system dependency ratios are about 33 and 49 per cent respectively. Male and female retirement age is set at 60 and 55 years respectively.

The financial position of the Social Protection Fund, which provides pensions and social benefits, and the Employment Fund deteriorated considerably in 1995 and the beginning of 1996 due to enterprise contribution arrears, which in March 1996 amounted to about 0.8 per cent of GDP.

Investment legislation

Extensiveness

Laws exist regulating domestic and foreign investment. Laws regulating the use of indirect investment vehicles, such as securities and investment funds, exist, but the activities of all funds were suspended in 1995. Most foreign investment proposals require government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. The ownership of land by foreigners or by foreign-owned local companies is prohibited. Foreigners or foreign-owned local companies may lease land. Security interests cannot be created over land, but may be created over shares; such security interests do not require notarisation, but require entry in an official register. Security interests over contracts, receivables and moveable assets can be created and do not require notarisation. Such security interests must be entered into an official register.

Effectiveness

The full texts of laws are published, although sometimes six months after being passed. Laws affecting investment, particularly indirect investment, are often issued by executive decree. Draft laws are rarely published or accessible to practitioners. 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 and unreliable. Important court decisions are not usually published or accessible to practitioners. Independent professional legal assistance is available, at least in Minsk. Private parties generally believe that courts would not always recognise and enforce their legal rights against the state. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits.

Bulgaria

The transition process was launched in 1991. However, government intervention into markets and into enterprise finances remains significant including some backtracking on prices and foreign trade. The emergence of new small private enterprises proceeded quickly in the trade and services sectors, but the restructuring and privatisation of large enterprises and banks has been very slow. Significant progress in structural reforms is envisaged under programmes adopted with IFI support during 1996 and 1997.

Enterprises

Size of the private sector

Due to delays in large-enterprise privatisation, the private sector's share in GDP and employment has – after an initial wave of restitution and the privatisation of small units – increased primarily as a result of new entrants and of the private sector's better performance relative to the state sector. The private sector share of GDP and employment was estimated at 45 per cent and 41 per cent, respectively, in early 1996. The private sector's share of value added was 90 per cent in agriculture, 71 per cent in trade, and 57 per cent in construction, but less than 15 per cent in industry and negligible in infrastructure services.

Large-scale privatisation

The privatisation of 3,485 state enterprises with a fixed asset value of US$ 7.8 billion was initiated in 1993 with a programme envisaging individual sales through a variety of mechanisms (direct sales, tenders, auctions, MBOs). The Privatisation Agency (PA) is responsible for enterprises whose book value of fixed assets exceeds US$ 1 million, smaller ones are sold by line ministries. Management and employees can bid for up to 20 per cent of shares on preferential terms (50 per cent discount). The privatisation process is open to foreign investors. In November 1994, Brady Bonds and domestic bad-loan bonds (ZUNKs) became useable as payment. This provided a short-term boost for privatisation. However, the scope for transfer abroad of profits and capital from Brady privatisations is restricted, and payment in the form of Brady Bonds is limited to 50 per cent of the transaction value. The debt-equity conversion value of ZUNKs was 140 per cent of the face value until 31 July 1996, and was to fall to 130 per cent thereafter.

Cash privatisation has been proceeding at a very slow pace, with only 6 per cent of total state enterprise assets transferred to the private sector by mid-1996. There was foreign participation in only 14 transactions of significant size. Total privatisation proceeds in January-August 1996 were US$ 84 million equivalent (most sales took the form of MBOs).

Administrative procedures have been cumbersome, relevant legislation (e.g. company valuation, concession laws) has been deficient, and there has been significant resistance to privatisation from line ministry officials and management. The programme and foreign investment in it are to accelerate significantly during the second half of 1996 with the inclusion of a stake in Bulgarian Telecoms and other major companies which have previously been excluded.

Implementation of a mass privatisation programme, modelled largely on the Czech scheme, has begun in 1996. Vouchers have been acquired by 2.8 million citizens (out of a total of 6.3 million that were eligible). Approximately two-thirds of the vouchers have been transferred by their holders to specialised investment funds, 92 of which had been licensed by early August 1996. There is no restriction on foreign ownership of funds, but managers and board members need Bulgarian residency. A first auction, for shares in a little over 1,000 firms, with a book value of assets representing 11 per cent of GDP, is scheduled for October 1996. This should result in the government's stake in firms representing 20 per cent of state enterprise assets falling below that of a blocking majority. Funds can own up to 34 per cent of shares of an enterprise (representing a blocking minority for certain decisions). A second wave of mass privatisation is to follow in 1997. By mid-1998 all state-owned firms except the utilities and a small number of "strategic" enterprises are to be privatised under a government programme agreed with the IMF.

Representing an important legislative advance, a Law on Concessions was passed recently which clarifies the bidding process for enterprises in the natural resource sector and allows foreign participation.

Small-scale privatisation

Municipalities owned about 90 per cent of small-scale enterprises at the onset of privatisation. A law regulating small-scale privatisation was adopted in January 1993 and the process is said to be largely completed. However, 3,130 out of 4,780 small properties subject to direct sales by municipalities were still on offer at end-1995. Most small-scale privatisation has taken place through restitution of some 22,000 municipal entities (by September 1995).

Property restitution

Significant restitution has taken place, following the Law on Ownership Restoration (1992) and the Compensation Law (1993). However, titles to less than 20 per cent of land have been issued, causing some uncertainty. Much of the remainder was restituted through "final land decisions" recognised as ownership documents and accepted as collateral. Recent progress has been disappointing. Legislation passed in June 1995 favours cooperatives and restricts the scope for sales of restituted land. Parts of this legislation have been declared unconstitutional by the courts.

Enterprise restructuring

After the initial break-up of state monopolies, many of the resulting enterprises passed effectively into the control of management and workers' councils (except in strategic sectors such as energy). While direct budgetary subsidies have largely been eliminated, financing of losses through the banking system and

suppliers' and tax arrears remained pervasive to mid-1996. While gross state enterprise losses represented 15 per cent of GDP annually on average in 1993-95, no bankruptcy procedures against major companies were recorded before July 1996 (in spite of the existence of a bankruptcy law), and there were few reports of sanctions against management. A full 43 per cent of the negative net cash flow of state enterprises in 1995 was financed by the banking system.

A government programme announced in May 1996 made 134 enterprises (including utilities), which are responsible for 75 per cent of state enterprise losses, subject to a special restructuring regime. Under this regime, 64 (of the 134) enterprises, which employ 24,000 workers, are to be liquidated. Bankruptcy proceedings against some of these had been initiated by late August 1996. The remaining 70 enterprises, which employ 230,000 workers, are to operate (from 30 June) without access to new finance from the state budget or the banking system, but with a moratorium on debt service. These are to be privatised by end-1997 if restructuring is successful and are otherwise to be liquidated. Public utilities are to be supported by sizeable increases in administered prices (the National Electricity Company and State Railways will retain access to short-term emergency funding). Laid-off personnel will receive severance pay, financed from the proceeds of a World Bank loan.

Markets and trade

Price liberalisation

After an initial sweeping liberalisation of prices in 1991 covering 90 per cent of the consumer basket, controls were subsequently reintroduced in steps on the basis of a State Council Decree of 1988 which allows the authorities to "prevent unlawful increases in prices". The Decree establishes fixed prices, ceiling prices and the monitoring of profit margins as instruments. Since January 1995, prices covering only 54 per cent of the consumer basket have been free of administrative controls. Fixed prices apply to energy products, post and telecoms and tobacco products; and ceiling prices to most fuels. Meanwhile, the monitoring of profit margins of both producers and traders applies to goods declared to be of vital importance to the living standards of the population, including all basic food products, certain non-food products (e.g. pharmaceuticals), and passenger transportation. A Price Law was passed by parliament in 1995 enabling the government to introduce further price controls at its discretion. It has yet to be applied but, in the first seven months of 1996, the National Pricing Committee carried out three times more inspections than in all of 1995 (there were 500 inspections in July 1996 alone). The administrative structure for price controls is set to be strengthened further under a recent initiative (envisaging local structures and a larger number of controllers).

Distortions in producer prices for agricultural goods are pervasive and have increased in 1996 (including through export restrictions on grains). Uniquely in central Europe, agriculture is effectively taxed through the price and export regime (the tax amounting in 1995 to 37 per cent of gross value added in the sector).

At the same time, in 1996 there has been significant progress in adjusting administered prices, including fuels, electricity, heating, urban transport, railways and telecoms, to cost-recovery levels. Formulas have been introduced which automatically adjust prices to exchange rate movements and other key cost components on a monthly basis.

Competition policy

The Law on Commerce (1991) eliminated *de iure* monopolies and the Law on the Protection of Competition (1991) 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 with *ad valorem* duties was adopted in 1992, with tariffs ranging from 5 to 40 per cent, few exemptions and a relatively low dispersion (average unweighted rate is 15 per cent). Specific duties apply to a few commodity groups. Only one formal import quota remains (on ice cream). Export restrictions on agricultural and certain other commodities (taxes and selected bans), however, have significantly increased in scope. Efforts to join the WTO have intensified, and accession is now expected during the second half of 1996. WTO's tariff bindings are generally below actual tariffs in Bulgaria, promising further liberalisation. However, an across-the-board import surcharge of 5 per cent was introduced in June 1996 as part of a fiscal stabilisation programme.

Currency convertibility

The lev has been floating freely on an interbank market 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. There is freedom to purchase domestic forex accounts and contract forex denominated loans; otherwise capital account transactions remain restricted. A foreign exchange crisis in 1996 has led to *de facto* restrictions on drawdowns from foreign currency deposits but no new current account restrictions have been reported. There are no operational intergovernment barter or payment arrangements, except for a gas delivery contract with Russia which will expire in 1996.

Wage liberalisation

Since 1991, the government has been imposing ceilings on the annual percentage increase in the wage bill of state enterprises. An excess wage tax applies when the ceiling is exceeded. In 1993 the ceilings began to be based on tripartite discussions between government, unions and employers in order to check social tensions. The ceilings have not allowed wages to keep pace with inflation. This has led to sustained declines in real wages except for a brief period towards the end of 1995. A continuation of the restrictive incomes policy has been agreed between the government and the IMF for 1996 as part of an effort to contain the fiscal deficit, the current account deficit and inflation.

Interest rate liberalisation

Interest rates were freed in 1991. However, due to a thin deposit base, the central bank refinancing rate has dominated interest rate developments. Real rates on credit turned positive in 1995 and the lending/deposit spread was significantly reduced as a temporary tightening of monetary policy led to increased competition for deposits. Spreads increased again to more than 50 per cent in mid-1996 as inflation soared, and both lending and deposit rates turned highly negative in real terms. Most lending in the interbank market has been made by the State Savings Bank; since June 1996, however, interbank lending and deposits by the SSB have been proscribed, except if collateralised with government securities, under a programme of monetary stabilisation. Programmes of directed lending to the agricultural sector on favourable terms have been formulated by the government but not implemented for lack of funds.

Financial institutions

Banking reform

The initial breaking up of the monobank in 1989 has been followed by various consolidation rounds coordinated by the Bank Consolidation Company, the state holding company for the banking sector. At the same time, there has been significant market entry by private domestic and foreign operators. In early 1996, the sector encompassed 49 banks, of which 10 were majority state-owned and 10 were branches of foreign banks or had foreign capital. Domestic private banks held 16 per cent of the assets of the banking system (which totalled Lv 758 billion). All banks are licensed as universal banks.

Bulgaria's banking sector is insolvent, with estimates of negative net worth ranging from US$ 1 billion upwards. The financial position of the sector reflects the banks' funding of state enterprise losses. Classified loans rose to 40 per cent of GDP (75 per cent of the loan portfolio) in 1995. Legislation to recapitalise state banks was passed in December 1993, and long-term (low-yielding) so-called ZUNK bonds, with a total lev-value equivalent to US$ 2.7 billion, had been issued by December 1994 to replace (on the asset side of the banks' balance sheets) pre-1991 non-performing claims on enterprises (with a nominal lev-value equivalent to US$ 1.8 billion). However, the bonds were low-yielding, so the banks were still left in a difficult cash-flow position. Moreover, recapitalisation was not supplemented with structural reforms to impose greater financial discipline at the enterprise level, and banking regulation and supervision remained wholly inadequate. Legislation to allow the liquidation of insolvent banks was passed only in May 1996. The absence of prudential regulations on foreign exchange cover allowed banks to run up very large open positions.

During 1996, there have been intermittent runs on deposits, including a drawdown of foreign exchange deposits from US$ 2.2 billion down to US$ 1.7 billion between January and May. Liquidation procedures have been initiated against two medium-sized banks (including the largest private bank) and four small banks. In May, the authorities adopted a programme of banking sector reform, including a partial deposit guarantee scheme, limited capitalisation, restrictions on unsecured financing by the central bank, work-out procedures for 19 ailing banks and improved supervision and accounting practices. The work-out procedures focus on loan recovery, place severe restrictions on lending and provide a time-table for capital accumulation (zero capital adequacy by December,

and 2 per cent by end-1997). The net worth position of the seven state banks in the restructuring programme was improved via a transfer of US$ 400 million in dollar-denominated government bonds previously held by Bulbank (which received cash for 50 per cent of the value). Further government contributions to recapitalisation are only to be made in the context of a privatisation of the banks, once buyers have been identified.

Non-bank financial institutions
There are around 30 active insurance companies operating on the basis of laws dating back to 1948. Life insurance penetration (ratio of premiums collected to GDP) was the highest of all transition economies in 1994, with 1.8 per cent. The draft of a new insurance law has been discussed since 1992. Foreign insurers are not allowed to establish subsidiaries in Bulgaria except in joint venture with local partners until five years after enactment of the new law. Private pension funds have been established, but operate in a legal vacuum and remain weak. By mid-August, 92 Privatisation Investment Funds had been licensed under the Mass Privatisation Scheme, and had succeeded in attracting approximately two-thirds of the vouchers that had been issued to the population. The first round of privatisation auctions is expected for October.

Securities markets and instruments
A primary securities market started operating in 1990 with state securities. A full range of 3-, 6- and 9-month T-bills has been issued since 1993, as well as longer-term (up to 10 years) treasury bonds. During the first five months of 1996, government lev-denominated securities worth the equivalent of approximately US$ 1 billion were issued, and secondary market trading totalled US$ 11.2 billion (more than 90 per cent with central bank as counterpart). A law on securities, stock exchanges and investment funds (July 1995) regulates proceedings connected with the trade in securities and created the Securities and Stock Exchange Commission (which regulates and supervises the issue of and transactions in securities). Seven stock exchanges and a large number of commodities exchanges started operating in 1992. These merged in early 1996 after minimum capital requirements were increased to Lv 200 million. The merger – together with a capital contribution by the government – led to the creation of the Bulgarian Stock Exchange. Trading in equity securities has remained thin because of the limited progress made in privatisation. Daily turnover has been less than US$ 50,000 and almost ceased entirely in mid-1996.

Fiscal and social safety net reform

Taxation
Fiscal reform was initiated in the early 1990s. The principal innovation to date has been the introduction of an 18 per cent tax on value added in April 1994. This was increased to 22 per cent in July 1996, as part of a fiscal stabilisation programme which also encompassed increases in excise taxes and a flat import surcharge. Indirect taxes raised the equivalent of 12 per cent of GDP in revenues in 1995, while direct taxes raised the equivalent of 8 per cent of GDP (half from profit tax and half from personal income tax). Social security contributions generated revenues equivalent to 8 per cent of GDP. Tax relief for companies with foreign equity participation has been eliminated. The tax administration showed weaknesses in 1995 and early 1996, when revenues undershot budgetary targets by a significant margin.

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 11 per cent of GDP in 1995, real benefit levels were extremely low. Parliament approved a Law on Social Insurance in December 1995, preparing the ground for a separation of social security from the budget, raising the mandatory retirement age, and revising the benefit formula to account for lifetime contribution rates.

Investment legislation

Extensiveness
Laws exist regulating domestic and foreign investment, directly, and through indirect investment vehicles, such as securities or investment funds. No governmental approval is required for most investment proposals in the country. Profits are freely convertible and may be freely repatriated, except in cases where assets are acquired in the privatisation programme with part-payment in Brady bonds, in which case certain restrictions apply (see above section on privatisation). There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Although ownership of land by foreigners is not permitted, foreign-owned local companies may own land, except land intended for agricultural use. Security interests over shares and land may be created. Security interests over land require notarisation. Security interests over contracts, receivables and moveable assets appear possible.

Effectiveness
The full texts of laws relating to investment are published, usually within one month of enactment. Draft laws are usually published and accessible to practitioners. Public records in share or land registries may be up to three months behind current status. Court decisions are generally available to practitioners. Independent professional legal advice is available. Private parties believe that courts would recognise and enforce their legal rights, including against the state. Foreign arbitral awards are generally required to be recognised and enforced without a re-examination of their merits.

Croatia

The first elements of "market socialism" were introduced in 1952. In 1976 an "associated labour" law institutionalised "social ownership". In 1989-90 the so-called "Markovic reforms" included widespread price, import and foreign exchange liberalisation. A programme of reform was adopted in the second half of 1991, which included further liberalisation and led to the creation of an independent central banking system, the introduction of temporary currency, and a national budget. The framework for private ownership was laid down. In October 1993 the government adopted a comprehensive macroeconomic stabilisation and reform programme.

Enterprises

Size of the private sector
The private sector is likely to account for about 50 per cent of total GDP, based on statistics from ZAP, the domestic payments transfer agency. In addition a significant proportion of private sector activity may escape the official statistics.

Large-scale privatisation
The inheritance of "social ownership" from former Yugoslavia provided for a degree of self-management at the enterprise level at the time of Croatian independence. The Law on the Transformation of Enterprises with Social Capital (April 1991), administered by the Privatisation Fund, required the conversion of almost all socially owned enterprises into joint-stock companies. By the end of 1995 about 1,200 out of a total 2,750 had been converted and wholly sold to their employees or management (often with deferred payment, see below) and in another 900 the state retained only a minority stake.

In practice, much of this privatisation did not succeed in greatly accelerating restructuring. Partly as a consequence, parliament approved a new privatisation law in February 1996. This provides a framework for the privatisation of large public enterprises. Within this framework, vouchers will be distributed to refugees, war invalids and other displaced persons who could use them to bid for shares, either directly or through investment funds – a new law on investment funds has also recently been approved by parliament. Vouchers are likely to be distributed to about 300,000 people in all, representing 10-15 per cent of the total nominal value of Croatian enterprises (about DM 3 billion). Work is still continuing on the finalisation of the eligibility list for the receipt of vouchers and the list of enterprises for which voucher holders may bid.

The new privatisation law has also extended the period over which employee and management shareholders may pay their instalments under the earlier law, from five years to 20 years. A discount scheme encourages early payment. The new privatisation law also provides framework guidelines for the sale of several large public enterprises including INA (the oil and gas conglomerate), electricity generation and distribution, TV and radio, and telecoms. It is envisaged that foreign bidding will be permitted for at least some of these enterprises.

Small-scale privatisation
Extensive small-scale private sector activity already existed under 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 in preparation.

Growth of private enterprise
The number of registered private companies increased from 55,000 in December 1992 to 122,000 in January 1995. However, many of these enterprises are inactive. Statistics from ZAP show that the number of active enterprises increased from 35,000 in 1993 to 60,000 in 1995.

Enterprise restructuring
Most enterprises now face a hard budget constraint. Access to soft credit through the banking system has been heavily curtailed and government subsidies sharply reduced. Although workers' councils for enterprises have been replaced by management boards there has, in practice, been only limited success in the transformation of management structures. In most privatised enterprises, the absence of a strong majority owner has inhibited restructuring. New shareholding structures have not in many cases led to the mobilisation of new capital investment or the injection of better management. Nor is the Croatian privatisation fund, where it is the majority owner, equipped to provide these.

A Bankruptcy Law was adopted by parliament in June 1996 and will become effective from the beginning of 1997.

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 Law on Competition and Monopoly was passed in the autumn of 1995, dealing with conditions prohibiting restraints on trade, monopolistic practices, and abuse from mergers and dominant positions. The law creates a Council for Competition Protection, which is operative and has already delivered some opinions on draft laws to parliament. However, the law is not yet fully operational and the Competition Protection Agency is yet to be established to implement the policy.

Trade liberalisation
The foreign trade system is liberal. Most quantitative restrictions have been removed. The new Law on Trade applies import quotas to less than 1 per cent of tariff items, mainly petroleum derivatives, fertilisers and cement. Export quotas still apply to 35 items, mainly timber, crude oil and natural gas. Import licences also apply to some pharmaceuticals, works of art and some other items. A new customs tariff law brings Croatian tariff codes into line with international practice, which is transforming almost all the remaining import restrictions into tariffs.

Croatia has applied for membership of the WTO and it is expected that negotiations will continue into 1997. Trade with the EU is still maintained on the basis of the agreement of the EU with former Yugoslavia. Croatia has been pressing the European Community to negotiate a cooperation agreement with a view to a full EU association agreement. It is expected that negotiations with countries of the Central European Free Trade Agreement, which have made slow progress so far, are likely to accelerate as Croatia approaches full WTO membership.

Currency convertibility and exchange rate regime
The exchange rate of the national currency, the kuna, is floating, but the National Bank intervenes in the light of market conditions. Croatia officially notified the International Monetary Fund in 1995 that it accepted all obligations under Article VIII (implying a commitment to full current account convertibility) of the IMF Articles of Agreement. Croatia is also committed to further liberalisation of the capital account, including relaxation of restrictions on investments abroad by local residents.

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 rates. The state-financed rehabilitation (see below) of two large banks, Rijecka Banka and Splitska Banka, triggered sharp reductions in the interbank rate in the spring and summer of 1996, introducing greater competition.

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 re-capitalised) and the Law on the Deposit Insurance Agency were passed by parliament in June 1994. In November 1995, Slavonska Banka (the fifth largest) entered rehabilitation, followed in the spring of 1996 by Splitska Banka and Rijecka Banka. In July 1996 it was also announced that Privredna, the largest bank, would also be put in rehabilitation and the BRA are now drawing up a full restructuring programme. In the rehabilitation phase, the bad claims of these banks are written off against the banks' capital with the state agency injecting bonds and cash into the banks, acquiring a majority shareholding. According to the law these banks will subsequently be privatised. Over fifty commercial banks are registered but the four largest account for three-quarters of all bank assets.

In mid-1995, savings and loans associations were put under the control of the National Bank. Out of about 40 operative savings banks in existence in mid-1995, 21 had obtained a licence from the National Bank and were operative in mid-1996.

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 the autumn of 1994, but the securities markets are developing slowly. The Zagreb stock exchange holds auctions for privatisation shares each week. Very few shares are listed and traded, although the spring 1996 listing of Pliva (a Croatian pharmaceutical company) on the London Stock Market (it is also listed in Croatia) has greatly increased interest in the market. Total stock market turnover in 1995 was about DM 66 million. There has been modest activity in a recently established informal over-the-counter market. In the spring of 1996 a law regulating securities and a new law regulating investment funds were both passed by parliament. These laws create a Securities Commission to oversee the issuance and trading of securities, provide trading regulations, lay down provisions for the protection of investors and create a framework for take-over legislation. In addition to the Zagreb stock exchange an OTC market exists in Varazdin and Osijek.

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 are 26.5 per cent on many goods, but 20 per cent on petrol, cigarettes and alcohol. VAT will replace the current turnover/sales taxes at the beginning of 1997, at a flat rate of 22 per cent. Excise duties on, *inter alia*, petrol and alcoholic and non-alcoholic drinks, coffee and tobacco, were introduced in mid-1994. Income tax is levied at 35 per cent for gross incomes above 2,100 kuna and 25 per cent of gross income below that level. Local income taxes exist in most cities, ranging from 5 per cent to over 20 per cent. Sales taxes raise nearly half of total income, excises about 17 per cent, and income and profit taxes about 16 per cent, taken together.

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. The workforce is estimated at 1.3 million.

Investment legislation

Extensiveness
Laws exist regulating domestic and foreign investment, directly and through indirect investment vehicles. Such investment generally

requires no government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners and nationals may, subject to reciprocity and usage restrictions, own or lease land. Security interests over shares and land may be created and require, in the case of land, notarisation, and in each case entry in an official register. Security interests over contracts, receivables, and moveable assets are possible, and in some cases require notarisation and registration.

Effectiveness
The full texts of laws relating to investment are published, usually within one to six months of enactment. Draft laws are usually published and accessible to practitioners. Public records in share or land registries may be up to 12 months behind current status. Important court decisions are usually published or accessible to practitioners within 12 months of issue. Independent professional legal advice is available. While private parties generally believe that courts will recognise their legal rights against other private parties, they do not believe the courts would enforce such rights against the state. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits.

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, the implementation of which continued after the dissolution of the CSFR in January 1993. The Czech Republic's mass privatisation programme was completed in March 1995; full current account convertibility was introduced in October and at the end of the year the Czech Republic became a member of the OECD, the first country in the region to do so.

Enterprises

Size of the private sector
According to official estimates from the Czech Statistical Office, the non-state sector accounted for 64 per cent of GDP in 1995, and almost 74 per cent in early 1996. This includes many enterprises in which the state, through the National Property Fund (NPF), continues to hold a minority share. Taking into account the continued growth, some of which may be under-recorded in official statistics, the private sector may have accounted for 75 per cent of GDP in 1996.

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 Kcs 650 billion) it comprised sales of shares (for cash) to domestic and foreign investors and the transfer of Kcs 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 for 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. In total, approximately 70 per cent of the vouchers had been placed with investment funds (so-called IPFs) which had used them to purchase shares. The Ministry of Privatisation was dissolved in mid-1996 and its remaining functions transferred to the Ministry of Finance.

Following the completion of mass privatisation, sales of state-owned companies have continued through standard methods (direct sales, public auctions and public tenders). According to the National Property Fund (NPF), the pace of privatisation accelerated in the first four months of this year as a result of an increase in the number of direct sales (540 were completed, which was almost half the total completed for 1995 as a whole), while there was also an increase in the number of auctions held. By the first quarter of 1996, over 90 per cent of all the property originally designated for inclusion in the large-scale privatisation programme had been transferred into private ownership.

In addition, the NPF retains shareholdings either as residual holdings in partly privatised companies or through its holdings in designated "strategic" enterprises. The value of NPF shareholdings was estimated at Kcs 210 billion in mid-1996, of which holdings in strategic enterprises accounted for almost Kcs 160 billion. The NPF is currently selling its residual holdings. Before the elections, the government indicated its intention of privatising the strategic companies by direct sales, including sales to foreign strategic partners. Initial cases of this approach were the sales of 49 per cent of the state-owned petrochemical company and 27 per cent of SPT Telecom to two consortia of Western companies, which were finalised towards the end of 1995. Both sales, especially the latter, contributed to the US$ 2.5 billion of foreign direct investment recorded in 1995. The new government has yet to announce its decision on the privatisation of other "strategic" entities, including the railways and the utilities.

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. Direct foreign ownership of land is not allowed, but ownership through a Czech legal entity wholly owned by foreigners is permitted.

In agriculture, farming in the communist period was carried out in cooperatives and on state farms. By 1993 the cooperatives had been transformed into either share-owning cooperatives or commercial companies; by mid-1995 almost 250 of the 316 state farms had been privatised. At the time it was estimated that 40 per cent of the agricultural land had been privatised (although small farms were never formally nationalised under the previous regime, but were in practice farmed under cooperative arrangements).

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 to be in the range Kcs 70-120 billion. The question of the return of property to the church is currently under discussion.

Growth of private enterprise
By 1994 the number of industrial enterprises had increased to 4,024 from 2,416 in 1992. Employees in enterprises with private ownership represented 58 per cent of total employment in 1994. Both SMEs and self-employment have accounted for a growing share of total employment.

Enterprise restructuring

One of the main features of Czech privatisation has been that privatisation has invariably preceded restructuring, with the latter to be carried out by the new owners. Until recently, the main pressure on enterprises to restructure came from a combination of tight subsidy and credit policies as well as import liberalisation. Commencing in 1995 there has been a consolidation of ownership among many enterprises, commonly known as the "third wave" of privatisation. An active role in this process has been played by the IPFs (as noted above, IPFs were among the largest owners of enterprises following privatisation, although they were restricted to holding no more than 20 per cent of the shares of any one company, while the holding in any one company cannot represent more than 10 per cent of the IPF's portfolio).

This process of consolidation accelerated in the first half of this year, partly because of the amendment to the Commercial Code (see below), which required those with majority holdings to offer to buy out other shareholders at the market price which prevailed over the previous six months. In addition some funds converted into holding companies where the regulations on ownership are less onerous. A number of large, domestic companies have also played a major role, while certain foreign purchasers have taken strategic stakes in companies. Although accurate data on trends in ownership are hard to come by, some unofficial estimates suggest that by mid-1996 many companies included in the mass privatisation programme had either dominant or majority owners. These trends, combined with the increase in fixed investment, is an indication that further restructuring is underway.

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 three-month protective period (which can be extended to six months in special cases). The law was amended in October 1995, so as to make it more difficult for bankrupt enterprises to request a grace period and to limit their ability to block creditors' claims. In March 1996 parliament approved another amendment (which took effect in June) which is intended to simplify bankruptcy procedures. The number of bankruptcies declared to date remains at a low level, although the flow of cases has increased over the years, according to figures from the Czech National Bank (CNB), from 60 in 1993, to 288 in 1994 and 393 in January-July 1995. Latest estimates suggest there has been a further increase in the number of bankruptcies in the first quarter of 1996.

In July 1995, parliament approved an amendment to allow companies to write off bad debts. For debts which were due to mature before the end of December 1994, firms can write off up to 10 per cent of their unpaid receivables from their pre-tax results each year. For bad debts with a maturity date after the end of December 1994, firms can claim the cost of provisions which range from 20 per cent on debts which are more than six months overdue up to 100 per cent on debts which are more than 36 months overdue, providing attempts have been made to recover the debts.

Markets and trade

Price liberalisation

Price liberalisation commenced in January 1991 and by the end of the year most prices had been deregulated. The only remaining significant controls pertain to utility charges such as heating, rents and public services, including transport. Mark-ups in the energy sector remain closely regulated. Regulated prices are, however, raised periodically, most recently in the case of gas and electricity prices for residential consumers in July 1996.

Competition policy

The Competition Law, passed in 1991, is designed to promote competition, avoid abuse of monopoly power and advise on mergers. It was amended in November 1993 to widen the definition of illegal practice, increase maximum fines and make the law more consistent with EU legislation.

Trade liberalisation

Almost complete liberalisation of quantitative controls on imports and exports was undertaken in 1991. The Czech Republic became a member of the WTO in January 1995. The Czech Republic maintains a very liberal trade regime; the average nominal import tariff is 8 per cent on an MFN basis and 6.8 per cent on a GSP basis, with an average weighted tariff of between 5.5 and 5.9 per cent. There are no serious administrative barriers to trade. As a result of the tariff reduction commitments of the Uruguay Round, the average tariff on an MFN basis will fall to 6.3 per cent.

Regional trade agreements account for some 80 per cent of merchandise trade and cover all of the Republic's main trading partners with the exception of Russia. In June 1995, 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 ceased from October 1995, although the customs union between the two countries has been maintained. Besides the customs union with the Slovak Republic, and membership of CEFTA, the Czech Republic has a Europe agreement with the EU (under which quotas on steel exports to the EU were abolished in January 1996 and restrictions on textile exports are due to be removed in January 1998).

Currency convertibility and exchange rate regime

The new Foreign Exchange Law, effective on 1 October 1995, provides full current account convertibility (IMF Article VIII obligations were accepted on the same day) and partial capital account convertibility. Czech citizens have the right to convert crowns into hard currency to buy foreign real estate, and Czech companies have the right to buy foreign currency to make investments abroad. Under the current law on inward investment, foreigners can repatriate profits and income from investment and other sources.

The exchange rate is pegged to a basket comprising the Deutschmark and the US dollar, with approximate weights of 65 per cent and 35 per cent, respectively. As a result of the substantial capital inflows during 1995, which with the fixed rate regime made it increasingly difficult for the Czech National Bank (CNB) to meet the inflation target, the CNB widened the fluctuation band around the central parity from +/- 0.5 per cent to +/- 7.5 per cent at the end of February 1996.

The implementation of monetary policy was complicated by the strength of capital inflows during 1995 and early 1996, much of it reflecting an increase in borrowing by domestic enterprises, utilities and banks. The CNB attempted to sterilise these flows in 1995, issuing its own paper, but also introduced various administrative measures in an attempt to slow the inflows, such as the limits that were placed in June 1995 on the amount of foreign currency borrowing banks could undertake.

Wage liberalisation

A tax on "excessive wage 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 this ceiling on the grounds that it was becoming the minimum level for wage increases. The minimum monthly wage was increased to Kcs 2,500 (US$ 96) at the beginning of 1996. The average monthly wage in 1995 was Kcs 8,154 (US$ 315).

Interest rate liberalisation

Interest rates were completely liberalised in April 1992.

Financial institutions

A two-tiered banking system was adopted in 1990. The CNB was established in January 1993 as the successor to the former State Bank of Czechoslovakia. At the end of March 1996, the Czech banking sector included 55 licensed commercial banks, including 14 wholly Czech-owned banks, 13 partly foreign-owned banks, 12 entirely foreign-owned banks, 9 branches of foreign banks, 6 building societies and one state financial institution. One of the newest banks is the Czech Export Bank (49 per cent state owned). All the banks operating in the Czech Republic are joint stock companies. The only exception is the state-owned Consolidation Bank. The latter was established in March 1991 to take over Kcs 110 billion of bad credits that were extended prior to 1989. However, the state, through the NPF, retains a substantial minority ownership in the main banks (47 per cent in Komercni, 43 per cent in the Savings Bank and 33 per cent in the Investment and Post Bank, with a further 7.6 per cent share held by the postal service), while the CSOB, the international trade bank, is owned by the Czech and Slovak authorities.

Following the rapid growth of banks in the early 1990s, the CNB restricted the issue of new licences as part of its aim to consolidate the sector. This included licences for foreign banks, although the moratorium on foreign bank licences was withdrawn in the first half of 1996 in response to the need to develop greater competition in the banking sector. At the end of 1995, the share of private Czech companies and natural persons in bank capital was 45.7 per cent; that of wholly owned foreign banks was 22.8 per cent with the balance reflecting state ownership. However, the state share is expected to fall substantially in coming years with the completion of privatisation of the main banks.

Most prudential regulations follow those of the EU, including the need for banks to meet the 8 per cent capital adequacy ratio by the end of 1996. For the sector as a whole, the capital position has gradually strengthened, so that at the end of 1995 the risk weighted capital adequacy ratio was 12.2 per cent, one percentage point more than at the end of 1994.

The volume of non-performing loans remains a problem and reflects bad credits inherited from the pre-1989 period (especially among the main banks) as well as more recent non-performing loans. The overall volume of classified credits was CZK 352 billion by the end of the first quarter of 1996, a little over 35 per cent of the total stock of credits of the banking system. The growth of "loss credits" (complete write-offs) has slowed; they accounted for 0.7 per cent of total credits in the first quarter of 1996. Since 1995 banks have been required to increase provisions. At the end of the first quarter of 1996, reserves and provisions amounted to CZK 109 billion. Legislative changes in 1995 allowed banks to claim tax relief on provisions against classified loans.

In January 1996, the CNB announced further measures to consolidate the banking sector. The measures were aimed mainly at the smaller banks. The banks are required to increase their share capital to cover problem loans, with the possibility that other investors will be sought if existing shareholders are unable to provide the increased capital. The main principle is to ensure bank shareholders meet the consequences of their bank's lending decisions; the interests of depositers have been covered by the Deposit Insurance Fund, with some finance provided by the CNB. The problems with small banks have, however, persisted this year. There have been a number of bank failures, resulting in the CNB withdrawing licences, placing certain banks in administration, and encouraging mergers in other cases.

On account of accumulated loan losses, the CNB closed Kreditni Bank, one of the country's larger banks, in early August 1996, and placed Agrobanka, another large bank, under administration in September. Ceska Pojistovna, the country's main insurance company, was the largest shareholder in Kreditni Bank.

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. A money laundering act was approved by parliament and came into force in July 1996.

Non-bank financial institutions

According to the Czech Statistical Office, there were 444 investment funds and companies registered in the first quarter of 1996 (compared with 410 in the first quarter a year earlier), 34 insurance companies and 21 health insurance companies.

Securities markets and instruments

The Law on the Stock Exchange and Securities was adopted in 1992. There are currently two main markets. The Prague Stock Exchange, which is used mainly by professionals, and the RM-system (originally established to handle trade in privatisation vouchers, though now used mainly by individuals) began operating during the first half of 1993. Foreigners are free to trade shares (except bank shares for which they need the explicit approval of the CNB). Profit repatriation is subject to the payment of income taxes on capital gains.

The Stock Exchange itself, comprising both the listed and unlisted equity and bond markets, is itself divided into three main tiers. With effect from 1 September 1995 securities traded in the former quoted and unquoted markets were divided into three (primary, secondary and free market), with the intention of improving the effectiveness of trading. The overall capitalisation of the Stock Exchange was estimated at nearly US$ 25 billion by the end of the first half of 1996, of which the primary and secondary share markets represented US$ 15 billion and the bond market US$ 3 billion. The capitalisation of the free market was US$ 6.4 billion, most of which was accounted for by unlisted equities.

In February 1995, the Rules for Direct Stock Exchange Trading were amended to allow automated data processing. In March this year, in addition to trading at fixed prices, the Stock Exchange introduced continuous trading at variable prices. Although there has been a sharp increase in the volume of trading, the Stock Exchange is not yet used by companies as a source for raising new capital.

In April 1996, parliament passed amendments to three pieces of legislation designed to improve the transparency and operation of the securities market. An amendment to the Commercial Code sets out thresholds for the disclosure of acquisitions or investments in a company, designed to give some protection to minority shareholders. An amendment to the Investment Funds Act requires them to provide more information on a regular basis, while the Securities Law was amended to improve the operations of the Securities Centre. Following the passage of the amendment on the investment funds, a number of funds converted themselves into holding companies.

