

Transition report 1997

Enterprise performance and growth

Albania Armenia Azerbaijan
Bahrain Belarus Bosnia
and Herzegovina
Bulgaria Croatia Czech
Republic Estonia
FYROM Macedonia Georgia
Hungary Kazakhstan
Kyrgyzstan Latvia
Lithuania Moldova
Poland Romania Russian
Federation Slovakia
Slovenia
Tajikistan Turkmenistan
Ukraine Uzbekistan

**Economic
transition in
eastern Europe
and the former
Soviet Union**

Progress in transition

Enterprise performance
and growth

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, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, FYR Macedonia, Hungary, Poland, Romania, Slovak Republic and Slovenia
Former Soviet Union	Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, 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
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
ILO	International Labour Organisation
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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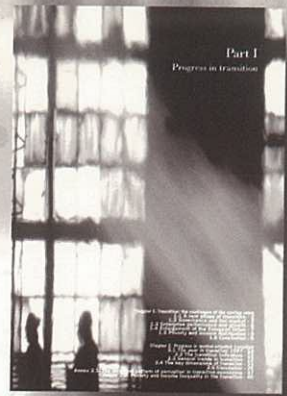
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Enterprise performance and growth



Part I.
Assessing progress in transition



Part II.
Enterprise performance and growth



Part III.
Macroeconomic performance



Transition indicators
Selected economic indicators

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Foreword

The purpose of this *Transition Report*, the fourth 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 central and eastern Europe, the Baltics and the CIS. The two special, and closely related, topics of this year's Report are enterprise performance and growth.

The EBRD seeks to foster the transition to an open market-oriented economy and to promote private and entrepreneurial initiative in all 26 of its countries of operations. The Bank does this as a participant investor with a private sector focus. It works with its partners on projects that are financially sound and advance the transition, and that would be unlikely to emerge or to function well without its participation. In this sense, the EBRD works as an investor to advance the frontiers of the transition process and thereby expands opportunities for further investment. For the EBRD to perform this task effectively, it is of great importance to analyse and understand the complex and multi-dimensional process of transition, to share the Bank's analyses with its partners, other investors and policy makers in the region, and to adapt its activities to developments in each country. Thus, the *Transition Reports* take an investment perspective on the transition process. It is important to see the Reports as a series in which each edition is complete in its own right but also inter-related and cross-referenced to previous editions. The analyses in the special topics for each year develop and complement the topics from earlier years.

The *Transition Reports'* analytical approach to developments of the market economies in the region also complements that of the European Commission's recent assessment of the preparedness for EU membership of the 10 applicant countries from central and eastern Europe, *Agenda 2000*. In areas of common focus, the two analyses are similar in both their approaches and assessments.

The building of a market economy requires the creation of markets, market-oriented enterprises and financial institutions so that competitive interactions among producers and consumers guide production and investment decisions. It also requires a dramatic reorientation of government away from commanding and controlling economic activity and towards establishing markets and enhancing their effectiveness as the arbiter of success and failure in economic activity. The creation of markets was a relatively simple task in the sense that it required governments to reduce their activity by abandoning their control of prices, trade and access to foreign exchange. This task has been largely completed in most transition economies, although there are still many important examples where the functioning of markets and the process of competition are still heavily influenced by the older practices and structures.

The development of enterprises which function effectively in markets is a more complex task than the liberalisation of markets in which they operate. This is true for both state enterprises and privatised firms, as they are encouraged or forced to adopt a more commercial approach, as well as for new private firms. Responding to the new opportunities created by market liberalisation requires of the enterprises which emerged from the command economy the ability and the incentive to adapt to the new economic environment. The sharp reduction of government support for enterprises, privatisation and the development of effective corporate governance are crucial if market forces are to operate and if enterprises are to respond effectively. To exploit the new opportunities, entrepreneurs need to be able to enter new markets unimpeded by discretionary and arbitrary bureaucratic barriers and by any attempts of existing enterprises to monopolise markets. In addition, government must provide crucial elements of the "institutional infrastructure" of a market economy, which shapes the practices, rules and organisations that guide and govern economic activities.

The building of market-oriented and stable financial systems and the restructuring of infrastructure towards serving customers on market principles have been particularly challenging aspects of transition. Financial institutions were essentially non-existent under the old regime. To perform well, they require time, skills, capital and the opportunity to establish a reputation for prudence. The infrastructure inherited from the previous regime was oriented towards a distorted and ideologically influenced production system and away from cost control and the needs of consumers. In encouraging the development and adaptation of infrastructure, government must perform important regulatory roles to protect both its finances and the interests of consumers. These regulations and their application form an important part of the institutional infrastructure.

As documented in previous *Transition Reports*, progress in transition tends to be more advanced in those areas where the market can quickly replace the older command structures (so that government can withdraw from its earlier activities) and to be less advanced in those areas where government must take on the difficult new challenges of building market-oriented institutions and of adapting its own practices to a market environment. Significantly, the past 12 months have seen continued progress in some of the more difficult aspects of the transition, such as privatisation of large-scale enterprises (including some in infrastructure) and of major state banks in those countries already at more advanced stages of transition. Some countries, which had allowed their reforms to stall, have redoubled their efforts in a resolute response to emerging economic crises by curbing “off-budget” government support for enterprises, accelerating their privatisation process and closing insolvent banks. However, there are still a few countries that have not yet allowed basic market forces to operate effectively in terms of liberalisation and privatisation.

The special topics of this year’s Report are enterprise performance and growth. The focus here on sustaining growth reflects the fact that most transition economies have begun to grow, in contrast to the position only a few years ago when many were experiencing severe economic contractions. The question is whether this initial growth will be

sustained and what measures are needed to deliver rapid growth over the medium and long term. Sustained growth does require investment in plant and equipment and in new skills, together with innovation in technology and business management, but investment does not, *per se*, automatically generate sustained growth, as the experience of the old regime showed all too clearly. It is important to recognise that sustained growth arises from the initiatives of entrepreneurs, managers and workers. These actions are shaped by many factors in market economies, such as the ability of investors to reap the returns to their investment and the extent of rivalry among producers. This Report examines, therefore, enterprise performance in transition economies, focusing on the factors determining restructuring and the creation of new businesses as well as the policies which encourage this.

The Report also considers the medium- and long-term prospects for growth in the region. The analysis emphasises that the process of structural change and restructuring together with the well-developed skills and wide technological deficits in the region form two significant sources of growth in transition economies. However, the weaknesses in the institutional infrastructure of transition economies impose a significant constraint on growth prospects. With resolute progress in transition, though, it could be that looking back in 20 years’ time some of the world’s “tiger” economies will have been found in the region.

The assessments and views expressed in this *Transition Report* are not necessarily those of the EBRD. The responsibility for them is taken by myself on behalf of the Office of the Chief Economist. While we have attempted to be as up to date as possible, the “cut-off” date for most of the information in the Report is August 1997.



Nicholas Stern
Chief Economist and Special Counsellor to the President

9 October 1997

Executive summary

Chapter 1: Transition: the challenges of the coming years

For the region as a whole, the process of transition is entering a new phase following the initial period of strong progress in liberalisation, privatisation, and the establishment of macroeconomic stability. In the second phase the key challenges will be to build, consolidate and strengthen the institutions, policies and practices which underpin a well-functioning market economy and the investment that supports growth. In responding to these challenges, good governance will be crucial. This must involve openness, transparency and credibility and the absence of bureaucratic interference and corruption. Such governance is vital to the emergence and maintenance of an effective competitive process. The private sector must also in this phase build the sound business practices which will lead to long-term success. Good governance both encourages and is supported by the development of civil society.

Chapter 2: Progress in market-oriented transition

The transition economies have continued to make progress in market reforms over the year, albeit at a slower pace than in the past. However, the pattern of reforms differs across countries, and progress is neither consistently strong across all areas of reform nor over time in each country. Several countries, including for instance Azerbaijan, Bulgaria and Turkmenistan, have advanced significantly after years of slow progress. Others, including Belarus and Uzbekistan, have taken steps backwards from already low levels of reform. The differences in the depth of reforms are increasingly the result of policy choices rather than the initial conditions in each country. A particularly encouraging development has been the commitment in several countries, including over the past year Albania, Bulgaria, the Czech Republic, Romania and Russia, to deepen reforms in the face of political challenges or economic crisis.

The EBRD's transition indicators have registered substantial progress over the past year in the privatisation of very large enterprises (in some cases involving the public utilities and energy sectors) and in banking reform. This is a fairly broad phenomenon, which now extends beyond the group of advanced reformers to countries ranging from south-eastern Europe to Russia and the Caucasus. However, institutional reforms to support capital markets and other non-bank financial sectors generally lag behind, and progress in enterprise restructuring and improving governance continues to be slow. An increasingly urgent challenge is the reform of government. While several countries are now tackling pensions reform, major problems remain, particularly in the CIS, concerning severe income inequality, haphazard and discriminating tax systems and corruption in the public administration.

Chapter 3: Growth in transition economies: sources and obstacles

Most transition economies are now growing. This is in contrast to the position only a few years ago, when many were experiencing extreme economic dislocation and rapid falls in output. Increases in output reflect in part the recovery from the effects of the collapse of the previous regime's central planning and from the initial challenges of market liberalisation. They also show the beginnings of market-driven growth. Basic questions for the analysis and formation of policy are whether this initial growth will be sustained and what measures will be needed to deliver rapid growth over the medium and long term.

Growth in transition economies hinges on the economic incentives faced by businesses and individuals, on how well markets function and on the new and evolving institutions and government policies. In particular, it is argued that the nature and strength of growth will be determined by the influence of competition among producers and the way that this stimulates new methods of doing business. The analytical approach of the Report is thus a market-driven perspective on the growth process, which focuses on innovation (the approach is commonly referred to as "Schumpeterian"). It is the responsibility of government to establish effective policies, to strengthen the institutional framework, and to conduct itself in a manner which will allow the competitive process to work to its full potential. Part of this responsibility lies in ensuring the provision of physical infrastructure and the development and maintenance of a skilled workforce, thereby enabling individuals and firms to participate effectively in, and share the benefits of, the market economy.

Chapter 4: Structural change, restructuring and enterprise performance

New market forces in transition economies have brought about significant structural change, with some sectors contracting (industry in all countries) and others expanding (services in the whole region and agriculture in some countries) in terms of shares of total employment. Trade flows of transition economies are also adjusting to the natural advantages of each country. In general, the emerging economic structures and patterns of trade specialisation are consistent with the operation of market forces. However, one area of change which conforms less well with market experience is the growth in employment in government services beyond those levels recorded in comparable market economies.

Evidence from market economies points to a number of factors that have a significant impact on enterprise performance, particularly product market competition, privatisation, corporate governance, government behaviour and the capabilities of the state. The experiences of transition economies confirm the importance of these

factors. The weak capability of the state and arbitrary government behaviour in the transition countries have been significant impediments to new private businesses, particularly in the CIS. In contrast, increased competition resulting from greater levels of imports leads to productivity gains in competing domestic firms while privatisation and concentrated outside ownership of enterprises contribute to strong performance.

Chapter 5: Enhancing enterprise performance

To improve enterprise performance, two aspects of the transition are crucial. The first involves altering radically the relationship between government and enterprises and the second requires the establishment of effective mechanisms for privatisation and corporate governance of enterprises. An early widespread reform in changing the relationship between government and enterprises was the sharp reduction in budgetary subsidies. However, this was followed by new forms of government support (usually off-budget), including leniency regarding tax and payments arrears and the persistence of soft bank lending. Even with effective reduction in government support for enterprises, the competition that is vital for improving performance is weakened by barriers to business start-ups, many of which are erected by government. It is important to recognise that eliminating these impediments can lead to the creation of private sector jobs, which in turn eases the pressures for continued government support for weak enterprises.

The governance of most medium-sized and large enterprises requires dramatic change. Privatisation represents a first step, but the form of privatisation (involving a number of compromises) has not, in most cases, provided effective governance. Following privatisation, therefore, change is often required in the ownership structures and in the methods of corporate governance. Instrumental to this change will be development of the financial sector to provide an effective source of outside finance for investment and a market in which changes in ownership and control can take place.

Chapter 6: Prospects for growth in transition economies

While attempting to forecast precise long-term growth rates is not sensible, it is possible to identify two reasons for optimism and one for pessimism. The potential for large productivity gains from structural change and enterprise restructuring and the potential contributions to growth from the highly skilled workforces in the region are two reasons for optimism. The experience of western Europe and Japan following the Second World War illustrates the major contribution that the more efficient use of resources can make to growth. In addition, the skilled population of transition countries can play a valuable role in adapting technologies from advanced market economies. It is the combination of high levels of skills and significant technological deficits in transition economies that creates a strong potential for growth. Well-functioning markets will drive the actions and investments which can realise this potential.

The main reason for pessimism is the weakness in the region, at present, of the institutions, policies and practices which are

needed to underpin a market economy. There are a number of important steps which many governments must take to improve the business climate and, in particular, to strengthen the institutions which support investment and innovation. The more advanced countries have made significant progress in this regard, and it is possible that looking back in 20 years' time some of the world's "tiger" economies will have been found in the region. However, this growth process should not be seen in any way as inevitable or automatic. Although the potential for growth is large, there is also a strong possibility of becoming trapped by resistance to change and vested interests.

Chapters 7 and 8: Macroeconomic trends

The resumption of economic growth is being witnessed in the region as a whole in 1997, at 1.5 to 2 per cent, after seven years of continuous decline in measured GDP. Eleven economies in the region, out of 26, are now growing at rates of 4 per cent or more. Nevertheless, the growth performance has been uneven across countries. Growth in eastern Europe has slowed for the third year in a row, with Albania, Bulgaria and Romania experiencing serious setbacks. On the other hand, economic contraction has finally come to an end in the CIS. This turnaround is largely due to the improving performance of Russia, which is likely to register in 1997 its first year of (mildly) positive growth. Growth in many of the advanced economies is currently driven by domestic demand and especially by private consumption, whereas exports were the driving force when growth first resumed. Prospects for 1998 are for higher growth in eastern Europe and positive growth for the CIS as a whole, with a more solid recovery in Russia.

Inflation performance has continued to improve despite several setbacks. Nine countries in the region now have inflation at less than 10 per cent per annum, and 18 countries at less than 20 per cent. The greater stability in prices in the CIS continues to be fragile. The past year has demonstrated continuing weaknesses in fiscal revenue performance and, as in previous years, these weaknesses have forced authorities into very heavy reliance on tight policies in pursuit of stabilisation.

External accounts have deteriorated sharply over the past two years, explained in part by the recovery in domestic demand. In 1996, more than half of all transition economies recorded current account deficits in excess of 5 per cent of GDP. These deficits have been financed by growing inflows of foreign private capital. Foreign direct investment alone is likely to reach US\$ 16-18 billion in 1997, with half accounted for by Poland and Russia. In addition, international bond and commercial bank finance and money market investments have been surging, particularly into Russia, and may contribute another US\$ 30-35 billion during 1997. These inflows are a sign of growing confidence in the region but they can bring their own problems. There is a danger of overheating, of excessive real exchange rate appreciation and of volatility, as the Czech Republic experienced in 1997. The growth of foreign indebtedness in some countries (including Armenia, Georgia, Kyrgyzstan, Moldova and Tajikistan, which largely rely on official external finance) will have to be handled carefully.

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8	Forecasts and prospects	Julian Exeter


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Part I

Progress in transition

Chapter 1. Transition: the challenges of the coming years

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Transition: the challenges of the coming years

1

1.1 A new phase of transition

A new phase is beginning in the process of transition towards a market economy in central and eastern Europe and the former Soviet Union. The first phase was dominated by the structure of the inheritance from the communist system and the political repercussions following the collapse of this regime. The key achievements of this first phase were the privatisation of assets, the liberalisation of markets and the establishment of a degree of macroeconomic stability. These achievements have led in most countries to the recovery of growth. In 1993, of the EBRD's 25 countries of operations only Albania, Poland, Romania and Slovenia were showing positive growth, and one year earlier this applied only to Poland. In 1997 it is likely that only six or seven economies will be in decline. The next phase of transition requires policies, institutions and behaviour that can foster and accelerate this growth.

The challenges of the second phase of transition, and the forthcoming response, will be determined not only by the conditions in the countries at the start of the transition but also by the events and actions of the first phase. This new phase of transition will be shaped therefore by both the broad history of each country and, more particularly, the very recent history of the first phase.

The policies and events of the first phase have varied greatly across and within countries. Starting with widely differing conditions, the result has been strong diversity across the region in the progress and shape of the transition and in the timing and form of economic recovery. In addition, the transition has not been a "linear" process in the sense of steady, continuing progress on all fronts. There are important examples where transition has faltered or been reversed in some areas and where recovery has not yet occurred. There are also examples, particularly in the last year, where governments or electorates have shown great resolve in moving the transition process forward where it had previously stalled. The nature of the challenges of the second phase will vary, therefore, across countries. Indeed, a few countries must still be regarded as entrenched in the problems of the first phase. However, all countries in the region face a common challenge, which will characterise the second phase: the task of developing and providing effective, market-oriented governance. By governance we mean the manner of governing within enterprises and within the economy as a whole, in particular the building and deepening of the institutions and behaviour that are at the heart of a well-functioning market economy. It will be a central theme of this Report and this chapter.

The challenges and issues of the new phase, which are present in some shape or form in all of the countries in the region, are complex, multi-dimensional and inter-related. They can be

grouped into the following broad areas: governance and institutions; macroeconomic and fiscal issues; restructuring enterprises and the financial system; regional issues; poverty and income distribution. First, the magnitude of the task of establishing the governmental, financial, legal and regulatory framework which is required for a well-functioning market economy is becoming ever more clear. This involves governance issues and in many countries dealing with the problems of bureaucratic interference, the haphazard or arbitrary effects of taxation, the fragility of financial systems, fraud, criminality and corruption, and the establishment or maintenance of monopolistic practices.

Second, on the macroeconomic front the challenges of ensuring the long-term sustainability of hard-won gains are starting to appear. For example, after the impressive reductions in inflation achieved across the region from 1993 to 1995, inflation has started to climb in a few countries. In other countries, growing current account deficits are beginning to raise problems of instability on the foreign exchange markets. This is partly because fiscal policy has, on the whole, been less rigorous than monetary policy. In the medium term both must play a strong role if inflationary pressures are to be contained. A fiscal reform will require not only careful attention to taxation but also to public expenditure. Indeed, the task of reorganising public expenditure, reforming pensions and creating an efficient and market-oriented civil service has barely begun in most countries.

Third, the experience of enterprise reform and building financial institutions and capital markets demonstrates the difficult and long-term nature of the challenges involved. The magnitude of the task of restructuring is being revealed in part by the "deflation" of the "cushions" which had earlier eased the pressure for fundamental restructuring. These cushions included small debt burdens, very low real exchange rates and under-employed or "surplus" labour.

Fourth, many countries are likely to see further and fundamental changes in their economic and political relationships on a regional level. A few of them have already joined OECD and NATO. Several are moving towards membership of the European Union. This enlargement of the EU would represent an event of outstanding significance for Europe as a whole and a landmark in the process of transition. However, the scale and scope of the challenges in meeting the conditions for accession to the EU, particularly in the areas of environment, health and safety standards for products and processes as well as the financial sector, are becoming more clearly defined. Major advances in the transition will be required, particularly in institutional development, and very large additional investments are needed. The changes to regional relationships will not be confined to the west of the

region. The countries of the former Soviet Union are looking to push forward the process of integration into the world economy, in sharp contrast to the narrow and rigid economic and political relationships which existed under the old regime. For example, the countries of Central Asia are seeking to develop their links (such as transport and petroleum) with their neighbours in other parts of Asia and with Europe.

Fifth, the early phase of transition brought an increase in poverty and widening disparities in income throughout much of the region. This involved great hardships and will have important policy and institutional consequences for the next phase.

This Report focuses on issues arising from growth and restructuring (see Part II), macroeconomic developments (see Part III) and governance issues, which are woven throughout the whole Report. As in earlier Reports, Chapter 2 of Part I charts the overall progress of transition in the past year and assesses the current position. The picture is broadly positive, but progress is mixed. While the past year has generally seen continuing, and often strong, progress, events have also shown that the emergence of a healthy and well-functioning market economy cannot be taken for granted. It requires continued commitment and effective leadership.

The remainder of this introduction looks more closely at governance and institutional issues, highlighting key lessons. It also comments briefly on regional and poverty issues which, notwithstanding their great importance, receive less attention in the chapters that follow. The discussion of the role and nature of governance is developed in section 1.2 below. The main conclusions from Part II of the Report on growth and restructuring are described in section 1.3. Recent developments in the process of the enlargement of the EU, in particular Agenda 2000, are examined in section 1.4. A brief discussion of poverty and income distribution, drawing on Annex 2.2 to Chapter 2, is provided in section 1.5. Concluding comments are offered in section 1.6. The main themes from the chapters which follow are highlighted in the Executive Summary at the beginning of this Report.

1.2 Governance and the market

The *Transition Reports* have attempted to apply systematic criteria to measure progress in the transition. They also present data from national accounts and other sources and, when appropriate, use formal economic models. However, sometimes conditions or issues that are measured explicitly or modelled formally (regardless of how accurately the underlying concepts are captured by the variables or numbers) can monopolise attention to the detriment of the regard which should be paid to more qualitative issues.

Governance is defined as the manner of governing. It is not something that can be measured easily. Yet it is fundamental to the market economy, to the transition and to the process of growth. That is why we have emphasised governance issues and the role of the state in earlier *Transition Reports* and why we give it prominence both in this introduction and in subsequent chapters of this Report.

It is striking that many of those who have looked at economic performance and growth from the perspective of economic history have emphasised governance as the key determining factor. A particularly graphic presentation of this view is in the famous fourteenth century Siena series of frescoes by Ambrogio Lorenzetti on the "Effects of Good and Bad Government".¹ It is also noteworthy that the more naive forms of state minimalism and the more dogmatic assertions of the efficiency of markets which were prominent in the 1980s (around the time of the collapse of communism) have brought a reaction not in terms of calling for a reversion to the command economy but for a closer analysis of the role and responsibilities of the state in the market economy.²

The understanding of the meaning and role of good governance in an advanced market economy has taken time to develop and is still developing. And the implementation of good governance is not easy or straightforward. Its establishment for a transition economy is a formidable task, since the state has to lead its own transformation and the basic understanding and experience of market-oriented institutions are limited. It is, in many respects, the central task of the new phase of transition. Detailed below are some of the governance issues that will be vital to the processes of restructuring and growth. Good governance for the market economy involves establishing government institutions that allow markets to work well and to deliver and protect living standards and the rights of its people. In discussing governance in this context, emphasis is placed on public-private partnerships and the inter-relationships between government and non-government activities.

The first two tasks of government in a market economy are the maintenance of macroeconomic stability and of law and order, including defence and basic property rights. These are the basic elements of the "night-watchman state", and most would agree that they are essential responsibilities of a state in a market economy. The next question is how far, and in what way, should the role of the state extend beyond those basic functions. For those creating and shaping the transition economies, the issue is what kind of state they have in mind and, more particularly, what is the goal for their transition. That question must be posed clearly now, and still more strongly as the economies pass from the first to the second phase. Entrenched positions can become established quickly, and sometimes opportunistically or haphazardly, and they can be very difficult to dislodge.

¹ In the frescoes in the Palazzo Pubblico, two mirror-image cities are displayed. One is governed by a prime minister counselled by Justice, Wisdom and Compassion and the other counselled by Pride, Wrath and Avarice. The former city is orderly, happy and prosperous and the latter is poor, corrupt and oppressed.

² See, for example, Stiglitz (1989), Stern (1989), Stern (1992) and Malinvaud et al. (1997). In their chapters in Malinvaud et al. (1997), Stern and Stiglitz emphasise the importance of partnership between public and private activities, rather than focusing on a single narrow one-dimensional question of public versus private.

The answer to the question is much deeper than the fraction of output which comes, or should be expected, from the private sector. Rather, the issue is one of establishing partnerships between the public and private sectors. These partnerships should build on the comparative advantages of the public and private sectors. They will take different forms in different areas where the government is likely to be involved in a fundamental way, including particularly health, education and pensions. Rather than analyse the structure of these partnerships in detail, we illustrate some of the key issues involved in their design and construction. Some brief comment is provided on two areas crucial to the second phase: pensions and infrastructure.

The example of pensions illustrates the complexity and subtlety of some of the issues. Since the demands, costs and requirements for pensions can vary widely in the population, the market may be well-placed to provide products tailored to the needs of different individuals or households and to invest funds effectively. On the other hand, the government has a comparative advantage in the crucial administrative tasks of following people over time and enforcing payments, for example, through a tax or social security system. Further, private pensions can be opaque, sold in a misleading way, fraudulent or suffer from heavy administrative and selling costs. While such problems can, in principle, apply to most products, they are much more severe where monies are entrusted to pension funds, and obligations incurred, over a long period of time. Regulatory institutions supporting private programmes are essential, but they will have to be built carefully over time. The building of such institutions and private pension funds can have profound and beneficial effects on the working of capital markets, on corporate governance, and on the generation and allocation of savings (see, for example, the 1996 *Transition Report*).

However, it would be a mistake to expect private provision to provide instant solutions to the pension problems faced in transition economies. The more urgent task for the public finances is to control the scale of expectations and obligations that governments have inherited from the past (see the 1996 *Transition Report*). This does not, of course, mean that the development of private funds and regulatory systems should be delayed. Tasks which take time to tackle and that are crucial for the medium term should be started now.

Public-private partnerships are also crucial in the development of infrastructure. Large-scale private involvement, through new entry of enterprises or privatisation, can be established in this sector much more rapidly than for pensions. The gains from competitive private provision can appear very quickly. However, regulation is required to control monopoly power in privatised utilities where competition is not possible. In the transition economies there have already been important examples where private sector participants in infrastructure have won privileged positions from the government (possibly involving illicit means). The result is lower efficiency, higher prices and poorer services both to industries and households. The victim is the final consumer, now and in the

future. The answer to the problem of public-private partnership in infrastructure is to exercise vigilance and care in the choice, design and implementation of regulatory structures. These must protect competition and the consumer while allowing reasonable profiles of risk and return to the private investor. Private participation in infrastructure has a great deal to offer the economy in terms of better services to consumers and reductions in pressures on public revenues. It presents real opportunities for the second phase of transition in many countries and was a major topic of the 1996 *Transition Report*.

The examples of pensions and infrastructure are of immediate policy relevance to transition economies and underline the importance of developing and maintaining the right kind of partnership. In particular, public-private partnership should never be confused with collusion between special private sector interests and the government to the detriment of the public at large. In these as in all other areas, it is crucial for the government to lead by example in promoting – in both the public and private sectors – the behaviour that is consistent with a well-functioning market economy. In particular, it must look for institutions, policies and actions that minimise the opportunities for arbitrary, self-interested or corrupt bureaucratic interference. Experience has already shown that such interference can stifle investment and growth in transition economies. Corruption is not only pernicious in itself; it also undermines free competition and therefore endangers one of the fundamentals of transition.

There is much that sound institutional and policy design can achieve in promoting responsible behaviour and limiting corrupt practices. Government structures should, as far as possible, limit the number of licences and permissions required and the discretion of civil servants over the ordinary economic activity of entrepreneurs and consumers. It is when permissions or discretionary decisions start to permeate throughout the economy and society³ that bureaucratic interference develops and the potential for corruption grows. This results in markets that do not function well and where entrepreneurship, investment and growth are inhibited. Where permissions or discretion are unavoidable, as they will be in a number of important areas of activity, openness and transparency are the key weapons against the misuse of power.

There is a great deal also that private firms and financial institutions, including international financial institutions, can do to limit corrupt practices. This issue is dealt with briefly below and discussed in a little more detail in Chapters 2 (Annex 2.1) and 5.

Corruption is not the only form of criminal behaviour which threatens the development of the open market economy. In many countries of the region organised crime and protection rackets are posing serious problems for business transactions. They impose heavy “tax burdens”, limit competition and drive away investment. The fight against organised crime will be a major challenge to the development of the economies and societies of the region.

³ In India the language of the “permit raj” is sometimes used.

The most prominent example of government activity where good governance is crucial for the functioning of a market economy is taxation. Raising revenue is, of course, fundamental for macroeconomic stability and the provision of basic services and social protection. The establishment of an effective tax system is, as was argued in the 1994 *Transition Report*, a fundamental issue of the transition. Under the old regime, the taxation system was not of over-riding importance since the government could command resources directly. In a market economy most of the resources used by government must be raised in some shape or form from the private economy. The challenge is to do this in a way that keeps distortions and disincentives to a minimum and takes account of the taxpayers' ability to pay. There is no area where the interactions of institutions, policies and behaviour are more important.

Taxation is one of the biggest problems facing foreign investors in a number of countries in the region, particularly in the CIS. The problems lie not in the existence of taxation but in its design and functioning. If taxation is to operate in a way that allows private enterprises to function effectively, it should be even-handed, predictable and based on reasonable definitions of profit, output or income. In practice, it often involves definitions of tax bases and rates which, if applied literally, could drive the honest taxpayer out of existence (for example, definitions of profits which make no allowance for a number of substantial and genuine costs⁴). The result is widespread discretion by both ministers and revenue officers and a plethora of special deals and exemptions. This in turn results in a shredding or demolition of the tax base, still higher rates on those who do pay, large distortions of competition and the allocation of entrepreneurial energies (or covert payments) to securing special privileges.

Investment, be it foreign or domestic, does not need special deals, discretionary or otherwise, and governments should not see the promotion of investment as lying in tax privileges. Research on investment and taxation⁵ has shown time and again that it is the stability, transparency and predictability of markets and the prospects for growth that are the main factors stimulating investment in a market economy. Investment and growth will be fostered, therefore, both by the transition itself and by macroeconomic stability. What is required from the tax system is predictability, even-handedness and a broad base, taking into account sensible economic concepts such as, for enterprises, profit or value added. Such a structure will in turn permit the reasonable rates which are required to strike a balance between revenue and disincentives. The establishment of such a tax system is central to the establishment of good governance.

In this discussion of governance, emphasis has been placed on the behaviour and practices of government itself. However, effective governance requires the cooperation and participation of the

governed. In particular, in economic affairs it requires sound business practices in enterprises. Sound practices are not only beneficial for the effective functioning of a market economy and the welfare of the population. They are also in the long-term interests of an enterprise devoted to the profits of its shareholders: this is one of the most important facets of the "invisible hand".⁶ Sound practices may be expressed in terms of those practices that implement long-term profit maximisation for the benefit of shareholders by maintaining and developing good and honest relationships with customers, suppliers, workers, those who supply finance, neighbours, local and central government, and anyone else who interacts with the enterprise. Indeed, it could be argued that the only effective method of long-term profit maximisation is the implementation of these practices and that a stable and predictable business environment encourages and rewards this long-term perspective. The definitions of, and arguments for, social business practices do not lie only, however, in the interests of the shareholders of the enterprise. Firms are institutions which have both rights and responsibilities. The responsibilities involve basic standards of behaviour and of transparency.

More specific statements of sound business practices can be provided in terms of explicit principles or codes, often specified in terms of checklists which should be followed. Recent years have shown great interest in, and controversy over, such codes. While the precise form of codes may be the subject of argument, the broad principles of maintaining and developing good and honest relationships with those interacting with enterprises is broadly accepted. It should not be assumed that such principles are widely and immediately understood in transition economies. Indeed, it has taken many decades (running into centuries) for them to be established in more advanced market economies. However, it is crucial that these practices become established quickly in transition economies. It is a major task of governments, leading domestic firms, foreign investors, and domestic, foreign and international financial institutions to take a lead in establishing these practices. In particular, the EBRD seeks to lead by example and insists on such standards in all the investments⁷ in which it is involved.

Lastly, good governance depends on the establishment and functioning of an effective civil society. Indeed, it could be argued that a key determinant of the performance of government is the effectiveness of civil society. This term refers to a collection of institutions that are neither governmental nor private enterprise, including political parties, voluntary organisations, religious groupings and labour unions. The term may also be taken as including the media (although in many cases the media does and should consist of private enterprises operating for profit) at least in the sense that free and effective media are crucial to the independence of the activities of civil society. It is civil society that helps provide an understanding of the public interest, that can express

⁴ These definitions can be particularly pernicious in an inflationary environment.

⁵ See, for example, the 1995 *Transition Report*.

⁶ The term "soundness of business practices" is sometimes used interchangeably with good corporate governance. The latter term, however, generally has a slightly narrower interpretation in terms of relationships between owners and managers of a firm. We shall not dwell on the distinction here.

⁷ The EBRD has recently made available a description of sound business practices which was constructed with some of its clients for a seminar at its 1997 Annual Meeting in London.

the wishes of various groups in the population and exercise vigilance over the abuse of power. Civil society was stunted under the old regime where such institutions were focused narrowly on the perceived interests of the state (or rather those in power). The growth and flourishing of civil society are crucial to the success of the political and economic transition.

1.3 Enterprise performance and growth

Growth and restructuring are the special topics of this year's *Transition Report* and are the subject of Part II (Chapters 3 to 6). They represent crucial and linked challenges for the second phase of transition. The central message of our analysis of these issues is that the effective operation of the competitive process, supported by good governance, will be the most powerful force driving the processes of growth and restructuring. The same policies, institutions and behaviour that promote the transition towards an open, competitive market economy will therefore also promote growth and restructuring.

The argument is developed in Part II by combining the basic ideas of the determinants of growth from theory and economic history with an examination of the processes of growth and restructuring in the transition to date. Chapter 3 begins with an analysis of theories of growth, emphasising those features of transition economies that can help us to identify the particular sources of, and obstacles to, growth in those economies.

The focus in this analysis is on the importance of raising productivity and output, not only through investment in plant and machinery but also through the creation and establishment of new methods of organisation and production. Indeed, the processes of investment, reorganisation, and introduction of new technology and methods of work are closely intertwined. It is the competitive process – the search for profit, the reward for entrepreneurial initiative and the risk of elimination if effective methods are not followed – that drives the process of change. In this sense it is the “Schumpeterian”⁸ story of growth through innovation, driven by opportunity and competition, that carries the strongest lessons for the transition countries. However, in emphasising the role of innovation, it is necessary to go beyond the technology which was Schumpeter's main focus. For the transition economies it is not simply technology that changes output, but the whole method of work in terms of market-driven methods of organisation and production.

This analysis of the sources of growth emphasises the need to continue to build and consolidate the transition and thereby to establish a strongly competitive environment. Although it can be stated briefly in these terms, this is not, of course, a simple matter. All of the *Transition Reports*, including this one, have emphasised the complex and inter-related nature of the many aspects of transition. All those subjects emphasised in earlier Reports, including international trade, the taxation system, financial institutions, savings and infrastructure, will be part of the story. Of special

importance will be the good governance and the absence of bureaucratic interference which has been discussed above. However, in considering all of these many elements and policies, it is helpful to keep in mind the central importance of competition in the whole process.

The growth described above clearly has restructuring – driven by competition – at its heart. Restructuring will indeed come from the process of competition, but real competition must be underpinned by hard budget constraints. A company facing competition without privileged access to special funding will be forced to change and adapt if it is to survive. The speed, effectiveness and social and economic costs of that adaptation will, of course, depend on how the processes of competition and finance function. These in turn will be closely influenced by the policies, institutions and behaviour which develop during the transition.

In Chapters 4 and 5 the process of restructuring in the region is charted and analysed. Many transition economies have seen substantial structural change in the balance of production across sectors, big shifts in the patterns of international trade and important reallocation of resources within sectors. The scale and nature of the structure inherited from the previous regime imply that restructuring will be a long and difficult process. However, substantial restructuring from the production patterns and processes of the old command regime has occurred in many countries. In addition, consistent with the message emphasised above, sectors that have been most exposed to market forces have shown the greatest change.

The balance across sectors has in the first few years of the transition already shifted towards the structure of comparable middle-income countries, with a move from the over-sized manufacturing sector towards services which were neglected under the old regime. There has also been a shift towards agriculture in some low-income transition economies and a widespread increase in the share of non-market services, perhaps reflecting the public sector's role as an employer of last resort.

Within sectors there have been sharp differences in restructuring across the region. In particular, much larger gains in productivity in industrial sectors have been achieved in eastern Europe than in the CIS. At the level of the individual firm there is clear evidence of the powerful influence of competition and hard budget constraints on performance, particularly where these are combined with effective corporate governance and limitation of bureaucratic interference. Where budget constraints have remained softer, especially in parts of the CIS, and prior to the current reforms in Bulgaria and Romania, enterprise adjustment has lagged.

Experience in the region has emphasised that private ownership *per se* is not enough to generate improvements in productivity in the private sector. If competition remains weak, budget constraints soft, management unchanged, and government controls and inter-

⁸ See, for example, Schumpeter (1942).

ference pervasive, neither restructuring nor improved performance can be expected. The problems of interference by government in privatised enterprises remain pervasive in many countries of the region, particularly in the CIS.

If enterprises are to break loose from government and find finance for restructuring, they must have access to sound financial institutions and capital markets. If such institutions are to be willing to provide finance, firms must adopt corporate governance practices, including transparency, which allow the financial institutions to feel confident that monies will be well used and loans repaid. While in east European countries and the Baltic states some of the problems of governmental interference in the private sector have receded, severe problems of corporate governance and the soundness of financial institutions remain throughout the region.

The problems of weak corporate governance take on particular importance in large, relatively closed economies, such as Russia, Ukraine and some of the Central Asian republics, where international competitive pressures do not yet impose strong discipline on managers. In this respect the emergence of financial and industrial groups (FIGs) in Russia and Ukraine poses risks, if not properly regulated, of cartelisation and damage to the competitive forces which are vital to the emergence of restructuring and growth. However, FIGs in a competitive and market-driven environment may play a positive role in creating synergies between finance and industry and also in breaking the pattern of dominant insider ownership in many large industrial companies.

The final chapter of Part II examines the prospects for growth in the region in relation to the theories of growth, the initial conditions of the transition countries and the experience of restructuring described in the preceding chapters. A comparison with historical periods of high growth elsewhere, such as in western Europe and Japan in the early post-war period and East Asia in recent years, provides some helpful insights, particularly into the roles of structural change and market-oriented institutions in fostering the growth of productivity. However, the comparison also shows a crucial and fundamental difference between the transition countries of the region and those examples. The transition countries face much more pronounced problems of resource reallocation, in terms of moving resources between sectors and using resources more effectively within sectors, than those which arose in the other historical examples. The old regime with its peculiar priorities left a strange and difficult legacy. That legacy lies not simply in the allocation and quality of the existing plant and machinery and other factors, but also in the attitudes, practices and working methods which it created.⁹ Restructuring is therefore central to the process of growth in a way which is very different from earlier examples of other regions.

The institutions and infrastructure which supported the competitive process leading to growth in these earlier examples are also required to deliver the restructuring and growth that is so crucial for the transition countries. However, the analysis reveals that the low quality of institutions supporting the functioning of markets is a key constraint on the growth prospects of transition economies. Unless there are further advances in the rule of law, freedom for enterprises to exit and enter markets, and development of financial institutions and market-oriented infrastructure, growth in transition economies could fall well below their considerable growth potential.

1.4 Enlargement of the European Union

While this Report does not examine in detail the problems of enlargement of the European Union, it is a fundamental part of the process of transition for the region. Enlargement of the EU is of outstanding historical significance both for countries seeking accession and for those that are already members. The requirements for accession are essentially a well-functioning, competitive economy and democratic institutions; in other words, they describe the aim of economic and political transition.¹⁰ The process and requirements represent great challenges and opportunities for reform and investment. Some brief comment is provided below on the events of the past months, which have seen substantial clarification of the likely next steps in the process of enlargement of the EU. In particular, the Amsterdam summit of the heads of government in June 1997 (following the completion of the work of the Inter-Governmental Council – IGC) saw the confirmation of the schedule for enlargement, with detailed negotiations for selected countries set to open in early 1998.

The publication in July of Agenda 2000, and accompanying documents and analyses, provided an assessment of the progress in economic and political transition of the 10 applicant countries. This was in relation to the development of a competitive market economy, the establishment of democratic and other institutions and the preparedness for subscribing to the “*acquis communautaire*” of the EU.¹¹ Five of the countries (the Czech Republic, Estonia, Hungary, Poland and Slovenia) were identified as leading candidates in terms of the progress they have made so far.¹² The summit of December 1997 in Luxembourg will examine this assessment and take a decision on which countries can begin the more detailed negotiations for membership with the EU in 1998. The analyses of progress made in establishing market economies, as presented in Agenda 2000, are consistent with the EBRD’s assessments of these countries in Chapter 2. In fact, the countries that were highly rated by the European Commission for their achievements in market-oriented transition also score highly in Table 2.1 of this Report.

While the conditions for successful transition and for meeting the requirements of membership of the EU are similar, the latter will

⁹ And, as described in earlier *Transition Reports* and in Chapter 2, the legacy involved severe environmental problems.

¹⁰ Indeed, there is a very striking similarity between the Copenhagen criteria for accession (European Council, June 1993) and Article 1 of the Agreement Establishing the EBRD, which sets out the meaning of transition for the Bank.

¹¹ The “*acquis*” are the obligations incurred in membership of the European Union.

¹² The other five are Bulgaria, Latvia, Lithuania, Romania and the Slovak Republic.

embody a large number of very detailed and demanding obligations. Some of these require the strengthening and adjustment of public institutions, for instance regarding the regulation of product standards or of competition. Others will have strong implications, particularly for infrastructure, enterprises and financial institutions. In infrastructure, there will be emphasis on integrating transport and communication systems to ensure the smooth functioning of the single market. For enterprises, EU rules for health and safety of processes in the workplace and environmental standards will be of particular significance, with major implications for restructuring and investment. Accession will imply that enterprises must conform with the stringent standards of the EU on the safety of products. Investment requirements for municipal services (such as the treatment of waste and water), for power generation and for heavy industries (emission standards) would appear to be especially large.

Financial institutions will be expected to perform to higher standards of financial strength and transparency than at present. They will have to demonstrate that they are well-regulated by government while at the same time showing independence in their allocation of credits. Financial systems are also expected to play a greater role in funding small and medium-sized enterprises than they do at present. Agenda 2000 identifies small and medium-sized enterprises as an important factor in stimulating innovation, competition and growth.

This process of transforming enterprises and financial institutions and of building infrastructure is likely to have important implications for the work of the EBRD and other international financial institutions over the coming years. It must be emphasised that the requirements for the first group of countries in order to begin negotiations for entry into the EU are also likely to apply to future applicants. The task of establishing the conditions for EU membership is therefore faced by all those countries that aspire to join.

Of the EBRD's 26 countries of operations, 16 are not yet applicants to join the EU, and many of these are unlikely to ever become applicants. The enlargement of the EU will have strong implications for them too. It is very important that the EU, enlarged or otherwise, embodies open market and free trade policies in relation to these countries. Indeed, open policies in relation to these countries are not only vital for the advancement of their transition but also for the development of the EU economy itself, its growth potential and the welfare of its consumers.

1.5 Poverty and income distribution

The first phase of transition has, in many countries, witnessed growing inequality in standards of living in the region and a sharp rise in poverty. While the heaviest sacrifices are probably over, there is no doubt that the hardships for substantial sections of the population have been severe and for many will continue. Some of the setbacks have been dramatic and shocking. In Russia, for example, male life expectancy has declined by six years since 1989 and is now below that for India. While the pace of change

has been remarkably fast, and faster than many anticipated, the scale of deprivation which would accompany this change in many countries was not widely foreseen.

Data on living standards are limited and problematic but it is clear that experiences vary sharply across countries. For example, in the Czech and Slovak Republics, Poland and Slovenia life expectancy has increased. The identity of the poor also varies. In Russia pensioners in single-person households have been predominant among the poor, whereas in Hungary persistent poverty has been focused on households with children. Some of the available evidence is presented in Annex 2.2 to Chapter 2 and problems of interpretation are discussed.

Another finding of Annex 2.2 is that differences across countries are also marked with respect to developments in income inequality. The starting points in this area are particularly difficult to measure accurately, but a variety of sources point to a substantial increase in inequality in many parts of the CIS to levels well above the OECD average. In contrast, several east European countries, notably the Czech Republic and the Slovak Republic, continue to record low levels of income inequality, partly as a result of an effective social security system. The evidence of increases in poverty and income inequality among the countries of the CIS presents a particular challenge for fiscal policy, which has been weak in most of these countries. The challenge is both to strengthen revenues and to improve the allocation of expenditures, in order to contain social hardship and to lay the foundations for the poor to participate in growth.

1.6 Conclusion

Following the rapid liberalisation and privatisation of the earlier years of transition and the impressive progress in macroeconomic stabilisation, growth is returning in the region as the transition enters a new phase. There is, however, great diversity. While some of the more advanced countries are already into the second phase, a few are still mired in the problems of the first. For all countries, the central challenge of the second phase is building the governance and institutions which will underpin a well-functioning market economy. Most countries of the region are already market economies in some shape or form. It is the next years which will determine whether they develop and deepen the policies, institutions and behaviour that will allow these nascent market economies to function well and to deliver the growth in living standards of which they are capable. The next few years will be crucial in shaping the future development of these economies.

The strengthening of governance and institutions must focus on the development of an environment that promotes the vibrancy, competitiveness and effectiveness of the private sector. This must involve strong infrastructure, sound financial institutions, healthy and active capital markets, and an effective legal system. Above all, it must be oriented towards effective competition, both domestic and foreign. The founders of the EBRD captured succinctly and clearly the key ingredients for a well-functioning market economy in Article 1 of the Agreement Establishing the

Bank, when its purpose was defined as “to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative”. The central theme of this Report is that these are the precise ingredients that will deliver restructuring and sustained growth. However, good governance and strong institutions are required if the open market economy and entrepreneurial initiative are to flourish and yield the growth of which the region is capable. Put briefly and simply, the main message of the Report is that good governance and institutions will deliver effective and competitive markets, which in turn will deliver restructuring and sustained growth.

While the message can be put simply, the tasks involved in building good governance and sound institutions are complex, inter-related, difficult and of long duration. The next phase will be no less challenging than the first and will, in many respects, be more subtle and difficult. The challenges will require both leadership and patience. The character of the market economies which will emerge will be determined largely by the policies and actions of the countries themselves. However, there must be major contributions from outside – from policy makers, investors and international financial institutions. Trading partners must keep their markets open. Investors have their part to play, not only in bringing finance and technology but also in demonstrating and building skills, methods of working, reputable behaviour and the sound practices which are associated with a well-functioning market economy. Perhaps the best way of building institutions is to invest in them. That principle is at the heart of the EBRD’s activities in the region.

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Progress in market-oriented transition

2.1 The year in transition 1997

This year has seen serious crises, dramatic turnarounds and reinvigorated reform initiatives in the course of market-oriented transition in eastern Europe, the Baltics and the CIS. Though progress in transition throughout the region has continued at a strong, albeit slower, pace than previous years, the path of change cannot be described as “linear”, i.e. as a steady march of progress across all dimensions. Instead, reforms in many countries have proceeded in spurts – advancing, stumbling, and then surging forward again, often with renewed vigour. The year has highlighted the fragility of the hard-won gains of macroeconomic stabilisation, particularly in those countries that have not introduced the necessary reforms at the microeconomic level. Deficiencies or delays in crucial institutional and structural reforms have contributed to financial sector instability and currency volatility. Combined with growing external imbalances, the result has been a series of macroeconomic crises and near-crises. But fortunately, the crises, for the most part, provoked a resolute response that included new commitments to the acceleration of long-overdue structural reforms. In the face of serious difficulties throughout the year, the reform process in many of the transition economies has demonstrated a new level of political robustness that provides encouraging signs for the many challenges ahead.

This “non-linear” pattern of reform characterised countries at all stages of the transition process. Bulgaria and Romania suffered severe macroeconomic setbacks, but the crises triggered new governments in both countries that have begun to implement bold programmes of stabilisation and structural reform. The Czech Republic faced a serious challenge to the stability of its currency arising from concerns over its growing current account deficit and weaknesses in its financial sector, but the government reacted with a renewed commitment to long-delayed structural reforms in privatisation and the capital markets. Political uncertainty surrounding the presidential elections in Russia seriously destabilised domestic financial markets and side-tracked structural reforms, but a reshuffled government in the aftermath of Boris Yeltsin’s victory, and his improvement in health, rebounded with a major new reform programme. Albania descended into crisis and chaos in the wake of the collapse of massive financial pyramid schemes. New elections brought a change of government that has expressed its intention to pursue more comprehensive reforms.

This encouraging robustness of the reform process has not been evident in all of the transition economies. In Uzbekistan, balance of payments difficulties led to reversals of earlier reform measures including the reintroduction of a multiple exchange rate regime and a wide range of discretionary state interventions in the

economy. In Tajikistan, a sharp depreciation of the national currency led to the reimposition of foreign exchange restrictions, new government interventions in the economy, and a weakening of fiscal and monetary policies. Following a further concentration of political power in Belarus, earlier progress in the development of a privatisation programme was stalled.

Notwithstanding these stops, or indeed reversals, the region overall continues to make substantial progress in the transition to market-oriented economies. The most advanced countries in eastern Europe and the Baltics have begun to make headway in the more complex areas of institutional reform, including: privatisation of banks and infrastructure; development of an effective regulatory framework for financial markets; fiscal reforms; and social security reform. Moreover, progress towards the initiation of accession negotiations with the European Union for a number of east European countries has led to further harmonisation with EU practices and guidelines in many areas.

In the CIS, growth is spreading and taking root; positive growth rates for 1997 are expected for all but Moldova, Tajikistan and Ukraine. Nearly all of the CIS countries have been able to reduce inflation to manageable levels and to maintain greater stability of prices. Mass privatisation has gained pace in countries in which it had long been delayed. Several countries have begun to tighten supervision over the banking sector. Kazakhstan, Moldova, Russia and Ukraine have gained access to international capital markets through Eurobond issues.

Outstanding challenges

Despite the considerable progress in transition over the year, the remaining reform challenges continue to be substantial for countries at all stages of transition. The very successes of the transition to date – which have yielded macroeconomic stability and an acceleration of the recovery – have revealed even more clearly the remaining shortcomings at the microeconomic level. Moreover, this turbulent year for several of the transition economies has demonstrated quite forcefully how inattention to these shortcomings can threaten the hard-won achievements of earlier macroeconomic reforms.

Surplus capacity¹ and the sharp depreciation of the real exchange rate early in the transition provided a “cushion” for enterprises to begin the process of recovery without engaging in fundamental restructuring. However, the acceleration of the recovery and rapid appreciation of the real exchange rate – themselves consequences of determined stabilisation efforts by governments – have, in many countries, begun to deflate those cushions.² Continued growth

¹ This arose partly from excess labour within enterprises under the old economic system and partly from economic contractions in the initial periods of the transition.

² The language of “cushions” in describing the process of recovery has been used by Vaclav Klaus, the Prime Minister of the Czech Republic.

depends to a large extent on significant restructuring at the enterprise level, yet progress in this area has been slow. Though financial discipline for enterprises in most transition economies has increased considerably with the elimination of budgetary and off-budget subsidies, this has not been matched by the real improvements in the structure of corporate governance which are required if the hard decisions on restructuring are to be taken in newly privatised enterprises. Outside a group of the most advanced reformers, enterprise restructuring remains generally limited. This suggests that many transition economies could hit a “ceiling of recovery” in which the acceleration of growth permitted and stimulated by the utilisation of surplus capacity and the earlier depreciation of the real exchange rate reaches an upper bound, while the slow pace of restructuring hinders progress in the expansion of exports, further productivity gains, and the development of new internal and external markets necessary for growth.

Macroeconomic stabilisation has also revealed the enduring weaknesses of the financial sector. With less exchange rate volatility, sharply reduced yields on government securities and decreasing interest rate spreads – all induced by stabilisation – the era of easy profitability that fuelled the phenomenal growth of financial institutions has largely come to an end. But in most of the transition economies, the new banks are not yet prepared to provide the basic array of intermediation services to secure their own future and to promote medium- and long-term investment in their economies. Lending to the private sector remains at low levels. Though major strides have been made across the region in strengthening banking and capital market supervision, consolidating weak and undercapitalised banks, and privatising the remaining state-owned banks, there remains much to be done in these areas. The adoption and enforcement of bankruptcy and collateral legislation, as well as creditor protection measures, remain weak, as examined in Box 2.1 of this chapter. Taxation rules in several countries continue to distort the incentives of bankers. As important is the development of a new set of banking skills within these institutions more attuned to the standard operations of banks in more developed economies.

In the early stages of transition, primary emphasis was placed on adopting reforms targeted at establishing markets and private ownership. But it is becoming still more apparent that these newly established institutions require the reform of the administration of government if they are to flourish. Recent surveys provide strong empirical evidence confirming the magnitude of such problems as: excessive and unpredictable taxation, policy uncertainty, arbitrary bureaucratic interventions, and corruption among the post-communist transitions.³ Indeed, the extent of these problems has been rated greater in the CIS than in any other region of the world.⁴

The detrimental effects of problems in governance on investment and output are increasingly recognised by those studying or commenting on economic development. Yet in the context of the transition economies, where new political and economic institutions are in the very process of formation and development, the consequences have the potential to be far more severe. The governance problems of the region can distort the development of human capital, damage the structure of emerging organisations, and shape the evolution of linkages between government and business with potentially long-term and severe consequences for the path of the transition and the type of economy and society to which it will lead.

The problem of corruption merits special attention. Annex 2.1 provides a review of evidence on the level and pattern of corruption in the region. The threat of corruption to the process of economic transition reaches far beyond its direct effects on investment. Corruption and concentrations of power are mutually reinforcing and can exacerbate the social and political strains on the state, which are already substantial in transition economies. The pervasiveness and visibility of corruption have made it a focal point of the political process in several transition countries with very uncertain consequences. Anti-corruption campaigns have become a prominent feature of electoral politics, in some cases as a means to reverse economic reforms (as in Belarus) and in others to spur on more extensive reforms (as in the recent Bulgarian elections). The Bulgarian case suggests that anti-corruption campaigns in the political arena do not inevitably spark populist reactions against reform. However, high levels of corruption can weaken popular support for the transition.

Perhaps some of the most difficult challenges to the transition derive from the exacerbation of social problems associated with periods of major transformation. Though data on social trends in the transition economies are still highly problematic, it is clear that poverty has increased dramatically across the region as a result of falling incomes, dislocation of employment and reduced or badly directed social transfers. On some estimates, the average incidence of “income poverty” for the transition economies increased sevenfold between 1988 and 1994 – from 4 per cent to 32 per cent – though the extent of the increase varies widely within the region.⁵ While poverty rates remain relatively low in the central European countries, they have climbed steeply in the Baltic countries and throughout the CIS. Along with rising poverty have come increases in many of the transition countries in health problems and social maladies, including dramatic increases in deaths from heart disease, higher suicide rates, and the spread of infectious diseases. Life expectancy in a number of countries has dropped sharply and the associated causes would appear to be related to higher stress and deterioration in the provision of public health services. These issues are examined in greater depth in Annex 2.2.

³ See the results of the World Bank’s survey of entrepreneurs in 69 countries, reported in Brunetti, Kisunko et al. (1997), as well as the survey of shopkeepers in Poland and Russia reported in Frye and Shleifer (1996).

⁴ The relative levels of various risk factors across regions of the world – with a particular focus on corruption and government policy instability – are presented in a review of commercial risk ratings and survey evidence in Annex 2.1.

⁵ Income poverty is measured by low income as distinct from other dimensions of poverty such as health and education. The poverty rate is based on a poverty line of US\$ 4 purchasing power parity per person per day. See UNDP (1997), p.34.

Levels of income inequality have also increased throughout the region, in some cases at a pace unprecedented in the post-war period. While this increase has been relatively modest in the central European countries, inequality levels in several of the CIS countries appear to have risen from just below the average OECD level to levels typical of some of the most unequal developing countries in the short span of 5-7 years.⁶ Yet the pattern of poverty and inequality in the transition economies suggests that, over the medium term, government policies to promote open and participatory private sector development and establish a well-targeted system of social security – both key elements of the transition – will, if well designed and implemented, be able to contain these problems.

Overcoming the environmental legacy inherited from central planning and establishing adequate environmental policies and processes constitute profound challenges for transition countries. While environmental quality has improved, notably through the reduction in industrial emissions resulting from the slowdown in economic activity, the problems are severe, including oil and chemical damage, the pollution of rivers, lakes and seas, the poor quality of water supplies, and air pollution. The nature of environmental pressures is also evolving with economic restructuring and lifestyle changes, such as the substitution of services for industrial output or increased motor vehicle use. Adequate environmental policies and processes, including environmental impact assessments, are part and parcel of a modern market economy and should be given due consideration in the reform process.

2.2 The transition indicators

In an effort to analyse and compare the progress in market-oriented transition in eastern Europe, the Baltics and the CIS, the EBRD has presented annually since 1994 an appraisal, across a number of dimensions, of the state of the transition. This appraisal provides a snapshot of the cumulative progress in the movement from a centrally planned economy to a market economy. Progress is measured against the standards of advanced industrial economies, recognising that there is no perfectly functioning market economy and that the institutional diversity among market economies does not present a unique end-point for the transition. We have also, since 1994, provided some summary indicators for each dimension in the form of Table 2.1. The numerical indicators in Table 2.1 are intended to serve only as summaries of the detailed qualitative assessments of progress in each area of the transition presented in the country-by-country analyses on pages 148 to 213 of this Report. These country analyses provide a comprehensive assessment of the reform process and describe the nature and effectiveness of the new economic institutions emerging in each country.

This year a number of changes have been made to the transition indicators. First, the classification system has been modified slightly. In an effort to present finer distinctions within the rather broad categories, we introduce a system of pluses and minuses to the standard numerical scores 1 through 4.⁷ The pluses and minuses are intended to identify those countries near the borderlines that distinguish the different categories.⁸ This distinction has become particularly important as the continued advance of the transition process has led many countries to shift towards the higher categories.

Second, in previous years we have included a measure of the extensiveness and effectiveness of legal rules on investment in the overall transition indicators. However, this year the focus of our survey in this area has narrowed to evaluate a more specific set of laws particularly critical for fostering market-based decision-making and investment, namely pledge law, company law and bankruptcy law. As a result, the classifications this year are not directly comparable to those of previous years, which assessed a range of investment-related laws and regulations from a broader, less precise, perspective. The legal reform indicators are presented separately in Box 2.1. A country-by-country examination of progress on these specific laws is included in the analysis of transition on pages 148 to 213 of this Report. Although the discussion of legal reform is presented separately, progress in this area should be recognised as an integral component of the overall process of transition whose importance is not diminishing with time.

Third, this year we have initiated preparatory work for a future set of transition indicators which will measure the extensiveness and effectiveness of environmental policy reform. Centrally planned economies had very stringent environmental standards, but their overall implementation was very weak. Thus, it is important to examine not only the similarities in environmental legislation between transition countries and Western market economies, but also the extent to which such legislation can be considered effective. Box 2.3 describes our preliminary analysis based on questionnaires and official sources. At this stage, it is intended to provide some initial analysis of the status of key dimensions of environmental reform in transition economies.

The categories covered by the transition indicators in Table 2.1 are selective and do not cover all the relevant aspects of the transition process. They continue to focus on three of the most basic elements of transition: enterprises, markets and trade, and financial institutions. On enterprises, the transition indicators are designed to measure the extent to which enterprises have been shifted into private ownership and have begun to alter their operations and governance structures in response to the market.

⁶ Income inequality is particularly difficult to measure in the CIS and any data must be treated with caution. For a comparison of income inequality across the region, see Milanovic (1996).

⁷ In previous years, we have used the score 4* to indicate standards and performance typical of advanced industrial economies in the relevant dimension. In keeping with the new system of pluses and minuses, we replace 4* by 4+ in this year's transition indicators; the score signifies the same classification as previous years.

⁸ Given that these pluses or minuses represent finer distinctions within the existing categories in comparison to the scores of previous years, the pluses or minuses do not necessarily indicate progress or regress over the preceding year. In many cases, they simply give a better indication of the position that a country has maintained over time within the range of a particular category. In the event that the plus or minus does correspond to real progress or regress over the course of the year, it will be indicated in the supporting text and in the appropriate section of the transition indicators at the back of this Report.

On markets and trade, the transition indicators are intended to gauge how well these markets are functioning. In this regard, they indicate the openness of markets, the extent of competitive practices, and the degree to which prices reflect costs. On financial institutions, the indicators attempt to capture the extent to which the financial system provides financial discipline, effective intermediation between savers and investors, and an efficient payments system. This requires an analysis of the ownership structure of financial institutions, the range of instruments and services they provide, the level of competition among them, their role in corporate governance and enterprise restructuring, and the effectiveness of the regulatory environment in which they operate.

The framework for a well-functioning market economy goes well beyond the areas covered by the transition indicators. Such an economy requires an effective government capable of providing for the security of contracts and property rights, for competition and a stable environment for investment (which includes macroeconomic stability).⁹ Indeed the role of government is becoming ever more important as the transition enters the next phase, as described in the previous chapter. Such an economy also both requires and fosters the development of human capital in terms of business, management and accounting skills, as well as entrepreneurship. It should embody appropriate standards of conduct in both private and public affairs if a sound business climate that facilitates long-term investment decisions is to be created.

Lastly, though market economies may make effective use of resources and provide incentives to invest and innovate, they can also leave parts of the population impoverished or excluded without effective government intervention. Education and health services are required if the population is to generate and maintain its ability to participate in market opportunities. If poverty is to be prevented, a social safety net will be necessary for those who are not in a position to participate.

Many of these aspects of a well-functioning market economy are difficult to measure succinctly and systematically in the form of simple indicators. That they are not incorporated into the transition indicators does not reflect an assessment of their relative importance, but rather the complexity of measurement in relation to both the underlying concepts and the information available.

Two remaining caveats concerning the transition indicators must be mentioned at the outset. First, the indicators describe the status of reform in each country as of August 1997 and, therefore, do not necessarily reflect the twists and turns of the reform process throughout the year. In some countries, they may give the impression of a steady, linear progress of reform that masks the reform pattern described at the beginning of this chapter.

Second, the general advance of the summary indicators should not be misinterpreted to mean that countries are converging towards a standard model of the market economy; in fact, they hide the considerable institutional diversity developing as the transition

advances. At the start of the transition, these economies had strong institutional similarities – though with a wide range of national variations – rooted in the largely monolithic model of central planning in the region. Yet as the transition progresses, their institutional patterns are increasingly diverging, despite sharing some key features common to all market economies. At the more advanced stages, similar ratings of progress in transition should not be mistaken for similarities in the institutional forms that have emerged as a result of the transition.

A number of aspects of this stage of transition, which do not lend themselves to synthetic “ratings”, are presented in much greater detail in the country-by-country analyses on pages 148 to 213 of this Report. They describe the course of reform over the previous year and outline the institutional forms that are evolving in each country. Taken together, they demonstrate the considerable institutional diversity that is emerging from the process of market-oriented transition. Table 2.1 is a short-hand for the more detailed descriptions provided there.

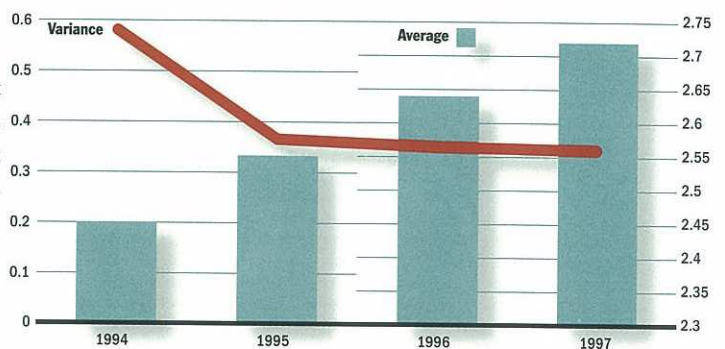
2.3 General trends in transition

The EBRD’s transition indicators now cover a four-year period, providing a greater opportunity to examine some general trends in transition over time than was possible in earlier years. In such an analysis some broad-brush descriptions can be provided using the aggregates of scores from the transition indicators, both over all the reform dimensions within each individual country and in comparing different reform dimensions across all the countries. While these aggregate scores provide a crude summary statistic to illustrate some general trends, they must be treated with great circumspection. The aggregation of scores across dimensions by simple addition both allocates equal weight across dimensions and assumes that the distances separating the various thresholds of the 1–4 scale within each dimension are comparable. There are real difficulties in interpreting or justifying either assumption. We therefore confine ourselves to descriptions of general trends and patterns that are not particularly sensitive to how aggregate scores are calculated.

Chart 2.1

Average annual EBRD transition indicators 1

Average variance 2



1 This is calculated as the average across all of the countries in Table 2.1 on all of the dimensions of reform with the exception of private sector share of GDP. Pluses and minuses are calculated as +/- 0.33, e.g. 2+ is counted as 2.33 and 3- as 2.67.

2 The variance represents the dispersion around the average score across countries and dimensions of reform. A higher variance represents greater dispersion of individual country scores around the average for the entire set of transition economies.

⁹ See Chapter 1 and, e.g., Stern and Stiglitz (1997) and the World Bank (1997).

Table 2.1

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

Countries ²	Population (millions, mid-1995)	Private sector share of GDP in %, mid-1997 (rough EBRD estimate) ³	Enterprises			Markets and trade			Financial institutions	
			Large-scale privatisation	Small-scale privatisation	Governance & restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions
Albania	3.2	75	2	4	2	3	4	2	2	2 -
Armenia	3.7	55	3	3	2	3	4	2	2 +	1
Azerbaijan	7.5	40	2	3	2	3	2 +	1	2	1
Belarus	10.4	20	1	2	1	3	1	2	1	2
Bulgaria	8.4	50	3	3	2 +	3	4	2	3 -	2
Croatia	4.8	55	3	4 +	3 -	3	4	2	3 -	2 +
Czech Republic	10.3	75	4	4 +	3	3	4 +	3	3	3
Estonia	1.5	70	4	4 +	3	3	4	3 -	3 +	3
FYR Macedonia	2.1	50	3	4	2	3	4	1	3	1
Georgia	5.4	55	3 +	4	2	3	4	2	2 +	1
Hungary	10.3	75	4	4 +	3	3 +	4 +	3	4	3 +
Kazakhstan	16.8	55	3	3 +	2	3	4	2	2 +	2
Kyrgyzstan	4.5	60	3	4	2	3	4	2	3 -	2
Latvia	2.5	60	3	4	3 -	3	4	3 -	3	2 +
Lithuania	3.7	70	3	4	3 -	3	4	2 +	3	2 +
Moldova	4.4	45	3	3	2	3	4	2	2	2
Poland	38.5	65	3 +	4 +	3	3	4 +	3	3	3 +
Romania	22.7	60	3 -	3	2	3	4	2	3 -	2
Russian Federation	148.4	70	3 +	4	2	3	4	2 +	2 +	3
Slovak Republic	5.3	75	4	4 +	3 -	3	4	3	3 -	2 +
Slovenia	2	50	3 +	4 +	3 -	3	4 +	2	3	3
Tajikistan	5.8	20	2	2	1	3 -	2	1	1	1
Turkmenistan	4.4	25	2	2	2 -	2	1	1	1	1
Ukraine	51.9	50	2 +	3 +	2	3	3	2	2	2
Uzbekistan	22.4	45	3 -	3	2	3 -	2 -	2	2 -	2

¹ The numerical indicators are intended to represent the cumulative progress in the movement from a centrally planned economy to a market economy in each dimension, rather than the rate of change in the course of the year. The classification system is described in detail on pages 15 and 16. This year the legal transition indicators are presented separately in Box 2.1. Selected indicators of environmental policy reform are presented in Box 2.3.

² This list includes all of the EBRD's countries of operations with the exception of Bosnia and Herzegovina, which has not been assigned scores due to the fact that the economy is still divided into separate enclaves not conducive to a single overall assessment.

³ The "private sector shares" of GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available. Here the term "private companies" refers to all enterprises in which a majority of the shares are owned by private individuals or entities. The roughness of the EBRD estimates reflects data limitations, particularly with respect to the scale of informal activity. The EBRD estimates may in some cases differ markedly from available data from official sources on the contribution to GDP made by the "private sector" or by the "non-state sector". This is in most cases because the definition of the EBRD concept differs from that of the official estimates. Specifically for the CIS countries, official data in most cases refer to value added in the "non-state sector" – a broad concept which incorporates collective farms as well as companies in which only a minority stake has been privatised.

Classification system for transition indicators ¹

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 and significant progress on corporate governance of these enterprises.
	4+	Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.
Small-scale privatisation	1	Little progress.
	2	Substantial share privatised.
	3	Nearly comprehensive programme implemented.
	4	Complete privatisation of small companies with tradable ownership rights.
	4+	Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.
Governance & 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.

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

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.

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

Box 2.1

1997 Legal survey

The extensiveness and effectiveness of pledge, bankruptcy and company laws in the EBRD's countries of operations

The table on the right provides an assessment of the progress made to date in legal reforms in three major areas of commercial law: pledge, bankruptcy and company law. The assessment was made on the basis of a survey conducted by the EBRD through the distribution of questionnaires to selected private law firms, academics and other experts familiar with commercial 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 third time that the EBRD has conducted a legal survey. In 1995 and 1996, it surveyed the extensiveness and effectiveness of investment laws generally in order to evaluate progress made in the reform of the general legal environment for investment in the region. The questions examined issues relating to foreign direct investment and the legal environment that would facilitate such investment. The EBRD conducted the survey for two years in order to chart the progress made in each country and to provide a basis for comparison.

The results of the 1995 and 1996 surveys were included in the *Transition Reports* for these years. These results demonstrated a significant correlation between the extensiveness and effectiveness of investment laws and other dimensions of the transition process.

The 1997 survey marks a shift in emphasis from investment law to three areas of commercial law of particular importance to private sector commercial transactions: pledge law, bankruptcy law and company law. Legislation in these areas must be both extensive and effective in order to facilitate commercial transactions and has a direct impact on the pace of private sector investment activity. The EBRD's Legal Transition Programme has identified the reform of pledge, bankruptcy and company laws and legal institutions relating thereto as a priority.

To complement the three specific topics in the survey, a section on general legal effectiveness has also been included. These questions attempt, as in past years, to gain an understanding of how commercial laws are being enforced and administered in each jurisdiction. Due to the distinct approach of the 1997 survey, it would be inappropriate to compare the 1997 results on extensiveness with those of the surveys conducted in 1995 and 1996, which dealt with investment law generally. The 1997 results should constitute a benchmark against which further reform efforts in the areas of pledge, bankruptcy and company law can be assessed in future years.

The table provides a numerical assessment (as of July 1997) of how closely the laws of the countries of the region approximate those of more developed countries in relation to their impact upon commercial transactions such as secured lending, project finance, debt restructuring, and the formation and governance of joint-stock companies. Pledge, bankruptcy and company laws have been evaluated and scored on the basis of two criteria: (i) the extent to which commercial legal rules approach laws and rules of more developed countries (referred to as extensiveness); and (ii) the extent to which such legal rules are clear and accessible and adequately supported administratively and judicially (referred to as effectiveness). The classification system is explained on page 19.

The table is not based upon a comprehensive survey of all commercial laws and regulations. For example, it does not evaluate banking and taxation legislation, although banking and taxation laws and regulations are pertinent to a well-functioning commercial legal regime. Much of the material that forms the basis of the Table is not readily verifiable and reflects the subjective assessments of survey respondents. Similarly, the information and views provided by respondents were not always consistent, and the EBRD has been selective in using material provided

Legal transition indicators 1997

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

by the survey. Accordingly, while the purpose of the survey and resulting analysis is to give an impression of how conducive the laws in the region are to facilitating commercial transactions, care must be taken in reading and interpreting the results.

Pledge law

The survey examined a number of key issues relating to the ability of a party to pledge *movable* property as security for credit. In particular, the survey examined whether countries had reformed existing civil codes and/or adopted new laws to provide for the non-possessory pledge of movable property. The survey also examined whether countries had provided for a cost-efficient mechanism for the registration and enforcement of security interests or pledges in movable property.