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. There have been several changes to tax rates since then, including some important changes 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 was the first of a series of VAT reductions aimed at harmonising tax rates with those applied in the EU. Since 1 January 1996, the basic rate of corporate tax has been 39 per cent. The marginal rates for income tax range from 15 per cent to 40 per cent. In March this year, the government proposed further reductions in the rates of both corporate and personal income tax.

Social security

The main elements of the social security system include social insurance which provides unemployment, health and pension benefits; state social support which provides benefits to specific groups, e.g. maternity and child benefit; and a system of income support for the most disadvantaged. Following the fiscal reforms of 1993, funding for these three main programmes was transferred from general taxation to an insurance based system, based on payroll taxes. The latter are currently set at 12.5 per cent of gross wages for employees and 35 per cent for employers. The present total of 47.5 per cent of gross wages compares with 49.5 per cent in 1993.

Further reforms to health care are likely since several health insurance funds have incurred losses while the debate on the future of health care funding is continuing.

Investment legislation

Extensiveness

Laws exist regulating domestic and foreign investments both directly and through indirect investment vehicles. Such investment generally requires no government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners and nationals normally may own or lease land. Security interests over shares and land may be created, and require, in the case of land, notarisation and entry in an official register.

Effectiveness

The full texts of laws affecting investment are published, usually within one month of being passed. Draft laws are generally not available to practitioners for comment. Public records in official registries may be up to six months behind current status. Important court decisions are usually published or accessible to practitioners within 12 months of the issue. Independent professional legal advice is available. Private parties generally believe that the courts will recognise and enforce their legal rights, including against the state. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits.

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 continued following Estonia's independence in August 1991 and accelerated in 1992 after the re-introduction of the national currency. Since then Estonia has progressed rapidly in structural reforms. Virtually all large and small-scale enterprises are in private hands. The trade and foreign exchange regimes are liberal, and the basic market economy institutions and legal infrastructure are mostly in place.

Enterprises

Size of the private sector
According to the Estonian Statistical Office, the private sector accounted for 64 per cent of GDP in 1995. Further private sector growth and finalisation of pending privatisations may have raised this ratio to 70 per cent of GDP by mid-1996.

Large-scale privatisation
By May 1996 virtually all of the 450 large and medium-scale enterprises that were included in the government's original programme for asset sales during 1993-95 had been privatised. In 1996 a majority stake in Estonian Air, the national airline, and Eesti Kindlustus, the state insurance company, were sold to foreign and domestic investors. A decision in favour of the sale of Esoil, the state fuel company, has also been taken by the government. The privatisation of the State Railway Company, Tallinn port and Estonian Telecom is envisaged for 1997-98. The Privatisation Act of 1993 allows for the sales of assets for both vouchers (up to 50 per cent) and cash.

The privatisation strategy under the 1993-95 privatisation programme was based on the East German Treuhand model. The majority of firms (433) were sold through tenders (9 international and 1 local) to strategic investors. The total purchase price in these tender rounds was about US$ 227 million. In addition, investors made contractual obligations to the Estonian Privatisation Agency regarding their intentions for investment and employment in privatised enterprises. Sales of minority stakes to the population (with payment in the form of vouchers that had been distributed to all residents) started in 1994 with public offering of 49 per cent of the Tallinn Department Store (51 per cent had previously been sold to a strategic investor). There are two types of privatisation vouchers: (i) "national capital vouchers", distributed to all residents with the number of vouchers per individual determined on the basis of his or her length of employment, and (ii) "compensation securities" for property that was expropriated in the 1940s. The face value of all vouchers is Ekr 300 (approximately equal to US$ 25), and they are tradable. Privatisation of the remaining state-owned enterprises, including utilities, will include public offerings of minority stakes for vouchers.

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 the end of 1994, privatisation of some 1,500 small enterprises (e.g. shops, other services and farms) had been largely completed through employee buy-outs and domestic auctions. An Act on Privatisation of Housing was passed in May 1993. As of April 1996 over 55 per cent of residential housing had been privatised. The privatisation of land has so far been the least successful part of the privatisation effort, partly delayed by continuing uncertainty regarding restitution of land, and a comparatively slow process of land registration.

Property restitution
More than 200,000 claims for restitution of pre-1940 property had been submitted by the April 1993 deadline. Of these claims, 80 per cent had been processed by October 1995. However less than a third of the processed claims have at this point resulted in completion of either restitution or compensation as the finalisation of these transactions has been a drawn-out process. Nevertheless, over a third of all the land that is claimed for restitution has been returned to the former owners.

Growth of private enterprise
The number of private enterprises in the Estonian Enterprise register had increased to over 60,000 by mid-1996. Some 10,000 new enterprises are established annually. The majority are, however, non-operating "shells".

The establishment of new private enterprises was first permitted by the adoption of the Enterprise Law in 1989. This law was replaced by a new Commercial Code in 1995. The new Code distinguishes between five different types of companies depending on the degree of shareholders' liability and management structure. The Code sets minimum capital requirements for different type of companies.

Enterprise restructuring
Competition from imports, tight credit policies and privatisation have provided a major impulse for enterprise restructuring. A Bankruptcy Law was passed in September 1992 and was quickly implemented, notably during the banking crisis of late 1992. Bankruptcy proceedings have been completed for some 20 medium-sized to large state enterprises and are in progress for another 20. In addition, a large number of small enterprises have been privatised through bankruptcy proceedings. The bankruptcy law does not make any provisions for restructuring.

Markets and trade

Price liberalisation
By the end of 1992 most price controls had been abolished. Utility tariffs and public housing rents remain regulated. Increases in administered prices are supervised by the Ministry of Economy and local municipalities. Electricity tariffs were raised in June 1996 (by 15 per cent for residential users and 35 per cent for industrial customers) but remain below full cost recovery levels.

Competition policy
A Competition Law was passed in June 1993 and amended in February 1995. Implementation is monitored by the Competition Board under the Ministry of Finance. Given the small size of the country, the main competitive force has been external trade, liberal rules for establishment of new companies, comprehensive privatisation, and tight subsidy and credit policies.

Trade liberalisation
The trade regime is among the most liberal in the world. Estonia is in membership negotiations with the WTO. A "Europe Agreement" with the EU was signed in June 1995 and the EU has become Estonia's largest trading partner. Estonia participates in the Baltic Free Trade Area alongside Latvia and Lithuania. 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 countries without a most-favoured-nation agreement, including Estonia.

Currency convertibility and exchange rate regime
An independent national currency, the kroon (or Ekr), was introduced in mid-June 1992 under a currency board arrangement whereby all kroons (cash, current and term accounts) issued by the Bank of Estonia (the central bank) are fully backed by gold and convertible currency reserves. The kroon continues to be pegged to the Deutschmark at Ekr 8/DM 1. There is full current account convertibility and no restrictions on the capital account. Estonia accepted obligations under the IMF Article VIII (obliging the government to maintenance of current account convertibility) in August 1994.

Wage liberalisation
Wage setting in the economy is free and decentralised except for civil servants and top management in state-owned enterprises. A minimum wage is set by the parliament. At end-1995, the monthly minimum wage was equivalent to US$ 40 and represented 20 per cent of the gross average wage.

Interest rate liberalisation
Interest rates are fully liberalised. While spreads between deposit and lending rates remain very wide, they have narrowed to less than 10 per cent during the first half of 1996.

Financial institutions

Banking reform
A two-tier banking system became fully operational after the currency reform in June 1992. During the four years to 1996, the number of commercial banks shrunk through liquidation and mergers from 42 to 14 (including a branch of one Finnish bank). The size of state holdings in the banking sector has been diluted and now (mid-1996) amounts to less than 15 per cent of the total share capital of the banking system.

The degree of market concentration is high. The six largest banks account for over 80 per cent of total assets and 70 per cent of share capital of domestic banks. Most bad loans were transferred to the state-owned North-Estonian bank in 1994. This bank had been created on the basis of two liquidated banks during the course of

1994. Since then, Estonia has been pursuing a regime of tight banking supervision, strengthened by the new Credit Institutions Act, which became effective in January 1995. A deposit insurance law has been drafted. A few Estonian banks have started to offer mortgages.

Non-bank financial institutions
As of September 1996 there were seven open-end and six closed-end investment funds in Estonia. Their activities are regulated by a number of government acts that were passed by parliament in 1994. A law on investment funds is being drafted.

There are 8 life and 16 non-life insurance companies, regulated by the 1992 Insurance Law (amended in 1995). A state-owned insurance company was recently sold to an insurance arm of a domestic bank. Leading domestic banks are increasingly active in the non-bank financial sector through their insurance and investment subsidiaries.

Securities markets and instruments
Before the opening of the Tallinn Stock Exchange in May 1996, shares in investment funds, enterprises and banks were traded over-the-counter at the computerised depository which opened in 1994. Stock market capitalisation amounted to 11 per cent of GDP as of mid-1996. Average total daily turnover at the stock exchange and over-the-counter market amounted to approximately US$ 1.1 million in July 1996.

The securities markets are regulated by the 1993 Securities Market Act and various other regulations adopted in 1994. The responsibility for coordination between the markets lies with the Securities Division of the Ministry of Finance, whereas supervision is the task of the State Securities Board.

Fiscal and social safety net reform

Taxation
The tax structure was changed substantially in January 1994 when a flat rate income tax of 26 per cent was introduced. Over 50 per cent of government revenues are derived from indirect taxes, notably from the VAT (currently set at 18 per cent). Excise taxes have been raised in 1996 to compensate for revenue falls from raising tax thresholds for direct and indirect taxes. The authorities are continuing their effort to bring the Estonian tax system in line with EU standards.

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 old-age pension (on a pay-as-you-go basis) was about 30 per cent of the average wage in 1995.

Investment legislation

Extensiveness
Laws exist regulating domestic and foreign investments both directly and through indirect investment vehicles. Such investment generally requires no government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners and nationals normally have the right to own or lease land but some regional restrictions may apply (a consent of the city/local government is required when there are such restrictions). Security interests over shares and land may be created, require notarisation and entry in an official register (in respect of shares, where such shares are dematerialised). Security interests over contracts, receivables and moveable assets are possible, and require registration where registries exist.

Effectiveness
The full texts of laws relating to investment are published, usually within one month of enactment. Draft laws are usually not circulated to practitioners for comment prior to enactment. Public records in land registries may be up to one month behind current status. There are no registries for certain types of moveable assets. Important court decisions are usually published or accessible to practitioners within 12 months of being issued. Independent professional legal advice is available. Private parties generally believe that the courts will recognise and enforce their legal rights, including against the state. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits.

FYR Macedonia

Reforms were initiated in 1989-1990 throughout the former Yugoslavia, including widespread price, import and foreign exchange liberalisation. FYR Macedonia gained independence in 1991, and established an independent currency in April 1992. The introduction of the new currency was accompanied by 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 sector activity, taking into account activity in the informal sector, probably accounts for 45-55 per cent of GDP.

Large-scale privatisation
As of July 1996 838 of the 1,217 enterprises covered by the law on transformation of social capital (passed in June 1993) had been privatised, mainly through employee buy-outs, or had become subject to liquidation proceedings. In most cases the only bidders have been management and employees. Using the same legal framework it is intended to increase the cumulative total of enterprises in privatisation to 900 by the autumn of 1996 and 1,150 by the spring of 1997. In addition, the privatisation (through the transfer of shares to employees and management) of about 400 enterprises has been initiated under a law which pre-dated the collapse of Yugoslavia.

In April 1996, parliament passed a law enabling privatisation of agrokombinats (the Law for Transformation of Enterprises and Cooperatives with Social Capital that Manage Agricultural Land), which control 15 per cent of total agricultural land. The remainder is in private hands. This law gives the Privatisation Agency (created under the main Privatisation Law) the authority both to force privatisation of the agro-kombinats and to hive off non-core businesses, including hotels, transport and milling and baking facilities. Privatisation plans are to be drawn up or liquidation proceedings initiated for at least 75 per cent of eligible enterprises in the agriculture sector, and at least two of the four largest agrokombinats are to submit proposals to the Privatisation Agency before the autumn of 1996.

Small-scale privatisation
Over 95 per cent of all enterprises are privately owned. Almost all of these are small (with less than 20 employees).

A number of impediments to the creation of a free market in urban land will be removed by a draft Law on Land Use, intended for parliamentary approval by the summer of 1997, which will limit restrictions on land to standard planning considerations, simplify the transfer of land ownership and privatise a significant proportion of state-owned land.

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

Growth of private enterprise
According to the Statistical Bureau, the number of private enterprises had increased from 6,000 in 1992 to almost 90,000 by July 1996. This represents more than 95 per cent of the total number of registered enterprises. Initially these were mostly very small firms, although several hundred medium-sized and larger firms have entered the group as a result of the privatisation of socially owned enterprises. According to data from the Payment Operations Service, which collects income statements from registered enterprises, just over 33,000 are active. Of these, 31,400 were formed privately and another 637 are privatised enterprises. These enterprises account for around 50 per cent of GDP and a similar share of employment.

Enterprise restructuring
Within the overall privatisation programme a "Special Restructuring Programme" (SRP) was introduced in 1994 to restructure the 25 largest loss-making enterprises, with the imposition of a hard budget constraint, and the preparation of a restructuring plan for each enterprise (including proposals for reductions in the labour force and the hiving-off of profitable or potentially profitable sub-units). This group of enterprises includes two utilities, three agricultural kombinats, four mines, six textile companies and six chemicals and mechanical and electrical machinery producers. The group accounts for over half the total losses of the enterprise sector. Plans to restructure the two utilities, electricity and rail, would bring about full cost recovery, achieved by a combination of cost savings through rationalisation and increases in pricing. It is now intended that by the spring of 1997 over 130 business units will have been identified for privatisation from these firms, in addition to 10 firms hived off from the railways and electricity utilities. Substantial downsizing of these enterprises has already been undertaken with over 14,000 employees, or around 25 per cent of the original work force, already made redundant.

The 1989 bankruptcy law of Former Yugoslavia is still in force. A new law is before parliament.

Markets and trade

Price liberalisation
About 90 per cent of prices in the retail price index are free of controls, including all retail prices for basic foods, except bread. However, guaranteed base prices for agricultural products remain for wheat, sugar, sugarbeet, sunflower and tobacco. There have been large increases in recent years in the relative price of electricity and oil derivatives, but further increases are required to bring prices to cost-recovery levels.

Competition policy
A draft anti-monopoly law has been in preparation for some time and is to be presented to Parliament before the end of 1996.

Trade liberalisation
Trade policy reform is well advanced, with the removal of import licensing and quantitative import restrictions for all but 4 per cent of all import categories (remaining restrictions apply mainly to chemicals, steel and some foodstuffs). Auction mechanisms have been created for imports still subject to quotas. A new customs tariff was introduced in July 1996 with rates ranging from zero to 35 per cent for most items. The new customs tariff system has seven bands (compared with the old system's 18 bands). The new system reduces the average rate to 15 per cent from the previous level of 28 per cent. A programme of further tariff liberalisation, consistent with negotiations for accession to the WTO, is being prepared. Administrative simplification will be achieved with the centralisation of all trade policy functions in one ministry, mainly by placing customs administration under the Ministry of Finance.

Currency convertibility and exchange rate regime
Officially, the denar has been floating since the beginning of 1994, but in practice it has remained closely aligned to the DM. 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 1996.

Interest rate liberalisation
Real interest rates are positive and largely market-determined, although a bank-by-bank credit ceiling has remained 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), which took over the bad loans of 17 of the major socially owned loss-making enterprises. 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 the BRA. The bank's balance sheet has been partly downsized and bad loans have been partly replaced by government bonds. Five of Stopanska Banka's largest branches were split off at the beginning of 1995 and are now operating as independent banks. The only branch of the former Ljubljanska Banka from Slovenia was established as an independent Macedonian bank in 1995. In April 1996, a new banking law was passed by parliament which brings the law close to internationally accepted banking standards. The National Bank Law was passed in 1992 and amended in the spring of 1996. The law provides for independence of the Central Bank and gives it the power to enforce compliance with its decisions. A significant improvement in banking supervision has taken place with the creation of a banking supervision department in the Central Bank. Several applications for banking licences from foreign banks have recently been received. The Commercial Bank Law, passed by parliament in the spring of 1996, creates the legislative framework to enable the imposition of a new deposit insurance scheme, but this has not yet been introduced.

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
A stock exchange was created in March 1996 but turnover is currently small.

Fiscal and social safety net reform

Taxation
Over the last three years a succession of measures have fundamentally reformed the tax system, including a sharp reduction in exemptions, the simplification of the structure of tax rates and the creation of an internal revenue service to enforce collection. In early 1994 the sales tax was streamlined, 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 have been simplified and the rates were increased on oil, alcohol, cigarettes and cars in the spring of 1994. Personal income tax rates have been consolidated and many exemptions have been removed. The main sources of revenue in 1995 were personal income tax (24 per cent), sales taxes (17 per cent) excises (28 per cent) and import duties (16 per cent).

Further major reforms are planned. These include the introduction of VAT, probably in 1998, to plan for which the government has already created a VAT development unit. This is already recruiting and training staff. The government is considering the elimination of extensive personal income tax exemptions, and the reduction of many of the remaining corporate tax preferences.

Social security
Extensive pension fund reform has been undertaken over the last three years with an increase in the retirement age and a reduction in pension entitlements. Means-testing has been introduced for most general social security benefits. There have been cuts in child allowances and also vacation allowances. Further measures are under consideration, including a reduction in the duration of cash benefits to the unemployed from the existing two years, further reductions in public pension provision and the introduction of some user charges in health care.

Investment legislation

Extensiveness
A law regulating foreign investment exists. Domestic investment is not regulated, but free market principles are guaranteed by the constitution. To a limited extent, legal provisions governing economically undeveloped areas involve the use of indirect investment vehicles. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners are prohibited from owning land. Security interests over shares and land may be created, and require entry in an official register. Security interests over contracts and moveable assets are possible.

Effectiveness
Generally, laws are published, usually within one month of enactment. Draft laws affecting investment are generally not published or accessible to practitioners. Public records in share or land registries may be up to six months behind current status. Despite requirement for registration, registers do not always exist. Important court decisions are usually published and accessible to practitioners. Independent professional legal advice is available. While private parties generally believe that courts will recognise their legal rights against other private parties, they do not believe that courts would enforce such rights against the state. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits.

Georgia

Early stabilisation efforts and structural reforms in 1992 were interrupted by a civil war which led to a drastic output decline and a suspension of structural reforms until autumn 1994. Since then, the government has implemented a comprehensive stabilisation and reform package.

Enterprises

Size of the private sector
The private sector may now account for about 50 per cent of GDP.

Large-scale privatisation
Large-scale privatisation began in 1994, and has accelerated over the past year. Around 880 medium and large-scale enterprises out of 1,189 enterprises identified for privatisation had been corporatised by June 1996. Of these, 407 had been privatised (in the sense that more than half of their shares had been sold to private entities or individuals). The government plans to complete the process by mid-1997. Privatisation methods include: a donation of 5 per cent of the shares to the employees; a management-employee buyout option at a 20 per cent discount for 51 per cent of the shares in each enterprise; a public offering at voucher-based auctions for a minimum of 35 per cent of shares; and cash-based auctions and/or tender for the remaining shares. A few larger enterprises may be sold in full through cash-based auctions. Foreign investors can participate in cash auctions.

While the employees at many of the corporatised enterprises applied for share options, most of them are facing difficulties in meeting the deadline for payment. Consequently, the payment deadline has been delayed several times: the final deadline for the payment is July 1996. Under the voucher programme that started in March 1995, vouchers with a face value of US$ 30 each have been distributed to the population. A total of 45 out of the planned 50 auctions had taken place by the end of June 1996. Around 30 per cent of the shares offered at these auctions had been sold. From August 1996 cash auctions are planned for the remaining shares. It is expected that bankruptcy proceedings will be filed against some enterprises with large unsold blocks of shares at the end of the privatisation programme.

Small-scale privatisation
Small-scale privatisation has been comprehensive. By June 1996, almost 10,000 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.

In March 1996, the Law on the Ownership of Agricultural Land had been passed. Under this law, farmers now have clearer property rights to land which was transferred to the farmers in early 1992 (representing a total of 22 per cent of agricultural land), and to land that was used for private gardens before 1992. The law provides for the rights of private entities to buy, sell, lease and inherit land, and this law applies to the land on which enterprises reside.

A significant share of housing in Georgia was already in private hands before independence. Privatisation of housing is now virtually complete.

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.

Enterprise restructuring
The enterprises have been faced with relatively hard budget constraints since the autumn of 1994, as government subsidies and directed credit to enterprises have been almost eliminated. Some degree of "hidden subsidisation", in the form of tolerance of payment arrears on energy bills, remains in place. Nevertheless, with the abolition of the state order system (see below) and improved energy tariff collection, such "hidden subsidies" are gradually being reduced.

A Law on Bankruptcy has been in place since 1991 but without any significant enforcement. A new bankruptcy law has been enacted this year and is to become enforced from January 1997.

Markets and trade

Price liberalisation
Administrative control of prices was abolished in 1994 with the exception of prices for bread, gas, electricity, municipal services, pharmaceutical products, public transportation and telecommunications. These remaining administered prices were increased to cost-recovery levels in September 1994, effectively eliminating all direct price subsidies (although, as noted above, incomplete collection of utility tariffs continued to represent an implicit subsidy to enterprises). The state order system was completely phased out on 1 June 1995.

A restructuring plan for the energy sector was implemented in 1995 to enhance efficiency. It was, however, ill-designed and reintroduced cross-subsidisation from enterprises to residential consumers, and a variety of tariffs for different distributors. In early 1996, a uniform wholesale tariff was established. Further reforms to the wholesale and retail tariff structures are planned.

Competition policy
An anti-monopoly law is expected to be enacted in 1996.

Trade liberalisation
The system of bilateral trade agreements had been eliminated by mid-1995. Subsequently, trading arrangements have been substantially liberalised: the export tax has been abolished and a unified import tariff structure has been introduced. Export licensing is being phased out gradually and most other export restrictions are to be eliminated by the end of 1996.

Currency convertibility and exchange rate regime
The Georgian coupon, which was introduced in April 1993, was replaced by a new currency, the lari, in late September 1995 and became the

only legal tender on 2 October 1995. The lari is fully convertible for current account transactions. The currency surrender requirement was eliminated towards the end of 1995.

Wage liberalisation
According to the official statistics, the average monthly wage in 1995 was 15.7 laris (US$ 13) and during the first quarter of 1996 this has risen to 23 laris (US$ 18) in the public sector and between 60 and 90 laris (between US$ 48 and US$ 72) in the private 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 free to set their own interest rates.

Financial institutions

Banking reform
A new Law on the Central Bank was passed in mid-1995 and a new draft Law on Banks and Banking Activity has been submitted to parliament.

The two-tier banking system was created in 1991. It consists of the National Bank of Georgia (the central bank), five specialised state-owned banks (in 1995, three of the five banks were merged), 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 75 per cent of the assets. Unofficial estimates indicate that bad assets comprise between 14 per cent and 35 per cent of the portfolios of state-owned banks.

The National Bank 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. By end-1995, over half of 229 operating commercial banks had been closed on the grounds of non-compliance with this standard. The remaining banks are to be audited by the National Bank and certified for household deposit taking. A study of the 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 any significant intermediation role in Georgia.

Securities markets and instruments
No stock exchange exists in Georgia.

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. Tax revenues remain at critically low levels. The fiscal strategy for 1996 continues to emphasise improvement in 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. Due to the serious budgetary constraints, measures to improve targeting and increase benefits began to be implemented in late 1994. Since then, pension payments to working pensioners have been terminated, provision of child allowance has been limited (while the amount per individual has been raised) and the pension age has been increased.

Investment legislation

Extensiveness
Laws exist regulating both domestic and foreign investment, directly and through indirect investment vehicles. Such investment generally requires no government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprise. Foreigners may not own or lease land. Security interests over shares and land may be created, and require notarisation and entry in an official register. Security interests over contracts, receivables and moveable assets may also be created, and require notarisation.

Effectiveness
The full texts of laws relating to investment are published, usually within one month of enactment. Draft laws are generally available to practitioners for comment prior to enactment. Public records in share or land registries may be up to six months behind current status. Court decisions are not generally available to practitioners. Independent professional legal advice is available, but only from a limited number of lawyers. Private parties generally believe that courts would not recognise and enforce their legal rights, whether against a state party or another private party. 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 untested in practice.

Hungary

Hungary became a member of the OECD in May 1996. Having experimented with increased enterprise autonomy since 1968, Hungary embarked on more ambitious market-oriented reforms between 1989 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 end 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 independent Hungarian research company GKI has recently published estimates, putting the share at 58 per cent for 1993, 65 per cent for 1994, 70 per cent for 1995 and 73 per cent for 1996.

Large-scale privatisation.
A number of large privatisation deals were completed in November-December 1995. In the largest individual deal, Magyarcom (the 50/50 joint venture between Ameritech and Deutsche Telekom) acquired 37 per cent of the shares of Matav (the main Hungarian telecommunications company) for US$ 852 million. The deal raised Magyarcom's total ownership share in Matav to 67 per cent. In addition, the government (and the municipality of Budapest) sold majority stakes in six regional gas distributors for a total of US$ 556 million, large minority stakes in six regional electricity distributors for a total US$ 1,114 million, and large minority stakes in two power generating companies for US$ 215 million. A majority stake in Budapest Bank was sold in December to EBRD and GE Capital for US$ 87 million. During the course of 1995 and the first half of 1996, the government sold 23 per cent of the shares in the largest bank, the National Savings Bank (OTP), to foreign investors for about US$ 53 million (with no single investor obtaining more than a 2.5 per cent stake). An additional 5 per cent was sold to OTP staff, and 24 per cent to other domestic investors. The government also sold, in 1995, an extra 28 per cent of the already partly privatised pharmaceutical company EGIS to NatWest Markets after which the EBRD and Natwest sold their shares in EGIS to the French company SERVIER which thereby became a majority owner

of EGIS. On the back of these and other deals, the total cash foreign investment inflow into Hungary rose in 1995 to about US$ 4.5 billion.

These transactions took place under the Privatisation Law that was passed by parliament on 9 May 1995. This law merged 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 law, 46 companies will remain fully state-owned, including postal services and the railways. The state will maintain majority stakes in MVM which holds the electrical grid and the country's only nuclear power plant (the state attempted unsuccessfully to sell 24 per cent of MVM in December 1995). The state will also maintain 25 per cent ownership in some of the largest banks.

Implementation of a so-called "simplified privatisation" procedure was devised in 1995. Each participating company was to have total assets of less than Ft 600 million and employed less than 500 people. Towards the end of 1995, the privatisation company held 300 qualifying companies. Under the simplified procedure, bids are evaluated and contracts signed by designated privatisation committees within 60 days of the bidding round. For companies that fail to attract bids, management may attempt to privatise the company or to proceed with a management buy-out with non-cash payment being an option. By September 1996, 118 companies had been offered for sale. Of these, 50 had been sold off in the first round and another 19 were certain to be sold to the incumbent management or employees.

The bulk of the "old" Hungarian industrial enterprises have been privatised, mainly in sales undertaken between 1991 and 1995. A broad indication of the extent of this process is contained in the following numbers. When the State Property Agency was created in 1990, it held the ownership rights to 1,857 enterprises. Since then, another 30 enterprises have been transferred to the SPA from other institutions (municipalities etc.). After liquidation of some of these enterprises and break-up of others, 1,676 joint-stock companies emerged from this initial grouping. By the end of March 1996, state ownership had been reduced to less than 50 per cent in 1,109 of these companies (up from 902 in April 1995). About 190 of the original 1,676 companies were in liquidation or liquidated (in March 1996) and another 62 had been transferred to other institutions (municipalities, ministries etc.), leaving 316 joint-stock companies with majority state ownership in the hands of the state privatisation agency.

Small-scale privatisation
Privatisation of state-owned shops and small enterprises is virtually complete. 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.

Property restitution
About 1.2 million Hungarians have been granted compensation coupons as restitution, mainly for nationalisation of property. Coupons have in practice been useable mainly towards the purchase of land, although shares in some industrial companies have also been offered for sale to coupon-holders.

By the end of 1994 about 2 million hectares of land had been sold to half a million people for compensation coupons. Coupons have been useable as a means of payment in auctions for 185,000 hectares of farmland. Shares in a number of enterprises have also been offered for sale against coupons. During 1996, shares in, for example, gas and electricity companies have been offered for sale to holders of coupons.

Growth of private enterprise
By March 1996, there were 878,215 registered businesses (up marginally from 874,830 at the end of 1994 but down from 901,642 at the end of 1995). Of these, 107,014 were legal entities (joint-stock companies, etc.) up from 90,824 at the end of 1994. At the end of 1995, each of about 45 per cent of the registered businesses provided full-time employment to at least one person. The remainder of the registered businesses were inactive.

Enterprise restructuring
Restructuring has been achieved mainly through subsidy reduction, tighter access to finance for loss-making enterprises, and greater competition on account of liberal rules for establishment of new companies and a liberal import regime. These factors have resulted in production cutbacks, rationalisation and reduction of employment in large former and current state-owned enterprises. The productivity of labour in the manufacturing sector has risen sharply in recent years (see Chapter 8).

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 the joint creditor-position on proposals for out-of-court restructuring settlements. The revision has slowed the rate of bankruptcies and liquidation: there were 343 new bankruptcy cases and 12,575 new liquidation cases between 1 January 1994 and the end of March 1996, compared with 987 bankruptcy cases and 7,242 liquidation cases in 1993 alone.

The framework for state-financed 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 led to restructuring of only about 20 per cent of enterprise 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. Following large increases in prices of electricity and gas during the course of 1995, prices for these products were raised further in March 1996 and were originally meant to rise again in October to a level that would ensure cost recovery for producers. Independent experts were to screen the energy sector to assess the required size of the final round of price increases in October 1996, before a move to a fixed formula linked to the overall producer price index. However, in late August the government decided, controversially, to postpone this price-jump until January 1997.

Competition policy
The Law on the Prohibition of Unfair Market Practices, passed in 1990, provided the initial 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.

On 25 June, the Hungarian parliament adopted a new competition law, modelled on European Union competition rules. The new law will become effective on 1 January 1997. It will, *inter alia*, replace the current law's restrictions on "unfair behaviour in the market" by restrictions on "unfair competition".

Trade liberalisation
Trade liberalisation was phased in gradually, mainly in 1989-91. 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, and to 90 per cent in 1991. It stood at 95 per cent in 1995.

Some consumer goods imports are regulated by the so-called "global quota", with individual ceilings set for about 20 product groups (mainly cars, textiles and precious metals). The aggregate value of the global quota has been increased gradually in recent years and was set at US$ 550 million for the first half of 1996, up from US$ 340 million during the same period of 1995. Importation of energy products, cars, and many agricultural products still requires a licence. So does exportation of energy products, pharmaceuticals and some agricultural goods.

Among the important vehicles for trade liberalisation in recent years have been Hungary's "Europe Agreement" with the EU (the trade protocol of which entered into force in March 1992). In addition, Hungary participates in the Central European Free Trade Association, which was established in 1993 (see details on the Europe and CEFTA Agreements in the 1994 *Transition Report*, pp. 108-109). Hungary was a member of GATT already in the 1980s and became a member of the WTO in December 1994.

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 and in trade with the other members of CEFTA.

On 20 March 1995, Hungary introduced an 8 per cent import surcharge on all goods, except primary energy carriers and machinery for investment. The government has announced a schedule for the phase-out of the import surcharge. It was reduced by 1 percentage point in July 1996, and will be reduced further by 1 percentage point in October 1996, and 2 per-

centage points in January 1997. The remaining four percentage points will be eliminated in June 1997.

Currency convertibility and exchange rate regime
The Hungarian authorities declared the forint convertible for current account transactions from 1 January 1996 by pledging compliance with Article 8 of the IMF agreements.

The exchange rate is pegged to a basket of currencies. The central rate against the basket is devalued daily at a pre-announced rate. The cumulative monthly rate of devaluation was reduced from 1.3 per cent to 1.2 per cent on 1 January 1996. The spot rate may fluctuate within a band of +/-2.25 per cent of the central rate. 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 government and the central bank have announced that, effective on 1 January 1997, the Deutschmark will replace the ECU in the currency basket to which the forint is pegged.

Capital account transactions have been liberalised gradually during the 1990s. Financial institutions and enterprises may borrow abroad long-term with approval from the central bank. For short-term borrowing abroad, financial institutions and enterprises are only required to report to (as opposed to obtain approval from) the central bank. Inward investment may occur without prior approval, except in the areas of banking and insurance. 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.

A number of measures were taken in mid-1996 to liberalise capital transactions so as to pave the way for Hungary's OECD membership (which became effective on 7 May 1996). Hungarian investors were granted permission to buy low-risk securities with more than one year's maturity from other OECD countries. The domestic Hungarian market was opened for trade in such securities. Foreigners were granted permission to invest freely in Hungarian debt instruments with more than one year's original maturity.

Wage liberalisation
Attempts to control wages by taxing wage increases above a defined limit were abandoned in 1993. About one-third of all employees are members of labour unions.

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 the end of 1994.

Majority stakes in the Hungarian Foreign Trade Bank, Budapest Bank and the National Savings Bank have been sold to private owners (see details on the latter two transactions above under "large-scale privatisation").

Two of the five largest 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 the end of 1997.

There is a substantial presence on the Hungarian banking scene of smaller private banks, most of them with foreign participation.

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. A new Insurance Law came into force on 1 January 1996. The law establishes an independent regulator with substantial powers of authorisation and intervention, in a move to adapt Hungarian regulation to that prevailing within the European Union.

The state-run 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. A large number of investment funds are active in Hungary.

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. By the end of March 1996, 42 stocks were listed. Equity capitalisation was Ft 577.2 billion (about US$ 3.8 billion) at the end of July 1996, more than twice the level at the end of 1994. A number of Hungarian companies are listed on western European and US markets.

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. The top rate (applying to annual incomes above Ft 900,000) was raised from 44 per cent to 48 per cent in 1996. There are two VAT-rates of 12 per cent and 25 per cent. Excise taxes (including on alcohol, tobacco and fuel) are also an important revenue source for the government.

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
The retirement age is 55 for women and 60 for men. A 1995 amendment raised the age at which the employer can initiate retirement for women to 56 but women can still choose to retire at 55. A 1996 amendment provided for a gradual increase in the legal retirement age to 62 for both men and women (to be phased in over the period to year 2007). Pensions have been indexed to net wages since 1992. Government efforts to tighten family allowances and sick-leave benefits were struck down by the Constitutional Court in June 1995. Eligibility for unemployment benefits has been tightened substantially over the past four years.

Employer and employee payroll tax contributions (covering contributions to funds for pensions, health, unemployment insurance and vocational training) were lowered from 52.5 per cent and 12 per cent respectively of the wage sum in 1993 to 50.5 and 11.5 per cent in 1994, and to 50.1 and 11.5 per cent in 1995.

Kazakstan

A comprehensive reform programme was implemented in January 1993. Tighter monetary and fiscal policies since mid-1994 have reduced inflation and succeeded in stabilising the currency. Banking reform has started more recently. The privatisation of large enterprises and farms is proceeding gradually.

Enterprises

Size of the private sector
According to official estimates, the non-state sector accounted for 20 per cent of GDP in 1994. By early 1996, this share had grown to more than 50 per cent (the non-state sector includes firms with minority private ownership). The private sector (excluding companies with majority state ownership) is likely to account for about 40 per cent of GDP.

Large-scale privatisation
Large-scale privatisation in Kazakstan has proceeded in three stages.

The Kazak government launched its first Programme on Destatisation and Privatisation in June 1991, alongside spontaneous ownership take-overs by employees and management. This programme aimed chiefly at the sale of retail trade and service facilities and the legitimisation of the transfer of state property to insiders (employees and managers).

The second such programme, which covered the period 1993-95, foresaw mass privatisation of medium- and large-sized enterprises (i.e those with over 200 employees) through auction sales of shares, with participation of investment privatisation funds (IPFs). This would occur in parallel with case-by-case privatisation of very large enterprises (over 5,000 employees). Approximately 170 investment privatisation funds (IPF) were established in 1994. In the second half of that year, points-denominated vouchers were distributed to the public who in turn placed their vouchers with the IPFs. A total of 1,700 companies were earmarked for privatisation through this programme. Between 51 and 90 per cent of shares in each enterprise were offered for sale (employees received 10 per cent and the state could retain up to 39 per cent). By early 1996, 60 per cent of the total equity of the 1,700 large enterprises had been transferred into private hands in 22 auctions, with private owners having a majority of voting stock in 43 per cent of the enterprises. Overall, one-third of these shares had been exchanged against vouchers, one-third against cash, and the remainder given to employees. Virtually all agro-industrial enterprises have been formally transferred into private hands, albeit often into cooperative ownership. But only five (out of 180) of the "very large" enterprises with more than 5,000 employees have been privatised.

The most important objectives of the third stage of the privatisation programme, covering the period 1996-98, are: (i) the completion of small-scale privatisation; (ii) the cash sale of further shares in medium- and large-scale enterprises; (iii) the sale of very large enterprises on a case-by-case basis. In accordance with these intentions the government started in February 1996 to divest the remaining state-held shares, including the 39 per cent stakes that had been excluded from the auctions, as well as all shares that had been offered for sale but had not been sold.

Small-scale privatisation
Under the small-scale privatisation programme (involving companies with less than 200 employees), approximately 11,000 entities had been sold by early 1996 (about 70 per cent of the total). In retail trade, public catering and service industries, 84 per cent of all facilities were sold. Completion of the programme is expected by the end of 1996.

About 90 per cent of all farms and about 80 per cent of the farmland had been privatised by the summer of 1996. Privatisation has involved providing farm workers with long-term leases and buy-out options to land and then distributing shares in non-land farm assets to those with land rights. Farm privatisation has often led to cooperative ownership structures. Land reform suffers from lack of clarity as to the rights applicable to different types of agricultural land.

Property restitution
There has been no property restitution in Kazakstan.

Growth of private enterprise
New firms tend to be concentrated regionally (Almaty), and in a few sectors (energy and mineral). In the spring of 1996, the government announced its intention to identify priority sectors to be supported by government investment and loan guarantees and to closely monitor price-setting behaviour.

Enterprise restructuring
Overall, restructuring of large loss-making units has been difficult and slow. In an attempt to foster industrial restructuring, 44 enterprises, the majority related to extraction industries, have been subjected to outside management under so-called "management contracts", whereby an enterprise is placed under the management of an interested outside party, usually a potential investor (implicitly often assumed to hold the option of buying the enterprise later). Twelve of these outsiders are foreign managers. At the other end of the quality spectrum, 30 of the biggest loss-making units have been placed under the control of the "Rehabilitation Bank" which, with World Bank funds, has been designed to restructure or liquidate them. More than 40 per cent of all enterprises were reported to operate at a loss in 1995.

While farmland appears to be almost completely privatised, restructuring in the agricultural sector has been slow. Cooperative farm ownership coupled with monopoly holdings in agribusiness still dominate this sector.

In an attempt to induce enterprise restructuring, the government introduced a new bankruptcy law in April 1995, which allows for out-of-court liquidation of insolvent enterprises. The Rehabilitation Bank and a Restructuring Agency were set up to deal with financially distressed enterprises. However, neither the agencies nor the new bankruptcy law are, as yet, fully operational.

Markets and trade

Price liberalisation
Kazakstan completed price liberalisation by the end of 1994, but is yet to raise utility prices (including electricity) to cost-recovery levels. In June 1994, all fixed prices for crude oil and oil products together with ceilings on the margins of oil refiners were removed, and compulsory grain deliveries terminated.

Competition policy
The existence of monopolies in trade and distribution remains a serious impediment to competition. The abolition of the State Order System and the removal of internal and external trade restrictions early on provided first steps at tackling that problem. In June 1994 a new Anti-monopoly Law was introduced, giving the anti-monopoly committee the power to regulate the prices of natural monopolies. In February 1995 the government started to dismantle the 80 state holding companies, responsible for about 1,700 enterprises. Additional measures included the removal of the monopoly rights of 14 state trading organisations in external trade of strategic goods.

Trade liberalisation
During the course of 1995, all export quotas and most export and import licensing requirements were abolished, and barter trade was prohibited. While the ratification of the Partnership and Co-operation Agreement (PCA) with the European Union was delayed, the European Parliament in the same year passed the trade provisions of that agreement, granting MFN status to Kazakstan, as an interim solution. Kazakstan entered a Customs Union with Belarus and Russia in 1995, and also participates in trilateral agreement on free trade and economic cooperation with Uzbekistan and Kyrgyzstan.

Currency convertibility and exchange rate regime
The national currency, the tenge, was introduced in November 1993. A 50 per cent surrender requirement for export proceeds, was abolished in August 1995. The tenge is convertible for foreign trade. Official and commercial exchange rates are unified, with rates determined on the Kazak Interbank Currency Exchange market (the rate is floating), in which all major domestic banks participate. The ceiling on the amount of dollars an individual can take out of the country is US$ 10,000 per year. In July 1996, Kazakstan accepted all obligations under Article VIII of the IMF Agreement (committing the authorities of Kazakstan to refrain from restricting current account transactions or from implementing discriminatory currency arrangements).

Wage liberalisation
The Law on Employment of the Population (1991) gives the government discretion on minimum wage adjustment.

Interest rate liberalisation
Since 1995 interest rates, previously high in real terms, were gradually reduced, as inflation continued to decline. The budget deficit in 1995 amounted to 3.9 per cent of GDP, with approximately 30 per cent of that deficit financed through issuance of Treasury Bills. Directed credits were abolished in early 1995 and limits were placed on the amount of NBK net credits to the government. During 1995 virtually all NBK credit was extended via credit auctions (in which

only those banks that meet prudential standards can participate).

Financial institutions

Banking reform

New banking legislation, adopted in August 1995, further separates investment banks from deposit-taking banks. It was held that the introduction of proper accounting procedures had to precede further liberalisation of banks' activities. Foreign banks are only allowed to have subsidiaries, joint ventures or representative offices. Foreign investors' shares in Kazak banks' capital can exceed 25 per cent (excluding portfolio investment) only with special permission from the central bank. The presence of foreign banks in Kazakstan is, however, steadily increasing.

The number of banks in Kazakstan has been subject to large fluctuations. Having risen to 210 by mid-1993, it had fallen back to 123 by April 1996, largely on account of closures imposed by the central bank. Most of the closed banks have been small. The Kazak banking system is still dominated by the four largest banks.

The Programme for the Reform of the Banking Sector of 1995 reconfirms central bank independence, requires guarantees for all bank payment orders forwarded to the NBK (the central bank) for clearing and settlement (to hinder the accumulation of inter-enterprise arrears), adoption of BIS guidelines for prudential supervision, compulsory risk classification of assets and provisioning requirements and a tougher licensing policy, involving the closure of non-viable banks. In April 1995, capital requirements were increased, and the two-thirds of all existing banks which did not meet these requirements were asked to submit a business plan to the NBK, on the basis of which a decision towards sale, merger or liquidation was to be made. In addition, attempts are underway to restructure the sector-specialised banks. This will involve the transfer of non-performing loans of Agroprombank to a new agricultural support, the split of the former foreign trade bank (Alem Bank) into a commercial bank and a state-owned Exim Bank. The State Development Bank, which was established in September 1994, is to be merged with the Exim Bank.

Non-bank financial institutions

The ability of IPFs to impose corporate governance on enterprises has been strengthened by an increase in the maximum ownership share which each fund is permitted to hold in a single enterprise, from previously 10 per cent to now 31 per cent. Private pension funds or insurance companies have yet to develop.

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. However, most trading is conducted outside formal markets, due to taxation of distributed shares, high fees, and lack of over-the-counter operations.

Fiscal and social safety net reform

Taxation

For the fiscal year 1995, overall government revenues were estimated at only about 20 per cent of GDP. A new Tax Code, effective 1 July 1995, simplifies and modernises the tax system by reducing the number of taxes from 49 to 11, improving incentives by reducing tax rates and concessions and by moving away from production-based taxes. There is a 30 per cent corporate income tax for companies (45 per cent for banks and insurance companies), and the maximum income rate tax is 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 as well as gold purchases. However, tax revenues are expected to decline further in the fiscal year 1996 to 14 per cent of GDP.

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, it has been a policy aim to improve the targeting of benefit payments. When bread prices were liberalised, for example, income supplements to vulnerable groups were increased by 30 per cent.

In 1995, as it became apparent that the Pension Fund was undercapitalised, the government increased the pension age, eliminated early retirement with full benefits and reduced pension benefits for working pensioners. Nevertheless, arrears in pension payments is a growing problem.

Investment legislation

Extensiveness

Laws exist regulating domestic and foreign investment, directly and through indirect investment vehicles. Most foreign investment proposals must be registered with the relevant authorities and may require government approval. Profits are freely convertible and may be freely repatriated.There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners and nationals may, subject to restrictions, own or lease land. Security interests over shares and land may be created, and require notarisation and registration. Security interests over certain types of moveable assets may be created and in some cases require registration.

Effectiveness

The full texts of laws and decrees relating to investment are ordinarily published, usually within one month of enactment, although some decrees are not published. Draft laws may be accessible to practitioners. Public records in share or land registries may be up to 12 months behind current status. Important court decisions are not always published or accessible to practitioners. Independent professional legal advice is available. Private parties generally believe that courts will recognise their legal rights against other private parties or the state. Foreign arbitral awards are not necessarily recognised and enforced by local courts without a re-examination of their merits.

Kyrgyzstan

Following independence in December 1991 a comprehensive market-oriented reform programme was initiated in July 1992. Between 1992 and 1994 substantial progress was made with institutional reforms and macroeconomic stabilisation. Further structural reforms, including privatisation and agricultural reform, have accelerated under a new policy framework introduced in 1994-95.

Enterprises

Size of the private sector

According to official estimates, the non-state sector, which includes partially privatised enterprises, accounted for 58 per cent of GDP in 1994. However, given that the state still owned majority stakes in many partially privatised companies, the size of the true private sector may have been closer to 40 per cent of GDP in mid-1995 and around 50 per cent of GDP in mid-1996. The Kyrgyz authorities believe that the shadow economy constitutes around 20 per cent of GDP, of which only around 6 per cent is reflected in official GDP figures.

Large-scale privatisation

During 1992-93, 500-600 medium and large-scale enterprises were corporatised with shares transferred to workers' collectives, but the state retained large ownership shares in most of these enterprises.

At the beginning of 1994 the government initiated a more transparent mass privatisation programme under which remaining state shares in the corporatised companies were to be sold through voucher and cash auctions. Those medium and large-scale state-owned companies which had not previously been turned into joint-stock companies (around 1,500) were to be corporatised and then privatised with 5 per cent of the shares given for free to employees, 25 per cent sold at coupon auctions, and 70 per cent sold at cash auctions. By August 1995, 75 per cent of the total pool of vouchers had been distributed to the population.

A total of 948 companies were to be privatised in the 1994-95 mass privatisation programme. As of March 1996, 900 medium and large-scale enterprises had been put up for voucher auctions and the state's share of ownership in about 450 enterprises had been sold completely. With the aim of speeding up full divestiture in the remaining 450 enterprises, the government has recently reaffirmed its policy of selling shares in the second round of cash auctions without setting a minimum price. In addition, it has approved the 1996-97 privatisation programme which covers the 320 remaining medium and large-scale enterprises and includes the sale of shares in some of the major utilities through coupon auctions.

International tender rounds are being initiated for some of the large companies. However, the

first international share auction of 13 enterprises in November 1995 was unsuccessful as shares in only one company were sold.

Small-scale privatisation
Privatisation of approximately 4,000 previously state-owned small trade outlets, retail and service establishments was largely completed by end-1994.

Agricultural reform began in 1991-92, when 165 (out of around 500) state and collective farms were liquidated and replaced by around 17,000 peasant farms (10-30 hectares) and new agricultural cooperatives. In January 1994 the government passed a new Concept Note recommending privatisation of all remaining state-owned small-scale agricultural enterprises (with up to 100 employees) through cash auctions. By end-1995, most state-owned farms had been corporatised into joint-stock companies. The only state farms remaining were located in the Chui region, where there is still strong opposition to reform. A significant number of the corporatised farms, however, continue to operate as cooperatives. Only around 10 per cent of agricultural output was produced by private farmers in 1995.

Land legislation and administration is still inadequate. In November 1995 a Presidential decree extended the period of land-use rights to 99 years. These rights can be sold (only to Kyrgyz citizens), exchanged, rented or used as collateral. However, the 1991 Law on Peasant Farms still gives state land-use agencies broad powers to terminate land-use rights after one year of non-use. Preparation of legislation to secure land rights through the issuance of titles and establishment of a unified land registration system is expected to be submitted to parliament by the end of 1996. Also, a draft Law on Pledge which includes procedures for land to be used as collateral was submitted to parliament in May 1996.

Property restitution
Kyrgyzstan has no restitution programme. The National Land Fund, for redistribution of land or compensation for nationalisation in past decades, now only controls 25 per cent of the land (down from 50 per cent in 1995) and it is expected that it will either be completely eliminated, or that its stake will be further reduced to 12 per cent.

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. In the agricultural sector problems include bottlenecks in the distribution networks, credit availability, input and raw material supply and marketing.

Enterprise restructuring
In May 1994 a Presidential decree established the Enterprise Reform and Resolution Agency (ERRA) for a period of four years to oversee restructuring of the 27 largest, loss-making, state-owned enterprises. Following the audit of these enterprises, five are being fully liquidated, while others have undergone massive downsizing and restructuring, The restructured enterprises have been given working capital and a period of 6-9 months to demonstrate their financial viability, after which they are to be privatised, with the proceeds used for paying off creditors. International tenders for some of the companies are being prepared. However, the government cancelled the international tender for Maili-Sai, the first restructured enterprise, in January 1996 because the company was targeted to become part of a debt/equity swap scheme under negotiation with the Russian government.

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. There have been only few cases of bankruptcies. Out-of-court settlement procedures for creditors of insolvent enterprises have been introduced to side-step the implementation bottlenecks in the legal system.

Markets and trade

Price liberalisation
Almost all prices for goods and services have been liberalised but utility tariffs remain controlled at highly subsidised levels. Although tariffs for electricity, hot water and heating were increased by 50 per cent in April 1996 and further increased in July 1996, they remain low relative to costs. Since 1994 domestic prices for oil, gas and coal have been close to world market levels.

Competition policy
In December 1993 the ceilings on 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 over 35 per cent. 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. In 1994 the partial break-up of bread conglomerates and large transport holding companies started. The Bread Complex Kyrgyz Dan Azyk was corporatised and ceased to manage 44 medium-sized and large-scale companies and 37 small-scale enterprises formerly under its authority. All 37 small-scale enterprises have been privatised. As of January 1996, over half of the large-scale enterprises were privatised. Plans are proceeding for the state to divest its majority ownership in another six medium- to large-scale enterprises (including two grain storage and milling enterprises) and its minority ownership in another eight. The agro-industrial enterprise Kyrgyz Tamak'Ash has also been corporatised and all enterprises under it have ceased payment of the former mandatory management fee as of December 1995.

Trade liberalisation
In early 1994, the trade system was substantially liberalised. Remaining import and export licensing agreements were lifted, and export taxes reduced. The export tax on hides and skin was removed in February 1996 and a temporary export tax on silk cocoons was abolished at the end of 1995. However, a 30 per cent export duty on grain was introduced in August 1996.

The customs union with Kazakstan and Uzbekistan, established in early 1994, provides for duty-free import of goods of these countries. In March 1996, Kyrgyzstan, Russia, Kazakstan and Belarus signed a customs union treaty in Moscow (foreseeing the integration of Kyrgyzstan into the already existing customs union between the other three countries). However, the treaty has not been ratified within Kyrgyzstan and operational aspects of the union are yet to be specified. The Kyrgyz authorities have stated that they do not plan to change the uniform 10 per cent import tariff on imports from non-CIS countries or tighten the present liberal trading regime. The government has applied for the WTO membership (it was granted WTO observer status in May 1996) and is negotiating a partnership and co-operation agreement with the European Union.

Currency convertibility and exchange rate regime
The national currency, the som, was introduced in May 1993, and the exchange rate is determined in a managed float. In March 1995 the authorities formally accepted obligations under Article VIII of the IMF's Articles of Agreement regarding full current account convertibility.

Wage liberalisation
Increases in wages within the state budgetary sector are limited to the 10 per cent that was granted in November 1995. A further 10 per cent increase scheduled for September 1996 was recently suspended.

Interest rate liberalisation
Following the introduction of the som in May 1993, the NBK introduced several indirect monetary instruments, including weekly sales of foreign exchange to the interbank market, and auctions for treasury bills and credit. Interest rates have been market determined since 1994. 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 with the National Bank of Kyrgyzstan (NBK) at its core. In addition to the NBK, the banking system consists of 18 commercial banks. The sector is facing severe solvency problems, the magnitude of which became clear in early 1995, following the adoption of regulations requiring that provisions be made for doubtful loans, the on-site inspection of banks and the strengthening of supervision by the NBK. Half of all commercial banks were found to have negative net worth, totalling 1 billion som (40 per cent of broad money). Around 84 per cent of non-performing loans belong to the four former state-owned banks (Agroprombank, AKB Kyrgyzstan, Elbank and Promstroi).

The NBK adopted a two-stage strategy to implement systemic reform of the banking system. The first stage involved assessing the long-term viability of all banks and as a result four were put under direct supervision and two had their licences suspended and were subject to temporary NBK administration. The NBK also instituted a freeze on new lending to enterprises in payment arrears, and has limited access to refinance auctions. The second stage involves the restructuring or liquidation of the former state banks, including possible recapitalisations, with the assistance of the the World Bank through its Financial Sector Adjustment Credit (FINSAC). As part of this programme, the NBK closed the former Savings Bank (Elbank) in March 1996 and worked out a deposit coverage plan for individual placements up to 3,000 soms. In addition, the NBK announced the closure of Agroprombank in May 1996, which is to be replaced in the short term by an emergency farm support programme

for the provision of farm inputs and working capital, and in the medium term by a commercially viable and sustainable rural banking and cooperative system. The two other large banks will be downsized and restructured through private recapitalisations and a temporary Debt Resolution Agency (DEBRA) will be established to help collect or write-off old non-performing loans.

Lastly, the programme includes the creation of an appropriate regulatory and supervisory framework for the banking system, including legislative approval of the new banking law and the tightening of prudential regulations. Legislation preparing a deposit insurance fund and amendments to the Central Bank Law and the Commercial Bank Law are being drafted. Minimum capital adequacy requirements have been introduced, as have liquidity ratios, reserve requirements at 15 per cent, loan classification and provision guidelines, as well as limits on lending to shareholders and single borrowers. These would become applicable after bank recapitalisations.

Non-bank financial institutions
Though money and capital markets are underdeveloped, there are also a number of non-bank financial institutions. These include 17 investment funds, 30 insurance companies, and one significant state-owned and two smaller private pension funds. The voucher privatisation was expected to boost the emergence of investment funds, but by mid-1995 only around 30 per cent of invested coupons had gone through investment funds.

Securities markets and instruments
The Law on Securities and Stock Exchanges was passed in December 1991. In May 1994, the government established the State Agency for Securities with responsibility for securities regulations. In September 1994, the Coupon Trading Centre started trading in privatisation vouchers, 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 (10 companies listed by early 1996 with only 3-4 actively trading), the institutional basis for a secondary market in shares is given. Extension of secondary trade to T-bills, regional currencies and municipal bonds is planned.

Fiscal and social safety net reform

Taxation
Profit tax is levied at 30 per cent and most exemptions and deductions were eliminated in January 1995. The personal income tax, effective from January 1995, includes in-kind payments in the tax base and requires the filing of tax declarations. Marginal personal income rates range from 10 to 40 per cent.

In 1995 the government submitted a new tax code for parliamentary approval, including revised VAT legislation, and new provisions for the income and profit tax, excise tax, and tax administration laws. The code aimed at simplifying existing tax legislation and administration. It did not involve any changes in tax rates. The revised tax code was finally approved in June 1996 for implementation in July 1996. The new VAT is a modern, invoice-based tax levied at 20 per cent. As a result of the uncertainties related to the Customs Union with Russia, Kazakstan and Belarus, it applies the origin principle for imports from CIS countries and the destination principle for imports from other countries.

Social security
The social safety net includes payments of old-age and other pensions, health-related benefits, unemployment benefits, and general social support programmes (family allowances and disability payments). Employers pay a payroll tax of 33 per cent on the wage bill of enterprises – of which 85 per cent is allocated to the Pension Fund and 15 per cent to the Social Insurance Fund. Pension Fund revenues are supplemented by a 2 per cent wage tax on salaries paid by employees. An additional tax of 1.5 per cent is levied on the payroll of enterprises and 0.5 per cent on salaries of employees to finance the Employment Fund. The agricultural sector pays virtually no contributions and some other sectors enjoy preferential rates. The retirement age is 60 for men and 55 for women (with a minimum of 25 and 10 years work experience respectively).

Investment legislation

Extensiveness
Laws exist regulating domestic and foreign investment, directly and through indirect investment vehicles. Most foreign investment proposals must be registered with the relevant authorities and may require government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners and nationals may not own or lease land. Security interests over shares and land may be created, and require notarisation and entry in an official register. Security interests over contracts, receivables and moveable assets are possible and require notarisation.

Effectiveness
The full texts of laws relating to investment are published, but circulation is limited and can be subject to substantial delays. Draft laws are usually published and available to practitioners. Public records in share or land registries may be up to six months behind current status. Independent professional legal advice is available. Private parties generally believe that courts will recognise their legal rights against other private parties, as well as the state. Foreign arbitral awards are not required to be recognised and enforced without a re-examination of their merits.

Latvia

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
In 1995 the share of the non-state sector (where central and local governments' participation is less than 100 per cent) in industrial output and employment was 53 and 54 per cent respectively. The share of the private sector in GDP is likely to be around 60 per cent.

Large-scale privatisation
The distribution of privatisation vouchers, which started in 1993, was practically completed in July 1995. By then, certificates with an aggregate face value of 2.9 billion lats had been distributed to 2.4 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 residential housing. The 1994 regulation stipulates that 50 per cent of any joint-stock company must be privatised for vouchers.

During 1994-96, 101 entities employing more than 50 employees were privatised, with more than 50 per cent of payment in vouchers. Acceleration of large-scale privatisation is expected from 1996 when the government authorised the sale of about 240 enterprises, including the Latvian Shipping Company and the state-owned gas company Latvijas Gaze, which are some of the country's biggest companies.

Other privatisation methods include international tenders of stakes in medium and large-scale enterprises (four concluded as of August 1996); restricted tenders and direct sales of large infrastructure enterprises; domestic auctions or direct sales of smaller enterprises, and public offerings of minority stakes. An important development has been that foreigners have been granted permission to purchase privatisation vouchers to pay for privatised enterprises.

Some 300 medium to large-scale enterprises were privatised predominantly through lease buy-out agreements and management and employee buy-outs in 1991-93. The number of medium to large enterprises at the start of the reforms was about 1,000.

Small-scale privatisation
The privatisation of small enterprises in the services and trade sector, most of which were previously owned by municipalities, is almost completed. In addition, 336 small-scale state-owned enterprises were privatised by the Latvian Privatisation Agency during 1994-96.

Very liberal draft legislation enabling unrestricted land ownership including that by foreigners has been submitted to the parliament but so far

land ownership in Latvia is restricted to Latvian citizens and legal entities where majority stake belongs to Latvian citizens or foreign nationals from countries with which Latvia has mutual investment protection treaties (this excludes Russia). Purchases of land by eligible persons is further hindered by administration difficulties and the slow pace of the restitution process. Despite an increasing number of private farms, the majority of these are based on usage rather than ownership rights.

Progress in the privatisation of residential housing has so far been limited, partly delayed by the slow adoption of the necessary legal framework.

Property restitution
About 350,000 restitution claims for land in towns and cities have been submitted, of which less than 20 per cent had been settled by end-1995. Claims for the restitution of urban land can be submitted over 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 guarantees against liabilities associated with compensation for the claimants in case their claims are accepted.

Growth of private enterprise
A total of 57,301 enterprises registered in the Latvian business register were thought to be active as of April 1996. Of these 2 per cent were owned by central or local authorities, 71 per cent had mixed ownership and 27 per cent were fully privately owned. There are no significant administrative obstacles to entry of new firms. As in other transition economies, 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 shifted to strategic investors including foreign investors, rather than the transfer of ownership to workers and management. Comprehensive insolvency and bankruptcy legislation was drafted in March 1996 to replace outdated and ineffective current legislation. Energy arrears that posed a serious problem after outright budgetary subsidies to enterprises were eliminated early in the transition process, fell dramatically in 1995. The government has recently removed previous restrictions on foreign investments in certain sectors of the economy.

Markets and trade

Price liberalisation
Price liberalisation began in early 1991 and was virtually completed by late 1992. Few formal price controls remain. However, rents, 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 moving towards cost recovery levels (the most recent increase amounted to 10 per cent and took place in January 1996). An increase to the full economic cost level is envisaged by the authorities by 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 by 1998. 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 for industrial goods but less so for agricultural goods. However, free trade in agricultural goods with Estonia and Latvia has been agreed as an extension of the Baltic Free Trade Agreement. By mid-September, the agricultural amendments were still awaiting ratification by the Latvian parliament (the parliaments of Estonia and Lithuania have completed ratification). Import tariffs are generally modest (1 per cent *ad valorem* on raw materials, component parts and some capital goods and 20 per cent for industrial products), except in the agricultural sector which remains protected by an average production-weighted tariff (for trade with non-Baltic countries) of more than 50 per cent.

Latvia signed the "Europe Agreement" with the EU providing for free trade in industrial goods in June 1995, and is in accession talks with the WTO. In addition, Latvia is part of the Baltic Free Trade Area and has bilateral free trade agreements with EFTA countries.

Currency convertibility and exchange rate regime
The national currency, the lat, has effectively been pegged to the SDR since February 1994 (although no formal announcement to this effect has been made). Latvia offers complete and effective current and capital account convertibility with no surrender requirements.

Wage liberalisation
Enterprises must keep wages above a legally specified minimum. Union influence on the wage-setting process is modest. The average gross monthly wage amounted to 90 lats (US$ 170) in 1995.

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 10-15 percentage points. The interbank market has recovered from very low levels of activity following the 1995 banking crisis.

Financial institutions

Banking reform
The 1992 Law on Central Bank established a two-tier banking system in Latvia. The banking sector is in the process of consolidation, following a period of rapid entry of new private banks during early years of economic reforms. The industry experienced a major shake-up in 1995 when the activities of more than a third of commercial banks were suspended, including Bank Baltija, an institution holding 30 per cent of total deposits.

Since then, banking supervision has been tightened considerably. The 1995 Credit Institutions Law raised the minimum capital requirement to 1 million lats (US$ 1.8 million, effective from April 1996) and introduced tighter limits on insider lending, credit concentration and foreign exchange exposure (effective from January 1996). As of August 1996 12 out of 29 commercial banks are allowed to take household deposits.

Although there is a large number of banks, the five biggest account for more than half of total assets. One western bank, Société Générale, is operating in Latvia and Hansabank from Estonia recently acquired a Latvian Deutsch-Lettische Bank. The largest state-owned bank, Unibanka, was privatised in 1996 and the privatisation of the state-owned savings bank, Latvijas Krajbanka, is underway.

Non-bank financial institutions
As of mid-1996 37 insurance companies were registered in Latvia, of which 12 were life insurance companies. The minimum capital requirement for insurance companies has been raised to 600,000 lats (approx. US$ 1 million) for non-life insurance companies and 1 million lats (approx. US$ 1.8 million) to life insurers. The insurance sector is dominated by private insurance companies, often with foreign participation.

Investment funds play a relatively minor role in the non-bank financial sector.

Securities markets and instruments
Securities markets are dominated by trade in treasury bills with three-month, six-month and one-year maturities. Foreign banks are allowed to participate in the primary market for treasury bills. Treasury bill rates have generally been falling throughout 1996. The Bank of Latvia introduced repo and reverse-repo auctions for treasury bills during 1995-96.

The Riga Stock Exchange and Latvian Central Depository started to operate in 1995. A securities law and related acts, adopted in August 1995, regulate the operation of securities markets, the stock exchange, the central depository and the Securities Market Committee, a supervisory body. Eight companies were quoted in mid-1996; the weekly turnover did not exceed 150,000 lats (US$ 270,000).

Fiscal and social safety net reform

Taxation
A major new tax package was introduced in February 1995, changing direct taxes from a progressive to a proportional rate structure and introducing uniform treatment for different types of income. The standard income tax rate for both private and legal persons is 25 per cent. A 10 per cent surtax is payable on annual income in excess of 4,000 lats. The standard VAT rate has been 18 per cent since November 1993. Since mid-1994, the standard VAT rate has also applied to food. The authorities plan to harmonise the tax system with the EU standards. Tax collection remains a problem. The authorities intend to introduce a comprehensive system of tax identification numbers in 1996 to limit the extent of tax evasion.

Social security
The standard rate of social security tax is 38 per cent (of the wage sum) and is paid mainly by employers. Pensions and unemployment benefits are financed from revenues generated by the social security tax. A gradual transformation of the pay-as-you-go system to a partly funded system has been initiated.

Social benefits are also provided by local municipalities in the form of heating allowances, assistance in kind, food coupons and free school meals. The government intends to widen the role of means-tested social benefits.

Investment legislation

Extensiveness

Laws exist regulating direct domestic and foreign investment. Indirect investment, through the use of indirect investment vehicles, such as securities or investment funds, is not specifically regulated. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners and nationals may, subject to restrictions, own or lease land. Security interests over shares and land may be created, do not require notarisation, but require entry in an official register. Security interests over contracts, receivables and moveable assets are possible and may require notarisation. Registration is not yet possible, but appropriate registers are being developed.

Effectiveness

The full texts of laws relating to investment are published, usually within one month of enactment. Draft laws are not always available to practitioners for comment prior to enactment. Where registries in respect of land or security exist, they are usually current within three months. Important court decisions are generally available to practitioners. Independent professional legal advice is available. Private parties generally believe that courts would recognise and enforce their rights against other parties, including the state. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits.

Lithuania

Since regaining independence in 1991, Lithuania has introduced a comprehensive programme of market-oriented reforms and macroeconomic stabilisation. By the end of 1993 substantial progress had been achieved in the areas of price and trade liberalisation and small-scale privatisation. During 1994-95 reform efforts focused on the privatisation of large-scale enterprises and the strengthening of the financial sector, which underwent a crisis at the end of 1995.

Enterprises

Size of the private sector

According to government estimates, the share of the private sector in GDP was around 65 per cent in 1995. In terms of employment, nearly 70 per cent of the total labour force was employed in the private sector. The private sector includes joint-stock companies with more than 51 per cent share of private capital, agricultural partnerships and cooperatives, and private farms in Lithuania.

Large-scale privatisation

Sales of state assets in Lithuania have been based on the Law on Initial Privatisation of State Property (passed in late 1991 and amended in 1993). A total 6,644 enterprises, out of the 8,457, participated in the first phase of privatisation. These companies represented 73 per cent of all enterprise assets (by book value). By the end of June 1995, when the first phase ended, about half of these assets had been sold, representing about 30 per cent of all the assets in the total 8,457 enterprises. By industrial sectors, 31 per cent of all state assets in industry, 60 per cent in trade, 6 per cent in transport and 4 per cent in utilities were transferred into private ownership during the first phase. It is estimated that around 45 per cent of the assets had been sold against vouchers (distributed to all adult citizens) and 30 per cent for cash. Cumulative state privatisation revenues amounted by the end of 1995 to about 230 million litai (US$ 58 million).

Most of the medium-sized and large enterprises which participated in the initial privatisation round were sold through share offerings in which preference was given to employees and management (with up to 50 per cent of shares reserved for these new shareholders). This process resulted in insider-controlled corporate structures in many privatised enterprises. Foreign participation in the privatisation process has been minimal so far.

A law (passed in February 1995) that exempted "strategic" enterprises with a total book value worth 6.8 billion litai (US$ 1.7 billion) from privatisation until the year 2000 was amended in July 1996 to allow up to 30 per cent private ownership in these companies. The "strategic" enterprises are mainly in energy, transport and telecommunications sectors.

The second phase of privatisation started under the new Law on Privatisation of State and Municipal Property of July 1995. A State Privatisation Agency and a State Privatisation Commission were established in late 1995 to administer the process. During the second phase, the remaining state assets will be sold predominantly through sales for cash. The government is expecting to raise over 3 billion litai (US$ 750 million) during the second phase of privatisation from the sales of "non-strategic" enterprises. A plan for 1996 involves sales of shares of 197 companies with a book value of 300 million litai (US$ 75 million). However, no sales under this programme have as yet taken place.

Small-scale privatisation

Privatisation of small units has been comprehensive, with 2,727 small enterprises having been privatised. Total sales revenues amount to 165 million litai (US$ 41 million). Based on the same law as large scale privatisation, small enterprises have been sold through auctions. Privatisation of state housing stocks proceeded very rapidly after passage of the privatisation law, and was virtually complete by the end of 1993, as the vouchers could be used for the purchase of dwellings. In agriculture, 1,100 collective and cooperative farms were, in 1993, broken into 12,300 units and privatised before the end of that year. A constitutional ban on foreign land ownership was lifted in June 1996. Foreigners can now own non-agricultural land.

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 as well as cuts in the budgetary allocation for compensation to former land owners. 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 output and employment shares of truly new enterprises in the manufacturing sector remains small. But a large number of mostly small new firms have been established in the services sector.

Enterprise restructuring

Direct subsidies to enterprises have been largely discontinued. State subsidies for agriculture, energy and housing amounted to 0.9 per cent of GDP in 1995. Credit policies of banks have, especially in the most recent years, been tight.

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, and five firms with approximately 500 employees were liquidated in 1995.

Markets and trade

Price liberalisation
Administrative controls remain on prices for energy and housing. Some prices for transport and utilities fall short of production costs (when capital replacement is included in the cost calculation).

District heating prices have been raised significantly in a number of discrete steps since the winter of 1994 and have now reached a price level that covers 90 per cent of the operating costs. As of April 1996, average electricity tariffs for industrial and residential users were 3.5 US cents per kWh and 5.0 US cents per kWh, respectively.

Competition policy
Some action has been taken to split up conglomerates. An Agency for Prices and Competition has been established, with the right 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. Import tariffs on some agricultural products were raised in July 1994, pushing the average tariff rate from 25 per cent to 44 per cent. The average tariff has subsequently been reduced incrementally to 27.5 per cent in October 1995. Import tariffs on agricultural products were removed within the Baltic Free Trade Area in 1996. There are no quantitative restrictions or tariffs on exports except for four items (feathers and down, raw leather, raw timber and medical supplies) that are banned from exportation.

A "Europe Agreement" with the EU was signed in June 1995. A free trade agreement with Poland was signed in 1996. Negotiations are under way for signing similar agreements with other Central European countries and for membership of the WTO, for which Lithuania applied in November 1995.

Currency convertibility and exchange rate regime
In early 1994, Lithuania introduced a currency board system that requires full foreign exchange backing for reserve money and other litas-denominated liabilities of the Bank of Lithuania (in gross terms). The exchange rate is pegged to the US dollar at the rate of 4 litai per US dollar. This system involves a very high degree of commitment to exchange rate stability. There is full current account convertibility (Lithuania accepted IMF Article VIII in 1994) and virtually full capital account convertibility.

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. At the end of 1995, the minimum wage was at 35 per cent of the average wage for the whole economy.

Interest rate liberalisation
Banks are free to set their own interest rates. The central bank's monetary policies are restricted by the existing currency board arrangement. The spread between the average time deposit rate and the average lending rate declined in 1994-95, but has widened in 1996, following the the banking sector crisis at the end of 1995. The spread was around 7.5 per cent in March 1996.

Financial institutions

Banking reform
The banking sector nearly faced a serious crisis at the end of 1995 following the suspension of operations of one large and two medium-sized private banks that held around 24 per cent of deposits in the banking system.

Lithuania's banking system is highly concentrated, with the three large state majority-owned commercial banks (the State Savings Bank, the State Agricultural Bank and the State Commercial Bank) accounting for nearly half of all the deposits. The largest private bank (one of the banks whose operations were suspended at the end of 1995) controlled around 15 per cent of all deposits. Subsequent to the planned takeover by the state of this bank, the state will control institutions that represent almost 75 per cent of all deposits in the banking system. The planned reduction to minority status of its shares in the three state-owned commercial banks has been suspended as a consequence of the banking crisis.

Lithuania's banking sector remains fragile: the majority of new banks are undercapitalised and hold a large amount of non-performing loans. Most banks were founded during 1991-92, when licensing requirements were lax and the minimum capital requirement was low. Banks failed to raise their capital proportionately to the rapid growth of their balance-sheets. Moreover, lack of lending skills, a large amount of politically motivated lending as well as insider abuse had led to a large number of non-performing loans in their portfolio. Tax laws that have not allowed banks to deduct credit losses from the tax base have also contributed to a rapid erosion of the banks' capital base.

A new Law on the Bank of Lithuania and a new Commercial Bank Law enacted in late 1994 gave the central bank (the Bank of Lithuania) the powers to enforce prudential regulations. In accordance with the new law, Bank of Lithuania enforced stricter prudential requirement during the course of 1995 that resulted in the reduction of the number of operating banks from 28 in early 1994 to 12 at the beginning of 1996. While 13 smaller banks have been liquidated, one large and two medium-sized banks' operations have been suspended (see above).

At the beginning of 1996, the government announced a banking sector restructuring plan that envisaged government recapitalisation and renationalisation of insolvent banks. In August 1996, the parliament passed a law that allows the recapitalisation of the State Commercial Bank as well as a law that will allow the establishment of a "Property Bank", which will manage bad loans carved out from the banks' portfolios.

In June 1996, the Commercial Bank Law was further amended to allow foreign banks to open branches in Lithuania.

Non-bank financial institutions
Investment funds held 30 per cent of all privatised state assets by the end of 1995. One state and 34 private insurance companies were operating in Lithuania at the beginning of 1996, of which 15 were providing life insurance. The gross premium of both life and non-life companies remained minimal at 150 million litai at the end of 1995, less than half a per cent of GDP.

Securities markets and instruments
A National Stock Exchange began operations in September 1993. At the end of 1995, around 400 securities were listed by the National Stock Exchange and market capitalisation stood at 630 million litai (around 2 per cent of GDP). However, total turnover remained very modest.

Fiscal and social safety net reform

Taxation
Since mid-1990, a series of tax reforms provided Lithuania with a tax structure broadly similar to those typically seen in Western 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. Whereas revenues from income and profit taxes declined from 61 per cent of total tax revenues in 1994 to 56 per cent in 1995, revenues from VAT and excise taxes increased from 30 per cent of total tax revenues in 1994 to 37 per cent in 1995.

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 5 per cent of GDP in 1995. This ratio of government pension expenditure to GDP remained largely unchanged from 1994. Contributions to the social insurance payroll tax amount to 30 per cent for employers and 1 per cent for employees.

Investment legislation

Extensiveness
Laws exist regulating domestic and foreign investment, directly and, to a limited extent, through indirect investment vehicles. Generally, foreign investment proposals require government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners or foreign-owned local companies may not own, but may lease, land. Security interests over shares and land may be created, and require notarisation and entry in a public register. Security interests over contracts, receivables and moveable assets are possible, and may require entry in an official register.

Effectiveness
The full texts of laws relating to investment are published, usually within one month of enactment. Draft laws affecting investment are generally not accessible to practitioners for comment prior to enactment. Public records in share or land registries, where available, may be up to six months behind current status. Registration systems are not yet complete, but are being developed. Important court decisions are not always published or accessible to practitioners. Independent professional legal advice is available. Private parties generally believe that courts would recognise and enforce their rights against other private parties, but not against the state. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits.

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 in the republic's guiding principles, and formally launched a large-scale voucher privatisation programme. Policy efforts, with the continued support of multilateral institutions, are now concentrating on structural reforms.

Enterprises

Size of the private sector
The private sector's share of GDP is likely to be in the range of 35-45 per cent.