While the survey confirmed that in most of the countries of operations of the EBRD it was possible to obtain a non-possessory pledge in another party's movable property, the survey indicated that only a few of the jurisdictions had established a functioning central registry for the registration of non-possessory pledges. The absence of such registries undermines the effectiveness of the non-possessory pledge. Such effectiveness may be achieved only through a system whereby the existence of charges over movable property and the priority of competing charges over the same property may be established without undue expense or delay.

Other impediments that are still present in a number of jurisdictions examined are high notary or registration fees relating to the legal notarisaton or registration of a pledge or security interest. Notarisaton is often the most common method whereby a security interest becomes legally enforceable and binding upon third parties. Another impediment is the absence of "self-help" remedies which permit the beneficiary of a charge to sell charged property in whichever way it considers most appropriate without the need to first obtain a court order.

In May 1997, Hungary introduced a centralised and computerised system for the registration of non-possessory pledges over movable assets, which provides for a reasonably efficient means of registering non-possessory charges and of conducting a search for the existence of charges on specific property. This major change follows Hungary's

1996 amendment to its Civil Code to provide greater flexibility in the area of secured transactions. Poland recently adopted a new pledge law that will come into force in January 1998. Polish regulations implementing a registration system for pledges are being prepared but have not yet been promulgated. Bulgaria, Estonia, Kyrgyzstan, Lithuania and Moldova have also recently introduced new pledge laws. These countries have not yet established efficient centralised systems for the registration of non-possessory pledges.

A middle category of countries has enacted changes to their pledge laws, but has yet to move to a more streamlined system of creation, registration and enforcement of pledges over movable property. Russia, for example, created a pledge law in 1992. This law permits creditors to obtain a non-possessory charge over a wide range of movable assets, both tangible and intangible, and permits parties to agree in the charging document that the charge may be enforced without the need to obtain a court decision. The law also provides that charges must be recorded by the debtor in a charges registry maintained by the debtor and required to be made available for inspection by interested parties. The law, however, does not provide for a uniform or centralised system of registration that would give public notice of the existence of pledges. In addition, burdensome notarisation fees (in Russia's case, 1.5 per cent of the value of the collateral) renders use of the charging instrument prohibitively expensive.

A last category of countries still lacks pledge laws that enable non-possessory security interests to be created over a wide range of movable property.

Company law

With respect to company law, the 1997 survey focused on issues such as the formation of joint-stock companies and the registration of shares. The other major focus of the company law section was corporate governance – that is the duties and responsibilities of directors – and the protections and rights afforded to shareholders.

A number of the countries in the region (the Czech Republic, Estonia, Hungary, Lithuania, Poland, the Russian Federation, the Slovak Republic, Slovenia and Uzbekistan) have enacted modern company laws that include provisions for the protection of shareholders' rights, such as the opportunity to be represented by proxy at meetings of shareholders. The laws of many of these countries now provide, in certain circumstances, that if a third party acquires more than a minimum percentage of the shares of a company, it must offer to purchase all of the remaining shares at the same price or, in some cases, at a price which is not less than the average purchase price for such shares in the six months preceding the acquisition. The Russian Joint-Stock Company Law (enacted 1 January 1996) contains even more extensive provisions that protect shareholder rights and also ensure a greater degree of director accountability. For example, provisions exist which require cumulative voting with respect to the election of the board of directors of a company with more than 1,000 shareholders. This provision enables minority shareholders to pool and direct their votes in an effort to elect one or more directors to represent their interests.

Most countries have enacted legislation which gives shareholders preemptive rights in the event that a company issues new shares. Preemptive rights protect the shareholders from having their stake in the company diluted.

Many jurisdictions still do not require share registries of companies to be maintained by an independent party.

Bankruptcy law

The bankruptcy section of the survey included questions on reorganisation proceedings (whereby creditors and a debtor can reach a settlement rather than liquidate the company), liquidation and the role of the liquidator/trustee/manager. The survey also examined the efficacy of bankruptcy legislation with a focus on the time, frequency and manner of liquidation proceedings. Many countries have recently enacted new bankruptcy legislation or amended laws that were adopted in the early 1990s. Armenia, Azerbaijan, Croatia, the Czech Republic, Estonia, Latvia, Lithuania and Moldova, for example, are countries that have recently adopted new bankruptcy laws.

Almost all of the countries have laws which provide that a debtor is insolvent when it cannot meet its debts as they fall due. Similarly, most countries provide for some form of reorganisation proceedings whereby a majority (either simple or, in some cases, qualified) of creditors may approve a plan of reorganisation binding on all creditors. The rules for distribution of liquidation proceeds, however, vary in each jurisdiction. In a number of countries, secured creditors do not receive the highest priority in a liquidation proceeding. The costs of liquidation, unpaid employee remuneration, and certain taxes and other charges are examples of the types of claims which may have priority over the claims of secured creditors in liquidation. This is not unique to central and eastern Europe or the CIS. Many jurisdictions in Europe and elsewhere also allow for the payment of liquidation costs and other amounts to be made prior to the payment of secured claims.

In many countries, bankruptcy laws confer on liquidators' wide powers of investigation coupled with relatively extensive powers to deal with the assets of the bankrupt. However, few countries provide for liquidators to be qualified or for their conduct to be regulated (other than by the courts).

In a last category of countries, bankruptcy laws do not provide for certainty or clarity with respect to the definition of an insolvent debtor, the scope of reorganisation proceedings or the priority of distribution to creditors following liquidation.

Effectiveness of laws

To achieve effective implementation and enforcement of new and amended commercial laws and regulations, countries in the region will need to devote substantial resources to the proper administration and enforcement of laws. In many instances, countries have undertaken significant reforms of their commercial laws. These changes, however, have not always been accompanied by effective means for implementation and enforcement. For example, large notary fees continue to impede secured lending in countries that have reformed their civil codes and pledge laws. In some jurisdictions, there are significant disincentives to the commencement of reorganisation or bankruptcy proceedings, including high costs, extensive involvement of the courts at each step of the proceedings, the lack of qualified insolvency practitioners and the lack of certainty of the outcome of such proceedings. Similarly, with secured transactions, many of the jurisdictions surveyed still require that a pledged asset be sold by the court at public auction or permit private sale only in limited circumstances.

On the next page is an explanation of the legal transition indicators used to assess the commercial laws of each country.

Classification system for the legal transition indicators

The extensiveness of commercial legal rules on pledge, bankruptcy and company formation and governance:

- 1 Legal rules concerning pledge, bankruptcy and company law are very limited in scope. Laws impose substantial constraints on the creation, registration and enforcement of security over movable assets, and may impose significant notarisation fees on pledges. Company laws also do not ensure adequate corporate governance or protect shareholders' rights. Bankruptcy laws do not provide for certainty or clarity with respect to the definition of an insolvent debtor, the scope of reorganisation proceedings or the priority of distribution to creditors following liquidation. Laws in these substantive areas often have not been amended to approximate those of more developed countries and the laws that have been amended contain ambiguities or inconsistencies.
- 2 Legal rules concerning pledge, bankruptcy and company law are limited in scope and may be the subject of conflicting interpretations. Legislation may have been amended but new laws do not necessarily approximate those of more developed countries. Specifically, the registration and enforcement of security over movable assets has not been adequately addressed, leading to uncertainty with respect to the registration and enforcement of pledges. Pledge laws may impose significant notarisation fees on pledges. Company laws do not ensure adequate corporate governance or protect shareholders' rights. Laws may contain inconsistencies or ambiguities concerning, *inter alia*, the scope of reorganisation proceedings and/or the priority of secured creditors in bankruptcy.
- 3 New or amended legislation has recently been enacted in at least two of the three areas that were the focus of this survey – pledge, bankruptcy or company law – but could benefit from further refinement and clarification. Legal rules permit a non-possessory pledge over most types of movable assets. However, the mechanisms for registration of the security interest are still rudimentary and do not provide parties with adequate protection. There is scope for enforcement of pledges without court assistance. Company laws may contain limited provisions for corporate governance and the protection of shareholders' rights. Bankruptcy legislation contains provisions for both reorganisation and liquidation, but may place claims of other creditors in priority to those of secured creditors in liquidation.
- 4 Comprehensive legislation exists in at least two of the three areas of commercial law that were the focus of this survey – pledge, bankruptcy and company law. Pledge law allows parties to take non-possessory pledges in a wide variety of movable property and contains mechanisms for enforcement of pledges without court assistance. The legal infrastructure, however, is not fully developed to include a centralised or comprehensive mechanism for registering pledges. Company laws contain provisions for corporate governance and the protection of shareholders' rights. Director and officer duties are defined. Bankruptcy law includes detailed provisions for reorganisation and liquidation. Liquidators possess a wide variety of powers to deal with the property and affairs of a bankrupt.

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

The effectiveness of legal rules of investment on pledge, bankruptcy and company formation and governance:

- 1 Commercial legal rules are usually very unclear and sometimes contradictory. The administration and judicial support of the law are rudimentary. The cost of transactions, such as creating a security interest or pledge over a movable asset, is prohibitive so as to render a potentially extensive law ineffective. Also, there are no meaningful procedures in place in order to make commercial laws fully operational and enforceable. There are significant disincentives for creditors to seek the commencement of bankruptcy proceedings in respect of insolvent debtors.
- 2 Commercial legal rules are generally unclear and sometimes contradictory. There are few, if any, meaningful procedures in place in order to make commercial laws operational and enforceable.
- 3 While commercial legal rules are reasonably clear, administration or judicial support of the law are often inadequate or inconsistent so as to create a degree of uncertainty (e.g., substantial discretion in the administration of laws, few up-to-date registries for pledges).
- 4 Commercial law is reasonably clear, and administrative and judicial support of the law is reasonably adequate. Specialised courts, administrative bodies or independent agencies may exist for the liquidation of insolvent companies, the registration of publicly traded shares or the registration of pledges.
- 4+ Commercial laws are clear and readily ascertainable. Commercial law is well supported administratively and judicially, particularly regarding the efficient functioning of courts, liquidation proceedings, the registration of shares, and the orderly and timely registration of security interests.

Overall score:

The overall score allocated in the third column of the table is the average (rounded down) of the scores given for the two indicators. Pluses and minuses are intended to indicate countries on the borderline that distinguishes the relevant categories.

One broad (albeit crude) measure of overall progress over the past four years is the average of the transition indicators for the region as a whole, depicted in Chart 2.1. The regional average shows steady progress in each year though at a slowing pace (at least according to this measure). This year, 15 countries increased their average scores over the previous year, four remained the same and six registered declines.¹⁰ The change in the average scores for each component of the transition – depicted in Chart 2.2 – shows that over the course of this year, the strongest progress has been made in large- and small-scale privatisation and banking reform. Less rapid improvement has been registered in competition policy and in the development of securities markets and non-bank financial institutions. Price and trade liberalisation have tended to advance more slowly given their rapid progress at the early stages of the transition. The average score for enterprise restructuring shows a slight decrease caused by recent backtracking in this area in Belarus and Uzbekistan.

Chart 2.2 also demonstrates some interesting trends over the course of the transition. Areas in which the transition has primarily involved liberalisation – i.e., the elimination of government-imposed restrictions on prices, trade, and the market for foreign exchange – saw rapid progress early in the transition before reaching a plateau more recently. Areas in which the transition has primarily entailed redistribution of assets – i.e., large- and small-scale privatisation – have on average moved steadily over the period measured by the transition indicators with early advances in some countries and later advances in others producing a fairly consistent increase in the average. Areas in which the transition has required rebuilding – i.e., the restructuring of enterprises, the overhaul of the banking system, the break-up of monopolies, and the establishment of securities markets and non-bank financial institutions – have made slower but not insubstantial progress. The overall achievements in banking reform are particularly notable.

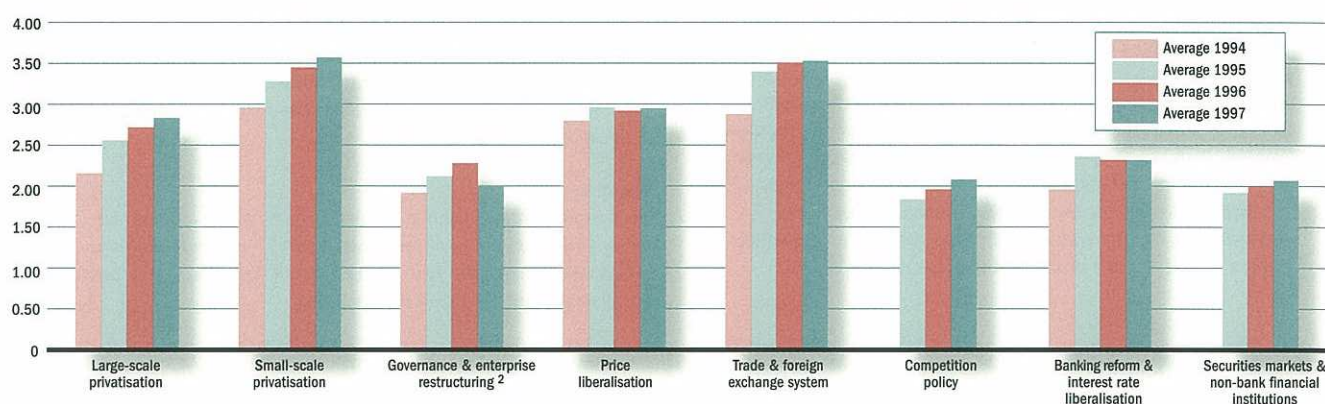
The trends over time also reveal an interesting pattern of variation across countries. Chart 2.1 presents the variance – measuring the dispersion of country scores around the mean across countries – of the average reform scores for all the transition economies in each year. At the start of the transition, the variation would have been very low with all countries showing low scores. By 1994 when the scoring system started, there was already strong variation across countries. At some stage in the future when most or all countries are advanced in the transition, we should expect the variance to decrease again. Yet the variance for the last three years has been virtually constant. This illustrates numerically that, while the transition is beyond the initial stages for most countries, this later stage of reducing variance has not yet begun. Moreover, while the scores do show strong diversity, their crude numerical construction and limited dimensionality conceal a much deeper and broader diversity across countries.

For a further description of patterns of diversity, Chart 2.3 plots the average reform scores for the transition economies grouped by standard regional categories. There is some evidence of a clustering of the scores of countries within each region, though the trend is weaker within the CIS than in eastern Europe, and a strong pattern across the regions. Countries within the same region have tended to reach similar measured levels of economic reform, regardless of the large qualitative variations among their reform efforts. Moreover, this clustering of reform scores has remained relatively stable over time. The extent of variation in the transition indicators within each region has declined or remained stable in every region except the central CIS countries, where the gap between rapid progress in Russia on a number of reform dimensions, slow progress in Ukraine, and regression in Belarus has continued to grow over time.

There are numerous possible explanations for this strong regional pattern of economic transition, among them: historical and cultural links to the market economy; initial socio-economic conditions;

Chart 2.2

Average annual EBRD transition indicators by dimension¹
1994-97

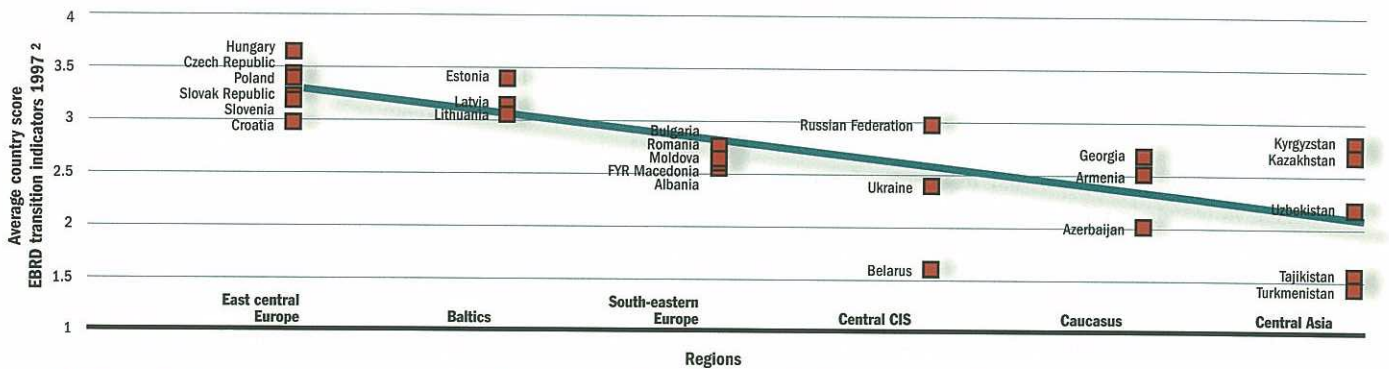


¹ For each dimension of reform in each year, the average score is calculated across all of the countries in Table 2.1 of the *Transition Reports* since 1994. Pluses and minuses are calculated as +/- 0.33. The score of 4* used in previous years is equivalent to 4+ or, according to the above standard, 4.33.

² The decline in this dimension from 1996 to 1997 reflects the finer distinctions associated with the introduction of pluses and minuses rather than a reversal of previous progress made in this dimension.

¹⁰ The larger number of declines than in previous years reflects the new grading system, which adds pluses and minuses to the 1-4 scale; for the purposes of aggregation these are calculated as +/- 0.33 (e.g. 2+ is counted as 2.33 and 3- as 2.67). In some cases, declines in the average score will reflect an actual regression in policies, as in Belarus, the Slovak Republic, Tajikistan and Uzbekistan. In other cases, they reflect the recognition that some countries have been near the borderline of certain classifications, though the finer distinctions were not used in the initial categorisations.

Chart 2.3

Regional patterns of reform ¹

¹ The line in this graph depicts the average score on the 1997 transition indicators across all countries in the given region. The placement of each country name represents the distance of that country's average score from the average for the region as a whole.

² This represents the average score for each country on the 1997 transition indicators in Table 2.1 on all reform dimensions with the exception of private sector share of GDP. Pluses and minuses are calculated as ± 0.33 .

opportunities for integration with international and regional institutions; regional demonstration effects; the structure of politics and political institutions; and differences among countries in the way in which the previous communist system collapsed. Disentangling these intricately related explanations would be extremely difficult. However, the persistence of this regional pattern of variation in economic reform even as the transition advances suggests an interesting relationship between initial conditions (including the length of the communist period and membership of the Soviet Union), the early patterns of reform and later policy choices. Of course, this does not imply that progress in transition is shaped by some geographical determinism or trapped in an immutable pattern of path dependency. A comparison of the neighbouring states of Russia and Belarus, for example, clearly suggests that policy choices can lead countries to veer away from any regional pattern of reform.

Reform groups

The transition indicators have been used in the past to distinguish between countries at different stages of transition. In previous *Transition Reports*, to facilitate discussion, countries have sometimes been classified into three broad groups based on their overall scores: (i) “countries at advanced stages of transition”, (ii) “countries at intermediate stages of transition”, and (iii) “countries at early stages of transition”. Though the division can be useful for some purposes, we have avoided attaching strong significance to these groupings. Further, as the transition progresses, the thresholds distinguishing these groupings have become even less clear. Some countries have moved ahead with reforms, but in an uneven manner, reaching what might be considered an advanced stage in some areas while remaining at an early or intermediate stage in others. Quite naturally, the relevance of the “early” stage has diminished over time as the transition has progressed. Indeed, according to the 1997 indicators, the only countries that would remain at the early stages of transition in the sense used in previous years would be Belarus, Tajikistan and Turkmenistan. This would not constitute a useful grouping for analytical purposes.

This year, the groups have been consolidated to reflect the overall progress in transition throughout the region. For the discussion in the remainder of this chapter, the countries are divided into two groups: (i) “countries at advanced stages of transition” and (ii) “countries at less advanced stages of transition”. The allocation of countries into each group is based on their total scores on the indicators in Table 2.1. Countries at the advanced stages of transition include all the central European countries (the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia) and the Baltic states (Estonia, Latvia and Lithuania). Though Croatia has been included in this group in previous years, the introduction of pluses and minuses to the scale this year places Croatia on the borderline of this group. The remaining 17 countries in the region, including all the CIS states as well as south-eastern Europe (Albania, Bosnia and Herzegovina,¹¹ Bulgaria, FYR Macedonia and Romania) are included in the less advanced group. This year, the Russian Federation is located on the upper boundary of this group and should be considered as a borderline case. It is, of course, of such size and importance that, for many purposes, it is best treated separately. This allocation of countries necessarily involves some degree of subjectivity, since it employs not only indices which involve judgmental assessments but also the specification of an exact cut-off point between the groups which is unavoidably arbitrary. Consequently, this categorisation should be seen primarily as a way to organise discussion of evidence rather than involving some firm predictive or modelling status.

The categorisation of transition economies into advanced and less advanced groups provides a short-hand indication of the cumulative level of progress in market-oriented reform over the course of the transition. However, this measure of cumulative progress is not necessarily the best indicator for analysing or predicting prospective trends in transition, especially in light of the non-linear pattern of reform described earlier. As the transition enters a new and challenging stage, it is increasingly important to examine the robustness and resoluteness of the reform process in each country. We shall use resoluteness to refer to the strength of a

¹¹ Bosnia and Herzegovina has not been assigned scores in the transition indicators table since the economy is still divided into separate enclaves not conducive to a single overall assessment.

country's commitment to a comprehensive programme of structural reforms and macroeconomic stability and the priority given to its implementation over other policy concerns. Robustness refers to a resolute commitment to reform which is sustained, tested by events, and which has delivered over time. In this sense, resoluteness is a necessary but not sufficient condition for robustness.

Gauging the strength, credibility and resilience of a country's commitment to economic reform, i.e., the robustness of reform, involves an examination of the record of reform measures and of the quality of the institutions governing or underlying the reform process. In distinguishing more from less robust reforms, we should ask: (i) does the institutional framework create enduring incentives for governments to initiate and sustain economic reforms, and; (ii) does the track record of reform thus far suggest that the commitment has been able to survive periods of setbacks and challenges? Such questions cannot be answered from trends in the transition indicators alone. Instead, they require a deeper understanding of the institutions and the patterns of governance that facilitate and reinforce the process of reform – issues that are taken up in greater detail in Chapters 4 and 5.

The track record of the advanced countries suggests that the robustness of reforms in the face of challenges from numerous directions has, in many cases, been impressive. Hungary, for example, faced severe problems associated with growing internal and external imbalances in 1994-95 and responded with a vigorous macroeconomic adjustment programme and intensification of structural reforms that are now showing positive results. More recently, the Czech Republic has endured a sharp fall in the value of its currency linked to a growing current account imbalance and responded by accelerating reforms in privatisation, by strengthening regulation of capital markets, and by seeking to enhance corporate governance. A serious banking crisis in Estonia did not weaken that country's commitment to reform.

The reform process in several of the advanced countries has also been robust in the face of substantial political uncertainty. Poland has maintained a strong commitment to economic reform through six different governments of various reform profiles since the collapse of communism. Estonia has endured five government turnovers and two major cabinet reshuffles and has, nevertheless, kept the reform process moving forward. Slovenia has sustained a consistent reform effort despite the uncertainties of a fragile multi-party coalition government and, more recently, a long delay in the formation of a new government following parliamentary elections in November 1996. Indeed, Slovenia has consistently received the highest country risk ratings of any of the transition economies.

The robustness of reforms in this group of countries – the Czech Republic, Estonia, Hungary, Poland and Slovenia – has been recognised by the European Commission in their "Agenda 2000" which indicates that, together with Cyprus, they are the leading candidates for accession during the next round of enlargement of the EU. The experience of these countries suggests that robustness

is associated with three key features of their progress in transition. First, they have implemented a critical mass of economic reforms creating sufficiently large domestic constituencies with a stake in sustaining the reform process. Second, they have a stable and increasingly well-institutionalised system of governance that minimises the risks of extreme policy shifts and constrains the discretionary power of political authorities. Third, they have achieved a high level of integration into world markets and into existing multilateral institutions which generates powerful incentives to maintain and deepen market-oriented reforms. There is considerable variation among the advanced countries with respect to these characteristics, making some transition economies more robust than others, though no absolute distinctions should be drawn. What distinguishes the most robust reformers is a strong foundation of political and economic institutions in support of market-oriented transition which will enable them to meet effectively the remaining challenges and shocks of the reform process that inevitably lie ahead.

While some countries at less advanced stages of transition may exhibit certain features of robust reformers, they have not yet reached the level of institutional development or the degree of integration into world markets that would ensure the resilience of market reforms, nor have they demonstrated a track record of steadfast progress in reform. The less advanced countries do vary quite considerably as to the resoluteness in reform. Within this group, there are countries with governments that have explicitly recognised the need for a comprehensive approach to economic reform and have marshalled the political will necessary to make significant progress in implementing such an approach. However, there are also cases within this group where the commitment is relatively new and major obstacles still exist in the form of political opposition to reform or powerful vested interests seeking to maintain special privileges. Other governments in countries at this transition stage have continued to display a more ambivalent approach towards economic reform and have been more likely to revert to old methods of direct control when problems or challenges arise.

Over the course of this year, Bulgaria and Romania have made new resolute commitments to a comprehensive reform programme in response to severe macroeconomic crises. Russia has reaffirmed its resolve to pursue structural reform with a new commitment to major privatisations, including infrastructure and energy, and to curbing the power of monopolies, although the position of special interests remains very powerful. In the past few years, Armenia, Azerbaijan, Georgia and Kazakhstan have adopted and are continuing to implement substantial reform programmes. The governments of Kyrgyzstan and Moldova have shown a consistently high commitment to reform, though conflicts with less resolute legislatures have slowed the reform process on occasion.

The experience of these countries suggests that there is no single set of factors that might motivate or underpin the resoluteness of government commitments to reform. In some cases, such as Bulgaria and Georgia, the resolve came in response to severe crises

that propelled governments to action.¹² In other cases, the resolve has been a function of strong leadership with a consistent commitment to reform. In still other cases, such as Kazakhstan, the commitment appears to have been motivated by the desire to attract foreign investors in natural resource sectors. Consequently, though resolute reformers can be identified by observing and comparing track records of reform, there is no simple, single explanation to account for the variation in this resolve across countries.

The robustness and resoluteness of a country's commitment to economic reform are not qualities conventionally associated with the institution of democratic elections. Elections have often been portrayed as a source of uncertainty in the reform process, as political priorities take precedence over economic pressures and as disgruntled voters have an opportunity to respond to the often high short-term costs of necessary, but difficult, economic reforms.¹³ Consequently, robust and resolute reforms are more often associated with committed leaders, states insulated from popular electoral pressures, and governments with concentrated political powers.¹⁴ However, the experience of transition in the post-communist countries – especially some of the events of the past year – suggests that the institution of democratic elections can play an integral role in strengthening the robustness of economic reforms and generating the necessary resolve to implement comprehensive reform programmes.

While particular elections in the post-communist countries have at times introduced considerable short-term uncertainty into the process of economic reform, the evidence from the 6-7 year experience of transition in this region suggests that the institution of democratic elections may, on balance, be associated with accelerated and strengthened reforms. The advanced countries have, on average, held a larger number of democratic elections, have had more frequent government turnovers, and have had shorter government tenures than the less advanced reformers. Since 1990, the advanced countries have held, on average, just over three legislative elections or nearly one every two years. The chief executive has been changed an average 4.2 times in the advanced countries since 1990, while only 1.3 times among the less advanced reformers.¹⁵ The average tenure of individual governments has also been substantially lower among the advanced countries than the less advanced countries.

Some of the most robust reformers in the region – such as Estonia and Poland – have also had the least stable parliamentary governments. The average government tenure in Poland is 396 days, while in Estonia the average tenure is 530 days. In both countries, electoral turnovers raised concerns that economic reforms might be derailed. However, progress in reform has remained steady. Indeed, early concerns that democratic elections might become vehicles for a popular backlash against comprehensive economic reforms have

not been realised in any of the advanced countries. Though individual elections have not always produced victories for the most reform-oriented governments, the process of competitive elections over time has proven the robustness of reforms in a number of transition economies.

Recently, democratic elections in a number of transition economies have had a galvanising effect on the reform process, especially in response to economic crisis or prolonged stagnation. Elections in Bulgaria and Romania in the midst of severe macroeconomic difficulties produced strong majorities for reform-oriented parties in both countries, which quickly committed to comprehensive economic reform programmes. The financial collapse in Albania sparked legislative elections which replaced the Berisha regime with a new government promising to revive the reform process. Though presidential elections in Russia generated severe uncertainty, the decisive victory of Boris Yeltsin was followed by a major reorganisation of the government team, which has committed to structural reforms with a renewed vigour. Parliamentary elections in Lithuania triggered an acceleration of the privatisation process, which had stagnated under the previous government. These cases suggest that the electoral process can, in some instances, generate the resolve to respond to existing economic challenges and reinvigorate the reform process.

Of course, each individual democratic election in the region has not necessarily advanced reforms, nor have all transition countries with competitive elections performed well. Yet the fears that difficult economic reforms would not endure in the face of challenges from popular elections have not materialised. This is a remarkable and important feature of the process of transition in the region and one which could not necessarily have been predicted with confidence. Moreover, there is evidence to suggest that the electoral process over time may contribute to the robustness of reforms and serve as a mechanism to generate resolute commitments to reform in response to crisis.

2.4 The key dimensions of transition

The remainder of this chapter summarises the key trends and developments in each of the major dimensions of transition over the course of the year. More detailed descriptions of the developments in each country are presented in the qualitative analyses on pages 148 to 213 of this Report.

The private sector share in GDP

The private sector share in economic activity has continued to grow rapidly. By the middle of 1997, the private sector share had reached or exceeded the 50 per cent mark in 19 of the EBRD's 26 countries of operations. Among the advanced countries, several have already met or exceeded the private sector share in many OECD countries, nearly all of which fall within the range of

¹² Drazen and Grilli (1993) argues that economic crises have certain benefits in triggering government macroeconomic stabilisation programmes.

¹³ For an analysis of the dynamics between elections and economic reform strategies, see Przeworski (1991).

¹⁴ See, e.g., the surveys of the politics of economic reform in developing countries in Haggard and Kaufman (1995) and Williamson (1994). More recently, the World Development Report has argued against insulating the state from popular pressures, but instead stresses the advantages of bringing government "closer to the people." (World Bank 1997).

¹⁵ The chief executive is defined as the prime minister in parliamentary and mixed systems and the president in presidential systems.

70-85 per cent of GDP.¹⁶ With privatisation nearing completion in the Czech Republic, Estonia, Hungary and the Slovak Republic, the growth of the private sector share in future will come primarily from the formation of new firms and higher growth rates in private enterprises than in remaining state sector entities.

The largest rises in private sector share were among those countries that showed particular resolve in reforms over the past year, including Azerbaijan (from 25 per cent to 40 per cent) and Kazakhstan (from 40 per cent to 55 per cent). This has been the result of initiatives in both large- and small-scale privatisation in both countries, as well as increased capital inflows into the natural resources sector. Relatively large increases were also recorded in Armenia, Georgia, and Kyrgyzstan. In Ukraine, the increase in the share of the private sector is the result of an acceleration in the pace of small-scale privatisation.

The limitations of the data in this category, in particular, must be stressed, especially in making cross-country comparisons. Recent research has begun to provide some indication of the extent of the informal economy throughout the region.¹⁷ The calculation of GDP on the basis of electricity usage data suggests that the share of the informal economy may reach as high as 50 per cent in some of the CIS countries.¹⁸ It is difficult even to define the private sector clearly, much less to estimate its size with a high level of accuracy in many of the transition economies. As the estimates of the informal economy diverge substantially within the region, cross-country comparisons should be made with caution. The EBRD's estimates of the private sector share of GDP are based on official statistics, which tend to underestimate the size of the informal sector.

Large-scale privatisation

The broad-based privatisation of large-scale enterprises has continued to advance at a strong pace in virtually every economy in the region. A wave of mass privatisation programmes – i.e., the largely cashless and simultaneous transfer of a substantial number of enterprises to new owners through the distribution of vouchers – has been completed in a number of countries, including: the Czech Republic, Georgia, Kazakhstan, Lithuania, Moldova, the Russian Federation and the Slovak Republic.¹⁹ These countries are now focusing on the sale of remaining state enterprises or state shares in privatised enterprises through a variety of cash-based methods. Estonia and Hungary, whose privatisations were based largely on such methods, have continued to make progress in the direct sales of enterprises on a case-by-case approach focusing increasingly on public utilities, banks and infrastructure.

The year has also seen a reinvigoration of the process of mass privatisation in a number of countries. New reform programmes in

Bulgaria and Romania have restarted once lagging mass privatisation campaigns, as well as direct sales of large enterprises. In Azerbaijan and Croatia, mass privatisation plans have finally moved into the implementation stage after long periods of delay. Limited mass privatisation programmes have even been approved in countries – such as Tajikistan and Turkmenistan – still at the earliest stages of transition. Though delays and setbacks of very different origins have slowed mass privatisation in Albania, Kyrgyzstan and Ukraine, only Belarus continues to postpone any broad-based privatisation effort.

Yet the wide embrace of large-scale privatisation by the transition economies has produced an equally wide array of outcomes on almost all dimensions of the process, including: the share of state-owned enterprises subject to privatisation, the extent of residual stakeholding by the state, the concentration or dispersion of ownership in newly privatised firms, the pattern of distribution to insiders versus outsiders, the access by and participation of foreigners in the process, and the design of intermediary institutions. It is in this considerable spectrum of variation that the seeds of future divergence in the institutional structure and development trajectories of transition economies are most likely to be found, given the critical importance of the pattern of ownership in defining economic systems. Yet it is still too early in this process to specify systematically the implications of these differences across privatisation programmes for the course of transition. Chapters 4 and 5 of this Report investigate this issue further.

Most of the countries that have finished their first wave of privatisation have turned to the privatisation of remaining state ownership in the economy, though with different methods and different priorities. The focus has shifted to the sale of remaining state shares in partially privatised firms and to the privatisation of infrastructure, energy, banking and other “strategic” enterprises that had been excluded from earlier rounds. The dominant methods have been the use of direct sales, auctions and tenders on a case-by-case approach. In many instances, foreign strategic investors have been actively sought. The initial phase of privatisation, in most cases, placed primary emphasis on speed and, where mass privatisation was the primary mechanism, on equitable distribution and the depoliticisation of property;²⁰ this new stage is more concerned with privatisation revenues for the state budget, with attracting long-term investment into key enterprises and sectors, and with improving corporate governance structures.

Hungary and Estonia have been at the forefront of cash-based privatisation from the beginning. Hungary has made especially active use of global placements in the privatisation of major manufacturing concerns, the country's largest banks and public

¹⁶ The estimates for private sector share of GDP in OECD countries are from 1996 as provided by the OECD.

¹⁷ See the paper by Kaufman and Kaliberda (1996).

¹⁸ The methodology, as well as potential problems, underlying these estimates of the unofficial economy are discussed in Chapter 4.

¹⁹ In many of these countries, though, voucher-based privatisation was not the only method used. Cash-based sales were often combined with voucher privatisations and other approaches as well. See the discussion in Chapter 5.

²⁰ Of course, this does not mean that mass privatisation achieved, in practice, an equitable distribution and depoliticisation of property as attested to by the dominance of insider privatisation in many countries that adopted mass privatisation programmes.

utilities. In Estonia, an estimated 30-40 per cent of total assets in industry and services have been privatised to foreigners. Latvia, Lithuania and Moldova have also pursued the path of international tenders, but through more limited programmes and with less success in attracting foreign investors. Kazakhstan has pursued case-by-case privatisation of large enterprises in the power, energy and telecommunication sectors, attracting some foreign investment. Bulgaria and Romania have accelerated the process of cash privatisations with methods specifically targeted at foreign investors. Kyrgyzstan was moving in a similar direction before a price-rigging scandal led to a temporary suspension of further privatisations.

The experience of the Russian Federation has been unique in the role that large domestic financial-industrial groups have played at this stage of privatisation. After some delay, the government has begun to sell its remaining shares in some of the country's most prominent enterprises, including those that were held by commercial banks through the controversial "loans-for-shares" scheme in 1995. Competitive tenders and auctions for these shares have become a high-profile battleground between rival financial-industrial groups, in some cases backed by foreign investors. This process is likely to intensify throughout the year as the government seeks to raise much-needed budgetary revenues through cash privatisations.

For those countries still implementing mass privatisation programmes, the year has seen substantial progress. Georgia and Armenia have had very rapid programmes of voucher-based privatisation covering over half of their medium-sized and large enterprises. In Poland, the exchange of privatisation certificates for shares in National Investment Funds (NIFs) listed on the Warsaw Stock Exchange marked the latter stages of the privatisation programme's implementation. Croatia has also just begun implementation of a voucher privatisation plan to sell residual state shares in enterprises with investment funds as intermediaries. Yet voucher privatisation programmes in Poland and Croatia include only a limited number of enterprises. Bulgaria completed the first round of voucher privatisation covering 13 per cent of the assets of state enterprises with shares to become tradable in the autumn. Azerbaijan completed the distribution of privatisation vouchers in the summer of 1997 and has begun the first voucher auctions for stakes ranging from 10-30 per cent in a large number of enterprises. Ukraine has introduced a new form of vouchers – compensation vouchers – to be exchanged for shares which are intended to compensate individuals for the erosion of their savings. At the same time, the President and legislature continue to disagree over which enterprises will be included in the mass privatisation programme. Tajikistan has also offered vouchers as compensation, in this case for government arrears on wages and pensions, though privatisation has been delayed by political instability.

Despite earlier commitments to a programme for corporatisation and privatisation, the government of Belarus has announced a new plan to "denationalise" enterprises which scales back the number and range of enterprises to be included and largely retains state control of enterprises via special "golden shares" to be held by the state.

Small-scale privatisation

Progress in small-scale privatisation has exceeded that in all other areas of reform, in terms of both speed and comprehensiveness. Most of the advanced countries – with the exception of Latvia and Lithuania – have reached the highest level in this category, i.e., ownership patterns for these firms typical of the advanced industrial countries.²¹

The less advanced countries have also made considerable progress in this area. There has been complete privatisation of small enterprises in Albania, FYR Macedonia, Georgia, Kyrgyzstan and the Russian Federation. Small-scale privatisation of enterprises is virtually complete in Ukraine, while Azerbaijan and Kazakhstan have committed to fulfil their programmes in this area by the end of 1997. The governments of Tajikistan and Turkmenistan have both announced new initiatives in small-scale privatisation. Only in Belarus have reforms stagnated.

Yet the progress in small-scale privatisation does not necessarily mean that it is easy to set up small firms in all of the transition economies. Indeed, there is considerable variation in the growth of small private firms throughout the region rooted, to a significant extent, in differences in the quality of governance across countries. In Poland, this sector has been the engine of the country's steady growth. In contrast, small firms in Russia still face numerous obstacles to entry into the market and to growth due to onerous bureaucratic restrictions.²²

Progress in the decollectivisation and privatisation of agriculture has been much less consistent across the transition economies. In some cases, such as Albania, Armenia, the Czech Republic, and Hungary, collective farms have been divided up and agriculture has been fully privatised.²³ Yet in many of the CIS countries, agriculture is still largely organised around large-scale collective farms and there are still continued restrictions on the tradability of land rights and the extent of total agricultural land subject to privatisation. In Kyrgyzstan, the sale of 50 per cent of existing land leases to private owners has begun in accordance with a recent presidential decree, yet there remains a constitutional provision prohibiting private ownership of land. A long political stalemate over the private sale of land in Moldova appears to have ended with the approval by parliament of a law allowing the sale and purchase of land, though with a five-year restriction on resale. In Russia and Ukraine, strong agrarian lobbies representing large collective farms have blocked the necessary legislation for the sale of land.

²¹ Yet problems remain in several of these countries regarding de facto tradability of land rights.

²² See the survey of shop-owners in Warsaw and Moscow in Frye and Shleifer (1997).

²³ In some cases, such as Poland and Slovenia, agriculture had not been collectivised during the communist period and thus was fully private at the start of the transition.

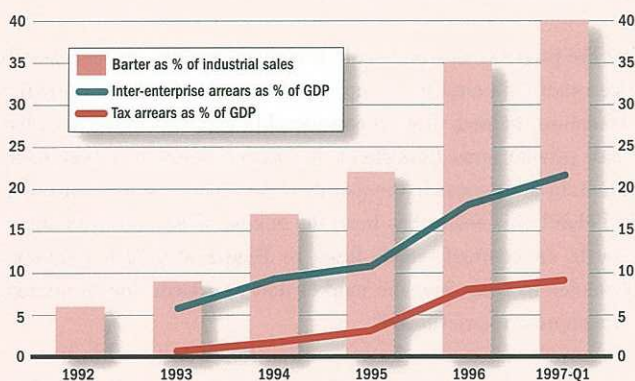
Box 2.2

Barter in Russia

One of the most striking features of the transition in Russia has been the widespread emergence of barter as the prevalent method of exchange in industry. Producers of cars, steel, oil, gas, electricity, coal, chemicals, textiles and food have been using their outputs to purchase inputs. These barter deals are typically bilateral. However, since suppliers cannot always directly utilise the goods received as payments-in-kind, they must either sell them or arrange another barter deal to exchange them for their own inputs. Hence, one barter deal induces the next, leading very often to complicated chains of cashless transactions. Debts, as well as taxes and wages, are often settled with payments-in-kind or through mutual write-offs.

While barter has not been very common in central and eastern Europe, it is widespread in the CIS. In Russia, where the problem is most serious, barter has increased continuously over the last few years, coinciding with rising inter-enterprise arrears, as well as wage and tax arrears (see chart). By the beginning of 1997, estimates of the extent of barter in total industrial sales in Russia ranged from 40 per cent to 70 per cent.

Barter imposes large costs on enterprises. When a company earns its revenues in goods, it must be able to sell or barter those superfluous to its needs. This requires additional marketing skills that can be complex and costly to acquire. The information necessary to arrange and

Barter and arrears in Russia

Source:

The data on barter is from the *Russian Economic Barometer* (1997). The data on arrears was provided by the Russian European Centre for Economic Policy.

coordinate barter chains opens profit opportunities for trading companies, whose services reduce profit margins for industrial companies. Furthermore, the stream of goods may be diverted into more complex and less efficient routes, involving more intermediaries before reaching the final consumer.

Barter also forces enterprises to become more dependent on each other due to their simultaneous supplier-customer relationship. While this may sometimes reduce market risk, it usually implies a loss of flexibility. It may introduce inertia into production techniques and product development as well as distortions in investment incentives.

Barter also imposes negative costs on the overall economy. Prices used in barter deals do not necessarily reflect the real values exchanged, making it difficult to assess the performance, creditworthiness or value of enterprises. This, in turn, inhibits the functioning of credit and capital markets and slows their development. As barter transactions are often used as a substitute for trade credits (i.e. when the exchange of goods is not simultaneous), commercial banks have fewer opportunities to gain expertise in granting working capital credit.

Furthermore, the lack of transparency in a barter-based system supports the persistence of the informal (or non-official) economy, as transactions through the banking system are avoided, making it easier to hide flows from the tax authorities.

The state plays a paradoxical role in what is often called the “non-payments crisis” in Russia. On the one hand, poor tax collection ratios have strained macroeconomic stabilisation efforts. On the other hand, the state and state-controlled enterprises appear to be part of the problem. Public utilities have accepted goods in return for their output. In public procurement direct payment is often replaced by cancellation of tax debts or debts to public utilities. In some cases, local authorities have even accepted tax payments-in-kind.

There are a number of explanations for the emergence of barter. First, weak enforcement of creditors’ rights, particularly in relation to the liabilities of large industrial enterprises, have led to a steep increase in arrears and bad debts, both on tax and commercial credit. The social importance of many larger enterprises on a regional level makes standard bankruptcy proceedings politically difficult to enforce. As non-payments are not fully punished and confidence in the system declines, holding cash becomes generally less desirable for a company since it can more easily delay its payment of debt by pointing to a lack of cash. Thus, barter can become a means to avoid confiscation of assets. The incentive for industrial companies to withhold tax payments is especially strong in the former Soviet economies, where the tax system is heavily biased against industry.

Corporate governance and enterprise restructuring

Much of the enterprise restructuring that has occurred to date in the transition economies has been motivated by increasing product-market competition and hardening budget constraints. Progress in both of these areas has been substantial since the very beginning of the transition in eastern Europe and the Baltic countries. Over the past two years, the CIS countries have followed suit. Most of the CIS countries have eliminated the state’s monopoly on foreign trade and removed or reduced quantitative restrictions on imports and exports, thus increasing product market competition substantially. Budgetary subsidies – once the key source of “softness” in budget constraints – have been substantially reduced throughout the CIS, in some cases at an extraordinary pace. Both Armenia and Georgia had virtually eliminated budgetary subsidies by 1996 – down from nearly 13 per cent of GDP in both countries in 1994.

However, the reduction of budgetary subsidies has, in many cases, been accompanied by an increase in off-budget subsidies and other cushions weakening financial discipline. Tax arrears have increased significantly in a number of countries. By the end of 1996, the stock of tax arrears had reached 10.2 per cent of GDP in Moldova and 13.4 per cent of GDP in Bulgaria. In the Russian Federation, high tax arrears have combined with an increasing reliance on barter. The stock of tax arrears (including those to off-budget funds) reached 10 per cent of GDP by the end of 1996.²⁴ Barter has climbed to alarming proportions in Russia; it is estimated that 40-70 per cent of total industrial sales were conducted through barter in the first quarter of 1997. (See Box 2.2.) Ukraine has a similar pattern of high tax arrears and barter. In several CIS countries, arrears on energy bills have also been a substantial problem.

²⁴ The stock of arrears continued to increase in the first quarter of 1997, but then decreased in the second quarter due to several one-time payments to clear outstanding arrears by a small number of the largest enterprises. The tax regime in Russia is discussed separately in Box 7.1 in Chapter 7.

A second explanation for barter is that the privatisation process has not yet produced corporate governance structures where profit maximisation is the primary goal of both owners and managers. In many cases, managers and employees have acquired ownership in their firms primarily to try to avoid costs arising from genuine restructuring. All too often maintaining production volumes and employment is the main goal of management. In these circumstances barter can be used both to conceal the true market value of output and inefficiencies in the production process which serve to justify excess production and employment.

The third explanation for barter arises from weaknesses in the financial sector in many transition economies. Uncertainty about the financial viability of industrial enterprises coupled with the lack of adequate expertise in commercial banks has led to relatively high interest rates for working capital credits and restricted availability of long-term loans. In Russia the high cost of credit was exacerbated by the mix of tight monetary policy and large fiscal deficits. To circumvent these credit constraints, enterprises can use trade credits to finance their working capital requirements. This is profitable due to high interest rate differentials and the strong integration of industrial enterprises, which provides greater information about enterprise capacity than would be available to banks. In transition economies, barter is used to collateralise such trade credits. When payments discipline and enforcement is weak, a claim on goods is more concrete and can be more easily enforced than a claim on cash, which many creditors would compete for in the case of liquidation.¹

There are a number of ways to address the problems underlying the barter crisis. First, payments discipline will have to improve. At a

minimum, this requires a more stringent application of bankruptcy proceedings. Second, corporate governance needs to be improved. In particular, shareholders will need to find ways to encourage management to focus more on profit maximisation and less on quantity targets. The latter will be easier if the state takes a more hands-off role in enterprises. Third, the banking sector will have to strengthen its capabilities in financial intermediation. This process will be encouraged by falling interest rates, which forces banks to identify new business opportunities.

Finally, a crucial agent of change will be foreign competition. Barter is virtually non-existent in central and eastern Europe and the Baltics, largely because industry is far more integrated into the world economy, giving firms greater flexibility to generate cash and thus avoid barter. Russia's industrial sector, however, is relatively insular and highly integrated domestically, making barter a more viable option. Russia's continued integration in the world markets should force large industrial enterprises to re-focus their strategies towards non-barter sales.

References

Marin and Schnitzer (1995), "Creating creditworthiness through reciprocal trade", *CEPR Discussion Paper*, No. 1185, May.

Russian Economic Barometer (1997), Vol. 4, No. 1.

¹ The notion that reciprocal trade can be used to collateralise trade credit has been discussed by Marin and Schnitzer (1995) in the context of international countertrade.

Enterprise restructuring has also been slowed by the ineffective implementation of bankruptcy laws in many countries of the region. Though most countries have adopted bankruptcy laws, the number of bankruptcies and liquidations has been relatively small, except in a handful of countries. Hungary continues to stand out because of the very large number of bankruptcy cases that have been brought and the large number of liquidations that have resulted.

An increasingly important element in determining the pace of enterprise restructuring has been the structure of corporate governance, shaped by the privatisation process and the continuing redistribution of ownership rights in new securities markets. Yet the wide variation across transition economies in privatisation strategies and in the organisation and functioning of securities markets has produced a broad range of corporate governance structures, whose effects on enterprise restructuring are only now appearing.

A key factor in analysing evolving corporate governance structures in transition economies has been the extent of ownership transferred to insiders versus strategic investors. In a large number of countries, including most of the CIS and the countries of the former Yugoslavia, the privatisation process has generated largely insider-controlled enterprises. The same is true for a substantial share of privatisations in Poland and the Slovak Republic. In most of the advanced countries, privatisation produced a pattern of corporate governance that gave a greater role to outside institutions, though there has been substantial variation both in the types of institutions established and the extent of their stakeholding in privatised enterprises. These institutions have included: foreign investors, investment funds of various forms, holding companies, banks and financial-industrial groups. While

it is still too early in the transition to draw definitive conclusions about the effects of evolving corporate governance structures on enterprise restructuring, some patterns of behaviour and outcomes can already be detected. These are examined in Chapter 4.

Ownership structures and management-owner relationships can change through government or private decisions and through market transactions. Over the past year, it has become apparent that the initial patterns of corporate governance established in transition economies will not necessarily remain stable over time. In Poland, the pursuit of multiple privatisation tracks has weakened the prevalence of insider ownership as stakes in key enterprises have been sold to strategic investors through direct sales and international tenders. In Russia, large banks and financial-industrial groups, in some cases backed by foreign investors, have become major players in the cash sales of state shares in large enterprises and in the secondary market for equity stakes in the increasingly active securities markets. This has led to several high-profile efforts to weaken the control of insiders in these enterprises through the defence of shareholder rights. In the Czech Republic, the completion of the privatisation of state shares in the major banks and the conversion of investment funds into holding and mutual funds companies may have a substantial impact on the initial pattern of corporate governance that resulted from voucher privatisation. In addition, the perception among foreign investors of declining risk in this region opens up the possibility that foreign strategic investors may play a greater role in the new stages of privatisation in Bulgaria, Latvia, Lithuania, Moldova, Romania and elsewhere.

Liberalisation of prices and wages

Prices have been substantially liberalised in virtually every country in the region. There appears to be widespread recognition that price

signals – the very foundation of decision-making in the market economy – should be clear and free to move in response to market forces. Most of the transition economies liberalised prices at the very start of the reform process with a consistent approach: the elimination of most price controls and state procurement at non-market prices. Though there have been occasional instances of the reimposition of price controls (such as in Belarus or in Bulgaria under the previous government), backtracking in this area has been relatively rare. The variance in the price liberalisation scores in the transition indicators between 1994 and 1997 has always been lowest among all the areas of reform.

The most substantial remaining price controls can be found in Belarus, Tajikistan, Turkmenistan and Uzbekistan. In Belarus, restrictions on wholesale and retail price margins are still prevalent. Price ceilings were reintroduced prior to the November 1996 referendum on constitutional changes. In Tajikistan, Turkmenistan and Uzbekistan, there remain price controls or state procurement at non-market prices on key agricultural commodities.

In other countries, the implementation of the market approach to pricing has not encompassed all sectors of the economy. Key exceptions include utility prices and housing. Since the pre-reform price levels in these sectors covered only a small fraction of long-term costs, a move to cost-recovery levels required very sharp real price adjustments that were deemed to be politically unfeasible. There has been progress in these areas, but until recently it has been slow.

Many countries have introduced substantial increases in utility prices in 1997. After some initial delays, Hungary has moved furthest in this area. The Law on Electricity and Gas required that utility prices be increased to cost-recovery levels as of 1 January 1997, based on assessments by a group of independent experts. This led to a series of price increases which began in 1995 and, after some delays, are planned to continue through the end of 1997. Similar price increases, though still not reaching cost-recovery levels, have been introduced in nearly all of the countries at advanced stages of transition and in many of the countries at the less advanced stages. Energy commissions to review and regulate the setting of energy prices have been established in Bulgaria, Kyrgyzstan and Lithuania.

Wages in the private sector are largely determined by the market or institutionalised bargaining in nearly all of the transition economies, though administrative wage-setting does continue in countries such as Ukraine. Trade union power in the wage-setting process is relatively weak in the region compared with west European economies. In the early stages of the transition, several countries made use of incomes policies as part of their programmes of macroeconomic stabilisation. Some early taxes on excess wages, such as the *popiwek* in Poland, were abandoned in most cases after privatisation. However, the recent process of recovery has been associated with wage growth that exceeds productivity gains, in some case by substantial margins, as examined in greater detail in Chapter 7. Several countries have responded with the reintroduction of various forms of wage control. The Slovak Republic has recently

put forward legislation to curtail wage increases that exceed productivity gains. The government of the Czech Republic has reduced public sector wage growth and has attempted to enforce similar guidelines on enterprises in which it holds a strategic stake. Wage ceilings linked to performance have been set for the state enterprise sector in Bulgaria, while Romania has recently imposed wage ceilings only on loss-making state enterprises.

Trade and foreign exchange liberalisation

The liberalisation of trade has been one of the areas of most rapid reform in the region. At the very beginning of the transition process, most east European countries implemented a drastic liberalisation of their import regimes with few protectionist measures. In the former Soviet Union, the state-order system through which the state maintained control over foreign trade was gradually and almost completely eliminated (with the exception of Belarus, Turkmenistan and Uzbekistan). Though export regimes were initially tight in the former Soviet Union, they too were gradually liberalised and are now mostly free.

However, over time, real appreciation of exchange rates throughout the region began to put competitive pressure on firms, which have exerted pressure on governments for protection. The result has been the emergence of import regimes in both the advanced and less advanced countries with a differentiated structure of tariffs that tends to favour agriculture, automobile producers, defence industries and other sectors deemed to be of structural importance.

Even the most robust reformers in the region – the Czech Republic, Hungary, Poland and Slovenia – have succumbed to protectionist pressures at various times through the raising of tariffs or the introduction of trade defences common in many advanced industrial economies, such as anti-dumping measures. However, in most cases, the discipline imposed by EU Association Agreements, WTO accession negotiations, and other regional trade agreements (CEFTA, BFTA) has generally provided an effective counterweight to protectionist pressures; the trade regimes do not look very different from those in mature market economies.

Not all of the advanced countries have responded to this external discipline. In the Slovak Republic, a new import surcharge and laws against “subsidised” and “excessive” imports have been introduced as part of a package to support the trade balance; this has led to a downward revision this year of the country’s trade liberalisation score in the transition indicators. Lithuania has failed to cut back high agricultural tariffs while maintaining a generally liberal trading regime.

Among the less advanced countries, there has been progress in trade liberalisation among the most resolute reformers. In Azerbaijan, Georgia and Kazakhstan, all export duties were abolished this year and import tariffs have been gradually decreasing. Though Romania’s agreement with the WTO allowed for exceptionally high individual tariffs in some cases, the Romanian authorities have adjusted most of them to levels broadly in line with other European trade regimes. Yet there has still been

some backtracking among the less advanced reformers. Import tariffs were increased in Moldova for key intermediate capital goods inputs, but were subsequently reduced. In Tajikistan, high export taxes have been reintroduced on selected commodities, while Uzbekistan has levied new excise taxes on consumer imports and increased average tariff levels. Ukraine has also reimposed export taxes on some products. While there have been some limited reductions in import duties in Belarus, import and export quotas are still prevalent on a range of different products.

Exchange rate regimes have been generally quite liberal throughout the region. There is now virtually full current account convertibility in nearly all countries, with substantial progress this year in Romania and Ukraine. In Russia, restrictions on the transfer of earned interest on treasury securities are scheduled to be removed by the end of 1997. In most of the other transition economies, certain restrictions do remain on foreign investment by residents, but they have not been effectively enforced. Surrender requirements on foreign exchange earnings have been eliminated in most countries with the exception of Belarus, Russia, Turkmenistan and Uzbekistan. Capital account controls in the Czech Republic, Hungary and Poland are being further liberalised as a result of their accession to the OECD. The Baltic countries have fully liberalised capital flows. Slovenia has increased restrictions on capital inflows to counteract pressures towards real exchange rate appreciation.

Exchange rates are liberalised in most countries of the region, generally through interbank currency exchanges, though significant problems in this area remain in a number of the less advanced countries. There are multiple exchange rate regimes in Turkmenistan and Uzbekistan. In Belarus, the official exchange rate remains overvalued leading to a de facto dual exchange rate regime. Over the last year, Uzbekistan placed new restrictions on access to foreign exchange. The government of Belarus has nationalised the interbank foreign currency exchange and placed it under direct control of the central bank. In Tajikistan, access to foreign exchange has been limited by the infrequency and unpredictability of interbank foreign exchange auctions.

There has been steady progress in 1997 on accession of the transition economies to multilateral trade organisations and agreements. Bulgaria became a member of the WTO in December 1996, while negotiations are well advanced with Armenia, Estonia, Georgia, Latvia and Lithuania. Slovenia and Kyrgyzstan signed agreements with the EU, the former applying the trade-related provisions of an Association Agreement and the latter of a Partnership and Co-operation Agreement.

Competition policy

Progress in competition policy among the east European and Baltic countries has been driven primarily by the incentives of harmonisation with EU policies. Over the course of the year, this has led to new legislation and the creation of new institutions in several countries. In Hungary, Latvia and Romania, new

competition laws were adopted based on the EU framework. New administrative structures were also established in Estonia, Latvia and Romania. The legislative framework on competition policy is now largely compatible with EU standards in most of these countries, with the exception of Bulgaria. There have been signs of active enforcement of competition legislation in the Czech Republic, Hungary, Poland, Slovenia and the Baltic countries in terms of case reviews, recommendations and fines, although significant actions to reduce the abuse of market power have still been limited. In most other countries there is a problem of inadequate staffing and training in the administrative structures created to enforce competition legislation.

A major new initiative to regulate monopolies has been introduced in the Russian Federation with the creation of a special commission combining the State Anti-Monopoly Committee and federal regulatory bodies in the energy, transport and communications sectors. While this may not be the optimal institutional solution to this problem, it has in Russia led to a much more proactive stance against abuses of market power by natural monopolies and anti-competitive measures by regional governments. At the same time, the rapid development of financial-industrial groups has raised some concerns about the excessive concentration of market power in key industrial sectors.

Among the less advanced transition economies, rudimentary legal and institutional frameworks to curb the abuses of market power have been created in most countries. However, there has been little evidence of concerted actions to promote a more competitive environment. Monopolies remain a serious problem as do entry and exit restrictions in key sectors.

Banking reform

The wave of high-profile banking crises in several transition economies over the past few years has had a powerful demonstration effect throughout the region. After an initial period of rapid and virtually unregulated expansion, a widespread recognition has emerged among countries at all stages of transition of the need to consolidate and strengthen the banking sector. Most countries in the region have initiated, or have announced plans to begin, a programme of bank restructuring. In addition, impressive progress has been made in enhancing the supervisory capacities of central banks, tightening prudential regulations, and increasing capital requirements to prevent the re-emergence of systemic problems in this sector. However, improved supervision is, by its very nature, a long-term task in which the development of effective human skills is as important as enhanced regulatory structures.

Notwithstanding the recent progress, the banking system in most of the transition economies remains fundamentally underdeveloped. Most banks in the region are still weak and undercapitalised. If internationally accepted rules on loan loss provisions and write-offs were properly applied, it is estimated that none of the countries of the former Soviet Union – with the exception of Russia – would have an entire banking sector even

approaching the size of a medium-sized Western bank.²⁵ The basic legal and institutional infrastructure in support of banking is seriously deficient. The development and enforcement of collateral and bankruptcy laws has been slow, as demonstrated in the legal indicators presented in Box 2.1. Internationally accepted accounting standards and modern portfolio and management information systems have not been widely introduced. Most importantly, banks in much of the region have not yet developed the skills necessary for the provision of the basic functions of financial intermediation.

As a result of these continuing problems, much of the region remains fundamentally “under-banked” in terms of the small scale of bank lending relative to the size of the economy. In few transition economies have banks reoriented to provide term lending on any significant scale to private enterprises. Moreover, there remains little confidence in the soundness of loans that are being made in many countries. Connected lending to bank shareholders is still common practice in much of the region.

Of course, given the importance of experience, skills, and coherent practices in the financial sector, such institution-building takes considerable time to develop and the progress made to date should not be underestimated. The advanced countries have already implemented bank rehabilitation programmes utilising some combination of write-offs, the purchase or transfer of bad loans, debt-equity swaps and direct recapitalisations. They have focused more recently on the privatisation of banks. Estonia and Hungary have again set the standard in this area. By August 1997, Hungary had privatised all five of the major state-owned banks formed from the initial break-up of the monobank system. In Estonia, the share of foreign ownership in banks has increased to 37 per cent of total bank equity. Latvia's largest state-owned bank was majority-privatised in 1996 and privatisation of the state's remaining interests in the banking sector is under way. After a wave of problems in small and medium-sized banks, the Czech government has finally announced its intention to complete the sale of the substantial state share held in the country's largest commercial banks, which themselves control a number of major investment funds that own large stakes in Czech industry. The government has agreed to sell its stake in Investicni a Postovni Banka to Nomura International and it has approved in principle the sale of state shares in the remaining three major commercial banks. Poland has privatised five of the nine original state-owned banks spun off from the monobank, albeit at a pace far slower than initially announced. Major bank privatisations are also planned in Lithuania and Slovenia.

Among the more resolute reformers of the less advanced countries (including Bulgaria, Georgia, Kazakhstan and Russia), substantial strides in banking reform have been made through the establishment and enforcement of higher capital requirements and capital adequacy ratios. These countries have forced substantial numbers of banks into liquidations or mergers. In Georgia, 174 of the 229 commercial banks operating at the beginning of 1994 were

closed or merged after the implementation of new banking standards. After a wave of bank insolvencies in Bulgaria, one-third of the country's commercial banks have been placed under administration or in bankruptcy procedures. Bulgaria also completed its first privatisation of a major state-owned bank – United Bulgarian Bank – with the participation of the EBRD; three more banks are scheduled to be sold through tenders in the second half of 1997. Russia has liquidated or merged more than 400 banks over the past year in conjunction with a major tightening of central bank supervision. In Kazakhstan, the government has forced the merger of two banks which together account for about 20 per cent of the outstanding stock of loans and has closed the country's fourth-largest bank. Substantial bank restructuring programmes under the guidance of the IMF and World Bank are also active in Armenia, Azerbaijan, FYR Macedonia, Kyrgyzstan and Romania. Among other less advanced countries, only limited progress has been made in banking reform. The sector is dominated in these countries by banks owned or controlled either by the state or by state enterprises. In Belarus, for example, directed credits at preferential rates are still channelled through commercial banks. The Government of Belarus also continues to intervene in the banking system, often in an arbitrary way.

Securities markets and non-bank financial institutions

Securities markets and non-bank financial institutions remain the least developed sector of the transition economies. Though rudimentary institutions have been created in most countries in the region, they are still far from fulfilling the key functions of securities markets in the transition process: (i) as an alternative to banks for debt and equity finance to the private sector; (ii) as a secondary market in ownership, and; (iii) as a means to encourage enterprise restructuring as a result of (i) and (ii). Yet these functions are critical to the further progress of transition. Given the very low level of term lending to enterprises by banks and the even lower level of lending to new private firms, an alternative source of debt and equity finance is necessary to promote private sector development. Perhaps even more important is the need for an adequate secondary market in ownership. In the wave of mass privatisations over the past few years, the speed and scope of the process often took precedence over concerns for improving corporate governance which has led to the common phenomenon of insider ownership or de facto insider control in the face of widely dispersed outside ownership. The securities markets, whose emergence was often encouraged by the authorities in the context of voucher-based privatisation programmes, were intended to overcome this problem by creating a means for outside owners to purchase shares and concentrate their stakeholdings. Without effectively functioning securities markets, the process of improving corporate governance has faced serious obstacles.

The problems affecting the development of securities markets are essentially similar throughout the region, though they vary significantly in terms of magnitude. Equity markets are generally thin, highly illiquid with the exception of a small number of “blue

²⁵ See Siegelbaum (1997).

chip” shares, and poorly regulated. However, the beginnings of a breakthrough have become evident in a small number of securities markets, namely in Estonia, the Czech Republic, Hungary, Poland and Russia, as described further in Chapter 5. The breakthrough is linked to the inclusion of some of the largest and most high-profile enterprises and banks of these countries into the privatisation process. This has attracted the attention of foreign portfolio investors who have spearheaded the enormous expansion of these markets. In Hungary, for example, turnover nearly quadrupled in 1996, while market capitalisation more than doubled in the first half of 1997. Similarly, in Russia share prices more than doubled in the first half of 1997, bringing the market capitalisation above US\$ 80 billion. The Warsaw Stock Exchange received a substantial boost with the listing of National Investment Funds in June 1997, contributing a deeper capital base to what was already the most liquid stock exchange among the transition economies. Estonian securities markets have also shown explosive growth, with their share prices soaring by 360 per cent in the first half of 1997. Indeed, the sudden “boom” in several of these markets, which is partly related to their shallowness in comparison with major Western securities markets, has begun to raise concerns about the sustainability of such increases.

The rapid expansion of these markets has been accompanied by some improvements in their regulatory structure. With a new set of amendments to its Securities Law, Poland has taken the lead in this area. After eliminating the legal barriers separating commercial and investment banking, Hungary consolidated the structure for regulating the banking system and securities markets. At the same time, Russia strengthened the enforcement powers of the Securities Commission while granting regulatory power over the securities operations of commercial banks to the central bank. After much debate, the Czech Republic has announced its intention to create an independent securities commission.

Beyond this top tier of securities markets, most of the transition economies remain at a very early stage of development in this area. Treasury bill markets have been relatively active in several countries. The continuing advance of privatisation should give a boost to some markets, such as in Bulgaria, Kazakhstan, Latvia and Lithuania. Kazakhstan has embarked on a particularly interesting approach to the development of equity and security markets and, at the same time, pension reform. The idea is to rely on newly created private and state pension funds to help establish liquidity on these markets. This approach has sparked considerable debate both about the potential stability of share prices and the capacity of these untested markets and regulatory frameworks to handle such sensitive liabilities as pensions.

Serious inadequacies in the legislative and regulatory framework in the financial sector among the less advanced countries resulted in another high-profile collapse of pyramid schemes, this time in Albania. Much like the MMM scandal in Russia and the Caritas

collapse in Romania, a large number of Albanian investment funds began to lure deposits with unsustainably high returns, using new deposits to finance interest payments on old ones. However, the ultimate collapse of many of these funds, affecting the savings of nearly 80,000 households, prompted a widespread breakdown of political and social order in Albania.

This year has seen a considerable increase in the activities of transition economies on international capital markets. After a wave of Eurobond issues by Kazakhstan, Lithuania, Moldova, Russia and Ukraine, many of the CIS countries have been actively preparing their own debt issues, as are many regional governments in the Russian Federation. An increasing number of firms in the region have issued American or Global Depository Receipts, which simplify the investment process and lower custody and settlement risk for foreign investors in local securities.²⁶ Yet the growing use of such instruments is one indication of the continuing weaknesses in transparency, liquidity and custody of domestic equity markets in the region.

Environmental challenges and reform

The decades of central planning and the peculiar priorities and methods it embodied left a legacy of serious environmental degradation, a legacy that will take great time, resources, effort and commitment to overcome. Although environmental policy and management in socialist economies were characterised by very stringent environmental standards and non-compliance fines, the implementation, monitoring and enforcement of such standards and fines were weak. Distorting economic policies and practices focused on industrial output with little attention to economic and social cost further contributed to the poor quality of the environment. The emphasis on the production of heavy industry and material inputs and the failure of the price system to reflect economic costs, for example, greatly contributed to inefficient resource allocation and high energy intensity causing high levels of air and water pollution in the region. Low technical and maintenance standards contributed to increased risks from nuclear plants and led in 1986 to the profoundly serious accident in Chernobyl.

At the very start of the transition, some environmental problems required immediate attention. Exposure to lead and heavy metal dust from smelters and the use of leaded petrol, high levels of particulates from industrial emissions, and drinking water pollution were identified by the Environment Action Programme for Central and Eastern Europe in the early 1990s as the three main environmental risks to human health.²⁷ In Central Asia two of the most prominent risks were exposure to pesticides and chemical residues and the poor quality of rural drinking water.

This environmental legacy has affected public health and has contributed directly and indirectly to lower economic productivity and standards of living. Declines in average life expectancy in the

²⁶ ADRs are securities issued by recognised investment banks in the US securities market which are backed by the cash flow of securities issued in other markets. They are subject to US Securities and Exchange Commission approval and have the benefit of the more efficient and transparent securities market infrastructure in the US. GDRs are similar securities listed on other Western markets.

²⁷ See Hughes (1995).

Box 2.3

Selected indicators of environmental policy reform

Introduction

This box describes aspects of environmental policy reform in the EBRD's 26 countries of operations. The purpose is to enable an initial understanding of the scope of reform, while the ultimate goal will be to assess in the future both the extensiveness and effectiveness of environmental policy reform. The findings are based on information from several sources, including answers to a questionnaire sent to the ministry of environment for each country.

In this box environmental policy reform is described by selected national legislation and a few processes and instruments. The legislation assessed includes framework environmental laws, environmental sector laws and standards, environmental liability, environmental impact assessment, and signature and ratification of international environmental treaties. The environmental policy instruments assessed include the preparation of a National Environmental Action Plan and the development of financial incentive mechanisms.

Environmental legislation

In the past, environmental legislation in transition economies was based on a legal system where the regulator and the regulated were agencies of the same government. This structure has changed to reflect the government's new role as regulator only. In such a context, environmental legislation is evolving at different speeds. In a number of areas environmental legislation

is not structured as in western Europe. General legislative instruments, such as framework environmental laws, are frequently used, while technical issues are left to be governed by regulatory instruments. By contrast, Western legislation typically identifies individual sector regulations. The generation, production, utilisation, transport, storage and disposal of waste in transition countries, for example, are usually regulated by a framework environmental law.

All transition countries have framework environmental laws in place, except Bosnia and Herzegovina where new environmental legislation is being introduced following recent political changes. The Polluter Pays Principle is at least partially reflected in the environmental legislation of all countries. In many countries in the region, the environmental impact assessment process has been more or less fully adopted. The extent to which environmental liability is defined in legislation varies from country to country; in many countries, liability for past contamination is not defined. Some countries that have applied for EU membership, notably Bulgaria, the Czech Republic, Hungary, Lithuania and the Slovak Republic, have fully incorporated environmental liability requirements into their national legislation.