Large-scale privatisation
The creation in 1994 of a Ministry for Privatisation and State Property Administration laid the basis to complete, in mid-1995, the 1993/94 Privatisation Plan, which envisaged the privatisation of about 1,600 enterprises (40-50 per cent of state assets), mostly through sales for vouchers distributed to the population.

The privatisation of some enterprises left over from that programme, as well as of other enterprises, was targeted by the 1995/96 Privatisation Plan adopted by Parliament in March 1995.

The first voucher-based part of the programme has been carried out by November 1995, while the planned cash privatisations have not so far met expectations: by the end of 1995 only 44 enterprises, out of the planned 183, had been sold, generating total revenues of Lei 22 million. The value of the companies still to be privatised is estimated at around Lei 400 million (US$ 87 million).

The first international tender (in the tobacco sector) was initiated in December 1995. Other tenders partly aimed at international investors are under preparation, with the aim to sell (for cash) around 40 strategic enterprises in various sectors. These would include Moldtelecom, the state telecommunications company, and Cereale and Fertilitatea, the former state monopolies in the grain and fertiliser sectors.

The 1997/98 Privatisation Programme, which will be submitted to parliament by the end of 1996, is expected to stipulate which enterprises are to remain in state ownership and to provide for the completion of the mass privatisation process.

As a result of the mass voucher privatisation, about 70 per cent of industrial enterprises were in private hands as of mid-1996. A total of 2,235 enterprises have been privatised, but many of these are small. Fiduciary companies and investment funds accounted for 80 per cent of the share subscription, while individuals accounted for the remaining 20 per cent.

Workers, former workers and management own majority stakes in 186 medium-sized or large companies.

Small-scale privatisation
The sale to private entities of small-scale units, which began in September 1993 under the programme described above (in the comments on large-scale privatisation), has been comprehensive.

Housing has been privatised partly against payment in the form of the vouchers that could also be used as payment for shares in state enterprises. By June 1996 more than 191,000 dwellings were in private hands, corresponding to more than 80 per cent of the total to be privatised. Of these, 54 per cent were privatised free of charge, 41 per cent in exchange for vouchers, and 5 per cent for cash. Housing privatisation is due to be completed by mid-1996.

Given the importance of agriculture in Moldova, land privatisation is a key issue for the development of a dynamic private sector, but progress in this area has been slow. Some small-scale land ownership was already permitted before Moldova gained independence. In the first stage of land privatisation, household plots of an average size of 0.3 hectare were distributed to the population. In the context of the second stage, initiated in 1992 but suspended in the same year and resumed only in 1995, land certificates are being distributed to collective farm members, with strong limitations to the exit of individuals from collective farms enforced by the Land Code, which was introduced with the explicit objective of softening the effects of privatisation (these limitations have been challenged by a recent ruling of the Constitutional Court).

By the end of 1995, 10 per cent of the total land of the country (13 per cent of total agricultural land) had been privatised. Excluding land held by individuals that continue to be part of collective farms, "true" private farming is estimated to cover only 3.7 per cent of agricultural land. The Land Code forbids trading of land until 2001, but this ban has been lifted for small plots and urban land, leading to the existence of a small market. Furthermore, transactions within collective farms are now possible. The government is working on legislation that would support free trade in agricultural land from the beginning of 1997.

Property restitution
No property restitution has taken place.

Growth of private enterprise
By June 1995, more than 44,000 private businesses had been registered in Moldova as of June 1995. Of these, 29,000 were private companies and 15,000 private farms. However, only about half of the registered entities are currently thought to be operating.

In December 1995 there were 662 registered joint ventures, up from 412 by the end of 1994.

Enterprise restructuring
March 1995 saw the passage of a Bankruptcy Law, which makes it easier for creditors, especially budgetary organisations, to trigger bankruptcy proceedings against debtors. Bankruptcy proceedings have been initiated against 20 state companies. Ten of these bankruptcy cases have been completed.

Enterprise restructuring is one of the priorities of Moldovan authorities. An Agency for Assistance in Restructuring Enterprises has been set up with funding from the World Bank and other institutions, and a pilot project for the restructuring of 16 industrial enterprises is under way.

Electricity and heating prices have been raised by 50 per cent by May 1996, and energy suppliers are now able to disconnect non-payers and thus increase collection rates.

Markets and trade

Price liberalisation
In January 1992 all consumer goods prices were liberalised, with the exception of those for bread, dairy products, some transport prices, and utilities. By 1 January 1995 the government had removed margin controls on most goods. Prices are still controlled for a small number of public services, electricity and gas, and, in the form of margin controls, for some basic goods.

The government has already raised heating and residential electricity tariffs by 50 per cent, and is planning to increase industrial electricity tariffs by 13 per cent. As a result, average gas and electricity tariffs are at operating cost recovery levels. The government furthermore intends to raise all tariffs by the end of 1997, in order to bring them to full cost-recovery levels, and eliminate the current cross-subsidies from industries to households, and from heating to gas and electricity.

Competition policy
Legislation governing anti-monopoly activity was passed in early 1992 but has been relatively ineffective. Further legislation is planned by the government.

Trade liberalisation
On 1 December 1995 the last export quotas on grains and grain products were lifted and the maximum tariff was lowered to 20 per cent, with very few exceptions. The tariff structure is composed of 5 bands with tariffs ranging from 0 to 20 per cent. Import licences have been eliminated, with a few exceptions regarding national security and goods subject to medical and cultural regulations. The government is committed to repeal excise taxes on wine and unprocessed tobacco by July 1996. Indirect taxation of trade with CIS countries is carried out in accordance with the principle of the country of origin, whereas taxation of trade with the rest of the world follows the principle of the country of destination. The 1996 Budget Law introduced a new excise tax on petroleum.

On 28 November 1994 the EU and the Government of Moldova signed a Partnership and Cooperation Agreement, in force since March 1996, granting the country a generalised system of preferences. Wine imports are a notable exception from the concessions. A trade and economic agreement for 1996-97 has been signed with the Russian government, and should lead to the removal of the quantitative restrictions and high excise taxes on Moldovan exports of alcoholic products imposed by Russia. Moldova has signed free trade agreements with 10 countries, including Romania, and Most Favoured Nation agreements with another 14 countries. The Transdniestrian authorities have during 1996 introduced taxes on all transit trade between Moldova and other countries.

Currency convertibility and exchange rate regime
November 1993 saw the introduction of a new national currency, the leu. The exchange rate is determined every day at the Moldovan Foreign Currency Interbank Market. In July 1995 an agreement was signed on simultaneous circulation in Transdniestria of both the Moldovan leu and Transdniestria's rouble, introduced as a separate currency by the local authorities in 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.

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 credit auctions for National Bank credit. The commercial banks set their own interest rates, following the refinancing rate quoted by the National Bank of Moldova.

The medium-term monetary programme envisages the gradual elimination of credit auctions and the phasing in of open market operations.

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, and directed and preferential credits were eliminated. Banks are subject to regulations regarding capital adequacy (minimum capital has recently been raised to Lei 4 million), the ratio of deposits to capital, the maximum exposure to single borrowers, and the weighted capital asset ratio (recently raised to 12 per cent). The reserve requirement currently stands at 8 per cent. International accounting standards are to be introduced by the beginning of 1997.

The new Financial Institutions and Central Bank Laws, introduced in January 1996, have increased the powers of the central bank, including the ability to place banks with negative capitalisation into receivership, and have instituted a loan quality classification.

The financial sector consists of four large banks and 23 other commercial banks. The banking system remains affected by serious problems: some banks remain severely undercapitalised, competition is weak, as reflected in the large spread between lending and deposit rates, and actual reserve ratios are well in excess of compulsory ratios, pointing to low levels of financial intermediation.

Non-bank financial institutions
There are currently 15 investment funds and eight trust companies in Moldova. 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. In June 1995 the first stock exchange was opened with the support of USAID. Ninety five per cent of trading is in shares of privatised companies, and turnover reached a peak of US$ 650,000 in March 1996. Independent registrars are preparing the share registers, which are expected to be completed by July 1996.

The first auction of three-month government securities was held in March 1995, while the introduction of six-month government bonds is scheduled for 1996. The legal foundations of a securities market are in place, and a State Commission on Securities Markets with the powers of a ministry has been created to oversee the activity of market participants.

Fiscal and social safety net reform

Taxation
Enterprise profits are taxed at progressive rates of up to 32 per cent. VAT is charged at 20 per cent. Fundamental changes in tax provisions approved on 8 June 1995 have affected the provisioning for losses and taxes of Moldovan commercial banks. The 1996 Budget Law eliminates the excess wage tax on enterprises. In 1995, the structure of taxation relied heavily on VAT (37 per cent of tax revenues) and profit tax (25 per cent), rather than on the personal income tax.

Social security
Taxes destined for the Social Fund and for the unemployment fund amounted to 45 per cent of the company payroll.

The Social Fund is increasingly burdened by arrears in payroll payments and budgetary contributions.

The government has drafted new legislation in 1996 to improve the structure of pension and social allowances, envisaging private provision of pension plans, and a reform of unemployment benefits and severance pay regulations.

Since 1996, the responsibility for paying family allowances and price compensations has been shifted to the Social Fund, so far without a clear commitment of resources in the 1996 Budget Law to allow the Fund to carry out the new tasks.

Investment legislation

Extensiveness
Laws exist regulating domestic and foreign investments, and the use of indirect investment vehicles, such as securities or investment funds. Such investment generally requires no government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners or foreign-owned companies are prohibited from owning land, although they may lease land. Security interests over shares and land may be created, requiring notarisation and entry in an official register. Security interests over contracts, receivables and moveable assets may be created, and require notarisation and in some cases registration.

Effectiveness
The full texts of laws relating to investment are published, usually within one month of enactment. Draft laws are not usually published and accessible to practitioners. Public records in share or land registries may be up to three months behind current status. Important court decisions are not generally available to practitioners. Independent professional legal advice is available. Private parties generally believe that the courts will recognise their legal rights against other private parties, including the state. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits.

Poland

Tentative market-oriented reforms began in 1981-82, with measures aimed at reducing economic administration, increasing enterprise autonomy, and strengthening workers' self-management. The Balcerowicz plan, implementation of which began in late 1989, launched much more comprehensive reforms, especially with respect to market liberalisation. With the election of a left-of-centre coalition government in September 1993, the pace of structural change, particularly that of privatisation, slowed. While implementation of the long-delayed National Investment Funds programme began in July 1995, other forms of privatisation remain stalled. New proposals link privatisation with pension reform, but both issues are complex and politically sensitive.

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. The private sector share of GDP rose to 55 per cent in 1995. This share is likely to have risen to about 60 per cent in 1996.

Large-scale privatisation
Under the 1990 Privatisation Law, enterprise participation in the national privatisation programme is voluntary, requiring the consent of enterprises and their workers' councils, and allows for different tracks to private ownership. The three main tracks are liquidation (sale or leasing of enterprise assets to a new private company), commercialisation (conversion into a treasury-owned joint-stock company) followed by privatisation through share sales, and inclusion in the National Investment Funds (NIF) programme. By the end of June 1996, 2,624 of the 8,853 enterprises that were owned by the government in July 1990 had been liquidated or privatised through asset sales, 248 had been sold in cash privatisations, while 1,049 had been commercialised. Among the latter 1,049, a total of 512 were included in the NIF programme.

The NIF programme, which involves 15 privately managed investment funds, provides for enterprise restructuring through the allocation of lead shareholdings in each enterprise to one NIF, with each of the other NIFs holding small minority stakes. While investor participation in the NIF programme has been extensive, a few problems have emerged with the NIFs themselves. The first is tension between the government-appointed supervisory boards and the private fund managers, owing to both performance failures by management teams and ambiguity in the respective roles of the boards and fund managers. Second, early sale of two enterprises to strategic investors raised concerns about the fund managers' commitment to restructuring. The third relates to the compensation of fund managers and the strength of their financial incentive to promote restructuring of enterprises in which they have lead ßßshareholdings.

The 1996 Privatisation Guidelines call for the commercialisation and sale of 90 enterprises, but this target is unlikely to be met, with only 11 sales in the first half of the year.

Small-scale privatisation
The bulk of the small retail, wholesale and construction enterprises (approximately 20,000) were privatised by local governments early in the reform programme.

Property restitution
Under current law, restitution claims may only be enforced if the nationalisation law provided for compensation and none was paid. While several thousand restitution claims have been filed, compensation has been awarded 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 had reached 2.2 million by the end of June 1995.

Enterprise restructuring
The hardening of budget constraints and market competition (in part from liberalised trade) have initiated significant enterprise restructuring and large productivity gains. State subsidies to enterprises were substantially reduced early in the reform programme, falling from 12.9 per cent of GDP in 1989 to 3.2 per cent in 1992 and to about 2 per cent in each of the subsequent two years. Soft credits through the banking system have been largely eliminated through successful implementation of the 1992 Law on the Financial Restructuring of Enterprises and Banks.

A major restructuring challenge is the coal sector, where output per worker falls well below that in other producing countries. In April 1996, a government committee approved a draft restructuring plan calling for an 18 per cent drop in production and a 30 per cent reduction in employment. The estimated cost to the state of mine closures and related social expenditures is 2.6 per cent of GDP.

In June 1996, the government controversially allowed the state-owned Gdansk shipyard to enter bankruptcy. This move could allow renegotiation of existing sales contracts and the state to provide aid to any new shipbuilding firm that emerges in Gdansk.

Markets and trade

Price liberalisation
Most prices were liberalised in 1990-91. However, 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 markets for farm products. It implements price supports, provides export subsidies, gives credit guarantees, and manages state reserves.

The average tariff for electricity remained at the equivalent of 5.5 US cents/kWh at the end of 1995 – below the estimated long-run marginal cost of 7.4 US cents. Electricity tariffs were increased by less than the rate of inflation in the 1996 budget.

Competition
The 1990 Law on Monopolistic Practice serves to prevent anti-competitive practices, to foster development of competition, and to safeguard consumer interests. The law also provided for establishment of the Anti-Monopoly Office (AMO). Enterprises with a market share of over 80 per cent have been monitored closely by the AMO.

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 on most products, leaving licensing requirements for only a limited range of products (cigarettes, dairy products, natural gas, petroleum and spirits). After a significant deterioration in the trade balance, previously suspended tariffs were reimposed in late 1991. The average tariff rate returned to the pre-reform level and, in 1993, a 6 per cent import surcharge was imposed. Multilateral trade agreements with the EU, EFTA and CEFTA were signed in 1992-93.

In May 1995, quantitative restrictions on agricultural imports were converted into tariffs in line with GATT (Uruguay Round) and EU commitments and in July 1995 Poland became a member of the WTO. In 1996, the average tariff rate stood at 5.6 per cent for industrial products and 20.2 per cent for agricultural goods. The import surcharge, which was cut to 3 per cent at the beginning of 1996, is to be eliminated by the end of 1996.

Currency convertibility and exchange rate regime
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.

In May 1995, the exchange rate regime was modified to allow the zloty to fluctuate within a band of +/- 7 percentage points around the central rate against a basket of five currencies. The centre of the band is adjusted daily at a pre-announced rate (which was reduced in May 1995 to a level that would produce a cumulative 1.2 per cent devaluation per month). The central rate of the zloty was revalued by 6 per cent in December 1995. In January 1996 the pace of daily devaluations was slowed further to a level which produces a cumulative devaluation of 1 per cent per month.

Wage liberalisation
In January 1995, the 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 government, employer, and worker representatives. This approach replaced an excess-wage tax (Popiwek) for state enterprises, which was operating between 1990 and 1994.

Interest rate liberalisation
In January 1990, banks were permitted freely to set deposit and interest rates. The refinancing rate on credits for central investments, which used to be the main reference rate, 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, buying and selling treasury securities in the open market to regulate the money supply.

Financial institutions

Banking reform and development
The Banking Law (1989) and the NBP Act (1989) divided the banking system into two tiers and, between 1989 and 1991, the commercial banking operations and branches of the nine regional departments of the NBP were transformed into independent commercial banks. In addition to these nine state-created commercial banks, there are four specialised state banks (two savings banks, a foreign trade bank and a bank for agriculture). Many new private banks were licensed in 1991 and 1992, but then issuance of new licences was sharply curtailed.

Banking supervision is carried out by the NBP, through its General Inspectorate of Banking Supervision. 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 worth Zl 2.1 billion (1½ per cent of GDP). The state bank for agriculture and the second state savings bank received additional capital injections in 1996 amounting to Zl 0.6 billion. The pace of bank privatisation has been slower than anticipated, with only four of the nine commercial banks privatised by mid-1996. A government proposal involves consolidating several of the remaining state banks around the former foreign trade bank.

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 banks. It covers deposits up to ECU 1,000 in full and provides 90 per cent coverage for deposits up to ECU 3,000.

Performance of the banking system remains weak. The ratio of total domestic credit to GDP at the end of 1995 was 35 per cent, of which only about one-third was credit to private sector. 50 per cent bank credit is short term; however, this includes a substantial amount of guaranteed housing loans and centrally directed credits extended under the previous regime.

Non-bank financial institutions
The 1991 Law on the Public Trading of Securities and Trust Funds permits the establishment of open-end investment funds. The first such fund was established in 1992, and in May 1995 the securities commission authorised three new open-end investment funds. A 1995 law authorised the formation of closed-end investment companies.

The 1990 Insurance Law, as amended in 1995, provides for the regulation of insurance companies. The Law establishes principles for authorisation of insurance companies, minimum capital and solvency standards, a State Office for Insurance Supervision with strengthened enforcement powers, and an Insurance Guarantee Fund. The insurance sector is dominated by a state-owned company and its subsidiary, along with a former state-owned insurer. Another 36 companies operate in the market, of which 12 are foreign controlled.

The government is considering pension reforms which may allow for the establishment of private pension funds.

Securities markets and instruments
The Warsaw Stock Exchange (WSE) reopened in 1991, with the Law on Public Trading in Securities and Trust Funds (1991) and the Act Establishing the Warsaw Stock Exchange (1991) providing the basic legal framework for securities activities. The Securities Law 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 WSE has expanded steadily, with 53 listed companies and a total market capitalisation of US$ 4.3 billion (3.8 per cent of GDP at end-1995). This market is among the most liquid of those in transition economies. A further 12 companies with a total market capitalisation of US$ 150 million are listed on the exchange's parallel market, while an OTC market is expected to open in mid-1996.

The stock market will receive a substantial fillip with the listing of NIFs on the WSE in early 1997 and the separate listing of some companies participating in the NIF programme on the OTC and parallel markets.

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, while personal income tax rates were raised in 1994 (to 21, 33 and 45 per cent). The government's medium-term economic programme calls for gradual cuts in the personal income and corporate profits tax rates.

The composition of government revenues has shifted dramatically. In 1989, levies on enterprises accounted for 43 per cent of state budget revenues, while their share had fallen to 10 per cent in 1995. The VAT and personal income tax now accounted for 68 per cent of state revenues.

Social security
The Social Insurance Fund and the Labour Fund are the largest extra budgetary funds for social expenditures. Outlays from these funds have increased rapidly in recent years due to demographic trends, generous incentives for early retirement, and job losses. Their expenditures amounted to 16 per cent of GDP in 1995, up from 8 per cent in 1989. With pensions and benefits indexed to wages, transfers from the state budget to these funds have increased sharply. The 1996 budget suspended for one year this indexation to wages and restricted the real increase in benefits to 2.5 per cent.

The government is considering proposals for a comprehensive pension reform involving two basic issues. The first is overhaul of the existing pay-as-you-go (PAYG) system, possibly including a shift in the basis for indexation from wages to prices, a rise in the retirement age for women and the elimination of the general early retirement provision. The second is a phased introduction of a fully funded capital system with management of pension fund assets by private financial institutions. Some proposals link capitalisation of new pension funds to privatisation of remaining state enterprises.

Investment legislation

Extensiveness
Laws exist regulating domestic and foreign investment, directly and through indirect investment vehicles, such as securities or investment funds. Such investment generally requires no government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners and nationals, subject to permit, own or lease land. Security interests over land and shares (but only in favour of banks) may be created, require notarisation and entry in an official register. Security interests (only in favour of banks) over contracts, receivables and moveable assets are possible.

Effectiveness
The full texts of laws relating to investment are published, usually within one month of enactment. Draft laws are not always published and available to practitioners. Public records in share or land registries may be up to three months behind current status. Important court decisions are not always published or accessible to practitioners. Independent professional legal advice is available. Private parties generally believe that courts will recognise and enforce their legal rights, including against the state. Foreign arbitral awards are required to be recognised and enforced without a re-examination of their merits.

Romania

Reforms began in November 1990 with radical price liberalisation and the devolution of decision-making power to enterprises. Gradual further reforms followed in 1991-92. From mid-1993 onwards, a serious effort was made to tighten credit policy, and thereby the budget constraint facing enterprises. These efforts also involved an improvement in the efficiency of allocation of credit and foreign exchange. A comprehensive scheme of mass privatisation was launched in earnest in 1995, after having been on the drawing-board for years. The access of enterprises to purchases of foreign exchange has become more restricted in 1996 than it was in 1995.

Enterprises

Size of the private sector
According to government estimates, the private sector share of GDP has risen from 35 per cent in 1994, to 45 per cent in 1995, and further to about 50 per cent in 1996. The private sector accounted for about 57 per cent of total employment in 1995 and 62 per cent in 1996. The employment share of the private sector was, in 1995, 16 per cent in industry, 87 per cent in agriculture and about 67 per cent in construction, with shares in imports and exports of 45 and 41 per cent, respectively. The private sector share in value added for 1995 was estimated at 89 per cent in agriculture, 29 per cent in industry, 61 per cent in construction and 60 per cent in services, including trade.

Large-scale privatisation
By March 1996, more than 1,500 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 was initially granted 70 per cent of the shares in 6,280 "commercial companies", while the rest of the shares in these companies were transferred to the five "private" funds which were themselves established as joint-stock companies.

A new Privatisation Law was passed on 21 March 1995. Under the new Law, Romanians would be able to purchase state assets using (i) "certificates of ownership" coupons distributed to 15.5 million individuals in 1992, and (ii) new issues of "vouchers". The distribution of vouchers to all 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. In exchange for coupons and vouchers, citizens can choose either to subscribe for shares directly in companies or to obtain shares in one of the five private ownership funds, which are to become mutual funds. By mid-1996, about 90 per cent of the population had subscribed, and the distribution of shares was due to be finalised by the end of September 1996. The shares will be traded on an over-the-counter market (see the comments below on Securities markets and instruments).

During the mass privatisation process, up to 60 per cent of the ownership in an individual company may be sold for coupons and vouchers, while the remaining at least 40 per cent is to be sold for cash. Prices of assets sold for coupons and vouchers will not be determined through auctions or other market-clearing mechanisms but will be based on the enterprise book value.

A bank privatisation law was been adopted by the Senate in September 1996. It identifies the State Ownership Fund, to which the shares held by private ownership funds will be transferred, as the entity legally responsible for the sale of banks. The government has yet to decide on the maximum block of shares which can be acquired by "strategic" (outside) investors.

In September 1996, the Senate approved a bill on the transformation of the five private ownership funds into investment funds.

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. In October 1995, less than half of the ownership certificates had been converted into formal titles. This process may now speed up as a law on cadastral surveys came into force in July 1996. The privatisation of state farms has proceeded more slowly, particularly since the government has decided to preserve them as unified production units.

Small-scale privatisation
More than 7,000 small units (shops, etc.) have been put up for sale and about 3,000 have been privatised. The latter employ 13,500 individuals. 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 under Large-scale privatisation, above).

Property restitution
The law on property restitution grants partial restitution rights and compensation packages to former owners of around 250,000 residential properties that had been confiscated by the state since World War II.

Growth of private enterprise
The number of registered companies with private capital increased to 468,207 by September 1995, up by about 51 per cent on 1993.

Enterprise restructuring
The main restructuring tool has been enforcement of competitive pressure through subsidy reduction, attempts to introduce market-oriented credit policies, price liberalisation, and more liberal import competition. 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 (especially in 1993-94 – there appears to have been some loosening over the past year), 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.

In a step that may have slowed the pace of restructuring, a National Oil Company was established in August 1996, to unify oil import and export trading strategies, and also to keep control over the foreign currency transactions associated with that activity (see the section below on currency convertibility and the foreign exchange rate regime).

A Bankruptcy Law was passed by parliament in March 1995. The law does not apply to the largest state sector companies, the "regies autonomies", for which special bankruptcy legislation is being drafted.

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 and mark-up limits eliminated. By the middle of 1995, the share of administered prices on consumer goods and services had fallen to 3 per cent. Prices for oil and other energy products remained subject to state control by the autumn of 1996, as did a few agricultural products.

Competition policy
A Law regulating Competition was passed in April 1996, to become effective on 1 January 1997. A Council of Competition has been established for supervisory purposes.

A law regulating copyrights was passed in June 1996. A copyright office has been created to supervise implementation and compliance.

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 non-agricultural imports is fairly liberal. However, very high tariffs, on average about 110 per cent, remain in place for most agricultural products.

The full version of Romania's "Europe 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 phase-in over 10 years (from May 1993) of free trade in industrial goods between Romania and the EU. This part of the agreement was already fully operational under the interim arrangement. In June 1995, Romania applied formally for EU membership. Romania became a member of WTO in December 1994. The new tariff regulations, in accordance with WTO agreements designed to replace the old quantitative restrictions, allow in some cases for exceptionally high individual tariffs, especially in the agricultural sector.

Currency convertibility and exchange rate regime
For the financial and exchange rate markets, 1996 has been a difficult year. The leu is officially convertible for the purpose of foreign trade transactions and for repatriation of capital and profits of foreign investors. The exchange rate of the leu is floating. 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), although there has continuously been a gap between these rates, occasionally reaching 20 per cent in 1995.

In August 1994 Romania launched an interbank foreign exchange market. From July 1995 onwards, foreign banks with local branches were granted permission to operate as dealers on this market. Exposure was limited to US$ 1 million or the equivalent in local currency converted at the official rate for dealers and to US$ 100,000 for brokers. In an attempt to control the downward tendency of the leu, the authorities started at the beginning of 1996 to impose increasingly tight restrictions on enterprises' access to conversion of lei into foreign currency and on the foreign currency operations of commercial banks. Since March, only four banks have been able to participate in the interbank market for foreign exchange. None of these four is foreign and only one is not state-owned.

In April, the government of Romania, supported by March credit ratings of BB- (Standard and Poors) and Ba3 (Moody's), issued its first international bonds (raising a total of US$ 825 million in the two issues that had been marketed by August 1996). The official exchange rate has remained about 10-20 per cent above (i.e. more appreciated than) the "bureaux rate" over the summer of 1996.

In August 1996, the government announced new surrender requirements for a set of more than 100 firms; later these requirements have been given a liberal interpretation in official announcements, but the original decree formally remains in place.

Wage liberalisation
Collective bargaining is well established, but the government pursues an incomes policy, through taxation of "excessive" wage increases. The net average monthly salary stood at Lei 301,558 (approx. US$ 100) in April 1996. In July 1995 the government, the employers' association and the trade unions all signed an agreement on the stipulation of a minimum wage. Through this agreement, the government has promised to 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 formally established. However, directed credits, mainly to agriculture, are still channelled through the banking system.

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). By the middle of 1996, the banking system consisted of 30 licensed banks, of which 20 have private and mixed – state and private – capital, and nine are branches or subsidiaries of foreign banks. Private banks represent an increasing percentage of the capitalisation of the banking sector, estimated to have risen to well above 40 per cent from about 30 per cent in January 1994. Many foreign banks have branches in Bucharest.

Conditions attached to the World Bank FESAL agreement included the privatisation of the Romanian Bank for Development, the preparation of a deposit insurance scheme, and the imposition of international accounting standards on banks. In August 1996 the Romanian government approved an insurance deposit system, designed to cover deposits up to Lei 10 million (approx. US$ 3,000), with the whole amount being indexed to the annual rate of inflation. In addition, the Savings Bank, the only one for which deposits are fully guaranteed by the government, was turned into a commercial bank in the middle of 1996.

A formal state-financed recapitalisation of Romanian banks took place in 1991, when 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 Lei 150 billion (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 Lei 50 billion (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-deductible provisions for general credit risk.

With effect from the end of January 1996, the central bank raised to Lei 25 billion banks' minimum requirement capital. The capital of existing banks can be gradually increased to the prescribed level. Two large private banks became illiquid during the first half of 1996.

Non-bank financial institutions
Private open-ended mutual investment funds were set up in 1994. In April 1996, the National Securities Commission started to enforce the rules on net assets value computation, which caused the value of most unit trusts to fall steeply. The value of the biggest fund in the country fell by about US$ 71 million, or 45 per cent, in May 1996, and a number of funds were subjected to a 90-day suspension period in mid-1996. By September of 1996, 12 open-ended funds were still operational.

A total of 40 companies are active in Romania's insurance market. Most of these are privately owned, though the largest are state-owned. The insurance sector is dominated by three state firms. A new Insurance Law, effective from 1 February 1996, has led to the establishment of two funds to provide coverage to clients of bankrupt insurance companies and to victims of car accidents.

Securities markets and instruments

The National Bank of Romania issued the first treasury bills in March 1994. The first US dollar-denominated domestic bonds were issued in August 1996.

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 trading began on 20 November. The NSC, which will regulate the market, has licensed 25 securities

companies to operate on the exchange. The stock exchange currently trades the stocks of 13 companies, only one of which is 100 per cent privately owned. The market capitalisation, in February 1996, amounted to Lei 131.6 billion (approx. US$ 46.17 million).

In late September 1996, an over-the-counter market (RASDAQ), based on the US NASDAQ model, will starting trading the shares created in the wake of the mass privatisation programme.

The first Romanian company to launch a private placement (of US$ 10 million) on international markets was a furniture maker, in April 1996.

Fiscal and social safety net reform

Taxation

Personal income is taxed on a progressive schedule, with a maximal tax rate of 60 per cent. Value added tax is levied at a flat 18 per cent. In January 1995, that rate was reduced to 9 per cent for certain food products 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 and is applicable to all permanently established legal entities, including limited-liability and joint-stock companies with foreign investment. Branches of foreign companies are subject to an additional 6.2 per cent profit tax.

Social security

Romania's social security system is financed in part through a payroll tax (employer's contributions are about 35 per cent of the wage sum; and employees pay an additional 1 per cent), with the difference financed by the government.

Investment legislation

Extensiveness

Laws exist regulating domestic and foreign investment, directly and through indirect investment vehicles, such as securities or investment funds. Such investment generally requires government agency approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners are prohibited from owning, although they may lease, land. Security interests over shares and land may be created, requiring notarisation and entry in an official register. Security interests over contracts, receivables and moveable assets are possible, and require in some cases entry in an official register.

Effectiveness

The full texts of laws affecting investment are published usually within one month of being passed. Draft laws are rarely published or available to practitioners. Public records in share or land registries may be up to one month behind current status. Important court decisions are usually published or accessible to practitioners within 12 months of being issued. Independent professional legal advice is available. While private parties generally believe that the courts will recognise their legal rights against other private parties, they do not believe that courts would enforce such rights against the state. Foreign arbitral awards are required to be recognised and enforced by the courts without a re-examination of their merits.

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, including mass privatisation, currency convertibility, creation of financial markets and legal reforms. Financial stabilisation has also taken hold since early 1995. In March 1996, an agreement was reached on a three-year Extended Fund Facility with the IMF. The programme aims to consolidate achievements in financial stabilisation and accelerate structural change, especially in areas lagging behind, such as fiscal reforms, land privatisation (and other agricultural reforms), enterprise restructuring and creation of an effective social safety net.

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) represented over 70 per cent of GDP at the beginning of 1996. Non-state industrial enterprises accounted for 89.1 per cent of industrial output, 81.8 per cent of industrial employment and 79.7 per cent of the total number of enterprises (excluding small businesses, joint ventures and industrial parts of non-industrial enterprises). The share of the "true" private sector in GDP (including only companies that are majority owned by private entities) is likely to be around 60 per cent.

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. The implementation of the second, cash-based, phase of the privatisation programme, which started in mid-1994, has proceeded at a much slower pace than had originally been planned.

The government revitalised cash-based sales through a variety of schemes in the fourth quarter of 1995. The key new scheme was the loan-for-share programme, under which financial institutions could bid, in auctions, for the right to hold shares in selected companies in trust for 1-3 years (with the exact terms varying across individual contracts). Under this scheme, payments for the right to hold shares is made by the individual buyer in the form of a low-interest loan to the government. A bid of a particular amount in the auctions is interpreted to represent an offer to lend the government that amount in return for shares in the company that is offered for sale. The successful bidder is entitled to keep 30 per cent of any capital gain they can make before reselling the shares on the market. A total of 29 initial auctions are to take place. At this stage (mid-1996), 12 have been completed. The circumstances of the auctions have in some cases been the source of significant controversy. (Parliamentary committees have been set up to examine the legality of previous privatisations but no clear decision has been reached.)

In 1995 as a whole 2,770 medium and large enterprises were commercialised and partially privatised. The privatisation revenue for the federal budget last year amounted to Rb 7.2 trillion, including Rb 4.7 trillion from the loans-for-shares scheme.

Privatisation targets for 1996 include sale of residual state-owned shares in about 1,000 enterprises, which were partly privatised under the voucher scheme. Moreover, at least five large companies are to be privatised for cash. The authorities are also committed not to initiate renationalisation of privatised enterprises. (Repayment of loans and taking back state shares from trust under the loan-for-share scheme would not mean renationalisation.) Privatisation slowed down considerably in the first half of 1996 mainly due to the uncertainties associated with the presidential election (held in June 1996).

The emphasis in the Russian large-scale privatisation efforts has shifted from speed and revenue maximisation to transparency and promotion of enterprise restructuring. A new privatisation programme reflecting the new priorities was adopted in July 1996. The programme abolishes the privileges of workers' collectives and expands the rights of local authorities in the privatisation process.

Farm privatisation continues to be blocked due to a stalemate between the Duma and the executive branch regarding property rights to agricultural land. A March 1996 Presidential Decree provides for full land privatisation but the new Land Code, adopted by the State Duma in mid-1996, preserves restrictions on land sale. The Code has, however, been rejected by the Federation Council.

Small-scale privatisation

By mid-1996 over 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 are in retail trade, public catering and consumer services where the privatisation rate is around 90 per cent. Progress in small-scale privatisation varies substantially across regions. Small firms have been sold primarily through employee buy-outs or public auctions.

Over the last year the number of private farms has been stagnating at 280,000 due to the adverse investment climate.

About 40 per cent of the housing stock was already in either private or cooperative ownership at the end of the Soviet period. Since then between 35 and 40 per cent of the remaining

dwellings earmarked for privatisation have been transferred to private owners, including 6.5 per cent of such dwellings in 1995.

Property restitution
No property restitution to former owners has taken place to date.

Growth of private enterprise
The approximately 1 million registered new small businesses account for about 12 per cent of officially recorded GDP. Estimates suggest that an additional 2-3 million small undertakings exist but remain unregistered. Macroeconomic and legal uncertainties, registration and licensing obstacles, lack of access to external finance and commercial space as well as extortion threats are among the key obstacles to the initiation of private enterprises. The major governmental incentive has been a two-year tax holiday for small enterprises. A new federal programme for support of small businesses in 1996-97 was recently adopted by the government. Key priorities are the establishment of small farms and conversion of military enterprises. A fund which will provide finance for small businesses has recently been created. It will be able to utilise a 5 per cent levy on privatisation transactions for this purpose. In 1996 a streamlined taxation system was introduced for small enterprises.

Enterprise restructuring
With steady progress in financial stabilisation since early 1995 the budget constraint of the enterprise sector had tightened substantially. The sharp real appreciation of the rouble has, in the meantime, added to the restructuring pressures on enterprises in the tradable goods sectors. However, the still widespread regulatory exemptions and accumulation of arrears has partly offset such pressures. Enterprise restructuring has hitherto been achieved mainly through changes in the product mix, shedding of labour through attrition, expanded use of unpaid leave or reduced hours. Deeper restructuring in the form of factory shutdowns, changes in management, major reorganisations and modernisations would need tougher and enforceable bankruptcy rules as well as much improved corporate governance and could clearly be helped by a better functioning financial sector (providing finance for the most deserving investments).

By the end of 1995 the Federal Bankruptcy Agency, dealing with debtors with more than 25 per cent state ownership, had investigated close to 15,000 firms, declaring 3,343 insolvent. Only about 5 per cent of these cases were brought to court. Formal bankruptcy proceedings remain relatively rare, both for privately owned and for state-owned companies. A debtor company can be declared insolvent if it fails to fulfil a creditor's claim (in excess of US$ 7,000) for three months. Insolvency may be proclaimed by decision of a court or by the company itself. Russian bankruptcy law offers three options for further action: reorganisation, liquidation or reconciliation. However, creditors get little legal protection during these proceedings. The new Civil Code moves down pledged claims in the pay-back order during bankruptcy. Foreign debtors are subject to the same legislative procedures as are domestic creditors but foreign creditors can lodge insolvency claims only through their Russian subsidiaries. The draft of an amended version of the bankruptcy law, providing strengthened rights for creditors, has been submitted to the Duma.

Corporate governance remains handicapped by the continued strong concentration of ownership in the hand of insiders (workers and management). However, commercial banks are an increasingly active influence. They have taken large equity stakes in many enterprises and are exercising external control, partly in the framework of Financial Industrial Groups. Recent evidence suggests that real restructuring is coming mainly from this source. The Law on Joint Stock Companies, which became operational on 1 January 1996, introduces a new set of principles and rules for efficient corporate governance. The deadline of 1 July 1996 for companies to bring their charter into compliance with the law has been extended by one year.

Markets and trade

Price liberalisation
Only basic necessities and a restricted list of producer goods and services remain subject to price controls at the federal level. However, widespread direct and indirect price controls continue to be applied at the local level. In 1995 the scope of controlled prices was estimated at 30 per cent. Domestic oil and oil product prices are liberalised. Crude oil prices currently stand at about 65 per cent of the world price levels while prices for oil products are above their international levels. Prices for natural monopolies, including gas, heat, pipeline fees and railway tariffs, have since early 1996 been linked to the increase in the overall Russian producer price level.

A March 1995 presidential decree envisages 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. This process, however, has been slow so far, partly due to the election campaigns.

Competition
The Law on Competition and Limitation of Monopolistic Activity in the Goods Market (of March 1991) has been adjusted to new developments by over 30 normative acts issued by the State Anti-monopoly Committee. The Committee has a broad mandate with regard to the development of competition, the limitation of monopolistic activities and the suppression of unfair competition. The Committee, which was given ministerial status in March 1995, may impose fines, invalidate contracts and issue binding orders to both state agencies and private companies. A special register of firms with dominant market position (defined as over 35 per cent market share) is kept by the federal and regional branches of the Committee. (At the end of the first quarter of 1996 the federal section of the registry included 486 industrial enterprises accounting for 19.2 per cent of all industrial output). Dominant market positions, including those created by cartel agreements, are monitored and (in the case of abuse) sanctioned. In addition, prior approval of an anti-monopoly committee is required for a variety of transactions such as merger, acquisition and direct investment in Russian companies above certain limits. For example, acquisitions of more than 20 per cent (recently decreased from 35 per cent) of the shares of a company, or acquisition of shares in any firms included in the register of dominant firms, requires prior approval.

In November 1995 a special Law on Financial Industrial Groups (FIGs) was adopted. A full set of implementing legislation has not been issued as yet. In mid-1996 there were about 35 such officially registered FIGs and the application for registration of over 120 was under consideration. The FIGs may be opting to register in the hope of achieving some kind of special state support. While these groups may create useful synergies between banks and industry they may also cause re-monopolisation and reduced transparency within the economy. The stance of the Anti-monopoly Committee in this regard is not as yet clear.

Trade liberalisation
Since the implementation of increases in mid-1995, the average weighted import duty has been about 13-14 per cent. The authorities are committed to reducing it by at least one-fifth before the end of 1998. However, in response to sharp real appreciation of the rouble, protectionist pressures from industrial enterprises have grown. Tariff dispersion is to be further reduced. The government is committed to scaling back all remaining import duties in excess of 30 per cent by the end of the third quarter of this year. To contain capital flight, the "commodity passport system", previously applied only to exports, has been extended since early 1996 to imports as well.

Having fully phased out export quotas and scrapped the system of "special exporters", the government has been implementing new liberalisation measures in the area of exports since mid-1995. By late 1995, export tariffs had been eliminated, except for gas and oil. Export tariffs on gas were replaced by excise taxes in April 1996, and so were export tariffs on oil in July 1996. Significant progress has been made in limiting the extent of centralised trade which presently amounts to less than 5 per cent of total exports.

Russia made a formal request to join the WTO in 1994. Since then three basic fact-finding working party meetings have taken place. In mid-1995 Russia created a customs union with Belarus and Kazakstan. Kyrgyzstan signed the customs union treaty in early 1996 (but the Kyrgyz parliament has yet to ratify this decision).

Currency convertibility and exchange rate regime
The rouble is fully convertible for current account purposes. In June 1996, Russia officially assumed the obligations of Article VIII of the IMF Charter. *De facto* convertibility for several categories of capital transactions is also in place. A 50 per cent surrender requirement continues to be applied for exports. Surrendered currency is sold at the interbank market (i.e. at the prevailing market exchange rate).

From June to the end of 1995, the exchange rate was (for the first time) pegged within a band of Rb 4,300-4,900 per US dollar. The currency corridor was extended to the first half of 1996, and the band was adjusted for that period to the range Rb 4,550-5,150 per US dollar. Since July 1996, a crawling band has been applied. Its initial range (on 1 July) was Rb 5,000-5,600. Since then, the band has been depreciated at a pre-determined rate of about 1.5 per cent per month. The band is scheduled to be Rb 5,500-6,100 by year-end (strictly speaking, the rate of depreciation is defined in absolute terms, rather than in percentage terms). Since 17 May 1996, the official exchange rate has been set daily by

the Central Bank of Russia (CBR) on the basis of a string of indicators, including inflation, balance of payments and reserves, and is committed to defending this rate. Prior to this change, the official rate was determined, to a large extent without intervention, on the Moscow International Currency Exchange (MICEX) — the MICEX-rate is now a direct function of the setting of the official rate.

Wage liberalisation
Wages are determined without government intervention outside of the budgetary sector. The tax-based incomes policy, covering both state and non-state enterprises, was abolished in January 1996. Public sector wages are set as multiples of the nominal minimum wage. The minimum monthly wage was at the level of Rb 75,900 (US$ 15) in June 1996. At that time, the average monthly wage was about Rb 837,200 (approximately US$ 165).

Interest rate liberalisation
Banks in Russia are free to set deposit and lending rates without government intervention. The refinance rate is set by the CBR and has been at a high level in real terms over the past year. Its nominal monthly level was reduced from 13.3 per cent in late 1995 to 6.7 per cent in August 1996. The refinance rate sets the floor on the credit auctions but has not been actively used. Interest rates on the interbank market have been oscillating well below the refinance rate but reflect only the transactions of an elite group of banks.

Financial institutions

Banking reform
To date there are fewer than 2,200 operating commercial banks in Russia, sharply down from about 2,600 in early 1995 as a result of severely tightened licensing policy. The banking system is dominated by private banks, with only three banks, including Sberbank, remaining in majority state ownership. The largest 10 banks accounted for 42 per cent of total bank assets in 1995. The banking sector as a whole is severely undercapitalised, oversized and illiquid. Only the top 10 banks have charter capital in excess of the rouble-equivalent of US$ 100 million, while 80 per cent of the banks have capital of less than US$ 1.1 million (5 billion roubles). In 1995 about 800 banks reported losses, with approximately half of them being technically insolvent. The ratio of non-performing loans to the total loan portfolio was estimated at around 30 per cent. The August 1995 crisis in the interbank market demonstrated the problems banks have in managing liquidity. To deal more effectively with short-term liquidity fluctuations, the CBR has introduced deposit auctions and a Lombard facility. Repo operations are to begin in late 1996. Financial stabilisation poses a more general challenge by eroding "easy" sources of profits in hard currency operations, high-yielding transactions in government securities and short-term lending at very high interest rates. Meanwhile, the majority of banks have yet to develop core traditional banking activities. The CBR is developing its capacity to deal with troubled banks. Special bankruptcy procedures for banks are expected to be adopted in 1996.

Following the enactment of a new Law on Banks and Banking Activity, new prudential regulations came into effect in April 1996. The minimum capital requirement for banks is to gradually rise to ECU 5 million by mid-1998 from ECU 2 million in April 1996. The minimum risk-weighted capital adequacy ratio is to rise to 8 per cent by early 1999 from 5 per cent in July 1996. Liquidity ratios and exposure limits have also been tightened. A reform programme supported by the EBRD and the World Bank aims to create a core select group of banks which will be capable of complying with international prudential standards and which will in return become eligible for certain regulatory privileges. By mid-1996 32 banks have been accredited under the programme.

Non-bank financial institutions
The key new development in the area of non-bank financial institutions is the establishment of the legal and regulatory framework for mutual funds in mid-1995. The first mutual funds emerged in early 1996. Many of the existing voucher investment funds and the so-called investment companies are also expected to be transformed into mutual funds. Regulations for pension funds are being revised. By June 1996, about 140 private pension funds and 52 companies managing the funds' assets were granted licences to operate.

Securities markets and instruments
Within the Russian securities markets, the government bond markets have seen the fastest development with the GKOs (T-bills), OFZs (federal loan bonds) and MinFins (hard currency denominated bonds) being the key instruments. Yields on GKOs and OFZs have been volatile but for most of the time extremely high in real terms. Access for foreigners to the GKO market has been permitted since early 1996 and further eased in July 1996. Yields have declined significantly since mid-1996.

Stock market prices fell almost continuously during 1995 and early 1996, driving down the market capitalisation from US$ 43 billion in September 1994 to US$ 16.5 billion in March 1996. In mid-1996, share prices doubled. They have continued to fluctuate sharply since then. The market remains illiquid, with active trading in the shares of only a few dozen "blue chip" companies. A few Russian companies have managed to issue ADRs/GDRs abroad since late 1995.

Since mid-1995 major progress has been made in the development of a legal framework for protection of shareholders' rights. Most importantly, Laws on Joint Stock Companies and on Securities Markets have been adopted. The capital market infrastructure has been strengthened, independent registrars have been created, and the Russian Trading System now links brokers in Moscow with several other other cities. This system is operated by the Professional Association of Stock Market Participants, which has been expanded into a nationwide self-regulatory organisation. The legal status and regulatory role of the Securities Commission has recently been upgraded. The Commission's priorities for 1996 are: further legal reforms to protect investors against crime; improved enforcement of the existing regulations; development of unit investment funds and continued support for market infrastructure.

Fiscal and social safety net reform

Taxation
Despite some improvements in the first half of 1996, the tax regime remains a key vulnerable area in financial stabilisation and at the same time the single most important deterrent to investment. The excess wage tax and the VAT surcharge were eliminated in early 1996. Tax penalties have been streamlined during the first half of 1996, while VAT legislation has been changed to the benefit of enterprises and some progress has been made in reforming energy taxation and phasing out tax exemptions. However, the tax system as a whole remains unstable, non-transparent and highly onerous for enterprises. The main structural distortion of the tax system by international comparison is the excessive role of profit taxation and the low share of taxes on individuals and the energy sector. The cumulative nominal tax burden on enterprises was close to 100 per cent of pre-tax profits in late 1995. As a result, tax arrears, tax exemptions and outright tax avoidance are rampant. Preparatory works on a new Tax Code have been delayed and the Code is not likely to be adopted and phased in before 1997. Efforts will, in the meantime, focus on improving tax collection by strengthening tax administration, shifting VAT and profit taxes to an accruals-based system, reducing exemptions and eliminating preferential treatment of many large energy users in paying for utilities.

Social security
The social safety net is the weakest element of the new Russian socio-economic structure. The current system is characterised by shortcomings in its financing, the level of benefits and its coverage. It is financed mainly through a range of extrabudgetary funds (the Pension Fund, the Employment Fund, the Social Insurance Fund and the Social Support fund), local budgets and enterprise expenditures on social services. The extrabudgetary funds are financed by a combination of payroll taxes (set at 40 per cent of the wage bill) and all of them are in difficult financial straits as a result of their shrinking tax base, arrears and avoidance of contributions, plus a growing number of eligible recipients and an inefficient administrative system. The Pension Fund provides income support for about a quarter of the population. In 1995 real average pensions were equal to 38 per cent of the average wage, while minimum pensions were at 19 per cent of the average wage. A series of pension reforms aimed at creating a three-pillar system (consisting of a basic state pension, an insurance-based state pension and private pension funds) are scheduled to be implemented from 1997.

Laws delinking pension and unemployment benefits from the minimum wage are expected to be adopted before the end of 1996. Comprehensive reviews and assessments of the Pension and the Employment Funds are under way. The future coverage and benefits of the social safety net depend to a large extent on potential savings on other types of budgetary expenditures and on the future revenue performance of the state budget.

Investment legislation

Extensiveness
Laws exist regulating domestic and foreign investment directly and through indirect investment vehicles, such as securities or investment funds. Such investment generally requires no government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enter-

prises. Ownership of land by nationals, foreigners or foreign-owned local companies is restricted. The leasing of land is generally permitted. Security interests over shares and land may be created, requiring notarisation and entry in an official register. Security interests over contracts, receivables and moveable assets are possible and, in the case of moveables, require entry in an official register to be maintained by the pledgor.

Effectiveness
The full texts of laws relating to investment are published, usually within one month of enactment. Draft major laws are made available to practitioners for comments. Public records in share or land registries may be up to six months behind current status. Major court decisions are generally available to practitioners. Independent professional legal advice is available. Private parties generally believe that courts will recognise their legal rights against other private parties, including the state. Foreign arbitral awards are required to be recognised by the courts without re-examination of their merits.

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. Rapid progress on privatisation was achieved in 1992-93, mainly via vouchers, but progress then slowed, partly reflecting changes to the government in 1994. Following the government's decision to cancel the voucher element of the second wave of privatisation in 1995, most of the subsequent privatisations have taken the form of direct sales, especially management buy-outs. The government hopes to complete this part of the privatisation programme during 1996.

Enterprises

Size of the private sector
The private sector is officially estimated to have accounted for 58 per cent of GDP in 1994. According to the latest official figures, the private sector accounted for 70 per cent of GDP in the first quarter of 1996. In April 1996 the private sector accounted for 67 per cent of industrial output and 57 per cent of total employment. These shares include enterprises where the National Property Fund (NPF) continues to hold a minority share.

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 166 billion Slovak crowns. In this process, 80 billion crowns worth of shares in 503 firms were distributed through a voucher-based "mass privatisation" scheme. 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 voucher privatisation under the second wave. Amendments were also made to the laws regarding investment funds, and parliament adopted a law concerning state interests in enterprises.

Under the new legislation, the 3.5 million voucher holders have, in exchange for their vouchers, received five-year bonds with a nominal value of 10,000 crowns, issued (and guaranteed) by the NPF. The interest rate is the same as the discount rate of the National Bank and the principal falls due at the end of the year 2000. There are a number of options for bond holders. First, they can hold the bonds until maturity. Second, they can sell the bonds. Third, they can use the bonds to buy shares of companies in the NPF's portfolio, and this may be an option the NPF would prefer since it would reduce the number of bonds the NPF will have to redeem at the end of the year 2000. Other options include using the bonds as part-payment for apartments and/or health insurance. The bonds can also be used to pay off debts to the NPF, and it is expected that some companies will buy up bonds for this purpose.

At the beginning of August the government published the trading regulations for the bonds, having earlier set a minimum price of 75 per cent of the bond's nominal value. The NPF is responsible for determining and publishing the list of institutions entitled to purchase bonds from the general public. The initial list comprised 28 institutions, and is expected to increase over time. Trading commenced on 1 August through the RM system (described below under Non-bank Financial Institutions), although, during the early days of trading, orders to sell heavily outnumbered orders to buy.

The immediate effect of the cancellation of the voucher scheme has been that privatisation has continued via direct sales, including management and employee buy-outs, with a preference given to existing management. A typical direct sale entails the purchaser agreeing a price for the company with the NPF; making a down-payment of between 10 and 20 per cent of the purchase price and paying the balance in instalments; agreeing on an amount which will be invested in the company, and which can be regarded as a contribution towards the loan repayments to the NPF. An amendment in early 1996 to the income tax law allows companies to claim tax relief on the amount of investment management agrees with the NPF to make in the company subject to the management buy-outs.

According to estimates from the Ministry of Privatisation, over 600 privatisation proposals with a value of 136 billion crowns (US$ 4.5 billion) were submitted to the NPF by March 1996 under the "second wave". It is estimated that two thirds of these enterprises had been privatised by mid-1996. It is intended to sell the remainder (many of which are in the agricultural sector), during the second half of the year.

The law relating to state interests lists 29 companies which will not be privatised (mainly in gas and electricity generation, telecommunications, armaments and agriculture). It also lists a further 45 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). Under the amendment the state would retain ownership either via a shareholding in excess of a third of the total number of shares or through a "golden share". Under this proposal, the state would have enjoyed special voting rights. However, in April 1996 the Constitutional Court declared that the golden share concept was unconstitutional on the grounds that it violated the rights of other shareholders. A subsequent amendment to the law (on state interests), passed in June this

year, added the names of the three largest banks to those companies which could not be privatised, although, in the case of the banks, the effect of this amendment expires at the end of March 1997.

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. Within the CSFR 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 shares in each privatised company and currently has stakes in some 500 companies with a market value of over 2 billion crowns. Revenues (estimated at 500 million crowns in 1995) from sales of shares and dividends are used to meet claims.

Growth of private enterprise
The number of profit-driven institutions rose from 42,250 in October 1995 to over 46,800 by May 1996. Over 96 per cent of these are private sector companies.

Enterprise restructuring
The main restructuring tools have been indirect: privatisation, tight access to credit and subsidies for enterprises, liberal rules of entry, and import competition. Restructuring has essentially been left to the new private owners. The initial Law on Bankruptcy was passed in August 1991 and came fully into effect in 1993. Although it allows creditors to bring bankruptcy cases to court after a three-month protective period and also provides scope for both creditors and debtors to propose arbitration procedures, in practice there is virtually no possibility of external creditors forcing companies into bankruptcy.

The number of bankruptcies has been small. A total of 1,530 bankruptcy petitions were filed last year, but only one company went into liquidation as a result. Recent proposals by the government on a new draft law contain certain improvements to procedures, but also exclude strategic enterprises from bankruptcy proceedings.

The government has introduced a number of programmes to support SMEs, focusing on the provision of business counselling services and training programmes. Support also includes initial capital for companies with less than 200 employees and which are majority Slovak owned; loans are also available for SMEs which have been established from former state-owned enterprises. With the support of both the EBRD and Phare, the government established in 1996 a Post Privatisation Fund amounting to a little over ECU 50 million which will invest in and, where necessary, provide technical assistance to medium-sized companies which have recently been privatised or established but which face capital constraints.

Markets and trade

Price liberalisation
In January 1991, the majority 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.

In November 1995, parliament approved a law allowing the Ministry of Finance to regulate the prices of certain goods and services in the domestic market, including gas and electricity. The law took effect on 1 April this year. The government approved increases in electricity prices for both industrial consumers (10 per cent) and residential consumers (5 per cent) with effect from 1 August. This represents the first increase in electricity prices for several years.

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 has indicated where changes to the legislation in this area are required 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 elimination of quantitative controls on imports and exports was undertaken in 1991. Export licences are required only for certain natural resources.

The average weighted import tariff is 4.9 per cent (and will fall to 3.8 per cent with the implementation of the Uruguay Round). A 10 per cent surcharge on all imports of consumer goods and foodstuffs was introduced in March 1994. Following pressure from a number of sources, especially the WTO, the government agreed to reduce the surcharge to 7.5 per cent from 1 July 1996 and abolish it at the beginning of next year. The bilateral Payments Agreement for trade with the Czech Republic ceased to be effective in October 1995, although the customs union was maintained.

The Slovak Republic became a member of WTO in January 1995, succeeding the CSFR in its GATT membership. On 1 February 1995, the interim version of the Slovak Republic's "Europe Agreement" was converted into the fully fledged version. As well as maintaining the customs union with the Czech Republic, the Slovak Republic has free trade agreements with both EFTA and CEFTA, and with Romania and Bulgaria. In April this year, it signed similar agreements with both Latvia and Estonia.

Currency convertibility and exchange rate regime
Current account convertibility for enterprises was introduced in January 1991. Full current account convertibility, for both individuals and enterprises, was introduced on 1 October 1995, following parliament's approval of a new foreign exchange law. *Inter alia,* this allows Slovak citizens to exchange Slovak crowns for foreign payments on all current account transactions for goods and services in hard currency. Some restrictions on capital account remain including limits of foreign lending by Slovak entities and purchases of real estate by non-residents. However, the Slovak authorities intend to progressively liberalise the capital account over the next few years. 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 National Bank of Slovakia (NBS) widened the fluctuation band around the central parity for the Slovak crown to +/- 3 per cent from the beginning of 1996 and then to +/- 5 per cent in July.

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. Wages policy is currently determined via collective bargaining on a tripartite basis between the government, employers and the trade unions. As part of the agreement concluded in March this year, the minimum monthly wage was increased to 2,750 crowns, compared with an average monthly wage of 7,150 crowns in the first quarter.

Interest rate liberalisation
Interest rates were completely liberalised in April 1992. At the beginning of 1996 the discount rate was lowered to 8.75 per cent, although since then monetary tightening has led to higher money market rates. Lending rates have remained 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, central bank) was established in January 1993 as the Slovak successor to the former State Bank of Czechoslovakia. At the time of independence at the beginning of 1993 there were 23 banks operating in the Slovak Republic. In 1996, 31 banks were operating in the Slovak Republic, including six wholly domestically owned banks, 16 with foreign capital participation, seven branches of foreign banks and two state-owned banks.

The sector remains dominated by the three main banks, the VUB General Credit Bank (46.9 per cent state owned), the Investment and Development Bank (36 per cent) and the Savings Bank (97 per cent). These account for some two-thirds of all loans and 70 per cent of all deposits, while the majority of all personal deposits are held with the Savings 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 credits to enterprises) of "permanent revolving credits" (perpetual loans characterised by low interest rates and issued for inventory financing). State-financed recapitalisation of the banks totalling Kcs 50 billion was conducted in November 1991 (these recapitalisation figures cover the CSFR as a whole).

Non-performing loans, however, remain a source of concern. At the end of 1995 classified claims (generally those where payment is overdue by more than 90 days) amounted to 132 billion crowns – 29 per cent of total claims of 451 billion crowns, most of which are on the books of the main banks. By mid-1996, the value of classified loans had fallen to 121 billion crowns.

To assist with the restructuring of banks' balance sheets, the NBS approved a 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. There have been discussions between the Ministry of Finance and the NBS over the extent to which banks can set aside tax-deductible provisions for loan losses, which would require changes to the tax laws (at present provisions are subject to corporate income tax).

The policy of the NBS over the last year has been to strengthen the banking sector partly by strengthening its own supervisory capability. 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. At the end of 1995, it is estimated that all but two of the banks met the interim capital ratio guideline of 7.25 per cent.

In February 1996, parliament approved an amendment to the 1993 Banking Act which strengthened the powers and the position of the Supervisory Department of the National Bank. Amendments included changes to the rules on bank secrecy, making it necessary for banks to inform the NBS of any loans/guarantees in excess of 1 million crowns.

The amendment to the Banking Act of 1996 also set out the legal framework for the provision of mortgages. The act enables banks to lend up to 60 per cent of the value of the property and to take possession in the event of a default.

In March this year, parliament passed a law on the Deposit Insurance Scheme, which provides protection for personal (not corporate) deposits at all banks. Until then, only personal deposits held at the three main banks were guaranteed by law. The new law, which came into effect on 1 July, provides protection up to a limit of 30 times the average monthly salary in the Slovak Republic. The Deposit Security Fund has been financed by initial contributions from the commercial banks and the NBS, and thereafter by regular contributions from the banks in the region of 0.1 to 0.3 per cent of their deposits in the previous quarter.

The privatisation of the three main banks and the main insurance company, Slovenska Poistovna, which was intended to be undertaken early in 1996, has been postponed at least until the end of March next year. This was reported to reflect the need for further discussions with the Czech authorities on the transfer of their shares in VUB. There were, however, also differences of view on the approach to the privatisation of these banks between the coalition parties.

Non-bank financial institutions

At the beginning of 1995 about 160 investment funds were in operation, the majority dating from the first round of voucher privatisation. The future of some of the funds has been in doubt following the government's decision to cancel the second round of voucher privatisation. Despite the offer of cooperation from the government, some funds have suffered financial losses owing to costs incurred with the preparations for the second round. In addition, amendments to the Investment Funds Act have restricted the role of the funds on the management boards of companies they own and have also limited the share that a fund may hold in any one company to 10 per cent.

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 and matches buy and sell orders, mainly for retail investors, via its 150 branches throughout the country. 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 were fragmented and lacked liquidity, it is estimated that over 80 per cent of all trades were over-the-counter in the initial years.

The government has recently taken a number of measures to consolidate the structure of the securities market and improve transparency. In October 1995 the licence of the Options Exchange was terminated and both the Stock Exchange and the RM-system were given authority to organise the spot market for publicly traded securities. The amendment to the Securities Law approved in late 1995 requires all publicly traded companies to publish annual and semi-annual accounts to FIAS standards (on a quarterly basis for the 19 companies listed on the stock exchange), provides some protection for minority shareholders in the event of take-overs and proposes the establishment of an independent supervisory body to regulate the securities market (currently undertaken by the Ministry of Finance). Other changes that have been introduced cover block trading and the agreement of an average price for securities traded on both the stock exchange and the RM system.

In July 1996 bond issues by both the EBRD (750 million crowns for one year) and the IFC (1.2 billion crowns for three years) saw the opening of the Euro-Slovakian koruna market.

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, 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. At the beginning of 1996 parliament approved a law to allow the VAT rate to be lowered to 23 per cent and for the range of goods subject to the lower 6 per cent band to be widened.

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.

Investment legislation

Extensiveness

Laws exist regulating domestic and foreign investment, made directly and indirectly through the use of indirect investment vehicles, such as securities or investment funds. Such investment generally requires no government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners and nationals may, subject to certain conditions, own or lease land. Security interests over shares and land may be created, require notarisation and entry in an official register. Security interests over contracts, receivables and moveable assets are possible.

Effectiveness

The full texts of laws relating to investment are published, usually within six months of enactment. Draft laws affecting investment are not usually published. Records containing land registers are usually current within one month, while share registers are current within three months. Important court decisions are not usually published or easily accessible by practitioners. Independent professional legal advice is available. Private parties generally believe that courts will recognise and enforce their legal rights, including against the state. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits.

Slovenia

In 1990, after independence, a comprehensive reform programme was adopted. Liberalisation of prices and trade, extensive restructuring of industry and banking reform have taken place, alongside successful macroeconomic stabilisation. Comprehensive mass privatisation is in progress.

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 but no recent official estimates are available.

Large-scale privatisation
Privatisation of the "socially owned" enterprises is governed by a law passed in December 1992. The government's objective is to privatise a total of 1,549 of such companies. The first step of the privatisation process has been the preparation of an "opening balance sheet" and submission of privatisation plans to the Agency for Restructuring and Privatisation. 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 be exchanged either for shares directly in enterprises or for shares in the Investment Funds.

In the privatisation plans prepared by the individual company, it has been possible to distribute a maximum of 20 per cent of the shares in the company to incumbent employees free of charge. A further 40 per cent of the shares will be transferred to three state-run funds: 20 per cent to the Development Fund, 10 per cent to the Pension Fund and 10 per cent to the Restitution Fund set up to compensate individuals for previous nationalisations. The remainder may be sold to management/employees or to outside investors.

From January 1995 to mid-September 1996, the Privatisation Agency gave first approval to a total of 1,266 privatisation programmes, with 31 transferred to the Development Fund (SKLAD). Approximately 707 enterprises have reached the stage of second and final approval by the Agency, 25 per cent of which are currently awaiting official registration with the courts. In companies representing about half of the book value of the 707 privatised companies, employees own a majority stake. Only 100 socially managed enterprises have not presented their privatisation plans: they are mostly non-viable enterprises that will have to be restructured or closed down. It is expected that, by the end of 1996, most companies will be privatised.

Large public utilities are still majority to totally state owned. However smaller utilities are currently either minority publicly owned (either by state or municipality) or they have been privatised according to the same principles as other enterprises.

Banks and insurance companies 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 (Restitution Fund) is being recapitalised with shares in privatised companies. Lack of clarity on land ownership is a common feature. When a conflict arises between the former owner of an enterprise to be privatised and the enterprise itself on the restitution claim and/or on the valuation of the enterprise, the conflict is resolved through mediation. Given the size of restitution claims, the Restitution Fund appears to be undercapitalised. In the context of the association agreement with the EU, the government has made a commitment to changing the current legislation which prevents foreigners from owning land.

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. About 93 per cent of enterprises are small, 4 per cent medium and 3 per cent large.

Enterprise restructuring
Substantial action has been taken to break up large "socially managed" enterprises into smaller units. Slovenia's law on bankruptcy and liquidation became effective in 1994 and is being enforced.

In November 1994 a law was passed to regulate the privatisation of companies rehabilitated by the Slovenian Development Fund (SKLAD). SKLAD, a government agency, was established in 1990 to supervise, restructure and assist the privatisation process. In 1992 the Fund assumed ownership of 98 large and medium-sized companies, mostly in the manufacturing sector, which were in financial and operational distress and it started to implement organisational, financial and operational restructuring. SKLAD's ultimate objective was to return the enterprises on its portfolio to financial viability to enable their privatisation. SKLAD now has a controlling interest in 18 companies. The remainder of the companies originally on its portfolio have been privatised or forced into bankruptcy. As a result of restructuring carried out by SKLAD, 21,000 of 55,000 workers originally employed in the 98 enterprises were laid off.

Markets and trade

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 are steadily being raised (in 1995 they increased 5 percentage points over the rate of inflation, and 4.1 percentage points during the first four months of 1996) and in June 1996 amounted to just over 70 per cent of EU equivalent levels. Natural gas prices are close to EU levels. The government has, during the first half of 1996, turned down requests to raise some utility tariffs, prices of butane, city public transport and telephone services; however, it did increase petrol prices in July 1996 (but reduced the relevant tax rate).

Competition policy
Entry barriers have been completely removed in the manufacturing sector, but not in agriculture and services. 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. The 1994 government decree authorised 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 estimated rate of effective protection amounts to 4 per cent (down from 38 per cent before liberalisation begun). The government is committed to further liberalisation and to the elimination of all non-tariff barriers (still substantial in sectors such as telecommunications and electrical equipment). Slovenia became a full member of GATT in September 1994, and joined the Central European Free Trade Agreement on 1 January 1996. On 10 June 1996 Slovenia signed the Association Agreement with the EU.

Currency convertibility and exchange rate regime
The national currency, the tolar, was introduced in October 1991 and is fully convertible for current account transactions (Slovenia accepted IMF Article VIII obligations in 1995). The exchange rate is floating. 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. Foreigners are permitted to repatriate profits and capital.

Wage liberalisation
Collective tripartite contracts between the government, employers and trade unions are the legal basis for determining wages. 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. The 1996 Social Agreement set the minimum wage at 53,500 tolars (US$ 390), and established that the base wage is to be indexed to retail price inflation. There is no uniform legislation on wages of civil servants, which caused some social upheaval in 1996, when the wages of members of Parliament and those of judges were changed.

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).

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, majority state-owned Ljubljanska Banka (LB), the government carved out separate banks from some of LB's subsidiaries. There are 33 banks in total; only nine of them are important market players, the others are small; the two largest are state-owned. Foreigners have majority ownership in five banks and two banks are fully foreign-owned. Shares of two banks are listed at the national stock exchange. In 1993 the state Agency for Bank Rehabilitation recapitalised two state-owned banks by swapping bad loans with its own bonds issued against security provided by the government. At the end of 1995, such bonds were replaced with government bonds with different maturity dates and for a total value equivalent to 6.4 per cent of 1996 expected GDP.

The banking law expected to be enacted during 1995 (concerning bank privatisation) has not yet been approved. 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. However, banks under rehabilitation do not comply with the requirements of investment restrictions and are still dependent on special liquidity loans from the central bank. Bank supervision is well developed.

Non-bank financial institutions

About 81 Authorized Investment Companies (known as privatisation funds) managed by 24 management companies are licensed to collect "ownership certificates" from citizens (see the section on Large-scale Privatisation above) and issue shares. They are closed-ended investment companies. These funds can participate in auctions organised by the Slovenian Development Fund, where shares of privatised companies are sold for cash or ownership certificates. Their total equity is currently about DM 4.5 billion. The rate of subscription at the end of 1995 was 78 per cent. Subscription is still under way in 11 investment companies. The remainder have already closed. Estimates suggest that 90 per cent of ownership certificates distributed to the population have been used.

In September 1994 the parliament passed a law regulating insurance companies, in accordance with directives about the level of capital at risk. The share of insurance and reinsurance activities in GDP did not exceed 4 per cent in 1995. There are 11 insurance and two reinsurance companies, all registered as joint-stock companies (none entirely foreign-owned, and only four partly foreign-owned).

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 36 securities are listed, and 57 members are registered for trading. Government, municipal and enterprise bonds are traded. Market capitalisation of the stock exchange is still relatively modest (4.6 per cent of GDP at the end of 1995).

A law on financial operations with foreign entities and a take-over law are expected later in the year. Within this framework, the privatised companies appear to be waiting for these laws to be passed before going public. 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 started futures trading in March 1996.

There is a great concentration of shareholding on the informal markets. Administrative procedures for registration of companies and share issues at the Clearing and Depository House are lengthy.

Fiscal and social safety net reform

Taxation

Following a comprehensive tax reform in 1990-93, corporate profits are taxed at a flat rate of 25 per cent; 20 per cent of profits may be placed in a tax-free reserve, conditional on reinvestment within four years. Personal income tax is progressive, with a minimum rate of 17 per cent and a maximum rate of 50 per cent. The personal income tax is, however, *de facto* a wage tax (in 1994 wages and salaries represented 87 per cent of the personal income tax base). There is a sales tax of 20 per cent for goods, 5 per cent for services and equipment, and 4 per cent on exports. Dividends are taxed at a 25 per cent rate for residents and 15 per cent for non-residents. Losses may be carried forward for five years. A new customs law became effective at the beginning of 1996 and a new law on customs tariffs is currently being discussed in parliament (customs charges are to be reduced by 45 per cent). At the beginning of 1996 parliament initiated procedures for the proposed law on value added tax and for that on excise duty. From 1 January 1997, a 30 per cent capital gain tax on securities held by individuals for less than three years will be introduced (gains made on first sale of shares bought during mass privatisation programme will be exempt). In July 1997 new legislation giving more authority to tax inspectors came into effect. The government's strategy is to shift more of the burden of taxation to indirect taxes and to reduce labour costs. This is slowly being put into practice. A value added tax is expected to be introduced in January 1998.

Social security

The Slovene pension system was partially reformed in 1992. Social security payments are contributed in equal shares by employers and employees at a total rate of 38 per cent of the gross wage (down from 42 per cent prior to July 1996). The share of expenditures for pensions in GDP is growing and in 1995 amounted to 13.8 per cent.

Investment legislation

Extensiveness

Laws exist regulating domestic and foreign investment, made directly and indirectly, by issuing bonds or through the activities of private investment funds. Such investment generally requires no government approval. Profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Nationals can freely own or lease land, but foreigners cannot own land. Security interests over contracts, receivables and moveable assets are possible and, in some cases, may require notarisation.

Effectiveness

The full texts of laws affecting investment are usually available and published within one month of being passed. Draft laws are usually published and accessible to practitioners. Public records in share or land registries may be up to six months behind current status. Court decisions are generally available to practitioners. Independent professional legal advice is available. Private parties generally believe that courts will recognise and enforce their legal rights, including against the state. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits.

Tajikistan

Due to civil war and political instability, the reform process in Tajikistan has lagged far behind that of most other countries in the region. Although an economic reform programme focusing on privatisation and liberalisation was launched in 1995, reform measures were still limited in scope and progress remained slow. In early 1996, the Tajik government embarked on a renewed effort at stabilisation and structural reforms, which aims at a sharp reduction in inflation through tighter fiscal and monetary policies, and accelerating progress on privatisation.

Enterprises

Size of the private sector
Largely as a result of slow pace of privatisation, continued government interference in product markets and armed conflict within the country, the private sector has grown very slowly. The share of the private sector in GDP is likely to be about 15-20 per cent.

Large-scale privatisation
The privatisation process, which proceeded rapidly initially, 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, 380 relatively small enterprises (out of a total 1,304 enterprises) had been privatised by the end of 1995. Privatisation has mainly taken the form of ownership transfers to labour collectives or leasing arrangements.

In late 1995, there was improvement in legal framework to accelerate the privatisation process by opening up all sectors to the possibility of foreign ownership and envisaging a standard method for fast privatisation with strict deadlines for completion. The Tajik government launched a new programme in May 1996, which aims at privatising 40 per cent of the total state-owned enterprises by the end of 1997. The programme foresees privatisation of 280 large state-owned enterprises, of which 20 had been sold by the end of June 1996. The programme introduces a "privatisation cheque", which will be paid out for government arrears on wages and pensions, and will be used only for purchasing shares of state-owned enterprises to be privatised under the programme.

Small-scale privatisation
As of end-June 1996, about 1,800 small companies (about 10 per cent of the total number of enterprises) had been privatised. While over a quarter of the consumer service sector had been privatised, very few entities have been sold in transport, wholesale trade and industry. While most transactions have involved insider privatisation, there have been cases of sales to outsiders (i.e. to individuals or entities other than the incumbent management or employees), mainly in trade and other parts of the services sector.

Private ownership of (agricultural) land is not envisaged; land has been either assigned to agricultural collectives or joint-stock companies without the right of resale, or leased to farmers on a long-term basis. In agriculture, 6 per cent of cultivated land, which accounts for an estimated 30 per cent of total agricultural production, has been leased to private farmers. A decree from November 1995 calls for all non-irrigated land to be handed over to private farmers as long as the farmers agree to grow grains. Almost all dwellings have been privatised.

Property restitution
There has been no property restitution in Tajikistan.

Growth of private enterprise
Obstacles to 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. As of mid-1995, Tajikistan had only 1,600 registered new private enterprises and corporations, employing about only 16,000 workers. As of end-June 1996, about 200 joint ventures had been registered, of which 135 were actively operating.

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. However, the restructuring of loss-making enterprises has been delayed because of the fear of the emergence of mass unemployment.

The number of people on compulsory unpaid leave or shortened working hours has increased rapidly in recent years; and huge stocks of inter-enterprise arrears have been accumulated, equalling about 20 per cent of estimated GDP at end-1995.

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 by the maximum mark-ups, and 17 basic consumer items (including bread, milk, rents and public transport) were controlled by executive order. In June 1995, prices for these goods were liberalised, except for bread and flour. Bread subsidies (cash allowances for low-income groups and subsidies to the bread complex) accounted for three-quarters of the government budget deficit in 1995. On 1 March 1996, bread and flour prices were completely freed. Currently, prices are controlled on agricultural commodities (cotton, grains and silk), electricity, fuel, telecommunications and transportation. Utility tariffs fall far short of covering costs.

Competition policy
A law on anti-monopoly and competition was adopted in December 1993. However, major sectors of the economy still remain highly concentrated, often with only one state-owned supplier in a given market segment. In mid-1995, the state order system had been abolished, with the exception of the 1995 cotton harvest. Later, the government decided that mandatory sales to the cotton complex would not be applied to the 1996 cotton crop. No effective competition exists in many market segments.

Trade liberalisation
Until recently, a command system, based on state orders, quotas, export licences and centralised trading, dominated production and trade. In 1995 and early 1996, however, there has been a substantial progress in trade liberalisation. During 1995, state monopoly export rights and requirements for export licences were abolished, except for cotton and aluminium. In February 1996, the state order systems for all trade effectively ended with abolition of the state grain fund allocation of cotton and aluminium. Surrender requirements on exports receipts had been reduced to 30 per cent from 70 per cent in October 1995, and were replaced with a repatriation requirement on all export earnings in February 1996, and export duties were abolished for all goods, effective from 1 March 1996. New barter trade arrangements were prohibited, with the exception of contracts involving aluminium. Despite these developments, most of external trade is still handled by state organisations.