The table below contains a set of selected indicators of environmental policy reform. The first six columns examines the degree of adherence to six key international environmental treaties. These are: the Convention on the Wetlands of International Importance; the Convention on International Trade in Endangered Species of Wild Fauna and Flora; the Montreal Protocol for the control of CFC (chlorofluorocarbon) emissions; the Convention on Climate Change; the Convention on

Selected indicators of environmental policy reform

	International treaties						Standards	NEAP	Financial instruments
	1. Wetlands	2. Endangered Species	3. Montreal Protocol	4. Climate Change	5. Biodiversity	6. Transboundary	7. Air and Water (Effluent Index)	8. Status of NEAP or equivalent	9. Status of financial instruments
Albania	s&r			s&r	s&r	s&r	1	1	
Armenia	s&r			s&r	s&r	s&r	1	2	
Azerbaijan			r	s&r	s		1	2	✓
Belarus		r	s&r	s	s&r	s	1	1	
Bosnia and Herzegovina			r				na	2	✓
Bulgaria	s	r	r	s&r	s&r	s&r	1	2	
Croatia	s&r		r	s&r	s&r	r	2	2	✓
Czech Republic	s&r	r	r	s&r	s&r	s	3	1	✓
Estonia	s&r	r	r	s&r	s&r		2	1	✓
FYR Macedonia	s&r		r				1	1	
Georgia	s&r	r	r	s&r	r	s	1	2	
Hungary	s&r	r	r	s&r	s&r	s&r	3	1	✓
Kazakhstan				s&r	s&r	s&r	1	2	
Kyrgyzstan					r	s&r	1	1	
Latvia	s&r	r	r	s&r	s&r	s&r	2	1	
Lithuania	s&r		r	s&r	s&r	s&r	1	1	✓
Moldova			r	s&r	s&r	r	1	1	✓
Poland	s&r	r	r	s&r	s&r	s&r	3	1	✓
Romania	s&r	r	r	s&r	s&r	s	2	1	
Russian Federation	s&r	r	s&r	s&r	s&r	s	1	1	✓
Slovak Republic	s&r	r	r	s&r	s&r	s	2	1	✓
Slovenia	s&r		r	s&r	s&r	s	2	2	
Tajikistan	*		r				1	2	
Turkmenistan			r	r	r		1	1	
Ukraine	s&r		s&r	s&r	s&r	s	1	1	✓
Uzbekistan	*		r	s&r	r		1	2	

Source by column: 1: IUCN Suisse; 2: Secretariat of the Convention on International Trade in Endangered Species of Wild Fauna and Flora, Geneva; 3: The Ozone Secretariat UNEP, Kenya; 4: Secretariat of Convention on Biological Diversity, UNEP, Quebec; 5: Climate Change Web page: <http://www.unfccc.de/fccc/sect/adress1.htm>; 6: ECE/ENHS United Nations; 7: Approximation of EU Environmental Legislation, The Regional Environmental Centre for CEE, 1996; EBRD's *Investors' Guidebook for Environment, Health and Safety*; 8-9: Responses of Environmental Ministries to EBRD Questionnaire.

Legend by column: Columns 1-6: See footnote 1: s=signed, r=ratified, s&r= signed & ratified, * means the country has completed part of the adherence process. Information in columns 1, 2 and 6 as of July 1997; columns 3 and 5 as of June 1997, and column 4 as of May 1997. Column 7: Air and Water Ambient and Emission (Effluent) Standards System: 1 means maximum permissible concentrations (MPC) system in place, broadly based on the former Soviet system; 2 means a new system is being introduced, either as an evolution of MPC or in order to meet EU requirements; 3 means essentially new standards system is in place, often following EU requirements. Column 8: National Environmental Action Plan (NEAP): 1 means prepared or under implementation; 2 means planned or under preparation. Column 9: ✓ = Three or more financial instruments in place.

Biodiversity; and the Convention on Environmental Impact in a Transboundary Context.¹ Some countries have either signed, or signed and ratified, all six treaties: they are Bulgaria, the Czech Republic, Georgia, Hungary, Latvia, Poland, Romania, the Russian Federation and the Slovak Republic. On the other hand, countries such as Bosnia and Herzegovina, FYR Macedonia, Kazakhstan, Kyrgyzstan, Tajikistan and Turkmenistan have ratified three or fewer treaties to date.

In conducting environmental impact assessments (EIAs), many countries in the region use the State Ecological Expertise system. In principle, the scientific basis underlying such systems is similar to that in the West. However, typically, the "Expertise" discussion is required later in the decision-making process than in an EIA system. Several Western and transition country organisations are working on the "harmonisation" of approaches in eastern Europe and the CIS with Western approaches and methodologies related to environmental impact assessments.

Environmental mechanisms

Following the launch of the Environmental Action Programme for Europe (EAP) in Dobris in 1991, National Environmental Action Programmes (NEAPs) are being adopted in the region. A NEAP is a national level plan designed to integrate environmental management into overall development objectives. Particular requirements of NEAPs in the region are public participation processes and the well-balanced combination of regulatory (command-and-control) instruments and economic tools (market incentives).

NEAPs or NEAP equivalents have been either already prepared or are being prepared in most countries of the region. Kyrgyzstan, Latvia, Lithuania, Moldova, Poland, Romania and the Slovak Republic are implementing NEAPs. The Czech Republic and Hungary have prepared and are implementing their own national environmental plans (though these are not termed NEAPs). Albania, Belarus, FYR Macedonia, Russia, Slovenia, Tajikistan and Ukraine had prepared NEAPs or equivalents as of August 1997. Azerbaijan, Armenia, Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Georgia, Kazakhstan, Tajikistan and Uzbekistan are either starting or planning NEAP preparation.

To assess the extent to which environmental financial mechanisms are used, the EBRD sent a questionnaire to the authorities in charge of the environment in each of the countries of the region. The questionnaire requested information on four instruments: (i) existence of an environmental fund for channelling the money collected in fees and fines to environmental investments; (ii) provision of taxes/other penalties or financial incentives for energy and resource efficiency; (iii) waste and pollution reduction; and (iv) the use of clean technologies. Twenty-one countries have already established environmental funds. These funds are separate from normal government financing mechanisms. They are

earmarked to support environmental investments and are operated by semi-independent or independent organisations. Environment-related levies, such as pollution charges and fines as well as fees on the use of natural resources, constitute major revenue sources. Environmental funds have been used for investments in pollution control and prevention technology by industries, for environmental education and research, for the establishment of environmental monitoring systems, and for natural resource conservation. Environmental funds have been disbursed in the forms of soft loans and grants. Countries that are operating three or more of the above-mentioned financial instruments are indicated in column 8.

Concluding comments

The evidence on environmental policy reform presented in this box is clearly too limited in scope for assessing the status of environmental transition. The commitments of industry to environmental improvements or appropriate resource recovery policies, for example, are not captured, nor does the analysis reflect the quality of environmental conditions in the EBRD's countries of operations. An array of legislative measures and mechanisms influence the quality of the environment, but they are not the only factors which determine environmental quality. Other critical factors include the industrial structure and quantity of output, the nature of indigenous fuel supplies, technological advances and population densities. Further work will be required to gain a better understanding of the progress made in environmental management to overcome the legacies of the past and to address new challenges arising in transition economies. Nevertheless, the information presented here suggests that the environmental challenge is being taken seriously throughout most of the region.

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¹ **Ramsar Convention on Wetlands of International Importance** enables contracting parties to designate particularly important wetland areas and protect them from development. **Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES)** establishes worldwide controls on the international trade in threatened species of animals and plants.

The Montreal Protocol for CFC Control requires nations to help protect the earth from excessive levels of ultraviolet radiation by cutting chlorofluorocarbon consumption by 20% over their 1986 level by 1994 and 50% over their 1986 level by 1999.

Convention on Climate Change aims to stabilise atmospheric concentration of greenhouse gases at levels that will prevent human activities from interfering dangerously with the global climate system.

Convention on Biological Diversity seeks to conserve biological diversity by appropriate access to genetic resources and by appropriate transfer of relevant technologies.

The Convention on Environmental Impact Assessment in a Transboundary Context (ESPOO), lays down the general obligation of States to notify and consult each other on all major projects under consideration that are likely to have a significant adverse environmental impact across boundaries.

former Soviet Union over the period 1990-94, for example, have been linked to the reduced capacity of urban residents to cope with some illnesses, which have been exacerbated by exposure to high levels of air pollution.²⁸ The lack of basic sanitation infrastructure in the villages and small towns of Central Asia, which has deteriorated during the transition with the failure of governments to raise or allocate necessary resources, has contributed to high levels of infant mortality from water-borne diseases. Thus, while environmental pollution exposure is not the only threat to health in the region, available evidence suggests that health damage caused by environmental pollution is significant.

Besides its impact on human health, productivity and standards of living, poor environmental conditions and the lack of environmental infrastructure act as important deterrents to foreign direct investment. Foreign investors are generally reluctant to invest in areas and countries that have a bad environmental record. A recent survey of 1,000 large mining, construction and manufacturing companies in western Europe and North America found that environmental risks are rated as high as exchange rate and political risks in determining the attractiveness of the investment climate.²⁹ Environmental factors appear most significant regarding plant site. Potential liability from past environmental practices was found to be the most important environmental issue for investors for which they often actively seek indemnification from governments. Investors are equally concerned about the uncertainty surrounding liability for present and future practices as well as that regarding future environmental standards.

To overcome the environmental legacy of the past and aim at achieving an environmentally sustainable development, transition countries have to undergo structural changes which are similar to the economic and legal structural changes associated with the transition indicators in this Report. The process of transition provides an opportunity to correct past failures and put in place adequate environmental policies and processes. This opportunity is created not only by the possibility to use new information and technologies (on energy efficiency, recycling and renewable resources, for example) but also by increased public participation brought about by political decentralisation and enhanced corporate governance. Common goals are cleaning the environment and the establishment of those fundamentals that characterise the environmental policies and processes of a modern market economy.

In some transition countries, notably the Baltic states and eastern Europe, environmental policies and instruments introduced since 1990 have started to bear fruit. The decline in industrial activity has contributed to reductions of air and water pollution in most transition countries. The drop in economic activity was also accompanied by a sharp decline in the use of fertilisers. In

countries such as Bulgaria, the Czech Republic, Poland and Romania there have been significant reductions in air emissions of lead and other heavy metals. Similarly, municipal and industrial discharges into water have decreased considerably in some countries.

The challenge for all transition countries is to try to resume economic growth without a resurgence of pollutant emissions. This challenge is what is referred to as the "decoupling" of pollution intensity and economic growth. A recent OECD survey of environmental indicators, which covers a selection of five east European countries as well as Russia, found that in Hungary and Poland (two countries at an advanced stage of transition) there are indications that sulphur dioxide emissions, for example, have started to fall despite the resumption of economic growth.³⁰ Carbon dioxide emissions in the same countries, on the other hand, have remained relatively stable. In less advanced countries, such as Bulgaria, sulphur dioxide emissions have recently increased, while in Russia the decline in air pollutant emissions still follows the decline in GDP. Nevertheless, available data on ambient air pollution and water quality do not yet show any clear and discernible trends. Given the available air quality monitoring systems in these countries, emissions data tend to be collected from large industrial sites. The less-than-proportional reduction in ambient air quality compared with total emissions may have been largely caused by the relatively small reduction in emissions from small and medium-sized polluters, such as households and commercial establishments, that have substituted domestically produced, low quality coal for gas and other petroleum products following their increases in price.

Overall, despite the efforts and investments of the past seven years to clean up the environmental legacy of central planning, the challenges are major and profound. Energy intensities and air pollution remain between two and three times higher than the OECD average. Additional environmental pressure is likely to arise from economic restructuring, including increased waste and rapidly expanding motor vehicle use. In this context, some countries are taking steps to strengthen their environmental policies and to enhance their capacity for environmental management. The countries seeking accession to the EU, in particular, face the challenge of adapting to EU standards. There is a need to adapt environmental legislation as well as to finance the investments necessary to make technology and production processes compatible with EU environmental standards. Although the true cost of such adaptation is not known, a recent review of available studies estimated that total investment costs of environmental adaptation could amount to ECU 100 billion, an estimate which covers water supply, sewerage, waste-water treatment, air pollution from combination plants and waste management.³¹ However uncertain these estimates may be, they reflect the magnitude of the challenge that lies ahead.

²⁸ See the discussion of causes of the fall in average life expectancy in Annex 2.2 of this Report.

²⁹ See Klavens and Zamparutti (1995).

³⁰ See OECD (1996).

³¹ See European Commission (1997).

Box 2.3 summarises the information obtained thus far regarding a selection of environmental legislation and policy mechanisms. While a distinct divide emerges in the extensiveness of legislation, primarily linked to differing degrees of adherence to international environmental treaties, there is more diversity among the transition economies regarding environmental processes.

Environmental legislation, on the other hand, will not go far in restoring environmental quality if it is not accompanied by adequate policy instruments and processes. While there is no single blueprint for how a modern market economy should choose its policy instruments and processes to address the environment, there are a few basic “dos” and “don’ts” that command widespread acceptance and can help shape environmental policy in transition economies.³² Given the scarcity of financial resources, it is important to identify priorities in a cost-effective manner so that environmental improvements per unit of resources invested are maximised over time. This is, in principle, the objective of a national environmental action plan (NEAPs). A NEAP is neither a necessary nor a sufficient condition to identify environmental priorities. It can, nevertheless, help to do so and to enhance the process of public consultation. In any case, an adequate selection of priorities should help identify actions and policies where environmental improvements and resource savings can occur simultaneously. The phasing-out of subsidies in the consumption of energy, water and natural resources, for instance, is an excellent example of a win-win policy in that it improves both economic efficiency and environmental policy. Lastly, given their limited institutional capacity and financial means, transition country governments cannot work alone but need the cooperation of others. The private sector, in particular, has a crucial role to play by helping to disseminate best practice in environmental impact assessments, by financing investments in energy efficiency and waste-water treatment, and by helping to jump-start industry producing environment-related products.

2.5 Conclusion

A new phase of reform has emerged in the transition economies in which the focus of change has shifted from liberalisation and stabilisation to restructuring and growth. Over the past year, countries at all stages of transition have concentrated their efforts on building, renewing and improving institutions that shape the incentives of market actors. Consequently, the strongest progress over the year was seen in those dimensions of reform – large-scale privatisation, banking and securities markets – that are critical to the establishment and strengthening of institutions underpinning the market economy, to the effective structure of corporate governance and to the promotion of enterprise restructuring.

With the completion of the “first wave” of broad-based privatisation, many countries have turned to cash sales of remaining state shares in large, high-profile enterprises on a case-

by-case basis. Typical privatisation methods at this stage are direct sales, auctions, international tenders and initial public offerings. Priorities have shifted from the depoliticisation of enterprises to the search for strategic investors, the concentration of ownership stakes, and the effort to raise much-needed revenue for state budgets. Such an approach to large-scale privatisation, once thought feasible only for the most advanced reformers, has now spread across the region to such countries as Bulgaria, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Romania and Russia. Foreign strategic investors, domestic holding companies and newly created financial-industrial groups are becoming more active in a wider range of countries and, in the process, breaking the entrenchment of insider control that has been a key obstacle thus far to further enterprise restructuring.

In the financial sector, a broad consensus has emerged across countries at all stages of transition on the need to strengthen and consolidate commercial banks, to introduce international banking standards, and to improve prudential regulation and supervision. Several countries – such as Bulgaria, Georgia and Russia – have been engaged in major efforts to reduce the number of weak banks in their financial systems, through bankruptcies, liquidations and mergers. With the assistance of international financial institutions, central banks across the region have been able to strengthen their institutional capacities and introduce new regulatory standards. Murky patterns of cross-ownership between banks, investment companies and industrial enterprises in some countries are slowly becoming more transparent, as are the relationships between commercial and investment banking within banks. Securities markets have also been subject to tighter regulation. These developments are not only improving, albeit slowly, the provision of basic financial intermediation services, but are also enhancing the role of financial markets as an arena for the secondary reallocation, by sales and purchases, of ownership rights.

Yet in all of these areas, there remains a long road ahead. Building institutions on this scale is, by its very nature, a long-term task, requiring not only the creation of new structures, but also the development of human skills and practices. Moreover, effective institution-building often requires complementary changes in a number of areas, such as the legal system and the organisation of government institutions, that have their own particular dynamics. Lags, delays, inconsistencies and mistakes are all to be expected in this process, even as overall reforms continue to advance.

This year has shown that problems in the development of institutions can have serious implications for sustaining some of the hard-won achievements of the earlier phase of reform. Indeed, as crises in Albania, Bulgaria and Romania demonstrated, the maintenance of macroeconomic stability is still vulnerable in the face of delays and shortcomings in institutional reforms. The process of transition is likely to continue along a complex,

³² For example, the EBRD’s principal environmental policies include: (1) promotion of environmental protection through an appropriate legal, economic and policy framework, particularly via the use of market mechanisms; (2) environmental performance to be monitored and regulations enforced; (3) capacity building for environmental regulation, assessment, management, monitoring and enforcement; (4) particular importance attached to energy and resource efficiency, waste reduction, resource recovery and recycling, use of cleaner technologies, promotion of renewable resources, investments with primarily environmental objectives; (5) implementation of multilateral environmental agreements and contribution to international environmental initiatives; and (6) advancement of appropriate environmental and health and safety standards.

occasionally serpentine path posing many challenges for countries at all stages of transition. However, the experience of 6–7 years of transition in the region has already provided some important lessons regarding the factors that generate a resolute commitment to reform and that strengthen the robustness of that commitment in the face of inevitable challenges. Stable and effective market reforms entail not only the broad transformation of the economy, but also the establishment and reinforcement of a wide range of market-supporting institutions in the government, in the legal system, and in civil society. These institutions that together constitute the broad structure of governance of the market are critical to the success of the new phase of transition and are examined in greater detail in the remaining chapters of this Report.

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Corruption is generally regarded as widespread throughout the developing world and, indeed, the developed world. However, the problem is often regarded as particularly pervasive and severe among the transition economies. Surveys of foreign investors and local entrepreneurs, as well as private risk rating agencies and the assessments of regional analysts, all tend to rate the extensiveness of corruption in the transition economies – especially in the CIS – as among the highest of any region in the world. This disparity raises several questions: Why do the transition economies exhibit such high levels of corruption in comparison with other countries? Is the difference rooted in factors inherent in the process of transition from a command to a market economy? What accounts for differences in the level of corruption among the transition economies? Does transition produce a unique pattern or nature of corruption? The answers to these questions have important implications for the development of effective approaches to combating corruption.

Corruption, by its very nature, is extraordinarily difficult to measure. Given the illegality of corrupt transactions, the problem does not lend itself to any objective direct or proxy measurements. Instead, corruption tends to be measured in relative terms across countries on the basis of survey evidence or assessments of country analysts. There are clearly limitations, even in anonymous surveys, to any attempt to get respondents to reveal their own participation in corruption. Survey questions are thus generally phrased to elicit responses about the perception of corruption in a particular field or country, rather than counting the actual instances of corruption in which respondents might be engaged. Similarly, analytic assessments are also based on the relative perception of corruption in different countries. It is important to recognise that the perception of corruption could be influenced by other factors besides the respondents' personal experience of corruption, including the extent of media coverage of the issue, the profile given to corruption in political campaigns, or the general level of trust in government – all of which may not necessarily be perfectly correlated with the actual level of corruption in a given society. Indeed, in some cases, an open press in a moderately corrupt society may lead to the impression that corruption is greater than in a less open, but more corrupt, society.

The most common cross-country measures of corruption are based on assessments of regional and country analysts, often in the context of estimating country risk. The level of corruption is a key element in determining overall country risk for foreign investors, especially those involved in direct investment, and therefore is a factor taken into

consideration by several of the commercial risk rating services. Though a comparison of such risk ratings may provide some information on the perception of corruption levels across regions, the potential for measurement error is especially high as country experts – far removed from corruption transactions themselves – are more likely to rely on less direct and potentially biased sources.

Charts 2.1.1 and 2.1.2 present the average corruption ratings for countries grouped by regions provided by the Economist Intelligence Unit (EIU) Country Risk Service and the DRI McGraw-Hill Global Risk Service, which have broad coverage of the transition economies. The EIU asks country experts to assess the “degree to which public officials are involved in corrupt practices” on a 0 (very low) to 4 (very high) scale. Among the 97 countries covered by the service are included 18 transition economies (the service has a greater focus on eastern Europe and the Baltic countries than on the CIS). Based on the survey results for the first quarter of 1997, the average corruption score for the transition economies (3.35) is higher than any other region in the world. All five CIS countries included in the survey (Azerbaijan, Kazakhstan, Russia, Ukraine and Uzbekistan) received the highest rating (4) for corruption among public officials.

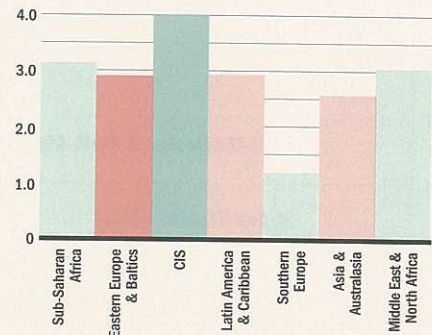
The DRI McGraw-Hill Global Risk Service includes 21 transition economies in its analysis of 33 risk factors in a total of 106 countries. The corruption scores represent the assessment of country analysts of the probability that over a five-year period a company will experience losses or costs due to increases in corruption.¹ For the 12 countries of the CIS included in the survey the average corruption score is 64 per cent, a level only slightly exceeded by the countries of sub-Saharan Africa. Corruption scores for the east European and Baltic countries are substantially lower.

The assessments of local entrepreneurs within these countries confirm the perceptions of high levels of corruption in the transition economies by country analysts, though they suggest a much larger gap between the transition economies and other regions. In a recent cross-country survey of over 3,600 entrepreneurs in 69 countries, entrepreneurs were asked to respond to the following statement: “It is common for firms in my line of business to have to pay some irregular ‘additional payments’ to get things done.”² Chart 2.1.3 shows the percentage of respondents divided by region who stated that this is frequently, mostly, or always true. Within the 10 countries of the CIS included in the survey, 65 per cent of the respondents said that this claim is frequently, mostly, or always true. The regional average for the CIS countries is 15 percentage points

Chart 2.1.1

EIU Country Risk Service

Regional corruption scores (First quarter, 1997)

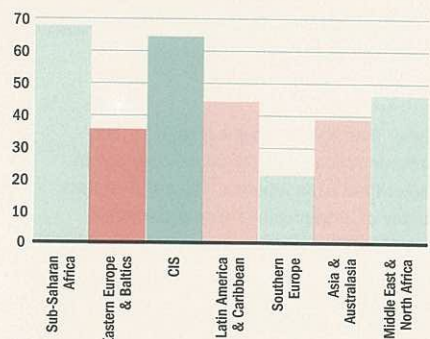


Source: Economist Intelligence Unit

Chart 2.1.2

DRI/McGraw Hill Global Risk Service

Regional corruption scores (1997)

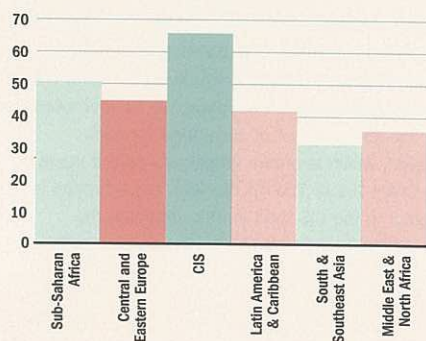


Source: DRI/McGraw Hill

Chart 2.1.3

World Bank survey of entrepreneurs (1997)

“It is common for firms in my line of business to pay some irregular ‘additional payments’ to get things done.”
Percentage of respondents who answered frequently, mostly or always.



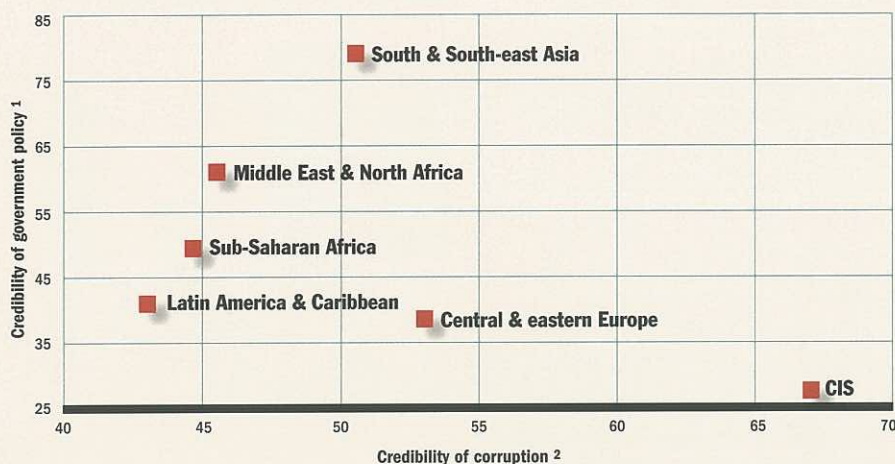
Source: Brunetti, Kisunko et al. (1997)

¹ In an effort to focus on changes in corruption over a longer time horizon, the DRI/McGraw Hill estimates of risk focus on the probability of a sharp and sudden deterioration in corruption, rather than its absolute level. The service does suggest, though, that one would expect the absolute level to be closely correlated with the probability of a deterioration, since an environment of extensive corruption is more likely to be associated with sudden and large changes in its level. Yet given the lack of evidence for this assumption, this data should be treated with considerable caution, though it is highly correlated with other measures of corruption levels.

² Among the transition economies, the survey included respondents from 10 countries of the CIS and from 11 east European and Baltic countries. See Brunetti, Kisunko et al. (1997).

Chart 2.1.4

Corruption and government policy



1 This is an index based on the responses to two questions in the World Bank's survey of entrepreneurs (Brunetti, Kisunko et al., 1997) concerning the credibility and predictability of government policy towards business. Higher percentages represent greater credibility of government policy.

2 This is an index based on the responses to two questions in the above survey concerning the credibility and predictability of corruption defined as irregular additional payments to get things done. Higher percentages represent greater credibility of corruption.

higher than the next highest region – sub-Saharan Africa – and 24 percentage points higher than Latin America. The cross-country survey of entrepreneurs also provides an opportunity to compare some characteristics of corruption across regions and to relate corruption to other factors affecting the investment climate. The survey included two questions to measure the predictability and credibility of corruption transactions, respectively: (i) “Firms in my line of business usually know in advance about how much this ‘additional payment’ is”, and (ii) “If a firm pays the required ‘additional payment’ the service is usually delivered as agreed”. On the first question, the CIS respondents reported a level of predictability of corruption nearly twice as high as any other region with the exception of eastern Europe. On the second question, more than 80 per cent of the respondents in the CIS and eastern Europe claimed a high degree of credibility of corrupt transactions, though the distinction with other regions is less substantial.³ On the basis of the responses to these questions, we have created a “credibility index” of corruption for each region, which is shown graphically on the x-axis in Chart 2.1.4. Though the level of corruption is higher in the CIS than in other regions, the predictability and credibility of such transactions are higher as well.

This pattern of corruption in the CIS is in stark contrast to the predictability and credibility of government policies in the region. A similar credibility index of government policy can be created from the responses to the following questions: (i) “Do you regularly have to cope with unexpected changes in rules, laws or policies which materially affect your business”, and (ii) “Do you expect the government to stick to announced major policies?” The responses from CIS countries rated the predictability and credibility of government policy substantially lower than in any other region, as shown on the y-axis in Chart 2.1.4.

Comparing the two indices across the regions, as in Chart 2.1.4, reveals an important trend: the CIS combines a high level of very predictable and stable corruption with a high degree of policy instability at the government level. Moreover, this pattern is largely unique to the CIS, though it is evident to a much lesser degree in the countries of eastern Europe and the Baltics. This unique association is also revealed more directly in the survey. When entrepreneurs were asked to rank the most significant obstacles to doing business in their countries, the CIS was the only region in which policy instability and corruption ranked together in the top three. Though corruption was at or near the top in most regions, policy instability was much further down the list, reaching no

higher than sixth place (Latin America) in any other region.

Of course, this correlation between the stability of corruption and the instability of government policy does not necessarily imply a causal relationship, nor does it indicate the direction in which a causal relationship might go. However, it does suggest an interesting potential relationship between the two. In an environment of extreme instability of government policy, firms may turn to corruption in their relationships with individual government officials as a “hedge” against the uncertainty of government policies. This would make sense only if corruption transactions between firms and individual government officials were more predictable and more credible than overall government policies towards firms; the responses to the survey questions reviewed above suggest that this is indeed the case in the CIS.

The use of corruption as a hedge against the uncertainty of government policy has strong parallels with practices common under the previous system of central planning. The classic empirical studies of the firm under central planning⁴ described how managers developed a network of personal relationships with government officials and with other firms to create parallel markets – often referred to as the “shadow economy”. These markets were developed in response to the high degree of uncertainty in the planning process associated with frequent changes in plan targets and supply bottlenecks. This pattern of behaviour may have survived, to a certain extent, under the very different conditions of the transition. The uncertainty of plan targets has been replaced by the uncertainty of government policies towards the market. While the introduction of markets has obviated the need for a shadow economy of this nature,⁵ the demand for close personal networks between firm managers and individual government officials may still be high in response to continued policy uncertainty. Corruption is the fuel for such networks.

If the relationship between government policy instability and corruption suggested by the regional comparisons is correct, then it should also hold among the transition economies themselves. Again the difficulties of measurement are severe. To measure the level of corruption across the transition economies, we use corruption indicators developed by the *Wall Street Journal Europe* based on assessments by regional analysts.⁶ To measure the level of policy instability, we use the results of a broad survey of foreign investors in the region sponsored by the EBRD in 1995.⁷ The investors

³ While the credibility that a service agreed upon through a corrupt transaction will be delivered is high, there is still considerable concern that other officials might ask for additional payments, according to the survey.

⁴ See Berliner (1957) and Granick (1954).

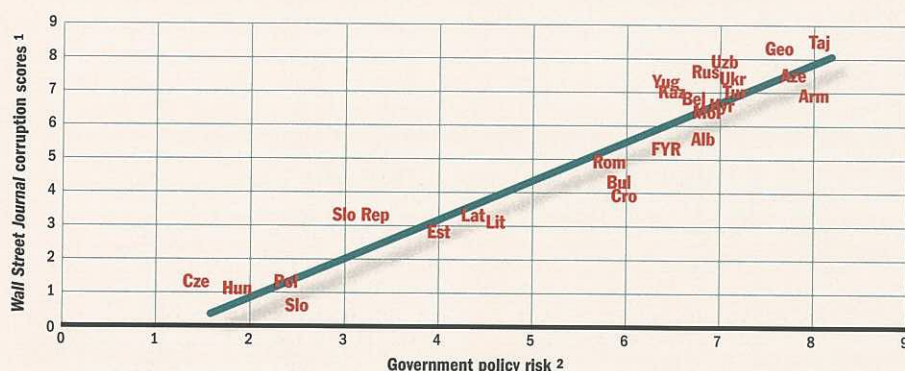
⁵ Though there is still a very large informal sector in many transition economies where firms seek to evade government taxation and regulation.

⁶ The *Wall Street Journal Europe* assembled a panel of regional analysts to rate corruption (among other characteristics) in 25 transition economies on a 1 (most corrupt) to 10 (least corrupt) scale; the average of the scores given by the analysts is used as the overall corruption score for the country. (CEER 1995-96) The *WSJ* corruption survey has the most complete coverage of transition economies. Its assessments of corruption among the transition economies is highly correlated with other less comprehensive corruption ratings such as those from the DRI/McGraw Hill Global Risk Service ($r = 0.78$) and the Economist Intelligence Unit Country Risk Service ($r = 0.82$).

⁷ The survey results are reported in Lankes and Venables (1996).

Chart 2.1.5

Corruption and government policy stability in the transition economies



¹ These scores are based on an assessment of levels of corruption in 25 transition economies as determined by a panel of regional analysts. The scores have been revised from the original so that higher scores represent higher levels of corruption. Source: CEER (1995–96).

² This is an index based on a survey of foreign investors sponsored by the EBRD. Investors were asked to rate the policy risk associated with unpredictable legal and regulatory processes in each of the transition economies. Higher scores represent greater policy risk. Source: Lankes and Venables (1996).

were asked to rate policy risk associated with unpredictable legal and regulatory processes in each of the transition economies. This can be used as a measure of the perception of government policy instability across the transition economies.

Chart 2.1.5 presents a scatterplot graph relating the level of corruption to the level of government policy instability in the transition economies. Clearly, there is a very strong correlation ($r = 0.94$). The relationship suggested by the regional comparisons holds true among the transition economies alone: countries with high levels of government policy instability tend to have high levels of corruption. Of course, the correlation only suggests an association between two phenomena and not necessarily a clear causal connection. Both phenomena could be caused by some third variable or the correlation could be spurious. Moreover, even if there were a causal connection, it would not be clear from the scatterplot whether government policy instability causes corruption or vice versa. Nevertheless, the pattern is consistent with the view that corruption constitutes a strategy for hedging against government policy uncertainty. The continuity in this pattern of behaviour from the command system to the transition strengthens this view of the causal argument.

Of course, corruption is a multi-faceted problem in which numerous factors play a role, as discussed further in Chapter 5. Yet the evidence presented here suggests that a key element explaining the remarkably high levels of corruption in transition economies in comparison with other regions in the developing world is the comparatively high degree of uncertainty of government policies towards the market in these countries. Managers, especially in the

CIS, appear to rely upon corruption – transactions which they regard as relatively predictable and credible – as a means of hedging against the risks associated with the instability of government policy, much as they did under central planning.⁸

Though any implications drawn from this argument must be treated with some caution, the evidence suggests the following hypothesis: improving governance of the market by enhancing the predictability of government regulation and intervention could have a strong impact on reducing the underlying causes of widespread corruption in the transition economies.

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S. Rose-Ackerman (1996), "When is corruption harmful?", Background paper for *World Development Report 1997*, August 1996.

⁸ This argument is not intended to suggest that corruption leads to net efficiency gains in the transition economy. For a discussion of the efficiency implications of corruption in the medium term, see Rose-Ackerman (1997).

A central purpose of the transition to a market economy in eastern Europe, the Baltics and the CIS is the improvement of general living standards. Despite the large falls in output in most of the region, living standards have improved for many people as rationing and shortages have disappeared, the quality and choice of products has increased, and new opportunities for private initiative have opened up. At the same time, it has to be recognised that in the short term many have suffered. The success and sustainability of the transition process will depend to a considerable extent on the numbers, characteristics and treatment of those who have seen their living standards fall, and indeed on the nature and extent of the deprivation they have experienced. The analysis of who are the gainers and losers, and by how much and in what way they have gained or lost, is an essential part of understanding the transition itself. The analysis in this appendix is based primarily on the results of a seminar on "Poverty and inequality in transition economies", held at the EBRD in May 1997 and supported by the UK Know-how Fund.

Social statistics on the standard of living and the distribution of income in command economies are particularly hard to interpret. Distorted prices, substantial transfers in kind, pervasive queuing and inadequate statistical records under the old regime, together with the difficulties of building new statistical services, make a comparison of social developments over time since the start of transition very difficult. Moreover, even in market economies, measuring the distribution of income poses considerable problems connected to the coverage of surveys, the unit of observation (households or individuals), and the measurement of income itself and of its spending power. Similarly, measures of poverty are faced with the problems of adjustment to different resource requirements for different individuals and social groups. The definition of a poverty line is always to some extent arbitrary, and the measurement of poverty needs to be done in the awareness that there are substantial potential variations in incomes and consumption below such a threshold. For these reasons, the analyst of data on poverty and income distribution in the transition has to apply particular caution. Lastly, it should be noted that poverty has many dimensions, of which income is only one. It is important to recognise these other dimensions, in particular health and education.

While we must be aware of the above caveats, sources of data are increasingly available for the transition period and a variety of indicators for developments in the standard of living can be constructed (see also Transition Report, 1995, Chapter 2). A broad conclusion from the information now available is that poverty has increased across the region as a result of falling national income, rising unemployment, reduced social transfers and declining public services. The increase in poverty differs widely from country to country, however, and in some cases poverty may already have started to decline. The varying patterns of output fall and recovery, together with the efficiency with which the state provides basic investment in health and education and a social safety net, have been crucial determinants of the different developments of living standards in the transition countries.

Developments in poverty

One indicator of the standard of living that has received attention in recent years is the development of life expectancy. Movements in life expectancy are usually fairly informative indicators of movements in health status and they have shown substantial variation across the countries of the region. As shown in Table 2.2.1, life expectancy at birth has declined precipitously in several economies, most notably Russia, where the average life expectancy for men in 1995 at 58.3 years was three years below the level of India, and a stunning six years lower than at the start of transition.¹ The fall in life expectancy in other countries, such as Ukraine and the Baltics, is similarly concentrated among the male population. Recent research indicates that there is a relationship both across countries and regions and over time between declining life expectancy rates in the transition and economic variables such as high labour turnover, rising unemployment and high levels of income inequality.² These variables are generally thought to be determinants of psychological stress, which in turn counts as one of the chief causes of increases in cardiovascular diseases and higher death rates from violence and suicides. This evidence supports the claim that for a significant number of people in transition economies the standard of living has fallen as a result of economic dislocations.³

Table 2.2.1 also shows that the decline in life expectancy has not been uniform across the region. In the Czech Republic, Poland, the Slovak Republic and Slovenia, life expectancy has increased. These economies have also

recorded some of the highest economic growth rates in the region. To some extent, therefore, movements in poverty on the income and health dimensions have been in the same direction.⁴ This broad conclusion is supported by other social indicators such as developments in infant mortality and secondary school enrolment (Tables 2.2.2 and 2.2.3), although there are important regional deviations. Infant mortality reflects the health status of children below 1 year (and of their mothers during pregnancy and nursing), which may differ considerably from the average health status of adults, the major force behind developments in life expectancy in the region. Secondary school enrolment rates are a measure of access to education.⁵ The central European countries again show an improvement in both indicators. Infant mortality has increased in Albania, the Baltics and the western part of the CIS since 1989, although the change is far less pronounced than that in life expectancy and, at least in the Russian case, the trend has been reversed since 1993. Infant mortality has declined in Armenia and Azerbaijan, a notable achievement against a background of military tensions and large falls in GDP. In contrast to developments in central Europe, secondary school enrolment rates have stagnated or indeed deteriorated sharply in Bulgaria, Romania, the Baltics and the CIS. It is important to note that while the extent of the decline in the social indicators reviewed here has been associated with the severity of the transition-related recession, one cannot assume that these worrying trends will automatically reverse themselves once recovery sets in. Monitoring people's access to health and education and hence their participation in economic growth will remain important for an evaluation of developments in poverty.

The analysis so far has focused on the health and education dimensions of poverty. Concerning the income dimension, Chart 2.2.1 gives a snapshot of the current distribution of absolute poverty across the region, measured as the share of the population living below the UNDP poverty line of US\$ 4 per person per day in terms of purchasing power parity (a level commonly used for middle-income countries).⁶ The number of poor people is small in most east European countries and increases dramatically as one moves to the poorer CIS countries of the Caucasus and Central Asia. This is to be expected, although there are some significant outliers, such as the Baltics, where in spite of relatively high average income levels

1 The table also reports life expectancy rates for 1980 and 1985. It can be seen that the decline in Russia since 1990 has followed a marked increase during the 1980s (partly as a result of the anti-alcohol campaign) but that the decline since 1989 has been far more pronounced. Cornia (1996) reports econometric times series results that shows a clear break in trend in the crude death rate during the 1990-95 period compared with 1970-89.

2 See Cornia (1996). The same study relates the decline in life expectancy in transition to historical examples of sudden and far-reaching institutional and structural changes such as that brought about by the abolition of slavery in the USA, which caused an initial deterioration in black people's health.

3 It should be noted that recent micro-survey data for Russia show a decline in poverty over the 1992-95 period (Commanier et al. 1997).

4 This is generally true for a collection of social indicators collected by UNICEF (1997). Note, however, the exception of the Caucasian countries, where in spite of war and considerable declines in GDP, life expectancy has remained stable or declined much less than in the western parts of the CIS.

5 Children's health in centrally planned economies was promoted through extensive public immunisation campaigns, but deaths from diseases such as tuberculosis have recently been on the increase. Primary school enrolment rates have traditionally been high in command economies and have generally been maintained at a level above 90%. However, there is some indication that pre-primary school enrolment rates (kindergarten) have been falling, often sharply, since the start of transition. See UNICEF (1997) for details.

6 See UNDP (1997).

Table 2.2.1

Life expectancy at birth

(in years)

Country		1980	1985	1989	1990	1991	1992	1993	1994	1995
Czech Republic	Male	66.8	67.3	68.1	67.5	68.2	68.5	68.9	69.5	70.0
	Female	74.0	74.7	75.4	76.0	75.7	76.1	76.6	76.6	76.9
Hungary	Male	65.5	65.1	65.4	65.1	65.0	64.6	64.5	64.8	65.3
	Female	72.7	73.1	73.8	73.7	73.8	73.7	73.8	74.2	74.5
Poland	Male	66.9	66.9	66.8	66.5	66.1	66.7	67.4	67.5	67.6
	Female	75.4	75.3	75.5	75.5	75.3	75.7	76.0	76.1	76.4
Slovak Republic	Male	na	na	66.9	66.6	66.8	66.8	68.4	68.3	68.4
	Female	na	na	75.4	75.4	75.2	75.3	76.7	76.5	76.3
Slovenia	Male	67.4	67.9	68.8	69.4	69.5	69.4	69.4	69.6	70.3
	Female	75.2	75.9	76.7	77.3	77.4	77.3	77.3	77.4	76.8
Albania	Male	67.7	68.5	69.6	69.3	na	68.5	68.5	69.5	na
	Female	72.2	73.9	75.5	75.4	na	74.3	74.3	75.6	na
Bulgaria	Male	68.4	na	68.6	68.4	68.0	67.8	67.7	67.2	67.2
	Female	73.6	na	75.1	75.2	74.7	74.4	75.1	74.8	74.9
Romania	Male	66.5	66.8	66.6	66.6	66.6	66.1	65.9	65.7	na
	Female	71.8	72.8	72.7	73.1	73.2	73.2	73.3	73.4	na
Estonia	Male	64.0	65.0	65.7	64.6	64.4	63.5	62.4	61.1	61.7
	Female	74.0	75.0	74.7	74.6	74.8	74.7	73.8	73.1	74.3
Latvia	Male	63.6	65.5	65.3	64.2	63.8	63.3	61.6	60.7	60.8
	Female	73.9	74.5	75.2	74.6	74.8	74.8	73.8	72.9	73.1
Lithuania	Male	65.0	66.0	66.9	66.6	65.3	64.9	63.3	62.8	63.6
	Female	75.0	75.0	76.3	76.2	76.1	76.0	75.0	74.9	75.2
Belarus	Male	65.9	66.7	66.8	66.3	65.5	64.9	63.8	63.5	62.9
	Female	75.6	75.5	76.4	75.6	75.5	75.4	74.4	75.0	74.3
Moldova	Male	62.4	63.1	65.5	65.0	64.3	63.9	64.3	62.3	61.8
	Female	68.8	69.5	72.3	71.8	71.0	71.9	71.1	69.8	69.7
Russia	Male	61.5	63.8	64.2	63.8	63.5	62.0	58.9	57.6	58.3
	Female	73.0	74.0	74.5	74.3	74.3	73.8	71.9	71.2	71.7
Ukraine	Male	64.6	66.0	66.0	66.0	66.0	64.0	63.5	62.8	na
	Female	74.0	74.0	75.0	75.0	75.0	74.0	73.0	73.2	na
Azerbaijan	Male	64.2	65.3	66.6	67.0	66.3	65.4	65.2	65.2	63.4
	Female	71.8	73.1	74.2	74.8	74.5	73.9	73.9	73.9	73.5
Armenia	Male	69.5	70.5	69.0	68.4	68.9	68.7	67.9	68.1	na
	Female	75.7	75.7	74.7	75.2	75.6	75.5	74.4	74.9	na
Georgia	Male	67.1	67.4	68.1	68.7	na	na	na	na	na
	Female	74.8	75.1	76.7	76.1	na	na	na	na	na

Source:
UNICEF (1997).

Note:

Life expectancy at birth gives a summarisation of the mortality rates across all age groups. It may be understood as the theoretical length of the life of a newborn taking all mortality rates in this year as constant.

Table 2.2.2

Infant mortality during transition, 1980-95

(per 1,000 live births)

Country	1980	1985	1989	1990	1991	1992	1993	1994	1995
Czech Republic	18.4	14.0	10.0	10.8	10.4	9.9	8.5	7.9	7.7
Hungary	23.2	20.4	15.7	14.8	15.6	14.1	12.5	11.5	10.7
Poland	25.5	22.0	19.1	19.3	18.2	17.3	16.1	15.1	13.6
Slovak Republic	na	na	13.5	12.0	13.2	12.6	10.6	11.2	11.0
Slovenia	15.3	13.1	8.2	8.4	8.3	8.9	6.8	6.5	5.5
Albania	50.3	30.1	30.8	28.3	32.9	30.9	33.2	43.2	na
Bulgaria	20.2	15.4	14.4	14.8	16.9	15.9	15.5	16.3	14.8
Romania	29.3	25.6	26.9	26.9	22.7	23.3	23.3	23.9	21.2
Estonia	17.1	14.1	14.8	12.4	13.4	15.8	15.8	14.5	14.8
Latvia	15.4	13.0	11.1	13.7	15.6	17.4	15.9	15.5	18.2
Lithuania	14.4	14.2	10.7	10.3	14.3	16.5	15.6	13.9	12.4
Belarus	16.3	14.5	11.8	11.9	12.1	12.3	12.5	13.2	13.3
Moldova	35.0	30.9	20.4	19.0	19.8	18.4	21.5	22.6	21.2
Russia	22.0	20.8	17.8	17.4	17.8	18.0	19.9	18.6	17.6
Ukraine	16.6	15.7	13.0	12.8	13.9	14.0	14.9	14.5	14.4
Azerbaijan	30.4	29.4	26.2	23.0	25.3	25.5	28.2	25.2	22.6
Armenia	26.2	24.8	20.4	18.3	18.0	18.9	17.8	14.7	14.2
Georgia	25.4	23.9	19.6	15.8	13.7	12.4	18.3	25.2	na

Source:

UNICEF (1997).

Note:

Annual number of deaths of infants less than 1 year of age per 1,000 live births. The definition of live births has changed in a number of countries over the sample period. For details see UNICEF (1997).

Table 2.2.3

Secondary school enrolment ratio, 1980-95

(% of relevant population)

Country	1980	1985	1989	1990	1991	1992	1993	1994	1995
Czech Republic	na	na	na	79.6	79.3	88.4	88.5	88.5	97.4
Hungary	69.0	72.0	74.9	74.5	74.6	75.5	78.2	81.4	91.1
Poland	77.0	78.0	78.9	77.8	78.1	79.3	80.6	82.0	83.1
Slovak Republic	na	na	88.7	88.2	88.0	92.2	93.2	90.2	91.7
Slovenia	na	na	79.3	80.3	83.1	81.9	82.9	84.7	82.5
Bulgaria	84.0	102.0	78.2	77.0	74.2	73.0	70.6	65.0	76.1
Romania	71.0	84.0	91.1	81.9	75.4	71.3	75.2	75.5	76.9
Estonia	na	na	na	88.8	87.8	86.0	83.7	84.6	78.6
Latvia	na	na	84.7	83.5	80.7	79.4	79.0	81.2	81.0
Lithuania	na	na	na	93.4	na	84.5	82.7	83.3	85.4
Belarus	na	na	88.7	86.0	85.3	83.8	84.0	84.2	84.4
Moldova	na	na	92.0	90.0	88.0	86.0	85.0	82.0	92.0
Russia	95.6	98.9	96.3	95.3	93.6	92.3	91.4	91.8	92.0
Ukraine	na	na	62.2	61.2	55.2	55.8	44.8	54.8	na
Azerbaijan	na	na	76.0	76.0	77.0	77.0	75.0	76.0	68.0
Georgia	91.0	99.9	94.2	94.9	94.4	87.8	75.9	76.0	na

Source:

UNICEF (1997).

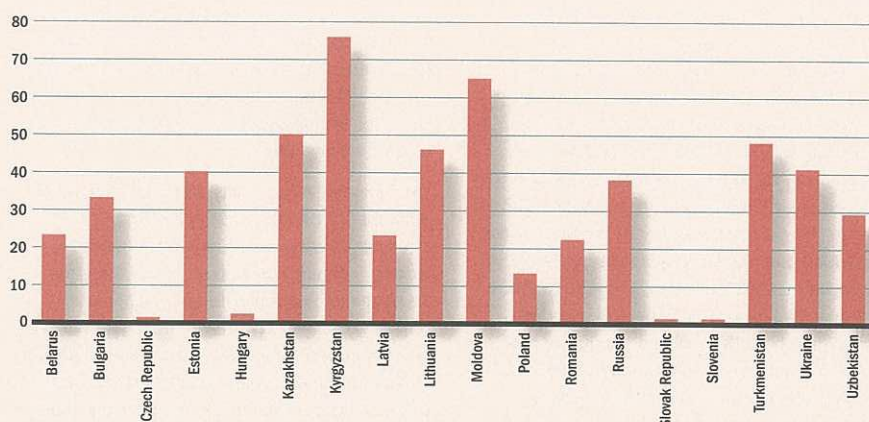
Note:

Total number of children enrolled in secondary schools as a percentage of the relevant age group. The figures refer to gross enrolment rates, which may include children below or above the relevant age (for instance, children who repeat a year at school or enrol early). The enrolment rate may thus exceed 100%.

Chart 2.2.1

Population in poverty (%)

(\$4 per day PPP\$)



Source:
UNDP (1997)

and a good growth performance in recent years, a large proportion of the population seems to suffer from absolute poverty. This corresponds to the Baltics' deteriorating record in the social indicators reviewed above.

A crucial question for understanding what has happened and thus for social policy is, who are the poor? International evidence⁷ and basic economic theory suggest that the incidence of poverty falls on those groups of the population with no independent source of income and/or low personal "entitlements" such as access to education, social transfers or public goods. Further, for the transition economies, it is important to distinguish spells of poverty from persistent poverty. In a period of rapid structural change, people may be expected to move in and out of poverty, particularly if poverty is

measured by short-term rather than longer term incomes. By pooling information from several observations in time one may reduce the likelihood that poverty is mismeasured due to temporary shocks to income, or the possibility that certain income sources occur at discrete time intervals while their use is spread over time. The share of the persistently poor in the population is typically small even in a country such as Russia, where over 30 per cent of the population may fall below the poverty line in any given year (Chart 2.2.2).⁸ For Russia and Hungary, an analysis of the incidence of persistent poverty (defined as falling below the poverty line in every year or survey period) among various groups of the population reveals strikingly different results. In Russia, mainly single person households (a large proportion of

which are pensioners) are affected, as the budgetary crisis led to an erosion in the real value of pensions, particularly during the very rapid inflation of 1992-93. In Hungary, pensions have been indexed to average wages relatively successfully (replaced in 1997 by an index combining wages and the consumer price index), the average ratio of pensions to wages has been high (around 60 per cent) and only 1.5 per cent of old age pensioners were permanently poor over the 1992-94 period. In this country, persistent poverty affected mainly children, recipients of child allowance and other dependants, such as recipients of disability pensions. In both countries, educational and professional status is an important determinant of poverty, with unskilled labourers faring much worse than white collar workers. There is a strong regional element to persistent poverty, with rural and less industrialised regions losing out relative to the metropolitan centres. Additionally, in Hungary, almost half of the Roma population (an ethnic minority prominent in south-eastern Europe) suffers from persistent poverty. In general, the quality of data and different interpretations and treatment of data can lead to sharply differing conclusions concerning the number and identity of the poor. So too can different specifications of the poverty line. Hence, one must avoid placing too much emphasis on specific numbers. Nevertheless, the general picture described here does seem to be consistent with the variety of sources available.⁹

Income inequality

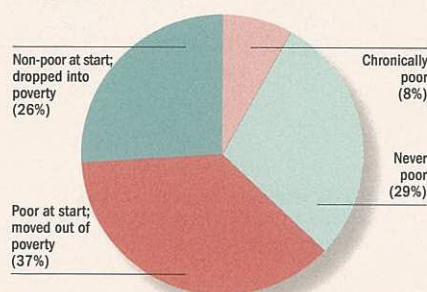
There is a close relationship between poverty and income inequality.¹⁰ Among the central European countries in 1992, the more equal societies had fewer poor people and the poor were generally closer to the average income

Chart 2.2.2

Distribution of poor by duration

Russia

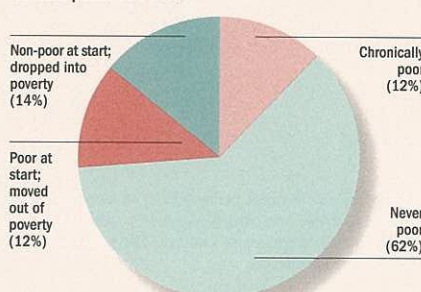
First panel 1992-93



Source:
Comander et al. (1997).

Russia

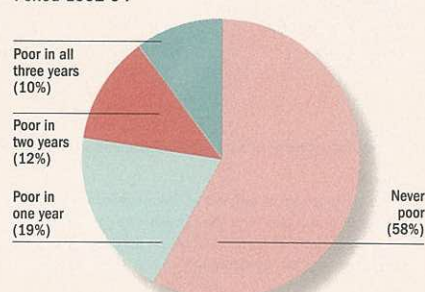
Second panel 1994-95



Source:
Comander et al. (1997).

Hungary

Period 1992-94



Source:
Andorka and Speder (1997).

⁷ See Dreze and Sen (1989).

⁸ In many existing studies, the poverty line is defined in relation to average incomes and may thus vary over time. The data for Hungary give the number of people falling below the official subsistence level. For Russia, Comander et al. (1997) construct a poverty line based on a basket of 35 commodities transformed into monetary values using regional prices. These two countries are used here because they were the only cases for which evidence on persistent poverty was presented at the EBRD conference.

⁹ For instance, the result that educational and professional status as well as location are important determinants of poverty is generally confirmed by studies looking at the characteristics of the poor in any given year (e.g. Bailey, 1997). The particular vulnerability of children during the transition process is highlighted by UNICEF (1997). This report finds that for every percentage point increase in the headcount poverty rate, poverty amongst children tends to increase by 1.4-1.6 percentage points.

¹⁰ This is so by definition, when poverty is defined relative to an average income level or to some percentile of the distribution.

earner (Table 2.2.4). However, income inequality is an issue of importance in its own right. Even when the incidence of poverty is low, substantial income inequalities can cause political instability and may depress economic growth through the effect inequality may have on human capital accumulation and investment.¹¹ At the same time, poor but relatively equal countries, including some in East Asia during the 1960s and 1970s, have grown rapidly on the basis of relatively stable political regimes and large investments in physical and human capital. In the event, their high rates of growth have led to substantial reductions in the incidence of poverty.

The transition economies started their reform process from very different initial conditions with respect to income inequality. Although special caution is warranted in using the available data, Chart 2.2.3 nonetheless suggests that the ideological emphasis on equality in command economies was not always reflected in the reality of the old regime. Most countries of the region probably fell somewhere between the lowest and the mean level of inequality recorded in the OECD, although Czechoslovakia and Hungary apparently had some of the lowest degrees of inequality in the world. In terms of earnings inequality, which is better measured than personal incomes, Russia by the late 1980s appeared to show greater inequality than Germany and France and was roughly on a par with the UK.¹²

There is no doubt that inequality has since increased substantially throughout the region. But again, this increase is far from uniform. Because starting points are often unreliable,¹³

comparisons over time are particularly difficult. The broadest data base is provided by a collection of household budget surveys for a large number of countries and years presented by UNICEF.¹⁴ These data point towards the emergence of three groups of countries, distinguished by the pattern of inequality over time. In the first group, the Czech Republic, Hungary, the Slovak Republic and Slovenia, inequality was historically low and has risen moderately, for reasons explained below. In the second group, Poland, Romania and the Baltics, inequality was slightly higher at the start of the transition and has since increased to levels at or above the OECD average. In the third group, primarily Russia and Bulgaria and perhaps including other CIS countries, inequality has shot up dramatically from moderate levels to reach levels typical of the more unequal developing countries.¹⁵

Comparisons across countries and over time are particularly affected by the measure of inequality chosen and the data quality issues raised above. The comparisons made here with other parts of the world are meant to be indicative of various patterns of change rather than an attempt to establish clear rankings. In some countries, data on income inequality calculated from official budget surveys have been challenged by the results of recent independent surveys. This Annex reports the most recent results available to us for Bulgaria, the Czech Republic, Hungary, Russia and the Slovak Republic. The data come from either independent or official household surveys and have been used to analyse some of the underlying causes of the increase in inequality

in transition economies (Table 2.2.5). Two qualifications to the general pattern sketched above emerge from these data. First, inequality in Russia as early as 1992 was probably much larger than is usually recognised by the official surveys. Second, Hungary similarly may have been initially less equal than previously thought. However, the broad trends over time in the five countries shown appear to correspond to those in the grouping above.

The increase in inequality during transition has a number of causes. First, the changing structure of economic activity may increase income inequality as workers leave the state sector either voluntarily to take higher paid private sector jobs or reluctantly to join the pool of unemployed.¹⁶ Second, earnings are likely to become more dispersed as the market system allows rewards to be more closely associated with risk-taking, training, individual talent and effort. The design of reform policies may also open new possibilities for opportunistic behaviour (such as rent seeking associated with remaining distortions), thereby contributing to increased earnings inequality. A major influence on changes in income distribution appears to have been changes in wages distribution. Somewhat surprisingly, the empirical evidence also suggests that increases in income inequality have been only moderately related to a rising premium for well-educated workers. Idiosyncratic factors, such as location or access to a private sector job (e.g. through family relations) so far outweigh individual characteristics such as the level of education and skills as determinants of personal incomes. In this respect, both theoretical reasoning as

Table 2.2.4

Poverty indicators for Visegrad countries

	Poverty rate (%)	Poverty gap (%)	Poverty indicator	Gini
Czech Republic 1992	6.0	15.0	0.90	0.2047
Hungary 1991/92	14.7	26.7	3.93	0.2812
Hungary 1994/95	14.2	31.1	4.42	0.3233
Poland 1992	16.3	26.0	4.24	0.2914
Slovak Republic 1992	5.8	15.4	0.89	0.1868
Average 1992	10.7	20.8	2.49	0.2410

Source:

Luxembourg Income Survey microdata basis; Foerster and Toth (1997).

Notes:

The poverty rate is defined as the proportion of persons in households with incomes below 60% of median income. The poverty gap is the difference between the average income of the poor and the poverty line, defined as a percentage of that line. The poverty indicator is defined as poverty rate * poverty gap * 100. The Gini coefficient is derived from the cumulative distribution of incomes across the population, ranked by per capita incomes - the so-called Lorenz curve. It is defined as one half of the mean difference between any two observations in the income distribution divided by average income.

¹¹ See Benabou (1996) for a survey of the theoretical literature linking inequality to growth. Papers addressing this issue at the EBRD seminar on Poverty and Income Inequality in Transition include Ferreira (1997), Alesina (1997). The impact of inequality on macroeconomic volatility is analysed in Aghion et al. (1997).

¹² The decile ratio (defined as the ratio of the 90th percentile to the 10th percentile of the distribution) for earnings of full-time workers in Russia was 3.36 against 4.40 in Canada, 3.40 in Britain, 3.02 in France, 2.45 in Germany and 2.44, 2.64 and 2.77 in Czechoslovakia, Hungary and Poland respectively. See Flemming and Micklewright (1997).

¹³ For a discussion see Milanovic (1997).

¹⁴ See UNICEF (1997), Table F.3.

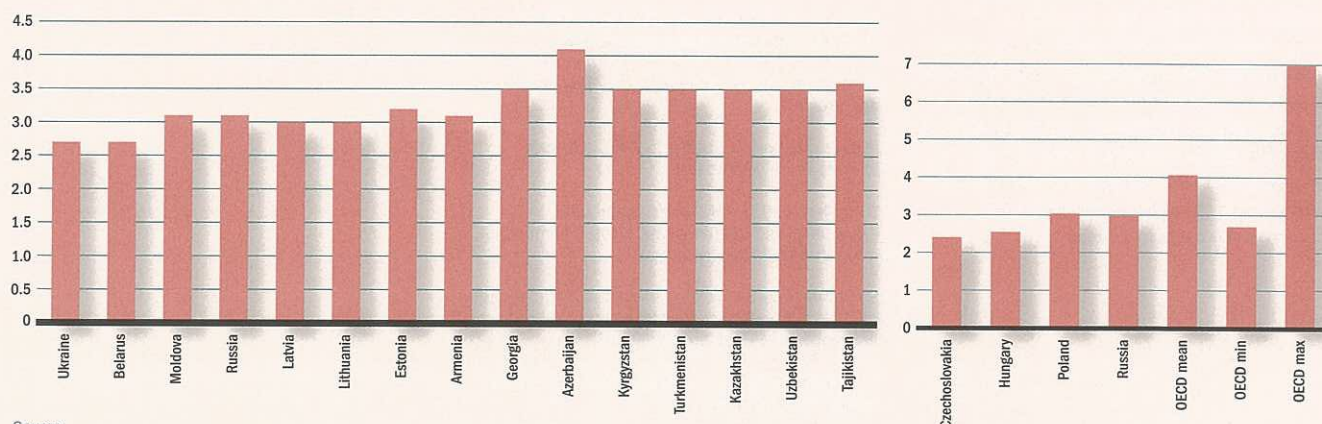
¹⁵ For instance, Russia in 1995 recorded a Gini coefficient of 0.46 (see Table 2.2.3), close to the Gini coefficients recorded in countries such as Thailand and Mexico (see World Bank, 1997). The Gini coefficient is a measure of inequality that can be derived from the cumulative distribution of incomes across the population, ranked by their income level - the so-called Lorenz curve. It is defined as half the mean difference between any two observations divided by the mean. Data are unavailable for the Caucasus and Central Asia. Inequality here was high to begin with (Chart 2.2.3) but there is no information on whether and by how much it has increased since independence.

¹⁶ See for instance Commander et al. (1997) and Coricelli (1997). The empirical evidence draws on Commander et al. (1997) for Russia, Bailey (1997), Galasi (1997), and Garner and Terrell (1997) for central Europe, and Kotzeva and Woergoetter (1997) for Bulgaria.

Chart 2.2.3

Initial inequality in transition economies differed

USSR, 1989; and Central Europe, Russia, OECD – mid-1980s



Source:
Flemming and Micklewright (1997).

Note:
The decile ratio is defined as the ratio of the income of the 90th percentile to the 10th percentile of the distribution.
The decile ratio is computed for per capita incomes.
OECD refers to 16 countries.

well as the available evidence suggest that policies which promote rapid private sector development and thus create new income opportunities for workers displaced by the relative shrinking of the state sector may also contribute to lowering inequality after an initial upward adjustment.

One additional factor that is expected to raise inequality over time is the redistribution of wealth and hence changes in the distribution of capital incomes. The privatisation of state

assets in transition economies has profound implications for wealth distribution. The empirical evidence concerning the effect on income distribution so far is very limited. In Russia, changes in the distribution of capital incomes have contributed only little to the overall rise in income inequality. However, the distribution of wealth in addition to generating capital incomes (which in many cases will not be properly recorded) is important in its own right: it may influence individuals' ability to

borrow and invest, and more generally to command resources. It also has important dynamic implications for economic growth in the presence of capital market imperfections, which are likely to receive continuing attention as the transition proceeds.¹⁷

A particularly interesting aspect of changes in income inequality concerns the impact of government redistribution through the tax and benefit system. The efficiency of social targeting differs tremendously across countries. In some cases, the relatively richer parts of the population have benefited disproportionately from social benefits and inequality has increased as a result of redistribution.¹⁸ The need for efficient social targeting is crucial in many CIS countries, where the collapse of government revenues severely limits their ability to counteract growing inequality in gross earnings through redistributive policies (see in particular Chapter 7 on the fiscal situation in the CIS). More generally, choices over cuts in fiscal expenditures should bear in mind the particular dependence of poorer segments of the population on the provision of basic public services, such as health and education.

In sum, poverty and income inequality have increased in most transition economies since the late 1980s. Some increase in income inequality in the region, even in the long run, is probably an unavoidable consequence of the introduction of market-based rewards. The scope of structural change and economic dislocation may introduce some additional temporary inequality. However, as the varying developments across the region suggest, the major determinants of the rise in poverty and

Table 2.2.5

Inequality has generally increased but to different degrees – Gini coefficients

Russia (1992-95)	Round 1	Round 2	Round 3	Round 4	Round 5	Round 6
Gini	0.426	0.419	0.441	0.439	0.465	0.458

Source: Russian Longitudinal Monitoring Survey

Bulgaria	1989	1990	1991	1992	1993	1994	1995
Gini	0.217	0.228	0.235	0.331	0.337	0.366	0.378

Source: Bulgarian Household Business Survey

Hungary	1992	1993	1994	1995	1996
Gini	0.283	0.284	0.287	0.3	0.302

Source: Hungarian Household Panel (TARKI)

Czech Republic	1989	1993
Gini	0.183	0.187

Slovak Republic	1989	1993
Gini	0.176	0.185

Source:
Family Business Survey

Notes:
Russia: Gini on per capita basis, Commander et al. (1997).
Bulgaria: Gini on per capita basis, Kotzeva and Woergoetter (1997).
Hungary: Gini grouped by deciles, Galasi (1997).
Czech Republic and Slovak Republic: Gini per capita, Garner and Terrell (1997).

For definition of the Gini coefficient see Notes to Table 2.2.4.

For Hungary, the Gini coefficient is computed for decile averages only. For all other countries the calculations are on a per capita basis.

¹⁷ See Ferreira (1997); Benabou (1996).

¹⁸ Bulgaria seems to be a case of regressive transfers (Kotzeva and Woergoetter, 1997). An interesting contrast can also be established between the Czech and Slovak Republics, both of which run a relatively extensive and efficient redistribution system. However, relative to the resources expended, the Czechs seem to have been more successful in targeting the poorest parts of the population. Possibly in part as a result of this difference, inequality since 1989 has increased by less than in the Slovak Republic (Garner and Terrell, 1997).

inequality are probably the severity of the output falls and differences in the willingness and ability of the state to maintain the provision of basic public services and an efficiently targeted social safety net. Creating an investment climate conducive to private sector development and resolving the budgetary crisis in many countries of the region remain two crucial policy challenges, not just for generating economic growth, but also to allow for an improvement in the standard of living of those who have so far borne a disproportionate burden of the costs of transition.

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Part II

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Growth in transition economies: sources and obstacles

3

Most transition economies are now growing. This is in contrast to the position only a few years ago, when many were experiencing extreme upheaval and rapid falls in output (see Chapter 7). In some countries, such as Poland, growth has been sustained for six years whereas in others, such as Azerbaijan, it is just beginning. Increases in output suggest that the transition economies are recovering from the effects of the collapse of central planning and the liberalisation of markets, but these increases may also indicate the start of more sustained economic growth. Because of the brief history of transition, it is not easy to separate these two aspects of emerging growth (initial recovery and sustained expansion). However, the speed and strength of the growth are closely associated with sustained, broad-based market liberalisation and macroeconomic stabilisation (see previous editions of the *Transition Report*). Basic questions for the analysis and formation of economic policy are whether this initial growth will be sustained and what measures will be needed to deliver rapid growth over the medium and long term.

Sustained growth requires investment in new plant and equipment and in new skills, as well as innovation in technology and business management. However, growth does not inevitably result from this, and the state cannot insist on the investment and innovation which will produce growth. Neither do they simply “happen” in an automatic way regardless of the actions of government. It is important to recognise that growth stems from the initiatives of entrepreneurs, managers and workers and that their activities are shaped by an economy’s “institutional infrastructure”. The term “institution” here covers the practices, rules and organisations that guide and govern economic activities. The institutional infrastructure of a market economy includes the way that markets operate, the ease of entry into the market by new firms (the avoidance of bureaucratic obstacles and restrictive procedures) and for the exit of established firms (including bankruptcy procedures), property law and contracts and their judicial enforcement, taxation, the effective regulation of financial and infrastructure services and environmental protection.

In transition economies enormous change has been brought about by liberalisation, privatisation and progress towards the establishment of market-based institutions. However, there are many remaining challenges associated with the way that market forces interact with the economic practices, structures and institutions inherited from central planning. In market economies, rivalry among firms is a driving force for innovation, and the search for competitive advantage and profit opportunities continually leads

to improvements in technologies and business organisation. These market forces have already initiated substantial structural change and restructuring in transition economies and they will bring about future innovation and development.

Growth in transition economies hinges, therefore, on the economic incentives faced by businesses and individuals, on how they operate in the market and on the new and evolving institutions and government policies. This chapter focuses on the factors governing growth, such as the legacies inherited from central planning, the extent of market competition, the organisation and ownership of firms and financial institutions, the capacity of the state and the behaviour of government. This analytical approach is, in essence, a market-driven perspective on the growth process which focuses on innovation (commonly referred to as “Schumpeterian”¹). This is surely the natural approach to growth in the transition, a process which is itself all about markets and change.

The other chapters in Part II of the *Report* expand on the key theme developed in this chapter: the central role of market competition and enterprises in the process of growth. Chapter 4 examines the changes in broad economic structures and in patterns of specialisation in production resulting from the introduction of market mechanisms in transition economies. It also focuses on enterprise performance and restructuring. Chapter 5 assesses what is needed from government for the development of well-functioning markets and well-performing enterprises in transition economies. Particular emphasis is given to exploiting the links between key policies, to harnessing the strength of the state and to strengthening the behaviour of government. The final chapter in this part of the *Report*, Chapter 6, assesses the prospects for growth in the region, drawing on both historical evidence from industrialised and developing market economies and on techniques that allow some weighting of various factors which determine long-term growth in market economies.

Section 3.1 of this chapter summarises some of the main economic theories of growth, which analyse the role of investment in plant and equipment, the acquisition of skills, innovation and institutions. This analysis involves some conceptual analysis of the sources of growth, but it is an unavoidable prerequisite for the identification of the key factors underlying growth and for the assessments of prospects and policies for the future. Section 3.2 discusses how the particular features of transition economies form a unique combination of sources of, and obstacles to, growth. Section 3.3 provides some brief conclusions.

¹ See, in particular, Schumpeter (1932) and (1943). The “Schumpeterian” perspective has a long lineage, dating back at least to Marx’s description of the process of growth under competitive capitalism (see Marx [1867]). Marx understood much about the forces of competition but failed to see how powerful competitive capitalism would be over the long term in creating and sustaining growth and change. The Schumpeterian tradition has been taken forward within modern growth theory, and this recent work informs the discussion which follows.

3.1 An economic perspective on growth

For the output of an economy to grow, at least one of two things must happen. Either the inputs of capital and labour used to produce goods and services must expand or the efficiency with which inputs are used in production must increase. The purpose of this section is to examine the processes in a market economy which determine the level of investments in plant and equipment and the development of a skilled workforce. It also looks at the circumstances that generate innovations in technologies, new products and ways of organising businesses. Market-driven investment and innovation are likely to make significant contributions to growth in transition economies. However, the extent of their contribution will be shaped by the effectiveness of the newly established institutions which determine the incentives and constraints for enterprise investment and innovation. Moreover, the contribution of innovation is likely to be unusually strong because of the unusual circumstance of transition economies. With their legacy from central planning of massive but misallocated investments in both the workplace and the workforce, a priority is to find more effective ways of making use of existing resources, although some plant and equipment has been simply rendered economically obsolete by market reforms.

Early discussions on growth focused on the quantity of physical capital, such as plant and equipment, as the most important factor, treating the growth in labour (population) as determined by other, non-economic factors.² However, it is increasingly recognised that the qualities of both capital and labour (in terms of their potential contributions to output) can vary widely and that improving the quality of both physical capital and individual skills (human capital) is just as important for growth as increasing their quantity. Of similar importance is the way in which different factors and skills are combined in the organisation of production. Investment in new machinery and a skilled workforce must be financed through savings by households, domestic enterprises, foreign investors or government. The achievable rate of growth in output also depends, therefore, on the mobilisation of savings.

Investigations of growth in industrialised and developing market economies find that it is not easy to account for the bulk of long-term growth by simply attributing it to the accumulation of physical and human capital, at least not as typically measured (see Chapter 6).³ The “residual”, the growth in output that cannot be accounted for by the growth of other factors, is sometimes described as “technical progress”. This residual is also sometimes known as growth in total factor productivity. Because technological change is itself an outcome of economic decisions, this finding emphasised the importance to growth of the mechanisms and the economic and institutional conditions that foster innovation.

Box 3.1

Elementary growth theory

A basic building block of growth theory is the relationship $Y = F(K)$, which shows how much output Y can be produced with the aggregate capital stock K , under a given state of knowledge, with a given range of available techniques and with a given set of other non-capital inputs (as embodied in the function F). While investment contributes directly to growth in output through an increase in feasible production, a crucial assumption is that there are diminishing returns to capital. In other words, the marginal productivity of capital decreases as capital accumulates. In a closed economy, moreover, gross capital accumulation (gross investment) must equal aggregate savings. In the models which follow, issues concerning aggregate demand and the process by which savings and investment come into balance are put to one side, with full employment of factors assumed, in order to focus directly on the effects of capital accumulation.