Currency convertibility and exchange rate regime
The Russian rouble remained the official currency until 10 May 1995, when Tajikistan introduced its independent national currency (the last republic in the former Soviet Union to do so). The exchange rate of the new currency, the Tajik rouble, is in principle floating (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 via the State Foreign Exchange Fund, and currency auctions were effectively suspended as there were limited supplies of foreign exchange. From early 1996, foreign exchange transactions through the formal market were resumed, with auctions once a week. A parallel foreign exchange market has been tolerated by the government. The central bank still *de facto* controls all hard currency earnings and currency convertibility is very limited. 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 in the state sector are tied to the minimum wage through norms set by the government via the Law on Wage Indexation (December 1993). However, outside the budgetary sphere, centralised wage-setting no longer exists. At the end of 1995, the average monthly wage was about 1,032 Tajik roubles (US$ 3.6) well under the level it costs to cover the monthly needs of one person for basic foods. This was the lowest in the FSU, about one-third the dollar wage in Armenia and Azerbaijan, and only one-tenth the level in Kyrgyzstan and Uzbekistan.

Interest rate liberalisation
Until the currency introduction in May 1995, interest rates remained centrally controlled: deposit rates of the Savings Bank were regulated at 8 per cent per annum for a demand deposit and 30 per cent for a one-year savings deposit. In the context of the currency reform, all commercial bank interest rates were liberalised, except for on-lending of National Bank of Tajikistan (NBT) credit. However, the NBT still imposes maximum lending margins on commercial banks and directs credit resources to priority sectors. In response to the interest liberalisation, banks more than tripled deposit interest rates. Nonetheless, the nominal deposit rates have remained highly negative in real terms. Credit allocation has favoured priority sectors such as agriculture, and regions affected by natural disasters.

Financial institutions

Banking reform
The Law on Banking Activities and the Law on the National Bank established a two-tier banking system in February 1991.

Apart from the National Bank the financial sector in Tajikistan is dominated by 19 licensed banks, three of which account for 80 per cent of total lending and hold forex licences. The first joint venture bank started operations in 1995.

Banking regulations, approved by the National Bank Board in August 1995, concerned reserve requirements, extension of large credit and the banks' asset-liability structure. In January 1996 the minimum capital requirement for newly created banks was set at US$ 300,000. A number of existing banks already comply with this requirement. More than 80 per cent of the total paid-in capital must be in the form of cash (Tajik roubles only). Foreigners cannot own more than 49 per cent of a bank in Tajikistan.

Banks are inspected annually by the Supervision Department of the central bank, which produces its own annual "audit" of the bank. Auditing standards are those of the old Gosbank. A law on collateral was adopted in the second half of 1995.

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 corporative insurance companies are operating. A small leasing company was created in 1991, but closed down soon after as there was no market at the time.

Securities markets and instruments
A securities market has been established but it is not operating yet. A number of small insurance companies have emerged.

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. Excise duties, which account for a significant portion of tax revenue, range from 10 per cent (on jewellery) to 90 per cent (on alcohol). The profit tax rates range from 25 per cent (for farmers and small enterprises) to 60 per cent (in brokerage) with standard rate at 40 per cent. Personal income is taxed at progressive rates of up to 40 per cent for monthly income of more than 43 times the minimum wage.

In 1995, largely due to bread prices subsidies, the budget deficit increased dramatically to 21 per cent of GDP on an accruals basis. In an effort to combat this growing deficit, the Tajik government took a number of measures in late 1995 and early 1996: introduction of presumptive taxes on cotton and aluminium; elimination of the linkage between bread subsidies and the minimum wage; and a restructuring of budgetary functions. The 1996 budget targets a deficit of 5.4 per cent of GDP.

Social security
A payroll tax is levied on the monthly wage bill of enterprises at the standard rate of 37 per cent, of which 85 per cent goes to the Pension Fund, and 15 per cent to the Social Insurance Fund. Employees pay 1 per cent of wages to the Pension Fund. Budgetary transfers are made to the Pension Fund to cover the cost of family benefits. For the Employment Fund, employees pay 1 per cent of wage and the government budget also contributes. In 1995, the Pension Fund and the Employment Fund failed to pay pensions and unemployment benefits on a timely basis.

Investment legislation

Extensiveness
Laws exist regulating domestic and foreign investment directly, and indirectly through the use of indirect investment vehicles, such as issuing of securities. Most foreign investment proposals require government approval as to the repatriation of profits. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners are prohibited from owning, but may lease, land. Security interests may be created over shares, but not over land. Security interests over shares require notarisation and entry in an official register. Security interests over contracts, receivables and moveable assets are possible and require notarisation and entry in an official register.

Effectiveness
The full texts of laws affecting investment are usually published within six months after enactment. Draft laws affecting investment are generally published and accessible to practitioners. Public records in share or land registries may be up to 12 months behind current status. Despite requirement for registration, registers do not always exist. Important court decisions are not usually published or accessible to practitioners. Independent professional legal advice is available but from a limited number of lawyers. While private parties generally believe that courts will recognise their legal rights against other private parties, they do not believe the courts would enforce such rights against the state. 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 untested in practice.

Turkmenistan

While very little privatisation has occurred, and implicit subsidisation (through price controls on key production inputs) remains pervasive, the government is increasingly emphasising the need for the enterprises and farms to get by without explicit government subsidisation and without reliance on state-directed credits from the banking system. Consistent with public statements to this effect, monetary data for the first half of 1996 point to a very substantial tightening of credit policies. Among the important measures introduced this year are the prohibition of barter for non-gas exports, and the unification of the "official" and "commercial" exchange rates.

Enterprises

Size of the private sector
According to government estimates, the officially recognised private production or service units employed about 22 per cent of the labour force and accounted for 9 per cent of GDP in 1995. Government estimates indicate a total private sector share of GDP of about 18 per cent in 1995, including the "home industry" and Sunday market trading.

Large-scale privatisation
The government aims to privatise 600 medium-sized or large enterprises during the remainder of this year but no decisions have been made as to the exact identity of these enterprises or to the privatisation methods that are to be applied. Reportedly, four enterprises, with between 100 and 500 employees each, have been privatised.

Small-scale privatisation
In the first stage of the government's privatisation programme (enacted in 1993), ownership has changed in 1,800 small units (mainly catering shops, tailors, hairdressers, laundries and repair shops). Within this group of units, 600 were auctioned off to private individuals. The remainder were purchased by cooperatives. The 1,800 "privatised" units represent 40 per cent of all small-scale state-owned units (with "small units" defined to be those with fewer than 20 employees). Shops for food, including small outlets for fruit and vegetables, remain fully government-owned.

Six departments of the Ministry of Agriculture were recently turned into so-called "associations" that are to act as holding companies for enterprises owned by the Ministry. Each of these holding companies is to pursue privatisation for the companies in its care. However, non-state ownership in these companies is limited by Presidential decree to at most 49 per cent.

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 15 hectares.

Property restitution
Turkmenistan has no programme of property restitution.

Growth of private enterprise
Official estimates point to 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 (until early 1996) 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
During the course of 1995 and the first half of 1996, Turkmenistan's formerly comprehensive system of price controls has been loosened significantly. January 1995 saw a reduction in the number of goods and services subject to price controls and rationing from more than 400 to about 50. Remaining controls include state-defined prices for bread, meat, baby food, sugar, milk, heating and housing. The ratio of most controlled prices to the average price level has been raised sharply since the beginning of 1995. Meanwhile, market-based trading is taking place in goods that are subject to rationing (for example, in late May 1996 meat rations were sold at 200 manat per pound whereas meat in the market sold at 6,000 manat per pound). Rations of gas, electricity and water continue to be distributed to the population for free.

Competition
Turkmenistan does not have an anti-trust law.

Trade liberalisation
Centralised state trading remains a prevalent influence on both foreign trade and production. Outside this system, licences can be obtained for most imports and exports. However, duties and tariffs can be very high. The establishment of a commodity exchange, on 1 August 1994, led to further centralisation of foreign trading operations as all trade transactions (domestic or foreign) exceeding a certain modest amount (initially 250,000 manat) had, by law, to be carried out at (or be registered and endorsed at) the exchange.

The Turkmen authorities banned barter for cotton, wool, oil and oil-products from 1 May 1996. Exports of these goods must now be sold for cash at the commodity exchange.

Currency convertibility and exchange rate regime
There are formally few quota restrictions on imports and exports but most foreign trade is subject to licensing. Turkmenistan introduced its own fully fledged currency, the manat, on 1 November 1993. Having pursued a system of multiple exchange rates, heavy foreign trading controls and high export surrender requirements during most of 1994-95, the Turkmen authorities moved to unify the exchange rate on 2 January 1996 at a rate of 2,400 manat per US dollar, close to the parallel market rate. Prior to this, a so-called "official rate" had applied to all government transactions and a so-called "commercial rate" had applied to all other transactions, including sales of currency by individuals to commercial banks, and foreign currency conversion by foreign businesses and tourists.

After keeping the two exchange rates largely unified during January 1996, the authorities allowed a substantial wedge between the rates to emerge during the first half of February and then revalued the official rate to 1,000 manat per US dollar on 22 February. This appears to have been a response to the unpopularity of very substantial price increases for bartered goods that had occurred in the wake of the devaluation of the official rate in early January. The latter devaluation had made the effective cost of barter arrangements transparent and had moved the cost of unfavourable terms of trade in such arrangements from the exporters to the consumers (i.e. the consumers of goods that were imported from Ukraine and Georgia in return for gas deliveries from Turkmenistan). The revaluation in late February moved the cost back to the exporters and away from consumers.

On 30 March, the official rate was again devalued sharply, leading to a reunification of the official and commercial exchange rates at 3,000 manat per US dollar. By 19 July, both rates had depreciated further to 4,025 manat per US dollar. In principle, the exchange rate is to be determined in regular interbank auctions but by late May only one such auction had taken place.

Since 27 December 1995, currency receipts earned by state entities have, as a general rule, been subject to a 50 per cent surrender requirement, except in the case of oil and gas, to which a 70 per cent surrender requirement applies. There is no foreign currency surrender requirement for private sector export earnings.

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. The officially recommended average salary was adjusted on 1 May 1996 to 30,000 manats per month (about US$ 10 at the then-prevailing official exchange rate), from previously 20,000 manats per month.

Interest rate liberalisation
Both 1994 and 1995 saw large amounts of quasi-fiscal directed credits being channelled via off-budget ministries to industry, energy extraction, agriculture and priority state investments. The flow of such credits appears to have dried up since the announcement on 27 December 1995 by the President of a move towards more reform-oriented policies. Following this announcement, nominal interest rates have risen markedly although they remain in all cases substantially below the level of inflation. The highest rates apply to lending for the small private sector. In May 1996, one of the largest private enterprises in the country informed the EBRD that it was paying a local commercial bank about 185 per cent per annum on its working capital credit. Short-term lending rates in the interbank market were 90-95 per cent.

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. The five largest state banks, which were established in the late 1980s as a number of so-called "specialised banks" to handle commercial lending and deposit-taking previously undertaken by the State Bank, 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. Turkmenistan's banking sector now includes 15 commercial banks. Seven banks were liquidated in 1995. Some banks are owned by state enterprises which are also the main recipients of loans from these banks. Six of the commercial banks are owned by enterprises and other non-government owners: and two banks are 50 per cent foreign-owned joint-stock companies.

In mid-February 1995, the President issued a decree which 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 for state-owned enterprises to 15 per cent per annum. Interest rates have subsequently been raised substantially (see the section on interest rates above).

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 per cent to 35 per cent in January 1992 and further to 25 per cent one year later. Certain exemptions apply to foreign investors and some sector-specific rates apply. The personal income tax structure was simplified in June 1994. Rates in the new system ranged from 0 to 10 per cent. This system was replaced by a new flat rate of 8 per cent in July 1995 with a tax-free threshold at twice the minimum wage. 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 2 $^1/_2$ years.

Social security
The social security system is partly financed by payroll taxes set at 20 per cent of wages.

Investment legislation

Extensiveness
Laws exist regulating both foreign and domestic direct investment and the use of indirect investment vehicles, such as securities or investment funds. Most foreign investment proposals require government approval; profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by

foreigners and nationals of shares in companies/enterprise. Foreigners are prevented from owning, but may lease, land. Security interests over shares and land may be created, require notarisation and entry in an official register. Security interests over contracts and moveable assets are possible. No legislation exists as to security interests over receivables.

Effectiveness
The full texts of laws relating to investment are published usually within one month of enactment. Draft laws affecting investment are not always accessible to practitioners. Although there is a law on pledge, registers of ownership interests and pledges of assets granted by way of security rarely exist. Important court decisions are not generally available to practitioners. Independent professional legal advice is available but from limited number of lawyers. While private parties generally believe that courts will recognise their legal rights against other private parties, they do not believe that courts would enforce such rights against the state. Foreign arbitral awards are not required to be recognised and enforced by the courts without a re-examination of their merits.

Ukraine

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. However, structural reform, including large-scale privatisation, has proceeded slowly, and progress with delayed land and agricultural reform has been blocked by the agrarian lobby in the parliament. At the end of June 1996, a new constitution was adopted. This resolves some of the issues regarding the division of powers between the President, the government and parliament, allows the President to issue decrees on economic issues for three years and guarantees private property rights.

Enterprises

Size of the private sector
According to Ukrainian statistics, the non-state sector (which includes companies with only a minority private ownership stake) accounted in the first quarter of 1996 for 60 per cent of the number of industrial enterprises and 48 per cent of industrial output. The private sector may account for about 40 per cent of GDP, of which a large share is in the informal sector.

Large-scale privatisation
Large-scale privatisation was slow until 1994. Privatisation commenced officially in 1992, mainly via non-competitive methods, including management/employee buyouts, and leasing to employees. In July 1994, mass privatisation was suspended altogether by the Ukrainian parliament. Following this suspension, a Presidential Decree of November 1994 introduced a new voucher-based mass privatisation programme (MPP) and required the State Property Fund to privatise at least 8,000 medium-sized and large-scale enterprises in 1995.

By mid-1996 it is estimated that some 3,500 enterprises had been sold to private shareholders under the MPP. The proportion of shares sold to private shareholders has differed between entities, but in some 2,000 of these enterprises, at least 70 per cent of the shares have been sold to private shareholders. Approximately 40 per cent of these enterprises are in the agro-industrial sector. However, the majority of sales have taken the form of preferential sales, share transfers and buyouts by management and employees. The authorities intend to accelerate the programme and bring the total number of companies in which 70 per cent ownership has been privatised to 5,000 in 1996.

The main reason for delays in privatisation is the opposition from the agro-industrial groups in the parliament. In early 1996 draft legislation was prepared by the parliament which stipulates a transfer of 51 per cent of shares in some 3,600 agro-industrial enterprises to the managers of collective farms, and the reversal of previous privatisations in some cases. The President has vetoed this legislation on a number of occasions, but the draft has nevertheless created considerable uncertainty over the status of these enterprises. In addition, parliament had earlier voted to exclude over 6,000 companies from the MPP altogether. The State Property Fund, however, is proceeding with privatisations, including the sale of agro-industrial enterprises. Another source of a slowdown in the pace of privatisations slowed has been the setting of minimum prices in voucher-based auctions. This often leads to under-subscription of shares and the need for multiple auctions. Procedures for the inclusion of enterprises in the auction process are also rather complicated.

Steps have been taken to accelerate the privatisation programme. These include the decision to end the voucher scheme in 1996 (although the deadline for issuing vouchers was recently extended from end-June to 1 October) and streamlining the procedures for privatisation to reduce the time required to prepare enterprises for privatisation. Compensation certificates are being distributed to holders of savings deposits to compensate them for the inflation-induced erosion in the value of their savings. These can be used to buy shares in enterprises that were not sold in the main auctions. No minimum price will be set at auctions in which companies will be sold for these certificates, and the certificates are tradable. The authorities have taken a number of other measures to improve the efficiency and transparency of the auction system, including the introduction of a comprehensive information system. In August 1996 the government approved a list of over 200 companies to be sold via international tenders.

Small-scale privatisation
Parliament adopted a Law on Privatisation of Small State-owned Enterprises in March 1992 (and a further law, passed by parliament in May 1996, has not altered the main thrust of small-scale privatisation). However, by the end of 1994 only around 8,000 of some 45,000 small enterprises (defined as those with less than 200 employees) had been transferred from state ownership into private hands, while approximately half of all enterprises were held in collective ownership, and obtained the right of access to production facilities through leasing arrangements. The main method of privatisation has been management and employee buy-outs; the use of leasing arrangements with buy-out rights, often extended to employee collectives, has left many enterprises in an intermediate state of privatisation.

During the course of the current year, the pace of small-scale privatisation has accelerated. By the end of June 1996, a cumulative total of about 31,000 small enterprises had been privatised. Of these, the majority had been sold to workers and management. Since September

1995, however, increasing use has been made of auctions. The remainder of small-scale enterprises are expected to be sold by the end of 1996. Residential privatisations have been successful as well, with 37 per cent of all formerly state-owned housing privatised by mid-1996. Privatisation in agriculture has had less success, mainly because of opposition from Parliament to allow sales of agricultural land.

A new constitution, adopted by Parliament in June 1996, guarantees private property rights including land ownership, but there is a six-year moratorium on land sales. The number of registered private farmers increased from 32,000 at the beginning of 1995 to 34,800 in April 1996, but the state and collective farms still account for some 85 per cent of the arable land area.

Property restitution
There has been no restitution to former owners of nationalised property in Ukraine.

Growth of private enterprise
The private sector has increased but its growth has been constrained by the frequency with which laws have been changed, high effective tax rates and the existence of numerous regulations. Part of private sector activity has therefore contributed to the growth of a large informal sector, although the latter also includes some of the activities of the state sector.

Enterprise restructuring
Most of the formal economy exhibits a high degree of horizontal integration and concentration. Enterprise budget constraints have remained soft because of budgetary subsidies, continued cheap directed credits, especially to depressed industrial regions, and tolerance of non-payment for utilities.

At the beginning of 1996, important changes were introduced in the gas market. The government transferred the responsibility for distribution of gas within the Ukraine to a number of commercial companies and gave them powers to cut off supplies to persistent non-payers. In early 1996 the government also announced that there would be a World Bank sponsored programme to begin restructuring in the coal sector, with the intention of closing some unprofitable mines.

The Law on Bankruptcy was adopted in May 1992. There has, however, been little enforcement thus far. A new draft law is currently under discussion.

In July 1996 the cabinet approved a resolution supporting the creation of financial-industrial groups. These groups are intended to carry out structural programmes for the development of the main sectors of industry; the intention is that the groups would be led by a manufacturing enterprise, and would include a bank.

Markets and trade

Price liberalisation
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.

From 1993 administered prices have been raised for energy, agricultural products and communal services with the aim of moving towards cost recovery/border-prices for these products.

Rents and the prices of some utilities (including gas and electricity) were raised in January 1996 and again in July 1996. These price adjustments increased the proportion of costs paid by consumers (to the extent tariff collection is enforced). These increases will also help lower the amount of consumer subsidies paid from the budget, although they will be accompanied by higher pensions and other means-tested benefits for those on low incomes. The only goods and services which remain subject to price controls are bread, utilities (gas, electricity, central heating, water supply and sewerage), public transport and rents.

Energy prices for industrial users were brought closer to world market levels during the course of 1995. Reforms will be introduced into the wholesale market for electricity in 1996 with the intention of promoting competition between electricity generating companies. It is also intended to establish a regulatory commission to monitor developments in the wholesale market. Industrial users of gas have been charged border-prices since March 1995, with adjustments of the local currency price being made regularly to reflect depreciation of the exchange rate. The prices paid by residential consumers of gas and electricity are subsidised, but the subsidy element fell substantially during the course of 1995 and following the above-mentioned rounds of price increases in 1996.

Competition policy
The February 1992 Law on Limitation of Monopolistic Activities provides the basic framework for establishment of a competition policy and created the Anti-monopoly Committee, the activities of which are further governed by the November 1993 Law on the Anti-monopoly Committee.

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 requirements may affect many newly founded enterprises. On this basis, the Committee estimated in 1995 that there are 480 national monopolies and more than 1,500 regional monopolies. The most monopolistic sectors are heavy industry and the chemical and pharmaceutical industries. In 1995, the focus of the Anti-Monopoly Committee gradually shifted from price regulation of monopolies to demonopolisation. Up until June this year, action by the Committee had led to the establishment of at least 460 additional economic units. Where possible, however, demonopolisation is undertaken at the time of privatisation, or by breaking up horizontally integrated structures that produce the same commodity.

Trade liberalisation
In 1994 state trading and barter trade were abolished, and the process of eliminating export quotas and licences commenced.

At the end of 1995 and in early 1996 the export regime was further liberalised. Export quotas and licences now only apply to goods subject to voluntary export restraints (VERs) under international agreements and to goods falling under the "special export regime" (coal, precious metals and alcoholic spirits). The system of indicative export prices was removed in December 1995.

In 1996, the authorities abolished the state order system for grain and eliminated quotas and licence requirements for grain exports. Exporters are now free to enter into forward contracts and to pledge deliveries of the 1996 crop. However, some recent backtracking in liberalisation has occurred through the introduction of export taxes on ferrous metals and on some agricultural products.

The overall level of nominal tariff protection is estimated at between 5 and 8 per cent on a trade weighted basis (the modesty of these figures partly reflects the large share of energy imports which are not subject to tariffs). Tariffs on some agricultural products were raised in early 1996 (generally to 30 per cent), under pressure from the agricultural sector. However, according to a Presidential decree introduced in April 1996, upper limits for import duties on industrial products were set at 30 per cent, while the intention over the medium term is that import duty rates should reflect WTO standards.

On 1 February 1996 the Interim Trade Agreement with the EU came into effect, which represents the first step towards the entry into force of the Partnership and Cooperation Agreement which grants Most Favoured Nation status to Ukraine and abolishes quantitative restrictions on trade, with some exceptions. Ukraine has also applied to join the World Trade Organisation.

Currency convertibility and exchange rate regime
In October 1994 a unified exchange rate was introduced. The official exchange rate is now determined by the Ukrainian Interbank Currency Exchange (UICE). The frequency of trading at the UICE has increased to five times a week with a broader access to the market. Banks are now free to sell hard currency directly to their customers within agreed margins of the official rate. In August 1995, the use of foreign currency for domestic trade was prohibited. In the same month, the central bank (NBU) liberalised the regulations governing the opening and operation of foreign currency accounts by residents and non-residents in Ukraine. In a further move, a new foreign currency law increased the amount of foreign currency which Ukrainian citizens can take overseas to US$ 1,000 per year. More recently the government has also signalled that it will ease the requirement that exporters convert 50 per cent of their foreign earnings through the UICE.

The government introduced a new currency, the hryvna, on 2 September 1996. The hryvna replaces the temporary currency, the karbovanets, at a rate of 1 : 100,000 (at the time of its introduction the karbovanets was trading at 175,000 to the dollar). The introduction of the hryvna was accompanied by the announcement of a price freeze during the first half of September.

Wage liberalisation
Administrative setting of wages continues. Wage coefficients for workers of different skills are set on the basis of the minimum wage. In September 1995, the government reinstated the 80 per cent wage indexation ceiling, according to which wage increases are limited to 80 per cent of CPI inflation. This policy is enforced by an excess wage tax. Wages for professionals in the budgetary sphere are indexed to the level of the industrial wage average with a one-month lag.

Interest rate liberalisation
Since March 1995, real interest rates have generally been positive. During 1996, there have been a series of reductions in the NBU's refinancing rate as inflation has slowed but, under the new IMF programme, the NBU will ensure that the refinancing rate remains positive in real terms.

Financial institutions

Banking reform
Ukraine's financial sector is at an early stage of development and an effective regulatory system is only gradually being created. A two-tier banking system was introduced in 1991. In mid-1996 there were 228 banks registered in Ukraine, although a number of these were in the process of liquidation. The banking sector remains dominated by the five former state-owned specialised banks, two of which remain state-owned although their share of assets has declined from 90 per cent in 1994 to around 70 per cent by early 1996. Consolidation of the banking sector is accelerating and in 1995 alone more than 20 banks went out of business. Credit to the private sector is still scarce as commercial banks are risk-averse; the spread between lending and deposit rates is high and loans are mainly short-term.

Regulation and bank supervision are being tightened. The minimum capital requirement is to be raised to ECU 1 million (ECU 100,000 by July 1996 rising to ECU 1 million by January 1998) according to a law adopted in February 1996. The minimum capital requirement for banks with foreign participation is ECU 3 million and for wholly foreign-owned banks ECU 5 million. A resolution of the NBU at the beginning of 1996 provided for the establishment of a private deposit insurance fund. The authorities have also introduced prudential ratios for banks, introduced a loan classification scheme, set exposure limits and introduced legislation which prohibit insider lending.

Non-bank financial institutions
Non-bank financial institutions in Ukraine include trust companies, investment funds, insurance companies, credit unions and pension funds. There are around 600 insurance companies, 265 investment funds, investment companies and trust funds and a large number of brokers, with some overlap between these groups. The minimum capital requirement for investment funds is US$ 20,000.

A comprehensive regulatory framework is still lacking. Activities of investment funds are regulated by a February 1994 decree "On Investment Funds and Investment Companies", amended in March 1995. Present supervisory functions are fragmented between various government agencies. In an attempt to tighten supervision, the State Property Fund has revoked the licences of some investment funds.

Securities markets and instruments
The Law on Securities and Stock Exchange has been in effect since January 1992. In July 1996 new securities regulations were adopted by Parliament, establishing a commission for securities and stock market. The commission has administrative and disciplinary powers over brokers and trading activities. Most trade still takes place in Kiev in an unregulated over-the-counter market. The more 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. At present only a small number of companies are officially quoted on the stock exchange and weekly trading volumes are very small. As a result the exchange suffers from a lack of liquidity. In addition there is no independent and transparent share registration and share custody system and minority shareholders' rights are not protected.

Auctions for Treasury Bills were first introduced in March 1995. The auctions are now held on a regular basis and sales, which were originally only to institutions, have now been extended to individuals.

Fiscal and social safety net reform

Taxation
A Presidential decree in August 1996 announced that the tax system would be simplified. Currently, marginal rates on personal income tax are between 10 to 50 per cent. Corporate income tax is levied at 30 per cent on net income and value-added tax is levied at 20 per cent. The right of enterprises with foreign participation, registered after 1 January 1995, to enjoy a five-year tax holiday has been eliminated.

In the first half of 1996, parliament approved the introduction of new excise and customs dues. These were designed to increase revenue and protect domestic producers from import competition, especially in the case of alcohol products.

Social security
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 employment 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.

Until the end of 1994, the benefit system was not targeted. It covered approximately one-third of the population and was estimated to have accounted for over 14 per cent of GDP, of which pensions were 8 per cent and consumer subsidies over 5 per cent. The Government has already taken some measures to improve the targeting of benefits and reduce the cost. A government resolution, effective in May 1995, stipulates that a family is entitled to receive income support if its housing and energy bill exceeds 15 per cent of its total income regardless of the form of ownership of the apartment (private, state-owned or collective). The government is also considering ways in which to reform the pension system.

Investment legislation

Extensiveness
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. Foreign investment proposals do not require government approval, profits are freely convertible and may be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners are prohibited from owning, although they may lease, land. Security interests over shares and land may be created and require notarisation and entry in an official register. Security interests over contracts, receivables and moveable assets are possible, and require notarisation.

Effectiveness
The full text of laws relating to investment are published, usually within six months of enactment. Legal rules enacted by regional or local governments are rarely accessible to practitioners. Draft laws affecting investment are not always accessible to practitioners. Legally prescribed registers for interests in respect of land, shares or other moveable assets are, where they exist, in some cases at least six months out of date. Superior court decisions are usually published or accessible to practitioners; decisions from lower courts are not always available. Independent professional legal advice is available. Private parties generally believe that courts will recognise their legal rights against other parties, including the state. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits, but there is a lack of an adequate mechanism for enforcing awards.

Uzbekistan

The government of Uzbekistan initiated reforms in a partial and gradual manner in 1992-93, but accelerated the pace of reform in 1994. In 1995, a comprehensive programme was adopted, with strong assistance from multilateral financial institutions.

Enterprises

Size of the private sector

The share of the private sector in GDP is likely to have been about 40 per cent as of mid-1996. The GDP share of the non-state sector (which includes companies with majority state ownership) at the end of 1995 has officially been estimated at 67 per cent.

Large-scale privatisation

By end-1995, about 2,300 medium-sized or large state-enterprises out of about 11,800 (or about 20 per cent of the total number of enterprises) had been privatised. Almost all closed joint-stock companies (with limited transferability of shares) had been converted into open ones. The share of state ownership in corporatised enterprises had been significantly reduced, to an average of about 30 per cent. The government plans to privatise more than 400 medium/large enterprises during 1996.

Privatisation methods applied in 1996 and in preceding years have been diverse and include, most importantly, auctions, direct sales, joint venture privatisations and flotation on the stock exchange. Application of vouchers has been excluded from the very beginning. The first auctions of medium and large-scale enterprises took place in March 1994.

Nevertheless, while corporatisation and allocation of shares to employees have proceeded swiftly, involvement of outside investors has been much slower than planned.

A mass privatisation scheme using investment funds was adopted by the government in 1995. However, implementation of the scheme has been significantly delayed. The programme is expected to reach the implementation stage during the second half of 1996. As an important ingredient of this programme the government will limit the combined share of state and insider (employee and management) ownership in non-strategic enterprises to less than 50 per cent. The state will temporarily retain a majority interest in strategic sectors, such as energy, fuel and gold mining.

Small-scale privatisation

Privatisation of smaller units began in late 1992 based on the Law on Denationalisation and Privatisation (passed in November 1991) and the Law on Leasing (passed at the same time). To date, over 60,000 (or 96 per cent of the total) small-scale businesses have been privatised or leased, primarily to workers' collectives. Around 40 per cent of these businesses were originally privatised as closed companies, with 51 per cent of the shares being retained by the government. The shares in many of these companies have subsequently become tradable.

For retail trade, consumer services, public catering and local industry, small-scale privatisation is at an advanced stage. Housing privatisation is almost complete. Since January 1994 cash auction has become the basic method of small-scale privatisation. During 1994, restrictions on the output-composition and employment policy were imposed on privatised companies. These were removed in early 1995.

The state owns almost all land but long-term leases for land exist. In fact, most of agricultural land had been leased to state farms and collectives. Land for individual use (commercial and residential) and attached to a building can be owned by private individuals, but the land must be used for its original purpose and cannot be traded freely. One-fifth of the agricultural land is occupied by private farms or household plots. In January 1996, the government issued a regulation which permitted the auctioning of land with the rights of lifetime ownership and heritage.

Property restitution

There has been no property restitution for former owners in Uzbekistan.

Growth of private enterprise

By early 1996 about 90,000 new private enterprises had been registered. Among them are 14,235 private farms. The main obstacles to private sector development are unfavourable entry rules, mainly in the form of licensing procedures; financial constraints; domination of distribution channels by monopolies; unstable taxation; lack of access to commercial space; and low mobility of labour force (artificially restricted by a system of residence permits).

Presidential decrees of January and July 1995 on private entrepreneurship alleviate many of these obstacles, including registration and the tax burden. Since the introduction of these decrees, the creation of new enterprises has been rapid. About 64,000 individual and small enterprises were registered during 1995, of which 10,700 were small-scale enterprises and the remaining were agricultural cooperatives or firms with only one individual. Over half of the government's privatisation income is earmarked for financial support of SMEs.

Enterprise restructuring

Economic restructuring has been hindered by the slow pace of privatisation, the predominantly insider nature of the privatisation process so far, strong bureaucratic hurdles and shortage of skilled managers, as well as low degree of competition throughout the economy. There is still a lack of political will to allow widespread unemployment and bankruptcies. State farms have been transformed into cooperatives or joint-stock companies without major impact yet on enterprise behaviour. The Law on Bankruptcy was adopted in May 1994, although the effectiveness of this implementation remains uncertain. In 1995 about 20 medium or large-scale enterprises were declared bankrupt.

Markets and trade

Price liberalisation

The bulk of consumer prices was liberalised in January 1992. Subsequently this process was partly reversed and a rationing system was introduced for a wide range of goods. The state order system was initially retained, covering in 1993 between 20 and 80 per cent of the production and distribution of the 200 most important commodities.

In early 1994, liberalisation of prices resumed. The state order system was phased out during 1994 and early 1995 except for cotton and grain. The remnants of the rationing system were abolished in early 1995, as were the profitability ceilings that used to apply to all goods apart from certain medicines and natural monopolies. Those prices that remain administered by the government are being adjusted to cost-recovery or world market levels, except for heating, hot water and housing. Oil and oil product prices reached world market levels in late 1995.

Competition

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 before the end of 1996. Monopolies are defined as enterprises (or specific products) with market shares of over 35 per cent, or those that engage in certain specified activities. By end-1995, there were 945 enterprises and 3,096 products identified as monopolies at either the national or the regional level. In May 1996, a Committee on Demonopolisation and Promotion of Competition was established to monitor market activity. A separate Office of Public Utility Regulation is being established for the administration of utility prices. Demonopolisation of dominant firms in the warehouse, wholesale, trade, energy and transport sectors has started with an initial focus on the transport sector.

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 when import tariffs were reintroduced on 61 product groups with rates ranging from 5 per cent to 100 per cent. On 1 April 1996 the maximum rate was reduced to 30 per cent. The number of product categories subject to export quotas and export licensing systems was reduced from 70 to 11 in early 1995 and to four (cotton, oil, ferrous and non-ferrous metals) at the end of 1995. A surrender requirement of 30 per cent (15 per cent for CIS currencies) is applied to export proceeds and with an obligation to sell this amount on the currency market at the prevailing market exchange rate. The system of export tariffs, applying in 1995 to 102 product groups (and ranging from 5 per cent to 100 per cent) was simplified and liberalised in two steps in April and July 1996. By now, exports tariffs are imposed on 72 product groups, with rates ranging from 1 per cent to 100 per cent, and with the rates for most groups being between 5 per cent and 30 per cent. The bulk of foreign trade is still channelled through state-owned foreign trade companies.

Currency convertibility and exchange rate regime

The sum-coupon, the temporary national currency, was introduced in mid-November 1993, first as a parallel currency with the rouble, and then from early 1994 as the sole legal tender. Originally the sum-coupon was pegged 1 to 1 to the rouble.

Between mid-April 1994 and April 1995, the "official exchange rate" was set by the central bank on the basis of closed auctions attended by only a few state-owned banks.

Foreign currency auctions are now accessible to all banks, and have been held twice a week since April 1995. The amount of foreign currency channelled through the auction sharply increased in 1995. In mid-1995 the restrictions on the purchase by individuals of foreign exchange were eliminated.

However, availability of foreign exchange in the auction has declined sharply in 1996, and a very large wedge has developed between the official exchange rate and the rate quoted by banks. There is a further large wedge between the rate quoted by the banks and that quoted in the black market, pointing to increasingly severe administrative limitations on currency convertibility. The total wedge between the official exchange rate and that in the black market had widened to about 50 per cent by early September 1996. The rules (and the implementation of rules) governing access of private companies to conversion of local currency into foreign exchange remain non-transparent. The same applies to the rules for repatriation of profits generated by joint ventures in local currency.

Wage liberalisation
Wages in budgetary organisations are adjusted in line with the minimum wage. Outside the budgetary sector, both private and state-owned companies have, since June 1994, been subject to a strict incomes policy. Increases in the wage bill cannot exceed 70 per cent of the increase in the output value. As a supplement to this system, a tax-based income policy was adopted for state enterprises in 1995 and was subsequently extended to cover also the first half of 1996. Minimum wages and pensions are adjusted every few months to keep pace with inflation.

Interest rate liberalisation
During 1994-95 interest rates for both deposits and lending were raised sharply, with lending rates occasionally reaching levels that were positive in real terms. The spread between lending and deposit rates remains high, reflecting the high reserve requirement, inefficiencies of payment systems, and a high risk premium for lending. A system of directed and subsidised credits is still in place, although the scope of it has been sharply reduced. Since March 1995 the central bank refinance rate has been determined on the basis of past and expected rates of inflation.

Financial institutions

Banking reform
A two-tier banking system was introduced in early 1988. The current republican law on Banks and Banking Activities were adopted in February 1991 (and amended in May 1993). In April 1996, a new law was introduced, strengthening licensing rules, prudential regulation, reporting and inspection requirements. The statutes of the Central Bank were approved in March 1992. A modern Law on the Central Bank was adopted in December 1995. There are about 32 commercial banks, including 14 private banks, out of which three are joint-venture banks. Seven foreign banks have offices but no foreign banks have as yet opened branches in the country. Corporate banking remains dominated by Agroprombank and Promstroibank while foreign exchange transactions are channelled primarily through the National Bank for Foreign Economic Activity. The Sberbank enjoys a quasi-monopoly on deposit-taking from households. Many of the new banks are state-owned, either directly or indirectly (i.e. via state-owned enterprises).They tend to have strong sectoral specialisation.

Prudential regulations, including rules for capital adequacy and provisioning and exposure limits, are still fairly loose compared with international standards. Minimum capital requirements were raised in early 1996. International audit of the largest banks has started. The Government is currently working with the World Bank on the design of a bank reform programme for the Uzbek financial system, including plans for a major restructuring of the sectoral banks.

Non-bank financial institutions
A national insurance company and some private insurance companies, including a major joint venture, are active in Uzbekistan. A few leasing companies have emerged. A wide range of investment funds is being established. These funds are to play a key role in further privatisation as around 30 per cent of the shares of the privatised enterprises have to be sold through these funds.

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. The regional network of the stock exchange is widening. A secondary market in shares is not yet in place but a related draft law has been submitted to the parliament. The issuance of government bonds started in early 1996. A State Commission on Securities and the Stock Exchange was established in late 1995.

Fiscal and social safety net reform

Taxation
Early 1992 saw the replacement of turnover tax by new VAT and excise taxes. During the same year, the legislative basis for the tax system was created.