In the basic model introduced by Solow (1956), it is assumed that people save a constant fraction s of their income Y , so that gross capital accumulates at rate sY . If a constant fraction δ of the capital stock disappears each year as a result of depreciation, then the net increase of the capital stock is $\Delta K = sF(K) - \delta K$. In the absence of population growth and/or technological progress, such an economy cannot grow forever at a positive rate. Indeed, because of diminishing returns to capital, national income $F(K)$ does not grow as fast as the capital stock, which means that savings $sF(K)$ cannot grow as fast as depreciation. Eventually depreciation catches up with savings and at that point the capital stock stops rising and the economy stops growing.

The fundamental determinant of long-term growth of income per capita is therefore the rate of technical progress in this framework. Long term here means the steady-state in which output and the capital stock grow at the same constant rate (which may be zero without technological progress). Recall that $F(K)$, the production function, was defined for a given state of knowledge. A higher savings (investment) rate raises the rate of growth temporarily, that is over the medium term. If maintained, it permanently increases the long-term level of per capita income, but the long-term rate of growth does not depend on the savings rate. Of course, the medium term may last for many years, so savings and investment behaviour remain important factors for growth.

Another implication of this model (sometimes called conditional convergence) is that, for two economies characterised by the same technology, savings rate and depreciation rate, the economy that begins with the lower level of income per capita will have a higher growth rate of income per capita because of diminishing returns to capital accumulation. This implies that a relatively low initial level of capital stock raises the medium-term growth rate of an economy, other things being equal. Of course, this does not mean that the levels of income per capita in different countries or regions will converge over time, since those will typically differ in structural characteristics, such as the level of technology, savings rate and other factors.

² This is a simplification of a long and rich history of the theory of economic growth. In some of the earliest systematic discussions of growth (such as by David Ricardo), land was considered an important limiting input and working capital to pay labour ahead of the harvest played a prominent role. However, at least since Marx, physical capital has been at the centre of the discussion of growth in capitalist economies. Nevertheless, for the purposes of this chapter, where the focus is on the economic and institutional framework that fosters the accumulation of private capital and technological change, land and other inputs (natural resources) can be omitted.

³ Measured capital accumulation often does not adequately account for improvements in the quality of such inputs. Jorgenson and Griliches (1967) showed that when capital and labour inputs were carefully adjusted for quality changes, much of the “residual” in post-war US growth could be accounted for by factor accumulation. While later studies have disputed the quantitative findings for the United States and other countries, this work focused attention on the need to make quality adjustments to both measured inputs and outputs, and on the economic mechanisms that generate quality change in an economy.

The findings that much of growth cannot be accounted for by investment alone also underline an important lesson from economic growth theory. While investments in skills, plant and equipment are critical to medium-term growth, they cannot by themselves sustain growth in output per person over the long term. Because additional investment tends to become less productive as the amount of capital per worker increases (which is often referred to as the “diminishing marginal productivity” of capital),⁴ the impact of investment on growth tends to decrease over time. This leaves technical progress as the primary source of sustained growth in output per person over the long term (see Box 3.1).

One way to offset the effect of the diminishing productivity of capital and to boost the growth rate temporarily is to increase the aggregate savings rate and the rate of investment.⁵ This was the approach to boosting faltering growth rates in centrally planned economies of eastern Europe and the former Soviet Union, as their savings and investment rates doubled from 15 per cent of GDP to 30 per cent between the 1950s and 1980s (see Chapter 6 of the 1996 *Transition Report*). The poor growth performance of countries in the region was partly due to the misallocation and poor quality of capital investment (see Chapter 3 of the 1995 *Transition Report*). However, their failure to sustain growth also confirmed the basic lesson of the Schumpeterian growth perspective, which is equally applicable to market economies. Growth which does not embody continued advances in technology cannot be maintained indefinitely. Investments in the workplace and the workforce, particularly that driven by competitive market price signals, are important to raising the level of output per capita. Nevertheless, in order to sustain positive growth in output per capita, there must be continued advances in the form of new goods, new markets, and new ways of organising and conducting business. In other words, there must be technological progress.

Much progress has been made in recent years in formalising the insights associated with Schumpeter and others concerning the process by which technological progress is generated and remunerated in market economies.⁶ The Schumpeterian perspective on economic growth arises from the following set of ideas. Innovations (which lead to the introduction of new production processes, new products, new management methods and new organisation of production activities) are created by self-interested firms, entrepreneurs and researchers who expect to be rewarded in the event that their innovation is successfully implemented.⁷ These rewards are often seen as monopoly rents (profits earned from market

power) in that they result from the special position of a firm which has successfully made an innovation. In general, these rents will eventually be dissipated, as the new processes or products introduced by current “innovators” will become obsolete at some point in time. That is, new innovations will occur in the future which will compete with current innovations and, possibly, drive them out of the market entirely. The Schumpeterian approach to growth is thus based on the notion of “creative destruction”, by which Schumpeter meant the competitive process whereby entrepreneurs are constantly looking for new ideas and for new sources of rents that will render their rivals’ ideas obsolete.

Technological progress involves a whole range of inputs to, and participants in, the production and diffusion of innovations, not just the small part that takes the form of formal research and development (R&D) activities. Innovations are created by a variety of self-interested individuals in the process of trying to solve new production problems, to learn from experience, to find new and better ways of organising and conducting business, to profit from opening new markets, and to adapt methods and processes invented elsewhere to the domestic or local market environment. By focusing explicitly on innovations as an economic activity, distinct from capital accumulation, the Schumpeterian approach to growth enables a deeper understanding of how market structures and imperfections, international trade, technological spillovers, business organisations, financial institutions and the legal framework affect long-term growth through their effects on incentives to engage in knowledge-producing activities. Box 3.2 summarises the key findings of the Schumpeterian perspective on growth.

By focusing on innovative activity and entrepreneurship as key sources of productivity growth, the Schumpeterian perspective provides an important starting point for analysing growth prospects in transition economies. Structural change, enterprise restructuring and significant productivity improvements will constitute a driving force for medium-term growth in transition economies. This growth will arise from the proliferation of new private businesses, from foreign direct investment and the potential technology transfers it generates and from the creative restructuring and reallocation of existing enterprises and capital resources. Key challenges for growth include reforms that facilitate the new entry of enterprises, the selection by market competition and survival of superior projects and firms and the allocation of capital resources to them, and the restructuring of existing activities inherited from the previous regime of central planning.

⁴ With just two factors, capital and labour, constant-returns-to-scale (that is, production conditions where doubling all inputs leads to a doubling of output) necessarily implies the diminishing marginal productivity of each factor.

⁵ Another way in which the effect of the diminishing productivity of capital may be offset permanently is through the benefits of learning associated with investment. While investment by individual firms may be subject to diminishing returns, a by-product of investment is often the collective accumulation of technological and organisational know-how through learning-by-doing and learning-by-watching (demonstration effects). If this effect is sufficiently strong, the diminishing returns to capital at the firm level can in principle be overcome at the level of the economy as a whole. See Frankel (1962) and Romer (1986).

⁶ Earlier growth theory and associated empirical work showed the importance of technological change, but provided only limited formal explanation of how it was produced or remunerated. In fact, under the standard assumption of constant returns to capital and labour, one can show that once these factors of production have been remunerated at their competitive price, there is nothing left to remunerate “technological progress”. Without an incorporation or an explicit analysis of the determinants of technical progress, growth theory was, from a purely formal perspective, equally applicable to centrally planned and market economies. This is not to say, of course, that centrally planned economies were actually successful at producing high-quality investment, technological change and growth. The “Schumpeterian” perspective places greater emphasis on the market mechanisms generating technological progress and thus are particularly relevant to transition and other market economies.

⁷ The Schumpeterian approach is an example of so-called “endogenous growth theory” because it seeks to explain the process of technological change as the consequence of rational decisions and actions of firms and entrepreneurs.

Box 3.2**The main results of the Schumpeterian approach**

Technological progress results both from purely innovative activities and also from the diffusion or adaptation of new technologies or products to other sectors or market environments. In Schumpeterian models of economic growth, firms compete by devoting resources to innovation, for which research and development (R&D) is used as a shorthand (see Romer [1990], Aghion and Howitt [1992] and [1997]). The outcome of this effort is uncertain in the sense that, with various probabilities, some experiments succeed and others fail. The probability of success depends positively on the level of R&D. If a firm produces a successful innovation, it earns temporary “monopoly” rents, but these are competed away when other firms (be they incumbent firms or new entrants) generate superior inventions. In addition, the rents may decline as the existing innovations diffuse or spread through the economy – for example, through demonstration effects and learning-by-watching. The rate of growth of the economy depends on the rate of innovation generated by total R&D in the economy.

The long-term rate of growth will therefore depend positively on any factor which increases the probability of successful innovation or the rents accruing to innovation, or which reduces the cost of innovation. Factors that increase the rate of diffusion have ambiguous effects on growth from a theoretical perspective. While these factors increase the use of superior techniques or products and thus raise productivity, greater diffusion normally means less ability of the original innovating firm to capture rents, and thus less incentive to innovate in the first place.

Innovation in the Schumpeterian framework tends to be fostered by:

- a high productivity of R&D – this encourages further R&D and therefore increases the expected number of innovations;
- a large supply of skilled labour – more skilled labour decreases the cost of implementing and diffusing new innovations throughout the economy;
- a large market size – this provides higher rents for successful innovators, indicating a growth-promoting role for trade liberalisation and market enlargement, such as accession to the European Union;
- a legal environment in which property rights on new innovations are adequately enforced;
- a low real interest rate – R&D, like any other investment activity, tends to be discouraged by high real interest rates (hence the need for both macroeconomic stability and financial development);

- low depreciation rates for physical and human capital – the lower these depreciation rates, the higher is the net present value of investing in new vintages of capital goods and/or new skills (hence the importance of education policy);
- flexible labour markets – lower hiring and firing costs facilitate implementation of new technologies by reducing the associated labour costs and mitigating the power of vested conservative interests;
- a strong, market-oriented infrastructure – this facilitates productivity, flexibility and effective markets.

The widespread adaptation of new technology also tends to be fostered by:

- a high degree of mobility of skilled workers across firms and sectors – this speeds up the diffusion of new technologies throughout the economy;
- a high degree of R&D spillovers (learning-by-watching and other activities) across firms, sectors and countries – this directly contributes to technological diffusion. International R&D spillovers are facilitated by trade with technologically more advanced countries (see Coe and Helpman [1995]);
- a high rate of learning-by-doing within particular sectors and of learning across sectors or countries – this is promoted by labour mobility to disseminate information;
- market-oriented infrastructure – this facilitates mobility, spillovers and learning.

There are both positive and negative effects of product market competition on the incentives both to innovate and to adapt. While more product market competition tends to reduce rents (profits from market power) and thereby discourage innovative activities by small entrepreneurial firms, it also reduces managerial slack within large enterprises, forcing them to adopt new innovations and to restructure and reorganise their activities. In addition, product market competition enhances the mobility of workers across sectors which, as was argued above, speeds up the diffusion of new technologies and intensifies learning-by-doing. While the overall effect of competition on growth is ambiguous from a theoretical perspective, recent empirical studies on different countries have found a positive association between product market competition and the rate of productivity growth in manufacturing industries (see Blundell et al. [1995] and Nickell [1996]).

The challenges for growth in transition economies also include measures that improve the environment for business investment. If firms cannot take advantage of the benefits of investment because they are subject to arbitrary losses through corruption and criminality (or the threat thereof), to unpredictable tax regimes and to ineffective judicial enforcement of property rights and contracts, their incentives to invest are blunted and investment is discouraged. Foreign direct investment is particularly sensitive to these risks, since foreign investors are able to look elsewhere and global competition for capital funds is intense. Moreover, both investment and domestic savings are influenced by financial institutions that can provide secure outlets for household and corporate savings and that can channel them into productive, market-oriented investment projects. Even without formal consideration of these aspects, the results summarised in Box 3.2 and above point to the importance of the institutional structures for investment and savings.

Before turning to a detailed consideration of the factors governing growth in transition economies, however, it is useful to examine briefly available evidence on the determinants of growth in industrialised and developing market economies. A number of investigations have attempted to identify key factors which are empirically associated with growth. Despite data and statistical difficulties, the main conclusions from this work support some of the important aspects of the economic perspectives on growth reviewed above. Chapter 6 provides a more detailed analysis of the cross-country evidence regarding the factors governing productivity and growth.

A basic result of the economic perspective of growth is that, if there are diminishing returns to capital, countries with lower levels of per capita income grow more rapidly than those with higher levels of income, other things being equal. There is some evidence that this is the case, which would imply that diminishing returns to capital will lead to a convergence of GDP per capita.⁸ However, this process of catching up has been very slow, and applies only to groups of countries that are relatively similar in terms of other determinants of growth, such as levels of labour skills and institutional arrangements.

There is, in addition, considerable evidence that growth is stimulated by a skilled workforce, adequate institutional and physical infrastructure, political stability, economic openness and absence of market distortions. The importance of skills (measured by school attainment, for example) arises not only from their direct contribution to output but also from their indirect impact on output growth through productivity gains.⁹ These effects are significant both for countries which generate technological changes and for those which rely on adapting technologies from more advanced countries. Aspects of the institutional infrastructure have a significant influence on growth. Indicators of institutional development, such as measures of the rule of law, are significantly and positively associated with long-term growth,¹⁰ and there is evidence that political instability (measured by the frequency of strikes and of coups, for example) is detrimental to growth.¹¹ Economic openness to foreign trade and the absence of significant market distortions (in the form of a black market premium) also contribute significantly to growth in market economies.¹²

An important conclusion to be drawn from available evidence on the determinants of long-term growth in market economies is that an environment supportive of private investment and well-functioning markets is associated with high, sustained rates of growth. Also, a skilled workforce facilitates innovation and the spread of new technology and thus contributes to an increase in growth for countries with relatively low levels of per capita income.

3.2 Factors governing growth

The main factors governing growth are the same for both transition economies and market economies. However, in transition economies certain features have been inherited from the previous centrally planned system that also affect prospects for medium- and long-term growth. Among the most important features are a well-educated workforce, relatively old and economically obsolete plant and equipment, a need for radical reallocation of resources both within and between sectors, an inadequate physical infrastructure, and underdeveloped market-oriented institutions. This chapter examines separately the sources of, and obstacles to, growth in transition economies. There are, however, strong paral-

els between these two elements since any removed obstacle is an additional source of growth.

Consideration is given to four general sources of growth: recovery from the recession that tends to take place at the early stages of transition; structural change and enterprise restructuring; the high level of education of the workforce; and lastly investment and technological change. The first two sources are relevant for only a limited period, albeit important and possibly long lasting, while the others are permanent factors. Chapters 4 and 5 discuss these temporary sources of growth in more detail, while Chapter 6 attempts to quantify the impact of both the temporary and permanent factors governing growth prospects in the region. This section also considers four general obstacles to growth: impediments to competition; weakness or absence of market-oriented institutions; bureaucratic interference, corruption and criminality; and underdeveloped financial sectors.

Sources of growth

Recovery from the transition recession

The magnitude and duration of the slump in the early stages of transition differ sharply across the region, being significantly larger in CIS countries than in central Europe. For example, the measured decline in output from the pre-reform levels to the trough during the transition varied from lows of about 20 per cent in the Czech Republic, Hungary and Poland to much deeper levels in the region of the former Soviet Union, with declines of about 45 per cent in Russia, 50 per cent in the Baltics and 60 per cent in Ukraine. Considerable caution must be exercised in interpreting these figures, however, because of the difficulties in measuring output accurately in transition economies. Among the most serious measurement problems are those associated with the growth of the informal economy, the improvement in the quality and customer-orientation of goods and services, and the growth of the service sector, none of which tends to be captured very accurately in available statistics on output and price indices (for discussions of these issues, see Chapter 4 of this *Report* and Chapters 2 and 11 of the 1995 *Transition Report*). Notwithstanding these limitations, it seems clear that transition has involved greater disruption in the former Soviet Union than in central Europe.

Because of the distorted economic structures and production patterns within enterprises inherited from the central planning of the previous regime, price and trade liberalisation and removal of enterprise subsidies led to a large number of economic activities becoming loss making and non-viable. These changes brought about an initial contraction in output and forced state-owned and privatised enterprises to restructure their activities or to face closure. Moreover, the introduction of markets had the effect of disrupting the traditional trade links and supply chains among

⁸ See, for example, Chapters 11 and 12 of Barro and Sala-i-Martin (1995).

⁹ See Benhabib and Spiegel (1994).

¹⁰ See Knack and Keefer (1995).

¹¹ See Alesina and Rodrik (1994).

¹² See Edwards (1997).

producers, requiring a restructuring of commercial relationships and a search for new customers and supply sources.¹³ The extensive vertical integration and regional specialisation in the organisation of production activities in the former Soviet Union contributed to the more severe drop in output in this region compared with the decline in central Europe. The countries of the former Soviet Union were also severely affected by the extreme macroeconomic instability and trade disruption associated with the collapse of the federal Soviet state.¹⁴ However, market liberalisation is a “one-off” event and the effects of these factors can be expected to fade.

While initial economic conditions at the start of reform and market liberalisation are associated with a decline in output early in the transition, it is important to recognise the central role of these reforms in introducing market forces and thereby promoting growth. There is now considerable evidence that macroeconomic stabilisation and broad-based structural reform stimulate a market-led recovery from the recession in the early stages of transition and lay a foundation for medium-term growth. A number of investigations examine the contribution of market-oriented reforms (as measured by the EBRD’s transition indicators, for example) and of macroeconomic stabilisation (as measured by inflation rates and fiscal deficits) to growth rates in transition economies.¹⁵ The findings of these studies, and the analyses of the previous *Transition Reports*, support the view that stronger growth in transition economies is associated with superior macroeconomic stabilisation and the more effective operation of market forces. These factors explain much of the variation in short-term growth in the region (such as the divergence in growth between central Europe and the CIS). There is also evidence that these factors are associated with increased foreign direct investment (FDI) per capita (see Chapter 7),¹⁶ suggesting that a critical element of growth, namely private investment, is unlocked by these measures.

As with all empirical work, however, these studies are subject to qualifications. Data measurement is extremely difficult (as discussed above in relation to output measures), the liberalisation and structural reform indices are imperfect, and the sample period is too short to draw definitive conclusions about medium-term growth prospects. Despite these problems, the studies all point to the same basic conclusion: macroeconomic policies and market-oriented reforms both generate stability and efficiency and promote output recovery and growth.

Enterprise restructuring, new firms and structural change

Transition countries are operating far below their production potential. This is due to their inheritance of distorted economic structures and inefficient methods of production within enter-

prises, together with the initial upheaval associated with the collapse of the old system. However, to realise this potential from the existing inputs, it is not sufficient to acquire new, market-oriented technology and skills, important though that is. It also requires a radical change in the way that resources such as plant and equipment and the workforce are allocated and used. This involves a market-driven process of searching for new products, processes and organisational arrangements and developing new market-based relationships. This process includes both restructuring of existing enterprises and new business start-ups. Both of these are closely linked to the institutional infrastructure, which shapes the incentives and constraints on firms and on resource mobility more generally.¹⁷

The introduction of market-oriented reforms not only led to a large number of the existing economic activities becoming loss-making (particularly in industry and defence-related sectors) but also it created new profit opportunities (mostly in service sectors and, in some countries, agriculture – see Chapter 4). These new market opportunities in turn should create a strong incentive for existing enterprises to undertake investments aimed at changing existing working methods and to upgrade technologies or improve existing resources in some way. Such investments, together with new management and a more customer-oriented business approach, are at the heart of the process of “deep” restructuring of enterprises (see Chapter 8 of the 1995 *Transition Report*). At the same time, new private businesses (domestic and foreign), if unimpeded by bureaucratic and other obstacles to entry, are likely to develop new market opportunities created by the reforms. Private firms can also challenge the existing state-owned and privatised enterprises in established sectors.

Strengthening product market competition should also reduce the scope for inefficiency within firms and spur innovation in technologies and business organisations. The main ways in which competition has been strengthened in transition economies are economic openness through trade liberalisation and new entry by domestic and foreign producers, with the reduction of bureaucratic and other obstacles to private activity (see Chapter 4). Restructuring in existing firms is being facilitated by developing adequate governance structures through privatisation and mechanisms for corporate control that enable more efficient ownership structures to evolve (such as concentrated outside ownership). The development of well-functioning credit markets should also help these firms make the new investments required for a “deep” restructuring of their activities.

As shown by the recent growth in some transition economies (see Chapter 4) and by the experience of emerging Asian economies

¹³ Blanchard and Kremer (1997) and Roland and Verdier (1997) develop formal models of the output decline based on the “disorganisation” and the search for new suppliers and customers which follows the creation of markets.

¹⁴ See de Melo et al. (1997) on the role of initial conditions in the output decline in transition economies.

¹⁵ See, for example, Aslund et al. (1996), Berg et al. (1997), de Melo et al. (1996), Fischer et al. (1996), Sachs (1996) and Selowsky and Martin (1997).

¹⁶ See Lankes and Venables (1996) and Selowsky and Martin (1997).

¹⁷ See McMillan et al. (1989) for evidence, based on the Chinese experience, that the introduction in 1978 of market-based incentives, and individual rather than collective responsibility and rewards, raised agricultural productivity substantially within a period of only a few years. The scale of the reform was such that, even though it may not have changed the permanent rate of growth of productivity (as opposed to its level), it produced rapid growth in agricultural output over the medium term and made possible other growth-enhancing reforms in the industrial sectors of the Chinese economy.

including China, new private firms are probably the most significant potential source of output recovery and growth. These firms provide a natural channel through which markets can reallocate resources and activities to more cost-efficient and more demand-oriented uses. Such firms are unencumbered by past business decisions, such as those regarding product lines, investment and location, and are able to develop freely new market opportunities. New private firms are also likely to be more responsive and flexible and, therefore, more competitive due to their small size and because the workforce is likely to be more dedicated owing to the close relationship between ownership and managerial control of the firms.

Labour skills

An important feature of transition economies is the high level of education inherited from the socialist era. People are far better educated than in other countries at similar levels of income per capita (see Chapter 2 of the 1995 *Transition Report*).¹⁸ In the former Soviet Union, for example, enrolment in primary and secondary education has been almost universal since the late 1950s. In 1989 over 90 per cent of employees had taken eight or more years of school and university and, in 1989-90 there were more university students relative to the total population in Russia than in most OECD countries. Table 3.1 shows measures of education for all transition economies (primary, secondary and tertiary education enrolment rates) along with comparable measures for high-income (industrialised market) countries and middle-income (developing market) countries. Throughout the region there is extensive access to education at all levels, which in many countries is on a par with that of industrialised market economies.

The mix of skills generated by the previous system of education and training, however, is not well-suited to the requirements of a market economy. Problems include a lack of attention to social sciences, including law, economics and business administration, a strong emphasis on mathematics and science but a weak emphasis on problem-solving, and an excessive allocation of resources to fundamental research at the expense of product development (with the exception of the military sector). These and other features of the education system in post-communist countries call for structural reforms aimed at refocusing programmes and research priorities towards the needs of a market economy while maintaining the positive legacy of education from the previous system.¹⁹

This inheritance of a skilled workforce can promote growth in various ways. Since skilled labour generally adds to the productivity of physical capital, such as plant and equipment, an abundant supply of skilled labour increases the profitability of investment and provides enterprises with an incentive to invest. While this is important, skilled labour plays another more

Table 3.1

Levels of education in transition economies, 1993

(in per cent of relevant age group)

	School enrolment		
	primary	secondary	tertiary
Albania	96	na	10
Armenia	90	85	na
Azerbaijan	89	88	na
Belarus	96	92	44
Bulgaria	92	72	23
Croatia	85	83	27
Czech Republic	103	86	16
Estonia	83	92	38
FYR Macedonia	87	54	16
Hungary	95	81	17
Kazakhstan	86	90	42
Latvia	83	87	39
Lithuania	92	78	39
Moldova	77	69	35
Poland	98	84	26
Romania	95	na	na
Russia	107	88	45
Slovak Republic	101	89	17
Slovenia	97	89	28
Tajikistan	89	100	na
Ukraine	87	80	na
Uzbekistan	80	94	na
Middle-income countries	104	62	20
High-income countries	103	97	55

Source: World Bank, World Development Indicators 1997.

dynamic role in the growth process. To a large extent, education entails learning how to gain knowledge, adapt and react rather than absorbing a particular body of knowledge. These are essential skills in the transition and, indeed, any changing environment. This view is supported by recent evidence which indicates that the contribution of labour to growth is larger in countries where technological change is more dynamic.²⁰ However, this potential contribution can be fully realised only if labour and product markets are reasonably open and flexible. These conditions are needed to ensure that skilled labour can move in search of new opportunities and enter markets with new approaches and ideas. Although centrally planned economies emphasised the importance of developing skills, they promoted general education rather than learning-by-doing and experimentation and largely neglected the role of other factors (learning-by-watching) in the development of new skills.

To make the most effective use of skilled labour resources, it is necessary to improve labour mobility across firms and sectors. This is achieved through improvements in infrastructure (see below), privatisation and development of housing markets, and minimising regulatory barriers. The benefits of greater labour

¹⁸ See also World Bank (1996).

¹⁹ However, educational inputs (including equipment and high-quality teachers) have suffered from absolute cuts in public spending in many countries since the beginning of transition (even though broadly maintained relative to GDP). This, together with the brain-drain of east European and especially Russian scientists (prompted by low pay at home and the removal of emigration restrictions, together with the economic downturn experienced in most countries), raises serious concerns about the ability of transition economies to maintain and improve the quality of their skills base.

²⁰ This hypothesis was proposed and empirically tested by Welch (1972). See Benhabib and Spiegel (1994) for cross-country evidence consistent with this view.

mobility include a better match between skills and technologies and between skills and products, which in turn should encourage both the development of new skills and the implementation of new technologies. It should also lead to a greater distribution of knowledge and learning-by-doing within and across sectors.

Investment and technological advance

Following market liberalisation in transition economies, much of the industrial structure was rendered economically obsolete, raising the opportunity for new investment. Investment returns over the medium term are likely to be particularly high for those investments that facilitate the restructuring of existing enterprises and which enable new private firms to enter the market (see above). Such investment is central to long-term growth, as in mature market economies. Growth will also be assisted by the introduction of new technologies, processes and organisations and their subsequent replication and adaptation.

Growth-enhancing investments in transition economies will rely importantly upon establishing open trade regimes and attracting foreign direct investment, and also upon key structural reforms including: (i) reform of the financial sector and the establishment of a competitive banking system that effectively screens and monitors investment projects; (ii) the impartial enforcement of clear and stable laws and regulatory rules via accountable state institutions; and (iii) investments (such as in infrastructure and housing) that enhance product market competition and labour mobility. In the medium term, transition economies will develop at different rates. The structure of growth will, no doubt, vary across economies, but the form it takes is perhaps less important than the establishment of an institutional framework that will underpin the growth by helping to promote a reallocation of resources according to market forces, the entry into the market of new firms and open competition.

Obstacles to growth

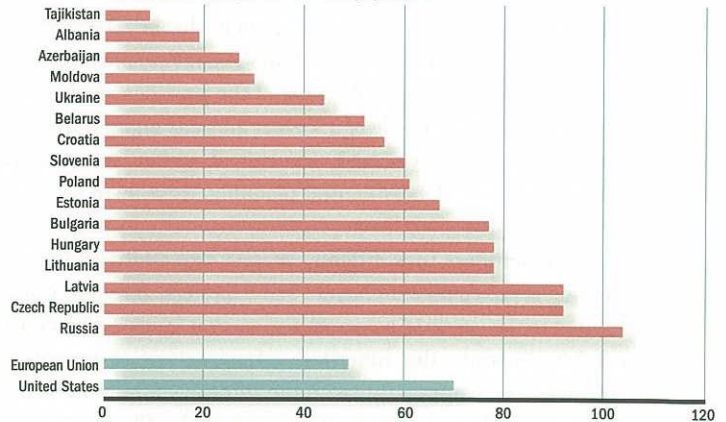
Impediments to competition

The process of improving the allocation and utilisation of resources across firms and sectors must be governed by market forces, and this requires effective competition. However, competition in transition economies remains severely limited by a number of factors. Arbitrary business licensing procedures, regulations and taxation create significant barriers to entry by new private firms (particularly in the CIS), while country-risk factors influence the extent of foreign entry through direct investments (see Chapter 4). The continuation of soft budget constraints for at least some enterprises, particularly by allowing tax and energy tariff arrears and soft bank loans, blunts the operation of market forces in a number of transition economies (see Chapter 5). Also, inherited market structures in transition economies often are concentrated and lack a competitive fringe of small and medium-sized producers. Entry by such firms is limited in a number of countries, particularly in the CIS, by government-related obstacles and by criminality. It is often the case that new firms are “visited” by representatives of organised crime within a few days of setting up and are required to pay substantial protection money.

Chart 3.1

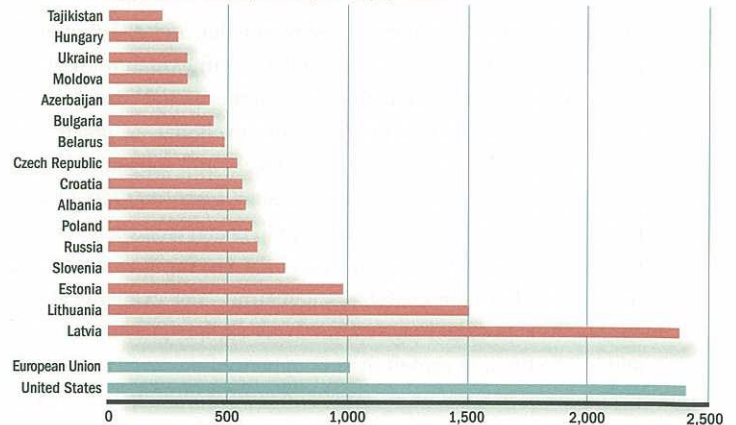
Rail network densities, 1993

Kilometres of rails per 100,000 of population



Road network densities, 1993

Kilometres of roads per 100,000 of population

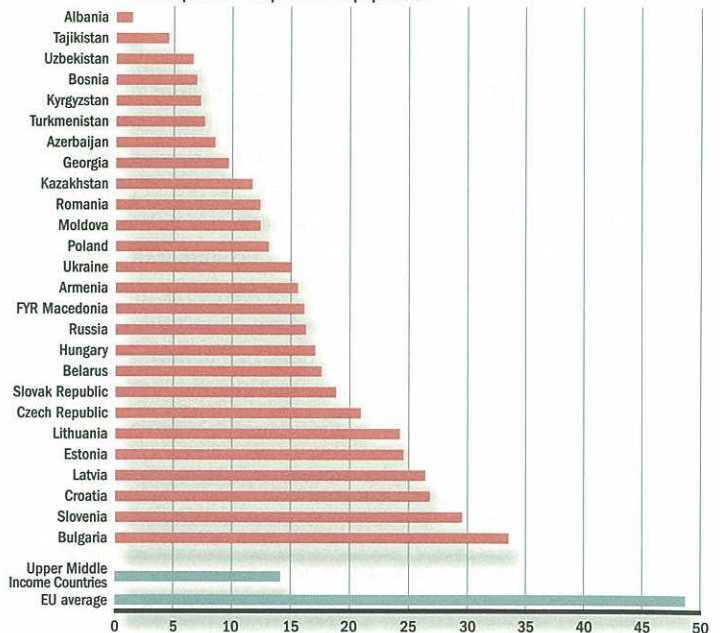


Source: International Road Transport Union (1996).

Chart 3.2

Telecommunications network penetration rates, 1994

Main telephone lines per 100 of population



Source: International Telecommunications Union

The potential for competitive markets is also undermined by inadequate physical (and institutional) infrastructure. This is a key area for determining the level of “transactions costs” in any economy, and therefore its ability to adapt to change. The physical infrastructure (especially roads, railways and telecommunications) inherited from the central planning of the previous regime was designed to meet the needs of a system that was highly vertically integrated (for political and ideological rather than sound economic reasons). Under central planning, there were very few small or medium-sized firms, little horizontal communication between enterprises from different sectors, and relatively limited provision of information to buyers and suppliers. As such, it was unsuited to the needs of a competitive market system. Charts 3.1 and 3.2 illustrate the inherited infrastructure of transition economies and contrast this with the infrastructure of industrialised and developing market economies (see also Chapter 3 of the 1996 *Transition Report*).

The emergence of new networks of production and distribution in the transition requires new investment in infrastructure (particularly in roads and telecommunications networks and other forms of information systems) to facilitate the exchange of goods and services and information among producers and consumers. Such infrastructure can help lower transactions costs (including transportation costs and the search for suppliers and customers) both in vertical relationships among firms (in buying and supplying inputs) and between customers and firms. For example, it can enable firms to search more effectively for low-priced suppliers and to identify and exploit market opportunities more rapidly. By improving access to new markets and market participants, investment in infrastructure can also reduce local market power and stimulate product market competition.²¹ In short, greater market-oriented infrastructure makes a major contribution to a more competitive environment that can weed out both high-cost established firms and weak potential entrants.²²

Lack of market-oriented institutions

The points about the role of physical infrastructure apply equally to the institutional infrastructure, which supports market interaction. This infrastructure includes the legal framework (especially contract and other commercial law and protection of physical and intellectual property), bankruptcy institutions, regulation of financial institutions, competition agencies, tax authorities and other regulatory and licensing bodies. In the same way that restricted access to physical infrastructure weakens competition, “captured” or non-transparent public institutions can distort, confuse and manipulate the rules of the game and thereby undermine the competitive process.

It is possible for firms to find ways of adapting their operating procedures to take account of a poor institutional infrastructure, but this leads to an increase in social costs and distorts competition. For example, studies show that when legal contracts are difficult or expensive to enforce, enterprises find other ways of disciplining customers and suppliers for not complying with a contract. Market transactions tend to be organised at a local level, where the desire to maintain a good reputation enforces good behaviour, or they are restricted to similar ethnic groups where there is mutual trust.²³ This behaviour has the effect of softening competition among established firms and limiting the weeding out of weaker enterprises. It also becomes difficult for new entrants to gain a foothold, partly because customers may be less willing to buy from new firms without legal or other safeguards.

A key requirement of well-functioning, market-oriented institutions is that they enforce transparent, stable rules that facilitate open market processes, particularly for the entry into, and exit from, markets by enterprises. A basic and powerful way to accelerate institution-building in transition economies is to create private sector demand for it by privatisation and other policies to reduce the role of the state in economic life.²⁴ These policies are undoubtedly important in their own right. However, this “demand creates its own supply” view of institutional development runs the risk of creating institutions that are designed to serve, or are “captured” by, particular vested interests. For example, competition authorities are important for enforcing level playing fields for rivalry among producers. However, they can also be misused to protect the established competitors rather than to promote open competition. The same danger exists in other regulatory institutions, tax authorities and even the legal system itself. Regardless of the form it takes, the “capture” of public institutions by private interests undermines sustainable growth because it dilutes the incentives, and the ability, of new firms to compete with those already in place.

The interplay between public officials and enterprises can have a significant influence on the development of state institutions and government policies in transition economies. Privatisation of existing state-owned enterprises, for example, was widely viewed as the most effective way of “depoliticising firms”.²⁵ Although it certainly increased the authority of enterprise managers at the expense of government officials, mass “insider privatisation” (as in Russia) introduced a new source of political pressure and vested interests. It increased the ability of incumbent managers (of large firms and through industrial groupings created from previous branch ministries) to “capture” some aspects of government policy and regulation. In particular, the new-found autonomy and power

²¹ This allows low-cost firms to compete more successfully with high-cost firms (gaining market share), which in turn lowers overall production costs in the economy. Lower transactions costs make it more attractive for low-cost potential competitors to enter the market (compared with high-cost entrants) because they know they will be able to compete more effectively after entry. The intensification of competition also increases the incentives of incumbent firms to reduce their costs by restructuring.

²² For a formal model of some of these mechanisms, see Aghion and Schankerman (1997). Note that these arguments apply to any form of infrastructure that facilitates market interactions. This would include a subset of physical infrastructure – transport and telecommunications but not electricity or water supply – but also many forms of institutional infrastructure.

²³ For an interesting study of Vietnam, see McMillan, Naughton and Woodruff (1996). Similar research is under way on a number of east European and CIS countries. The role of ethnic groups in enforcing commercial contracts and other dealings is particularly prominent in African countries, but may also apply to some ethnically heterogeneous transition countries.

²⁴ See, for example, Boycko et al. (1995) and World Bank (1996).

²⁵ For example, Shleifer and Vishny (1994) argue that while under public ownership the government could use its coercive power to force non-profit maximising decisions on firms’ managers.

of some enterprise managers have been used to lobby government to stifle potential competition, to oppose the introduction and/or enforcement of new tax systems, to prevent new outside owners buying into their firms and to gain additional economic power.

To promote entrepreneurship and growth, public institutions should have the following attributes: independence from the enterprises they “regulate”, accountability, transparency, stability and adaptability. In practice there is some conflict between these elements. For example, adaptability requires some degree of flexibility and discretion in rule-making, which may conflict with stability. As a result, there is some variation between countries in the particular forms that institutions take. In that sense, no specific institutional designs could be described as prerequisites for growth.²⁶ What is critical for growth, however, is that government institutions (including tax and licensing systems) are designed to facilitate the entry of new products, ideas and firms into the market place, a competitive environment and the exit of enterprises that are not commercially viable. It is against these standards that government institutions should be judged.

Corruption and predatory behaviour

A basic public good provided by government in a market economy is the legal and institutional framework to enforce contracts and safeguard property rights and its failure to do so creates a serious obstacle to private activity. In the absence of reliable enforcement of property rights and contracts, private businesses become exposed to risks of state or criminal expropriation of profits and assets, in whole or in part. Anticipating this, private businesses cut back on investments, including those in innovation, or refrain from developing market opportunities altogether (see Chapter 4). The weak capacity of a state to enforce those rights necessary for a well-functioning market economy can lead to corruption by officials and Mafia-type activities as an alternative means of enforcing these rights. Many of these practices are simply criminal, such as protection rackets, and should be combated directly through law and order measures. This takes leadership and courage.

In addition to weak state capacity, the misdirected use of this capacity can also create scope for corruption. Bureaucratic and cumbersome procedures for business registration and regulation can create significant scope for the misuse of power by officials and for corruption. These practices are particularly prevalent at local government level in some transition economies.

The tax system is another important example of how unclear rules, weak institutions and bureaucratic discretion contribute to business uncertainty and corruption and undermine private sector activity. Enterprise surveys from developing and transition countries have shown that it is not so much the average level of

taxation, but rather the unpredictability, haphazard definition of bases, discretionary enforcement and sometimes confiscatory nature of taxes which deters business activity. In response to this government-created uncertainty, businesses tend to invest less in plant and equipment and more in financial assets, accumulate tax arrears, avoid taxes with corrupt payments, or engage in informal economic activity. These business strategies, however, involve social costs, undermine formal private sector activity and reduce the ability of government to raise the tax revenues needed to fund critical expenditures (such as those on law and order, the judiciary, education, health, social security and infrastructure).

Introducing effective monitoring of government officials, and minimising the scope for “insider behaviour” in the broad sense of the term, is necessary to create a more even-handed climate for private business activity. This will require a change in the way government functions, which will not be easy to achieve. Governments must recognise that their primary role in economic affairs is to set and enforce clear and stable rules that maintain a level playing field for competition, to ensure accountability and to exercise a minimum of arbitrary control while giving officials an interest in a well-functioning market economy (see Chapter 5). However, at the same time, the private sector should establish a corporate culture of transparency and accountability, underpinned by strong corporate governance based on outside ownership.

Underdeveloped financial sector

The private investment, entrepreneurship and innovation that drive growth cannot be sustained without well-functioning credit institutions and markets. These include all forms of institutions that mobilise savings and/or channel savings into productive private sector investment projects – banks, equity markets, private pension funds and other large institutional investors as well as less formal sources of credit.²⁷ By providing the external finance needed for new investment projects, these institutions serve as an additional source of project screening and of financial discipline on the governance of enterprises.²⁸ They also help enforce hard budget constraints by increasing the likelihood that new investment projects that turn out to be unprofitable would not be refinanced.²⁹ This is in contrast to the system under central planning, where most projects operated under soft budget constraints. In place of decentralised re-evaluation of projects after approval by the standard of market performance, there was extensive, centralised bureaucratic project review which was confined to decisions prior to approval.³⁰

To promote high-quality investment and growth, however, financial institutions need to be restructured, effectively regulated and subjected to effective governance and competitive pressures. A balance must be struck between stringent prudential regulations

²⁶ See Gershenkron (1968).

²⁷ For discussion of financial markets, see Chapters 5 and 10 of the 1995 *Transition Report*. Chapter 6 of the 1996 *Transition Report* discusses savings in transition economies.

²⁸ See King and Levine (1993) for a formal model of financial intermediation in a Schumpeterian growth model.

²⁹ The idea that a decentralised banking sector is less likely to refinance projects that involve large sunk costs *ex ante* but turn out to be unprofitable *ex post*, was formalised by Dewatripont and Maskin (1995) in a paper on the determinants of hard budget constraints.

³⁰ For discussion in the context of R&D, see Qian and Xu (1997).

to protect the stability and integrity of the financial sector, on the one hand, and sufficient competitive pressure on the other. The approach of essentially unregulated "free entry" into financial markets, adopted by the Baltics and Russia in the early years of transition, led to excessive risk-taking, financial manipulation and instability that can undermine the long-term confidence in the financial sector that is needed for growth. However, competitive pressures within the financial sector are necessary to spur innovation in the form of new financial instruments and services and of increased efficiency in service delivery.

Creating effective financial markets will also require, in most transition economies, a more aggressive policy of restructuring and privatisation of existing state-owned banks. Being traditionally closely connected with large state-owned enterprises, these banks entered transition with portfolios that were both insufficiently diversified and overburdened with non-performing loans. This has had the effect of restricting potential lending to new private firms and inhibiting therefore the creation and expansion of new private sector enterprises, while at the same time contributing to financial sector instability. The reform and privatisation of existing state-owned banks will enhance growth by reducing financial instability and improving access to credit for new private businesses (see Chapter 5). At the same time, it will strengthen the ability of domestic banks to compete effectively when financial markets are open to foreign competition, as is mandated by the Europe Agreements. The strengthening of financial institutions will be a crucial part of the process of accession to the European Union.

3.3 Conclusion

It will be market-oriented innovation that will deliver growth – new products, production techniques and methods, organisational forms and ways of doing business. At the core of this process is entrepreneurship, experimentation and adaptation. It can only work if there are flexible markets, open and effective competition, and adequate institutions and infrastructure. Among the most important institutions is the legal system itself, which must impartially protect private property, enforce contracts and prevent corruption, fraud and other forms of criminality. Without this basic ingredient, it is not possible for other critical public and private institutions to develop and function properly – including licensing and tax authorities, regulatory bodies, and financial institutions and markets.

Less favourable initial conditions, and slower progress in macro-economic stabilisation and in market liberalisation and privatisation, partly account for the delayed and weaker output recovery and growth in CIS countries compared with central Europe. However the analysis in this chapter suggests that further progress in liberalisation and privatisation will not, by itself, produce sustained growth in Russia and other CIS countries. The serious institutional obstacles to entrepreneurship, competition and private investment must be addressed effectively before sustained growth can be achieved in this region. This will not be easy to accomplish, in part because of the strong vested interests that have been reinforced by mass insider privatisations, and the limited ability of government institutions to exert the required authority to levy taxes and to enforce laws. The process of accession to the EU will, for central European countries, bring enhanced access to the market, technical assistance and harmonisation of key institutions. The result may contribute to an increasing divergence in the state of institutional development between countries in central Europe and the CIS. Lastly, the dramatic increase in poverty and income inequality in CIS countries compared with the levels in central Europe may pose serious problems for the maintenance of macro-economic stability and growth in the long run.³¹ All these considerations underline the importance for governments in the CIS to provide and encourage the deep institutional reform which is vital for sustained economic growth.

³¹ See Gavin and Hausman (1996) for detailed cross-country evidence of the detrimental effects of inequality and poverty on stabilisation and growth in Latin America.

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Structural change, restructuring and enterprise performance

4

Growth in transition economies depends on how enterprises adapt to new and changing market conditions and develop innovative ways of doing business (in particular, in terms of products, production processes and business organisations). An important element of this process of adaptation and innovation is the creation and growth of new private enterprises in response to emerging business opportunities. This Schumpeterian perspective on growth, which was discussed in Chapter 3, emphasises the importance of product market competition, including the entry and exit of firms, and its impact on enterprise performance. Market competition and the way that enterprises respond are in effect the microeconomic factors governing growth, shaping the quantity and quality of investment and encouraging innovation. The microeconomic viewpoint adopted here complements macroeconomic analyses focusing on savings and capital accumulation as determinants of growth. Individual decisions drive savings and investment in a market economy, and microeconomic conditions have a vital influence on those decisions. Moreover, this perspective is particularly relevant to transition economies because at the centre of transition is fundamental change in the way enterprises operate.

This chapter analyses the microeconomic sources of growth in transition economies. In particular, it examines the response of enterprises in transition economies to the introduction of market forces and considers key aspects of enterprise performance: how enterprises have adapted their output and use of resources to the introduction of market mechanisms, and how the performance of enterprises, both old and new, is affected by factors such as the extent of product market competition, the policies and practices of government (particularly toward new private firms) and the effectiveness of privatisation and corporate governance.

At an aggregate level, the response of enterprises to market forces is seen through changes in the composition of output and the use of resources. The introduction of market forces into the economic structures inherited from central planning has brought about significant structural change in transition economies, with some sectors contracting and others expanding. Transition economies have also redirected trade away from other countries in transition and towards international markets. One part of this chapter analyses changes in economic structures and in patterns of trade in transition economies in terms of the operation of basic market forces. It is evident from this analysis that market forces have driven many of the changes that have taken place, and that the emerging economic structures are moving towards those of market economies.

A number of factors have a significant impact on enterprise performance according to evidence from industrialised and developing

market economies. These include product market competition, government behaviour and state capacity, and privatisation and effective corporate governance. The other part of this chapter assesses available evidence from transition economies on how these and other related factors influence enterprise performance. The empirical results highlight the parallels that exist between market economies and those in transition, with two aspects deserving particular emphasis. In transition economies, the entry of new private firms plays a particularly crucial role in the process of enterprise sector adjustment and the role of state institutions and government policy is instrumental in fostering development of the new private sector.¹

Section one of this chapter examines the changes in the sectoral structure of transition economies (as reflected in the share of employment in industry, services and agriculture). Section two looks at the pattern of trade specialisation, while the third section builds a bridge between these aggregate analyses of enterprise performance in transition economies and the microeconomic factors for enterprise performance. Section four examines the impact of competition on enterprise performance. The fifth section considers the obstacles to enterprise development resulting from inefficiencies in government behaviour (such as policy uncertainty, arbitrary interventions and corruption) and a weak state. Section six examines how enterprise performance in transition economies is affected by privatisation and various corporate governance arrangements. The seventh section offers some brief conclusions.

4.1 Transition and structural change

Decades of central planning have resulted in distorted economic structures for countries in transition. Industries had become over-extended by the emphasis of central planners on material production, while services were neglected. Much of agriculture was collectivised, limiting private activity and, it was argued, exploiting economies of scale. Transition and the introduction of market-determined prices, competition between producers, and entry and exit of enterprises have brought about large-scale changes in output and employment. Some sectors in transition economies have expanded and others have contracted, sometimes dramatically.

To analyse structural change in transition economies it is useful to start with established patterns of development in market economies. This reveals a systematic relationship between the sectoral composition of economic activity and the overall level of income per person (measured by per capita GNP, for example).² In particular, as economies grow and countries (and individuals) become richer, the allocation of resources and the composition of

¹ The importance of state institutions and the exercise of governance are further explored in Chapters 1 and 2.

² See Chenery and Syrquin (1975) and Syrquin and Chenery (1989).

production shifts away from agriculture and into industry and services.

A number of economic factors help to shape the structural transformation of market economies as they develop. First, as per capita incomes rise, the relative demand for some products tends to decrease (such as food) and to increase for others (such as investment goods). Second, higher rewards typically draw resources towards higher-productivity sectors,³ contributing both to growth in per capita income and to shifts in the share of production between sectors. Third, the comparative advantage of countries in international trade encourages countries to shift away from labour- and low-skill-intensive production and towards more capital- and high-skill-intensive areas, as the accumulation of plant and equipment and the acquisition of skills alters the balance between unskilled and skilled labour and physical capital.

These factors are sources of uniformity in structural change and help to explain the strong historical relationship between changing economic structures and per capita incomes. However, this relationship is not rigid. Foreign trade allows countries to look beyond domestic demand in terms of production and to specialise according to their comparative advantage. The availability of natural resources, such as arable land or mineral resources, and the size of the country can have fundamental and lasting influences on economic structures and patterns of specialisation in individual countries. Similarly, economic policies can have important and lasting effects on resource allocation and hence economic structures, as the previously centrally planned economies amply demonstrate.

In which direction is structural change in transition economies likely to occur? A comparison of the relationship between the structure of economic activity and per capita GNP across countries helps to establish benchmarks against which the economic structures of transition countries can be analysed, both at the start of transition and after several years of progress in market-oriented reforms. In particular, the benchmarks suggest what economic structures would prevail if the transition economies were to approach market economies in their respective patterns of resource allocation.

Benchmarks for assessing structural change

While the structure of a market economy is often expressed in terms of the sectoral composition of output (real GDP), it would be

difficult to apply this approach to transition economies because of measurement problems. Calculating index numbers for prices of goods and services is problematic in all countries, but it is particularly so in transition countries. This is because of the dramatic changes in relative prices and, in many cases, because of the absence of the resource allocation role for prices under the old regime. The analysis here is based, therefore, on the structure of employment rather than output, since changes in the composition of employment can be measured more reliably than those of real GDP.⁴ In particular, this approach avoids reliance on index numbers to measure real quantities, since the number of employees can be recorded directly.⁵ Moreover, the reallocation of employment is central to transition and of interest in its own right.

For this analysis, employment has been broken down into three broad areas: agriculture, industry and services. In view of the importance of services in general and their role in the process of transition in particular, however, the services sector is in turn subdivided into those that are typically provided by the market and those whose provision usually involves a strong role for government. The sectoral classification used is thus as follows:

- Agriculture
- Industry (mining, manufacturing, electricity, gas, water and construction)
- Market-oriented services (trade, transport and communications, and finance)
- Non-market-oriented services (healthcare, education, defence, public administration and other services).⁶

To establish a benchmark for the division of employment between sectors for each transition economy, an examination of the relationship between employment by sector and GNP per capita (at purchasing power parity [PPP] exchange rates) in industrialised and developing market economies is needed. This relationship is estimated using data from 41 countries.⁷ The results are similar to those derived by others using output rather than employment. In particular, the higher a country's per capita income, the lower is its percentage share of employment in agriculture and the larger are its shares of employment in industry and in both market-oriented and non-market-oriented services.

The estimated relationships between each sector's share of total employment and per capita income, therefore, form the bases for

³ In a market economy, resources shift to equalise their marginal productivity across all occupations. This does not preclude substantial differences in average resource productivity between two sectors, such as is evident, for instance, in higher average labour productivity in industry than in services.

⁴ For an analysis of the structure of GDP of several transition countries along the lines of Chenery and Syrquin (1975) and others, see Döhrn and Heilemann (1996).

⁵ Comparing labour inputs across economic activities would in principle require adjustments for hours worked and for the quality of labour. The latter would raise issues of relative price adjustments for different types of labour.

⁶ Other services, including some market-oriented services, are included here because of limitations in the International Standard Industrial Classification (ISIC)-2 employment data. Employment data broken down by ISIC-2 categories do not permit separation of "other services" from non-market services; ISIC-3 does allow this but is available for relatively few market economies.

⁷ The cross-country regressions are of the non-linear form $S = a + b(\ln(Y)) + c(\ln(Y))^2$, where S is the share of a sector in total employment, and $\ln(Y)$ is the log of 1995 GNP per capita at purchasing power parity in 1995 US dollars. The squared term allows for curvature in this relationship. Statistical tests on the joint significance of the estimated coefficients b and c were always highly significant. Country size (population) was not included as an explanatory variable (as is often done in these analyses), because when included it was rarely significant. The data on GNP per capita at purchasing power parity are from the *World Bank Atlas*. The data on employment shares are from various sources (World Bank, International Labour Organisation and national statistical agencies) and, for reasons of data availability, are from a year in the period 1990-95.

calculating benchmark employment shares in each of the broad economic sectors for each of 21 transition countries. These employment share benchmarks are calculated for both the pre-transition period (1989 or 1990) and for 1995 (with the exception of Estonia at 1994).⁸ These calculations yield, for example, a benchmark for the share of employment in agriculture in Poland in 1995: that is, the share of employment that would on average be recorded in a market economy with the same per capita income that Poland had in 1995. Repeating the calculation using Poland's pre-transition per capita GNP in 1989 yields its 1989 benchmark for the share of employment in agriculture.⁹ With employment share benchmarks calculated in this way, comparisons with actual employment shares become possible. Actual and benchmark employment shares of the 21 transition countries included in the sample can also be averaged to yield actual and benchmark shares for an "average" transition country. The average benchmarks can be interpreted as the sectoral shares of employment that would be typical of a lower-middle-income market economy whose GNP per capita was equal to the transition country average.¹⁰

Economic structures before and during transition

Table 4.1 shows pre-transition employment share benchmarks and actual shares for an "average" transition economy. The results are in line with the standard view of the distorted structures of centrally planned economies and with results of earlier analyses.¹¹ The main distortion at the start of transition was a very large share of industrial employment relative to the benchmark. At the start of

transition, the average transition economy had 36 per cent of total employment in industry compared with a benchmark share of 24 per cent. The counterpart to the large employment share in industry was the relatively small share of market-oriented services (notably trade, which showed an actual 9 per cent employment share compared with a benchmark of 17 per cent). Non-market-oriented services and agriculture also accounted for smaller shares of employment than those indicated by the benchmarks.

The comparison of actual and benchmark employment shares at the start of transition would suggest that the introduction of market forces in transition economies would foster a reallocation of labour away from industry and into services, in particular market-oriented services. The position is more complex than this, however, because transition has been accompanied by declines in measured GNP, and hence by changes in the benchmarks; benchmark shares for industry and services are lower than they were pre-transition, while the benchmark share for agriculture is higher. Moreover, estimates of per capita GNP are likely to understate true incomes because of measurement problems,¹² including the omission of informal sector activity, which can be substantial and is typically not evenly distributed across economic sectors (see section 4.5 below).

Table 4.1 also shows the 1995 employment share benchmarks and actual shares for an average transition economy. A comparison between the actual employment shares at the start of transition and

Table 4.1

Benchmark and actual sectoral shares of employment

(in per cent)

	Pre-transition (1989-90)			1995			Change in actual share
	Actual share	Benchmark share	Difference	Actual share	Benchmark share	Difference	
Agriculture	23.8	29.4	-5.5	26.9	41.1	-14.2	3.1
Industry	36.1	23.4	12.8	28.0	20.4	7.7	-8.1
Market-oriented services	21.4	25.8	-4.3	24.0	20.6	3.3	2.5
Trade	8.5	16.7	-8.2	11.6	13.9	-2.2	3.1
Transport and communications	6.8	5.3	1.4	6.2	4.7	1.6	-0.5
Finance	5.3	3.7	1.5	5.6	2.1	3.4	0.3
Non-market-oriented services	19.5	21.5	-2.0	21.6	17.9	3.7	2.2
Average GNP per capita at PPP, 1995 US dollars	5,425	-	-	3,250	-	-	-

Sources:

International Labour Organisation, national sources, World Bank and EBRD calculations.

Notes:

Actual shares (columns 1 and 4) are average shares of sectors in total employment across 21 transition countries. Benchmark shares derive from cross-country regressions of the form $S = a + b(\ln(Y)) + c(\ln(Y))^2$, where S is the share of a sector in total employment and $\ln(Y)$ is the log of 1995 GNP per capita at purchasing power parity in 1995 US dollars, based on a sample of 41 industrialised and developing market economies. Benchmark shares for each of 21 transition countries are calculated using the estimated coefficients a , b , and c and GNP per capita pre-transition (1989 or 1990) or GNP per capita in 1995. The benchmark shares in columns 2 and 4 are average benchmarks for the 21 transition countries. Average GNP per capita (bottom row) derives from the average of log GNP per capita for these countries (logs because the estimating equation is in log form). For more details see main text.

⁸ The transition countries are (pre-transition year in parentheses) Bulgaria, Hungary, Poland and Slovenia (1989) and Armenia, Azerbaijan, Belarus, the Czech Republic, Estonia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, Moldova, Romania, Russia, the Slovak Republic, Tajikistan, Turkmenistan, Ukraine and Uzbekistan (1990).

⁹ *The World Bank Atlas 1997* presents data on GNP per capita in PPP US dollars for 21 transition economies in 1995. To arrive at estimates of pre-transition GNP per capita, real growth rates of GDP were applied backwards, adjusting for US inflation to obtain data in constant 1995 PPP US dollars.

¹⁰ More precisely, GNP per capita derived from the average of log GNP per capita, since the regressions are in log terms.

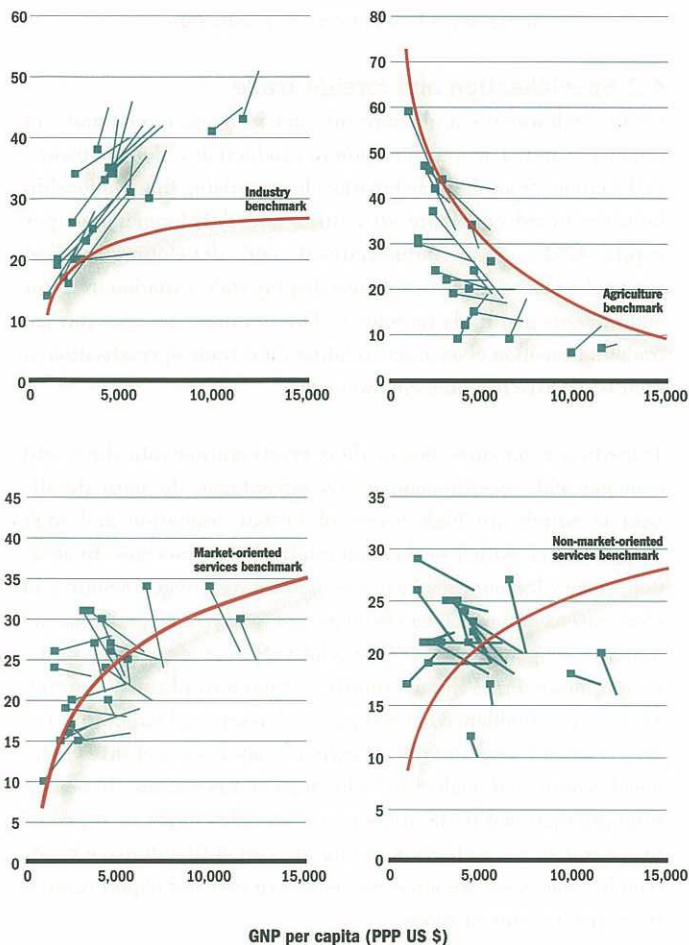
¹¹ See, for example, Winięcki (1988).

¹² See Appendix 11.1 of the 1994 *Transition Report* for a detailed methodological discussion.

Chart 4.1

Adjustments towards the benchmarks: structural change in transition, 1989-95

Employment shares, in per cent



Sources:

International Labour Organisation, national sources, World Bank and EBRD staff calculations.

Notes:

On the calculation of the solid benchmark lines, see footnote 4 and the note to Table 4.1. The line extending to each square shows the change for each transition country from its pre-transition (1989 or 1990) actual sectoral employment share and GNP per capita. Each square on the chart shows the actual sectoral employment share and GNP per capita for a transition country in 1995.

in 1995 indicates the direction of change in employment shares in each sector. In most sectors the direction of change is towards the 1995 benchmarks.

While industry in transition economies remains oversized relative to the benchmark, the share of industry in total employment in 1995 was 28 per cent, down from its pre-transition share of 36 per cent (a fall of 8 percentage points). Still further adjustment in industrial employment, though, would be predicted by the 1995 benchmark, which is 20 per cent. The share of employment in agriculture has increased, again towards the 1995 benchmark, although the discrepancy between the benchmark and observed shares is now large. Transition economies have on average 27 per

cent of their labour forces in agriculture, up from 24 per cent at the start of transition, but well below the benchmark of 41 per cent. The share of the trade sector in employment also moved up towards the new benchmark, and the broader category of market-oriented services (including also finance, transport and communications) moved from being below to slightly above the benchmark.

Chart 4.1 presents the results of the exercise in country-by-country detail for the four broad sectors. Each panel of the chart presents for a particular sector: (i) the benchmark employment share for the sector derived from data for 41 industrialised and developing market economies, which is depicted by a single solid line; (ii) the position of each of the 21 transition economies in 1995 denoted by a small square; and (iii) the size of the sectoral adjustment in each transition economy by a line showing the country's income and sectoral share pre-transition and the movement to its current position.

The upper left panel shows that a reduction in the size of the industrial sector has taken place in all 21 transition countries in the sample. Because measured income per capita has also declined, the trajectories of movement in countries' positions are all towards the graph's origin. Moreover, the industrial sector's employment shares in transition economies with low per capita incomes is smaller than in those economies with higher incomes, and indeed these shares are not far from the benchmark. In contrast, transition economies with higher per capita incomes may still have further adjustment to make in their oversized industrial sectors. These countries had, in 1995, industrial employment shares in excess of 30 per cent or even, in the cases of the two wealthiest transition countries, the Czech Republic and Slovenia, 40 per cent, compared with benchmark shares of 20-25 per cent. This conclusion would be unaffected even by large underestimates of income per capita, because the benchmark share of industrial employment is less than 30 per cent even for high-income countries.¹³

The upper right panel reveals a mixed pattern of adjustment in the share of agricultural employment. A number of transition economies with low per capita incomes and with large agricultural sectors at the start of the transition (Moldova, Romania and the Central Asian republics) have witnessed substantial increases in the share of employment in agriculture and hence movements towards the benchmark. Most of the remaining countries have seen little or no increase in the share of employment in agriculture and remain well below the benchmark. Moreover, a handful of countries, most with higher per capita incomes (the Czech Republic, Estonia, Hungary, the Slovak Republic and Slovenia), have seen their shares of employment in agriculture fall further below the benchmark. As with the industry benchmarks, the large gaps between actual and benchmark shares of agricultural employment would exist (except for some of the transition economies with the lowest incomes) even if measured incomes per capita were revised upwards by large margins.

¹³ A country with a per capita income of US\$ 20,000, which would be typical of western Europe and hence far in excess of that observed in the transition countries, would have an industrial employment benchmark of 28%. However, there is substantial variation around the benchmark and some high-income countries have an employment share in industry of up to 40%.

The “overshooting” of market-oriented services is evident in the lower left panel of Chart 4.1, which shows a number of transition economies moving above the benchmark in 1995, having started the transition below it. The average gap is not large, however, and would be further reduced or even eliminated if per capita incomes were adjusted upwards. The fourth panel shows that employment shares of non-market services (primarily the government-provided services of healthcare, education, defence and public administration) also grew substantially in most transition economies.¹⁴ This growth took place despite the fact that non-market services at the start of transition already had high employment shares in most of these economies. Most countries in 1995, therefore, have employment shares of government services which are high for their level of per capita income, with governments possibly absorbing some labour released by other sectors to cushion the impact of structural change on incomes. Available evidence suggests that employment shares in healthcare and education have increased, but that real wages in those sectors have fallen sharply.¹⁵

The pattern of changes in employment shares across countries in transition shows that, for higher per capita income countries, changes in employment shares in agriculture and in market-oriented services are consistent with higher per capita incomes than those that prevailed in 1995. However, employment shares in industry for higher-income transition economies remain well above their benchmarks, and even above the benchmarks for high-income market economies. The explanation for this may partly be that transition countries differ in a number of ways from non-transition countries with comparable levels of income: they are more urbanised, with higher levels of literacy and education, and recently had higher income levels. The low share of employment in agriculture in transition economies compared with the benchmark (and hence indirectly the higher shares of industry and services) may be explained by the level of urbanisation and the large-scale organisation of agriculture in transition economies due to past collectivisation. Underestimation of incomes would also contribute to the adjustment by higher-income transition economies as if their true incomes were higher than their measured incomes.

Many transition economies with lower per capita incomes are also the countries that have implemented market-oriented reforms more gradually. Nevertheless, by 1995 most transition economies had introduced basic reforms, in particular price and trade liberalisation.¹⁶ These measures alone would be sufficient to trigger substantial structural adjustment, even if some of the more demanding aspects of reform, such as restructuring enterprises, building efficient financial intermediation and strengthening the legal framework, were yet to be initiated.

While the benchmarking exercise in this section shows a broad pattern of structural change in transition economies driven by the introduction of market forces, its aggregate nature means that it

ignores the numerous aspects of structural adjustment within sectors and at the enterprise level. The next section looks in more detail at structural change in foreign trade, as one area where market forces and economic reforms can be expected to have a particularly strong impact on patterns of production.

4.2 Specialisation and foreign trade

Factor endowments and trade interact in market economies to produce patterns of specialisation in production which contribute to deviations from the benchmarks characterising the relationship between broad economic structures and development (or per capita GNP). Like industrialised and developing market economies, those in transition also display wide variation in factor endowments and trade policies.¹⁷ This section examines foreign trade in transition economies, relating their trade specialisation to their respective resource endowments.

Transition economies began their reintegration into the world economy with specific comparative advantages, the most significant of which are high levels of formal education and high proportions of skilled workers on relatively low incomes. In addition, some CIS countries have vast natural resources (including in some cases land) which can be expected to have a major impact on patterns of specialisation. One relatively scarce resource in the region, however, is the availability of modern physical capital. There is an abundance of existing fixed assets and structures, but their market values are often negligible after years of investment misallocation and neglect of technological innovations. To benefit from international trade, transition economies might be expected to specialise in production of labour- and skill-intensive goods (and in some cases resource-intensive exports) and import capital-intensive investment goods.

Table 4.2 provides an overview of trade specialisation in transition economies in 1995 by major product categories. The table is based on “mirror data” provided by all countries reporting to the United Nations. These data exclude much of the trade within the CIS and a significant proportion of trade with developing countries. The figures should therefore be interpreted with care, particularly for the CIS countries, whose share of exports to these two country groups accounted for around two-thirds of the total by the mid-1990s. Bearing this in mind, the table confirms expectations. The largest differences in export structures are between resource-rich economies and all others, with the former displaying very high shares of raw materials and fuel exports. In Russia, for example, slightly less than half of total exports are raw materials or fuels. East European and Baltic economies specialise to a greater or lesser degree in exports of manufactured products, albeit with large variations within manufacturing.

An example of variation within manufacturing is the low share of machinery and transport equipment in total exports from CIS

¹⁴ Indeed, employment in government-provided services in 1995 was higher in absolute terms compared with pre-transition in over half the transition countries examined.

¹⁵ See Horton (1996).

¹⁶ See Chapter 2 of the 1995 *Transition Report*.

¹⁷ Chapter 5 examines trade policy in transition economies.

Table 4.2

Structure of foreign trade in transition economies, 1995

Share of total exports, in per cent						
Country	Food, beverages, tobacco, and agricultural products	Raw materials except fuel	Fuels and electric energy	Chemicals and intermediates	Machinery and transport equipment	Other manufactures
Albania	7.8	17.7	0.7	21.0	3.3	49.5
Armenia	0.9	11.0	26.0	42.2	1.7	18.2
Azerbaijan	4.3	53.0	16.7	21.4	2.2	2.4
Belarus	4.1	13.7	7.8	49.1	12.2	12.9
Bosnia and Herzegovina	10.4	10.3	0.6	18.7	15.9	44.0
Bulgaria	13.9	7.5	2.8	50.8	8.2	16.7
Croatia	7.5	7.6	9.5	32.5	9.6	33.3
Czech Republic	4.3	6.9	4.4	40.5	27.2	16.8
Estonia	4.4	20.0	14.3	28.2	13.7	19.4
Georgia	3.5	23.5	7.1	55.8	5.4	4.7
Hungary	13.5	5.1	3.0	27.6	32.9	18.0
Kazakhstan	2.4	20.7	6.2	69.1	0.7	1.0
Kyrgyzstan	0.9	68.0	0.0	29.4	0.9	0.8
Latvia	1.8	26.4	34.6	25.8	2.0	9.5
Lithuania	8.5	19.9	14.7	32.1	8.5	16.3
Moldova	39.7	11.8	1.1	33.6	2.6	11.1
Poland	7.6	5.4	8.0	37.2	19.0	22.9
Romania	5.0	3.4	4.5	40.1	11.2	35.8
Russian Federation	4.6	10.2	34.4	43.0	2.7	5.0
Slovak Republic	4.2	5.5	4.2	50.2	21.7	14.2
Slovenia	2.9	2.6	0.2	38.4	31.5	24.5
Tajikistan	0.2	63.3	0.0	29.0	0.2	7.2
Turkmenistan	2.0	79.9	13.6	2.3	0.7	1.6
Ukraine	6.2	10.9	9.9	63.1	3.2	6.8
Uzbekistan	0.8	77.1	0.0	8.1	0.2	13.9

Share of total imports, in per cent						
Country	Food, beverages, tobacco, and agricultural products	Raw materials except fuel	Fuels and electric energy	Chemicals and intermediates	Machinery and transport equipment	Other manufactures
Albania	26.1	0.8	4.3	27.1	22.2	19.5
Armenia	47.4	5.7	1.0	9.8	10.8	25.2
Azerbaijan	47.6	0.3	0.6	20.5	19.4	11.5
Belarus	22.4	0.6	0.5	26.4	35.4	14.8
Bosnia and Herzegovina	42.4	1.3	4.5	23.8	14.9	13.2
Bulgaria	12.9	4.7	4.8	33.0	31.4	13.2
Croatia	12.4	2.7	6.6	32.9	29.9	15.4
Czech Republic	6.7	2.4	1.8	31.9	42.0	15.2
Estonia	15.9	3.4	5.4	26.8	32.8	15.7
Georgia	49.8	0.4	16.2	10.0	9.1	14.5
Hungary	5.1	2.3	2.1	34.9	40.6	15.0
Kazakhstan	18.1	1.1	0.6	19.4	37.8	23.0
Kyrgyzstan	26.1	0.7	0.3	29.4	24.4	19.0
Latvia	22.1	1.8	8.3	23.1	28.9	15.9
Lithuania	18.1	2.5	1.2	31.0	29.0	18.1
Moldova	23.1	1.8	7.1	28.7	24.9	14.3
Poland	8.7	3.0	3.3	35.5	34.1	15.4
Romania	11.9	3.5	5.1	33.0	31.3	15.3
Russian Federation	26.7	1.8	0.8	17.7	33.6	19.5
Slovak Republic	8.0	3.4	4.1	36.6	36.3	11.6
Slovenia	8.8	5.2	3.4	34.8	34.8	13.0
Tajikistan	39.5	1.3	0.2	10.8	37.7	10.4
Turkmenistan	17.2	0.6	0.4	28.3	40.3	13.2
Ukraine	17.9	2.5	9.2	23.6	31.7	15.1
Uzbekistan	19.5	0.7	0.2	19.3	46.0	14.3

Source:

EBRD staff calculations based on the "mirror data" of the UN Comtrade database.

countries and their high share in exports from more developed east European countries, such as the Czech Republic, Hungary and Slovenia, and to a lesser extent Poland and the Slovak Republic. The higher share of manufacturing production in capital-intensive goods, such as machinery and transport equipment, in higher-income countries of the region reflects the more extensive accumulation of capital, both plant and equipment and acquired skills, by these countries.

In contrast with exports, the structure of imports is relatively uniform across the region, with the high share of machinery and transport equipment in imports reflecting the shortage of capital assets with a positive market value. Most of the region is also a net importer of food and agricultural products. Because the data do not capture most exports from the CIS, imports of raw materials and fuels by east European, Baltic and resource-poor CIS countries are under-reported. However, more complete data would probably not alter the general observation of variation in export patterns across the region in response to differing factor endowments and a much more uniform composition of imports reflecting the common need to upgrade capital stocks.

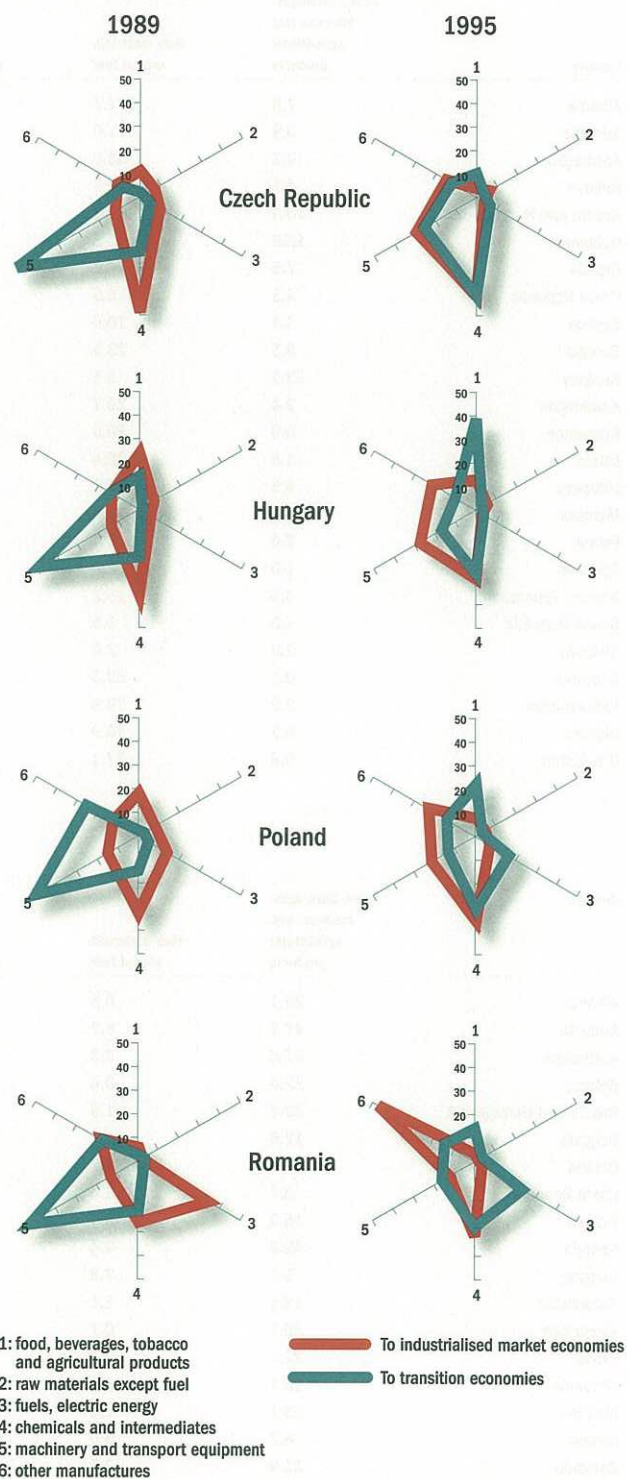
As broad economic structures of transition economies have changed with the introduction of market-oriented reforms, so too has the composition of trade. Chart 4.2 shows the changes in trade for a limited number of countries for which trade data by both product and destination reported by national authorities are available. It compares the structure of exports to industrialised market economies and to other transition economies.

In 1989 exports to industrialised market economies were very different from those to other transition economies. The latter received a substantially higher share of capital goods exports, such as machinery, while those to the industrialised market economies consisted mainly of intermediate goods and agricultural products.¹⁸ By 1995 the type of exports to these two destinations had become far more similar. This was due to two changes. First, liberalisation of trade among former Council of Mutual Economic Assistance (CMEA) members led to a reduction in the export of capital goods to transition economies and an increase in exports that reflected the exporter country's comparative advantage. Second, the type of exports to industrialised market economies changed significantly, particularly as more advanced transition economies increased their exports of machinery and transport equipment.

The narrowing of the difference between export structures and, in particular, the large reduction in the export of capital goods to other transition economies, illustrates the effect of market forces in directing structural change and specialisation in transition economies. Manufactured exports within the Soviet trading bloc were of poor quality and largely uncompetitive in international markets. Typical examples of such past exports are Bulgarian electronic goods, Czech rolling stock, Hungarian buses and Polish

Chart 4.2

The structure of exports to developed market economies and to other transition economies, 1989 and 1995, selected countries



Source: EBRD staff calculations based on the UN Comtrade database.

Note: The share of exports of a given SITC category (in per cent) is measured by the distance from the origin. Product categories correspond to the aggregation in Table 4.2.

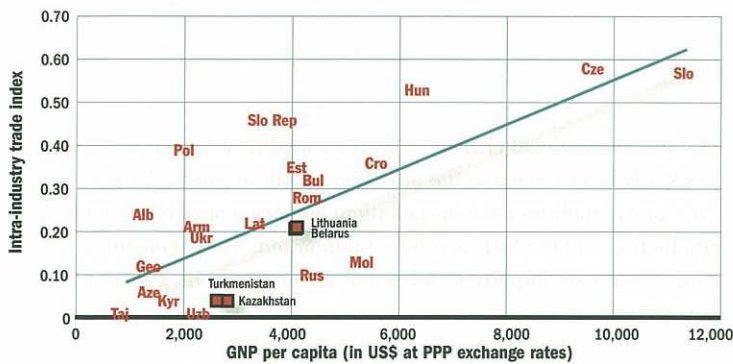
¹⁸ This dual structure of exports from former socialist economies has been found by others, including Hoekman and Djankov (1996).

trucks, the production of which has been sharply reduced. However, the gradual increase in the export of capital- and skill-intensive products to industrialised market economies by more advanced transition economies shows how changes to exports are increasingly reflecting these countries' long-term strengths. For example, transport equipment, in particular the assembly of automobiles, is leading the recovery in exports of capital goods, owing in part to substantial foreign direct investment.

Many advanced transition economies have experienced rapid growth in real wages and labour productivity in recent years and, if this trend continues, they are likely to shift increasingly away from labour-intensive sectors.¹⁹ This prospect, however, does not mean that opportunities for trade are being exhausted. Insights from trade theory suggest that countries with relatively similar levels of income per capita tend to have a high proportion of intra-industry trade.²⁰ In addition, some transition economies are attracting substantial foreign direct investment, much of which has been directed at export-oriented manufacturing. These factors suggest that intra-industry trade will gain an increasing share of trade flows between industrialised market economies and those in transition.

Chart 4.3 shows that the proportion of intra-industry trade in the total trade of transition economies with industrialised markets is directly related to their level of income. Moreover, in more advanced transition economies, this proportion has increased significantly in recent years. The largest increases have taken place in countries such as Hungary and Estonia with high levels of

Chart 4.3
Intra-industry trade with developed market economies increases with higher per capita incomes



Sources:

World Bank Atlas 1997, EBRD staff calculations based on the UN Comtrade database.

Notes:

Intra-industry trade is measured by the following formula:

$$1 - \frac{\sum_i |X_i - M_i|}{\sum_i (X_i + M_i)}$$

where: X_i and M_i are a country's exports to and imports from a trading partner in commodity i respectively. An index close to one indicates a large share of intra-industry trade. GNP per capita is calculated at purchasing power parity (PPP) exchange rates. Both GNP per capita and the intra-industry trade index are for 1995.

foreign direct investment. In contrast, intra-industry trade between Russia and industrialised market economies has fallen and is at an extremely low level.

In general, there are two forms of intra-industry trade. Horizontal intra-industry trade exploits preferences for product variety and allows two countries with very similar production structures to benefit from exchanging close substitutes with slightly different attributes. Some German consumers may have a taste for French wine and French cars, while some French consumers may prefer German cars and German beer. Vertical intra-industry trade arises from substantial quality differences among products and from outsourcing of production stages by companies operating internationally. For example, in the assembly of electronic goods, international companies often contract with low-cost manufacturers for those production stages that use low-skilled labour intensively. Intra-industry trade of transition economies with industrialised market economies is largely of the second kind (see Box 4.1).

As suggested by Box 4.1, exports from eastern Europe to the EU are generally of much lower quality than exports from other industrialised market economies and of only marginally better quality than exports from China and India to the EU. This finding highlights the challenge facing transition economies to achieve a level of competitiveness in high-quality and high-price segments of international markets that will enable incomes to rise to EU levels (and ease integration into the EU for those countries invited to join). However, it must be emphasised that quality upgrading is under way in more advanced transition economies. Continuation of this process requires additional investments at the enterprise level not only to replace outdated equipment but also to build skills in marketing and management strategies and to implement financial controls. In other words, enterprise restructuring is central to the emerging patterns of structural change and specialisation in transition economies.

4.3 Structural change, market reforms and enterprise performance

The performance of enterprises is at the heart of structural change and development in market economies. Entrepreneurs use their knowledge and skills to develop economic opportunities and to advance living standards by matching resources to consumers' demands. An important part of this process is the formation of new businesses, to which entrepreneurship makes a vital contribution. Managers in existing enterprises initiate product and process innovations in response to competitive challenges, thereby enhancing their companies' survival and growth. Workers contribute to this process through their effort and skills and through their willingness to adapt. Structural change and new specialisation in production are part of the visible process of economic growth and development. Entrepreneurs, managers and workers are the crucial agents in this process and their actions are shaped by how well markets and enterprises function. However, their activities are concealed below the surface of aggregate statistics.

¹⁹ See Chapter 7.

²⁰ Helpman and Krugman (1985).

Box 4.1

Quality gaps in east European trade with the EU

The quality of exports from eastern Europe is likely to be lower than the quality from industrialised market economies or indeed from middle-income developing countries. The main reason for this is the lack of attention that was paid to product quality under central planning, with the evaluation of enterprise performance almost exclusively in terms of output levels. Other reasons are the lack of customer awareness and of experience in product marketing.

Evidence shows that there are substantial quality gaps between east European and Russian exports and those of market economies (see Landesmann and Burgstaller [1997]). The comparison of unit prices for individual products at the most disaggregated level of trade statistics provides the basis for these findings. At this level, differences in unit prices are likely to result primarily from differences in quality. Based on the price comparisons of east European exports with those from market economies, it is possible to construct an indicator of the average quality gap in a particular industry, using export shares of each product category as weights. The ratio for a particular sector and country is given by:

$$Q^c = \sum (p^c/p^{EU}) s x^c,$$

where p^c is the price per unit at which country c sells exports of the product i on EU markets, p^{EU} is the average price of product i in total exports to the EU and $s x^c$ is the share of product i in country c 's exports to the EU market. The summation is over all i products belonging to industry j .

The table to the right shows the average quality gap for the engineering sector and the textiles, clothing and footwear sector for exports of seven transition countries to the EU in 1988-90 and 1992-94, where the average quality of all such exports to the EU in a given sector takes the value of one. The quality gaps for east European and Russian engineering exports were quite large in the earlier period. However, in the later period, the more advanced east European countries had registered a noticeable improvement to product quality levels more in line with those of middle-income developing countries. In contrast, quality gaps have remained large in Bulgaria, Romania and Russia. The quality gaps in clothing and textiles were smaller in the earlier period than those in engineering, but the general trend of improvement in more advanced transition countries and stagnation further east remains.

Estimation of quality gaps for exports to the European Union, 1988-90, 1992-94, selected sectors and countries

Country	Engineering		Clothing, textiles and footwear	
	1988-90	1992-94	1988-90	1992-94
Bulgaria	0.40	0.24	0.39	0.57
CSFR/Czech Republic	0.41	0.52	0.61	0.79
Hungary	0.38	0.44	0.74	1.03
Poland	0.34	0.42	0.60	0.76
Romania	0.12	0.14	0.53	0.51
Soviet Union/Russia	0.44	0.25	0.40	0.42
Yugoslavia/Slovenia	0.50	0.60	0.89	1.08
China	-	0.35	-	0.60
Greece	0.57	0.51	1.07	1.16
India	0.59	0.45	0.89	0.88
Portugal	0.83	0.90	1.04	1.05
Turkey	0.38	0.48	1.08	1.12

Source:

EBRD staff calculations based on Landesmann and Burgstaller (1997).

Notes:

Quality gaps are calculated as a weighted average of unit prices of exports from each country to the EU, relative to average export prices to the EU, at the lowest level of aggregation (eight-digit combined nomenclature, NACE). Price ratios are then aggregated to the three-digit industry level. The table reports the average quality gap of exports at the three-digit industry level for two particular sectors where the average quality of exports to the EU takes on a value of one.

Market economies share a number of features that enable and indeed require enterprises to exploit their full potential. Product market competition is one such characteristic that promotes both efficiency and innovation. Competition is the primary factor behind the process of market selection and hence the overall performance of the enterprise sector. Aggregate productivity increases when new businesses set up and expand successfully in an industry and when poorly performing enterprises leave the sector. Moreover, market-determined prices reconcile the preferences of consumers with the costs of production. Competitive pressures among existing producers in a market create strong incentives to maintain and improve their market position through efficiency gains and innovation. There are, however, important qualifications to this line of argument. The potential for temporary monopoly rents (profits from market power) is necessary to create an incentive for investments in product and process innovations

and in organisational changes.²¹ Further qualifications arise from market failures related to the provision of public goods, the presence of externalities (such as pollution) and economies of scale in production and the lack of public information. These considerations establish important roles for government in a market economy.²²

An essential public good provided by government in a market economy is the legal and institutional infrastructure for well-functioning markets.²³ For example, laws and their judicial enforcement serve to protect property rights and to implement economic transactions through contracts. Government fosters competition by limiting administrative hurdles for the entry of enterprises, by establishing rules for the exit of those producers no longer able to compete, and by controlling the concentration of market power through an active competition policy. There are also

²¹ These ideas are developed more fully in Chapter 3.

²² Stern and Stiglitz (1997).

²³ North (1990). Additional government activities in market economies include the provision of public goods and a limited range of government services.

a number of important regulatory tasks for government, particularly in the areas of finance, infrastructure and the environment. By establishing a stable and reliable policy and legal environment, government helps to reduce uncertainty, to facilitate economic decision-making and to improve the functioning of markets. Governments also support enterprises by avoiding counterproductive activities, such as arbitrarily favouring some enterprises and discriminating against others. The guiding principles should be a level playing field and an arm's-length relationship between government and all enterprises.

To respond efficiently to profit opportunities provided by well-functioning markets and to react effectively to competitive pressure, however, enterprise managers and workers need appropriate incentives. Private enterprises have systems of corporate governance which help to impart the profit motive of owners to managers as they exercise control over enterprise assets and operations. Apart from owner-managed firms, there is typically a separation between ownership and management. Because individual owners face difficulties in directly monitoring and controlling managers, the latter's incentives must be linked to enterprise performance through the mechanisms of corporate governance. These include managerial reward schemes, boards of directors, proxy contests among management teams and takeovers. Some corporate governance mechanisms also create the potential for new management teams to develop alternative and more valuable uses for enterprise assets.

The transition to a market economy requires progress in reforms in all three areas outlined above: the establishment of competitive markets, the need for government to support effectively markets and enterprises rather than directly provide goods and services, and the development of effective corporate governance mechanisms for private enterprises. International evidence, moreover, reinforces the importance of these market reforms. This evidence supports the view that weak product market competition, misdirected and unpredictable government policies and practices, and inadequate corporate governance mechanisms are detrimental to enterprise performance.²⁴ A central challenge for transition is, therefore, to strengthen the operating environment of enterprises and to harness the knowledge, skills, effort and initiative of entrepreneurs, managers and workers to achieve structural change, new specialisations in production and greater enterprise efficiency.

The remainder of this chapter examines the impact of the market reforms listed above on enterprise performance in transition economies. However, it is necessary first to define what is meant by enterprise performance and to examine how it is measured. Efficiency in production is central to enterprise performance and most performance measures examine the relationship between

input and output quantities. A commonly used performance indicator that captures this relationship is total factor productivity growth, measured as the difference between changes in output produced and changes in the sum of all inputs used, weighted by the respective shares of input payments in total costs. However, in practice there are problems in implementing this measure. Often appropriate data on the quality and price of inputs are missing. Fixed inputs, such as the capital stock, provide a flow of services that are difficult to measure. Alternative measures, such as labour productivity, profitability or asset market valuation, are therefore often used in evaluations of enterprise performance. In the context of transition, it is also useful to include qualitative indicators, such as the reorganisation of production.

4.4 Competition and enterprise performance

In transition economies, the impact of increased competition on enterprise performance can be measured in two ways. The first is to examine adjustments by state-owned enterprises (SOEs) early in the transition in response to price liberalisation, subsidy reductions, greater import competition and organisational changes. In a few countries where a significant new private sector already existed, elimination of legal restrictions on its operation also added some competitive pressures. The second type of analysis focuses on the entry of new private firms, which is becoming an increasingly important aspect of competitive pressures in the region, and an important source of economic growth at the enterprise level.

Competition and restructuring

State-owned and former state-owned enterprises in eastern Europe, the Baltic states and the CIS responded to the abolition of central planning and the liberalisation of prices and trade by undertaking very basic "defensive" restructuring measures. Defensive (or reactive) restructuring is a response to the short-term necessity to cut costs in order to stay in the market and involves such measures as shedding excess labour, containing wage costs and changing the product mix to stop producing unwanted goods and to deliver what customers demand. Enterprise managers often cited market pressure as one of the main reasons for the kind of reactive restructuring described here.²⁵

Several recent investigations highlight the importance of trade to product market competition and to enterprise performance. For example, a study based on a survey of several hundred Russian manufacturing enterprises in the period 1990-94 found a direct relation between measures of import competition (import penetration ratios) and enterprise adjustment indicators, such as labour productivity, change in product lines and total layoffs over the sample period. The study, however, failed to find a positive impact on enterprise performance from domestic product market competi-

²⁴ Nickell (1996) surveys the evidence on the positive relationship between competitive markets and enterprise performance and presents convincing new evidence based on panel data for 147 firms in manufacturing in the United Kingdom. Tybout and Roberts (1996) present a collection of empirical papers on the positive impact of market selection and enterprise turnover on economic growth. Evidence concerning the importance of government behaviour for enterprise performance will be reviewed in the next section. The positive relationship between private ownership, appropriate systems of corporate governance and enterprise performance is the subject of a vast theoretical and empirical literature (See section 6 of this chapter).

²⁵ See for instance Pinto and van Wijnbergen's (1995) survey of managers in 75 Polish SOEs. Heinrich (1995) similarly finds support for the impact of competition on enterprise adjustment in a survey of around 40 SOEs and privatised enterprises each in the Czech Republic and Hungary.

tion, measured by market share and two subjective indicators.²⁶ Another investigation focused on the shift in trade away from other transition economies to international markets as an indication of increased competition faced by Bulgarian enterprises. Trade orientation is found to be positively associated with total factor productivity growth at the enterprise level. In contrast, the share of exports in total sales has no impact on total factor productivity growth.²⁷

The beneficial impact of competition on enterprise performance can also be seen in the way that industrial sectors within a country have undergone different levels of adjustment. In Polish industry, for example, the growth in total factor productivity at the sub-sector level over the 1991-93 period was positively associated with import penetration ratios and negatively associated with sectoral concentration.²⁸ Caution in this interpretation is necessary, however, as competition in contested markets with only very few competitors can still be substantial, and hence competitive pressure might not be adequately measured by industrial concentration.

While available evidence suggests that openness to trade is significantly and positively related to enterprise performance, indicators of openness reveal that, despite significant increases in trade, transition economies remain less open than industrialised market economies. Chart 4.4 shows the levels of import penetration in the region in 1992 and 1995 and compares them with the levels of selected industrialised and developed countries that are roughly similar in size, resource endowments and income. The level of import penetration in most transition economies remains below the typical level in high-income west European economies. Compared with Greece and some developing countries, however, import penetration has already reached similar levels in many transition economies.

The initial high concentration of market structures of many transition economies highlights the importance of import competition as a source of restructuring pressure. Since the start of transition, many large industrial groups have been broken up and the number of enterprises has increased dramatically. The break-up of existing state-owned enterprises and the substantial labour shedding as a result of the recession have led to a smaller average enterprise size in many transition economies. It is hard to gauge, however, whether the resulting process of deconcentration has yet had a positive effect on the performance of the enterprise sector overall.²⁹

Competition and entry

With progress in transition, the entry of new private firms - private firms established *ab initio* - not only provides an increased pressure on state-owned and former state-owned enterprises to change but also furnishes one of the main sources of economic growth. With the abolition of legal barriers to enterprise entry, entrepreneurial activity has flourished in many transition economies, leading to substantial increases in the number of enterprises. By 1995 the Czech Republic and Hungary had reached an enterprise density per 1,000 inhabitants above the European Union average of 43, while Bulgaria, the Slovak Republic and Slovenia were just below that figure.³⁰ A recent study of the size of the *ab initio* private sector in eastern Europe and the CIS found that its share in GDP was highest in Albania, Poland and the Baltic states, and generally higher in eastern Europe than in the countries of the former Soviet Union.³¹ On average, according to these estimates, in 1995 the *ab initio* private sector accounted for 42 per cent of GDP in eastern Europe and the Baltic states against only 23 per cent in the CIS. The sectoral distribution of *ab initio* private firms has also become more diversified. By 1995, 25 per cent of new private firms in the Czech Republic, Poland, the Slovak Republic and Slovenia operated either in manufacturing or construction, representing a shift away from an initial concentration on consumer services.

Poland provides strong direct evidence concerning the contribution of the *ab initio* private sector to aggregate economic performance. In Poland, this sector has been the engine behind the rapid growth of manufacturing since 1992, despite its small size (7 per cent of industrial output) at the start of transition in 1989. Between 1992, when recovery started, and 1995, industrial output in Poland increased by 34 per cent, and the new private sector accounted for approximately two-thirds of this increase.³² In many other countries, the size of the *ab initio* private sector is only now reaching a level where a noticeable contribution to overall economic growth may be expected. In Russia, for instance, employment in new private firms increased from virtually zero to 15 per cent in mid-1996.³³

Together with its initial size, the contribution of the *ab initio* private sector to economic growth also depends on the rate of productivity increases in new private enterprises compared with state-owned or privatised firms. There have been many studies documenting the rapid growth of new private sector firms, and their strong performance compared with state and privatised

²⁶ Earle and Estrin (1997a). As discussed by Nickell (1996), market share may not be an ideal indicator of the degree of competition faced in the product market. The two subjective indicators therefore additionally try to capture the extent of contestability of markets in the Russian sample.

²⁷ Djankov and Hoekman (1996).

²⁸ Falk, Raiser and Brauer (1996). The study uses data for 21 sectors within Polish industry over the period 1991-93.

²⁹ However, at least for the case of the Czech Republic, it has been argued that the large-scale reorganisation of state-owned enterprises through break-ups of large conglomerates had no significant impact on the performance of individual enterprises. See Lizal, Singer and Svejnar (1995).

³⁰ These figures are from a recent comprehensive panel of new private enterprises in eastern Europe and the Baltic states, covering 92,000 recorded enterprises. See Eurostat (1996).

³¹ Johnson, Kaufmann and Shleifer (1997). The study estimates the size of the *ab initio* private sector by subtracting the share of initial private activity from the overall private sector share in GDP and adjusting for the impact of privatisation. While some of these adjustments appear rather ad hoc, the general trend of more private sector dynamism that they describe for eastern Europe would seem to be robust to measurement problems.

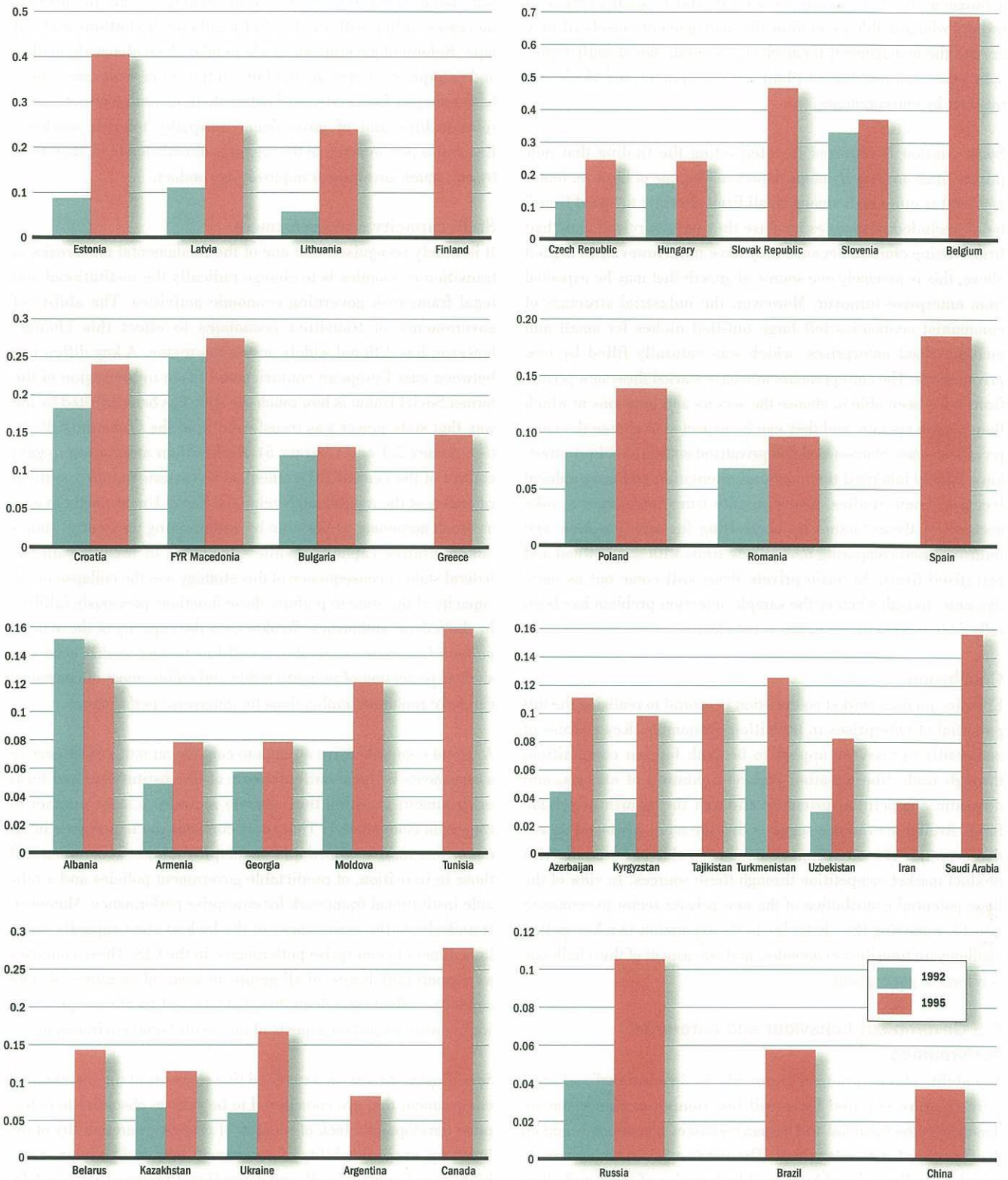
³² Gornulka (1997).

³³ *New Russia Barometer VI* (1996).

Chart 4.4

Import penetration has increased in most transition economies

Ratio of imports to GNP minus net exports



Sources:

IMF, World Bank and data provided by national sources.

Note:

GNP in US\$ at PPP exchange rates is used to calculate the import penetration ratios.

firms.³⁴ Several factors may explain this strong performance, although actual evidence on their relative importance is still lacking. First, new private firms have good corporate governance arrangements, with private ownership and a small number of owners who are able to monitor the management closely (if they are not the management themselves). Second, they usually represent new combinations of plant and equipment and skills put together by entrepreneurs.

Some caution is required in interpreting the finding that new private firms are very dynamic, however. The rate of turnover (entry and exit) is quite high among small firms, leading to “good firms” being included in samples because they have survived and “bad firms” being omitted because they have not. However, as argued above, this is precisely one source of growth that may be expected from enterprise turnover. Moreover, the industrial structure of communist economies left large unfilled niches for small and medium-sized enterprises, which was naturally filled by new private firms. The entrepreneurs who have started these new private firms have been able to choose the sectors and locations in which they want to operate, and they can be expected to choose the more promising ones. State-owned and privatised enterprises, in contrast, have largely inherited their sectoral orientation and geographical location. Some studies of new private firms have tried to take account of these factors by controlling for size, location and industry when comparing new private firms with state-owned and privatised firms. *Ab initio* private firms still come out as more dynamic, though whether the sample selection problem has been fully addressed in these studies is not clear.

Conclusion

Effective product market competition is central to realising the full potential of enterprises in transition economies. Key sources of competitive pressures appear to be both foreign competition, through trade liberalisation and reorientation of exports, and domestic competition primarily through the growth of private firms. Available evidence suggests that the more advanced transition countries of eastern Europe have been able to foster effective product market competition through these sources. In view of the large potential contribution of the new private sector to economic growth, removing the obstacles to its expansion is a key policy challenge in transition economies, and one aspect of this challenge is reform of government.

4.5 Government behaviour and enterprise performance

The ability of a government to provide the institutional and legal infrastructure required for a well-functioning market economy depends on the financial and human resources it commands and on the capacity of state institutions. The state’s capacity to perform its functions is limited and burdened by legacies of legal and other traditions and of established levels of public trust in state institutions. The behaviour of government also depends on leadership and on the incentives of government officials not to misuse public

office for private benefits. Where the probability or level of penalty is low and the culture and tradition of integrity are weak, public officials are more prone to corruption. Moreover, the scope for arbitrary behaviour and hence for “rent-seeking” by public officials increases in line with the level of regulatory distortions and red tape. Reform of government needs to take place alongside market and enterprise reforms, particularly in transition economies which have emerged from systems of paternalistic government-enterprise relationships and of government antipathy towards markets. Enterprise performance in the region is directly affected, therefore, by how much government improves its conduct.

State capacity and investment

It is widely recognised that one of the fundamental challenges in transition economies is to change radically the institutional and legal framework governing economic activities. The ability of governments in transition economies to effect this change, however, has differed widely across the region. A key difference between east European countries and those in the region of the former Soviet Union is how much the state has been affected by the way that state power was transferred from the Communist Party (see Annex 2.1 and Chapter 5). Rather than attempting to gain control of the central government as in eastern Europe, political reformers at the republican level in the Soviet Union sought to gain as much autonomy as possible by undermining the central state’s administrative capacity. While successful in breaking up the federal state, a consequence of this strategy was the collapse in the capacity of the state to perform those functions previously fulfilled by the federal authorities. Weakness in the capacity of the state to perform functions essential to a well-functioning market economy, such as protection of property rights and enforcement of contracts, can have profound implications for enterprise performance.

A recent comprehensive attempt to compile an index of subjective assessments by local entrepreneurs of the institutional and legal environment in which they operate includes a large number of transition economies.³⁵ This study confirms the importance in all countries, industrialised and developing market economies and those in transition, of predictable government policies and a reliable institutional framework for enterprise performance. Moreover, it underlines the seriousness of the lack of state capacity as an impediment to enterprise performance in the CIS. These countries as a group rank lowest of all groups in terms of measures of state capacity, reflecting a deep dissatisfaction of local entrepreneurs with several important aspects of the institutional environment.

Specifically, the survey examined five elements of the institutional environment that are considered to be serious obstacles to enterprise development: lack of security of property, unreliability of the judiciary, unpredictability of government laws and policies, instability in government itself, and corruption. Compared with the CIS, the extent of dissatisfaction in eastern Europe and the Baltic states is less on all criteria. The relative disadvantage of the CIS is greatest in respect of unpredictability of policy and level of

³⁴ See, for example, Belka et al. (1995), Johnson and Loveman (1995), Richter and Schaffer (1996) and Bilsen and Konings (1996).

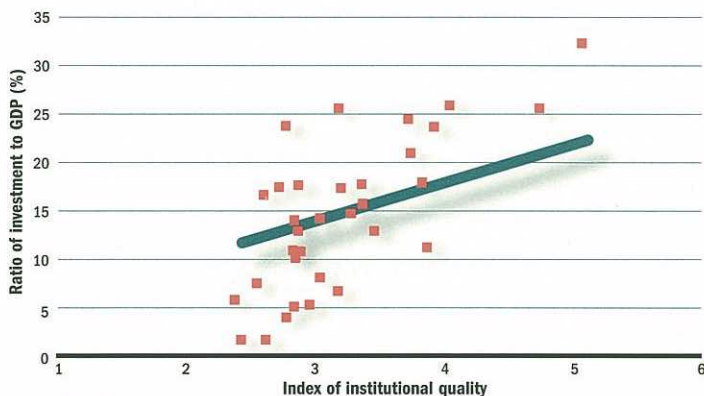
³⁵ World Bank (1997).

corruption. These findings are further substantiated by a recent survey of private shops in Moscow and Warsaw. Russian shop managers felt considerably more vulnerable to legal uncertainty and demands for bribes by public officials than their Polish counterparts did.³⁶

An unpredictable policy environment and an ineffective legal system represent major obstacles to investment and growth. A number of enterprise studies have inquired whether difficulties with implementing an investment project were related more to the cost of regulations or to their arbitrary and haphazard implementation. In a majority of cases, managers have highlighted regulatory uncertainty rather than the cost of regulations as a major impediment to the development of their businesses.³⁷ This point can be graphically illustrated by a partial correlation of an index of the quality of the institutional environment against average investment rates in the sample of countries included in the above-mentioned study (Chart 4.5).³⁸

Chart 4.5

Low institutional quality deters investment



Source:
World Bank (1997), p. 32.

Note:
The chart plots investment rates against an index of institutional quality using data for 33 countries over the 1984-93 period. The solid regression line controls for income per capita, education and policy distortions. The index of institutional quality comprises the following five dimensions: i) predictability of laws and policies, ii) stability of government, iii) security of property rights, iv) reliability of judiciary, v) corruption. The index of institutional quality was originally called index of political credibility by the World Bank (1997), on which this chart is based.

Government behaviour and the unofficial economy

With implementation of economic reforms, governments in transition economies have begun to create a legal and institutional framework supportive of competitive markets. However, myriad business regulations, arbitrary and incoherent tax regimes, and a prevalence of corruption continue to impose very high costs on existing and, in particular, new private businesses. Governments in many cases do not respect the arm's-length principle in dealing

with the enterprise sector, and privileges extended to state-owned enterprises remain prominent. Where the costs of abiding by the formal laws and regulations are high and where the state's capacity to enforce property rights and contracts is low, enterprises have an incentive to operate in the unofficial economy.³⁹

One way to measure the size of the unofficial economy in transition economies is to compare changes in official GDP with changes in energy consumption (see Box 4.2). Two general results emerge from such an exercise. First, the unofficial economy has increased almost everywhere in the region, pointing to considerable costs imposed on enterprises operating in the formal economy and the limited capacity of the state to provide essential services for well-functioning markets. It is noteworthy, however, that in some countries the estimated share of the unofficial economy in total GDP (including the unofficial economy) has fallen since 1994, notably in the Czech Republic, Estonia, Lithuania, Poland and the Slovak Republic. This may reflect improvements in the operating environment as well as increases in the governments' ability to enforce existing legislation and limit tax evasion. Second, the share of the unofficial economy in GDP is on average higher in the CIS, reflecting at least in part the greater cost of official business due to unpredictable and arbitrary government policies and the lack of state capacity and institutional quality. Given the rather strong assumptions underlying the methodology behind these figures, the observations made here should be viewed as suggestive rather than conclusive, however.

While the estimated share of the unofficial economy in total GDP in many transition countries is substantial, in another important respect the unofficial economy is rather shallow (Box 4.2). A distinctive feature of the informal economy in transition economies is that much of this activity consists of misreported or undeclared economic activities performed by registered enterprises using the same assets that are used to produce output for the formal economy. This part of the unofficial economy is particularly sensitive to changes in relative costs of official and unofficial activities, such as changes in business regulations and taxation, changes in the state's capacity, and changes in the level of bribes required to avoid detection by tax authorities and government regulators.

Survey evidence suggests that the costs for businesses associated with the unofficial economy bear more heavily on new enterprises and the growth of small firms than on activities of the state-owned and former state-owned medium-sized and large enterprises.⁴⁰ Government policies in many transition economies continue to violate the arm's-length principle. The expansion of private businesses without government connections is thereby hindered and the entry of *ab initio* private firms into the official economy discouraged. Chart 4.6 confirms this suggestion by showing that those transition economies with a larger new private sector

³⁶ Frye and Shleifer (1996).

³⁷ World Bank (1997) and Halligan and Teplukhin (1996). See also Chapter 9 of the 1995 *Transition Report*.

³⁸ The World Bank calls this an index of "political credibility". A broader terminology is adopted here to reflect the complementary nature of government policies and the state's capacity in generating an efficient institutional framework.

³⁹ See Borner et al. (1995).

⁴⁰ Kaufmann (1997), Frye and Shleifer (1996) and Johnson, Kaufmann and Shleifer (1997).

Box 4.2

Understanding and measuring the unofficial economy

A recent attempt to measure the unofficial economy across a large number of transition economies was carried out by Kaufmann and Kaliberda (1996). The basic concept was to find a variable that is very closely related with GDP everywhere in the world and to look at the rate of change in this variable compared with the rate of change in official GDP as an indication of the rate of change in the size of the unofficial economy. Kaufmann and Kaliberda suggest that electricity consumption fulfils this role on the basis of international evidence of a rough parallel between demand for electricity consumption and growth in GDP.

Share of the unofficial economy in GDP, 1989-95, selected transition economies

(in per cent)

	1989	1990	1991	1992	1993	1994	1995
Azerbaijan	12.0	21.9	22.7	39.2	51.2	58.0	60.6
Belarus	12.0	15.4	16.6	13.2	11.0	18.9	19.3
Bulgaria	22.8	25.1	23.9	25.0	29.9	29.1	36.2
Czech Republic	6.0	6.7	12.9	16.9	16.9	17.6	11.3
Estonia	12.0	19.9	26.2	25.4	24.1	25.1	11.8
Georgia	12.0	24.9	36.0	52.3	61.0	63.5	62.6
Hungary	27.0	28.0	32.9	30.6	28.5	27.7	29.0
Kazakhstan	12.0	17.0	19.7	24.9	27.2	34.1	34.3
Latvia	12.0	12.8	19.0	34.3	31.0	34.2	35.3
Lithuania	12.0	11.3	21.8	39.2	31.7	28.7	21.6
Moldova	12.0	18.1	27.1	37.3	34.0	39.7	35.7
Poland	15.7	196.0	23.5	19.7	18.5	15.2	12.6
Romania	22.3	13.7	15.7	18.0	16.4	17.4	19.1
Russia	12.0	14.7	23.5	32.8	36.7	40.3	41.6
Slovak Republic	6.0	7.7	15.1	17.6	16.2	14.6	5.8
Ukraine	12.0	16.3	25.6	33.6	38.0	45.7	48.9
Uzbekistan	12.0	11.4	7.8	11.7	10.1	9.5	6.5

Source:

Johnson, Kaufmann and Shleifer (1997).

Notes:

The share of the unofficial economy is defined over total GDP, i.e. correcting official GDP for estimates of the change in the unofficial economy derived from data on electricity consumption. The 1989 data comes from two survey studies conducted in the late 1980s.

There are a number of reasons why this relation between electricity demand and GDP may not hold during transition. Due to price liberalisation, increased energy efficiency and shifts away from energy-intensive sectors, electricity demand may drop during the upswing. At the same time, inefficiencies resulting from higher overheads during capacity under-utilisation, lack of basic maintenance due to shortage of funds, and substitution away from other sources of energy to electricity would tend to push up energy demand. Particularly where recorded output falls have been very large, such as in the CIS, enterprises may be unable to reduce electricity consumption commensurately, even without additional unofficial production. Taking these considerations into account, Kaufmann and Kaliberda adjust the income elasticity of the demand for electricity to 0.9 in all east European countries and to 1.15 in the CIS. The assumption of a unitary elasticity (1.0) is retained for the Baltic states. Note that these assumptions imply a higher estimate of the unofficial economy in eastern Europe and a lower estimate for the CIS than under a simple unitary elasticity scenario.

In order to arrive at the shares of the unofficial economy in GDP for 1990-94, a starting value for the year 1989 is needed. This value is taken from two international studies conducted during the late 1980s and early 1990s. The initial values are particularly high for Hungary, Bulgaria and Romania while very low for the Czech Republic. While level estimates may be distorted by starting points, the rates of change confirm the major message that the unofficial economy has increased considerably more in the CIS than in central and eastern Europe.

The table to the left shows the Kaufmann and Kaliberda estimates of the share of the unofficial economies in GDP for 17 transition economies.

The unofficial economy has also been measured in other ways for individual transition countries. For Hungary, for example, the methodology has relied extensively on household income and expenditure surveys (Arvay and Vertes, 1995). Lifestyle surveys were conducted to derive hidden incomes from a typical consumption pattern. Consumers were also asked to report the number of purchases made without receipts as an indication of undeclared sales. This methodology has found the share of the unofficial economy in Hungary to be around 29 per cent in 1992. This estimate is quite close to that of Kaufmann and Kaliberda.

(i.e. the officially recorded private sector excluding privatised enterprises) as a share of GDP tend to have a smaller unofficial economy as a share of estimated total GDP.

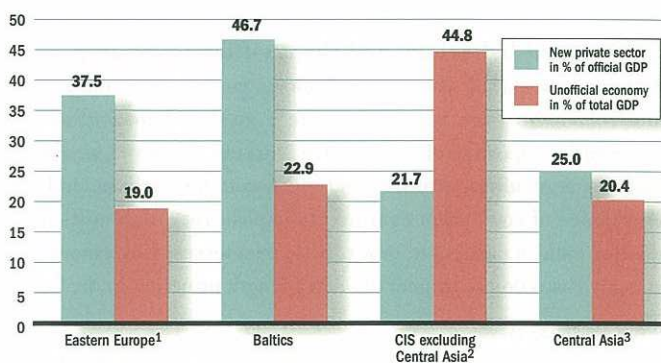
Conclusion

Transition involves a radical reorientation in the relationship between government and enterprises. The role of government shifts from an (in principle) all-powerful coordinator of economic activity to the role of a rule setter and enforcer. Government in most economies also continues to provide basic public services, such as healthcare and education, and to invest in basic infrastructure to complement private investment. As government's regulatory capacity increases, its involvement in the direct provision of these services may also be reduced, opening up new opportunities for government-business partnerships. However, in all its dealings with the private sector, the guiding principle for government must be to maintain an arm's-length relationship with enterprises.

Chart 4.6

Estimated share of the new private sector and the unofficial economy in GDP, 1995

In per cent



Source:

D. Kaufmann et al. (1997).

1 Includes Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovak Republic.

2 Excludes Armenia.

3 Includes Kazakhstan, Uzbekistan.

Government in transition economies has to adapt to this new role against the background of weak state capacity, manifested in a poor ability to enforce contracts, lack of public trust and high levels of corruption. The reliability and quality of the institutional framework is, therefore, low. This and repeated changes to laws and regulations increase uncertainty and depress investment. Moreover, myriad remaining administrative hurdles and policy distortions increase the cost of doing business and lead to the defection of enterprises to the unofficial economy. The development of the new business sector is thereby negatively affected and growth may suffer.

4.6 Privatisation, governance and enterprise performance

While previous sections have focused on factors external to firms and their contribution to enterprise performance and restructuring, this section turns to internal pressures for adjustment resulting from privatisation and corporate governance. The particular focus is on the impact of privatisation and alternative forms of corporate governance on enterprise performance.

Privatisation and enterprise performance

The early transition period was characterised by “defensive” adjustment measures by state-owned and privatised enterprises in response to increased competitive pressures and considerable hardening of budget constraints in most countries of the region. For a sustained improvement in performance, these defensive measures are not enough, however. International evidence from both industrialised and developing market economies suggests that private firms outperform state-owned firms even in competitive industries; the evidence also shows that firm performance improves following privatisation.⁴¹ Comparisons between the performance of state-owned and private firms in transition economies are only now becoming available, but the picture is similar: privatised and new private firms perform better than state-owned firms. Here the discussion focuses on the relationship between privatisation and performance (the new private sector was discussed above).

A useful starting point is a comprehensive study of the impact of privatisation on firm performance using data on over 6,000 enterprises from six east European countries (Bulgaria, the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia) for the period 1992-95.⁴² This study finds that growth in total factor productivity increases substantially after privatisation, by about 5 per cent per year. Various other studies have also shown privatised firms outperforming state-owned firms, or privatised firms improving their performance following privatisation, according to a number of measures of restructuring and performance.⁴³

Studies that seek to identify the effects of privatisation on the performance of firms face a key problem, however. Privatisation is typically not random, and enterprises that are selected for privatisation may simply be better, or potentially better, to begin with. While privatisation can be expected to foster better performance (for the reasons described earlier), it is also possible that better performance (actual or potential) leads to privatisation; when this is the case, the result is a form of sample selection bias. Studies need to establish not simply an association between privatisation and good performance, but that privatisation leads to good performance, and not simply the other way around. This sample selection bias can also exist between alternative forms of privatisation where multiple tracks to private ownership exist.

Management and employee buy-outs in Poland provide a good example of the problem. In this case, the selection bias works in favour of a specific group of owners rather than private versus state ownership in general. Insiders in small and medium-sized firms were given the right to purchase their enterprises from the state (via “liquidation privatisation”) and to borrow from the state to finance the acquisition. Employees were more likely to take up this option if the enterprise was profitable to begin with and, in particular, if it could generate the cash flow needed to service the debt. A survey of 200 Polish manufacturing enterprises found that those privatised to workers were relatively healthy.⁴⁴ However, this result is arguably not because workers are better owners but because workers are more likely to buy profitable enterprises.

A small but growing number of recent studies have tried to address the selection bias problem when analysing the impact of privatisation on firm performance.⁴⁵ These studies have produced the same results as those from the earlier studies and from the analyses of privatisation in market economies: private firms outperform state-owned enterprises across a range of performance and restructuring indicators. Studies of the effects of privatisation on enterprise performance are now turning to how corporate governance is exercised.

Corporate governance and performance

The experience of privatisation has been very diverse across, and within, transition economies, with a wide variety of privatisation methods being employed and a wide variety of ownership structures emerging (see Chapter 5). There have been voucher privatisations directly to the public or via investment privatisation funds, sales or give-aways to insiders (managers and workers) and direct sales to the public, to other firms or to foreign investors. Ownership is sometimes concentrated in a few shareholders, and sometimes it is very diffuse. Moreover, the initial structure of ownership changes following privatisation as share ownership changes hands.

⁴¹ See, for example, Vining and Boardman (1992) and Megginson, Nash and Van Randenborgh (1994).

⁴² Pohl et al. (1997)

⁴³ See, for example, Belka et al. (1995) for Poland, Barberis et al. (1996), Earle and Estrin (1997b) and Filatotchev et al. (1996) for Russia, and Frydman et al. (1997) for a study of the Czech Republic, Hungary and Poland.

⁴⁴ Earle and Estrin (1996).

⁴⁵ Barberis et al. (1996), Earle and Estrin (1997b), Claessens and Djankov (1997) and Frydman et al. (1997) are notable examples.

One of the initial concerns about privatisation programmes resulting in large-scale ownership by insiders was that insiders would prove ineffective owners of larger firms, lacking the incentives to undertake deep restructuring measures which may be painful or expensive in the short term. This is particularly the case in enterprises effectively controlled by workers, where adjustment involves lay-offs of a significant part of the workforce. While the problem might disappear eventually as insiders sell shares to outsiders and firms cease to be insider-owned, this process could be lengthy, especially if the insiders are able to set up obstacles preventing or making it difficult for outsiders to acquire shareholdings and eventually control.

A study of Russian industrial firms in the first years following privatisation presents evidence which suggests that managerial ownership of larger Russian firms is associated with better restructuring and performance, across a wide variety of restructuring measures, compared with both state-owned firms and firms with dominant worker ownership.⁴⁶ Outsider ownership, however, is associated with the most restructuring and the best performance, a finding consistent with the concerns expressed above about insiders delaying restructuring.

As noted above, the need for lay-offs may delay restructuring in worker-controlled firms, but the reasons for management ownership to delay restructuring are less obvious. Indeed, there are competing views as to why privatisation leads to improved performance in firms. Private owners may give the managers of their firms the right incentives to perform (for example bonuses when the firm does well) or the managers may themselves be the owners, claiming the entire residual cash flow. Alternatively, private outside owners may simply choose better managers. Managers of private firms are hired on the basis of their skill at managing the firm, whereas managers of state firms may be hired on other criteria (such as their connections). Managers in insider-dominated firms may similarly benefit from good relations with worker committees or indeed, as a result of a management buy-out, may not be subject to outside monitoring (and hence pressures to leave) at all.⁴⁷

One study of Russian shops following privatisation suggests that privatisation and the introduction of high-powered incentives for managers (such as share ownership) are not enough to cause shops to undertake major restructuring measures (engaging in major renovation, keeping longer hours, changing their suppliers). Instead, what appears to cause major restructuring is managerial turnover, i.e. the introduction of new human capital.⁴⁸ This finding suggests that, to promote enterprise restructuring following privatisation, it is not enough for privatisation programmes to give

management ownership stakes in their firms (and hence high-powered incentives). Programmes should be designed to promote share turnover and to enable new owners to exercise effective corporate governance by being able to replace the existing management (see Chapter 5).

The ability of outside owners to exercise corporate governance increases with the size of their shareholding. It is often argued that some concentration of ownership helps corporate governance. By contrast, diffuse ownership rights spread among many small shareholders will be ineffective. This was a concern of some at the start of the Czech voucher privatisation programme. In the event, investment privatisation funds emerged to take the vouchers which had been distributed to the population, and most individuals ended up investing their vouchers in these funds. The initial ownership structure of privatised Czech firms was already fairly concentrated, and subsequent trading of shares has increased the level of concentration. By 1995, the average listed Czech firm had close to 60 per cent of its shares held by five shareholders, and investment funds accounted for about 50 per cent of all shareholdings.⁴⁹

The natural question is whether increased concentration leads to improved enterprise performance. It has been shown using a sample of 300 listed Czech enterprises that firms with share ownership concentrated in a small number of shareholders, in particular investment funds, tend to have higher operating profits and higher stock market valuations.⁵⁰ Apparently, concentrated ownership leads to better operating performance, and it seems that the market values concentrated ownership. As before, however, care must be taken when interpreting these correlations: it is also possible that investment funds are better informed about firms' prospects and are better at finding good firms in which to invest. The Czech experience suggests also that corporate governance of the financial intermediaries themselves can itself be problematic (see Chapter 5).

Conclusion

The economic reforms introduced at the start of transition throughout most of the region (liberalisation of prices and trade, reduction in subsidies, decentralisation of decision-making to SOE managers) have been successful in generating initial adjustment by SOEs. In the medium term, international evidence and, increasingly, results from the transition economies suggest that private ownership is a crucial factor in improving enterprise performance. In choosing the right privatisation method, policy makers should bear in mind the evidence presented here, which points towards better performance in enterprises owned by a concentrated group of outsiders capable of bringing in new managers.

⁴⁶ Earle and Estrin (1997b).

⁴⁷ Incumbents also have assets that might qualify them for management during the transition. They have developed enterprise-specific human capital, in the form of network capital with other managers, technological knowledge and knowledge about workers' ability, which may all contribute to easing the adjustment at the enterprise level. Whether managerial turnover is decisive for the success of enterprise adjustment ultimately is an empirical matter.

⁴⁸ Barberis et al. (1996).

⁴⁹ Claessens, Djankov and Pohl (1997).

⁵⁰ Claessens et al. (1997).

4.7 Conclusion

This chapter has examined a number of aspects of enterprise performance in transition economies. It started with an analysis of adjustment at the aggregate level, in particular how the composition of output and the use of resources have responded to the introduction of market mechanisms. In general, the analysis found that introducing market forces has advanced the sectoral composition of employment in transition economies closer to market-based benchmarks. The share of industrial employment has declined sharply towards the benchmark, particularly for lower-income transition economies. For upper-income transition economies, considerable further adjustment could be required. The share of agricultural employment has increased towards the market-based benchmark, particularly for lower-income transition economies. The share of market-oriented services has also increased in most transition economies, reflecting the neglect of this sector under central planning. One striking and potentially worrying result, however, is that the proportion of employment in government services (healthcare, education, defence and public administration), those sectors not directly exposed to market forces, has increased well beyond benchmark levels in most transition economies. Nevertheless, the general picture that emerges is that the direction of change is towards those structures that would be expected in market economies with comparable levels of per capita income.

The analysis of foreign trade, moreover, supports the view that the changing composition of output in transition economies reflects the strong influence of market forces. In particular, the composition of trade in 1995, both of exports and imports, was broadly consistent with the comparative advantages of transition economies. The composition of exports varies widely across the region, reflecting differences in endowments of natural resources and in levels of development. Several resource-rich CIS countries export mostly primary products and energy, while most east European and Baltic countries export a variety of manufactured products, with the more developed countries exporting more capital-intensive manufactured goods. Imports throughout the region are dominated by capital-intensive goods, reflecting the need to upgrade the existing, partially obsolete capital stock. In addition, trade structures have become more aligned with comparative advantage, as the composition of trade among transition economies has moved closer to the composition of their trade with the rest of the world. Despite the substantial adjustment effort, however, formidable challenges remain, as shown by the inferior quality of east European exports on west European markets.

While the analysis of structural adjustment illustrates the effects of market forces on the composition of output and the use of resources, it conceals a number of important factors that shape enterprise adjustment and performance. The chapter examined, therefore, the effects of three broad factors on enterprise performance: product market competition; government behaviour and the capacity of the state to perform its functions; and privatisation and corporate governance.

The process of product market competition, of rivalry among producers and of entry and exit by firms into the market, is central to strengthening enterprise performance in transition economies. Available evidence reveals that increased competition from imports in transition economies is often associated with improvements in enterprise performance, such as gains in total factor productivity. There is also substantial evidence that in countries at more advanced stages of transition the entry of new private firms has made a substantial contribution to productivity increases and output growth. Compared with state-owned and privatised enterprises, new private firms register higher output and productivity growth, thereby subjecting existing enterprises to competitive pressures.

Concerning government behaviour and the capacity of the state to perform its functions, this chapter has focused on two issues. The first addresses the impact of limited state capacity and the uncertainty surrounding the formulation and implementation of policy on enterprise performance. Evidence from both market economies and those in transition points to a significant, positive relationship between state capacity and the quality of the institutional environment and investment. The results of a recent international survey of businesses suggest that the transition economies, and CIS countries in particular, have relatively weak states, as reflected in low values for political stability, reliability of state institutions and government policies, and high levels of corruption (see also Annex 2.1). The weakness of the state therefore represents an important obstacle to recovery and growth at least in parts of the region. A second issue concerns the costs imposed on new entrants and existing enterprises by remaining administrative hurdles and policy interventions. One response of businesses to high costs of operation related to government behaviour is to operate in the unofficial economy. This is promoted in countries where the state's capacity is weak, because detection costs faced by firms increase with the strength of state institutions. The evidence from transition economies strongly suggests that private enterprises suffer disproportionately from the costs associated with pervasive government interference and the neglect of the arm's-length principle.

A consistent finding of studies of transition economies is that the sale or transfer of state-owned enterprises into private hands is associated with, and indeed leads to, improved performance, in line with the findings from industrialised and developing market economies. Enterprise performance is also enhanced by effective corporate governance structures, in particular concentrated outside ownership which has both the incentive and means to exercise effective control over enterprise managers.⁵¹

Where this chapter has assembled evidence on how much enterprises have adjusted and on the factors governing enterprise performance, the next chapter addresses a number of policy issues raised by the evidence presented above. In particular, it examines the challenges in radically altering the relationship between governments and enterprises in transition economies, approaches to banking reform, ways of fostering increased product market competition, and implications of privatisation for corporate governance and its evolution in transition economies.

⁵¹ See also the discussion in the 1995 *Transition Report*.

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Enhancing enterprise performance

To improve the performance of enterprises in transition economies, two key aspects of market-oriented reforms are of paramount importance. The first involves altering radically the relationship between government and enterprises and the second requires the establishment of effective mechanisms for privatisation and corporate governance. This chapter examines in depth the past experiences and the future challenges of transition economies in these two areas. The analysis in Chapter 4 of the factors that determine how an enterprise performs in the transition to a market economy underlines the importance of progress in these reform areas. However, this progress varies widely across the region (see Chapter 2). A number of east European and Baltic countries have relatively few problems regarding the relationship between the state and enterprises, but effective institutions of corporate governance have yet to emerge. In contrast, many CIS countries remain severely affected by weaknesses in both areas.

A successful relationship between government and enterprises requires the establishment of predictable, non-arbitrary rules for business activities (such as taxation and business licensing) and the legal enforcement of property rights and contracts. Under the central planning of the previous regime, the state used a variety of measures to suppress private activity. However, in some countries continued bureaucratic interference in business activities and weaknesses in the legal framework have severely diluted the benefits resulting from the removal of prohibitions on private sector activity. In particular, many potential benefits from the development of the new private sector have yet to be realised. Such failures in many CIS countries are well documented¹ and are generally more severe than those in eastern Europe and the Baltic states (see Annex 2.1).

It is crucial to detach enterprises from their dependence on government support and to base their survival on performance in the market place. While many countries have hardened enterprise budget constraints by eliminating budgetary subsidies, this measure has sometimes been compromised by governments' willingness to allow tax and energy tariff arrears or by access to soft loans from banks. Continued government support of enterprises, whatever form it takes, often reflects resistance to the structural change and restructuring that is needed (see Chapter 4). Moreover, if forcing enterprises to rely on their own performance is to lead to enhanced efficiency, enterprises must operate in a competitive environment. Opening the economy to international trade has provided an effective and simple competition policy in many countries. However, active demonopolisation through effective competition policy is sometimes required, particularly in large or relatively closed economies.

Privatisation has launched the private ownership of many medium-sized and large enterprises in transition economies, but the design of privatisation programmes has often compromised the effectiveness of corporate governance in these privatised companies. To improve governance and enterprise performance, it is vital, therefore, to make changes in the initial ownership structures and the arrangements for corporate governance and to impose discipline from outside sources of finance. The budding financial sectors in the region have a central role to play in this process. However, building market-oriented and stable financial sectors has been one of the more challenging aspects of transition.

Government behaviour towards enterprises in transition economies is examined in section one, along with ways of strengthening the role of government. The second section looks at the need for enterprises to move from dependence on government to reliance on the market. While the policies required to implement this shift are widely recognised, this section examines the links between policies, including those aimed at strengthening the role of government, and the effectiveness of the institutions charged with implementing these policies. Particular attention is given to the challenges of financial sector reform and of implementing effective bankruptcy and competition policies. Section three focuses on developing the effectiveness of private institutions, in particular the privatisation and governance of enterprises and the market mechanisms which bring about improvements in corporate governance. The fourth section concludes with an assessment of key challenges ahead in enhancing enterprise performance.

5.1 Government behaviour and enterprise performance

Government behaviour affects enterprise performance and growth in two fundamental ways. The first concerns uncertainty about government policy (such as taxation and tariffs) and unpredictability of actions by the government and judiciary, both of which can lead to the postponement of investment and to short-term horizons for business decisions. The second stems from the state (the government, bureaucracy and judiciary) operating in a highly discretionary manner and thereby generating inefficiencies through the seeking and granting of special privileges and in some cases by stifling entrepreneurship altogether. Both factors inhibit growth because investment in existing enterprises is reduced, entry and growth of new firms is hampered and foreign investment is deterred. Chapters 4 and 6 provide evidence linking the function and behaviour of governments to enterprise performance, including development of the new private sector, and to long-term economic growth. This section examines some of the factors behind the weaknesses in the functioning of the state in transition and ways to strengthen its capacity.

¹ See EBRD (1997).

Weaknesses in the functioning of the state in transition economies

High levels of corruption exist in some of the transition economies. The adverse effect of corruption on enterprise performance and growth depends on the capacity of the state compared with other economic agents (managers, workers and entrepreneurs).² In economies where the state has sufficient capacity, it can protect existing rights at low cost. Corruption in this instance is not necessarily inconsistent with rapid growth. State officials interested in maximising the potential value of bribes have both the power and the incentive to create and protect productive rights. However, in countries where the state lacks the capacity to enforce rights, it becomes uncertain who has particular rights (for example, property rights), which then become highly contested. In this instance, state officials have little interest in the long-term performance of enterprises and are unable to monopolise the protection of rights (with a possible consequence that Mafia-type groups flourish).³

Compared with eastern Europe, the CIS has much higher levels of corruption and of perceived policy instability (see Annex 2.1). This fact and the reasons for corruption suggest that in the CIS the weakness of the state compared with other agents in the economy (such as managers of state-owned enterprises) may be due to the circumstances of the transition in the former Soviet Union.

A key difference between east European countries and those in the region of the former Soviet Union is the way that the transfer of state power from the monopoly of the communist party to new political regimes has affected the capacity of the state. In eastern Europe the opposition movements pursued a transition strategy that focused on gaining control of existing state institutions and on preserving the institutional foundations of state capacity. The political opposition pursued a quite different strategy in the context of the Soviet federal system. Rather than attempting to gain control of the centralised Soviet state, politicians at the republican level pursued a strategy of increasing their political autonomy by undermining the administrative capacity of the Soviet federal state. They did so by offering individual enterprises and organisations in their own republics "as much autonomy from the centre as they could take", to paraphrase a well-known slogan of Boris Yeltsin at the time, with the aim of winning their allegiance in the struggle against the centre. However, a by-product of this transition strategy was the collapse of the capacity of the state to perform the functions previously fulfilled by federal authorities.

The unravelling of the federal system in the Soviet Union has proved difficult to control, especially in Russia, where regional leaders have sought to use the same tactics to weaken the capacity of the Russian federal state. In contrast, the political transition in

the unified states of eastern Europe (with the exception of the Yugoslav federal state) did not entail the same challenge to the capacity of the central state, enabling the key state institutions to continue to function through the transition albeit under different political leadership.

Since the experience of communism and the nature of the political transition lie behind the weakness of the state in CIS countries, a straightforward duplication of the transition path of eastern Europe and the Baltics cannot be predicted for the CIS. This consideration means that listing desirable legal and policy changes is much easier than providing a convincing explanation of how they could be implemented.⁴

Russian tax reform provides an example of the problems of reform in a state with weak capacity (see Chapter 7, Box 7.1).⁵ The existing Russian tax system is deeply problematic because it does not generate enough revenue to finance basic government functions and because it severely distorts business decisions. The rules are ambiguous and contradictory, compliance costs are very high, application of rules is inconsistent and penalties for violation of frequently changing laws are draconian. Many improvements are contained in draft tax codes submitted to the parliament. However, serious obstacles block not only their passage into law but also the establishment of supporting institutions and appropriate incentives for both the private sector and state officials.

An approach to tax reform should recognise that officials will be tempted to engage in corruption and should provide incentives to increase interest in fostering private sector growth.⁶ In this case, the desire to stimulate private investment in new business by keeping tax rates low can be traded off against the need to promote public officials' private interest in the growth of such businesses by establishing them as a source of local tax revenue. The kind of policy that may work (in the context of an overall tax reform) is to allow state-owned and formerly state-owned enterprises to sell property and to levy a property tax, some receipts of which would accrue to local authorities.⁷ Medium-sized and large enterprises typically have excessive land holdings and have an interest in selling them. Such sales would open commercial property to new uses and generate revenue from a property tax, which could strengthen local officials' interest in new business formation.

In addition to altering the incentives of public officials, it is possible to constrain their ability to engage in corrupt practices. For example, cutting back on the state's role where it clearly impedes rather than facilitates the functioning of a market economy (by reducing distortionary trade and foreign exchange controls, arbitrary licensing requirements for new private businesses and

² Khan (1996) and Khan (1997) provide treatments of "rent-seeking" behaviour on which this section draws.

³ Olson (1993) refers to a state as a "stationary bandit" which will be more growth-promoting than an anarchic one characterised by "competing bandits".

⁴ Shleifer (1997) examines the role of political reform and in particular of the importance of local elections in arousing the interest of local politicians in local businesses.

⁵ McDonald and Alexeev (1997) also provide a useful summary of the current system and the proposed reforms.

⁶ Incentive structures are examined by Gordon and Li (1997).

⁷ These issues are discussed in Boycko (1996).

state ownership of enterprises) limits the scope for state officials to intervene arbitrarily in economic activity and for corruption. This reorientation of the state can also help to increase the state's capacity to perform other roles central to a well-functioning market economy. Chart 5.1 shows that in transition economies those countries that have made greater progress in market-oriented reforms tend to have lower levels of corruption, as measured by a survey of regional analysts.

Enterprises can also contribute to the battle against corruption through the adoption of principles, policies and practices designed to deal with this problem. There are important lessons to be learned from experiences of the corporate sector, with case studies being of value in showing what can be done. Indeed, a major international information technology manufacturer operating in Russia has refused all requests for bribes from the start of its operations, making clear that its position is absolute and non-negotiable. Today, its lead product has a large market share. Work in developing case studies of effective business strategies in this area is being supported by the EBRD.⁸

Impediments to developing laws for a market economy

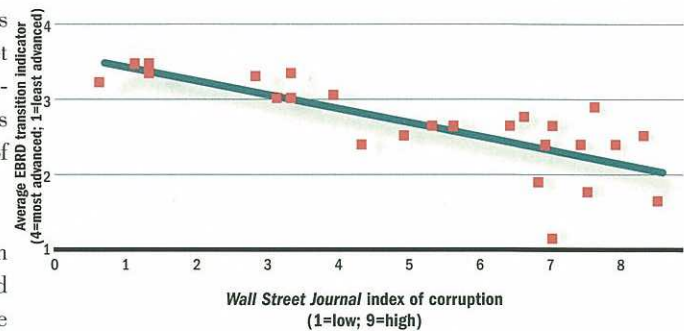
Developing the legal basis for a market economy requires three main ingredients: written laws that have legitimacy among the population; functioning institutions to enforce laws and to generate information needed for their enforcement; and individuals and enterprises with appropriate incentives to demand their implementation. A comparison between Hungary and Russia regarding the way that legal frameworks have developed finds much greater weakness in Russia along these three dimensions (see Chapter 2 for a summary of progress in legal reform in all transition economies).⁹

In Hungary, a new bankruptcy law was introduced in 1992 to facilitate reorganisation and liquidation under the direction of the courts. The law included an automatic trigger which required firms with arrears of more than 90 days to file for reorganisation or liquidation. The fact that thousands of managers did so reflected that they took seriously the penalties attached to failure to file.

Implementation of the Hungarian bankruptcy law overloaded the courts and revealed an inadequate infrastructure to support the processing of cases. In addition, for the law to work properly, creditors needed to be well-informed, as well as an array of accountants, auditors, bank supervisors and trustees to oversee the process and to prevent fraud. While the result was far from the intended outcome, with some debtors and creditors colluding to make use of bankruptcy to privatise assets and socialise liabilities, the episode marked significant progress in developing the rules of the market economy and of the associated law. In addition to the law's enactment, the process of implementation fostered the emergence of professionals, institutions and specialised knowledge

Chart 5.1

Progress in market-oriented reforms and levels of corruption



Source:
EBRD and *Wall Street Journal* (1995-96).

Note:
Points represent transition economies.

necessary to support a functioning bankruptcy law. This process also pushed forward privatisation of enterprises and thereby the establishment of market-based incentives.

The Russian experience of establishing company law differs in important respects. The task of creating from scratch a legal framework based on private property is enormous. For CIS countries such as Russia, moreover, the need to establish quickly a legal framework to support mass privatisation clashed with the requirement that, for the role of the law in the economy to take root, there must be a process of democratic approval – which can be slow. The priority placed on privatisation meant that company law developed in an ad hoc fashion through various presidential decrees, and at least in the initial stages it lacked the legitimacy gained through parliamentary approval.

While a company law is now in place in Russia, the supporting institutions (well-functioning judiciary) and information (credible financial disclosures) remain largely absent. Moreover, building up a demand for the enforcement and improvement of the law is hampered by insider control of privatised enterprises. Insider control reinforces the importance of personal connections rather than arm's-length business relationships and dampens demand for codified company law.

If Hungary and Russia are typical of eastern Europe and the CIS, the impediments to developing legal frameworks appear more significant in the CIS countries than in those of eastern Europe and the Baltic states. Not only are initial conditions in the CIS less favourable, owing to a lack of historical legal precedents, weaknesses in democratic institutions and fragmentation of the state, but it is also true that current approaches to structural reform, such as heavy reliance on insider privatisation, do not create strong demand for the types of laws required for a well-functioning market economy.

⁸ This work is being carried out by the Kinnerton Research Centre, with the support of the EBRD and the Soros Foundation.

⁹ Chapter 6 of the 1995 *Transition Report* examines the contribution of law to fostering investment. The specific comparison here between the development of legal frameworks in Hungary and Russia is based on Gray and Hendley (1995).

5.2 From dependence on the state to dependence on the market

Both economic analysis and empirical evidence emphasise the importance of competitive markets to enterprise performance. The selection of producers through the process of competitive entry to, and exit from, the market helps to ensure efficient use of assets over time and to spur innovation in the ways of organising businesses and in technologies. Competitive pressures also help to reduce the tendencies of managers to pursue their own interests rather than those of their shareholders, because market discipline leaves limited scope for managerial slack or empire building. Importantly, available evidence also reveals that greater product market competition is associated with higher total factor productivity of enterprises (see Chapter 4 for evidence in transition economies).¹⁰

For markets to become the decisive factor for economic success or failure in transition economies, there must be a dramatic reorientation of enterprises away from their dependence on government to a dependence on markets. This shift requires not only tough tightening of budgetary support for enterprises, but also elimination of off-budget sources of support, such as tax arrears and soft bank loans. Without hard budget constraints, enterprise managers have little incentive to focus on customers and costs. However, the extent of rivalry which emerges among producers facing hard budget constraints depends on a number of factors, including government-created barriers to the entry of domestic and foreign firms, openness to trade and concentration in market structures. Some aspects of inherited industrial structures and relationships can weaken product market competition if left unchecked.

Achieving hard budget constraints

Detaching enterprises from dependence on budgetary subsidies (along with price liberalisation) was one of the least controversial reforms in the transition. Trends in budgetary subsidies as a share of GDP provide a starting point for measuring progress in this aspect of transition.¹¹ Table 5.1 reports available data for most transition economies. In virtually every country, clear downward trends are present. In CIS countries the downward trend began in 1992 or 1993, while in eastern Europe and the Baltic states it began one or two years earlier. Nevertheless, by 1995 there was little variation in the level of subsidies across countries in the region. Indeed, the average level of subsidy in per cent of GDP for CIS countries is on a par with that of east European and Baltic countries.

A narrow focus on budgetary subsidies, however, fails to capture off-budget sources of government support. For example, in Bulgaria, where budgetary subsidies fell from 15 per cent of GDP

in 1989-90 to 1 per cent in 1995-96, off-budget subsidies (such as tax arrears and soft bank loans) remained unchecked for several years (until the recent reform package). Of the east European economies, Bulgaria entered the transition from a particularly difficult starting point, with its greater dependence on trade with and transfers from the former Soviet Union through the CMEA trade arrangements and more severely distorted industrial structure.¹² While slow but apparently steady progress in reform was made in the first half of the 1990s, the economy descended into crisis in 1996 as output collapsed and inflation soared. The roots of this crisis appear to lie in the failure to tackle off-budget sources of softness available to a small number of large loss-making enterprises.¹³

The data on off-budget routes through which subsidies are provided, however, is very incomplete. The remainder of this section examines tax, energy and inter-enterprise arrears, while the following section turns to the issue of soft bank loans.