In 1995, the enterprise income tax was replaced by a profit tax, while a number of tax exemptions were eliminated, and property and land tax rates were raised. Extrabudgetary funds (there were 14 of them in 1994) are being integrated into the budget.

Current major taxes include a profit tax (the basic rate is 37 per cent but the tax rate is 25 per cent for enterprises with over 30 per cent foreign capital participation); VAT unified throughout all industries at 17 per cent; personal income taxes levied at rates of between 15 per cent and 40 per cent; an enterprise property tax of 2 per cent; a land tax, with rates varying with the location; and a withholding tax on profit repatriation of 10 per cent. Joint ventures and wholly foreign-owned enterprises benefit from a range of special incentives, including a tax holiday of up to five years (depending on the sector), up to 10 years of protection against adverse regulatory changes, exemptions from import tariffs for production inputs; and exemption from foreign exchange surrender requirements.

Social security
There is a 41 per cent payroll tax, of which 40 percentage points are paid by employers (36 percentage points for the Social Insurance Fund, 2 percentage points for Trade Unions, 2 percentage points for the Employment Fund) and 1 percentage point paid by employees to the Social Insurance Fund. Pension expenditures amounted to about 10 per cent of GDP in 1994. In 1995-96 measures have been taken to limit the pension entitlement of the less vulnerable groups and in August 1995 a revised system was introduced to reduce the real value of pension adjustments over time. The system of family allowances has been rationalised; there is now a single family benefit, which is linked to the minimum wage.

Investment legislation

Extensiveness
Laws regulating both domestic and foreign investment exist. Laws exist regulating the use of indirect investment vehicles, such as securities. Certain foreign investment proposals may require government approval. Profits are freely convertible and may (subject to certain restrictions of a practical nature) be freely repatriated. There are no legal obstacles to the ownership by foreigners and nationals of shares in companies/enterprises. Foreigners and nationals may not own land, but may acquire rights to the use of land. Security interests over shares and rights to use land may be created. Security interests over contracts, receivables and moveable assets are possible.

Effectiveness
The full text of laws affecting investment are usually published within six months of being passed. Draft laws are not usually published or accessible to practitioners. Legally prescribed registers for interests in respect of land, shares or other moveables do not always exist. Where in existence, registers are usually 12 months out of date. Important court decisions are not always published or accessible to practitioners. Independent professional legal advice is available. Private parties generally believe that courts would not recognise and enforce their rights against the state. Foreign arbitral awards are required to be recognised by the courts without a re-examination of their merits.

Albania

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
Output and expenditure				*(Percentage change)*				
GDP at constant prices	9.8	-10.0	-27.7	-9.7	11.0	9.4	8.6	5
Industrial production	5	-7.6	-36.9	-44	-10	-2	2	3
Prices								
Consumer prices (annual average)	0	0	36	226	85	23	8	13
Consumer prices (end-year)	0	0	104	237	31	16	6	20
Monetary sector								
Broad money (end-year)	14.8	23.4	104	153	74.4	39.5	20	na
Government sector				*(In per cent of GDP)*				
General government balance (cash basis)[1]	-5.5	-3.7	-44	-22	-16	-14	-9.4	-15
General government balance (commitment basis)	-9	-15	-31	-22	-16	-13	-10.5	-15
General government expenditure (commitment basis)	56.8	62.1	61.9	47.6	44.6	41	36	42
External data in convertible currencies				*(In millions of US dollars)*				
Current account (excluding official transfers)	-49	-122	-293	-442	-268	-243	-107.1	-225
Current account (including official transfers)	na	-122	-213	-101	14	-162	-21.1	na
Trade balance	-83	-150	-308	-454	-490	-459	-475.0	-520
External debt, net of foreign exchange reserves	0	94.5	498	638	658	771	111.1	na
				(Percentage change in the US dollar value)				
Exports (data from the balance of payments)	25	-7	-56	-31	60	25.8	44.4	16
Imports (data from the balance of payments)	58	4	7	28	15	0	13.1	12
				(In months of current account expenditures, excluding transfers)				
Gross international reserves (end-year), excluding gold	12.5	5.9	0.2	0.6	2.3	3.0	6.5	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions)	3.2	3.3	3.3	3.2	3.2	3.2	3.2	3.2
Employment (percentage change, annual average)	1.9	0.2	-18.6	-27.8	-7.8	9.3	-0.1	na
Unemployment rate (per cent of domestic labour force, end-year)	na	7.6	11.7	30.3	22.4	19.2	13	na
GDP (in millions of lek)	18,681	16,813	16,473	49,519	113,041	166,297	204,519	na
The share of agriculture in GDP (per cent)[2]	26	40	44	54	56	56	56	na
The share of industry in GDP (per cent)[2]	37	37	32	17	14	13	13	na
Exchange rate (lek per US dollar, end-year)	8	10	25	97	101	95.4	94.1	na
Exchange rate (lek per US dollar, annual average)	8	8	14.6	75.1	102.1	94.7	92.6	na
Interest rate (lending, 12 months maturity, end-year)	1-2	1-2	8-12	39	30	20	15.8	na

Note:
Data for 1989-96 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 1996 reflect EBRD evaluations, partly based on information from these sources.

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	1996 Projection
Output				*(Percentage change)*				
GDP at constant prices	14.2	-7.4	-10.8	-52.4	-14.8	5.4	6.9	6.5
Prices								
Consumer prices (annual average)	4.8	10.3	100	825	3,732	5,273	177	25
Consumer prices (end-year)	na	na	25	1,341	10,996	1,885	32	19
Monetary sector								
Broad money (end year)	na	na	na	na	na	684	65	na
Government sector				*(In per cent of GDP)*				
Consolidated central government balance (on an accrual basis)	na	na	-1.9	-37.6	-48.2	-16.1	-8.7	-8
Consolidated central government expenditure (on an accrual basis)	na	na	-28.0	64.2	68.6	43.7	27	24
External data in convertible currencies				*(In millions of US dollars)*				
Current account, excl. official transfers	na	na	na	na	na	-231	353	300
Trade balance	na	na	na	-70	-227	-192	-364	-340
Exports (data from the balance of payments)	na	na	na	335	165	209	255	290
Imports (data from the balance of payments)	na	na	na	405	392	401	619	630
Miscellaneous items				*(Denominations as indicated)*				
Population (millions)	na	3.3	3.5	3.7	3.7	3.7	3.7	na
Unemployment (per cent of labour force, end-year)	na	na	4	19	26	na	8	na
GDP (in millions of US dollars)	na	na	na	na	na	653	1,337	na
GNP per capita (in US dollars) at PPP exchange rates[1]	na	na	na	na	na	2,170	na	na
The share of agriculture and forestry in NMP (per cent)[2]	15	17	26	41	55	na	na	na
The share of industry in NMP (per cent)[2]	50	45	55	53	32	na	na	na
Exchange rate (dram/US dollar, end-period)	na	na	na	na	na	287	406	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 PPP stands for purchasing power parity. The estimate quoted here stems from the World Bank Atlas 1996. In the computation of this estimate the country's nominal GNP per capita in local currency 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	1996 Projection
Output				*(Percentage change)*				
GDP at constant prices	-4.4	-11.7	-0.7	-22.6	-23.1	-21.2	-8.3	-3.5
Prices								
Consumer prices (annual average)	na	7.8	106	616	1,130	1,664	412	20
Consumer prices (end-year)	na	na	126	1,395	1,294	1,788	86	15
Government sector				*(In per cent of GDP)*				
General government balance	na	na	-5.0	2.8	-13	-14.8	-7	-3
General government expenditure	na	na	40.7	46.4	58	46.5	30	na
External data in convertible currencies				*(In millions of US dollars)*				
Current account	na	na	153	488	2	-121	-300	-500
Trade balance	na	na	60	489	-5	-109	-225	-350
vis-à-vis countries outside the former Soviet Union	na	na	-42	371	109	108	na	na
vis-à-vis former Soviet Republics	na	na	102	118	-114	-217	na	na
Exports (merchandise)	na	na	395	1,275	716	682	485	na
to countries outside the former Soviet Union	na	na	24	755	347	401	na	na
to former Soviet Republics	na	na	371	520	369	281	na	na
Imports (merchandise)	na	na	336	786	721	791	710	na
from countries outside the former Soviet Union	na	na	67	384	238	293	na	na
from former Soviet Republics	na	na	269	402	483	498	na	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions)	na	na	na	7.3	7.4	7.5	7.5	7.5
GDP (in billions of manat)[1]	na	1.5	2.7	25.1	157.0	2,078	7,900	na
GNP per capita (in US dollars) at PPP exchange rates[2]	na	na	na	na	na	1,720	na	na
The share of agriculture in GDP (per cent)	na	26	39	27	27	30	31	na
The share of industry in GDP (per cent)	na	22	30	31	25	25	22	na
Official exchange rate (manat per US dollar)	na	na	na	93	1,149	1,457	4,500	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

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 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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.

Belarus

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
Output and expenditure				*(Percentage change)*				
GDP at constant prices[1]	8.0	-3.0	-1.2	-9.6	-10.6	-12.2	-10.2	-5
Consumption at constant prices	na	na	-6.8	-10.2	-3.7	-13.0	-16.0	na
Investment at constant prices	na	na	4.4	-18.1	-12.5	-33.2	-26.1	na
Industrial production	na	na	-0.2	-5.2	-10.5	-19.9	-11.5	-7
Prices and wages								
Consumer prices (annual average)	1.7	4.5	84	969	1,188	2,220	709	70
Consumer prices (end-year)	na	na	93	1,558	1,994	1,957	244	61
Average real wages	7.8	11.6	-2.8	-14.4	12.2	-35.6	7	-6
Monetary sector								
Net domestic credit (end-year)	na	na	na	1,582	612	1,452	160	na
Broad money (M3, end-year)	na	na	na	508	928	1,883	159	na
Government sector				*(In per cent of GDP)*				
General government balance (incl. extra-budgetary funds)	na	na	3.6	-1.6	-8.3	-2.6	-1.9	-2
General government expenditure	na	na	43.9	45.6	51.9	51	45.1	40
External data				*(In millions of US dollars)*				
Current account	na	na	na	na	-1,113	-599	-254	na
Trade balance	na	na	na	na	-1,051	-710	-529	na
Exports (merchandise)	na	na	na	3,580	2,941	2,641	4,621	4,900
Imports (merchandise)	na	na	na	3,203	3,217	3,351	5,149	5,800
				(In months of current account expenditures, excluding transfers)				
Gross international reserves of the central bank	na	na	na	na	0.2	0.3	0.7	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions)	10.2	10.3	10.3	10.3	10.4	10.4	10.3	10.3
Unemployment (per cent of labour force, end-year)	na	na	na	0.5	1.4	2.1	2.8	na
The share of agriculture in GDP (per cent)	na	24.2	20.3	22.4	17.7	15.2	11	na
The share of industry in GDP (per cent)	na	38.6	40.2	36.6	32.2	30.3	26	na
GNP per capita (in US dollars) at PPP exchange rates	na	na	na	na	na	5,010	na	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

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 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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	1996 Projection
Output and expenditure				*(Percentage change)*				
GDP at constant prices	0.5	-9.1	-11.7	-7.3	-2.4	1.8	2.6	-4
Industrial production	-1.1	-16.0	-27.8	-15.0	-11.8	7.8	8.6	na
Prices and wages								
Consumer prices (annual average)	6.4	26.3	333.5	82.0	73.0	96.3	62	95
Consumer prices (end-year)	10.0	72.5	338.9	79.4	63.9	121.9	32.9	165
Real net wages the state sector (index 1991=100)	na	na	na	17.3	-8.7	-23.2	-4.5	na
Monetary sector								
Broad money (end-year)	10.6	16.6	122	43.5	52.9	78.6	39.6	na
Government sector				*(In per cent of GDP)*				
General government primary balance	na	na	3.2	0.9	-1.5	7.8	8.6	na
General government balance (cash balance)[1]	na	na	na	-13.0	-10.9	-5.8	-5.7	-5
General government expenditure (cash basis)[1]	58.4	65.9	45.6	45.4	48.1	46.0	41.7	na
External data in convertible currencies				*(In billions of US dollars)*				
Current account (accrual basis)[2]	-983.0	-1,180.0	-406.0	-801.0	-1386.0	203.0	281.0	300
Trade balance[2]	na	na	404.0	-212.0	-885.0	-17.0	427.8	na
Gross external debt (billion US dollars, end-year)[3]	na	9.4	9.9	12.6	12.9	10.8	10.4	na
				(Percentage change in the US dollar value)				
Exports (balance of payments data)	na	2,534.0	2,734.0	3,956.0	3,272.0	3,935.0	5,110	na
Imports (balance of payments data)	na	3,086.0	2,330.0	4,169.0	4,612.0	3,952.0	4,683	na
				(In months of current account expenditure excluding transfers)				
Gross official reserves (end-year), excluding gold	na	na	0.3	1.9	1.2	2.1	2.3	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions, end-year)	9.0	8.7	8.6	8.5	8.5	8.4	8.4	na
Employment (percentage change, end-year)	-2.3	-6.1	-13.0	-8.2	-1.6	0.6	2.1	na
Unemployment (per cent of labour force, end-year)	na	1.5	11.5	15.6	16.4	12.8	10.5	na
GDP (in billions of leva)	39.6	45.4	135.7	201	299	522	871	na
GNP per capita (in US dollars) at PPP exchange rates[4]	na	na	na	na	na	4,230	na	na
The share of agriculture and forestry in GDP (per cent)[5]	11	18	15	12	10	11	13	na
The share of industry in GDP (per cent)[5]	59	43	47	45	39	33	31	na
Exchange rate (lev per US dollar, end-year)	2.0	7.0	21.8	24.5	32.7	66.0	70.7	na
Exchange rate (lev per US dollar, annual average)	1.8	3.9	18.1	23.4	27.7	54.1	67.2	na

Note:

Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 Excluding (from expenditures) unpaid due interest amounting to 4.1 billion in 1992, 14.5 bn in 1993, and 5.4 bn in 1994. General government includes the state, municipalities, social security and extra-budgetary funds.

2 Balance of payments data.

3 Data refer only to convertible currency debt until 1991. From 1992, they refer to total debt. In 1992, debt to CMEA institutions amounted to approximately US$ 562 million.

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	1996 Projection
Output and expenditure				*(Percentage change)*				
GDP at constant prices	-1.6	-8.6	-20	-10	-3.7	0.8	2	5
Industrial production	na	-11	-29	-15	-6	-3	0.3	na
Prices and wages								
Retail consumer prices (end-year)	na	136	249	937	1,150	-3	3.7	4.5
Retail consumer prices (annual average)	na	na	123	664	1,517	97	1.6	3.5
Monetary sector								
Narrow money (end-year)	na	na	na	598	889	110	23.9	na
Government sector				*(In per cent of GDP)*				
Central government balance[1]	na	na	-5	-4	-1.0	1.7	-0.9	-3
Central government expenditure[1]	na	na	39	38	34.6	41.6	48.5	na
External data in convertible currencies[2]				*(In millions of US dollars)*				
Current account[2]	na	1,053	-589	823	104	103	-1,712	-1,100
Trade balance[2]	na	-1,168	-536	137	-763	-969	-2,877	-2,400
Exports[2]	na	4,020	3,292	4,597	3,904	4,260	4,633	-5,000
Imports[2]	na	5,188	3,828	4,461	4,666	5,229	7,510	-7,900
				(In months of imports)				
Gross international reserves (end-year)	na	na	0	0.4	1.6	2.3	2.4	na
Gross external debt (billion US dollars)[3]	na	na	3.0	2.7	2.7	3.4	3.7	
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions)	na	4.8	4.8	4.8	4.8	na	na	na
Unemployment rate (per cent of labour force)[4]	na	na	na	12.9	12.8	12.8	13.4	na
Exchange rate (average, kuna per dollar)[5]	na	0.011	0.033	0.26	3.5	5.9	5.2	na
GDP (in millions of US dollars at current exchange rates)	na	25,363	12,355	9,889	11,693	14,226	18,081	na
Debt/GDP per cent	na	na	24	27	23	24	20	
The share of agriculture in GDP (per cent)	na	10.4	10.8	14.1	12.9	13.3	12.4	na
The share of industry and construction in GDP (per cent)	na	31.3	30.7	28.3	28.5	25.7	23.8	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 Central government includes the state, budget and extra-budgetary funds.

2 For 1990 and 1991 these data exclude trade with Slovenia, FYR Macedonia and Bosnia. Goods only.

3 Post-1995 figures include an estimate of the debt recently assumed by Croatia, owed to external commercial bank creditors and Croatia's share of the non-allocated official debt of the SFRY.

4 With the labour force being 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. The kuna/US$-rate shown in this table for the preceding period was based on the application of this conversion rate to the dinar/US$-rate.

Czech Republic

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
Output and expenditure				*(Percentage change)*				
GDP at constant prices	1.4	-0.4	**-14.2**	**-6.4**	**-0.9**	**2.6**	**4.8**	**5.1**
Private consumption at constant prices	na	na	**na**	**15.1**	**2.9**	**5.3**	**6.4**	**na**
Gross fixed investment at constant prices	na	na	**na**	**8.9**	**-7.7**	**17.3**	**16.1**	**na**
Industrial production	0.8	-3.5	**-22.3**	**-7.9**	**-5.3**	**2.1**	**9.2**	**na**
Prices and wages								
Consumer prices (annual average)	2.3	10.8	**56.7**	**11.1**	**20.8**	**10.0**	**9.1**	**9.0**
Consumer prices (end-year)	1.5	18.4	**52.0**	**12.7**	**18.2**	**10.2**	**7.9**	**9.2**
Producer prices (annual average)	-0.7	4.4	**74.7**	**9.9**	**13.1**	**5.3**	**7.6**	**na**
Wages in industry (annual average)	3.2	4.5	**16.7**	**19.6**	**23.8**	**15.7**	**17.0**	**na**
Monetary sector								
Broad money (end-year)	3.5	0.5	26.8	22.8	**20.3**	**20.8**	**19.4**	**na**
Government sector				*(In per cent of GDP)*				
General government balance	-2.8	0.1	-2.0	-3.3	**0.8**	**0.9**	**0.4**	**0**
General government expenditure	64.5	60.1	54.2	52.8	**48.5**	**50.0**	**na**	**na**
External data in convertible currencies				*(Percentage change in the US dollar value)*				
Exports[1]	8.5	10.1	39.2	35.2	**9.8**	**9.2**	**19.3**	**na**
Imports[1]	-1.5	35.0	29.6	46.2	**1.3**	**15.7**	**41.7**	**na**
				(In billions of US dollars)				
Trade balance[2]	0.4	-0.8	-0.4	**-1.0**	**0.3**	**-0.4**	**-3.8**	**-5.2**
Current account balance[2]	0.4	-1.1	0.4	**0.6**	**0.1**	**-0.1**	**-1.9**	**-3.3**
Capital account, of which:	na	na	na	**na**	**3.0**	**3.3**	**8.4**	**na**
Gross foreign direct investment, cash	na	na	na	**1.0**	**0.5**	**0.8**	**2.5**	**na**
Portfolio investment	na	na	na	**0**	**1.1**	**0.8**	**0.9**	**na**
External debt, net of reserves of the banking system (end-year)	6.8	7.7	8.3	**3.5**	**2.3**	**1.8**	**-1.1**	**na**
				(In months of current account expenditures excluding transfers)				
Gross international reserves of the central bank (end-year)	1.8	0.7	1.4	1.0	**3.9**	**4.8**	**7.2**	**na**
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions, end-year)	**10.3**	**10.3**	**10.3**	**10.3**	**10.3**	**10.3**	**10.3**	**10.3**
Employment (change in per cent)	na	**-0.9**	**-5.5**	**-2.6**	**-1.6**	**0.8**	**2.7**	**na**
Unemployment rate (per cent of labour force, end-period)	0	0.8	**4.1**	**2.6**	**3.5**	**3.2**	**2.9**	**na**
GDP (in billions of crowns)	**759**	**567**	**717**	**791**	**911**	**1,038**	**1,212**	**na**
The share of agriculture in GDP (per cent)	6.3	**8.4**	**6.0**	**5.7**	**6.2**	**5.6**	**5.6**	**na**
The share of industry and construction in GDP (per cent)	na	**na**	**na**	**45.0**	**40.0**	**39.2**	**40.1**	**na**
GNP per capita (in US dollars) at PPP exchange rates[3]	na	**na**	**na**	**na**	**na**	**7,910**	**na**	**na**
Exchange rate (crowns per US dollar, end-year)	14.3	28.0	27.8	28.9	**30.0**	**28.2**	**26.6**	**na**
Exchange rate (crowns per US dollar, annual average)	15.1	18.0	29.5	28.3	**29.2**	**28.8**	**26.6**	**na**
Interest rate (average 3 month inter-bank PRIBOR deposit rate, per cent)	na	na	na	13.8	**8.0**	**12.7**	**10.9**	**na**

Note:

Figures in bold type are those for the Czech Republic, whereas figures in normal type are those for the former CSFR. Data for 1989-95 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 1996 reflect EBRD evaluations, partly based information from these sources.

1 Data from the balance of payments, collected on a settlement basis. The high rates of growth of trade between 1990 and 1992 reflect the fact that, as the CMEA's non-convertible trading arrangements collapsed, more trade began to be settled in convertible currencies.

2 Data for 1989-92 exclude trade with Slovakia and incorporate only trade settled in convertible currency.

3 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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	1996 Projection
Output and expenditure				*(Percentage change)*				
GDP at constant prices	-1.1	-8.1	-11.0	-14.2	-8.5	-2.7	3.2	3
Prices and wages								
Consumer prices (annual average)	6.1	23.1	211	1,076	89.8	48	29	26
Consumer prices (end-period)	na	na	304	954	36	42	29	24
Producer prices (annual average)	na	na	na	na	na	36	26	na
Producer prices (end-period)	na	na	na	na	na	33	22	na
Average real wages	na	na	na	-39	4	10	8	na
Monetary sector								
Domestic credit (end-year)	na	na	na	30	60	40	63	na
Broad money (M3, end-year)	na	na	na	71	87	31	30	na
Government sector				*(In per cent of GDP)*				
General government balance[1]	na	na	5.2	-0.3	-0.7	1.3	-0.8	-1.5
General government expenditure[1]	na	na	na	34.9	40.3	39.9	41.5	na
External data				*(In millions of US dollars)*				
Current account	na	na	na	36	23	-171	-186	-330
Trade balance (data from the balance of payments)	na	na	na	-90	-145	-361	-694	na
Exports (merchandise; data from the balance of payments)	na	na	na	461	812	1,327	1,859	na
Imports (merchandise)	na	na	na	551	957	1,688	2,550	na
Foreign direct investment	na	na	na	na	162	214	204	na
				(In months of current account expenditure excluding transfers)				
Gross international reserves (end-year)	na	na	na	3.2	3.7	2.5	2.3	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions)	1.6	1.6	1.6	1.6	1.5	1.5	1.5	1.5
Unemployment (per cent of labour force)	na	na	na	na	5.0	5.1	5.0	na
GDP (in millions of kroons)	na	na	na	13,054	21,918	30,103	41,503	na
GDP at current exchange rates (in US dollars)	na	na	na	na	1,658	2,316	3,620	na
GNP per capita (in US dollars) at PPP exchange rates[2]	na	na	na	na	6,860	na	na	na
The share of agriculture in GDP (per cent)[3]	na	na	na	12.5	10.0	8.8	7.1	na
The share of industry in GDP (per cent)[3]	na	na	na	23.6	18.8	18.3	16.6	na
Exchange rate (kroons per US dollar, end-year)	na	na	na	12.6	13.9	12.4	11.5	na
Exchange rate (kroons per US dollar, annual average)	na	na	na	na	13.2	13.0	11.5	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 The general government sector includes the state, local governments and extra-budgetary funds.

2 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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 At current prices.

FYR Macedonia

	1990	1991	1992	1993	1994	1995	1996 Projection
Output			*(Percentage change)*				
GDP at constant prices	-9.9	-12.1	-21.1	-8.4	-4.0	-1.5	3
Industrial production	-10.6	-17.2	-16.0	-10.0	-9.0	-11	4
Prices							
Retail prices (average)	na	na	1,691	350	122	16	4
Retail prices (end-year)	606	115	1,935	230	55	9	2
Monetary sector							
Private domestic credit	na	na	512.0	408.0	47.6	13.2	na
Private denar M2	na	na	446.0	1.123	43.3	18.3	na
Short-term lending rate (in per cent/end-year)	na	na	na	na	80.0	25	na
Discount rate (in per cent/end-year)	na	na	250	295	33	15	na
Government sector			*(In per cent of GDP)*				
General government balance	na	na	-10.0	-14.0	-3.0	-1	-1
General government expenditure	na	na	48.0	55.0	54.0	46	45
Central government balance[1]	na	na	-2.5	-9.0	-2.5	0	-1
Central government expenditure[1]	na	na	26	32	33	29	29
External data in convertible currencies			*(In millions of US dollars)*				
Current account	-400	-262	-19	-88	-213	-270	-275
Trade balance	-418	-225	-7	-172	-186	-232	-275
Exports[2]	1,113	1,150	1,199	1,055	1,086	1,205	na
Imports[2]	1,531	1,375	1,206	1,227	1,272	1,437	na
External debt (end-year)[3]	828	806	848	828	865	900	na
			(In months of imports)				
Official reserves, gross	na	na	0.6	1.2	1.3	1.9	na
Miscellaneous items			*(Denominations as indicated)*				
Population (in millions)	2.1	2.2	2.2	2.2	2.1	na	na
Official exchange rate (new denar per US dollar, end-period)	na	na	na	44.5	40.6	38	na
Official exchange rate (new denar per US dollar, average)	na	na	na	23.2	43.3	38	na

Note:
Data for 1990-95 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 1996 reflect EBRD evaluations, partly based on preliminary estimates for 1995 from these sources.

1 Includes transfers to extra-budgetary funds.

2 This series includes exports to other republics of the former Yugoslavia from 1991.

3 Estimated stock of debt including interest arrears, penalty interest and the FYRM's share of the unallocated debt of the former SFRY and excluding debt to the IMF.

Georgia

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
Output and expenditure at constant prices				*(Percentage change)*				
GDP at constant prices[1]	-4.8	-12.4	-13.8	-40.3	-39.0	-35.0	2.4	8
Industrial production	-6.9	-29.9	-24.4	-43.3	-21	-40	na	na
Agricultural output	-24.3	61.8	-10.6	-34.2	-42	-15	na	na
Prices								
Retail prices (annual average)	na	3.3	79	887	3,126	17,271	169	50
Retail prices (end-year)	0.9	4.8	131	1,176	7,488	7,144	65	23
Monetary sector								
Domestic credit (end-year)	na	na	na	794	2,048	3,448	28	na
Broad money (end-year)	na	na	na	464	4,319	2,229	114	na
Government sector				*(In per cent of GDP)*				
Consolidated government balance (cash basis)	na	na	-3	-37	-26	-7.4	-4.8	-4
Consolidated government expenditure (cash basis)	na	na	33	39	46	24	13	na
External data				*(In millions of US dollars)*				
Current account	na	na	na	-248	-354	-276	-124	na
Trade balance	na	na	na	-378	-448	-363	-343	-320
Exports	na	na	na	267	457	381	347	390
Imports	na	na	na	645	905	744	690	710
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions)	5.4	5.4	5.4	5.4	5.4	5.4	5.4	5.4
Unemployment rate (per cent of labour force)	na	na	na	5.4	8.4	na	na	na
GNP per capita (in US dollars) at PPP exchange rates[2]	na	na	na	na	na	1,160	na	na
Exchange rate (lari per US dollar, end-period)	na	na	na	na	na	na	1.23	na

Note:
Data for 1989-95 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 information from these sources.

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 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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.

Hungary

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
Output and expenditure				*(Percentage change)*				
GDP at constant prices	0.7	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.5
Private consumption	2.3	-3.6	-5.6	0.0	1.9	-0.2	-4.5	na
Public consumption	-6.3	2.6	-2.7	4.9	27.5	-12.7	-6	na
Gross fixed investment	7.0	-7.1	-10.4	-2.6	2.0	12.5	1	na
Exports of goods and services	1.2	-5.3	-13.9	-5.0	-9.5	15.4	17.5	na
Imports of goods and services	1.8	-4.3	-6.1	-10.0	24.2	12.5	-3.0	na
Industrial gross output	-5.0	-9.3	-18.4	-9.7	4.0	9.6	4.8	3
Agricultural gross output	-1.8	-4.7	-6.2	-20.0	–9.7	3.2	0	na
Prices and wages				*(Percentage change)*				
Consumer prices (annual average)	16.9	28.9	35.0	23.0	22.5	18.8	28.2	24
Consumer prices (end-year)	18.1	33.4	32.2	21.6	21.1	21.2	28.3	22
Producer prices (annual average)	15.2	21.8	32.7	10.7	11.0	11.3	28.9	23
Producer prices (end-year)	na	39.3	27.2	14.4	9.5	14.8	30.2	21
Gross monthly earnings per full-time employee in manufacturing	na	22.9	25.6	25.9	24.7	21.5	21.3	20
Monetary sector				*(Percentage change)*				
Broad money (end-year)	15.2	29.2	29.4	27.3	17.2	13.0	18.5	na
Government sector				*(In per cent of GDP)*				
General government balance[1]	-1.4	0.4	-2.2	-5.5	-6.8	-8.2	-6.5	-4
Consolidated central government balance[2]	-0.8	0.9	-3.3	-7.3	–7.8	-7.5	-6.7	-4
General government expenditure[2]	na	53.5	54.3	61.6	62.2	62.1	56.1	na
General government debt	na	na	75.4	79.4	90.2	87.7	85	na
External data in convertible currencies				*(In billions of US dollars)*				
Current account[3]	-1.4	0.1	0.3	0.3	-3.5	-3.9	-2.5	-1.5
Trade balance[3]	0.5	0.3	0.2	0.0	-3.2	-3.6	-2.4	na
External debt, net of reserves	19.2	20.2	18.7	17.1	17.9	21.8	19.6	na
Foreign direct investment settled in cash	0.2	0.4	1.5	1.5	2.3	1.1	4.5	na
				(Percentage change in the US dollar value)				
Exports (data from the balance of payments)[3]	17.1	-1.6	45.9	8.3	-19.3	-5.9	68.3	na
Imports (data from the balance of payments)[3]	17.8	1.5	51.2	11.1	12.5	-0.8	35.6	na
Exports (customs/survey statistics)[3]	na	na	na	7.4	-17.7	20.1	21.5	10
Imports (customs/survey statistics)[3]	na	na	na	-0.1	12.3	16.1	7.0	0
				(In months of current account expenditures, excluding transfers)				
Gross international reserves (end-year), excluding gold	1.5	1.3	3.8	3.6	5.2	5.1	7.0	na
				(In per cent of current account revenues, excluding transfers)				
Debt service[4]	48.8	48.2	33.9	34.4	43.2	54.8	45.9	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions, end-year)	10.4	10.4	10.3	10.3	10.3	10.2	10.2	na
Employment (percentage change, end-year)	-0.6	-3.1	-9.6	-9.3	-5.0	-2.2	-1.4	na
Unemployment (per cent of labour force)	0.3	1.9	7.5	12.3	12.1	10.4	10.4	na
GDP (in billions of forints)	1,723	2,089	2,498	2,943	3,548	4,365	5,500	na
GDP per capita (in US dollars)	2,803	3,179	3,242	3,617	3,748	4,069	4,290	na
GNP per capita (in US dollars) at PPP exchange rates[5]	na	na	na	na	na	6,310	na	na
The share of agriculture in GDP (per cent)	9.7	9.6	7.8	6.7	6.2	6.0	na	na
The share of manufacturing in GDP (per cent)	30.1	28.8	26.7	25.7	26.6	27.4	na	na
Exchange rate (forint per US dollar, end-year)	62.5	61.5	75.6	84.0	100.7	110.7	139.5	na
Exchange rate (forint per US dollar, annual average)	59.1	63.2	74.8	79.0	91.9	105.2	125.7	na
Interbank interest rate (14-30 days maturity, end-year)	na	na	35.4	15.4	21.8	31.3	30.4	na

Note:

Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 General government includes the state, municipalities and extra-budgetary funds.

2 Including the state and extra-budgetary funds; excluding privatisation revenues (which amounted to Ft 19-22 billion in 1992-93, Ft 59 billion in 1994 and Ft 452 billion in 1995).

3 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.

4 The denominator was estimated on the basis of balance of payments trade data which have been subject to large swings in recent years because of the leads and lags in payment flows and changes in the share of such flows that passes through the banking system. The numerator for 1995 excludes prepayments on debt to the IMF.

5 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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.

Kazakstan

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
Output				*(Percentage change)*				
GDP at constant prices	-0.4	-0.4	-13	-13	-12	-25	-8.9	0.5
Industrial output	2	-1	-1	-14	-16	-28	-7.9	na
Agricultural output	-14	16	-9	1	-10	-23	-21.3	na
Prices and wages								
Retail prices (annual average)	na	4.2	90.9	1,381	1,662	1,880	180	40
Retail prices (end-year)	na	na	149.5	2,567	2,169	1,160	60.3	26
Monetary sector								
Broad money (end-year)	na	na	211	391	692	560	116	na
Government sector				*(In per cent of GDP)*				
General government balance	0	1.4	-7.9	-7.3	-1.2	-6.8	-2.3	-4.0
Total expenditure	35.4	31.4	32.9	31.9	24.7	24	18.8	20
External data				*(In billions of US dollars)*				
Total trade balance	na	na	na	-1.1	-0.4	-0.9	0.2	0.4
Exports	na	na	na	3.5	4.8	3.3	5.2	na
Imports	na	na	na	4.6	5.2	4.2	5.4	na
Total current account	na	na	-1.3	-1.5	-0.4	-0.9	-0.7	-0.9
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions, end-year)	16.5	16.6	16.7	16.9	16.9	16.7	16.5	16.3
Unemployment rate (per cent of labour force, end-year)	0	0	0	0.5	0.6	1.6	2.4	na
Exchange rate (annual average, roubles per US dollar until 1993, tenge per US dollar thereafter)	0.63	0.59	117	222	930	36	60	na
GNP per capita (in US dollars) at PPP exchange rates[1]	na	na	na	na	na	2,830	na	na
The share of industry in GDP (per cent)	29.9	21	37.1	46.4	44.3	40.2	na	na
The share of agriculture in GDP (per cent)	34.8	41.8	34.1	30.4	31.4	38.8	na	na
Direct investment (millions of US dollars)	na	na	na	na	473	635	723	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

[1] PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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	1996 Projection
Output				*(Percentage change)*				
GDP at constant prices[1]	4	3	-5	-19	-16	-26.5	1.3	2
Industrial production	5	-0.6	-0.3	-26	-25	-28	-13	na
Agricultural production	0	1	-10	-5	-10	-15	4	na
Prices and wages								
Consumer prices (annual average)	na	3	85	855	1,209	280	43	30
Consumer prices (end-year)	na	na	170	1,771	1,366	87	31.9	27
Producer prices (end-year)	na	na	288	4,031	1,355	85	33	na
Monetary sector								
Broad money (end-year)	na	na	84	428	180	125	70	na
Net domestic assets (end year)	na	na	na	761	307	84	91	na
Government sector				*(In per cent of GDP)*				
Government balance	2.1	0.3	4.6	-17.4	-13.5	-7.7	-12.5	-5.5
Government expenditure and net lending	35.9	38.3	30.3	33.9	36.6	28.6	28.1	23.5
Government revenue (including grants)	38	38.6	35	17	23	20.8	15.6	18
Government tax revenue	28	26.3	17.1	14.5	13.5	13.4	13.6	14
External data				*(In millions of US dollars)*				
Current account balance, excluding official transfers	na	na	-136	-61	-267	-201	-391	-440
Official transfers into Kyrgyzstan	na	na	na	na	105	75	100	na
Trade balance	na	na	-136	-74	-166	-119	-263	na
Exports	na	na	3,719	258	335	340	409	na
to non-FSU	na	na	23	23	112	117	140	na
to FSU	na	na	3,696	235	223	223	269	na
Imports	na	na	3,855	332	501	459	672	na
from non-FSU	na	na	785	15	185	195	310	na
from FSU	na	na	3,070	317	317	264	362	na
External debt	na	na	na	na	290	414	585	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions, end-year)	4.3	4.4	4.4	4.4	4.4	4.5	4.5	na
GDP (in billions of roubles until 1992, in millions of soms thereafter)	8	8	86	765	5,720	12,019	17,369	na
GNP per capita (in US dollars) at PPP exchange rates[2]	na	na	na	na	na	1,710	na	na
Exchange rate (annual average, roubles per dollar, for 1989-92, som per dollar from 1993 onwards)	0.6	0.6	1.8	161.0	6.1	11.0	10.8	na
Share of industry in GDP (per cent)	na	26	27	32	25	20	16	na
Share of agriculture in in GDP (per cent)	na	32	35	37	39	38	40	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 Goskomstat, the national statistical office, reported a decline in real GDP of around 6 per cent in 1995. The real GDP growth of 1 per cent which is indicated above is taken from the IMF, which has applied more up-to-date weights to official data.

2 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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.