Table 5.2 presents information on the stock of tax arrears for countries in the region for which data are available over a number of years. For these countries, there is a consistent pattern in which tax arrears rose as budgeted subsidies fell, at least for a while. This observation is in line with enterprise survey evidence that, as enterprises experienced financial distress, they ceased meeting their tax obligations.¹⁴ However, in one country for which data are available (Poland), the rise in the stock of tax arrears (relative to GDP) has peaked and the trend is now downward following increased efforts to collect taxes.

Inter-enterprise arrears are also a potential source of government support. The arrears simply represent claims within the enterprise sector itself. It is therefore only through some form of government intervention that these arrears can become a source of softness. Overdue trade credits have been connected to soft budget constraints in a number of transition countries through two distinct routes, both of which stemmed from misguided government actions.

First, in some cases (such as Romania in 1991 and Russia in 1992), governments have responded to rapid increases in overdue trade credit and associated lobbying by enterprises, with clearing operations. The aim of these operations was to net out, by administrative means and with the injection of credit, the mutual indebtedness of enterprises. Net creditors were paid the value of their receivables net of payables they owed to other enterprises, while net debtors received credit to cover the amount they owed net of the receivables due from other enter-

¹⁰ See Blundell et al. (1994) and Nickell (1996) for evidence from industrialised market economies.

¹¹ The data reported here are for all budgetary subsidies. Until price liberalisation is complete, it is often difficult to distinguish producer from consumer subsidies. Moreover, not all countries report producer and consumer subsidies separately.

¹² Dobrinsky (1997) argues that Bulgaria's degree of integration with the Soviet Union was comparable to that of some of the ex-Soviet republics. Added to this source of disadvantage (relative to other east European economies), Bulgaria was heavily indebted as a sovereign borrower, unlike the former Soviet republics.

¹³ See Claessens and Peters (1997) for an econometric study which provides support for this view. See also Dobrinsky (1997) and Avramov and Sgard (1996).

¹⁴ Schaffer (1995) and Alfandari and Schaffer (1996) report that in Hungary, Poland and Russia tax arrears were concentrated in the weakest firms and were essential for keeping them afloat.

Table 5.1

Budgetary subsidies, 1989-96

(in per cent of GDP)

	1989	1990	1991	1992	1993	1994	1995	1996
Albania ¹	6.6	13.9	17.8	4.3	0.0	0.1	0.0	-
Bulgaria	15.5	14.9	4.2	1.8	2.2	1.4	1.1	0.8
Croatia	-	-	1.7	1.3	1.2	1.6	1.6	-
Czech Republic ²	7.8	-	-	4.9	4.2	3.5	2.4	2.0
FYR Macedonia	-	-	-	-	-	3.4	2.9	2.2
Hungary	-	7.0	5.7	4.0	3.8	4.5	3.8	3.8
Poland	10.2	7.3	5.1	3.2	2.3	3.3	3.0	1.7
Romania	-	7.0	9.1	13.0	6.8	3.8	4.1	4.3
Slovak Republic ²	7.8	-	-	5.3	4.7	4.2	3.7	3.3
Slovenia	-	-	2.8	2.8	2.2	1.6	1.7	0.8
Estonia	-	-	2.8	1.8	1.5	0.9	0.5	-
Latvia	-	-	1.3	0.3	0.0	0.1	0.4	-
Lithuania	-	14.0	5.5	2.1	1.3	1.3	0.9	1.0
Armenia	-	-	-	-	16.7	12.8	0.9	-
Azerbaijan	-	-	-	10.8	3.8	3.8	1.9	2.0
Belarus	-	-	-	9.2	15.0	6.5	3.4	3.7
Georgia ³	-	-	-	-	25.7	12.7	0.2	0.0
Kazakhstan	-	-	-	3.3	2.3	1.7	1.0	-
Moldova	-	-	-	5.2	2.8	2.0	-	-
Russian Federation ⁴	-	-	-	10.4	3.0	1.8	1.3	-
Ukraine	-	-	-	-	11.2	7.0	-	-
Uzbekistan	-	-	-	8.7	6.3	1.6	1.2	-

Sources:

IMF (1996), Halligan et al. (1996), IMF and World Bank.

¹ Budgetary and extrabudgetary subsidies to enterprises.² 1989 refers to the Czech and Slovak Federal Republic.³ 1993 and 1994 include implicit energy subsidies such as for energy imports.⁴ Federal budgetary subsidies and import subsidies to enterprises.

prises.¹⁵ Apart from being inflationary, these clearing operations softened budget constraints, since the credit injected went to net debtors. These schemes also reduced the incentive of enterprises to impose hard budget constraints on each other, since suppliers had less of an interest in ensuring that their customers would pay them.

Second, there are examples of enterprises that do not pay particular bills for extended periods, but which for political reasons continue to be supplied. The most prominent examples are enterprises that do not pay their energy bills. In the latter part of 1996, the stock of energy arrears in Russia exceeded 4 per cent of GDP, while in Latvia they amounted to almost 6 per cent (although the arrears situation there is improving). Other countries, notably Belarus, Lithuania, Moldova and Ukraine, have also been caught in a web of energy-related non-payments. Weak payments discipline and collection efforts by state-owned utilities provide a partial explanation for energy-related arrears. However, policies and practices of governments are also to blame, in particular the failure of governments to pay their own energy bills and the granting of privileges to some strategic energy users which exempt them from full payments.¹⁶ Failure to pay energy bills, of course, shifts the burden elsewhere in the economy.

Table 5.2

Stock of tax arrears, 1990-96

(in per cent of GDP, end of period)

	1990	1991	1992	1993	1994	1995	1996
Bulgaria ¹	4.7	6.7	10.3	10.9	12.2	11.1	13.4
Moldova ²	-	-	-	-	9.6	8.2	10.4
Poland ³	1.1	4.1	4.4	5.3	4.5	3.6	-
Romania ⁴	-	-	0.0	1.5	4.2	4.6	5.1
Russian Federation ⁵	-	-	-	1.7	2.5	3.5	10.0

Sources:

OECD (1996); Agency for Economic Analysis and Forecasting, Sofia; IMF; and Russian European Centre for Economic Policy.

¹ Liabilities of state-owned enterprises to the national budget and social security.² Including tax arrears to the social fund.³ Including arrears on social security contributions.⁴ 1996 refers to June.⁵ The tax arrears figures for 1993-95 exclude those to off-budget funds. The comparable figure for 1996 is 5.7.¹⁵ The clearing scheme tried in the Czech Republic aimed to net out mutual debts unaccompanied by an injection of bank credit. Probably for this reason, very little mutual inter-enterprise debt was actually cleared in the Czech scheme (OECD 1994).¹⁶ See Chapter 3 of the 1996 *Transition Report*.

The appropriate policy response to pressures for on- and off-budget subsidies to producers in most cases is, of course, to refuse. However, governments can also take significant steps to reduce the intensity of political pressures for bail-outs emanating from the inevitable financial distress of some enterprises. Perhaps the most important of these measures is to create conditions in which the new private sector can flourish and generate alternative and, in many cases, superior employment opportunities (see Chapter 4). It is either development of the new private sector or the social safety net which reduces resistance to restructuring in the state-enterprise sector; and there are tight fiscal constraints on the latter.¹⁷ The ability of governments to resist pressures for on- and off-budget bail-outs of enterprises can also be reinforced through fiscal policy commitments to international organisations such as the International Monetary Fund.

The removal of all subsidies from declining industries in the short term, however, is not possible because the social costs of closures can be high if a non-viable enterprise or industry is very large and if it is very important for a specific region (as a number are). Nevertheless, it is crucial that the level of subsidy remains highly visible and on-budget. One way to proceed is to transfer ownership of declining enterprises from industrial branch ministries to a finance ministry. As compared with bureaucrats in branch ministries, officials in finance ministries typically do not have close, long-standing connections with enterprise managers but do have a direct interest in the transparency and control of government expenditures. Going beyond reallocation of government responsibilities to establish an arm's-length relationship with non-viable enterprises, the longer-term objective must be to establish a credible commitment to cut industrial capacity within a specific time period. In transition economies with Europe Agreements, the strategic objective of entry to the European Union has influenced the approach of governments to declining industries through a dialogue with the European Commission on state aid.

From passive finance to financial discipline

While passive finance and soft bank loans were inherent features of central planning, a market economy requires financial discipline through application of sound banking principles to function effectively. Achieving this radical re-orientation of finance has been one of the more difficult challenges in the transition, with continuation of directed credits and soft bank loans a major source of cushioning of enterprises from market pressures in the transition (as for example in Bulgaria).

The institutional foundations of financial discipline are weak in transition economies, particularly in early stages of transition but also at more advanced stages. In most countries, state banks and

former state banks remain dominant, while the failure rate among new private banks has been very high. The financial condition of banks has often been impaired both by a stock of loans extended in the pre-reform era, which has been revealed as non-performing in the wake of the economic upheavals of transition, and by a flow of new bad loans due to the failure to apply sound banking principles in post-reform lending. For bank managers to act in ways that raise incrementally the capital value of banks, it is necessary that they have positive capital values. This assumes that the current and/or future compensation of bank managers is related to these capital values, as it should be. In addition, market-based banking skills are often in short supply for both state-owned and private banks.¹⁸ The incentive for managers of enterprises to repay loans is often weak. Mechanisms for bankruptcy (both reorganisation and liquidation) and for execution of collateral function poorly in most countries.

The extent of inherited bad loans and of soft bank lending are evident in the developments in non-performing loans. Table 5.3 reports data on classified bank loans in those transition countries for which data are available. All of these countries show increases in classified loans following the introduction of reform packages, including a reduction in budgetary subsidies to producers. However, some caution is required in interpreting these data. Both the definition of non-performing loans and the scope for discretion in their application can vary substantially, both within a country and across countries. The timing of the initial increase in non-performing loans tends to reflect when prudential standards were tightened more than when the loan losses actually occurred. Indeed, a recorded increase in bad loans often reflects a government's first step in recognising and resolving the problem.¹⁹

A few countries in the region, including Estonia, Hungary, Poland and Slovenia, have managed to achieve sustained reductions in non-performing loans. Also, several CIS countries achieved a significant reduction in non-performing loans in 1996, following the introduction of measures to tighten prudential regulations and to address bank insolvencies. These countries include Armenia, Georgia, Kazakhstan and Kyrgyzstan. Interpreting these trends, however, requires more information about developments in the banking system. For example, the sharp reduction in non-performing loans in Hungary and Slovenia occurred when these loans were transferred to specialised state agencies outside the banking system for resolution.²⁰ There, the extent of financial discipline depends on how these state agencies perform, in particular whether they enforce hard budget constraints on enterprises or whether they become a new source of government accommodation. In the Czech Republic the persistent high level of non-performing loans reflects in part the disadvantageous tax

¹⁷ See Aghion and Blanchard (1994).

¹⁸ The entry of new private banks has also been inadequately disciplined by licensing and initial capital requirements.

¹⁹ A number of countries have yet to introduce international accounting standards and adequate loan classification and provisioning standards, including Belarus, Tajikistan and Turkmenistan (which are in the early stages of transition) but also Croatia and Russia (where reform started much earlier). Bulgaria introduced adequate loan classification and provisioning standards in 1997.

²⁰ In contrast, the consolidation bank in the Czech Republic is part of the banking system, so the transfers of bad loans to this institution did not result in an immediate reduction in reported non-performing loans.

Table 5.3

Non-performing loans, 1991-96

(In per cent of total loans, end of period)

	1991	1992	1993	1994	1995	1996
Albania	-	-	14	27	-	-
Bulgaria	-	-	7	12	15	16
Czech Republic	2	19	23	38	35	35
Hungary	-	11	29	22	17	13
Poland	16	27	31	29	20	13
Romania	5	5	4	7	12	-
Slovak Republic	-	3	12	30	42	32
Slovenia	-	-	19	15	10	-
Estonia	-	7	7	4	3	2
Latvia	-	-	-	10	19	20
Lithuania	-	-	-	-	-	26
Armenia	-	-	-	32	33	23
Azerbaijan	-	-	-	13	34	-
Belarus	-	-	-	1	10	11
Georgia	-	-	-	24	31	10
Kazakhstan	-	-	-	-	35	18
Kyrgyzstan	-	-	-	62	63	22
Moldova	-	-	-	-	11	13
Russian Federation	-	-	-	-	7	7
Ukraine	-	-	-	5	13	40
Uzbekistan	-	-	-	8	11	-

Sources:

IMF, Central Banks and Borish et al. (1996).

treatment of loan write-offs by banks, giving them an incentive to keep bad loans on their books.

In general, there have been two approaches to resolving effectively the bad loan problem in transition economies: the liquidation of troubled banks and their conditional recapitalisation (see Chapter 10 of the 1995 *Transition Report*). Implementing the first approach is relatively straightforward provided there is a legal framework for suspending licences of banks that fail to meet prudential requirements, including the test of solvency, and for liquidating their assets. However, consideration of the repercussions for other banks of liquidating failed institutions and the political pressures to avoid widespread losses to depositors often constrain the application of this approach. Typically, in transition economies, it is only applied to small, private banks which play minor roles in a banking system and for which there is less political resistance to closure (as in recent cases in Armenia, Georgia, Kazakhstan and Kyrgyzstan). Nevertheless, Estonia and Latvia stand out for having applied this approach to relatively large, private banks and Bulgaria for having recently applied it to large banks, both private and state-owned (albeit after the banking system's near collapse).²¹

The conditional recapitalisation of banks in transition economies is much more difficult to implement successfully than bank liquidations, but this approach has been applied to dominant yet

troubled state banks which emerged from central planning institutions. These banks have tended to be considered too large to fail for the reasons identified above (perceived systemic risks and political pressures). The countries that apparently have implemented this approach with at least partial success include the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia. However, the design of conditional bank recapitalisation schemes is complex, with many potential pitfalls. The challenge is to establish a set of requirements for state banks to meet in order to receive recapitalisation from the government in such a way that this source of government funding does not perpetuate soft budget constraints for enterprises (see Box 5.1).

The unconditional recapitalisation of state banks in transition economies, of course, inevitably perpetuates passive finance and undermines financial discipline. Government bail-outs of state banks without conditions are readily transformed into soft budget constraints for enterprises, because bank managers (anticipating another bail-out) have little incentive to recover on non-performing loans. Recognising this lack of incentive to collect, enterprise managers have little incentive to service their outstanding loans. This unconditional approach to bank recapitalisation was pursued in some countries in their early stages of transition (such as Bulgaria and Romania) with predictable results.

While well-capitalised banks and an approach to insolvent banks that imposes discipline on bank managers and shareholders create incentives for sound banking, bank operations must also be constrained by effective prudential regulations to prevent fraud and other abuses. The scope for abuse arises because of the difficulties that individuals face in evaluating the credit-worthiness of individual institutions and of the trust which depositors must inevitably place in banks. While many countries in the region have made significant progress in enacting prudential banking regulations based on standards in industrialised market economies, the challenge remains in most countries to develop the institutional capacity needed to enforce these rules effectively (see Chapter 10 of the 1995 *Transition Report*).

For banks to become a source of financial discipline, however, they must have both the incentive and the ability to collect on their loans. This ability depends in part on a well-functioning mechanism for bankruptcy of enterprises (both reorganisation and liquidation). However, in most transition economies these mechanisms function poorly. Only a handful of countries at more advanced stages of transition, including the Czech Republic, Hungary and Poland, have bankruptcy procedures operating even at a minimal level.

Table 5.4 reports the number of bankruptcy proceedings initiated and completed in three advanced transition countries. Bankruptcy mechanisms in these countries are still hampered by a number of

²¹ On the Baltic banking crises, see Fleming et al. (1996).

Box 5.1

Conditional bank recapitalisations

The conditions typically applied by governments when recapitalising banks in industrialised market economies are twofold: to dismiss senior management of the failed bank (where poor performance was a key contributing factor to failure) and to write down the value of its shareholders' claims. These sanctions give both bank managers and shareholders incentives for prudence and sound banking. However, these conditions can be effectively applied to many troubled banks in transition economies. The initial post-reform stock of bad loans was typically beyond the control of bank managers, and most banks which have been recapitalised are state-owned. The task of bank recapitalisation in transition economies is further complicated by the absence of accurate information about the true quality of bank loans.

One approach to assessing the extent of loan losses in a troubled banking system is to conduct special portfolio audits, particularly where ongoing prudential supervision is weak. In a number of transition economies, international institutions such as the EBRD and the World Bank have commissioned international auditors to perform in-depth diagnoses of banks' balance sheets, earnings and operating procedures. However, the experience with portfolio audits in eastern Europe reveals that it is difficult to assess accurately the extent of losses in this way. Problems arose in part because accounts of enterprises did not conform to international accounting principles and independent auditing standards. Nevertheless, in Poland, a rough estimate of loan losses from a special portfolio audit provided the basis for the successful recapitalisation of seven state banks.

A possible alternative to special audits is to make bank recapitalisations conditional upon the outcome of bankruptcy (or other specially established) procedures for resolving non-performing loans. The key point here is that bankruptcies, special loan reconciliation procedures

and transfers of non-performing loans to specialised government agencies can serve as alternative ways of establishing the true value of non-performing loans. Whatever method is chosen, the challenge is to provide bank managers with an incentive to pursue recoveries on all non-performing loans or to transfer these loans to a specialised agency (see Aghion, Bolton and Fries [1996]).

Whether banks should be required to resolve their non-performing loans or whether these should be transferred to a specialised government agency remains largely an unresolved issue. The choice between the two approaches rests on a difficult judgement about which type of institution would be more effective in recovering on outstanding loans. An important issue is whether a specialised government agency or state banks are more likely to succumb to pressures from enterprises for special treatment and bail-outs. The experiences of Hungary and Poland, which have pursued bank-based approaches, and of the Czech Republic and Slovenia, which established bank restructuring agencies, suggest that it is possible to implement either approach with at least some effectiveness (on Poland, see Gray and Holle [1997]).

Following recapitalisation of state banks in transition economies, the approaches to creating incentives for prudence and sound banking have centred on commitments to bank privatisation. These commitments serve two purposes. First, they impose commercial objectives and incentives on managers of state banks, which for example can help to motivate recoveries on non-performing loans. Second, implementation of bank privatisation fundamentally changes the circumstances under which any future banking troubles would be resolved. Private shareholders could then be exposed to the risk of losses, and bank managers could then be held accountable for the commercial performance of their institutions. Commitments to bank privatisation were central elements of the recapitalisation programmes in Hungary, Poland and Slovenia, with Hungary having followed through on this commitment to the greatest extent.

difficulties.²² In the Czech Republic, the bankruptcy law is not conducive to financial reorganisations, leading to a predominance of liquidations. Hungary stands out for the sheer scale of its bankruptcy cases, many of which were initiated by an automatic trigger in effect from 1992 to 1993 requiring enterprises in arrears to file for bankruptcy. However, the effectiveness of the process was compromised by banks' weak incentives to monitor the proceedings and the incentives for liquidators to prolong the process. In Poland, bankruptcy legislation has a number of weaknesses in design and implementation, notably low priority given to secured creditors, inadequate provisions for reorganisations and institutional weaknesses in bankruptcy courts. For these reasons, a special out-of-court loan conciliation process was established as part of the bank recapitalisation programme.

Intensifying product market competition

While eliminating soft budget constraints and soft loans from the banking system is a precondition for the functioning of competitive markets, enterprise performance also depends on the intensity of rivalry among producers (see Chapter 4). The extent of product market competition is influenced by a number of factors in transition economies. Entry by new private businesses varies widely across the region. In particular, entry by new domestic firms is sharply curbed in a number of CIS countries by the behaviour of

government. Similarly, entry by foreign producers through direct investment differs enormously, with much investment concentrated in those countries more advanced in transition and macroeconomic stabilisation. There are also tendencies for industries in transition economies to be dominated by relatively few large enterprises and for cooperation among enterprise managers, often through industrial associations formed from former branch ministries.

The main policies used to instil greater product market competition in transition economies (in addition to eliminating government-created barriers to domestic and foreign entry, on- and off-budget subsidies to producers and soft bank lending) are trade liberalisation and competition policy. However, there are significant challenges to implementing both policies.

Liberalisation of trade and foreign exchange payments perform two important roles in transition: enhancing competition in domestic markets and reducing scope for bureaucratic interference in enterprise management. Trade and payments regimes under central planning were characterised by extensive quantitative controls over exports, by state-owned enterprises with sectoral monopolies in foreign trade and by restrictions on access to foreign exchange for trade transactions.²³ Liberalisation of trade and payments in

²² Balcerowicz, Gray and Hashi (1997) provide a recent survey of bankruptcy procedures in the Czech Republic, Hungary and Poland.

²³ Since centrally planned economies tended to be characterised by shortages, most quantitative trade restrictions were applied to exports rather than to imports. Imports were controlled primarily through limited access to foreign exchange.

Table 5.4

Bankruptcies in the Czech Republic, Hungary and Poland, 1990-96

	1990	1991	1992	1993	1994	1995	1996
Czech Republic							
<i>Number of bankruptcies filed</i>	-	-	350	1,098	1,816	2,393	2,990
<i>Number of bankruptcies completed</i>	-	-	5	61	290	482	725
Reorganisations	-	-	0	1	2	2	6
Liquidations	-	-	5	60	288	480	719
Hungary							
<i>Number of bankruptcies filed</i>	-	-	14,060	8,229	5,900	6,461	7,477
Reorganisations	-	-	4,169	987	189	145	80
Liquidations	-	-	9,891	7,242	5,711	6,316	7,397
<i>Number of bankruptcies completed</i>	-	-	1,302	1,650	1,241	2,276	3,007
Reorganisations	-	-	740	510	90	21	9
Liquidations	-	-	562	1,140	1,151	2,255	2,998
Poland							
<i>Number of bankruptcies filed</i>	151	1,327	4,349	5,936	4,825	3,531	3,118
Reorganisations	2	76	688	665	596	465	375
Liquidations	149	1,251	3,661	5,271	4,229	3,066	2,743
<i>Number of bankruptcies completed</i>	29	305	910	1,048	1,030	1,030	984
Reorganisations	1	8	98	179	235	287	173
Liquidations	28	297	812	869	795	743	811

Source:
Balcerowicz et al. (1997).

the region has taken two tracks, with east European and Baltic countries moving relatively rapidly and CIS countries more gradually. The initial steps involved elimination of most quantitative restrictions on trade and abolition of state trading monopolies. In general, east European and Baltic countries adopted these measures at least two years earlier than most CIS countries (see Table 5.5).²⁴ However, a few CIS countries have still not adopted basic reform measures (see Chapter 2).

The difference in timing of trade and payment reforms reflects in part more favourable conditions for liberalisation in eastern Europe and the Baltic states, with these countries benefiting from closer proximity to EU markets, more extensive trade links with industrialised market economies under central planning, and more rapid price liberalisation compared with CIS countries. The central planning legacy of a relatively high degree of industrial specialisation and inter-dependence among CIS countries also makes trade liberalisation more problematic.

While removal of quantitative trade restrictions and state trading monopolies (and state order systems) is the first step in increasing scope for product market competition for tradable goods and services, alternative forms of protection have often emerged in their place. One cushion for producers arose from the widespread under-valuation of exchange rates, as macroeconomic instability

generated a flight from local-currency assets. However, as transition economies gained control over their financial policies, explicit trade protection through tariffs and import surcharges tended to gain in significance. In many east European countries, tariff protection has increased following the initial liberalisation of trade (see Chapter 8 of the 1994 *Transition Report*) and a number of countries have applied import surcharges for balance-of-payments reasons.

The consolidation of trade and payments reforms in transition economies has typically taken place in the context of multilateral negotiations. Again, the east European and Baltic countries have tended to advance more rapidly than those in the CIS. Ten east European and Baltic countries had reached association agreements with the EU by 1995, which established timetables for free trade with the EU within 10 years and prospects of full EU membership. As Table 5.5 reports, eight of these countries have also accepted the Uruguay Round obligations under the GATT and had joined the WTO by the middle of 1997, and eight have accepted the obligation of Article VIII of the IMF Articles of Agreement on current account convertibility.

By the end of 1997 all CIS countries bar one (Tajikistan) will have reached Partnership and Cooperation Agreements with the EU, which call for the mutual granting of most-favoured-nation status,

²⁴ CIS reforms started in earnest only after the break-up of the former Soviet Union in late 1991.

Table 5.5

Trade policy

(Year in which policy benchmarks achieved)

	GATT/WTO membership	IMF Article VIII status	EU Association Agreement	EU Partnership and Coop. Agreements	Substantial removal of trade barriers		
					Quantitative restrictions		State trading monopoly
					Imports	Exports	
Albania	-	-	-	-	1992	1992	1992
Bulgaria	Dec-96	-	Jan-94	-	1991	1991	1991
Croatia	-	May-95	-	-	1991	1991	1991
Czech Republic	Jan-95	Oct-95	Mar-92	-	1991	1991	1991
FYR Macedonia	-	-	-	-	1992	1992	1992
Hungary	Jan-95	Jan-96	Mar-92	-	1989-91	1989-91	1989
Poland	Jul-95	Jun-95	Mar-92	-	1990	1990	1990
Romania	Jan-95	-	Mar-93	-	1992	1992	1990
Slovak Republic	Jan-95	-	Mar-92	-	1991	1991	1991
Slovenia	Jul-95	Sep-95	Jun-95	-	1993	1993	1993
Estonia	Jul-95	Aug-94	Jun-95	-	1992	1992	1992
Latvia	-	Jun-94	Jun-95	-	1992	1993	1992
Lithuania	-	May-94	Jun-95	-	1992	1993	1992
Armenia	-	-	-	Apr-96	1995	1995	1989
Azerbaijan	-	-	-	Apr-96	1995	1995	1994
Belarus	-	-	-	Mar-95	1995	1995	-
Georgia	-	Dec-96	-	Apr-96	1993	1995-96	1993
Kazakhstan	-	Jul-96	-	Jan-95	1995	1995	1994
Kyrgyzstan	-	Mar-95	-	Feb-95	1994	1994	1994
Moldova	-	Jun-95	-	Nov-94	1994	1994-95	1992
Russian Federation	-	Jun-96	-	Jun-94	1992	1994-95	1991
Tajikistan	-	-	-	-	-	-	1995-96
Turkmenistan	-	-	-	Nov-97 ¹	-	-	-
Ukraine	-	May-97	-	Jun-95	1994	1994	1994
Uzbekistan	-	-	-	Jun-96	-	-	-

Sources:

EBRD, IMF, WTO and OECD (1997).

¹ Expected signing date of the Agreement.

the removal of all quantitative trade restrictions and, if progress is made in movement towards market-oriented reforms, establishment of free trade with the EU. While most CIS countries are participating in negotiations over WTO membership, no agreements have been reached. Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia and Ukraine have accepted the obligations of the IMF's Article VIII on current account convertibility.

The pursuit of trade and payments reforms by transition economies through acceptance of multilateral rules and disciplines has the advantage of anchoring these measures in well-established institutions. The commitments related to WTO accession, IMF articles on currency convertibility and EU agreements on regional free trade reduce the likelihood of permanent reversals in trade and payment reforms and add to the transparency and predictability of trade and payment regimes. In particular, these international commitments will help authorities to resist pressures from domestic producers for ad hoc protection, while securing greater access to international markets for exporters.

While trade and payments liberalisation can intensify competitive pressures in some sectors, their impact on competition is limited in scope and intensity by at least two factors. Many services are location-specific (such as retailing and distribution) and trade in

goods is limited by geography and transportation costs. These considerations point to the importance of an effective competition policy to complement liberalisation of trade and foreign exchange payments, particularly in economies that are large in size and geographically remote from major potential trading partners (Russia, Ukraine and some Central Asian republics).

Competition policy establishes a set of rules governing the conduct and transactions of enterprises which are aimed at ensuring rivalry among producers. While the specific rules of competition policy vary from country to country, competition law broadly seeks to control the formation of cartels among producers (so as to prevent the exploitation of market power or the weakening of their competitors), to prevent the abuse of dominant market positions by a single producer and to stop those mergers or acquisitions that create or enhance market power. Enforcement of competition laws is typically vested in an independent yet accountable government agency with the power to stop violations of the law and to impose fines, and with the resources necessary to carry out its responsibilities.

Most countries in eastern Europe, the Baltics and the CIS with competition laws have at least loosely adapted their legislation from that of industrialised market economies, particularly those of the EU. As a result, the laws tend to focus more on preventing and

penalising anti-competitive behaviour and transactions than on changing market structures. This approach relies on the assumption that competitive tendencies are strong and will emerge provided that the law prevents the deliberate suppression of competition.

Significant experience with the application of competition law in transition economies is limited to a handful of countries. The Czech Republic, Hungary, Poland and the Slovak Republic have the most extensive experience in the region, with the number and nature of decisions by these competition offices reported in Table 5.6. A recent assessment of their performance observed that there has been extensive progress in enforcing competition laws in these countries, but cautioned that a majority of cases focused on alleged abuse of dominant market position and that most of these cases involved issues related to price control and vertical relations between enterprises (that is, between firms as both buyers and sellers).²⁵ There appear to be similar tendencies in the implementation of competition policy in Russia and Ukraine, where dominant issues have been implementation of price controls and unfair advertising, respectively.²⁶

The particular circumstances of transition economies, however, call for greater emphasis on implementation of competition policy on cartels (horizontal agreements between firms in the same product market) and abuses of market dominance that restrict entry to, or expansion of, markets. In other words, competition policy should ensure that barriers to entry imposed by incumbent enterprises in an industry are kept to a minimum. This emphasis would contribute directly to changing market structures and concentration, and thereby to reducing the potential to abuse dominant positions and to form and sustain cartels. However, its implementation would require from the competition agencies considerable capacity and independence.

5.3 Privatisation and governance of enterprises

In transition economies, corporate governance issues arise primarily for medium-sized and large privatised enterprises. Small privatised enterprises, small enterprises that were privately owned under central planning and start-up firms are typically not affected by serious governance problems. For these firms, there is usually one owner or a small group of owners who are also engaged in day-to-day management of the firm.²⁷

In industrialised market economies, the running of a medium or large-scale firm is typically delegated by shareholders to management, provided that operating and financial performance is satisfactory. Changes in management tend to occur for two reasons: either because shareholders judge the firm to be performing poorly (for which management is typically held responsible) or because another investor perceives a different, more profitable use for the firm's assets. If the firm is performing poorly, the governance struc-

Table 5.6

Competition policy, 1992-96

(Number and nature of decisions by competition offices)¹

	Czech Republic ²	Hungary	Poland	Slovak Republic
Abuse of dominant position	109	184	658	111
Violation found	-	40	327	35
No violation found	-	144	331	76
Mergers and acquisitions³	271	64	349	43
Violation found	-	1	19	16
No violation found	-	63	330	27
Cartels and other agreements	97	29	38	47
Violation found	-	18	17	29
No violation found	-	11	21	18
Total	477	277	1,045	201
Violation found	-	59	363	80
No violation found	-	218	682	121

Sources:

J. Fingleton et al. (1996) and annual reports of competition offices.

¹ Excluding consumer fraud cases.

² The Czech figures on violations exclude 1992 and 1995.

³ Includes mergers allowed subject to certain conditions, but except in the case of the Czech Republic these are very few.

ture should enable owners to press for changes to improve performance, including management turnover. Alternatively, a firm that is performing satisfactorily may be picked out by an investor who can envisage a different use of the firm's resources. The change in use of assets typically comes about through a change in ownership in the capital market.

Transition reveals a large proportion of enterprises to be poorly performing as a consequence both of poor or under-performing managers and of assets combined in ways that are not viable in a market economy. The challenge in transition economies, therefore, is both to establish mechanisms of corporate governance so as to improve managerial performance and to set up methods through which changes in the control of assets can take place. The problem is that these mechanisms have to be set up at a time when the demands on them are heavier than in a well-functioning market economy.

Privatisation of enterprises

Among the many objectives associated with privatisation, two are of particular relevance here. One is disengagement of the state as owner of enterprises, where speed in disengagement is sometimes important. The other is post-privatisation corporate governance and potential for subsequent changes in control. Additional considerations include consistency of privatisation with product market competition and considerations concerning the distribution of wealth. Feasibility is dictated by the balance of power between

²⁵ See Fingleton et al. (1996).

²⁶ See Joskow et al. (1994) and Cornelius (1997).

²⁷ There may be, however, problems with appropriate skills on the part of such owner-managers, which can be reflected in weak responses to new opportunities. The efficient use of assets by small-scale producers would thus be enhanced if entry and therefore competition were promoted and if bankruptcy were enforced.

Table 5.7

Progress and methods of privatisation of medium-sized and large enterprises ¹

	EBRD large-scale privatisation transition indicator score	Sale to outside owners	Voucher privatisation		MEBO ²	Other ³
			Equal access	With significant concessions to insiders		
Albania	2	Primary	-	-	-	-
Bulgaria	3	Primary	Secondary	-	-	-
Croatia	3	-	-	-	Primary	-
Czech Republic	4	Secondary	Primary	-	-	-
FYR Macedonia	3	-	-	-	Primary	-
Hungary	4	Primary	-	-	-	Secondary
Poland	3+	Tertiary	Secondary	-	Primary	-
Romania	3-	Secondary	-	-	Primary	-
Slovak Republic	4	-	Secondary	-	Primary	-
Slovenia	3+	Secondary	-	-	Primary	-
Estonia	4	Primary	-	-	Secondary	-
Latvia	3	Secondary	Primary	-	-	-
Lithuania	3	-	Primary	-	Secondary	-
Armenia	3	-	Primary	Secondary	-	-
Georgia	3+	-	-	Primary	Secondary	-
Kazakhstan	3	Secondary	Primary	-	-	-
Kyrgyzstan	3	-	Primary	-	-	-
Moldova	3	Secondary	-	Primary	-	-
Russian Federation	3+	Secondary	-	Primary	Tertiary	-
Tajikistan	2	-	-	-	Primary	-
Ukraine	2	-	Secondary	-	Primary	-
Uzbekistan	3	-	-	-	Primary	Secondary

Source:
EBRD.

¹ Progress in privatisation of medium-sized and large enterprises is measured by the EBRD's transition indicators. A score of 2 indicates that up to 25% of state-owned enterprise assets have been privatised, a score of 3 that up to 50% of these assets have been privatised, and a score of 4 that more than 50% have been privatised. A + or - indicates a borderline score. Primary, secondary and tertiary denote the first, second and third most important privatisation methods in a particular country, according to their contribution to privatisation of state-owned enterprise assets.

² Management-employee buy-outs.

³ Includes asset sales through insolvency proceedings and a mass privatisation programme based on preferential credits.

the state, managers and employees, by administrative capability and by electoral politics. The features of privatisation policy implemented in a particular country depend on the weight attached to various objectives and on constraints dictated by feasibility.

Table 5.7 shows the methods of, and progress in, privatisation for most transition economies. For many CIS countries, those in the region of the former Yugoslavia, and Poland, privatisation has primarily benefited insiders either through voucher privatisations with significant concession to insiders or through management-employee buy-outs (MEBOs). Reformers seeking depoliticisation of economic activity (in some cases rapidly), but facing the constraint of de facto or de jure control of enterprises by managers and employees had little choice in privatisation method. Nevertheless, aligning ownership with control rights through insider privatisation provided an opportunity for improvement in efficiency compared with state ownership.

In contrast, a number of east European countries and those in the Baltics benefited from favourable initial conditions because they

were not restricted to insider privatisations by the power of incumbent managers or employees in order to ensure progress. Estonia and Hungary used sales to strategic investors as their primary method and the Czech Republic, Latvia and Lithuania used equal-access voucher methods as their main approach. Equal-access voucher privatisation allocates vouchers to all citizens and does not provide special ownership privileges to enterprise insiders. All of these countries have achieved rapid privatisation of medium-sized and large enterprises.

To the extent that privatisation methods vary within a country, choice of privatisation method for a particular enterprise often reflects whether it is considered to be viable or potentially viable under market conditions. The best enterprises or parts of enterprises have frequently been singled out for sale to strategic investors. This pattern is true of countries with very different primary approaches to privatisation, including Hungary, Poland and the Czech Republic.²⁸ Finding effective owners for good enterprises has the merit of promoting rapid restructuring and signalling success which can elicit investor interest in other firms.

²⁸ The Czech privatisation scheme is often misrepresented as being one of full voucher privatisation. However, just 50% of large-scale privatisation was through vouchers. Available evidence suggests that firms selected for pure voucher privatisation were the weak ones (under-capitalised with weak profits and revenues). See Marcincin and van Wijnbergen (1997).

In contrast, some countries that have undertaken mass sale to insiders as their primary method, such as Russia, have privatised the entire spectrum of enterprises (viable, potentially viable and non-viable) to incumbent management and employees. This lack of differentiation among enterprises is likely to result in some poor managers becoming entrenched in good firms. Not only is the signalling role of successful privatisation and restructuring lost, but the growth of such enterprises will be constrained by the reluctance of poor managers to release control in exchange for access to external finance for investment.

Post-privatisation corporate governance

Privatisation schemes have produced different shareholding structures and approaches to post-privatisation corporate governance, sometimes by design and sometimes through market developments. Six types of dominant shareholders in transition economies can be identified. The sharpest contrast is between (i) strategic investors and (ii) incumbent management and employees. In addition, there are a number of institutional shareholders: (iii) various types of investment fund, (iv) holding companies, (v) banks, and (vi) financial-industrial groups.

Strategic investors

One aim of privatisation is to find an ownership structure in which the owner(s) has the capability to exert control over management and is able to provide access to finance for investment. The problem is that strategic investors with these characteristics are in short supply in transition economies. The two countries that opted for direct sales to strategic investors as their primary method of privatisation, Estonia and Hungary, entered the transition with particularly favourable initial conditions. More than in any other centrally planned economy, Hungarian enterprises were extensively engaged with Western companies by the 1980s and many of these original links formed the basis for subsequent direct sales. Estonia has a small economy, which began the reform period with a very strong, market-oriented government which was prepared to allow extensive foreign ownership. However, even with a small absolute number of enterprises to privatise and with full political support for primacy of direct sales, Estonia was left with some enterprises for which there was no investor interest. Management buy-outs (sometimes at a price of zero) were used to privatise the remaining potentially viable enterprises.

Experience in Hungary illustrates some potential benefits of enterprise control by strategic investors in transition economies. Available evidence reveals that strategic owners of Hungarian firms are more directly involved in management than is the case in the normal operation of a firm in an industrialised market economy.²⁹ New owners have tended to exert direct influence over the running of the firm rather than relying on the formal structures of corporate governance, such as the General Assembly or the Supervisory Board. However, as restructuring takes place and management skills are upgraded (or replaced if necessary), greater delegation by the owner to management and the establishment of a

more “normal” pattern of monitoring through the formal structures of corporate governance can be expected.

The benefits of strategic ownership are clear for transition economies. While sale to strategic investors is not feasible as the primary method of privatisation in most countries, it should be seen as a supplementary method for promising firms which can bring valuable demonstration effects.

Incumbent management and employees

A significant constraint on the design of privatisation programmes in many countries (such as Poland, Russia and the former Yugoslavia) has been the devolution of enterprise control rights to managers and workers under earlier partial reforms to central planning. While privatisation with major concessions to insiders often reflects the constraints imposed by this existing allocation of control rights, the resulting allocation of managers to privatised enterprises tends to preserve the status quo and to limit the scope for selection of new managers. However, in countries using management buy-outs (or management-employee buy-outs) as the main form of insider privatisation, a certain amount of effort by managers is typically required in order to secure ownership. As a result, some selection of managers occurs through the privatisation process. However, in voucher privatisations with concessions to managers and workers, the entrenchment of poor managers becomes more likely.

Two forms of competitive market pressures, however, are likely to influence the performance of insider-controlled enterprises. Faced with new market opportunities, managers can restructure and expand operations to exploit profit potentials. Alternatively, dwindling markets and revenues can force the contraction of operations. If incumbent managers are capable and their enterprises are potentially viable, they will (with the benefit of economic recovery) be able to guide their enterprises over restructuring hurdles, relying in the first instance on internal funds for financing any investments. Where internal funds prove insufficient, a competent manager will normally be willing to sacrifice some measure of control in exchange for access to external finance, and a gradual evolution of ownership structure from insider to outsider can be expected. In this case, potential concerns of managers over loss of control from increased outside ownership are balanced against the prospects of new profit opportunities.

The resistance to, or acceptance of, increased outside ownership by employee-owners is likely to depend on macroeconomic factors, such as the state of the labour market.³⁰ The relationship can be easily explained. If employee-owners are able to cooperate among themselves, they will internalise any cost of unemployment if control shifts to an outsider and restructuring goes ahead. If they cannot coordinate their decisions, an individual employee shareholder will assume that the sale of their stake will have no effect on control and hence on their future employment in the firm. The more depressed the opportunities for alternative employment (and

²⁹ See Török (1995) for details.

³⁰ See Aghion and Blanchard (1996).

the lower unemployment benefits), the greater the incentive of employee-owners to cooperate and the less likely it is that they will sell their shares. However, anonymous trading of shares reduces the chances of employee-owners acting in this way. And in some countries, such as Russia, enterprise managers have sought to control the shares of employees.

It is important to emphasise that, where managers are competent, the evolution of ownership from insiders to outsiders can be expected and has been observed on a small scale. One technique through which this is happening in Russia is via so-called investment tenders. Enterprises receive investment commitments from core investors in exchange for the government's remaining stake in the enterprise.³¹ A number of measures can also nudge insider-owned enterprises towards more outside influence, including the sale of remaining government stakes to outsiders, the enforcement of employee-shareholder protection from management influence and the representation of outsiders on boards.

Hard budget constraints and competitive pressures can severely constrain the prospects of those insider-owned enterprises which have poor managers. In this case, the threat of bankruptcy substitutes for the presence of a value-maximising owner.

Investment funds

While investment funds in industrialised market economies tend to rely on liquidating shareholdings when they are dissatisfied with performance rather than on taking active roles in corporate governance, many investment funds in transition economies behave quite differently – not as portfolio investors but as strategic ones. This observation can be explained by the facts that capital markets in transition economies are relatively illiquid and that most medium-sized and large enterprises have significant corporate governance problems. In some countries in the region, investment funds have participated significantly in corporate governance, although experience varies. A comparison of investment funds in Poland, the Czech Republic and Russia highlights some of the differences.

An integral feature of the voucher privatisation programme in Poland is the priority it placed on creating concentrated outside ownership of enterprises. The objective was to ensure that the investment funds established as part of the programme had both the incentive and the capability to exercise corporate governance over the enterprises in which they had been allocated substantial stakes. Fifteen state-owned investment funds were established as part of the programme, and their management contracts were put out to international tender. Each fund was allocated, by lottery, strategic holdings in 34-35 of the 514 participating enterprises and minority holdings in the rest. Polish citizens were able to buy for a small fee tradable certifi-

cates which are exchangeable for shares in the investment funds after their listing on the stock exchange.

Owing in part to its ambitious character in seeking to establish effective control over incumbent managers and employees, the Polish programme was delayed by political opposition for several years (contributing to a deterioration in many participating enterprises). On the positive side, the delay has meant that the Warsaw Stock Exchange is now sufficiently well-developed to enable flotation of shares of the investment funds and of their portfolio enterprises. Despite compromising speed for ensuring effective post-privatisation corporate governance, it is likely that because of its design, the programme will prove a sound method for privatising a large number of enterprises.

In the Czech mass privatisation programme, it was assumed that privately created investment funds would play the useful role of allowing citizens to diversify their portfolios by exchanging voucher points for fund shares. In addition, it was believed that strategic investors would buy up stakes from funds so that effective ownership and control would arise from the operation of an emerging capital market. It was not expected that voucher funds themselves would be effective agents of restructuring.³² Concentration of ownership has in fact followed the two waves of voucher privatisation, and strategic investors have emerged as significant shareholders in voucher privatised firms.³³

The contribution of the Czech funds to capital market development and corporate governance through some "control-oriented" funds has probably exceeded the modest expectations of the scheme's architects. However, some aspects of governance of Czech investment funds raise concerns. These relate in particular to the system of cross-ownership among state-owned banks and investment funds that has developed and that leaves management of these institutions insulated from external control. However, the affiliation of investment funds with banks was instrumental to their marketing and distribution successes, with investment funds attracting over two-thirds of all voucher points. Second, the lack of transparency and disclosure associated with the process by which stakes were concentrated after the privatisation process has deprived minority shareholders of fair value.³⁴

Russian investment funds have played only a very minor role in corporate governance, because privatisation has left insiders firmly in control of enterprises. In the interest of securing insider support for privatisation, initial regulations for the investment funds limited the stake of any one fund to 10 per cent of any enterprise, but a desire to boost the strength of outside owners led to the ceiling being raised to 25 per cent in 1994.³⁵ In contrast to the Czech Republic, where affiliations between banks and investment funds provided the latter with ready distribution channels, the

³¹ See Boycko (1996); however, there are instances of managers seeking to retain control by accepting low tenders from non-threatening investors.

³² This interpretation is supported by Ceřka (Deputy Minister for the Administration and Privatisation of National Property) (1996).

³³ For details, see Claessens, Djankov and Pohl (1996).

³⁴ For example, see *Central European Economic Review*, March 1996, pp. 8-11.

³⁵ For details, see Frydman et al. (1996).

Russian investment funds gained less than 10 per cent of the shares of privatised enterprises. Available evidence shows very limited activism by funds in terms of managerial turnover or restructuring behaviour.

Holding companies

Holding companies have emerged as a source of active post-privatisation corporate governance in several transition economies, often through conversion of the legal form of investment funds (the Czech Republic and Lithuania) or of former state trading companies (Poland and the Slovak Republic). There is clear economic rationale for such structures where strong complementarities exist between assets of the constituent parts and where holding structures provide a way to economise on scarce managerial talent.

Two reasons for scepticism about holding companies relate to implications for competition in an industrial sector and to dangers that a holding company will become a vehicle for attracting government subsidies. Particularly in the CIS, a concern is that holding companies can become vehicles for resurrecting or maintaining old patterns of non-market resource allocation in industrial sectors. In the Czech case, a *laissez-faire* attitude by the government allowed investment funds to convert to holding companies for the purpose of evading the more stringent disclosure rules and restrictions on the size of holdings.³⁶

A Lithuanian example highlights the potential merits of a holding company playing the role of a strategic owner. In this country, a holding company provided a way of restoring viability to a group of related enterprises for which former cross-border supply chains had been ruptured. The producers of electronics goods in Lithuania depended heavily on deliveries of supplies from Russian enterprises and most of their output was delivered to Russia.³⁷ Following voucher privatisation in Lithuania, eight large investment funds/holding companies emerged, which tended to concentrate their holdings in particular branches. One of these holding companies dominated the electronics branch and began the task of creating a domestic network of suppliers. Integrated ownership fostered a common strategy for investment and for attracting foreign investment.

Banks

In addition to standard functions of banks in industrialised market economies (financing investment and disciplining enterprise managers through outstanding credits), banks in transition economies are often called on to finance and oversee restructuring. In some industrialised market economies, banks carry out these functions, but only occasionally when a company is in serious difficulties. A small number of German banks have operated in this way. For profitable companies, the supervisory board on which

the bank is represented intervenes little in management. However, if a company is in trouble, banks can become heavily involved in evaluating and replacing management. It is striking that the historical origin of some German banks' holdings of non-financial companies lies in the intervention of the banks when enterprises to which they had made loans were in serious trouble.

Since transition can be viewed as a period when such special circumstances for a market economy of a company in serious difficulties are generalised across the whole economy, more widespread involvement of banks in enterprise restructuring might have been expected. However, expertise in the day-to-day banking functions of evaluating creditworthiness and monitoring loans is very limited in banks in transition economies. In even shorter supply is experience with corporate restructuring and turnarounds. One aim of policy should be to create the incentives for these skills to be acquired. This consideration highlights a potential benefit of delegating to banks the task of renegotiating bad debts with enterprises, as has been done in Poland.

While the evaluation of the Polish bank conciliation programme for enterprise restructuring suggests that the immediate results have been rather disappointing,³⁸ the conclusion to be drawn for other countries is not that this is a poor policy but rather that the scale of the task is enormous. The pay-off from a policy of this kind will come gradually and may not be evident in the early cases.

Financial-industrial groups

The financial-industrial groups (FIGs) established in CIS countries such as Russia and Ukraine share the common characteristic that they are large, multiple-enterprise groupings with activities straddling both industry and finance. In Russia at least two broad types can be distinguished with quite different efficiency characteristics.³⁹

The first type arose from concentrations of private capital originating in trade and finance. These finance-based empires have been built up by new private banks which have bought into industry.⁴⁰ These groups are potentially important sources of challenge to the insider domination of Russian industry and could evolve into effective agents of corporate governance and industrial restructuring. In addition, FIGs can create what is in effect an internal capital market within groups, with the parent company (often a bank or investment fund) allocating capital for investment based on private information about the operating performance of member companies. Depending on the mix of operations within the groups, there can also be the potential for economies of scale and synergies in production.

The second type of FIG was formed from pre-existing structures. One route was the transformation of former branch associations

³⁶ For details, see Canty (1996).

³⁷ See von Hirschhausen and Hui (1995) for details.

³⁸ See Gray and Holle (1996).

³⁹ For a description and analysis of financial-industrial groups, see Starodubrovskaya (1995), Prokop (1995) and Freinkman (1995).

⁴⁰ For an analysis of this type of financial-industrial group, see Freinkman (1995).

into joint-stock companies, which then diversified into finance and trade. Another route was the establishment of regional associations of enterprises through the participation of local authorities and typically including local financial institutions. The most active initiators of such FIGs were the directors of state or former state enterprises, especially in defence industries.

The debates surrounding the presidential decree of 1993 reveal some of the motives for establishing FIGs. Lobbying on behalf of certain enterprises, the State Committee for Industrial Policy and State Committee for the Defence Industry sought to establish a state-driven process of FIG formation through which members would get special privileges, such as tax concessions, guaranteed state orders and protection from anti-monopoly legislation. Opponents of this approach sought to ensure that FIG creation was market-driven and subject to anti-monopoly legislation. The 1993 decree formalised the status of FIGs and granted them privileges, but subjected them to existing monopoly legislation (implementation is weak though because of limited institutional capacity). Their status was further clarified and their promised privileges extended by the November 1995 Law on Financial Industrial Groups.

The 1995 law confers on FIGs a number of privileges.⁴¹ These include: the ability to convert the debt of its members into equity of the parent company; flexibility in the choice of depreciation methods for tax purposes; consolidated taxpayer status; government guarantees for domestic and foreign investors; special treatment of the bank-members of FIGs (lower capital adequacy requirements); and direct government financial support. However, not all provisions of the FIG law are fully effective, owing to conflicts within the tax regime, to lack of implementing legislation or to limited financial resources of the government. There has also been a recent major change in the approach towards FIGs initiated by the government formed in March-April 1997 and aimed at reducing special privileges in the economy.

With the apparent lack of effectiveness of many FIG privileges, the formation of industrial groupings in Russia seems so far to be largely market driven. However, there are at least two pitfalls associated with the remaining potential for government support of FIGs. First, it risks recreating industrial structures which prevailed under central planning (in the form of industrial or regional holdings) and undermining product market competition. In particular, FIG formation (and other industrial groupings) should be disciplined by an effective competition policy. Second, the lack of financial transparency within FIGs impedes their ability to implement internal financial controls and increases the likelihood of connected lending between banks and enterprises within a group. While assessing compliance with bank capital requirements in the absence of financial transparency is virtually impossible, easing capital requirements for banks exposed to pressures for connected lending and, in some cases, to lending concentrated by industrial sector is misdirected.

Evolution of ownership structures and governance

With the possible exception of enterprises sold to strategic investors, the immediate post-privatisation ownership structures and corporate governance arrangements in transition economies are likely to be transitory (see also Chapter 4 of the 1994 *Transition Report*). Moreover, the corporate governance arrangements that ultimately endure are likely to vary widely among countries and even among enterprises within countries. This expectation is based on the observation that a wide variety of corporate governance mechanisms co-exist in industrialised market economies, with no one approach being obviously superior to another.

In view of the diversity of post-privatisation ownership structures, evolution of corporate governance in transition economies cannot be expected to follow a unique path. One path arises from multiple privatisation tracks which lead to differing post-privatisation ownership structures and potentials for change in ownership and control. Poland is perhaps a good example of how to create multiple mechanisms for privatisation. A second path involves the operation of capital markets in which ownership and control rights of enterprises and their assets change hands. The transition economy with the most active market for corporate control is the Czech Republic, with the rapid consolidation of outsider ownership in the so-called "third wave" of privatisation following two distributions of ownership through voucher privatisation. A third path is gradual increase in outside ownership through the provision of outside finance, a process which appears to be taking hold slowly in Russia. Lastly, the threat of bankruptcy arising from the imposition of hard budget constraints and product market competition is in effect a last-resort approach to corporate governance. This mechanism is likely to be important for improving performance where functioning of institutions supportive of effective corporate governance are weak, such as in countries that relied heavily on insider privatisation and that have weak banks and capital markets.

By identifying potential sources of change in ownership and corporate governance, it becomes apparent that corporate governance in transition economies will be shaped by a wide range of factors in addition to how enterprises were initially privatised. Particularly important to this process will be financial sector development. Box 5.2 illustrates some potential interactions among privatisation and capital market development.

⁴¹ See Karlova (1996).

Box 5.2

Privatisation and capital market development

Privatisation methods across the region were rarely influenced in a major way by the objective of developing a modern capital market. The outcome of the varied privatisation policies has been a mixture of approaches to capital market development; some have been government-led and others market-led.

In the Czech Republic and Russia, mass privatisation took place early in the transition, and as a result securities activities started in earnest before there was a comprehensive regulatory and institutional infrastructure. Much of the development of capital markets in these countries has been in response to demands from market participants for improved services and regulation. This is referred to as a market-led approach. In contrast, in countries such as Poland and Romania delays in mass privatisation due to debates related to the scope and form of privatisation have had the consequence that a comprehensive framework for securities activities has been developed well before moving ahead with mass privatisation. Development of the capital market in these cases is referred to as government-led. Other countries have followed paths somewhere between these two approaches, with securities activities and development of the regulatory and institutional infrastructure moving more or less in step.

To gauge the impact of the alternative paths on capital market development, it is useful to consider two key indicators of market development. One is total market capitalisation relative to GDP and the other is market turnover relative to market capitalisation. The first is a measure of market size and the second of liquidity. Development of both dimensions is central to a well-functioning capital market.

The chart depicts the different development paths and the process of convergence towards market parameters similar to those of advanced industrialised countries. For example, in 1994 the Czech Republic realised a large stock market capitalisation (relative to other transition economies) through its mass privatisation programme, but only very low rates of market turnover. Essentially, the creation of shares in this case was not disciplined by the process of issuing equities to investors in exchange for cash and, as a result, financial transparency and investor confidence were low, at least initially. In contrast, those countries that developed well-regulated securities markets in advance of mass privatisation achieved initially high rates of market turnover, such as Poland in 1994, but this activity was limited in scope by the small capitalisation of the markets.

By 1996, as indicated on the chart, these paths of capital market development were beginning to converge. Market turnover in the Czech Republic has increased considerably, while market capitalisation in Poland is growing. It received a further, substantial fillip in mid-1997 with the listing of the privatisation investment funds. Those countries pursuing an intermediate approach to capital market development appear to be advancing along a balanced path.

While the various paths of capital market development have their own strengths and weaknesses, it is perhaps most important to identify potential pitfalls. In countries that have pursued a market-led approach,

Indicators of stock market development



Source:

IFC *Emerging Markets Factbook 1997*.

Note:

Unlabelled points represent selected industrialised and developing market economies (average of 1994 and 1996). CZ94 and CZ96 represent the Czech Republic in 1994 and 1996, HU94 and HU96 represent Hungary, PL94 and PL96 represent Poland and SL94 and SL96 represent Slovenia.

there have been significant problems with both regulation of securities activities and institutional infrastructure.

Largely because of their narrow interpretation of free market principles, the Czech Republic long delayed the creation of an independent regulatory agency for securities markets and institutions. As a result, the Czech stock markets lacked transparency, with most transactions taking place off the exchanges and with no disclosure of trade prices and quantities. This lack of transparency may have contributed to the poor functioning of investment funds associated with the mass privatisation programme. Non-transparent trading appears to have enabled some who managed these funds to engage in hidden transactions that deprived fund shareholders of fair value. In Russia, weaknesses in both the market infrastructure and the legal framework are major impediments to securities activities. However, in 1996 progress was made in the development of a legal framework for protection of shareholders' rights with adoption of laws on joint-stock companies and securities markets and strengthened enforcement powers for the Securities Commission. The capital market infrastructure has also been strengthened with the establishment of independent share registrars and an over-the-counter market, which links brokers in Moscow with those in other cities.

While the shortcomings of a purely market-led approach become apparent through problems within capital markets, the cost of a purely government-led approach is often the absence of some securities activities. For example, establishment of a comprehensive framework for securities activities can delay the issuance and trading of securities and over-regulation by government can suppress economically valuable securities activities.

5.4 Conclusion

Responding to the challenges of enhancing enterprise performance in transition economies will require improving the overall effectiveness of reforms, particularly by exploiting links between them and by strengthening both public and private institutions. Having examined in this chapter the progress in overhauling the relationship between government and enterprises and in strengthening the governance of enterprises, this conclusion identifies key

issues for the period ahead. These focus on altering the behaviour of government towards enterprises, on easing and resisting pressure for continued government support of enterprises, on strengthening competition among enterprises and on improving the effectiveness of privatisation and corporate governance.

As emphasised above and in Chapter 4, a key factor behind the weaker performance of enterprises in the CIS compared with those

in eastern Europe and the Baltic states appears to have been the failure to unlock the potential of the new private sector in the CIS. Constraining this potential is the limited capacity of state institutions in the CIS (reflecting in part the way in which the Soviet federal system unravelled). This constraint is often associated with unpredictable and discretionary actions of government, which are particularly damaging to the new private sector. One way to strengthen the state's capacity and to create a more predictable environment involves incremental policy changes (in tax reform, for example) that have the effect of strengthening the interests of officials in a well-functioning market economy. Another is to limit the ability of state officials to engage in corrupt practices through further market liberalisation and privatisation.

The importance of fostering a buoyant new private sector arises not only from its direct contribution to growth but also from spillovers it creates elsewhere in the enterprise sector. A rapidly growing new private sector facilitates implementation of other necessary reforms, such as hardening enterprise budget constraints, establishing financial discipline and promoting competition. The creation of new employment opportunities by small businesses and entrepreneurs reduces resistance to restructuring state-owned and formerly state-owned enterprises. Pressures for tax and energy arrears and soft bank loans can be mitigated by attractive private sector jobs. Fiscal commitments to international institutions, such as the IMF, can also help in resisting pressures for government support.

Measures aimed at eliminating soft bank lending through liquidation of insolvent banks or their conditional recapitalisation and through effective prudential regulation are inherently difficult and time consuming. The liquidation of banks is constrained by concerns over systemic risks and political pressures to protect depositors, while the recapitalisation of banks by governments risks adding a new financial cushion. Progress in this area has been slow in most countries, and some have yet to begin addressing these issues. Even where progress has been made, the performance of financial institutions themselves remains weak, owing in part to the lack of sound banking and finance skills and adequate capital. International institutions, such as the EBRD, the EU, the IMF and the World Bank, have important roles to play in helping to strengthen the performance of local financial institutions by investing in them, in restructuring some troubled banks and developing regulatory capacities.

To enhance competition in product markets, governments have pursued both liberalisation of trade and foreign exchange payments and development of competition policy. Most transition economies have made significant progress in trade and payments reforms and these are now being anchored by international commitments (with the WTO, the IMF and the EU). However, development of an effective competition policy has been more difficult, even with the adaptation of laws from industrialised market economies (such as those in the EU). Implementation of these measures in order to alter existing market structures and to remove barriers to entry requires well-functioning competition

agencies. While substantial progress in developing this institutional capacity has been made in some more advanced transition economies, significant challenges remain.

Transition economies have pursued a wide variety of privatisation methods, resulting in many different types of ownership structures, reflecting the multiple objectives and constraints on the design of privatisation programmes. These include widespread insider ownership (by managers and employees) and a variety of institutional owners – investment funds, holding companies, banks and financial-industrial groups. Sales directly to strategic investors have been relatively rare. Apart from sales to strategic investors, most forms of privatisation have led to compromises in the effectiveness of post-privatisation corporate governance.

A crucial link exists between the evolution of corporate governance and financial sector development. Instrumental in the improvement of corporate governance will be development of the financial sector to become an effective source of outside finance for investment and a market in which changes in ownership and control can take place. Even if the forms of corporate governance that eventually emerge in transition economies do not rely heavily on the market for corporate control, capital markets will probably play a central role in the evolution of ownership structures and control following many forms of privatisation.

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Prospects for growth in transition economies

6

For an economy's output to grow, either the supply of inputs (primarily capital and labour) must expand or the productivity of these inputs must increase. Therefore, the economic analysis of growth identifies its key elements as investment in physical capital, such as plant and equipment, development of labour skills, and innovations in technology and business organisation. However, it is also important to understand the role of market forces in stimulating innovation, investment in physical capital and the development of skills, in terms of both their quantity and quality. The failure of central planning to yield high and continuing rates of growth despite enormous investment efforts demonstrates the basic importance of market forces for the generation of investment and economic growth. Competition between profit-seeking firms promotes the efficiency of investment and leads to innovation. These factors governing growth are central to the Schumpeterian perspective on growth developed in Chapter 3. In transition economies, it is market-oriented reforms which must create the competitive process which in turn will deliver growth.

Chapters 4 and 5 examine how the newly established market forces operate in transition economies and what measures are required to strengthen their effectiveness. In particular, Chapter 4 demonstrates that the changes in broad economic structures (the balance of economic activities between industry and services, for example) and in patterns of trade specialisation are consistent with the way in which market forces operate in mature market economies. At the level of individual firms, there is also evidence that policies which facilitate or impede enterprise performance have much the same effect as they do in market economies. Chapter 5 examines some of the key policy challenges in improving the functioning of markets and the performance of enterprises in transition economies.

The purpose of this chapter is to carry forward this market-oriented view of the growth process in transition economies and to use it to examine the prospects for growth in the region. Section 6.1 looks at instances of rapid growth and of stagnation in market economies in a way which is useful for assessing growth prospects for transition economies. As might be expected, both investment booms and large gains in productivity are characteristic of periods of rapid growth. Perhaps less obvious is the important contribution made by the more efficient use of existing resources and technologies in some countries, such as in post-war Japan. Moreover, the failure of some countries to grow rapidly can often be attributed to resistance to structural change and restructuring, as the experiences of India and Britain for much of the period since the Second World War illustrate. In countries where extensive investment in machinery and equipment and development of labour skills have been wasted through a distorted economic structure, such as in the transition

economies, structural change and restructuring can produce considerable productivity gains and growth over the medium term.

Section 6.2 draws some key lessons for transition economies from historical episodes in market economies of catching up with and falling behind the advanced countries of that period and in so doing identifies the importance of structural change and restructuring for medium-term growth in transition economies. It also suggests that the post-war recovery in western Europe and Japan provides a conservative estimate of the magnitude and duration of this source of productivity gains and growth that might be achieved in transition economies.

The assessment of long-term growth prospects in transition economies is the focus of Section 6.3, where the emphasis is on investment and innovation. This analysis takes a long-term perspective of 20 to 30 years after the initial period of structural change and restructuring. It also focuses on quantifiable factors governing growth to try to predict how growth will develop. As Chapter 3 emphasises, an important potential source of growth in transition economies is the high level of skills acquired through the priority placed on education under the central planning of the previous regime. Through its ability to adapt and to innovate, a skilled population can play a particularly important role in helping transition economies catch up with technologically more advanced economies. It is the combination of high levels of skills and wide technological deficits which creates the potential for strong medium- and long-term growth in transition economies (with broad estimates for most countries in the range of 4 per cent to 7 per cent per annum). However, this analysis also reveals that the low quality of institutions which support the functioning of a market economy is a key constraint on growth in the long term. Unless there are further advances in the building and reform of institutions, growth in transition economies could fall well below its potential. Yet institutional change is by its very nature a slow and gradual process and, for this reason, it must be a priority if strong and sustainable growth is to be achieved. Furthermore, it must be nurtured carefully if it is to take a form which is genuinely beneficial for strong growth from which the whole community benefits and if the dangers of special privileges and vested interests in slowing and skewing growth are to be avoided.

6.1 Growth in market economies: catching up and falling behind

The distorted allocation of skills and resources, a lack of infrastructure and institutions, and the absence of markets are not entirely new phenomena. The sheer scale of the necessary reorganisation in transition economies may be unprecedented, but the phenomenon itself is not. To “catch up” with the most advanced market economies after the Second World War, western Europe and

Japan had to repair wartime destruction and shift whole economies from military to civil production. In East Asia, large structural shifts in employment took place during industrialisation.

This section investigates the lessons that can be drawn from these past experiences of successful catching-up. It also considers examples of countries which have stagnated, such as India and post-war Britain. A primary cause of their falling behind has been the resistance to necessary structural change and restructuring. To analyse these examples of sustained, rapid growth and of stagnation, a wide range of qualitative and statistical evidence has been drawn upon.

Cross-country overview of growth

Tables 6.1 and 6.2 provide a cross-country overview of the growth performance of many industrialised and developing market economies over the past century or so. These tables reveal that episodes of rapid economic growth, taken as sustained annual rates of growth in GDP per capita above 3 per cent, are relatively rare. In general, these episodes are associated with growth phases in which relatively under-developed countries have caught up with the more advanced economies of the time, including recovery from major dislocation and in particular from the destruction of war. This process typically involves modernisation of relatively backward economies through high rates of investment and significant improvements in productivity. In the absence of “catch-up” growth, real GDP per capita is historically unlikely to exhibit sustained growth of more than about 2.5 per cent per year. Episodes of rapid growth since the late nineteenth century are confined primarily to western Europe and Japan after the Second World War and to East Asian economies in

Table 6.1

Long-run growth rates of real GDP per capita in industrialised market economies

(in average annual per cent)

	1870-1913	1913-50	1950-73	1973-92
Australia	0.9	0.7	2.4	1.4
Austria	1.5	0.2	4.9	2.2
Belgium	1.0	0.7	3.5	1.9
Canada	2.2	1.4	2.9	1.5
Denmark	1.6	1.6	3.1	1.6
Finland	1.4	1.9	4.3	1.6
France	1.5	1.1	4.0	1.7
Germany	1.6	0.3	5.0	2.1
Ireland	1.0	0.7	3.1	2.7
Italy	1.3	0.8	5.0	2.4
Japan	1.4	0.9	8.0	3.0
Netherlands	0.9	1.1	3.4	1.4
New Zealand	1.2	1.3	1.7	0.5
Norway	1.3	2.1	3.2	2.9
Portugal	0.5	1.2	5.7	2.1
Spain	1.2	0.2	5.8	1.9
Sweden	1.5	2.1	3.1	1.2
Switzerland	1.5	2.1	3.1	0.8
UK	1.0	0.8	2.5	1.4
USA	1.8	1.6	2.4	1.4

Source:

Maddison (1995).

Table 6.2

Long-run growth rates of real GDP per capita in developing economies

(in average annual per cent)

	1950-73	1973-92
Africa		
Cote d'Ivoire	3.1	-2.2
Egypt	2.7	3.8
Ethiopia	1.7	-1.7
Ghana	0.2	-1.2
Kenya	1.9	0.6
Morocco	0.1	1.8
Nigeria	3.2	0.1
South Africa	2.4	-0.6
Tanzania	1.9	-0.5
Zaire	0.8	-3.9
Asia		
Bangladesh	-0.6	2.2
Burma	1.8	1.3
China	2.9	5.2
Hong Kong	5.5	5.4
India	1.6	2.4
Indonesia	2.5	3.1
Pakistan	1.8	2.7
Philippines	1.8	0.7
Singapore	4.3	5.9
South Korea	5.2	6.9
Taiwan	6.2	6.2
Thailand	3.2	5.3
Latin America		
Argentina	2.1	-0.2
Brazil	3.8	0.9
Chile	1.2	1.9
Colombia	2.3	1.9
Mexico	3.1	1.1
Peru	2.5	-1.7
Venezuela	1.6	-0.8

Sources:

Maddison (1995) and World Bank (1995).

the recent past. More generally, however, it should be recognised that in many countries opportunities for rapid growth remain unexploited or initial successes are not sustained (see the experiences of Brazil, Cote d'Ivoire, Mexico and Nigeria shown in Table 6.2).

The episodes of rapid growth in western Europe and Japan in the 1950s and 1960s and in East Asia more recently involved not only moving towards the levels of plant and equipment per worker of the leading economies (such as the United States) but also narrowing the gap with those countries in terms of efficiency and technology.¹ At the start of rapid growth in western Europe and Japan and in East Asia, levels of physical capital per worker were low and returns to investment were high. As the investment returns diminished only gradually, the sustained high rates of investment in these periods of rapid growth had a large impact on the growth of both capital stocks and output. The reconstruction and reorganisation of west European economies and Japan after the economic upheaval of the inter-war and wartime years also provided a significant opportunity for rapid improvement in productivity.

¹ See Milbourne (1995).

Components of growth

To understand how rapid growth comes about, it is first necessary to identify and to measure the components of growth. Put simply, growth involves the expansion of aggregate production. Firms generate production through their use of inputs, such as unskilled and skilled labour and plant and equipment, and their application of technologies and organisational methods. Growth, therefore, must come about either through increases in the use of inputs (for example, by investments in plant and equipment) or through improvements in technologies and organisation. In the long run, the latter will be crucial to prevent diminishing returns halting the growth process (see Chapter 3). At the aggregate level of an entire economy, a technique called growth accounting provides a way of presenting data which may, under certain strong assumptions, be interpreted as a breakdown of the sources of growth into various components: population growth, acquisition of skills, investment in plant and equipment, and improvements in technologies and business organisation (see Box 6.1).

Growth-accounting exercises suggest that periods of sustained, rapid growth typically result from high investment combined with strong total factor productivity growth. Table 6.3 reports that during both the "Golden Age" (post-war period) in western Europe and Japan and the "East Asian Miracle" there were strong contributions to growth from both capital accumulation and productivity gains. In fact, both periods witnessed investment booms, with the share of investment expenditure in total GDP exceeding 22 per cent in periods of rapid growth in these countries. Strong total factor productivity growth, which is explored further below, suggests that something was contributing to growth over and above the investment in plant and equipment and skills with given technology and organisation. In these cases, there were improvements in the use of resources (associated with, in particular, changes in the structure of employment, shifts to higher levels of effort and well-functioning processes for entry and exit of firms) together with gains from economies of scale (where relevant) and from innovations based on the successful assimilation and adaptation of foreign technology.

Table 6.3 reveals one important difference, however, between catching-up in East Asia and in western Europe and Japan: the differing contributions made by growth in labour inputs. The much more substantial contribution of labour to growth in East Asian economies arises from two sources: improvements in the quality of labour as a result of better education and training and increases in labour force participation which, unlike in western Europe, have not been offset by a decline in the number of hours worked per person employed.² Overall, it would appear that the fast growth in East Asia was generated much more by the accumulation of capital and expansion of labour than by growth in total factor productivity.

Notwithstanding the importance of increases in capital investment and labour inputs to the recent East Asian growth episode, the growth-accounting estimates reported in Table 6.3 also underline

Box 6.1

Growth accounting

Growth accounting is a technique which seeks to identify the components of growth and to provide a way of describing how (rather than why) growth happens. Contributions to growth are divided into those resulting from extra inputs and those stemming from improvements in the technology which transform inputs into outputs. The latter concept is known as total factor productivity (TFP) growth and measures increases in output after an allowance has been made for any increases in the quantity of each of the factors used in production. Total factor productivity growth is a comprehensive measure of productivity gains which takes into account the change in output allowing for the use of both capital and labour (or other inputs where relevant). The more familiar concept of labour productivity growth is simply the change in output per unit of labour. In growth accounting, inputs are weighted according to their importance in production and, at the level of an entire economy, an approximation (which may be precise when markets are perfect) can be obtained by weighting factors according to their shares in national income (see Oulton and Young [1996]). In measuring the growth of inputs, it is also desirable to include changes in quality as well as quantity. For labour this implies taking account of the education and skills of the labour force.

Growth accounting typically relies on the following identity:

$$\Delta Y/Y = \alpha \Delta K/K + \beta \Delta L/L + \Delta A/A,$$

where $\Delta Y/Y$, $\Delta K/K$, and $\Delta L/L$ are the percentage growth rates of output, capital and labour, respectively, and α and β are the shares of profits and of wages in national income, respectively. It is an identity because $\Delta A/A$ is defined as the growth in output not accounted for by increases in the factors of production, capital and labour. This term is the "residual" after calculating all the other components of the equation. By definition, this residual represents the contribution of TFP growth. This type of analysis was pioneered by Denison (1967).

Measurement issues are fundamental to the application of growth accounting. The technique is best regarded as a useful way of examining the data and not as a model of the growth process. Several points should be kept in mind when considering results from growth-accounting exercises. First, estimates of the growth of input factors and their share in national income are often difficult to form, leaving the residual of total factor productivity growth vulnerable to different techniques, assumptions and errors. Second, studies using this approach may not be strictly comparable because the application of the methodology differs in detail, due in some cases to data limitations. Third, the residual has been famously described as a "measure of our ignorance". In practice, it is likely to reflect a range of factors in addition to technological change, such as general deficiencies in the modelling process, improvements in allocation of resources, more intensive use of existing factors and economies of scale. All components of TFP growth are likely to be influenced by policy choices and the quality of institutions which establish the framework within which investment and resource allocation decisions are made.

the important role played by total factor productivity growth in periods of fast growth, notably in western Europe and Japan in the early post-war period. In considering what rapid growth episodes in market economies can teach us about medium- and long-term growth prospects in transition economies, it is particularly important to ascertain what has generated rapid total factor productivity growth in the past and whether similar conditions now prevail in eastern Europe, the Baltics and the CIS. In fact, the importance of productivity gains in transition economies is suggested by the very

² See Young (1995).

Table 6.3

Composition of output growth in western Europe and East Asia

(In average annual per cent)

	Capital accumulation	Increased hours of labour	Gains in total factor productivity	Output
1950-73				
France	1.6	0.3	3.1	5.0
Germany	2.2	0.5	3.3	6.0
Italy	1.6	0.2	3.2	5.0
Japan	3.1	2.5	3.6	9.2
UK	1.6	0.2	1.2	3.0
1973-92				
France	1.3	0.4	0.6	2.3
Germany	0.9	-0.1	1.5	2.3
Italy	1.0	0.6	1.2	2.8
Japan	2.0	0.6	1.2	3.8
UK	0.9	0.1	0.6	1.6
1966-90				
Hong Kong	3.0	2.0	2.3	7.3
Korea	4.1	4.5	1.7	10.3
Singapore	5.6	2.9	0.2	8.7
Taiwan	3.2	3.6	2.6	9.4
1979-94				
China ¹	4.2	1.2	3.9	9.3

Sources:

Hu and Khan (1996), Maddison (1996), Rossi et al. (1992) and Young (1995).

¹ Chinese labour inputs measured in persons not hours.

high rates of increase in labour productivity in those countries which are at more advanced stages of transition and which are growing rapidly (see Chapter 7).

From the standpoint of the economics of growth, it might seem logical to assume that total factor productivity growth was simply an indication of the contribution of technological progress to growth and that, in the context of catching up with more advanced economies, these improvements reflected primarily how successful economies were in achieving technology transfer from technologically advanced countries. Although it is important, this aspect is only part of the story. Particularly in the context of the modernisation of hitherto backward economies, a large part of productivity growth actually reflects improvements in the allocation of resources, the better use of investment, the elimination of inefficiency and, in some cases, a higher intensity of work. These aspects of productivity gains are essentially transitory in the sense that they cannot produce growth over the indefinite future, but they can have a substantial impact over two decades or more.

A recent study attempts, for four countries featured in Table 6.3, to divide the sources of total factor productivity growth between technological change and improvements in the efficiency with which existing resources and technologies are used.³ Table 6.4 shows these estimates. During the fast growth period 1950-73, the esti-

ated component of total factor productivity growth due to the more efficient use of existing resources and technologies ranges from 44 per cent in France to 83 per cent in Japan. These improvements stemmed from adjusting to trade liberalisation, exploiting opportunities for mass production as larger and better integrated markets emerged and from moving resources out of relatively low-productivity agriculture. As catch-up growth weakened, the absolute magnitude of this component fell markedly, especially in Japan where its contribution to growth fell by 2.2 percentage points per year in the period 1973-92.

Key lessons to be drawn from growth-accounting exercises for industrialised and developing market economies are that both investment in plant and equipment and growth in total factor productivity have made substantial contributions to periods of rapid growth. Moreover, an important, albeit non-permanent, source of productivity growth in the "Golden Age" of western Europe and Japan arose from improvements in the efficiency with which existing resources and technologies were used through trade liberalisation, economies of scale and structural change. The scope for these efficiency improvements arose in part from the collapse of world trade between the two world wars and the militarisation of the economies during the wartime years.

The potential for improving the use of existing resources in transition economies is in all likelihood much greater in these economies than it was in western Europe and Japan in the early post-war period. This potential arises from the heavily distorted economic structures that these countries inherited from central planning, including some vastly over-extended industries, neglected services and wasteful use of energy (see Chapter 4). The opening of these economies to international trade after decades of economic self-sufficiency and the restructuring of enterprises to focus on customers and costs increase the potential for productivity gains. These gains are likely to make a major contribution to growth in the transition economies over the next two to three decades.

Table 6.4

Components of total factor productivity (TFP) growth rates

(in average annual per cent)

	France	Germany	Japan	UK
1950-73				
TFP growth	3.1	3.3	3.6	1.3
Improvements in efficiency ¹	1.3	1.6	3.0	0.6
Residual ²	1.7	1.6	0.6	0.7
1973-92				
TFP growth	0.7	1.5	1.0	0.6
Improvements in efficiency	0.7	0.7	0.8	0.3
Residual	0.0	0.8	0.2	0.3

Source:

Maddison (1996).

¹ Improvements in efficiency is the sum of the separate effects labelled as catch-up, foreign trade, structural and scale.² The residual can be thought of as technological change plus measurement error.³ See Maddison (1996).

Determinants of growth

Role of government

Favourable incentive structures for both private businesses and governments have led to the strong total factor productivity growth and the investment booms characteristic of periods of sustained rapid growth. The ability of investors to realise their investment returns and the competitive pressure leading to increased managerial effort are central to investment, innovation and cost reduction. Government policies and institutional arrangements are, moreover, fundamental to the incentives to which firms respond. With regard to politicians' support of the market economy, key issues are their ability to benefit from the long-term success of business enterprises and their commitments to enforce property rights and not to expropriate profits.

The themes outlined above are commonplace in economic history, which has repeatedly identified the importance of political and institutional structures which permit strong yet restrained and predictable government.⁴ In particular, government needs to be able to protect property rights and enforce contracts but to refrain from expropriation, repudiation of its obligations and capricious behaviour.

The historical example of nineteenth-century American capitalism illustrates the concept more precisely. It is a common misconception that the country blossomed in conditions of lawlessness and corruption rather than by creating high-quality institutions. After all, this was the land of the California gold rush, Tammany Hall and the Wild West. It could be tempting, therefore, to ask whether transition economies could expect to prosper by permitting similarly unethical or dubious practices in political and economic activities.

This interpretation would, however, be a serious misreading of nineteenth-century economic history, even though it does depict a small part of the American experience. Certainly, the period saw the development of substantial political corruption associated with the machine politics of large American cities in the era of mass immigration.⁵ In addition, massive investment in the railway network was notorious for corrupt practices connected with the transfer of land rights to the railway companies, especially the Union Pacific.⁶ There were, however, a number of other important factors.

First, the United States had inherited from the colonial period a settled legal framework based on common law and, therefore, enjoyed from the outset the basic property rights fundamental to a market economy. The importance of this factor is reflected, for example, in the early development of patent protection for inventors⁷ and in the establishment and rapid refinement of mineral rights in some areas.⁸ Second, public land was securely privatised even though the process was often characterised by corruption

and violence. Third, the favours obtained by railway promoters accelerated projects which involved high rates of return, in terms of social benefits, on the enormous investments involved in developing the trans-continental system. Corruption, however, led to a serious misuse of resources. An example of this was the long delay in launching the New York subway system, which threatened the profitability of other transport assets run by the Tammany leaders.⁹

The right message to take from nineteenth-century America is that its strength stemmed from its pro-market institutions. Its rapid development was despite, not because of, the illegal and corrupt behaviour of some cynical and ruthless businessmen and politicians. Where governments are unable to enforce basic property rights and contracts, however, opportunistic behaviour by politicians or Mafia-type activities are likely to have detrimental consequences for growth. In fact, institutional quality (measured in terms of the rule of law, the risk of expropriation or repudiation of contracts by government and the efficiency and honesty of bureaucrats) discriminates well between the fast- and slow-growing countries in East Asia since 1960.¹⁰

The implications for transition economies are clear and already in evidence. As Annex 2.1 and Chapter 4 show, both arbitrary government behaviour and corruption are prevalent in transition economies, particularly in the CIS. There is also evidence that the unpredictable and arbitrary behaviour of government has had a detrimental effect on investment in the region, particularly in business start-ups and the new private sector. Economic history suggests that a high share of market-driven investment in GDP is one of the vital components to sustained high rates of growth.

Restructuring, resistance and growth

While there is a need to establish institutions and incentives that are conducive to investment and innovation, periods of catch-up growth typically involve significant changes in the composition and pattern of economic activity, leaving some economic activities loss-making. An important political dimension to growth is the potential for those who lose from technological change and restructuring to obstruct the process of modernisation.¹¹

Relatively weak total factor productivity performance has frequently been associated with inappropriate policies that sustain inefficient producers and institutions that give rise to "rent-seeking" (lobbying government for hand-outs and trade protection). The result has been a failure to exploit the full potential from the reallocation of resources and new technology. India in the post-war period provides a clear example. Estimates reveal that the ever-increasing distortions associated with the prevalence of import quotas, public utility pricing, investment decisions in nationalised enterprises and capital market controls, and the extensive rent-seeking to which they give rise, reduced total factor

⁴ See Weingast (1995).

⁵ See Benson (1978).

⁶ See Atask and Passel (1994).

⁷ See Sokolof (1988).

⁸ See Libecap (1978).

⁹ See Benson (1978).

¹⁰ See Rodrik (1997).

¹¹ See Abramovitz (1986).

productivity growth from about 3.7 per cent to around 1 per cent per year on average in the period 1950-80.¹² There is also evidence that in Indian manufacturing between 1959 and 1979 total factor productivity growth was negative (-0.2 per cent per year), with the worst performing sectors also the most heavily protected and subsidised.¹³

In the United Kingdom, misdirected intervention and political constraints on the reform of an unfortunate institutional legacy seriously undermined productivity performance. Tables 6.1 and 6.3 show that the United Kingdom was a case of relative economic decline and low total factor productivity growth during the European Golden Age. Table 6.5 extends this picture and shows the build-up of a large gap in manufacturing labour productivity between the United Kingdom and France and Germany up to the end of the 1970s, which was responsible for a substantial part of its poor performance in these years. The table also shows that this gap in productivity shrank substantially in subsequent years.

Following a winter of crippling labour strikes, the government elected in 1979 pursued a series of radical reforms that marked a major break from the supply-side policies of all previous post-war British governments. Key ingredients included privatisation, deregulation, abandonment of industrial policies involving both the subsidy of "lame ducks" and the support of "national champions", reduction of direct tax rates while relying more on indirect taxation and restraining the growth of government spending as a proportion of GDP, and reforms of industrial relations. Foreign investment, including the take-over of British-owned firms, was encouraged. Increased competitive pressures and a severe recession shifted bargaining power away from workers and facilitated a re-assertion of managerial prerogative. Strikes by powerful groups of public-sector workers were defeated.¹⁴

The most striking result of this policy experiment is the strong industrial productivity growth of the 1980s. To a large extent, this reflected a shake-out associated with the reduction in overstaffing, the exit of inefficient firms and changes in the effort levels of workers in the early 1980s as fears of bankruptcy and unemployment increased.¹⁵ By the end of the 1980s, comparative analysis suggests that British firms had become more efficient than their German counterparts at reducing costs, and the remaining gap in productivity reflected lower investment per worker.¹⁶ Although the implementation of British privatisation was mishandled to some extent, the inefficiencies that it eliminated were substantial.¹⁷

In some rapidly growing economies, however, industrial policy involving subsidies and non-tariff barriers to trade appears to have played a prominent role. Nevertheless, even in successful countries, such as Japan and Korea, the evidence is that, on balance, these policies retarded rather than stimulated growth. An analysis of industrial productivity growth across sectors in Korea during

Table 6.5

Relative productivity in manufacturing 1

(Index numbers with the United Kingdom set equal to 100 in each year)

	1950	1973	1979	1995
Federal Republic of Germany	97.5	142.0	163.7	116.8 ²
France	90.4	130.6	149.1	122.1
Japan	45.2	90.5	113.8	104.4
United States	245.7	186.6	179.9	143.5

Sources:

Pilat (1996) extended to 1950 and interpolated to 1979 using van Ark (1993). Note that the Pilat figures are comparisons between the other countries and the USA and were originally expressed using the USA as the base country.

1. Productivity is measured as value-added per hour worked.

2. Excludes the area of the Former German Democratic Republic in 1995.

1963-83 finds that tax and financial incentives did not enhance productivity growth, while protectionist policies (especially non-tariff barriers) reduced both capital accumulation and total factor productivity growth.¹⁸ There is also evidence that Japanese industrial policies diverted resources away from high-growth sectors towards declining industries and did not have a positive effect on total factor productivity growth within sectors during the period 1960-90.¹⁹ Rapid growth in these economies, therefore, was despite, not because of, their protectionist policies.

There are three main conclusions that can be drawn from these examples of resistance to restructuring and technological change. First, countries may fail to take full advantage of opportunities for productivity improvement if they do not adopt market-oriented policies. Second, the consequent poor productivity performance often reflects the weak incentives for managers to put effort into cost-reduction and the ability of vested interests to slow down restructuring, the reallocation of resources and the adoption of new technologies. Third, the changes in government policy required to redress these problems are often likely to encounter strong political resistance from those made worse-off by the changes. The ability of governments to withstand potential resistance to these changes is often associated with events during periods of political and economic crisis.

In most transition economies, the initial reforms of rapid price and trade liberalisation, elimination of budgetary subsidies and small-scale privatisation were implemented immediately after the collapses of communist regimes and changes in political power. The challenge in the transition economies has been to consolidate these reforms amid strong resistance, in particular pressure from state enterprises for off-budget bail-outs (tax arrears and energy arrears) and soft bank loans. Importantly, the elimination of impediments to new business start-ups and the growth of the new private sector can ease this resistance to change by creating new employment opportunities (see Chapter 5).

¹² See Hamilton et al. (1988).

¹³ See Ahluwalia (1991).

¹⁴ See Crafts (1991).

¹⁵ See Bean and Symons (1989).

¹⁶ See O'Mahony (1992).

¹⁷ See Newbery and Pollitt (1996), p. 23.

¹⁸ See Lee (1995).

¹⁹ See Beason and Weinstein (1996).

Technology transfer

While making more efficient use of existing resources is a crucial component of total factor productivity growth in periods of catching up, the transfer of technology from more advanced economies is also a major source of productivity gains. However, technology transfer does not simply involve imitation. It is important to recognise that the gains from importing technology vary and that, in successful cases, technology is often adapted and improved during the process of international diffusion. The striking success of East Asian economies reflects in part their unusually strong efforts to improve and develop imported technology.²⁰

Given that substantial application of resources is usually required to implement technology transfer, with foreign direct investment often a key ingredient, this process shares many of the aspects of research and development. As discussed in Chapter 3, productivity gains from technology transfer should be enhanced by wider markets and by the lower costs of acquiring and implementing technical change. Importantly, trade can play a role both in lowering the costs of adapting foreign technology and in expanding markets.²¹ The capability to absorb and adapt foreign technology is also significantly influenced by a recipient country's level of education and the extent of acquired skills.²² However, the adaptation of foreign technology to domestic conditions requires investment, which is unlikely to be undertaken by firms fearing that their profits may be at risk because of a lack of property rights.

The historical evidence tends to support the view outlined above. For example, it is clear that in the "American invasion" during the trade liberalisation of the 1950s and 1960s, the multinational companies which flocked to western Europe brought with them American technology. Europe was able to benefit more from American technology as the costs of technology transfer fell substantially following improvements in education, more research and development activity, lower transport costs and wider markets.²³ Japan also gained greatly from technology transfer in this period. It did so largely through extensive expenditure on reverse engineering and complementary research and development based on a strong initial base of a skilled workforce and stimulated by strong profit incentives.²⁴

Conclusion

Transition economies have much to learn from earlier periods of rapid growth. This section has drawn on both historical accounts and empirical studies of growth in industrialised and developing market economies to provide a clear picture of periods of rapid growth and of relative decline. Several key points emerge from the analysis of these periods. They are summarised below.

- Rapid growth is usually associated with successful advances by economies that are modernising and moving towards the levels of technology, organisation and capital per worker of leading countries.

²⁰ See Bell and Pavitt (1993).

²¹ See Coe et al. (1997).

²² See Benhabib and Spiegel (1994).

- Strong advances in growth are typically associated both with investment booms and with rapid growth in total factor productivity, as in western Europe and Japan in the 1950s and 1960s and in East Asia in recent years.
- Large productivity gains associated with periods of rapid growth depend not only on changes in technology (in part through adaptation) but also on improvements in the efficiency with which resources are used. This is a key point from the Japanese experience.
- Rapid growth to catch up with the more advanced economies is not automatic but requires appropriate policies and institutions. For example, it is important that credible property rights are established and contracts are enforced so as to underpin high levels of investment and innovation and that opportunism and rent-seeking are contained. This was fundamental to the growth of the United States in the nineteenth century.
- Political pressure from those groups concerned that a loss of jobs and wealth might result from restructuring and technological change can be an impediment to rapid growth. A period of political and economic crisis has, in some cases, been instrumental in changing perceptions of the costs and benefits from reform and in overcoming this resistance to change, as was the case in the United Kingdom in 1979.
- Technology transfer is a critical component of productivity growth in periods of catching up with more advanced economies. Trade and foreign direct investment often facilitate this process, as post-war experience in western Europe and Japan has illustrated. However, successful transfer requires both the incentive (market opportunities) and the ability (local skills base) to adapt technologies to local conditions.

6.2 Restructuring and growth in transition economies

While the examples of catching up and falling behind in market economies illustrate the importance of adapting to market conditions through structural change and restructuring, this process in transition economies is taking place on an unprecedented scale. Chapters 4 and 5 describe in detail some of the distorted economic structures inherited from central planning and the effects that introducing market forces had on the composition of economic activity and on the performance of enterprises. This analysis illustrates how progress in market-oriented reforms can enhance growth by improving the efficiency with which existing resources and technologies are used.

While the experience of transition is relatively brief and many factors influence developments in these economies, it is becoming apparent how important market-oriented reforms are to growth. There is some evidence that the depth of the initial falls in output in transition economies have been closely associated with the extent of the inherited economic distortions (macroeconomic

²³ See Nelson and Wright (1994).

²⁴ See Goto (1993).

imbalances and distortions in prices and the composition of output).²⁵ Moreover, the timing and strength of the recovery and growth have been linked to two factors: the successful implementation of macroeconomic stabilisation and of market liberalisation.²⁶ This suggests that over time the legacies from central planning will have less of an effect on growth and that the effectiveness of reforms will become more important. In fact, Chart 6.1 shows that output growth in transition economies after the initial fall in output is positively linked with progress in reform.

The positive relationship between market-oriented reforms and short-term growth in transition economies suggests further potential for growth through more efficient use of existing resources. In this short time span, the effects of investment and innovation are bound to be small relative to the stock of resources and existing technologies, with much of the recovery in the region originating from efficiency gains. While it is difficult to judge the likely intensity and duration of these efficiency gains for transition economies, the post-war recovery in western Europe and Japan provides a possibly conservative estimate of their potential contribution to medium-term growth in transition economies.

The process of transition, however, involves more than just structural change and restructuring. Over time, investment in plant and equipment, the acquisition of market-based skills and the adaptation and development of new technologies will come to dominate the long-term performance of these economies. Indeed, the mix of old and new plant and equipment and of technologies will change gradually. The growth of transition economies over the medium and long term will be determined, therefore, both by structural change and restructuring and by investment in plant and equipment and the introduction of new technologies.²⁷

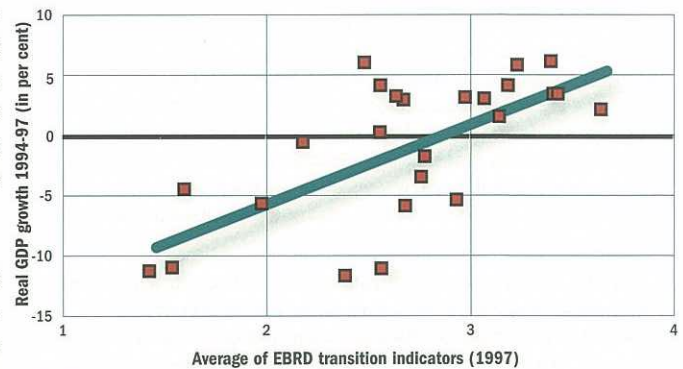
6.3 Long-term growth prospects in transition economies

While the analysis of examples of catching up and falling behind in market economies shows how important structural change and restructuring are to growth, this section considers the potential contribution of investment and innovation to long-term growth. These processes are present in all market economies, and considerable evidence is available for gauging their long-term potential in transition economies. This analysis requires weighting the relative importance of the determining factors for investment and innovation. The process of weighting, however, tends to over-emphasise those factors which are more easily quantified at the expense of those which might be more important but more difficult to measure. Nevertheless, some progress has been made in recent years in quantifying some of the important factors in investment, innovation and growth.

One method for weighting the various factors comes from cross-country growth regressions, which relate statistically a number of factors to cross-country variations in long-term growth performance. This is a way of organising the data to reflect the

Chart 6.1

Growth and market-oriented reforms in transition economies



Source:
EBRD.

Note:
Unlabelled points represent transition economies.

importance of positive and negative attributes of transition economies but it is not a way of delivering precise forecasts for particular economies. In fact, the approach has already been applied to transition economies by first estimating the statistical relationships for large samples of industrial and developing market countries during the 1960s to 1980s and then making growth predictions based on the known variables for transition economies. However, the variables used in these exercises omit the institutional factors identified in the preceding section as key determinants of rapid growth (see Box 6.2).²⁸

Growth projections using cross-country regressions

A typical cross-country growth regression suggests that growth will be positively associated with investment and educational enrolments and negatively with the initial level of income per person, which serves as a measure of the potential for catching up with more advanced economies (see equation [1] in Box 6.2). Table 6.6 shows the results of using these explanatory variables to project long-term growth rates for transition economies. An exercise of this kind is perhaps best suited to analysing growth prospects after the period of extensive structural change and restructuring, which is still many years from completion, and related to average growth over a period of about 20-30 years from that point. Table 6.6 contains some illustrative projections based on the gaps in income with the United States and the investment levels that prevailed in the mid-1990s. Comparable projections are calculated for the west European and East Asian countries that have experienced periods of rapid growth, where these projections are based on values of the explanatory variables at the start of their period of rapid progress in catching up with more advanced economies.

The general picture that emerges can be summarised as follows. First, the more affluent transition economies have income levels (relative to that of the United States) similar to those of southern Europe and East Asia at the start of their periods of rapid growth. However, they are much lower than those of the north European

²⁵ See de Melo et al. (1997).

²⁶ See Fischer et al. (1996) and de Melo et al. (1996).

²⁷ See Rühl and Vinogradov (1996).

²⁸ See IMF (1996) and Fischer et al. (1997).

Box 6.2

Cross-country growth regressions

The last decade has seen a proliferation of analyses which use cross-country data to carry out regressions of growth rates on a selection of variables thought to contribute to growth. However, these approaches to predicting growth must be treated with considerable caution for several reasons (see Stern [1990]). First, the equations describing the growth process are grossly over-simplified. Second, the approach suffers from the problem that growth can influence the variables used to predict growth as well as vice-versa. Third, most of the variables are poorly measured.

Initial analyses tended to link growth to the scope for closing the gap on the most advanced economy (measured by the initial income level relative to that of the most advanced country) and to investment in machinery and to development of skills. A useful overview can be found in Levine and Renelt (1992). These authors scrutinised the work carried out to that point and selected a fairly robust cross-section equation describing the general experience of growth by the expression:

$$(1) \text{ GYP} = -0.83 - 0.35\text{RGDP60} - 0.38\text{GPO} + 3.17\text{SEC} + 17.5\text{INV},$$

where GYP is the average annual growth rate of real GDP per capita for 1960-85, RGDP60 is real income per person in the initial year (1960), GPO is the population growth rate, SEC is the secondary school enrolment rate and INV is the share of GDP devoted to investment. The estimated relationship is for about 100 countries excluding eastern Europe. The numerical co-efficients represent the estimated impact of a unit change in the explanatory variable concerned on the per capita growth rate, holding the other variables on the right-hand side constant. Thus, other factors remaining the same, a rise in the investment rate by 0.01 (1 percentage point of GDP) would be associated with an increase in the growth rate of 0.175 percentage points. The equation finds that, allowing for investment in machinery and development of skills, growth is inversely related to initial income, suggesting that catching up with more advanced countries is part of the growth process.

It is striking that the above equation does not point to any great role for the institutions which shape investment incentives, nor does it reveal anything about the reasons for different investment rates across countries. Nevertheless, using an estimated relationship of this type to infer future growth prospects for transition economies is quite common. Yet such an approach would miss the fundamental question of the role to be played in subsequent growth by the design of appropriate institutions and by incentives to invest and to innovate. It would miss, therefore, much of what may be important in transition economies.

countries in 1950. The less affluent transition economies are more similar to the position of China in 1970. Second, the current secondary school enrolments in transition economies are higher than those in western Europe and Japan in 1950 and in East Asia in 1970 (but are similar in terms of average years of schooling of the labour force). Third, there is a wide range in the investment rates of transition economies, with only the strong performers matching the past investment rates of high-growth countries. Overall, this approach tends to produce reasonably optimistic projections for long-term annual growth rates in transition economies (in the range of 4 per cent to 7 per cent for most countries shown in Table 6.6), largely because of the significant scope for catching up with advanced economies and the high levels of educational enrolment.

Several recent empirical investigations of cross-country growth point to the importance of institutions in the exploitation of opportunities for growth. This has involved both establishing links between growth and factors such as the credibility of property rights and the enforceability of contracts and exploring what kinds of society are likely to create and to sustain good-quality institutions. The work of Knack and Keefer (1995) has been influential in this respect. An equation presented in Knack (1996) typifies this later approach, which is rather more appropriate for the transition economies than the earlier study:

$$(2) \text{ GYP} = -6.602 - 1.308\text{LogRGDP60} + 1.273\text{SEC} + 2.296\text{PRIM} + 12.086\text{INV} + 8.122\text{LFGR} + 0.755\text{PRIC} + 0.058\text{ICRG},$$

where variables are defined as before except that GYP now relates to 1960-89, PRIM is the primary school enrolment rate, LFGR is the labour force growth rate, PRIC captures the impact of changes in international prices (but is statistically insignificant) and ICRG is an index of the security of property rights and contract enforcement published in the International Country Risk Guide by Political Risk Services (a US commercial company). This equation is an extension of the earlier Levine-Renelt approach, with the main difference being the inclusion of the term measuring security of property rights. The positive (and significant) co-efficient implies that countries with better established property rights experience faster growth, allowing for the other variables, and thus that this aspect of institutional capability is important for growth prospects. Note that this leaves out any effect which operates through the share of investment in GDP since this is included elsewhere in the equation.

The ICRG index embodies five components. Two of these, "expropriation risk" and "rule of law" relate directly to the security of property rights. Risk of "repudiation of contracts by government" is a measure of contract enforcement, while "corruption in government" and "quality of the bureaucracy" characterise the general efficiency in provision of government services. The overall index is the sum of the scores of the five components.

The form of the equation illustrates, however, some of the above warnings. In this context, there are two particular omissions relevant to the discussion of historical growth in the preceding section. First, the specification of the regressions does not encompass some of the key messages from growth-accounting studies, in particular the importance of efficiency gains from the reallocation of resources in periods of rapid growth. Second, some aspects of success and failure in growth are overlooked because they cannot be easily quantified. For example, many institutional factors are particularly difficult to quantify.

Projections of growth of the kind shown in Table 6.6 and elsewhere²⁹ are unsatisfactory, however, because they ignore the role of policies and institutions and because of the serious modelling and estimation problems described in Box 6.2. Essentially, closing the gap on advanced economies is viewed as an automatic and mechanical process, which the experience of growth in market economies suggests is far from the case. A refinement of these basic predictions could result from comparing indices of institutional quality and policy design across countries and replacing the basic predictive equation with one that incorporates a measure of this kind. The institutional variable could relate to important aspects of the business environment, in particular those that reflect the ability to appropriate the returns to investment (such as the extent of security of property rights and enforcement of contracts). Both economic experience and theory suggest that these factors have sizeable

²⁹ See IMF (1996) and Fischer et al. (1997).

effects on investment and innovation (including the rate of technology transfer). The basic problems of the technique itself, however, may limit the value of these refinements.

The International Country Risk Guide (ICRG) index of the security of property rights and the enforcement of contracts (published by a commercial company) is available for some (but not all) transition economies, as well as a large number of market economies. A recent cross-country regression that includes this measure of institutional quality (equation [2] in Box 6.2) provides the basis for calculating a second set of growth projections for some transition economies which includes as an explanatory variable a measure of institutional quality. However, the exercise is no more than illustrative because it assumes that current levels of institutional quality are maintained and it uses an index that may flatter the transition economies somewhat. For example, while the ICRG index places the highest ranked transition economies in 1995 (the Czech Republic, Hungary and Poland) on a par with France and Germany in 1984 (the earliest year for which this index is fully available), an alternative index of business risk, compiled by Business Environment Risk Intelligence (BERI), places these

Table 6.6

Comparisons of transition economies with earlier cases of fast growth ¹

(in per cent)

	Per capita income relative to that of the US	Investment share in GDP	Secondary school enrolment rate	Forecast of average annual growth over 25 years
Albania	5.0	16.5	78	4.4
Armenia	8.6	8.8	85	3.2
Azerbaijan	5.6	15.9	88	4.6
Belarus	16.1	25.2	92	6.1
Bulgaria	17.1	20.7	72	4.6
Croatia	21.7	14.0	83	3.7
Czech Republic	37.4	24.7	86	5.3
Estonia	16.1	26.9	92	6.4
FYR Macedonia	8.2	15.4	54	2.8
Hungary	24.5	22.8	81	5.1
Kazakhstan	11.5	22.4	90	5.6
Latvia	12.9	20.8	87	5.2
Lithuania	15.8	19.2	78	4.6
Moldova	7.9	6.7	84	2.8
Poland	20.7	17.0	84	4.3
Romania	16.7	25.7	82	5.8
Russia	17.1	25.0	88	5.9
Slovak Republic	13.8	28.3	89	6.6
Slovenia	43.7	22.5	89	4.8
Tajikistan	3.5	17.4	100	5.3
Uzbekistan	9.1	23.3	94	6.0
Western Europe and Japan ²	49.7	24.7	50	3.8
East Asia ³	16.5	28.0	45	5.2

Sources:

Levine and Renelt (1992), IMF, World Bank and EBRD calculations. Implemented using their dataset and taking US1960=7,380 dollars with other initial income levels calculated using relativities reported in the table.

¹ Explanatory variables for the transition economies are from 1995. The equation used to obtain the growth forecast is the equation in Box 6.1.

² Values of explanatory variables are from 1950.

³ Values of explanatory variables are from 1970.

Table 6.7

Further comparisons of transition economies with earlier cases of fast growth

	Index of institutional quality	Baseline forecast of average annual growth over 29 years (in per cent)	Growth forecast based on an index value of 46 (in per cent)
Albania	36	3.2	3.8
Bulgaria	37	3.5	4.0
Czech Republic	42	4.2	4.5
Hungary	46	4.3	4.3
Poland	44	3.6	3.8
Romania	34	4.1	4.8
Russia	28	4.0	5.1
Slovak Republic	39	5.1	5.5
Western Europe and Japan	44	4.0	na
East Asia	38	4.5	na

Sources:

Knack (1996), Table 6.6 and EBRD calculation.

Note:

Predicted growth rates are based on the equation from Knack (1996) reported in Box 6.2 and where two additional variables have been set to sample means and added to the intercept.

The index 1 has a maximum of 49 and a minimum of 7; for western Europe and East Asia estimates are for 1984, the earliest year with full information. For transition economies the index is for 1995 and is only available for Albania, Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia and the Slovak Republic.

countries more plausibly on a par with Portugal and Spain in 1972 (the earliest year of this index). Moreover, the ICRG index focuses only on one aspect of institutional quality, the security of property rights and enforcement of contracts, and there may be other institutional factors that have a significant impact on growth prospects in transition economies (such as development of the financial sector and physical infrastructure).

Table 6.7 shows growth projections for eight transition economies based on the cross-country regression given by equation (2) in Box 6.2 and their 1995 ICRG index values. Several points are immediately apparent. First, it is clear that according to these measures transition economies (with the possible exception of the Czech Republic, Hungary and Poland) do not yet have institutional arrangements which match those which prevailed in western Europe and Japan in 1984 (the first year for which the index is available), although most transition countries covered by the index are on a par with East Asia (except for Russia). Second, two countries (Romania and Russia) which seemingly had very good prospects in Table 6.6 appear likely to be constrained to a significantly lower growth rate by low institutional quality. Third, many transition economies not covered by the ICRG index are in the CIS and are likely to have levels of institutional quality at or below that of Russia. Their seemingly good growth prospects reported in Table 6.6 are also likely to be constrained by low institutional quality.

The existence of substantial obstacles to private investment in transition economies, particularly those in the CIS, is borne out by a variety of evidence (see Chapters 4 and 5). These include the

arbitrary and discriminatory enforcement of taxation, weaknesses in basic legal institutions that undermine the enforceability of contracts, and unnecessary business licensing and interference that gives rise to corruption.³⁰ This strongly supports the argument that projections based on equations that ignore institutional quality will be seriously misleading and much too optimistic, particularly for CIS countries such as Russia. At the same time, it also suggests that the rewards for improving institutional quality could be substantial.

Table 6.7 also shows projections of the gains for transition economies if they achieved Hungary's level of institutional quality. These gains are estimated to be between 0.5 and 1 percentage point per year on the growth rate for those countries apart from the most advanced ones. The gains for those countries not covered by the index are likely to be 1 percentage point per year or more. However, it should be remembered that, in normal circumstances, historical experience suggests that major changes in institutional quality are quite unusual. For example, long-term changes in indices of security of property rights like the one used in the calculations reported here tend to be rather modest. In only one country (Chile) out of 36 for which there are long-term data has the cumulative change over 20 years been as large as the gap between Russia and Hungary shown in the table. In the years after a major social upheaval, however, experience suggests that there is often a window of opportunity for rapid change before blocking coalitions re-emerge.³¹ Obviously, in the transition economies that have established high institutional quality, there have been massive strides in a few short years since the collapse of communism.

In fact, the potential gains from improving institutional quality suggested by Table 6.7 are likely to be underestimates, particularly of the medium-term rewards, for three reasons. First, as noted above, the scope for improvement in institutions is probably understated by the ICRG index used in compiling Table 6.7 because of its somewhat flattering view of the transition economies. Second, the estimates do not allow for the indirect effects that would come through raising the investment rate. Related work suggests that a move from 28, the lowest institutional quality score, to 46, the highest score, would raise investment by enough to raise the growth rate by a further 0.5 percentage points per year on top of the direct effect.³² Third, equations of this kind understate the gains from the process of structural change and restructuring, which can be expected to yield significant increases in total factor productivity in transition economies.

Accounting for growth in transition economies

Because of the limitations of growth projections for transition economies based on cross-country regressions, it is important to check on the plausibility of these projections. One such check is to perform a growth-accounting exercise for transition economies. Such an exercise for transition economies basically involves forming quantitative predictions about the future expansion in inputs, physical capital, acquired skills and unskilled labour and

about growth in total factor productivity. As Box 6.1 emphasises, it is primarily a method of quantifying the growth process rather than a forecasting technique.³³ The approach followed here begins with acquired skills (human capital), a valuable and abundant resource in all transition economies.

There are two possible routes through which human capital promotes growth. The first is through the growth in skilled labour inputs, which are directly transformed by technologies and organisations into increased output. The second route is indirect and operates by enhancing an economy's capacity to adjust to opportunities for closing the gap on advanced economies and for raising total factor productivity. Available empirical evidence suggests that this latter channel is likely to be very important.³⁴

The approach followed here takes account of both of these effects and, once again, draws comparisons with western Europe and Japan and with East Asia. Table 6.8 shows estimates of the increases in the quantity of the labour forces and in their quality based on available projections of the growth of the labour force and of increases in schooling. Weighting this input growth in accordance with the growth-accounting formula gives an estimate of the direct effect on growth of changes in the labour force. The table also uses regression estimates which relate productivity growth to years of schooling and the scope for catching up with advanced economies. This shows the indirect effect of the labour force operating through the impact of acquired skills on total factor productivity growth. The table highlights several points. First, the likely contribution of increased labour inputs to growth of per capita output in transition economies is much lower than in East Asia. This difference arises because in many transition countries schooling levels are already high and because demographic trends are much less favourable. However, hours of work are unlikely to fall as they did in western Europe during the post-war period, and the contribution of labour inputs will surely exceed that of those countries. Second, the high stock of acquired skills has a positive effect on total factor productivity growth, and this effect can be a very positive factor in promoting growth, as in East Asia. Indeed, given the large initial shortfall in productivity in transition economies, there may be the potential for a strong impact on growth comparable with that in Japan, Korea or Taiwan in many transition countries. Third, combining the two components would suggest that in general the transition economies are not quite as well placed as their East Asian counterparts.

While Table 6.8 examines potential contributions to growth from a skilled workforce, both directly and indirectly through total factor productivity growth, a more complete growth-accounting exercise requires consideration of investment in plant and equipment and of population growth. For this purpose, growth of the capital stock is assumed to keep pace with the output increases resulting from extra labour inputs and total factor productivity growth, so that the ratio of output to capital remains constant on a "balanced-growth" path. This path is set out as a useful benchmark with which to focus the

³⁰ See EBRD (1997).

³¹ See Olson (1982) and Balcerowicz (1995), Chapter 1.

³² Based on Knack and Keefer (1995, p. 221 using equation [2]).

³³ Indeed, as a formal modelling technique it shows many of the problems embodied in the regression approach.

³⁴ See Benhabib and Spiegel (1994).

Table 6.8

Contributions to growth from extra labour inputs and total factor productivity (TFP) growth¹

(in average annual per cent)

	Growth of labour source	Labour force growth adjusted increase in schooling	Contribution to growth		
			Increased quantity and quality of labour	TFP growth	Combined effect
Azerbaijan	0.9	1.6	1.1	2.5	3.6
Belarus	0.2	0.7	0.5	2.4	2.9
Bulgaria	-0.2	0.3	0.2	1.8	2.0
Czech Republic	-0.1	0.2	0.1	1.5	1.6
Estonia	0.0	0.3	0.2	3.4	3.6
Georgia	0.2	0.9	0.6	2.3	2.9
Hungary	-0.1	0.1	0.0	2.0	2.0
Kazakhstan	0.3	1.0	0.7	2.0	2.7
Latvia	0.1	0.4	0.3	3.2	3.5
Lithuania	0.0	0.3	0.2	3.1	3.3
Moldova	0.2	0.8	0.6	3.4	4.0
Poland	0.1	0.5	0.4	2.4	2.8
Romania	0.2	0.7	0.5	2.4	2.9
Russia	0.2	0.5	0.4	2.2	2.6
Slovak Republic	0.1	0.4	0.3	4.3	4.6
Ukraine	0.1	0.7	0.5	2.3	2.8
Uzbekistan	0.8	1.5	1.0	3.5	4.5
Western Europe and Japan	-0.6	-0.3	-0.2	1.4	1.2
East Asia	1.5	2.3	1.6	2.3	3.9

Sources:

Table 6.6 and, for the transition economies, EBRD projections and calculations based on possible improvements in schooling from the levels reported in UNDP (1993).

- ¹ All estimates assume a standard weight of 0.7 for labour inputs in the growth accounting formula. Contributions to growth from the impact of human capital on TFP growth are based on Benhabib and Spiegel (1994, p.162, equation 5). Estimates for the transition economies are for 1995-2010, for western Europe and Japan are for 1950-73, and for East Asia are for 1966-90.

discussion. It is not intended as a prediction that there will be “steady-state growth” in the sense of a formal growth model in which the capital stock and output grow at the same constant rate.

The projections that result from this growth-accounting approach are set out in Table 6.9, and they have several implications. First, as shown, for the majority of the transition economies, the projections obtained using the basic cross-country regression which ignores institutional quality may be too optimistic in their implied assumptions with regard to the supply-side potential of the transition economies. Second, the growth-accounting projections are broadly similar to those based on the cross-country regression which takes account of the likely impact of institutional quality. However, this comparison only covers those transition economies with relatively high levels of institutional quality. This suggests that in those unrated transition economies with low institutional quality, the need for further institutional reform may well constrain the realisation of growth potentials.

Conclusion

The quantitative predictions for transition economies developed in this section offer only an initial suggestion as to their growth prospects. At first, this analysis might seem to suggest that the transition economies are generally well placed for rapid growth after their initial period of transition because of their high level of acquired skills and the large initial shortfall in productivity. These factors point to long-term average annual growth rates for transition economies in the range of 4 per cent to 7 per cent for most countries.

To realise this potential, however, the establishment of institutions that will create incentives for high investment and rapid TFP growth will be required. If further improvement in institutions does not materialise, the evidence available even for those transition economies with relatively high institutional quality (compared with other transition economies) suggests that long-term growth rates are likely to be reduced by up to 1½ percentage points per year. For many transition economies where the standardised measure of institutional quality is unavailable (in part because their institutional quality is below the level at which foreign investment can be attracted) the constraint of low-quality institutions on growth is likely to be particularly severe.

At present, there is not enough historical evidence to make confident predictions about the introduction of reforms and the future of

Table 6.9

A feasible “balanced growth” path compared with regression projections

(in per cent)

	Forecast of balanced growth	Difference with Table 6.6 forecast ¹	Difference with Table 6.7 forecast ²
Azerbaijan	5.2	0.6	na
Belarus	4.1	-2.0	na
Bulgaria	2.9	-1.7	-0.6
Czech Republic	2.3	-3.0	-2.0
Estonia	5.2	-1.2	na
Hungary	3.0	-2.1	-1.3
Kazakhstan	3.9	-1.7	na
Latvia	5.0	-0.2	na
Lithuania	4.7	0.1	na
Moldova	5.7	2.9	na
Poland	3.9	-0.4	0.3
Romania	4.1	-1.7	0.0
Russia	3.6	-2.3	-0.4
Slovak Republic	6.5	-0.1	1.4
Uzbekistan	6.5	0.5	na

Sources:

Tables 6.6, 6.7, 6.8 and EBRD calculations.

Note:

The balanced growth forecast uses the projections of Table 6.8 plus the population growth rate together with the assumption that capital-output ratio is constant as on a balanced growth path such that $\Delta Y/Y = \Delta L/L + TFP/B$ (using the notation of the growth accounting box). The growth rate is expressed in per capita terms.

- ¹ The second column is the difference between this balanced growth path and the projected growth rate of per capita income using the Levine and Renelt formulation as in Table 6.6.

- ² The third column is the difference between this balanced growth path and the projected growth rate of per capita income using the Knack formulation as in Table 6.7.

institutions. There are striking examples of rapid and radical change even though persistence in existing arrangements may be more usual. A recent survey seeking to identify the political circumstances most conducive to economic reform was largely inconclusive, although the critical importance of crises in precipitating change is often noted (see Box 6.3).³⁵

This analysis, moreover, is no more than a partial view of growth prospects in transition economies and does not take account of several factors that deserve careful consideration. In particular, the measure of institutional quality used here is very narrow, focusing only on the security of property rights and the enforcement of contracts. There are many other aspects of the institutional infrastructure that are important to investment and enterprise performance, including the predictability of tax administration, business licensing procedures, instability in governments and their policies, under-developed financial sectors and distorted physical infrastructure (see Chapters 4 and 5). In addition, these quantitative estimates are unlikely to capture the full medium-term growth potential from structural change and restructuring in transition economies, the scale of which is without historical precedent.

Others have drawn attention to the likely disincentive effects of the taxation necessary to support large government budgets, stressing that some transition economies spend high proportions of GDP on state pensions.³⁶ This is clearly an important area where future policy decisions may influence projected growth rates. It may be unrealistic, however, to suppose that it will be easy for the transition economies to reduce sharply social transfers in general and pensions in particular (whatever the inherent merits or otherwise of this policy). A key influence on patterns of social spending in democratic countries is the age distribution of the population. The available evidence suggests that both the initial age structure and the continuing ageing of the population in the transition economies will produce strong pressures against reductions in government spending on pensions and other aspects of spending on the welfare state.³⁷

6.4 Conclusion

Relative economic backwardness can offer the opportunity for very rapid growth. Recent decades have seen outstanding examples of this in western Europe and Japan in the early post-war period and in East Asia in recent years. These episodes of rapid growth stand in sharp contrast to the many countries in which opportunities for catching up with advanced economies remain unexploited or where initial successes have not been sustained. For those designing policies and building institutions in transition economies, the stakes are clearly high.

There is vast potential for medium-term gains in productivity in transition economies both through more efficient use of existing resources and technologies and through upgrading technology.

³⁵ See Haggard and Williamson (1994).

³⁶ See Sachs and Warner (1996).

³⁷ See Lindert (1993).

Box 6.3

Achieving reforms that improve institutional quality

Changing institutions is often both very costly and fraught with political difficulties. Reforms are often blocked by interest groups consisting of those who fear that change might have an adverse effect on them. To switch from the current set-up involves incurring high fixed costs and having to learn how to operate under the new arrangement. In contrast, conventional patterns of behaviour which are customary, predictable and self-enforcing help to reduce transactions costs. They develop through the accumulation of precedent and, once established, tend to persist. Although chance events may sometimes allow a new start, the process of institutional change usually occurs through small incremental changes and is often dependent on earlier historical events so that early mistakes may be very difficult to overcome (see North [1990]).

Italy is a case in point. Putnam (1993) distinguishes between the regions of Italy in terms of their civic norms and practices and notes that more civic regions have more effective governments, less corruption and a way of life that minimises opportunism and transactions costs. This seems to have been a fundamental reason for the more successful development of north and central Italy compared with the south. What is most striking about Putnam's analysis, however, is his demonstration that the existence of these positive civic attributes on a regional basis largely reflects their presence a century earlier, as measured by an index of civic involvement. While this particular finding is controversial, it suggests that the legacy of the social framework in a region may be more important for subsequent development than its level of resources or acquired skills.

India offers another example where the legacy of history, as emphasised by North, has been important. Bhagwati (1993) sketches the development of a blocking coalition of vested interests among politicians, bureaucrats and producers that was originally spawned by the planning system of the 1950s and 1960s and the controls to which it gave rise. The result has been a democracy which has consistently from the 1970s to the 1990s had its reforms blocked or diluted by the need to pacify important interest groups. This is despite widespread recognition of the inefficiencies of the state sector, the rent-seeking and corruption associated with controlled markets, the technological backwardness of much of Indian industry and the need for foreign direct investment. Even in the 1990s, reform has continued to be cautious and limited, and political constraints imply that this is likely to continue to be the case (see Manor [1995]).

This is in contrast to South Korea, which in the early 1960s was not on a rapid development path. Under the threat of a communist takeover, there was a military coup in 1961, after which the new government saw economic growth as a key requirement to ward off the continuing communist threat (see Reeve [1963]). The 1961 coup was a major turning point for Korea. It led to the establishment of what is now thought of as the Korean model of development based on outwardly oriented policies and predictable, rule-based government intervention reliant on a high-quality bureaucracy (see Root [1996]). The new regime acted quickly to build institutions that managed to limit corruption and channel it into less damaging forms. It also acted to ensure predictable rules and to limit uncertainty for business and to promote investment and innovation. It is possible that the trauma of the end of communism in the transition economies makes the Korean example more relevant than the Indian case.

Some countries have already made significant progress in a market-driven process of structural change and enterprise restructuring. However, sustained progress in reform is required, particularly in the areas of financial sector reform and of competition policy, which will be instrumental in further strengthening enterprise performance. Other transition economies have yet to achieve a strong commercial orientation in the enterprise sector and have yet to implement fundamental reforms, such as hardening budget constraints and privatising state-owned enterprises. The upgrading of technology to catch up with advanced economies typically involves the adaptation of foreign technologies to local conditions. Foreign trade and direct investment play important roles in this process. While countries in transition have made significant progress in opening their economies, considerable challenges remain, particularly in the CIS.

While the reforms required to unlock the medium-term growth potential of transition economies are broadly understood, it is often difficult to overcome the potential resistance from those that stand to lose in the short term from the resulting structural changes and restructuring. This resistance to change is one of the main reasons for slow progress in catching up with advanced economies, as the experiences of India and of post-war Britain illustrate. Evidence of resistance to change is also apparent in transition economies, where these pressures are reflected in rising tax and energy arrears and in soft bank lending in some countries. In this regard, measures that facilitate the growth of the new private sector and the employment opportunities that it creates can help to ease these pressures on transition economies. The most important of these measures are those that reduce the discretionary and arbitrary interventions of government that create large barriers to entry by new private firms.

Over the long term, the transition economies have one advantage and one disadvantage compared with countries that have achieved rapid growth in the past. The combination of a well-educated population and the relatively low productivity levels which exist in parts of the region (see Table 6.6) offers a unique opportunity for rapid productivity growth as transition progresses. This consideration alone would point to relatively robust long-term growth rates in the range of 4 per cent to 7 per cent for most transition economies, although a growth-accounting exercise suggests that these estimates may be optimistic. It must also be recognised that the quality of institutions supporting investment in resources and technological innovation (such as secure property rights and judicially enforced contracts) is low in many transition economies. Available evidence suggests that even for those transition economies with relatively high-quality institutions, this factor would lower long-term growth rates by up to 1½ percentage points in the absence of further reforms. For many transition economies for which no internationally comparable measure of institutional quality is available, the constraint on growth imposed by low-quality institutions is likely to be particularly severe.

This chapter underlines, therefore, the importance both of sustaining progress in market reforms that foster structural change and restructuring and of building the institutions that support investment in resources and innovation to sustained high rates of growth in transition economies. The more advanced reformers are well on the way to succeeding in this regard, and it could be that looking back in 20 years' time some of the world's "tiger" economies will have been found in the region. However, this growth process should not be viewed as in any way mechanical or automatic. Just as the growth potential is large, so is the possibility of becoming trapped by resistance to change.

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Part III

Macroeconomic performance

Chapter 7. Recent macroeconomic developments

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Chapter 8. Forecasts and prospects

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Recent macroeconomic developments



In 1997 economic growth is returning to the region as a whole. Fewer countries – largely those where structural reforms have been lagging – have experienced economic decline and more countries, 11 altogether, are experiencing GDP growth in excess of 4 per cent. The turnaround is primarily due to the end of economic contraction in Russia, the region's largest economy, which is expected to show cautious but positive growth this year. Performance has not improved consistently across the region. There have been some major setbacks that demonstrate the fragile nature of the recovery. Nevertheless, with a combined GDP of around US\$ 1 trillion or 3 per cent of the world economy, the region is rapidly establishing itself as a major "emerging" market.¹

With regard to inflation, developments have been similarly mixed. While average inflation in the CIS is likely to be cut in half this year, the average for eastern Europe is set to increase, primarily because of reversals in Bulgaria and Romania.

As output has recovered and foreign investor interest has risen, external balances have deteriorated rapidly. This is largely due to the fact that the recovery is increasingly driven by private consumption and investment demand, which demonstrates the growing confidence of consumers and investors in these countries as well as the existence of profitable investment opportunities. Large inflows of mostly private capital have both financed and contributed to these external imbalances. As the transition economies grow increasingly strongly over the coming years, current account deficits and the external funding that they imply are to some extent an inevitable and in principle a positive phenomenon. They allow countries to exploit their growing integration into the world economy by supplementing domestic savings with external savings in the growth process. Nevertheless, these flows create claims that will have to be serviced in the future, and runaway consumption as well as the inefficient use of external funds by governments are potential problems. The sustainability of current account positions is a matter that should receive increasing attention from policy makers in the region. In some economies external debt is growing at a rate which will have to be handled carefully.

Apart from developments in growth, inflation and external accounts, this chapter provides a discussion of trends in the external competitiveness of the transition economies. Productivity growth has continued at very high levels. At the same time, wages are beginning to catch up, compensating at least partly for the

hardship of the early transition years. The evidence does not yet suggest that increasing real wages and unit labour costs have seriously undermined competitiveness in general, but they do call for keeping up the pace of productivity growth by deepening restructuring and for wage growth moderation.

7.1 Output recovery: Revival of domestic demand

After seven years of continuous decline, the region as a whole is witnessing the resumption of economic growth in 1997, but the rate projected for the year is still fragile, at less than 1 per cent. Compared with 1996, average growth is likely to slow somewhat in eastern Europe but accelerate in the Baltics, while economic contraction seems finally to have come to an end in the CIS. This turnaround is largely due to the improving performance of Russia and Ukraine, with Russia likely to register its first year of (mildly) positive growth. Eleven economies in the region, out of 26 (including Bosnia and Herzegovina), are expected to grow at rates of 4 per cent or more in 1997, and only seven are in decline.² This compares with five and 13, respectively, just three years ago.

Cumulative growth rates suggest that in 1996 the level of real GDP in the region as a whole may have reached 70 per cent of the level in 1989 (and marginally more in 1997), but these estimates are fraught with conceptual and measurement problems. As discussed in Chapter 4, a substantial proportion of economic activity remains undeclared or underdeclared, whereas the earlier regime was characterised by over-reporting. In addition, relative prices have changed drastically following the introduction of market forces, and GDP in 1989 was simply not the same as it is now in its ability to satisfy consumer preferences, nor in terms of instant availability as opposed to the need to queue.

Nevertheless, in the absence of better data or methods, it is interesting to note that the indexes of GDP, thus estimated, differ enormously across countries (see Table 7.1). On average, weighted by the relative size of the economies, eastern Europe and the Baltics are expected in 1997 to achieve 95 per cent of the level of GDP in 1989, but even within this group there are stark differences, with Poland now easily surpassing the 100 per cent mark and Lithuania far behind at only 44 per cent. The CIS is, on average, only at 56 per cent of the 1989 level, ranging from 34 per cent in Moldova and Georgia to 86 per cent in Uzbekistan.

¹ It has around 7% of the world's population, and thus a GDP per capita a little under half of the world average. The countries are all middle income according to the World Bank classification, except for Albania, Armenia, Azerbaijan, Bosnia and Herzegovina, Georgia, Kyrgyzstan and Tajikistan, which are low income (less than US\$ 755 per capita in 1995; see *World Development Report 1997*, Table 1, which includes detailed information on these countries for the first time).

² Bosnia and Herzegovina is not included in Table 7.1.

Table 7.1

Growth in real GDP in eastern Europe, the Baltics and the CIS

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection	Estimated level of real GDP in 1996	Projected level of real GDP in 1997
	(Percentage change)							(1989=100)	(1989=100)	
Albania	-10.0	-27.7	-7.2	9.6	9.4	8.9	8.2	-15.0	85	73
Bulgaria	-9.1	-11.7	-7.3	-2.4	1.8	2.1	-10.9	-7.0	67	63
Croatia	-6.9	-19.8	-11.1	-0.9	0.6	1.7	4.2	5.0	70	74
Czech Republic	-1.2	-11.5	-3.3	0.6	2.7	5.9	4.1	1.0	89	90
Estonia	-8.1	-7.9	-14.2	-8.5	-1.8	4.3	4.0	7.0	71	76
FYR Macedonia	-9.9	-12.1	-21.1	-8.4	-4.0	-1.4	1.1	2.0	55	56
Hungary	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.0	3.0	86	89
Latvia	2.9	-10.4	-34.9	-14.9	0.6	-0.8	2.8	3.4	52	54
Lithuania	-5.0	-13.4	-37.7	-24.2	1.0	3.0	3.6	4.5	42	44
Poland	-11.6	-7.0	2.6	3.8	5.2	7.0	6.0	5.5	104	110
Romania	-5.6	-12.9	-8.7	1.5	3.9	7.1	4.1	-1.5	88	87
Slovak Republic	-2.5	-14.6	-6.5	-3.7	4.9	6.8	6.9	4.5	90	94
Slovenia	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.1	4.0	95	99
<i>Eastern Europe and the Baltic States</i> ¹	-6.8	-10.6	-4.2	0.4	3.7	5.3	4.1	3.1	92	95
Armenia	-7.4	-17.1	-52.6	-14.8	5.4	6.9	5.8	5.8	37	39
Azerbaijan	-11.7	-0.7	-22.6	-23.1	-18.1	-11.0	1.3	5.2	39	41
Belarus	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.6	3.0	64	66
Georgia	-12.4	-13.8	-44.8	-25.4	-11.4	2.4	10.5	10.5	31	34
Kazakhstan	-0.4	-13.0	-2.9	-10.4	-17.8	-8.9	1.1	2.0	57	58
Kyrgyzstan	3.0	-5.0	-19.0	-16.0	-20.0	1.3	5.6	6.0	57	60
Moldova	-2.4	-17.5	-29.0	-1.0	-31.2	-3.0	-8.0	-2.0	35	34
Russia	-4.0	-5.0	-14.5	-8.7	-12.6	-4.0	-5.0	1.0	57	57
Tajikistan	-1.6	-7.1	-29.0	-11.1	-21.5	-12.5	-7.0	-3.0	37	36
Turkmenistan	2.0	-4.7	-5.3	-10.0	-19.0	-8.2	-3.0	-15.0	60	51
Ukraine	-3.4	-11.6	-13.7	-14.2	-23.0	-11.8	-10.1	-3.0	39	37
Uzbekistan	1.6	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	1.0	85	86
<i>The Commonwealth of Independent States</i> ²	-3.7	-5.8	-14.3	-9.3	-13.5	-4.9	-4.6	0.8	56	56
Eastern Europe, the Baltics and the CIS	-4.9	-7.7	-10.3	-5.4	-6.6	-0.8	-1.1	1.7	70	72

Notes:

Data for 1990-95 represent the most recent official estimates of results as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1996 are preliminary actuals, mostly official government estimates. Data for 1997 represent EBRD projections.

¹ Estimates for real GDP represent weighted averages for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. The weights used were EBRD estimates of nominal dollar-GDP for 1996.

² 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 1996.

If local currency GDP is converted into US dollars, the region has been growing for several years, driven by the rapid process of real appreciation of currencies in the CIS and the Baltics and, to a somewhat more moderate extent, in eastern Europe.³ In 1996 the total dollar (official) GDP of the region is estimated at US\$ 945 billion, an increase of more than 50 per cent compared with 1994. Real appreciation has continued at a slower pace in 1997, but there are reasons to expect that it will continue for several years to come (see Box 7.2).

There are some interesting patterns in the growth performance (see Table 7.1). In eastern Europe and the Baltics, eight countries out of 14 grew at rates of 4 per cent or more in 1996, but three of these (Albania, the Czech Republic and Romania) are experiencing sharply lower or negative growth in 1997.⁴ In Albania, economic contraction is the result of financial and social turmoil in the wake of the collapse of vast deposit pyramid schemes, while in Romania it is linked to the reining in of fiscal and monetary accounts (loosened in 1996) and accelerated restructuring of the economy. Growth in the Czech Republic has slowed down as the result of an austerity programme aimed at scaling back external imbalances

³ Real appreciation means that the purchasing power of domestic incomes in acquiring dollar-denominated goods and services from trading partners increases even though it may be flat in real (local currency) terms.

⁴ The other countries in this group are Bosnia and Herzegovina, Croatia, Estonia, Poland and the Slovak Republic.

following the crisis on the currency markets during the spring. Otherwise, countries in this group are continuing to grow at a healthy rate, though a slowdown from high growth is expected in Poland and the Slovak Republic. It should be noted that *all* countries of eastern Europe and the Baltics that grew at 4 per cent or more in 1996 experienced a deterioration in their trade balances, in some cases very significantly (in Estonia, Croatia and the Slovak Republic the shift was equivalent to more than 6 per cent of GDP; see Chart 7.5).

A second group of countries, which includes FYR Macedonia, Hungary, Latvia, Lithuania and Slovenia, grew at more moderate rates in 1996. Three of these countries had driven a course of cautious demand management since 1995, Hungary to counter a growing current account deficit and Latvia and Lithuania to re-establish confidence in their financial sectors after a series of bank failures. In all of these countries, growth is poised to accelerate in 1997. Lastly, there is Bulgaria, the only country in eastern Europe that experienced economic decline in 1996. That decline was the result of a collapse of confidence in the financial system and the currency after years of delayed and half-hearted reforms. An ambitious programme of structural reforms and macroeconomic management adopted since the second quarter of 1997 has arrested further declines in production, but GDP for the full year will nevertheless fall markedly.

In the CIS, growth in 1996 was above 4 per cent in three countries where GDP had declined particularly sharply earlier in the decade, namely Armenia (where growth had been high since 1994), Georgia (where it accelerated to “tiger” levels) and Kyrgyzstan. Each of these countries continues to grow at a brisk pace in 1997, but all have very large current account deficits and increasing external debt, which may call for cautious demand policies (see Section 7.3 below). A group growing more moderately includes Azerbaijan, Belarus, Kazakhstan and Uzbekistan. An acceleration of growth is expected in 1997 for Azerbaijan and Kazakhstan, the two oil economies where substantial production is beginning to come on stream, while growth rates in Belarus and Uzbekistan, two economies with a substantial reform backlog, remain broadly unchanged.

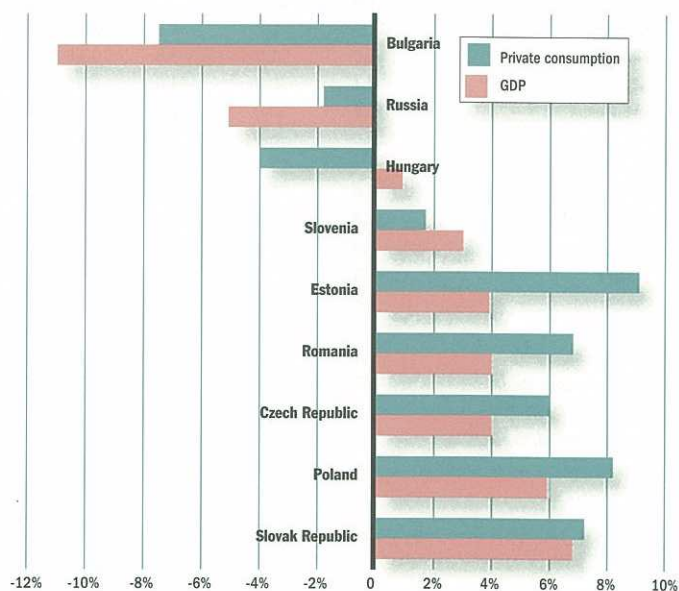
Finally, five countries in the CIS continued to have negative GDP growth in 1996. While continued contraction is expected for 1997 in Moldova, Tajikistan, Turkmenistan and Ukraine, it is Russia’s turnaround in 1997 which has attracted the greatest attention. After projections of a recovery in Russia repeatedly proved to be premature, it does appear that 1997 will finally see it happen. GDP has been essentially flat since the middle of 1996 but there are now signs of growth. It is the change in Russia’s performance which is largely responsible for the region’s overall growth in 1997, both because of its size and because of its importance as a market for other countries in the CIS.

In 1996 and 1997 growth across much of the region has been led by domestic demand. Earlier in the transition, net exports played a greater role in the recovery, especially in eastern Europe, while domestic consumption and investment were depressed by systemic risk and uncertainties. The limited available information on the demand composition of GDP⁵ is consistent with a rapid rise in private consumption demand in most of the high-growth countries, and an investment boom in some of them. As shown in Chart 7.1, private consumption has outstripped GDP growth in all five countries growing at more than 4 per cent in 1996 for which data at that level of detail were available. Meanwhile, in the Czech Republic, Poland and the Slovak Republic, investment spending grew at rates of more than 10, 20 and 30 per cent, respectively.⁶ Hungary, while growing again, is an exception to these trends, with net exports the more important source of GDP growth in 1996.

Chart 7.1

Growth in private consumption and GDP, 1996

Change over 1995



Source:
National Statistical Yearbooks.

Higher consumer spending reflects brighter expectations about the future – precautionary savings are less necessary when it is perceived that income growth “is here to stay” – and higher real wages. Market growth itself, combined with greater price stability and more efficient financial systems, stimulates investment. Combining information from six advanced transition countries (see Chart 7.10), real wages in industry rose by about 7 per cent in 1996, after a rise of between 4 and 4.5 per cent in 1994-95. Real wage increases continued in the first quarter of 1997. At the same time, growing external imbalances, analysed in greater detail in Section 7.3, indicate that some economies may be in danger of

⁵ Comprehensive data on the expenditure side of GDP in transition economies is relatively scarce as most countries tend to produce and/or publish only supply-side GDP series. Up-to-date direct estimates of final demand components of GDP in constant prices are available for relatively few countries, mostly advanced transition economies.

⁶ In the Slovak Republic, this was partly caused by one-off, large investments related to the completion of the Mochovce nuclear power plant.

overheating. This highlights the need for careful macroeconomic management.

With growth, the production structure is changing. Services, neglected under central planning, are rapidly expanding their share of GDP, while industrial production is stabilising at a far lower share than before the transition.⁷ The pattern for agriculture is less clear. The expansion of services and the rise in their relative price (see Section 7.2) forces the manufacturing and other tradable sectors to generate rapid productivity gains in order to maintain margins and growth. Such productivity gains are intimately linked to the pace of, and thus the conditions for, enterprise restructuring discussed in Part II of this Report.

7.2 Stabilisation: Lower inflation but fragile fiscal positions

Inflation has been brought further under control in most of the region. End-year inflation in 1997 is expected to be 40 per cent or less in 20 out of 26 countries. Median inflation fell from 32 per cent in 1995 to a projected 14 per cent in 1997. There is now single-digit inflation (on an end-year 1997 basis) in nine countries (see Table 7.2).⁸ Most cases of improvement have been in the CIS. However, inflation performance has not been uniform. There have been slip-pages both in the CIS and in some countries of eastern Europe.

In Albania the achievement of reducing inflation to a single digit in 1995 was compromised in 1996 in the run-up to elections. The situation in 1997 is clearly worse, and it is in fact remarkable, given the social chaos during the first half of the year and continuing difficulties for the new administration to re-establish control, that there is no evidence of more extreme inflation. Inflation is expected to move into the range of 40 per cent for the full year 1997.

In Bulgaria the loss of macroeconomic control during 1996 and early 1997 drove the economy back into extreme inflation. Year-end inflation of 311 per cent was recorded in 1996, and is projected to be nearly 600 per cent in 1997. Since March, however, there has been a rapid process of disinflation, which was reinforced by the introduction of a currency board system in July.

In Romania the monetisation of fiscal deficits in the context of elections led to the build-up of inflationary pressures during the second half of 1996. Despite significant monetary tightening in 1997, inflation is expected to accelerate to just over 100 per cent by the year-end, following the removal of administrative price controls.

In the CIS reversals in previous stabilisation efforts have occurred in Armenia, Belarus and Tajikistan, while only a gradual improvement at relatively high levels of inflation is expected for Uzbekistan. In all these cases, a resumption of expansionary

monetary policies, typically in support of ailing state enterprises, lies behind inflation in 1997.

Countries that were more consistent in their stabilisation commitments have nevertheless had difficulties reducing inflation to levels typical (at present) of Western market economies. Similar to experiences in some developing countries, it has been far easier to bring inflation down from annual triple-digit rates to rates between 10 and 20 per cent a year, than to move beyond that success. Early disinflation has relied on strict monetary policy combined with the stabilisation of exchange rates by design and/or as a result of inflows of foreign capital. However, an important factor in explaining the persistence of double-digit inflation in the transition economies is the continuing adjustment of relative prices. While the prices of most goods and services quickly found equilibrium levels after the initial liberalisation, the adjustment of administered prices, in particular for utilities and social services (e.g. housing, medicine and health care) has proceeded far more gradually in a process likely to last several more years in most countries (see Chart 7.2). These services have substantial weight in the consumer price index, and for the most part the increase in their prices has not been offset by reductions in the prices of other goods. The result is continuing upward pressure on the general price level.⁹

Disinflation over the past two years in the CIS has been helped by the development of a domestic securities market which has allowed governments to limit the monetary financing of fiscal deficits. In some countries, most prominently Russia, international portfolio investment has contributed to this process. Partly as a result of substantial capital inflows, the yield on Russian treasury bills (GKOs) fell from 200 per cent in mid-1996 to 20 per cent by July 1997.

However, public finances in much of the region remain fragile. Measured at the level of general government,¹⁰ fiscal deficits in excess of 3 per cent of GDP were recorded in more than half of the transition economies in 1996 (see Table 7.3).¹¹ In general, fiscal deficits are higher in the countries of the CIS than in eastern Europe and the Baltics (except for Bulgaria and Albania, where deficits have been extraordinarily high). Fiscal balances are expected to improve further in eastern Europe in 1997. However, fiscal expansion is expected in some countries (such as the Slovak Republic) in a move that may be ill-timed at the current stage of the economic cycle.

⁷ See Chapter 4.

⁸ Bosnia and Herzegovina is not included in Table 7.2.

⁹ In addition, there may be statistical problems of measurement. In particular, the upgrading of product and service quality that has been associated with the opening of borders and the growing private sector tends to be difficult to reflect in price surveys. Higher product prices may, in some cases, simply indicate quality improvements.

¹⁰ This definition includes the state, municipalities and extrabudgetary funds, such as social insurance.

¹¹ In some countries in Table 7.3 whose fiscal deficits appear to be low, such as Belarus and Turkmenistan, the general government accounts hide substantial quasi-fiscal deficits, such as subsidised directed credit by state-owned banks.

Table 7.2

Inflation in eastern Europe, the Baltics and the CIS

(change in the year-end retail/consumer price level, in per cent)

	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Albania	104	237	31	16	6	17	42
Bulgaria	339	79	64	122	33	311	592
Croatia	250	938	1,149	-3	4	3	4
Czech Republic	52	13	18	10	8	9	9
Estonia	304	954	36	42	29	15	12
FYR Macedonia	230	1,925	230	55	9	0	8
Hungary	32	22	21	21	28	20	17
Latvia	262	959	35	26	23	13	8
Lithuania	345	1,161	189	45	36	13	10
Poland	60	44	38	29	22	19	15
Romania	223	199	296	62	28	57	116
Slovak Republic	58	9	25	12	7	5	7
Slovenia	247	93	23	18	9	9	9
<i>Eastern Europe and the Baltic states</i> ¹	193	510	166	35	19	38	65
Armenia	25	1,341	10,896	1,885	32	6	19
Azerbaijan	126	1,395	1,294	1,788	85	7	7
Belarus	93	1,558	1,994	1,900	243	40	99
Georgia	131	1,177	7,488	6,473	57	14	9
Kazakhstan	137	2,984	2,169	1,160	60	29	12
Kyrgyzstan	170	1,259	1,363	96	32	35	24
Moldova	151	2,198	837	116	24	15	11
Russia	144	2,501	837	217	132	22	14
Tajikistan	204	1,364	7,344	1	2,132	41	105
Turkmenistan	155	644	9,750	1,328	1,262	446	44
Ukraine	161	2,730	10,155	401	182	40	15
Uzbekistan	169	910	885	1,281	117	64	40
<i>The Commonwealth of Independent States</i> ²	139	1,672	4,584	1,387	363	63	33

Notes:

Data for 1990-95 represent the most recent official estimates of results as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1996 are preliminary actuals, mostly official government estimates. Data for 1997 represent EBRD projections. Figure for Albania for 1997 is based on the information from parts of the country where data collection was possible.