Latvia

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
Output				*(Percentage change)*				
GDP at constant prices	6.8	2.9	-8.3	-35.0	-16.0	0.6	-1.6	1
Prices and wages								
Consumer prices (annual average)	4.7	10.5	124	951	109	36	25	19
Consumer prices (end-year)	na	na	262	958	35	26	23	19
Producer prices (annual average)[1]	na	na	na	na	117	17	12	na
Producer prices (end-year)[1]	na	na	na	na	36	11	16	na
Real average wage in the state sector (annual average)	na	na	-16	-16	1	11	3	na
Monetary sector[2]								
Domestic credit (end-year)	na	na	91	304	146	65	-24	na
Broad money (M2, end-year)	na	na	153	170	84	49	3	na
Government sector				*(In per cent of GDP)*				
General government balance	na	na	na	-0.8	0.6	-4.0	-3.3	-2.0
General government expenditure	na	na	na	28.2	35.2	38.2	38.2	na
External data				*(In millions of US dollars)*				
Current account balance	na	na	na	25	151	-86	-171	-160
Trade balance	na	na	na	-215	-160	-378	-445	na
Exports (merchandise)	na	na	na	831	998	997	1,306	na
to FSU	na	na	na	396	541	503	499	na
to other countries	na	na	na	435	457	494	807	na
Imports (merchandise)	na	na	na	1,046	1,158	1,357	1,751	na
Energy	na	na	na	na	525	407	492	na
from FSU (non-energy)	na	na	na	na	237	245	239	na
from other countries (non-energy)	na	na	na	na	396	722	1,020	na
Gross foreign debt	na	na	na	43	225	359	430	na
				(In months of imports of goods and non-factor services)				
Gross international reserves	na	na	na	2	4.4	4.5	3.2	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in million)	2.7	2.7	2.7	2.6	2.6	2.5	2.5	na
Unemployment (per cent of labour force, end-year)	na	na	na	2.3	5.8	6.5	6.6	na
GNP (in millions of lats)	52	62	143	1,005	1,467	2,043	2,361	na
GNP (current US million)	na	na	na	1,365	2,173	3,648	4,472	na
GNP per capita (in US dollars) at PPP exchange rates[3]	na	na	na	na	na	5,170	na	na
The share of agriculture and fishing in GDP (per cent)	na	21.1	22.5	16.5	10.6	8.4	8.5	na
The share of industry in GDP (per cent)	na	33.4	34.9	26.5	21.1	17.8	16.8	na
One month treasury bill auction rate (per cent, per annum)	na	na	na	na	24.5	18.2	25.7	na
Exchange rate (lats per US dollar, end-year)	na	na	na	0.843	0.595	0.548	0.537	na
Exchange rate (lats per US dollar, annual average)	na	na	na	0.736	0.675	0.560	0.528	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 For 1991-93, this series covers prices in the manufacturing sector only.

2 Figures for 1995 reflect the suspension of activities of 15 banks and 2 credit unions.

3 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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	1996 Projection
Output and expenditure				*(Percentage change)*				
GDP at constant prices[1]	1.5	-5.0	-13.4	-37.7	-24.2	1.0	3.1	1.5
Gross industrial output	na	na	na	na	-34.4	-26.5	5.2	na
Prices and wages								
Consumer prices (annual average)[2]	2.1	8.4	224.7	1,020.5	410.4	72.1	39.5	28
Consumer prices (end-year)	na	na	345	1,161.1	188.8	45.0	35.5	26
Producer prices (annual average)	na	na	148.2	1,517.4	397.7	44.7	28.3	na
Average monthly wages (whole economy)	10.5	21.1	129.2	797.7	171.0	95.9	58.5	na
Monetary sector								
Broad money (M2)	14.2	55.4	143.0	245.3	100.4	63.6	30.8	na
Government sector				*(In per cent of GDP)*				
General government balance[3]	-3.6	-5.4	2.7	0.8	-3.1	-4.2	-3.3	-3.4
General government expenditure and net lending	53.8	49.1	38.7	31.3	33.3	29.3	27.9	na
External data in convertible currencies				*(In millions of US dollars)*				
Current account	na	na	na	203	-132	-175	-177	-196
Trade balance	na	na	na	101	-283	-308	-334	na
External debt	na	na	na	94	281	448	757	na
Foreign direct investment (net)	na	na	na	10	23	60	55	na
				(percentage change in the US dollar value)				
Exports (merchandise, percentage change)	na	na	na	na	49.6	12.9	14.5	na
Imports (merchandise, percentage change)	na	na	na	na	91.4	12.3	13.7	na
				(In per cent of total exports or imports)				
Exports								
to countries outside the FSU (in per cent of total exports)	na	na	na	48.8	41.9	44.7	47.7	na
to former Soviet republics (in per cent of total exports)	na	na	na	51.2	58.1	55.3	52.3	na
Imports								
from countries outside the FSU (in per cent of total imports)	na	na	na	32.9	26.1	32.4	35.3	na
from former Soviet republics (in per cent of total imports)	na	na	na	67.1	73.9	67.6	64.7	na
				(In months of merchandise imports)				
Gross international reserves of the central bank (end-year), excluding gold	na	na	na	0.5	2.1	2.8	3.6	na
				(In millions of US dollars)				
Debt services	na	na	na	0.2	0.6	0.8	2.7	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions, mid-year estimate)	3.7	3.7	3.7	3.7	3.7	3.72	3.71	na
Employment (percentage change, annual average)	na	na	2.4	-2.2	-4.2	-5.8	-1.9	na
Unemployment (per cent of the labour force)	na	na	0.3	1.3	4.4	3.8	6.2	na
GDP (in millions of litai/litai equivalent)	122.7	129.0	381.8	3,268.6	12,219	22,214	31,096	na
GDP per capita (in US dollars)	na	na	265.4	492.9	754.1	1,501.1	2,095.4	na
GNP per capita (in US dollars) at PPP exchange rates[4]	na	na	na	na	na	3,240	na	na
The share of agriculture in GDP (per cent) at current prices	27.3	27.6	19.2	11.6	11.0	7.3	9.5	na
The share of industry in GDP (per cent) at current prices	34.5	32.8	55.7	39.4	30.4	25.8	23.5	na
Exchange rate (end-year)	na	17	110	379	3.9	4.0	4.0	na
Exchange rate (annual average)[5]	na	na	38.5	177.3	4.3	4.0	4.0	na
Interbank interest rate (average rate with maturities up to one month)	na	na	na	na	na	69.5	26.8	na

Note:

Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 Figures are for NMP until 1990, GDP thereafter. NMP excludes depreciation and the value added from most of the service sector.

2 Figures for retail prices until 1990, CPI thereafter.

3 The general government sector includes the state, municipalities and extra-budgetary funds.

4 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas* 1996. In the computation of this estimate the country's nominal GNP per capita in local currency 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 Roubles per US dollar for 1990 and 1991; talonai per US dollar in 1992; and litai per US dollar for 1993-95.

Moldova

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
Output				*(Percentage change)*				
GDP at constant prices	na	-2.4	-17.5	-29	-1	-31	-3.0	4
Prices								
Consumer prices (annual average)[1]	na	4.2	98.0	1,208	1,283	587	30	25
Consumer prices (end-year)[1]	na	na	151	2,198	837	116	24	18
Government sector				*(In per cent of GDP)*				
State budget balance[3]	2	3	0	-4.2	-6.4	-5.4	-4.9	na
State budget expenditures and net lending[2]	na	na	na	24.8	23.8	29.0	19.6	na
General government balance (GFS concept)[4]	na	na	na	-23.4	-6.8	-9.0	-5.5	-4
General government expenditures and net lending (GFS concept)	na	na	na	43.6	19.8	32.1	29.4	27
External data in convertible currencies				*(In millions of US dollars)*				
Current account	na	na	na	-39	-182	-98	120.0	-390
vis-à-vis countries outside the FSU	na	na	na	-22	-8	-26	-5.0	na
vis-à-vis former Soviet Republics	na	na	na	-17	-174	-71	-114.0	na
Trade balance	na	na	na	-37	-180	-54	-32.0	-280
vis-à-vis countries outside the FSU	na	na	na	-20	-35	-11	3.0	na
vis-à-vis former Soviet Republics	na	na	na	-17	-144	-43	-36.0	na
Exports	na	na	na	868	451	618	741.0	750
to countries outside the FSU	na	na	na	185	174	213	273.0	na
to former Soviet Republics	na	na	na	683	277	406	468.0	na
Imports	na	na	na	905	631	672	773.0	1,030
from countries outside the FSU	na	na	na	205	210	224	269.0	na
from former Soviet Republics	na	na	na	700	421	449	504.0	na
of which: energy	na	na	na	na	na	-287	-283	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions)	4.4	4.4	4.4	4.3	4.3	4.3	4.3	na
GDP (in millions of Moldovan lei)	na	na	26	192	2,210	5,780	7,639.0	na
GDP at current exchange rates (in millions of US dollars)	na	na	na	na	na	1,410	1,697.0	na
GDP per capita (in US dollars) at current exchange rates	na	na	na	na	na	327	390.0	na
The share of agriculture in GDP (per cent)	na	na	33	38	46	48	49.0	na
The share of industry in GDP (per cent)	na	na	30	31	29	25	22.0	na
GDP per capita (in US dollars) at PPP exchange rates[3]	na	na	na	na	3,210	na	na	na
Exchange rate (lei per US dollar, average for the year)	na	na	na	na	na	4.1	4.5	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 Retail prices for 1989-91.

2 Includes republican and local budgets except for the Trans-Dniester region.

3 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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 1995 figure excludes net lending. GFS stands for "government finance statistics" and denotes an IMF concept of the fiscal balance.

Poland

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
Output and expenditure				*(Percentage change)*				
GDP at constant prices	0.2	-11.6	-7.0	2.6	3.8	5.2	7.0	5.0
Private consumption at constant prices	-0.3	-15.3	6.3	2.3	5.2	4.3	na	na
Public consumption at constant prices	-4.6	0.5	10.2	6.4	3.8	2.8	na	na
Gross fixed investment at constant prices	-2.1	-10.6	-4.4	2.3	2.9	9.2	na	na
Exports of goods and services at constant prices	2.6	15.1	-1.7	10.8	3.2	13.1	na	na
Imports of goods and services at constant prices	4.3	-10.2	29.6	1.7	13.2	11.3	na	na
Industrial production	na	na	-8.0	2.8	6.4	11.9	9.4	8.0
Agricultural production	na	na	-1.6	-12.7	6.8	-9.3	na	na
Prices and wages								
Consumer prices (annual average)	251.1	585.8	70.3	43.0	35.3	33.2	27.8	21.0
Consumer prices (end-year)	639.5	249.0	60.4	44.3	37.6	29.4	21.6	19.0
Producer prices (annual average)	212.8	622.4	48.1	28.5	32.3	30.1	25.6	na
Wages and salaries (annual average)	291.8	398.0	70.6	39.2	33.6	36.8	32.9	na
Monetary sector								
Broad money (end-year)[1]	526.5	160.0	36.9	57.5	36.0	38.2	34.8	na
Government sector				*(In per cent of GDP)*				
General government balance[2]	-7.4	3.1	-6.5	-6.6	-2.9	-2.0	-3.5	na
General government outlays[2]	48.8	39.8	48.0	50.7	50.5	47.5	na	na
State budget balance[3]	-6.1	0.7	-7.0	-6.9	-3.4	-2.5	-2.8	-2.7
State budget outlays[3]	36.9	32.7	32.7	33.7	32.8	31.9	32.0	30.3
External data in convertible currencies				*(In billions of US dollars)*				
Current account balance[4]	-1.8	0.7	-2.2	-0.3	-2.3	-1.1	-2.1	-3.5
"Adjusted" current account balance[4]	na	na	na	na	na	2.0	3.8	1.0
Trade balance[4]	0.2	2.2	0.1	0.5	-2.3	-0.8	-1.8	-2.5
External debt	40.2	48.9	48.3	48.2	48.7	40.9	39.4	na
				(Percentage change in the US dollar value)				
Exports (data from the balance of payments)[4]	7.6	10.9	12.8	14.0	13.6	24.3	35.5	na
Imports (data from the balance of payments)[4]	7.3	8.6	12.7	13.5	15.9	11.9	38.8	na
Flow of foreign direct investment settled in cash	0.0	0.0	0.1	0.3	0.6	0.5	0.9	na
				(In months of imports of goods and non-factor services)				
Gross international reserves (end-year), excluding gold	2.4	3.8	2.5	2.9	2.6	3.1	5.7	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions)	38.0	38.2	38.3	38.4	38.5	38.6	38.6	na
Employment (percentage change, end-year)	-0.8	-4.2	-5.8	-4.2	-2.4	1.8	na	na
Unemployment (per cent of the labour force, end-year)	0.1	6.1	11.8	13.6	15.7	16.0	14.9	na
Exchange rate (zloty per US dollar, end-year)	0.650	0.950	1.096	1.577	2.134	2.437	2.468	na
Exchange rate (zloty per US dollar, average)	0.145	0.950	1.058	1.363	1.812	2.272	2.425	na
Interest rate (refinancing rate, end-period)	140.0	55.0	40.0	38.0	35.0	33.0	29.0	na
GDP (in billions of zloty)	11,832	59,152	82,527	114,944	155,780	214,700	292,600	na
Private sector share of GDP (per cent)	28.6	30.9	42.1	45.4	47.5	53.0	na	na
The share of agriculture in GDP (per cent)[5]	11.8	10.3	9.0	6.7	6.6	6.2	na	na
The share of industry in GDP (per cent)[5]	44.1	44.9	40.2	34.0	32.9	32.2	na	na
GNP per capita (in US dollars) at PPP exchange rates[6]	na	na	na	na	na	5,380.0	na	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 Beginning December 1991, data are based on a new system of accounts and an improved reporting system.

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 The unadjusted series is based on official trade data which are likely to understate exports very significantly. The "adjusted" estimates take into account export revenues that flow through the so-called "kantor" market for small-scale foreign exchange transactions. Such flows were negligible prior to 1994.

5 At current prices.

6 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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.

Romania

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
Output and expenditure				*(Percentage change)*				
National accounts								
Real GDP	-5.8	-5.6	-12.9	-8.8	1.3	3.9	6.9	4.5
Private consumption	0.6	8.1	-16.2	-9.2	-2.1	na	na	na
Public consumption	6	14.1	10.5	1.8	2.4	na	na	na
Gross fixed investment	-1.6	-37.4	-36.7	19.3	-3.7	14.6	na	na
Exports of goods and services	-8.2	-41.8	-26.2	2.4	12.1	25.8	22.2	na
Imports of goods and services	10.6	14.5	-41.6	7.8	4.2	9	33.3	na
Industrial output[1]	-5.3	-23.7	-22.8	-21.9	1.3	3.3	9.4	9.0
Prices and wages								
Consumer prices (annual average)	1.1	5.1	174.5	210.9	256.1	131.0	32.2	40
Consumer prices (end-year)	0.6	37.7	222.8	199.2	295.5	61.7	27.8	60
Wages (annual average)	3.9	10.6	121.3	170	202.1	129.5	54.1	na
Monetary sector				*(Percentage change)*				
Broad money (M2, end-year)	6.3	22	101.2	79.6	143.2	138.1	71	na
Government sector				*(In percent of GDP)*				
Central goverment balance (national definition)	na	na	-1.7	-4.4	-2.7	-3.0	-4.1	-3
General government balance[2]	8.4	1.2	0.6	-4.6	-0.1	-1.0	-2.8	-2
General government expenditure[2]	42.7	39.3	38.7	42.2	33.7	32.4	36.3	na
External data in convertible currencies				*(In billions of US dollars)*				
Current account balance	2.9	-1.8	-1.3	-1.5	-1.2	-0.4	-1.3	-1
Trade balance	2.6	-1.8	-1.3	-1.5	-1.2	0.4	-1.2	na
Gross external debt, net of reserves (end-year)	-0.8	0.6	1.4	2.4	3.3	3.4	4.8	na
				(Percentage change in the US dollar value)				
Exports (data from the balance of payments)[3]	-7.9	-44.0	-1.7	21.1	13.6	26	22.2	na
Imports (data from the balance of payments)[3]	17.3	49.9	-10.2	11.3	10.7	9.1	33.4	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	3.4	2	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	22.7
Employment (percentage change, end-year)	1.3	-1.0	-0.5	-3.0	-3.8	-2.7	na	na
Unemployment rate (in per cent of the labour force, end-year)	na	na	3.0	8.1	10.2	11	8.9	na
GDP (in billions of lei)	800	858	2,204	6,029	20,051	49,795	72,249	na
GDP per capita (in US dollars) at current exchange rates	2,321	1,651	1,245	859	1,157	1,325	1,570	na
GNP per capita (in US dollars) at PPP exchange rates[4]	na	na	na	na	na	2,920	na	na
The share of agriculture in GDP (per cent)[5]	13.9	21.8	18.9	19.0	21.0	20.1	na	na
The share of industry in GDP (per cent)[5]	52.8	40.6	37.9	38.3	32.4	32.3	na	na
Exchange rate (lei per US dollar, end-year)[6]	14.4	34.7	189.0	460.0	1,276.0	1,767	2,760	na
Exchange rate (lei per US dollar, average)[6]	14.9	22.4	76.3	308.0	760.1	1,580	2,036.6	na
Bank lending rate (end-year)[7]	3.8	3.8	19.5	43.6	86.4	62.4	41.5	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 For 1988 and 1989: industrial real value added.

2 General government includes the state, local governments and extra-budgetary funds. Figures are on a cash basis.

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 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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 dollar would buy in the United States.

5 At current prices.

6 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.

7 Commercial banks, average lending rates as reported by the National Bank.

Russian Federation

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
Output and expenditure				*(Percentage change)*				
Real GDP	na	na	-13.0	-14.5	-8.7	-12.6	-4.0	-3
Real NMP	1.9	-4.0	-14.0	-21.0	-13.0	-16.0	-4.0	na
Investment at constant prices	4.1	0.1	-15.0	-40.0	-12.0	-26.0	-13.0	-10
Industrial production	1.4	-0.1	-8.0	-18.8	-16.2	-22.8	-4.7	-5
Prices and wages				*(In percentage)*				
Consumer prices (annual average)	2.0	5.6	92.7	1,354	896	302	190	45
Consumer prices (end-period)	na	na	143.9	2,318	841	203	131	25
Wages (annual average)	12.9	15.2	80.1	994	879	273	na	na
Industrial wholesale prices (annual average)	1.2	3.9	138.1	1,949	na	na	na	na
Industrial wholesale prices (end-period)	na	na	236.3	3,275	1,007	345	179	na
Monetary sector				*(Percentage change)*				
Credit to enterprises and households	na	na	127	803	452	242	na	na
Broad money (end-period)[1]	14.6	17.6	126	643	416	190	119	na
Government sector				*(In per cent of GDP)*				
General government balance (cash basis)[2]	na	na	-31.0	-18.8	-7.6	-10.1	-4.9	-6
External data[4]				*(In billions of US dollars)*				
Current account balance *vis-à-vis* non-CIS countries[3]	na	na	3.5	-5.7	2.3	1.2	5.7	5
Trade balance *vis-à-vis* non-CIS countries[3]	na	na	8.1	4.4	11.9	14.3	18.1	15
Gross external debt in convertible currencies (of the Soviet Union/Russia, end of period)	54.4	61.1	67.0	78.2	83.7	93.6	103.8	na
				(Percentage change in the US dollar value)				
Exports to non-CIS countries (incl. gold)[3]	0.7	-4.8	-28.4	-16.8	4.5	20.0	24.2	na
Imports from non-CIS countries[3]	8.0	4.8	-45.6	-16.9	-11.3	12.3	19.5	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions, end-year)	147.6	148.3	148.9	148.6	148.3	148.2	148.1	na
Unemployment rate (per cent of labour force, end-year)[4]	0.0	0.0	0.1	0.8	1.1	2.1	3.2	na
Open unemployment (per cent of labour force, end-year)[5]	na	na	na	na	5.5	7.1	8.2	na
Exchange rate (roubles per US dollar, end-year)	0.6	1.7	169.0	415.0	1,247.0	3,550.0	4,640.0	na
Exchange rate (roubles per US dollar, average)	0.6	1.7	67.1	222.1	933.2	2,205.0	4,565.0	na
Refinancing rate (in per cent, end-year)[6]	na	na	6 to 9	80.0	210.0	180.0	160.0	na
Nominal GDP (in trillion roubles)	0.6	0.6	1.4	19.0	171.5	630.1	1,888.0	na
GNP per capita (in US dollars) at PPP exchange rates[7]	na	na	na	na	na	5,260.0	na	na

Note:
Data for 1989-95 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 1996 eflect EBRD evaluations, partly based on information from these sources.

1 Excluding foreign currency deposits.

2 Includes the federal and local governments, all extra-budgetary funds and unbudgeted import subsidies.

3 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. The main source for external data are the IMF and Russian Economic Trends. Forecasts for 1996 are those of the EBRD.

4 Officially registered unemployed.

5 Open unemployment data correspond to the ILO definition and are based on Goskomstat labour survey figures.

6 This is the refinancing rate that is quoted by the Central Bank of Russia (CBR). It does not truly reflect the compound annualised interest rate on refinancing. It is instead computed by multiplying by 12 the monthly rate charged by CBR on refinancing loans.

7 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. 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	1996 Projection
Output				*(Percentage change)*				
GDP at constant prices	1.4	-2.5	**-14.6**	**-6.5**	**-4.1**	**4.8**	**7.4**	**5.5**
Industrial production[1]	**-0.7**	**-3.6**	**-17.6**	**-14.4**	**-10.2**	**6.4**	**8.3**	**na**
Prices and wages								
Consumer prices (annual average)	2.3	10.8	**61.2**	**10.1**	**23.2**	**13.4**	**9.9**	**7.0**
Consumer prices (end-year)	1.5	18.4	**58.3**	**9.1**	**25.1**	**11.7**	**7.2**	**5.9**
Producer prices (annual average)	-0.7	4.4	**68.8**	**5.3**	**17.2**	**10.0**	**9.0**	**na**
Average wages in industry	3.2	4.5	**16.5**	**20.2**	**16.8**	**17.4**	**15.3**	**na**
Monetary sector								
Broad money (end-year)	3.5	0.5	26.8	4.7	**18.5**	**18.8**	**20.7**	**na**
Net domestic assets (end-year)	0.9	5.2	21.9	7.2	**19.0**	**12.4**	**3.0**	**na**
Government sector				*(In per cent of GDP)*				
General government balance	-2.8	0.1	-2	**-11.9**	**-7.1**	**-1.1**	**3.2**	**-1.5**
General government expenditure	64.5	60.1	54.2	**57.9**	**51.2**	**47.7**	**48.3**	**na**
External data in convertible currencies				*(In billions of US dollars)*				
Current account balance	0.4	-1.1	0.4	0.2	**-0.6**	**0.7**	**0.6**	**-1.2**
Trade balance	0.4	-0.8	-0.4	-0.7	**-0.9**	**0.1**	**0.0**	**-1.6**
Exports[2]	na	na	na	na	**5.4**	**6.7**	**8.5**	**na**
Imports[2]	na	na	na	na	**6.3**	**6.6**	**8.5**	**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**	**22.8**	**27.7**	**na**
Imports (data from the balance of payments)[2]	-1.5	35	29.6	46.2	**-12.5**	**4.0**	**28.5**	**na**
				(In billions of US dollars)				
Official reserves (excluding gold)	**na**	**na**	**na**	**na**	**0.4**	**1.7**	**3.4**	**na**
External debt (net of official reserves)	**na**	**na**	**na**	**na**	**3.2**	**2.6**	**2.4**	**na**
				(In months of imports)				
Official reserves	**na**	**na**	**na**	**na**	**0.7**	**2.6**	**4.0**	**na**
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions, end-year)	**5.3**	**5.3**	**5.3**	**5.3**	**5.3**	**5.3**	**5.3**	**na**
Unemployment rate (per cent of labour force, end-year)	**0**	**1.5**	**11.8**	**10.3**	**14.4**	**14.8**	**13.1**	**na**
GDP (in billions of crowns)	759	**244**	**280**	**301**	**370**	**441**	**518**	**na**
The share of agriculture in GDP (per cent)[3]	6.3	**8.2**	**5.8**	**6.1**	**6.6**	**6.6**	**6.4**	**na**
The share of industry in GDP (per cent)[3]	59.6	**61.6**	**63.9**	**38**	**36.7**	**35.4**	**32.5**	**na**
GNP per capita (in US dollars) at PPP exchange rate[4]	na	**na**	**na**	**na**	**na**	**6,660**	**na**	**na**
Exchange rate (crowns per US dollar, end-year)	14.3	28	27.8	28.9	**33.2**	**31.3**	**29.6**	**na**
Exchange rate (crowns per US dollars, annual average)	15.1	18	29.5	28.3	**30.8**	**32.0**	**29.7**	**na**
National Bank discount rate (end-year)	na	na	na	na	**12.0**	**12.0**	**9.8**	**na**

Note:

Figures in bold type pertain to the Slovak Republic whereas figures in normal type pertain to the former CSFR. Data for 1989-95 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 1996 reflects EBRD evaluations, partly based on information from these sources.

1 Covers only state enterprises until 1991, but includes the private sector from 1992.

2 The values and the growth rates quoted take into account trade with the Czech Republic.

3 The share of NMP for 1989-90 and of 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 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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	1996 Projection
Output				*(Percentage change)*				
GDP at constant prices	-1.8	-4.7	-8.1	-5.4	1.3	5.3	3.5	3
Industrial production	-0.1	-10.5	-12.4	-13.2	-2.8	6.4	2.0	1.5
Agricultural production	-3.3	1.6	-3	-6	-3.7	1.6	2.5	3
Prices and wages								
Retail prices (annual average)	1,306	550	117.7	201.3	32.3	19.8	12.6	10.0
Retail prices (end-year)	2,772	105	247.1	92.9	22.9	18.3	8.6	9.5
Industrial producer prices (annual average)	1,413	390	124.1	215.7	21.6	17.7	12.8	na
Nominal wages, net of tax (annual average)[1]	1,141	379	82.5	198.5	52.0	28.3	18.6	na
Monetary sector								
Broad money (end-year)	na	na	na	132	64.2	50.7	30.2	na
Government sector				*(In per cent of GDP)*				
General government balance	0.3	-0.3	2.6	0.3	0.3	-0.2	-0.03	-0.4
General government expenditure	42.1	49.6	41.1	46.2	46.8	47.3	46.2	45
External data in convertible currencies				*(In billions of US dollars)*				
Current account[2]	1.08	0.53	0.13	0.93	0.15	0.54	-0.04	-0.1
Trade balance[2]	0.19	-0.61	-0.26	0.80	-0.15	-0.34	-0.96	-1.0
External debt, net of official reserves[3]	na	na	1.7	1.0	1.1	0.8	1.2	1.5
				(Percentage change in US dollar value)				
Exports (data from the balance of payments)[2]	3.19	20.8	-6	8.1	-9	16.1	19.1	3
Imports (data from the balance of payments)[2]	9.9	47.0	-12.6	0.1	5.9	14.4	27.2	5
				(In months of current account expenditures, excluding transfers)				
Gross international reserves, excluding gold	na	0.6	0.4	1.2	1.2	2.1	2.0	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	2.0
Employment (percentage change, annual average)	-1.1	-3.8	-7.8	-6.6	-2.2	-1.8	-0.3	na
Unemployment (per cent of labour force, annual average)	2.9	4.7	8.2	11.6	14.4	14.4	13.9	na
GDP (in 10 trillions of dinars up to 1990, in billions of tolars thereafter)	34.8	196.1	349.4	1,005	1,435.0	1,844.7	2,198.5	na
The share of agriculture in GDP (per cent)	4.3	4.7	4.9	4.9	4.5	4.5	na	na
The share of industry in GDP (per cent)	44.3	38	40.8	37.6	35.4	35.1	na	na
Exchange rate (tolar per US dollar, end-year)[4]	11.8	10.7	56.7	98.7	131.8	126.5	126	na
Exchange rate (tolar per US dollar, annual average)[4]	2.9	11.3	27.6	81.3	113.2	128.8	118.5	na
Working capital nominal interest rate (end-year)	na	na	562.6	71.6	42.6	38.5	28.0	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 Data for 1989-91 covers only the social sector. Data for subsequent years take into account private enterprises employing three or more persons.

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	1996 Projection
Output				*(Percentage change)*				
GDP at constant prices	-2.9	-1.6	-7.1	-29.0	-11.1	-21.5	-12.5	-7
Industrial production	1.9	1.9	-2.0	-23.3	-17.8	-31.4	na	na
Agricultural production	-13.0	-9.2	-4.4	-26.7	-4.4	0.1	na	na
Prices and wages								
Consumer price (average of period)[1]	na	4	112	1,157	2,195	350	635	700
Consumer price (end-period)[1]	na	na	204	1,364	7,344	5	1,500	200
Wholesale prices (annual average)	na	na	79	3,450	4,241	295	628	na
Monetary sector								
Broad money (end-year)	na	na	68	579	1,429	159	na	na
Government sector				*(In per cent of GDP)*				
General government balance[2]	na	na	-16.4	-31.2	-25	-10.5	-11.2	-6
General government expenditure[2]	na	na	49.6	57.8	52.1	55	30.6	22
External data				*(In millions of US dollars)*				
Current account (incl. official transfers)	na	na	na	52.8	-208	-169	1	na
Trade balance total	na	na	na	-54.8	-204	-147	29	na
vis-à-vis countries outside the FSU	na	na	na	-21.4	-79	29	128	na
vis-à-vis former Soviet Republics	na	na	na	-33.4	-125	-176.0	-98	na
Exports total	na	na	na	184.8	456	559	657	na
to countries outside the FSU	na	na	na	110.8	318.0	406.0	462	na
to former Soviet Republics	na	na	na	74.0	139.0	154.0	195	na
Imports total	na	na	na	239.0	660.4	707.0	628	na
from countries outside the FSU	na	na	na	132.2	396.0	377	334	na
from former Soviet Republics	na	na	na	107.4	264.0	330	294	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions, end-year)	5.1	5.2	5.3	5.6	5.7	5.7	5.8	5.8
GDP (in millions of roubles)[3]	4,817	5,490	10,540	64,760	631,162	1,717,974	64,843	na
GDP per capita (in US dollars) at PPP exchange rates[4]	na	na	na	na	na	1,160	na	na
Industry's share in NMP (per cent)	37.2	38.3	43.9	32.8	36.1	34.6	na	na
Agriculture's share in NMP (per cent)	26.7	28.6	30.6	45.4	23	19.0	na	na
Investment (in per cent of GDP)	na	na	na	na	na	22.3	17.4	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 RPI through 1991, CPI thereafter.

2 Includes state budget, pension and employment funds.

3 NMP for 1989-91: in Russian roubles until 1994, in Tajik roubles thereafter.

4 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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	1996 Projection
Output				*(Percentage change)*				
GDP at constant prices	-6.9	2.0	-4.7	-5.3	-10	-20	-10	0
Price and wages								
Consumer prices (annual average)	2.1	4.6	103	493	3,102	1,750	1,005	500
Consumer prices (end-period)	na	na	155	644	9,750	1,330	1,000	250
Government sector				*(In per cent of GDP)*				
Central government expenditure[1]	30.1	43.6	38.2	42.2	19.2	10.4	10	na
Central government balance[1]	-1.9	1.2	2.5	13.2	-0.5	-1.4	-1.6	na
External data				*(In millions of US dollars)*				
Current account	na	na	na	na	776	84	55	na
Current account (cash basis)[2]	na	na	na	na	-151	-462	-10	na
Trade balance	na	-249	590	1,140	1,100	486	536	na
Exports	na	151	1,238	2,149	2,693	2,176	2,008	na
Imports	na	400	648	1,009	1,593	1,690	1,472	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions)	3.6	3.7	3.8	3.8	3.9	3.9	na	na
Employment (in millions)	1.49	1.54	1.57	1.57	na	na	na	na
The share of agriculture in NMP (in per cent)[3]	43	48	46	48	17	na	na	na
The share of industry in NMP (per cent)[3, 4]	23	16	20	11	39	na	na	na
GDP per capita in purchasing power terms (US dollars)[5]	na	na	na	3,950	na	na	na	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

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 NMP excludes depreciation and the value added from most of the service sector.

4 The methodology used by the Turkmen Statistical Office leads to an understatement of the contribution from natural gas production.

5 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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	1996 Projection
Output and expenditure				*(Percentage change)*				
GDP at constant prices	4	-3.4	-9.0	-10.0	-14.0	-23.0	-11.8	-7
Private consumption	5	2	-8	-9	-21	-22	na	na
Public consumption	7	5	19	-17	-26	na	na	na
Net fixed investment	-2	-32	-79	-37	-23	na	na	na
Industrial production	3	0	-5	-6	-9	-28	-13	na
Agricultural production	na	-4	-13	-8	2	-16	-2	na
Prices and wages								
Consumer prices (annual average)	2.2	4.2	91	1,210	4,700	891	375	90
Consumer prices (end-year)	na	na	161	2,000	10,155	401	182	55
Producer prices (annual average)	na	4.5	125	2,384	2,453	1,040	488	na
Producer prices (end-year)	1.7	4.5	163	4,129	9,668	602	272	na
Average wages (annual average)	na	na	na	1,523	2,236	786	426	na
Monetary sector								
Broad money (end-year)	na	na	na	859	1,778	573	117	na
Net domestic assets of the banking system (end-year)	na	na	na	1,639	1,133	583	180	na
Government sector				*(In per cent of GDP)*				
General government balance[1]	na	na	-13.6	-29.3	-9.7	-8.2	-5.0	-6.5
State budget balance[1]	5.8	2.6	-14.1	-30.4	-11.6	-9.2	-5.0	na
State budget expenditure[1]	27.3	31.4	41.0	71.9	54.3	53.5	45.0	na
State budget revenue[1]	na	na	na	41.5	42.9	44.3	40.0	na
External data				*(In billions of US dollars)*				
Current account balance	na	na	-2.9	-0.6	-0.8	-1.4	-1.5	-15
vis-à-vis non-FSU countries	na	na	na	na	0.7	0.4	0.6	na
vis-à-vis FSU republics	na	na	na	na	-1.5	-1.8	-2.1	na
Merchandise trade balance total	-9.0	-12.7	-3.4	-0.6	-2.5	-2.3	-2.3	-3.4
vis-à-vis non-FSU countries	-0.8	-2.6	-2.7	0.5	0.5	0.3	0.5	na
vis-à-vis FSU republics	-8.2	-10.1	-0.7	-1.1	-3.0	-2.7	-2.8	na
Exports total	77.1	74.6	50.0	11.3	12.8	12.1	13.6	na
to non-FSU	14.0	13.2	7.3	6.0	5.2	4.6	5.7	na
to FSU republics	63.1	61.4	42.7	5.3	7.6	7.5	7.9	na
Imports total	86.1	87.3	53.4	11.9	15.3	14.5	16.0	na
from non-FSU	14.8	15.8	10.0	5.5	4.7	4.3	5.2	na
from FSU republics	71.3	71.5	43.4	6.4	10.6	10.1	10.8	na
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions)	51.7	51.8	51.9	52.0	52.1	51.7	51.3	51.2
Employment (percentage change)	na	-3.5	-1.6	-4.0	-2.3	-5.3	na	na
Unemployment rate (per cent, end-year)	0	0	0	0.3	0.4	0.4	0.6	na
GDP (in billions of roubles until 1991, in trillions of karbovanetsi thereafter)	154	165	295	5	148	1,137	5,140	na
GNP per capita (in US dollars) at PPP exchange rates[2]	na	na	na	na	na	3330	na	na
The share of agriculture and fisheries in GDP (per cent)	28	24.4	24.5	20.8	18.4	14.3	13.2	na
The share of industry and construction in GDP (per cent)	42.6	42.6	54.6	52.1	36.8	42.4	43.7	na
Exchange rate (roubles or karbovanetsi per US dollar, average per year)[3]	0.62	0.59	1.74	253	8,858	52,225	158,302	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 The general government sector includes the state, municipalities and extra-budgetary funds. The state budget includes direct credits. All balances on cash, are quoted on a cash basis. On the IMF definition of the budget defecit (foreign interest payments classified as below the line), the deficits as a share of GDP were -7.5 per cent in 1994 and -3.5 per cent in 1995 and 1996.

2 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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 Roubles per US dollar until 1991, karbovanets per US dollar thereafter (auction exchange rate).

Uzbekistan

	1989	1990	1991	1992	1993	1994	1995	1996 Projection
The real economy				*(Percentage change)*				
Real GDP	3.7	1.6	-0.5	-11.1	-2.3	-4.2	-1.2	-1
Real NMP	3.1	4.3	-0.9	-12.9	-3.5	na	na	na
Industrial output	3.6	1.8	1.8	-12.3	-8.3	na	na	na
Agricultural output	-4.3	6.3	-5.2	-7.3	-0.7	na	na	na
Prices and wages								
Consumer prices (annual average)[1]	0.7	3.1	82.2	645	534	1,568	305	50
Consumer prices (end-period)[1]	na	na	169	910	885	1,281	117	35
Wholesale prices (annual average)	2.1	7.2	147.3	3,275	2,545	1,428	499	200
Wages (annual average)	6.4	11.2	51.1	612	1,350	905	210	na
Government sector				*(In per cent of GDP)*				
General government balance	-0.9	-1.1	-3.6	-18.4	-10.5	-6.1	-4.1	-3.5
General government revenue	35.0	44.9	49.1	31.4	42.6	32.3	35.2	32.3
General government expenditure	35.9	46.1	52.7	49.7	53.0	38.4	39.2	35.8
Monetary sector								
Broad money (end-period)	na	na	na	335.8	785.0	680.3	151	15
External data				*(In millions of US dollars)*				
Exports	na	na	na	1,424	2,877	2,940	3,805	4,006
Imports	na	na	na	1,660	3,255	2,727	3,598	4,125
Trade balance	na	na	na	-236	-378	213	207	-119
Current account	na	na	na	-239	-429	117	-53	-512
Miscellaneous items				*(Denominations as indicated)*				
Population (in millions, end-year)	20.0	20.5	20.9	21.3	22.0	22.5	22.7	na
Unemployment rate (per cent of labour force, end-year)	0	0	0	0.1	0.2	0.4	0.4	na
Exchange rate (annual average; roubles per US dollar for 1989-93, sum per US dollar for 1994-95)	0.63	0.59	0.58	222	933	11.4	29.7	na
Share of industry in GDP (per cent)	26.0	23.8	26.3	26.6	22.4	17	16.4	na
Share of agriculture in GDP (per cent)	42.3	44.3	37.2	35.4	27.9	34.5	28.5	na
Investment (per cent of GDP)	32	32	26	24.9	14.7	18.2	29.6	33.8
Nominal GDP (in billions of roubles until 1992, in millions of sum from 1992)	30.7	32.4	61.5	444.0	5,095.0	64,878	298,530	na
GNP per capita (in US dollars) at PPP exchange rates[2]	na	na	na	na	na	2,390	na	na

Note:
Data for 1989-95 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 1996 reflect EBRD evaluations, partly based on information from these sources.

1 Retail prices for the period 1989-93.

2 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate the country's nominal GNP per capita in local currency 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.

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