¹ Unweighted average for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

² Unweighted average for all countries of the former Soviet Union, except Estonia, Latvia and Lithuania.

In many countries, in fact in most of those that experienced a deterioration in their fiscal positions during 1996, poor revenue performance rather than a lack of expenditure control was the main source of budgetary difficulties. Compared with 1995, the share of general government expenditure in GDP was reduced in all countries of the region with the exception of Georgia and Moldova. However, in many cases revenues fell even faster, often with striking speed. Chart 7.3 shows that, over the two-year period 1994-96, the share of government revenues in GDP declined in 20 countries, with the decline exceeding 10 per cent of GDP in ten cases.

The development of fiscal revenues reflects various factors. On the one hand, government in many countries, especially in central Europe, is rather large and there have been efforts to reduce the

tax pressure. Furthermore, revenues have fallen for cyclical reasons – economies have shrunk, and parts of the tax base (such as profit and income taxes) have moved disproportionately as a result. However, arguably the most important factors explaining the rapidly worsening performance in recent years have been structural and institutional. These problems stem from the challenges of creating effective tax systems in the new market-oriented environment with a much higher degree of decentralisation.¹²

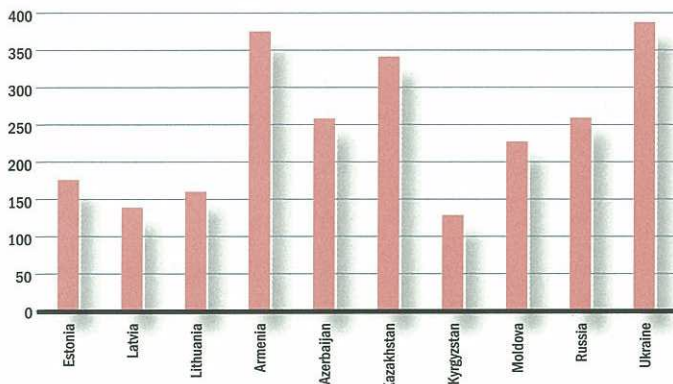
Poor tax collection often has its roots in the poor design and administration of taxes. The definitions of tax bases remain problematic throughout the CIS, often including items that would, by any reasonable standard, be treated as costs (such as standard bank provisioning for bad loans or parts of the wage bill). Taxes also tend to change frequently without due notification, and have

¹² For further discussion see *Transition Report 1994*, Chapter 6, Taxation and transition. It must be remembered that in the old regime profits and turnover were the primary base for taxation and could be assessed and manipulated fairly directly by governments. Competition has in many cases lowered profits and undermined this base.

Chart 7.2

Change in relative prices in selected transition economies

Change in the CPI for services relative to the general consumer basket (=100) 1994-96

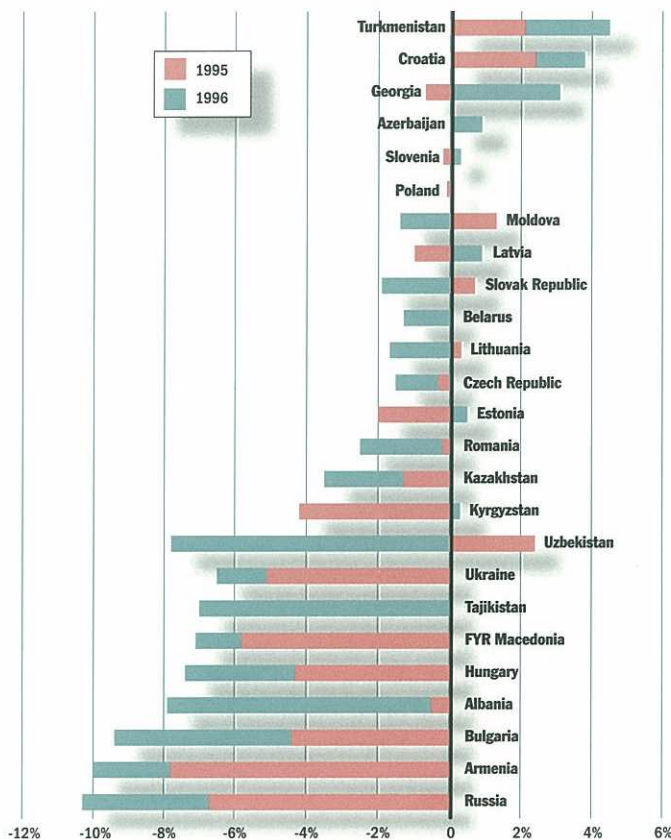


Source:
National Statistical Institute.

Chart 7.3

Change in government revenues, 1995-96

As a share of GDP



Note:
Consolidated general government balances are not available for Poland, in 1996, and for Azerbaijan, Belarus and Tajikistan, in 1995.

Source:
Calculated on the basis of the selected economic indicators at the back of this Report.

sometimes been applied retroactively. In addition, there is often a dizzying array of taxes whose relation to each other is unclear. The result is widespread discretion by tax administrators, a plethora of special deals that undermine the revenue base, and a lot of management time dedicated to the avoidance or evasion of taxes. Continued use of barter, payments in kind and accumulation of arrears (whereby a large share of transactions and income effectively escapes taxation) are partly associated with tax evasion and are major causes of poor tax revenues, particularly in the CIS.¹³

Box 7.1 provides greater detail on the problems of raising government revenue in Russia. In Russia and in other countries tax reform, and in particular the reform of tax administration, has been high on the agenda but, as the numbers suggest, it may take time before these measures are effective.

In the longer term, the ability of all the transition economies to raise sufficient government revenue and implement expenditure controls would be difficult to sustain without fundamental public sector reforms. Taxes raised to finance social security, in particular pensions systems, are already disproportionately large and, given current demographic trends, the pension burden will increase further in the coming years. Health and education systems, as well as public spending on infrastructure, have suffered under the transition process. There are additional and growing claims on budgetary resources to finance restructuring and environmental clean-up. These are issues that are likely to be of particular importance in countries that have applied for membership in the EU. Some steps towards the reform of public expenditures have already been taken. Far-reaching pension reforms have been initiated in a number of countries. Generally speaking, if only for budgetary reasons, governments across the region will have to rely to a growing extent on private sector involvement in some of their traditional responsibilities. Public-private partnerships, which may offer a solution, are discussed in Chapter 1.

7.3 External trends: Growing imbalances

Most countries in the region – Russia being the main exception – are experiencing growing trade deficits and a continued deterioration of their current account positions. Almost half of the transition economies recorded current account deficits in excess of 7 per cent of GDP in 1996. In 10 countries the deterioration in the current account balance in 1996 was equivalent to at least 4 per cent of GDP (see Table 7.4). These developments have been driven above all by booming domestic demand assisted, and partly stimulated, by growing private capital inflows. While overall, this is a welcome sign of growing confidence in the region, the current account deficits may raise questions of sustainability, in particular in view of the rapid build-up of foreign debt. In some countries, they have already contributed to currency volatility, and careful demand management through fiscal adjustment is advisable to ward off the potential for balance-of-payments crises.

¹³ See Box 2.2 (Chapter 2) for a discussion of barter in Russia.

Table 7.3

General government balances in eastern Europe, the Baltics and the CIS

(in per cent of GDP)

	1990	1991	1992	1993	1994	1995	1996 Estimate	Change 1995-96
Albania	-15.0	-31.0	-22.0	-15.0	-12.0	-10.0	-12.0	-2.0
Bulgaria	na	na	-5.2	-10.9	-5.8	-6.4	-13.4	-7.0
Croatia	na	na	-4.0	-0.8	1.7	-0.9	-0.5	0.4
Czech Republic	na	na	na	2.7	0.8	0.4	-0.2	-0.6
Estonia	na	5.2	-0.3	-0.7	1.3	-1.2	-1.5	-0.3
FYR Macedonia	na	n.a.	-9.6	-13.6	-3.2	-1.3	-0.4	0.9
Hungary	0.4	-2.2	-5.5	-6.8	-8.2	-6.5	-3.5	3.0
Latvia	na	na	-0.8	0.6	-4.1	-3.5	-1.4	2.1
Lithuania	-5.4	2.7	0.8	-3.1	-4.2	-3.3	-3.6	-0.3
Poland	3.1	-6.7	-6.6	-3.4	-2.8	-3.6	-3.1	0.5
Romania	1.0	3.3	-4.6	-0.4	-1.9	-2.6	-3.9	-1.3
Slovak Republic	na	na	na	-7.0	-1.3	0.1	-1.2	-1.3
Slovenia	-0.3	2.6	0.2	0.3	-0.2	0.0	0.3	0.3
<i>Eastern Europe and the Baltic states</i> ¹	-	-	-	-4.5	-3.1	-3.0	-3.4	-0.4
Armenia	na	-1.8	-8.1	-56.1	-16.5	-11.1	-9.3	1.8
Azerbaijan	na	na	2.8	-12.7	-11.4	-4.2	-2.6	1.6
Belarus	na	na	na	-1.9	-2.6	-1.9	-1.6	0.3
Georgia	na	-3.0	-25.4	-26.2	-7.4	-4.5	-4.4	0.1
Kazakhstan	1.4	-7.9	-7.3	-1.3	-7.2	-2.0	-2.5	-0.5
Kyrgyzstan	0.3	4.6	-17.4	-14.2	-7.7	-13.5	-6.4	7.1
Moldova	na	0.0	-26.2	-7.4	-8.7	-5.7	-6.7	-1.0
Russia	na	na	-21.6	-7.2	-10.4	-5.5	-8.3	-2.8
Tajikistan	na	-16.4	-31.2	-25.0	-10.5	-11.2	-5.3	5.9
Turkmenistan	1.2	2.5	13.2	-0.5	-1.4	-1.6	-0.2	1.4
Ukraine	na	na	-25.4	-16.2	-7.8	-4.9	-3.2	1.7
Uzbekistan	-1.1	-3.6	-18.4	-10.4	-6.1	-4.1	-7.3	-3.2
<i>The Commonwealth of Independent States</i> ²	-	-	-	-11.2	-7.4	-5.4	-4.4	1.0

Notes:

Data for 1990-95 represent the most recent official estimates of results as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1996 are preliminary actuals, mostly IMF estimates. Change in fiscal balances in 1995-96 represents the difference between the ratios of fiscal balances to GDP in the respective years. General government includes the state, municipalities and extrabudgetary funds. Balances reported on cash basis except for Albania and Poland. 1996 figure for Albania refers to the first half of 1996. Data for Armenia refer to the consolidated state government, for Croatia refer to the consolidated central government and for Uzbekistan refer to the state and extrabudgetary funds.

¹ Unweighted average for Albania, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

² Unweighted average for all countries of the former Soviet Union, except Estonia, Latvia and Lithuania.

Foreign trade

Current accounts have largely followed developments in external trade (see Chart 7.4). The growth in the dollar value of both merchandise exports and imports fell sharply during 1996 (however, note the data problems discussed below). After registering increases of 26 per cent and 34 per cent respectively in 1995, growth of only 6 per cent for exports and 12 per cent for imports was recorded in 1996. At the level of individual countries, the performance was mixed, with most of the decline recorded in eastern Europe and some countries of the CIS actually increasing

exports. Taking into account the real appreciation of exchange rates over the period, which increased the dollar value of GDP, the share of exports in GDP in the region excluding Russia fell by more than 10 per cent in 1996 (3.3 percentage points), while that of imports remained broadly constant (see Chart 7.5).

The sharply lower measured growth in both export and import values in most countries of the region is surprising and appears in fact to have been associated with valuation problems and one-off events in 1995.¹⁴ When valuation problems are considered, it

¹⁴ Examples of the kinds of problems that arise are as follows. The balances of payments, from which the data discussed above were taken, are partly at odds with customs and national accounts statistics. Trade statistics were adjusted in the Czech Republic in 1995. Without that statistical break, imports would have grown at around half the registered 69% increase. In Hungary balance-of-payments statistics are recorded on a cash basis, and currency substitution accompanying the progressive liberalisation of capital account transactions made it difficult to keep trade-related and other capital flows apart. In 1994 and 1995 Hungarian customs recorded import growth of 16% and 7% respectively compared with -0.9% and 37% registered in the balance of payments. National accounts statistics measuring the growth in volume terms of trade in both goods and non-factor services also paint a very different picture for 1996, with a modest decrease in export growth rates in the Czech Republic, Hungary and Poland, a deceleration of import growth in the Czech Republic and a relatively sharp increase for Hungary and Poland. Unfortunately, reliable national accounts are not available for a wider range of countries. Finally, if trade figures are converted into Deutschmarks at annual average DM/dollar cross rates, export values for the region as a whole – but excluding again Russia – grew 17.3% in 1995 and 9.5% in 1996, and import growth increased slightly from 19.7% in 1995 to 21.5% in 1996.

Box 7.1

Tax regime and tax revenues in Russia

Tax collection has been one of the weakest elements of Russia's macroeconomic performance throughout the transition process. At the same time, the structure and operation of the tax regime has been the single most important flaw in the Russian business climate. Since late 1991 there has been no comprehensive overhaul of the tax regime. Changes have been mainly of an ad hoc nature, driven by the short-term imperatives of fiscal crisis, resulting in slow and inconsistent tax reforms, and deep tensions in the fiscal relationships between the centre and Russia's 89 regions. A new Tax Code, which would represent a significant advance over the present system, was approved by the Duma in its first reading and is scheduled to be finally adopted by the end of the year. It is expected to enter into force on 1 January 1998.

Characteristics of the current tax regime

With a nominal (statutory) tax burden of around 35 per cent of GDP (for local, regional and federal taxes and contributions to extrabudgetary funds combined), the Russian tax effort is not high by international standards. However, a range of structural characteristics of the tax system can make taxation extremely onerous for businesses. Compared with other countries, a much larger part of the tax burden falls on businesses than on individuals. Enterprises have faced a variety of taxes which are based on the companies' revenue as opposed to profits. The outdated Russian accounting system has artificially increased the profit tax liability for companies due to non-deductibility of many legitimate business expenses, the lack of inflation accounting and low depreciation rates.

A further and no less severe problem has been the basic instability and the lack of transparency of the tax regime. Currently, the tax system is governed by around 2,000 legislative acts, leaving wide scope for contradictory interpretation by various tax authorities. There is a proliferation of federal, regional and local taxes, with the total number exceeding 200. Frequent changes in taxation, in some cases applied retroactively, as well as arbitrary enforcement of the taxation rules, have made the effective tax burden largely unpredictable.

The reaction of the authorities to the adverse impact of the tax regime on the real economy and on tax compliance has magnified these problems. A web of tax exemptions, tax deferrals and other tax privileges has developed over the years granted by various levels of government to mitigate the adverse impact of the nominal tax burden on businesses or out of political considerations. Taxation has increasingly become a matter of bargaining between the tax authorities and the tax payers.

Faced with decreasing tax compliance and growing outright tax evasion, the authorities resorted to different measures, which until very recently proved to be largely ineffective. Initially they introduced a draconian tax penalty system and created a special tax police, who tended to be more interested in collecting tax penalties or kickbacks than in revenue-raising. There have been recurring attempts to reform the tax administration. However, progress in this area has been very slow. In late 1996 an Emergency Tax Commission was created to deal with the largest tax-delinquent enterprises, using the threat of bankruptcy to force these companies to pay off their tax arrears.

Decline in tax revenues

Tax revenues have declined sharply throughout the transition period. According to official data, the actual tax revenues of Russia's enlarged budget (including the consolidated revenues of the federal and the regional budgets and those of the extrabudgetary funds) fell from over 44 per cent of GDP in 1992 to less than 30 per cent in 1996, with the decline accelerating in the 1994-96 period. This trend continued in the first quarter of 1997 when tax collection ran at a mere 64 per cent of the budgetary targets, compared with 80 per cent in 1996. Tax collection improved significantly during the second quarter as a result of major one-off payments of tax arrears by a number of large enterprises, most importantly by Gazprom.

The key factors underlying the deteriorating revenue performance, in addition to the decline of output and profits, have been the following: (i) There is a shrinking tax base caused by the impact of exemptions, tax deferrals and other tax concessions. At the end of 1996 total tax concessions amounted to an estimated Rb 163 trillion (7.2 per cent of GDP). (ii) Reductions have been made in the statutory rates under the profit tax and VAT reform steps, such as the elimination of the excess wage tax and the phasing out of export tariffs. Although these were inevitable and positive changes in themselves, they also contributed to the revenue decline as they have not led to the hoped for improvements in tax compliance. (iii) There has been a deterioration in tax discipline. The level of tax arrears has increased sharply in recent years. In 1996 the stock of identified arrears to the consolidated budget were estimated at close to Rb 128 trillion (5.7 per cent of GDP) while arrears to the extrabudgetary funds were close to Rb 100 trillion (4.3 per cent of GDP). Tax evasion, reflecting both the growth of the informal economy and weaker tax compliance in the formal economy, has increased. Under-reporting of production, barter transactions, capital flight and non-wage forms of remuneration of employees have been the main avenues for tax avoidance. According to the State Tax Service, at the beginning of 1997 about one-third of enterprises did not pay any taxes and only 16.6 per cent of the enterprises (or a quarter of the functioning taxpayers) are regularly paying the taxes that are due. (iv) The budgetary revenue performance is further complicated by the fact that, since 1994, the Government has received an increasing share of revenue in various non-monetary forms or as offsets against public expenditure, with adverse implications for the flexibility of fiscal policy.

The budgetary revenue crisis has acquired a self-reinforcing character in recent years. The Government has increasingly resorted to the sequestration of budget expenditures and has been prevented from complying with its own obligations, including the payment of pensions and public wages. As a result, the Government itself contributed to the deterioration of tax discipline and the deepening of the general payment crisis. A lasting turnaround in the current budgetary crisis can be expected only if the Government regains its credibility (which has recently received a major boost with the paying off of pension arrears) and the Russian tax system is comprehensively reformed.

Table 7.4

Current account and trade balances in eastern Europe, the Baltics and the CIS

	Current account balance 1996	Merchandise trade balance 1996	Current account balance 1996	Merchandise trade balance 1996	Change in current account balance 1995-96	Change in merchandise trade balance 1995-96
	<i>(In million US dollars)</i>		<i>(In per cent of GDP)</i>		<i>(Change in GDP-share in per cent)</i>	
Albania	-123	-692	-4.7	-26.7	2.7	-7.1
Bulgaria	117	209	1.3	2.4	1.8	1.5
Croatia	-1,452	-3,276	-7.6	-17.2	1.8	-1.2
Czech Republic	-4,476	-5,972	-8.1	-10.9	-5.3	-3.4
Estonia	-448	-1,058	-10.3	-24.2	-5.6	-6.2
FYR Macedonia	-288	-317	-7.8	-8.6	-1.7	-2.4
Hungary	-1,700	-2,600	-3.8	-5.9	1.9	-0.4
Latvia	-361	-929	-7.2	-18.5	-3.5	-7.0
Lithuania	-440	-631	-4.4	-6.3	0.0	0.0
Poland	-1,352	-8,154	-1.0	-6.1	-5.7	-4.6
Romania	-2,336	-2,130	-5.9	-4.6	-1.0	-0.1
Slovak Republic	-1,941	-2,106	-10.2	-11.1	-8.0	-9.8
Slovenia	47	-853	0.3	-4.6	0.5	-0.1
<i>Eastern Europe and the Baltic states</i> ¹	-	-	-5.3	-10.9	-1.7	-3.1
Armenia ²	-424	-436	-26.6	-27.4	10.9	3.9
Azerbaijan	-811	-549	-23.6	-8.0	-12.1	1.9
Belarus	-909	-1,335	-6.7	-9.9	-4.3	-4.8
Georgia	-222	-295	-4.9	-6.5	3.4	5.2
Kazakhstan	-700	-300	-3.4	-1.4	0.6	-0.3
Kyrgyzstan	-414	-373	-23.7	-21.4	-4.4	-3.7
Moldova	-250	-234	-13.1	-12.2	-4.5	-9.0
Russia	9,600	23,100	2.2	5.2	0.9	0.3
Tajikistan	-110	-50	-10.9	-5.0	-11.1	-9.5
Turkmenistan	43	159	1.7	6.1	1.4	1.6
Ukraine	-1,184	-4,296	-2.7	-9.8	1.5	-3.5
Uzbekistan	-1,075	-931	-7.9	-6.8	-7.4	-8.9
<i>The Commonwealth of Independent States</i> ³	-	-	-10.0	-8.1	-2.1	-2.2

Notes:

Data are the most recent official estimates of results as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Change in current account and merchandise trade balances in 1995-96 represents the difference between the ratios of current account and merchandise trade balances to GDP in respective years.

¹ Unweighted average for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

² The current account balance for Armenia excludes transfers.

³ Unweighted average for all countries of the former Soviet Union, except Armenia, Estonia, Latvia and Lithuania.

appears in fact that imports may have continued to grow at previous rates, while export growth decelerated and trade deficits increased. This is consistent with the view that external accounts have been driven, above all, by the boom in domestic demand that the region is experiencing (see Section 7.1). The rapid increase in consumption and investment spending has stimulated imports and diverted potential export goods to the domestic market. However, other factors are also likely to have played a role in determining recent trade patterns. Among them is the sluggish demand in western Europe, the destination for between one-third and two-thirds of exports of most transition economies and where total import growth dropped from 7 per cent in 1995 to 2.5 per cent in 1996. It is interesting to note that intra-regional trade, which had all but collapsed

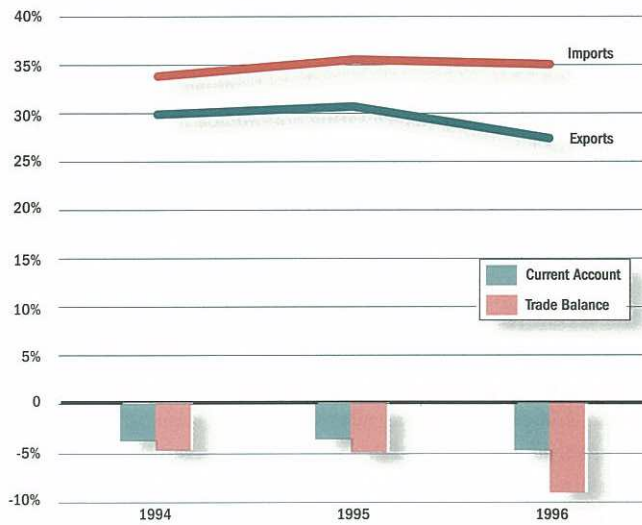
in the early 1990s, showed growth which far outpaced that of trade with developed and developing market economies in 1996. The importance of western European and in particular German demand for eastern Europe's export performance is confirmed by preliminary information for 1997, which has seen improvements in the pace of export growth and a narrowing of the gap between import and export growth in the Czech Republic, Hungary and Poland that are hard to explain by domestic events, but are consistent with growing demand from Germany.

A microeconomic factor contributing to the external trade performance may be the slow pace of restructuring in industry. On the basis of a product-level analysis, the United Nations Economic

Chart 7.4

External trade and balances,

Whole region excluding Russia (in per cent of GDP)



Source:
Calculated on the basis of the selected economic indicators at the back of this Report.

Commission for Europe¹⁵ concludes that eastern European producers have often been unable to capitalise on rising domestic demand. While there is still unused capacity in many companies, there seem to be difficulties in supplying higher-quality consumer and investment goods and in responding quickly to changing demand patterns (see also Chapter 4). Similar considerations apply to export markets. Hungary, which is often viewed as having the best record in enterprise restructuring, was incidentally one of the very few countries to record export-driven growth in 1996. Finally, it is possible that increasing competitiveness problems are associated with rising dollar wages in manufacturing, especially for exports of weaker companies. Nevertheless, the country-level evidence in this regard is inconclusive (see Section 7.4).

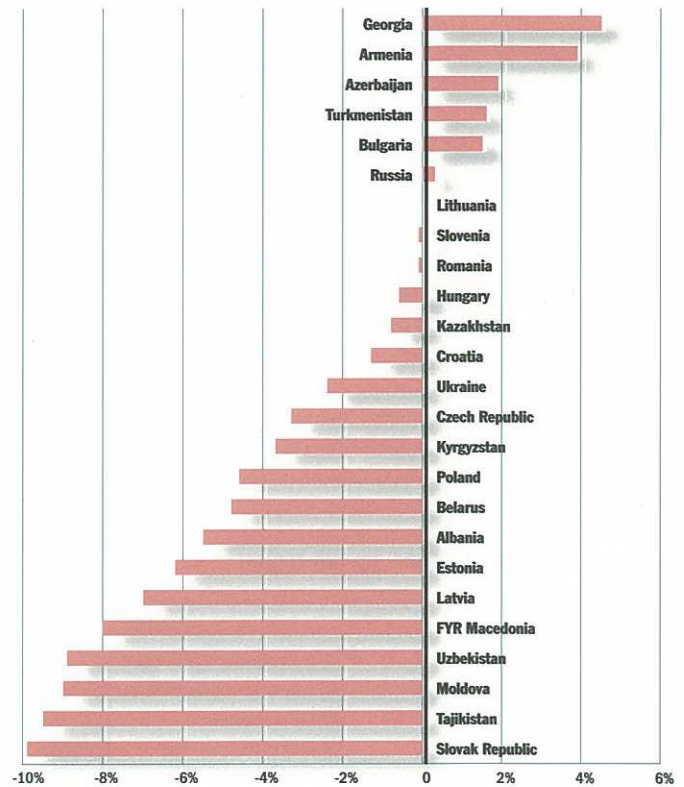
Capital flows

Capital inflows may have contributed to domestic demand and thus external imbalances as much as they helped finance them. There has been a significant shift of financing away from official to private sources of funds. Private capital flows are notoriously difficult to estimate, but all available information points to a rapid increase in inflows over the past few years. According to one source, the Institute for International Finance, net private flows (covering direct investments, portfolio investments in debt and equity securities, commercial bank lending and trade finance) into the seven main recipient countries of the region¹⁶ increased from US\$ 13.9 billion in 1993 to US\$ 33.7 billion in 1996 and is projected to rise further to a striking US\$ 52 billion in 1997. Over

Chart 7.5

Deterioration in trade balances, 1996

Change over 1995 (in per cent of GDP)



Source:
Selected economic indicators at the back of this Report.

the same period, net official flows decreased from US\$ 9.5 billion (1993) to US\$ 7.3 billion (1996), and are not expected to pick up in the near future.

Charts 7.6 and 7.7 provide a graphic representation of developments in commercial bank lending and bond issues by sub-region. The share of the former Soviet Union in the total, large in 1990 and 1991 before its break-up, remained low from 1992 to 1996 but has been rising strongly in 1997. The more advanced countries of eastern Europe attracted growing amounts of funding over the same period.¹⁷ While sovereign and sovereign-backed issuers have been particularly prominent on the international bond markets – with Kazakhstan, Lithuania, Moldova, Russia, Ukraine and the cities of Moscow and St Petersburg making debut public offerings since late 1996 – significant issues have also been made by “blue chip” commercial entities and banks, especially in the advanced countries of central Europe. A large number of Russian regional authorities, municipalities and enterprises are expected to launch bonds during the remainder of 1997. Since 1995, private borrowers have dominated the commercial loan market, the vast

¹⁵ UNECE (1997).

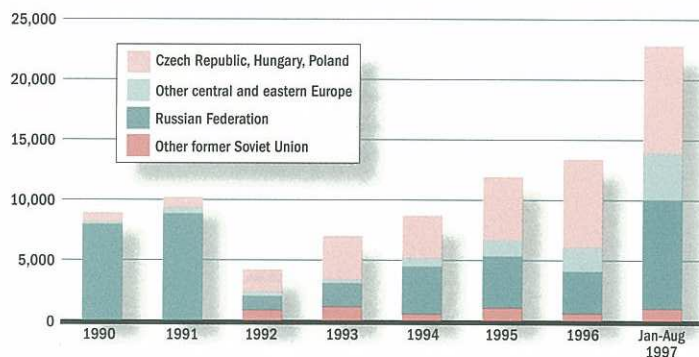
¹⁶ Bulgaria, Czech Republic, Hungary, Poland, Romania, Russia and the Slovak Republic.

¹⁷ The “blip” in bond issues to eastern Europe in 1993 is due to the Bank of Hungary’s issuing 21 bonds to finance growing current account deficits.

Chart 7.6

Syndicated lending by commercial banks, by sub-region

In millions of US\$

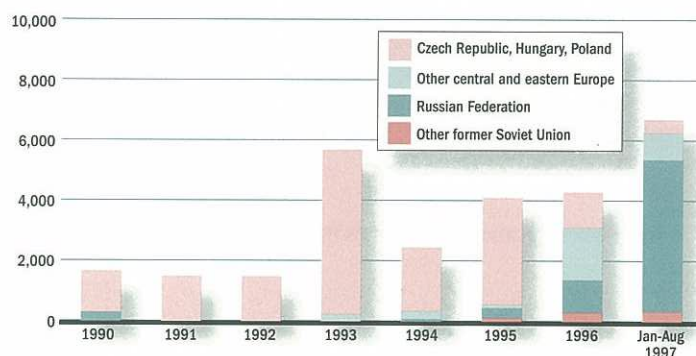


Source:
Euromoney: Loanware

Chart 7.7

International bond issues, by sub-region

In millions of US\$



Source:
Euromoney: Bondware

Note:
For 1990 and 1991, Russian data refer to the whole USSR. For 1990 to 1992, Czech data refer to the whole of Czechoslovakia.

majority in the form of bank-to-bank loans and project financing. Again, borrowers in Russia have been particularly active on this market recently. Syndicated loans to 21 Russian banks for a total value of US\$ 1.2 billion have been recorded during the first half of 1997 alone.¹⁸

Along with rising volumes, terms have generally improved, but there are cases of rapid reversal which demonstrate the fragility of these markets and the information problem still faced by

investors.¹⁹ Issue spreads of 375, 325, 100 and 80 basis points over US Treasuries were recorded in recent bond issues by Russia (June 1997, 10 year maturity), Ukraine (August, one-year), Poland (June, 20-year) and Croatia (February, five-year) respectively. As of mid-September, effective spreads were 312, 283, 120 and 152 basis points, suggesting improved confidence in the former two countries and slightly deteriorating confidence in the latter. In the syndicated loan market, spreads over LIBOR declined by 133 (to 323), 75 (to 47) and 70 basis points (to 20) for Russia, the Slovak Republic and Hungary respectively during the first quarter of 1997.

Over recent years, eastern European and Russian corporates and banks have increasingly taken the direct route to overseas equity markets, although this still represents a small share of aggregate flows. Issues have generally taken the form of American Depository Receipts²⁰ and private placements, but there have also been direct listings on western Stock Exchanges. International equity issues, primarily in conjunction with privatisation, were initially dominated by Hungary, which issued US\$ 837 million in shares abroad over the period 1994-96. Poland had issues of US\$ 218 million in 1995, but it is in 1996 that this form of finance "took off", with a total of US\$ 1.3 billion in share issues from seven countries. Russia (US\$ 800 million) again dominated this segment.²¹ Overseas issues are viewed increasingly as an attractive option by large companies in the region because of the lack of depth and liquidity of domestic equity markets. Some 15 Russian corporates had launched ADR programmes by the spring of 1997, and at least as many others were preparing such issues.

Inflows into local money markets are a similarly recent phenomenon, have made an equally spectacular start, and are again dominated by Russia. Inflows into the Russian treasury bill (GKO and OFZ) market have been prompted by the gradual relaxation of restrictions on purchases by non-residents since early 1996, which has been partly motivated by the authorities' desire to lower the cost of public debt. Non-residents purchased US\$ 5.6 billion in treasury bills through "S" accounts²² in 1996, and US\$ 5.4 billion in January-April of 1997 alone. By April, they held approximately one-quarter of outstanding issues through these official channels, and probably more through "grey market" operations with Russian intermediaries. Since mid-1997, with yields on GKO's having declined significantly, foreigners have been entering the more "exotic" Russian regional and municipal bond markets in search of higher yields (e.g. Orenburg treasury bills yielded 600 basis points over GKO's in August 1997). Unhedged positions are now being taken in roubles.

¹⁸ However, these loans tend to carry short maturities of one year or less.

¹⁹ Information on terms is drawn from the Euromoney Loanware and Bondware databases.

²⁰ American (and Global) Depository Receipts spare non-resident investors the settlement and custody problems of what are still weak institutional infrastructures for capital markets in the region. They are securities issued on the US market by reputable financial institutions, regulated by the US Securities and Exchange Commission, but backed by the cash flow of shares or debt securities held in other countries.

²¹ The largest single issue by a company in a transition economy was Gazprom (US\$ 430 million ADR). Lukoil plans to raise US\$ 1 billion in New York this year. In central Europe, MATAV will likely be largest issue so far, perhaps US\$ 0.5 billion.

²² Since early 1996, non-residents are allowed to open so-called rouble "S" accounts at designated Russian banks to buy government paper, but profits have to be repatriated through contracts involving a cap on dollar yields. This requirement is gradually being phased out and markets are set to be fully liberalised by early 1998. "Grey" market purchases involving Russian intermediaries have played on the large arbitrage margins between resident and non-resident markets.

The experience of Ukraine and Bulgaria demonstrates how rapidly market conditions have adapted to changed expectations (see Chart 7.8). In both countries, foreign investors were all but absent from the domestic securities markets until late 1996. Foreign hedge funds and proprietary traders of various investment banks began to enter the Hryvna treasury bill market in January 1997 and contributed to driving down annualised yields by about 25 percentage points within a matter of two weeks and by a further 10 percentage points (to 20 per cent on six-month paper) by mid-July. In Bulgaria, yields on four-week treasury bills fell from 600 per cent to 100 per cent within the first three weeks of April after the Government had signed an IMF programme. They declined further to less than 6 per cent in July. Foreigners accounted for 20 per cent (or DM 171 million) of the outstanding stock of treasury bills at end-August, after accounting for virtually nil in March. In addition, over the same period US\$ 225 million was invested in Bulgarian bank recapitalisation bonds with a 25-year maturity (indexed to the US dollar but payable in leva), helping to drive the market price up from around 40 per cent to 75 per cent of nominal value at a time when the liquidity of Bulgarian buyers was severely weakened.

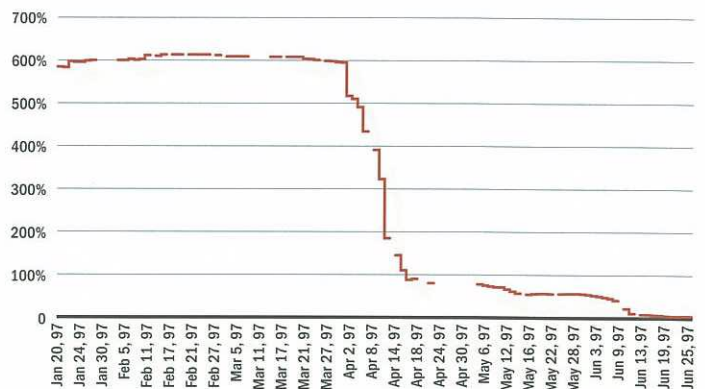
Recent low yields on transition economy debt are partly explained by excess liquidity in the international capital markets and not only by falling risk perceptions – or the reality of risk. Indeed, in some cases the yields may look unrealistically low in relation to the risks involved. Similar phenomena have been observed in other emerging markets, and one should be cautious in projecting these conditions too far into the future. The markets can be unforgiving when debt servicing problems surface and risk perceptions are sharply adjusted, possibly across the board even for borrowers who show little sign of trouble.

Foreign direct investment (FDI) has continued to flow into the region at a rapid pace, covering an increasingly broad range of countries (see Table 7.5). What would appear to be a slight pause in 1996 for the aggregate flow into the region (down by approximately US\$ 500 million compared with 1995) masks an underlying growth trend. Several large infrastructure privatisations in Hungary, (power sector) and the Czech Republic (telecoms) took place in December 1995 and distort the annual comparison. Poland was the region's leading recipient of FDI in 1996, replacing Hungary which had held that position since 1989. In both Russia and Poland, FDI has accelerated further in 1997. Azerbaijan, Kazakhstan and Ukraine have begun to attract an increasing share of the regional total, and Latvia and Lithuania have both caught up with Estonia as investment locations. Generally speaking, FDI continues to follow natural resources – where these are abundant – and progress in transition. Its broader distribution is primarily witness to the progress that countries outside the core group of advanced reformers have made in establishing environments worth investing in. Over the coming years, FDI into the region is likely to increase further, with some projections reaching around US\$ 18 billion in 1997 and more than

Chart 7.8

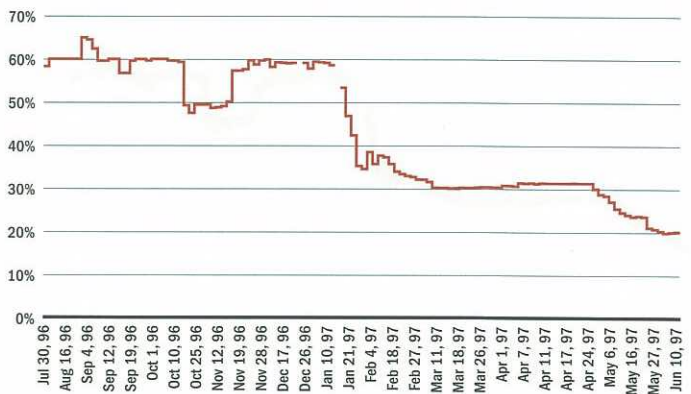
Bulgaria: yield on four-week treasury bills, January-June 1997

On annual basis



Ukraine: yield on six-month treasury bills, July 1996-June 1997

On annual basis



Source:

Salomon Brothers International.

US\$ 20 billion in 1998. In 1997, Poland and Russia are each expected to attract about one-quarter of the total. Large-scale privatisations through direct sales, especially in the infrastructure sector, are likely to be a key driving force along with a consolidation of investments in the automotive industry (see Chapter 2).

Sustainability of current account deficits

Private and official capital flows over the past few years have easily exceeded current account deficits and contributed to the replenishment of foreign exchange reserves. They reflect above all rising confidence of foreign investors and creditors, deriving from the economic recovery and the growing track record of reforms, combined with attractive investment opportunities. As discussed in Chapters 3 and 6, the potential productivity (and profitability) of new capital in the transition economies is likely to be higher than in more settled market environments. At the same time, domestic financial systems are still unable to offer much support to

Table 7.5

Foreign direct investment

(net inflows recorded in the balance of payments)

	1994	1995	1996 (revised)	Cumulative FDI-inflows 1989-96	Cumulative FDI-inflows 1989-96 per capita	FDI-inflows per capita in 1996	FDI-inflows as a share of GDP in 1996
	<i>(In millions of US dollars)</i>			<i>(In millions of US dollars)</i>		<i>(In US dollars)</i>	<i>(In per cent)</i>
Albania	53	70	90	298	93	28	3
Bulgaria	105	82	100	425	51	12	1
Croatia	98	81	349	615	129	73	2
Czech Republic	1,024	2,720	1,264	7,120	692	123	2
Estonia	212	199	110	735	477	71	3
Hungary	1,097	4,410	1,986	13,260	1,300	195	4
Latvia	155	165	230	644	258	92	5
Lithuania ¹	31	72	152	285	76	41	2
FYR Macedonia	24	13	39	76	38	20	1
Poland	542	1,134	2,741	5,398	140	71	2
Romania	347	404	210	1,186	52	9	1
Slovak Republic	178	134	177	623	117	33	1
Slovenia	131	170	180	743	372	90	1
<i>Eastern Europe and the Baltic states</i>	<i>3,997</i>	<i>9,654</i>	<i>7,628</i>	<i>31,408</i>	<i>273</i>	<i>66</i>	<i>2</i>
Armenia	3	19	22	44	12	6	1
Azerbaijan	22	284	661	987	130	87	19
Belarus	10	7	75	167	16	7	1
Georgia	8	6	25	39	7	5	1
Kazakhstan	635	859	1,100	3,067	187	67	5
Kyrgyzstan	45	61	31	147	33	7	2
Moldova	18	73	56	161	37	13	3
Russia	584	2,021	2,040	5,843	40	14	0
Tajikistan	12	13	13	55	10	2	1
Turkmenistan	103	233	129	544	118	28	5
Ukraine	100	300	500	1,270	25	10	1
Uzbekistan	73	-24	50	156	7	2	0
<i>The Commonwealth of Independent States</i>	<i>1,613</i>	<i>3,852</i>	<i>4,702</i>	<i>12,480</i>	<i>44</i>	<i>17</i>	<i>1</i>
Total	5,610	13,506	12,330	43,888	110	31	1

Sources:

IMF, central banks and EBRD estimates.

¹ FDI figures for Lithuania are only available from 1993. For 1993 and 1994, figures cover only investment in equity capital. For 1995 and 1996, equity capital and reinvested earnings are covered but inter-company debt transactions are not covered.

investors and savings are limited, especially during the recovery from the transition-related recession when future earnings expectations stimulate consumption. Foreign financing can help the transition economies realise their growth potential and cope with the demands of consumption. Current account deficits may thus merely represent the other side of the growth coin.

However, foreign financing also creates obligations that will have to be serviced in the future, and growing current account deficits introduce, therefore, an element of vulnerability and instability into a country's economic framework. Shifts in perceptions can lead to quick revisions in credit assessments by foreign sources of finance, possibly inducing rapid reversals in capital flows and currency crises. Market perceptions as to the sustainability of a current account deficit are notoriously hard to predict. However,

they tend to focus on the way in which the economy generates the means for repaying external claims in the future and, more specifically, on whether the government, the main obligor in most countries, continues to be able and willing to pay. The rate at which an economy invests rather than consumes foreign funds, the soundness of fiscal and monetary policy, the structural reforms and political stability that help underpin prudent macroeconomic policy in a lasting way and the size of existing foreign debt all enter this assessment. The perceived ability to address short-term refinancing needs on external debt, and thus the term structure of existing obligations, can be an important additional consideration.

As mentioned above, during the past year international markets overall have clearly passed a favourable judgement on most transition economies despite the worsening current account situation.

But events in the Czech Republic and Bulgaria have, in very different ways, also demonstrated how things can go wrong.

In early 1997 the Czech Republic combined relatively low external debt and a near-balanced budget with a large and growing current account deficit. While a private consumption boom – partly induced by substantial real wage increases – contributed to the external imbalances, this was matched by a strong investment performance and thus, in principle, favourable prospects for future earnings. Nevertheless, confidence in the efficiency and transparency of the financial system declined during 1996 following a series of bank failures. In addition, the fixed exchange rate of the koruna had contributed to loss of competitiveness and was the subject of political debate²³ – a debate which, incidentally, exposed the vulnerability of the Czech banking sector, which had large foreign liabilities, to devaluation. The koruna regime became the focal point of speculation about the sustainability of the country's external accounts. In April 1997 the koruna was subject to attack as doubts grew about the Government's willingness and ability to take corrective action. The "small package" of economic reforms announced in April 1997 was deemed insufficient to stave off the growing external imbalance. In addition, it reinforced the perception that the Government itself had doubts about sustainability and caused large amounts of short-term external funds (portfolio investments and bank deposits) to be withdrawn. The Czech Republic spent about 2 billion dollars in foreign exchange reserves before letting the exchange rate depreciate and switching to a managed float system. The markets reacted favourably to further government policy announcements in May. In addition, there was an improvement in the current account in the second quarter. By August, the koruna had reversed about one quarter of its initial 12 per cent decline against its central parity, though the crisis left a legacy of interest rates which remain 200-300 basis points above pre-crisis levels.

Bulgaria in early 1996 faced a very different set of conditions. Its external and internal debt stood at about 80 per cent and 35 per cent of GDP respectively, making them among the highest in the region. The same applied to the fiscal and quasi-fiscal deficits (with estimates for the sum of these in 1995 and 1996 in the range of 15-18 per cent of GDP), while the current account was broadly in balance. Two factors contributed directly to a currency crisis, which lasted from January 1996 to March 1997. First, for several years the banking system had refinanced the losses of the essentially unreformed state enterprise sector. When liquidity problems developed towards the end of 1995 (and problem banks were increasingly propped up with uncollateralised National Bank deposits), confidence in the banking sector was quickly eroded. Second, money creation spilled over into a loss of international

reserves (which were at US\$ 1.2 billion at end-1995). Given external debt servicing needs of around US\$ 1 billion during 1996 and deep disagreements between the Government and the international financial institutions on economic policy-making, doubts grew about the country's ability to refinance obligations as they came due. These developments led to the withdrawal of US\$ 900 million (10 per cent of GDP) in foreign currency deposits from the banking system, despite restrictions, and increasingly a generalised run on banks and on the lev. As of February 1997, broad money was at less than a quarter of its real value in late 1995, the lev had depreciated by about 4,500 per cent, and international reserves were at critically low levels. After a change in government, cross-party agreement was reached on an ambitious programme of stabilisation and structural reform. The foreign exchange market reacted almost instantly. The exchange rate stabilised and appreciated by about 100 per cent, foreign capital was attracted into domestic securities as early as March and by the time of the introduction of a currency board on 1 July international reserves were exceeding their end-1995 level. However, vast amounts of savings had been destroyed and economic activity suffered severely.

Table 7.6 provides a grouping of countries around some standard indicators for analyses of sustainability, the size of the current account and fiscal deficits and the ratio of external debt to exports.²⁴ It also displays groupings around debt-to-GDP ratios, but these ratios should be viewed with some caution as, in the transition economies, they have often changed rapidly in response to real exchange rate appreciation. In such a broad-brush categorisation, the cut-off points for "low", "medium" and "high" are necessarily somewhat arbitrary. Also, the fiscal deficit criteria should ideally be expanded to cover "quasi-fiscal deficits" resulting from the state's influence over the activity of banks and enterprises. The accounts of Belarus and Turkmenistan, for instance, would then look far worse. Nevertheless, Table 7.6 offers some useful insights. With very few exceptions, the external debt burden is not high by international standards. For instance, the Latin American average for the debt-to-exports ratio (including goods and non-factor services in the denominator) was 203 per cent in 1996²⁵, a level surpassed among transition economies only by Armenia, Bulgaria and Georgia. The average for all developing countries was 146 per cent, compared with 121 per cent for the transition economies.²⁶ However, while external debt is not (yet) high, it has been growing very rapidly. The large number of countries with significant current account deficits provides one indication of this.²⁷ While, as mentioned above, in the more advanced transition economies a growing share of external finance has taken the form of equity, debt-creating flows continue to be prevalent in many CIS countries.

²³ In fact, following earlier debates on the impact of capital inflows on the exchange rate regime the National Bank had widened the fluctuation band of the koruna from $\pm 0.5\%$ to 7.5% in February 1996.

²⁴ Where the data were available, "exports" here include revenue from goods and non-factor services.

²⁵ *World Debt Tables 1997*, World Bank.

²⁶ The ratio was almost the same in eastern Europe and the Baltics (123%) and in the CIS (118%).

²⁷ Note that developing countries have, on average, maintained current account deficits within 2% of GDP over the past few years. This is the cut-off point between "low" and "medium" deficits in Table 7.6.

Table 7.6

Debt indicators and deficits in 1996

	Current account balance ¹	Fiscal balance ^{2,3}	Gross external debt/ Current account revenues ^{4,5}	Net external debt/GDP ^{6,7}
	<i>(In per cent of GDP)</i>		<i>(In per cent)</i>	
Low	Russia (2.2)	Belarus (-1.6)	Albania (82.1)	Albania (20)
	Bulgaria (1.3)	Croatia (-0.5)	Azerbaijan (66.4)	Armenia (28)
	Poland (-1)	Czech Republic (-0.7)	Belarus (16.3)	Azerbaijan (10)
	Slovenia (0.3)	Estonia (-1.5)	Croatia (58.9)	Belarus (4)
	Turkmenistan (-0.7)	FYR Macedonia (-0.4)	Czech Republic (67.3)	Croatia (13)
		Latvia (-1.4)	Estonia (11.8)	Czech Republic (15)
		Slovak Republic (-1.2)	Kazakhstan (69.3)	Estonia (-7)
		Slovenia (0.3)	Latvia (29.4)	FYR Macedonia (25)
		Turkmenistan (-0.2)	Lithuania (34.8)	Georgia (27)
			Slovak Republic (70.2)	Kazakhstan (9)
			Slovenia (36.9)	Latvia (-4)
			Turkmenistan (36.0)	Lithuania (4)
			Ukraine (45.5)	Moldova (27)
			Uzbekistan (61.7)	Poland (17)
				Romania (16)
				Russia (26)
				Slovak Republic (24)
				Slovenia (9)
				Turkmenistan (-19)
				Ukraine (17)
				Uzbekistan (1)
Medium	Albania (-4.7)	Azerbaijan (-2.6)	FYR Macedonia (128.9)	Hungary (40)
	Belarus (-6.7)	Georgia (-4.4)	Hungary (143.7)	Kyrgyzstan (35)
	Georgia (-4.9)	Hungary (-3.5)	Kyrgyzstan (141.0)	
	Hungary (-3.8)	Kazakhstan (-3.1)	Moldova (100.2)	
	Kazakhstan (-3.8)	Lithuania (-3.6)	Poland (145.3)	
	Lithuania (-4.4)	Poland (-3.1)	Romania (110.5)	
	Romania (-5.9)	Romania (-3.9)	Russia (125.9)	
	Ukraine (-2.7)	Ukraine (-3.2)	Tajikistan (186.0)	
High	Armenia (-26.6)	Albania (-12.0)	Armenia (211.4)	Bulgaria (105)
	Azerbaijan (-23.6)	Armenia (-9.3)	Bulgaria (204.0)	Tajikistan (90)
	Croatia (-7.6)	Bulgaria (-13.4)	Georgia (331.0)	
	Czech Republic (-8.1)	Kyrgyzstan (-6.4)		
	Estonia (-10.3)	Moldova (-6.7)		
	FYR Macedonia (-7.8)	Russia (-8.3)		
	Kyrgyzstan (-23.7)	Tajikistan (-5.3)		
	Latvia (-7.2)	Uzbekistan (-7.3)		
	Moldova (-13.1)			
	Slovak Republic (-10.2)			
	Tajikistan (-10.9)			
	Uzbekistan (-7.9)			

¹ Categories: "Low": current account deficit smaller than or equal to -2% of GDP.
"Medium": current account deficit between -2% and -7% of GDP.
"High": current account deficit greater than -7% of GDP.

² Data refer to the general government.

³ Categories: "Low": fiscal deficit smaller than or equal to -2% of GDP.
"Medium": fiscal deficit between -2% and 5% of GDP.
"High": fiscal deficit greater than 5% of GDP.

⁴ Categories: "Low": ratio of gross external debt to current account revenues smaller than or equal to 100%.
"Medium": ratio of gross external debt to current account revenues between 100% and 200%.
"High": ratio of gross external debt to current account revenues greater than 200%.

⁵ Current account revenues include merchandise exports and exports of non-factor services. In the case of Armenia, Azerbaijan, Belarus, Bulgaria, FYR Macedonia, Georgia, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Moldova, Romania, Tajikistan and Uzbekistan, the gross external debt is divided only by merchandise exports.

⁶ Categories: "Low": ratio of gross external debt to GDP smaller than or equal to 30%. "Medium": ratio of gross external debt to GDP between 30% and 50%. "High": ratio of gross external debt to GDP greater than 50%.

⁷ Net external debt equals gross external debt net of gross reserves of the monetary authorities.

Sources:

Calculations on the basis of the selected economic indicators at the back of this Report.

A further cause for concern is the association of high current account deficits with significant budgetary imbalances in several CIS countries, notably Armenia, Kyrgyzstan, Moldova, Tajikistan and Uzbekistan. Together with evidence of low public investment activity,²⁸ this suggests that a large proportion of foreign funding may serve to meet current outlays that do not improve those countries' future repayment capacity. Foreign borrowing was in some cases explicitly earmarked to reduce budgetary pensions and wage arrears (e.g. a recent Russian bond issue and a planned Kazakh issue).²⁹ The association between budgetary and external imbalances is particularly worrying if viewed against the background of the weak fiscal revenue performance across much of the CIS (see Section 7.2). The vast majority of CIS debt is owed by sovereign or sovereign-backed borrowers. Problems of fiscal sustainability are perhaps the most likely source of external instability in the future.

The sources of the external imbalances in the region, in particular the rapid growth in consumption and, in the CIS, the precarious fiscal positions, suggest that governments should drive a course of cautious demand management in order to pre-empt instability in the future. As indicated in Section 7.2, this requires above all a strengthening of the fiscal revenue base, public expenditure reforms, especially in the area of social expenditures, and – as illustrated by the Bulgarian crisis – a strong commitment to press ahead with restructuring in the enterprise and banking sectors. The need for reforms would appear to be particularly urgent in countries that perform poorly on several of the indicators in Table 7.6. Armenia, Bulgaria, Kyrgyzstan, Moldova, Tajikistan and Uzbekistan all score badly on two or more of the indicators. Georgia has also had problems in managing its debt, but debt indicators seem to be improving as the dollar value of GDP is rising fast. Over time, sustainability is likely to be enhanced by a rising share of foreign direct investment in total capital flows on the one hand, and by increasing domestic savings rates on the other (see Chapter 6 of the 1996 *Transition Report*). The ability to attract such investment and raise savings depends, however, on many of the same policies outlined above.

Finally, the past year has also demonstrated the need for ensuring a careful mix of policies. One factor that may have contributed to current account deficits in several countries, including the Czech and Slovak Republics, Croatia and Estonia, was the combination of tight monetary policies, fixed or pegged exchange rates, and moderately slackening fiscal policies. This resulted in sizeable differentials of domestic over foreign interest rates and thus profit opportunities for short-term foreign capital, which contributed to demand pressures. Apart from the impact this may have had on the size of current account deficits, short-term financing of external deficits also makes a country particularly vulnerable to changes in

risk perceptions leading to sudden reversals of capital flows. While foreign direct investment was strong in the Czech Republic in 1996 and the term structure of debt generally quite favourable, during the last two quarters of 1996 the ratio of short-term debt rose to 28 per cent, while portfolio inflows also accumulated rapidly. This led to a more volatile structure of foreign capital and added to the pressures which arose in the spring of 1997. In the case of Estonia and the Slovak Republic, short-term capital inflows increased dramatically to over 50 per cent of the total in 1996, attracted primarily by high interest rate differentials. A reassessment of the mix of monetary and fiscal policies in these two countries would seem prudent.

7.4 Productivity, real exchange rates and competitiveness

International competitiveness in manufacturing declined somewhat during 1996 and 1997 in several countries of the region. In the advanced countries of eastern Europe, the average increase in unit labour costs in Deutschmark terms was 9 per cent in 1996.³⁰ During the same period, unit labour costs in Germany fell by 1 per cent. This development reflects partly the delayed adjustment of wages to productivity growth in earlier years and the continuing upward adjustment of real exchange rates after the sharp depreciation at the start of the transition.

Specifically, the change in Deutschmark unit labour costs can be attributed to three factors, which are analysed for 12 countries for which the full range of data was available (see Table 7.7): (i) Labour productivity growth in manufacturing continued to average around 8 per cent in 1996 and was growing at double-digit rates in Croatia, Latvia and Romania (see Chart 7.9). (ii) For the first time in 1996, real wage growth in terms of domestic producer prices outpaced the growth of labour productivity in six out of 12 countries, which resulted in a squeeze on profit margins. At the same time, real wage growth in terms of consumer prices continued to lag behind productivity growth, as consumer prices increased considerably faster than producer prices (see Chart 7.10).³¹ (iii) Except for Bulgaria and Romania, currencies continued to appreciate strongly against the Deutschmark (and other hard currencies), with the median rate of appreciation among the 12 countries surpassing 10 per cent during 1996 (see Chart 7.11). As discussed in Box 7.2, there is reason to believe that real appreciation will continue for some time to come.

The result was a considerable increase in unit labour costs in terms of Deutschmarks during 1996 in seven of the 12 countries. This trend has continued into 1997, except in Estonia, where productivity growth has accelerated, and Russia, where real wages

²⁸ See Kapur and van der Mensbrugghe (1997).

²⁹ And, in fact, certain state-owned enterprises are said to have borrowed abroad to meet their tax liabilities. This is a reflection of the liquidity crisis in the enterprise sector of the CIS (see the discussion of barter in Russia in Chapter 2, Box 2.3).

³⁰ The growth rate refers to an employment-weighted average of Croatia, the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia.

³¹ This phenomenon has characterised relative price adjustments in the region for some time. Its origins may be traced to the larger weight of prices of non-tradable goods, such as public utility prices and other services (most importantly rents) in the CPI, and the moderating effects of real exchange rate appreciation on the PPI, which is dominated by tradable goods. Therefore, generally speaking, reduced manufacturing profits and reduced purchasing power of wages have financed increased transfers to public utilities and providers of services.

Table 7.7

Indicators of competitiveness

(change, in per cent)

	1994	1995	1996	1997-Q1		1994	1995	1996	1997-Q1
Bulgaria¹					Lithuania⁷				
Industrial gross output	8.5	4.9	0.2	na	Manufacturing gross output	-29.7	0.9	1.3	-4.8
Productivity in industry	12.6	7.3	3.3	na	Productivity in manufacturing	-12.1	11.9	4.9	-9.0
Real wage in industry (PPI-based)	-12.1	3.3	-17.9	na	Real wage in manufacturing (PPI-based)	16.4	11.3	21.6	10.9
Real D-Mark exchange rate (CPI-based)	-4.5	13.6	-18.7	na	Real D-Mark exchange rate (CPI-based)	76.9	21.1	29.0	8.7
D-Mark unit labour costs	-31.7	4.9	-30.1	na	D-Mark unit labour costs	102.2	12.7	42.7	34.0
Croatia²					Poland⁸				
Industrial gross output	-2.7	0.3	3.1	3.0	Manufacturing gross output	13.6	11.6	10.5	10.4
Productivity in industry	1.6	5.8	11.4	10.8	Productivity in manufacturing	13.9	7.0	9.9	9.8
Real wage in industry (PPI-based)	29.8	30.8	11.0	6.0	Real wage in manufacturing (PPI-based)	5.1	5.4	18.3	12.4
Real D-Mark exchange rate (CPI-based)	13.0	1.3	3.1	6.3	Real D-Mark exchange rate (CPI-based)	1.6	3.8	11.6	9.9
D-Mark unit labour costs	33.3	26.0	2.1	1.5	D-Mark unit labour costs	-5.9	2.6	12.5	7.0
Czech Republic³					Romania⁹				
Manufacturing gross output	0.1	8.2	5.5	-3.0	Manufacturing gross output	3.7	12.1	12.6	16.2
Productivity in manufacturing	4.9	11.1	9.6	1.1	Productivity in manufacturing	13.3	19.2	16.7	19.6
Real wage in manufacturing (PPI-based)	11.2	9.5	12.0	9.6	Real wage in manufacturing (PPI-based)	-7.3	16.7	3.6	-14.2
Real D-Mark exchange rate (CPI-based)	6.4	2.6	10.1	14.0	Real D-Mark exchange rate (CPI-based)	3.9	-6.6	-5.3	2.5
D-Mark unit labour costs	11.0	1.5	10.0	22.3	D-Mark unit labour costs	-3.6	-5.0	-7.9	-24.3
Estonia⁴					Russia¹⁰				
Manufacturing gross output	-3.2	2.9	4.8	17.8	Manufacturing gross output	-24.0	-3.9	-6.8	3.3
Productivity in manufacturing	6.7	0.4	6.3	20.8	Productivity in manufacturing	-17.7	4.8	1.3	6.4
Real wage in manufacturing (PPI-based)	26.9	14.1	7.8	11.1	Real wage in manufacturing (PPI-based)	-17.5	-31.3	6.0	-13.0
Real D-Mark exchange rate (CPI-based)	43.7	26.6	21.3	8.6	Real D-Mark exchange rate (CPI-based)	76.2	23.9	35.9	10.5
D-Mark unit labour costs	61.4	35.2	16.3	-2.1	D-Mark unit labour costs	94.7	-6.4	47.5	-5.4
Hungary⁵					Slovak Republic¹¹				
Manufacturing gross output	9.3	5.3	3.5	8.9	Industrial gross output	4.7	8.3	2.5	1.7
Productivity in manufacturing	7.3	11.2	9.1	9.8	Productivity in industry	6.8	4.0	2.5	2.5
Real wage in manufacturing (PPI-based)	9.2	-5.9	-0.2	-0.8	Real wage in industry (PPI-based)	7.0	5.7	10.1	7.2
Real D-Mark exchange rate (CPI-based)	-0.8	-7.0	5.4	10.6	Real D-Mark exchange rate (CPI-based)	4.0	2.8	6.1	7.8
D-Mark unit labour costs	-2.8	-19.4	-3.6	5.4	D-Mark unit labour costs	3.8	5.5	13.8	13.9
Latvia⁶					Slovenia¹²				
Industrial gross output	-9.4	-6.7	0.9	-4.4	Industrial gross output	6.4	2.0	1.0	0.2
Productivity in industry	9.4	-1.1	12.6	-3.1	Productivity in industry	11.4	7.2	6.6	5.8
Real wage in industry (PPI-based)	39.6	15.2	4.6	22.5	Real wage in industry (PPI-based)	8.1	3.9	7.0	7.8
Real D-Mark exchange rate (CPI-based)	56.8	14.7	16.6	16.1	Real D-Mark exchange rate (CPI-based)	1.6	6.9	-0.5	4.7
D-Mark unit labour costs	76.7	21.9	6.3	43.0	D-Mark unit labour costs	-1.5	4.9	-1.5	5.7

Notes:

Numbers in the first three columns represent the percentage change in annual averages. Numbers in the last column represent the change in the average of 1997 Q1 from the average of 1996 Q1.
Productivity is calculated as the ratio of manufacturing production to manufacturing employment.
The real D-Mark exchange rate is calculated as the domestic CPI divided by the product of the German CPI and the exchange rate. A positive sign represents a real appreciation.
D-Mark unit labour costs are calculated as D-Mark wages divided by productivity.
Data on the exchange rate to the D-Mark, on CPI and PPI are based on National Sources, the International Financial Statistics and EBRD estimates.

- ¹ Data on industrial production, employment and wages are taken from the *Statistical Yearbook*, various issues, and annual reports by the National Bank of Bulgaria. Real wages are calculated as average gross monthly wages in industry, deflated by the PPI in industry.
- ² Data on industrial production, employment and wages are taken from the 1996 *Statistical Yearbook* and various issues of *Monthly Statistical Report*, published by the Central Bureau of Statistics. Real wages are calculated as average monthly wages in industry, deflated by the PPI in industry. The 1994 growth rate refers to net wages, subsequent growth rates refer to gross wages.
- ³ Data on production, employment and wages are taken from annual and monthly publications of the Czech Statistical Office. Real wages are calculated as average monthly gross wages in manufacturing, deflated by the PPI in industry.
- ⁴ Data on production, employment and wages are taken from annual and monthly reports by the Estonian Statistical Office. Real wages are calculated as average gross monthly wages in manufacturing deflated by the PPI in manufacturing.
- ⁵ Data on production, employment and wages are taken from the *Monthly Bulletin of Statistics*

of the Hungarian Statistical Office. Real wages are calculated as average monthly gross wages in manufacturing deflated by the PPI in industry.

- ⁶ Data on production, employment and wages are taken from the OECD Short-term Economic Indicators, various issues. Real wages are calculated as average monthly gross wages in industry deflated by the PPI in industry.
- ⁷ Data on employment and wages are taken from OECD *Short-term Economic Indicators*, various issues. Output includes mining and is taken from the *International Financial Statistics*, various issues. Real wages are calculated as average monthly gross wages in manufacturing deflated by the PPI in industry.
- ⁸ Data on production, employment and wages are taken from monthly and quarterly reports of the Polish Statistical Office. Real wages are calculated as average monthly gross wages in manufacturing deflated by the PPI in manufacturing.
- ⁹ Data on production, employment and wages are taken from OECD *Short-term Economic Indicators*, various issues. Real wages are calculated as average net wages in manufacturing deflated by the PPI in industry.
- ¹⁰ Data on production, employment and wages are taken from OECD *Short-term Economic Indicators*, various issues. Output and employment figures for 1996 and 1997 Q1 refer to industry rather than manufacturing. Wages for 1997 Q1 are taken from *Russian Economic Trends*. Real wages are calculated as average gross monthly wages in manufacturing deflated by the PPI in industry.
- ¹¹ Data on production, employment and wages are taken from OECD *Short-term Economic Indicators*, various issues and from annual and monthly publications by the Slovak Statistical Office. Real wages are calculated as average gross monthly wages in industry deflated by the PPI in industry.
- ¹² Data on production, employment and wages are taken from the Slovenian Institute for Macroeconomic Analysis and Development. Real wages are calculated as average gross monthly wages in industry deflated by the PPI in industry.

appear to have declined recently. The sources of the increase in unit labour costs differ somewhat among countries, with real wages the key element in central Europe and real appreciation of exchange rates relatively more important in Russia and the Baltics. Hungary has been an exception to the trend in that real wages declined in 1996. At the same time, real appreciation against the Deutschmark was relatively moderate, so that labour cost competitiveness in manufacturing improved substantially. In 1997, however, Hungary has moved back towards the pattern observed in the other advanced countries.

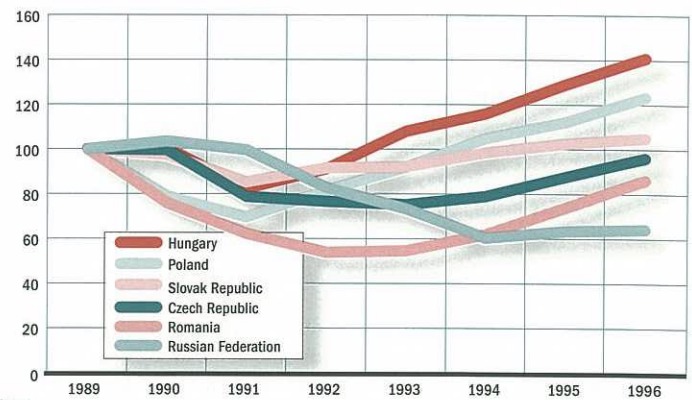
As the transition progresses, certain patterns are emerging in productivity growth. Labour productivity is the ratio between the value of output, measured in constant prices, and the level of employment. In the early stages of transition developments in productivity throughout the region were dominated by the decline in output. The initial decline in measured productivity began to be reversed in most countries as surplus labour was shed, but with a delay. Since many enterprises were maintaining excess labour under central planning, and labour forces as a share of the population were very high compared with those in market economies, the effect of redundancies could, in proportional terms, easily surpass that of the initial decline in output and generate very high rates of measured productivity growth over and above the "starting level". Finally, in a third phase which the more advanced transition economies have entered and which partly overlaps with the second, productivity begins to be driven by fresh capital investment, improved technologies and modern management methods – the "deep restructuring" discussed in more detail in Chapters 4 and 5.

In summary, most countries lost some of their labour cost advantage *vis-à-vis* more developed market economies. However, in hard currency terms wages remain low compared with western Europe (see Chart 7.12) while education levels and other important assets are substantial in comparison with developing countries of the same income category. There is little evidence that the increase in unit labour costs has damaged exports in general so far. Export performance across the region does not appear to be strongly correlated with the growth in unit labour costs (the simple correlation co-efficient for 1996 was -0.25).³² Nevertheless, for some firms, especially if they underwent little restructuring, competitive pressures have begun to intensify compared with the early years of the transition. There may also be some impact on international investor confidence. The rapid rise in real wages was a factor in the debates surrounding the Czech currency crisis. In the context of stagnant industrial productivity, it contributed to the growing pressure on the Czech currency during the first five months of 1997. The Slovak Republic has similarly recorded sluggish labour productivity growth coupled with a substantial real wage increase during the first half of 1997.

Chart 7.9

Labour productivity in manufacturing

Index: 1989=100

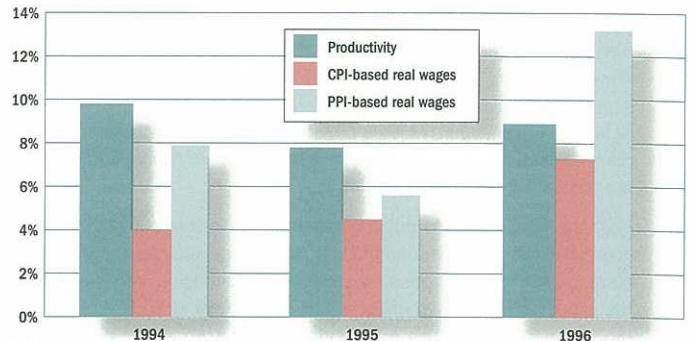


Note:

Data were taken from the sources described in the footnotes on Table 7.7. In the Slovak Republic, productivity refers to industry.

Chart 7.10

Annual average growth in productivity and real wages in six advanced transition economies



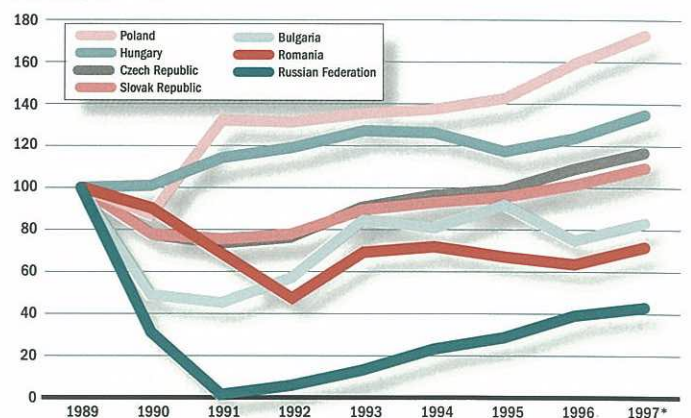
Note:

Data are based on the sources described in the footnotes on Table 7.7. Growth rates shown are the averages for Croatia, Czech Republic, Hungary, Poland, Slovak Republic and Slovenia, weighted by manufacturing employment.

Chart 7.11

Real exchange rates against the Deutschmark

CPI-based, 1989=100



Note:

An increase in the index represents a real appreciation.

* Data for 1997 are extrapolated from first-half 1997 figures.

Box 7.2

Sources of real exchange rate appreciation

Real exchange rates are one of the most important determinants of international competitiveness.¹ Real appreciation was rapid in countries of the former Soviet Union where the exchange rate depreciated most dramatically at the beginning of transition. This suggests that the trend of real appreciation may have been the result of a continued correction process after an initial under-valuation. Comparisons of actual and purchasing power parity (PPP) exchange rates indicate that most currencies in the region were substantially below their PPP values in the early transition and have since then rapidly moved to reduce that gap.

However, the concept of under-valuation is problematic in that it presumes the existence of a "correct" value of an exchange rate. There is no general theoretical reason why nominal exchange rates should ever equal their PPP values.² The initial "under-valuation" was, in fact, the result of rational behaviour of financial markets as domestic and foreign holders of local currencies required large risk premia to be compensated for the uncertainty arising from the short track record of the new governments and central banks, indeed the process of transition itself.

A decrease in the perceived country risk, as evidenced by recent "investment grade" ratings for a number of countries, provides the most convincing explanation for the initial real appreciation. This boost in confidence induced domestic savers to hold domestic currency rather than to convert earnings into "safe" currencies and it makes domestic firms more willing to invest locally. At the same time, lower risk has also improved the confidence of foreign investors, making them more willing to provide loans and make investments. Taken together, these responses to lower risk contributed to net inflows of capital and thus the general trend in real appreciation.

Real appreciation is also a function of the exchange rate regime. Many currencies are officially or unofficially pegged against a foreign anchor currency. At the same time, consumer prices continue to rise driven by the upward adjustment of utility and housing prices which is a continuing process in many transition economies, as discussed in Section 7.3. Given the large weight that these services have in the CPI – which is used as the deflator in many calculations of the real exchange rate – this combination has been an important contributing factor to real appreciation. Given the remaining gap between cost-recovery prices and retail prices for these services in most countries of the region, it may well remain a source of real appreciation for some time to come.

A further explanation for real appreciation is based on the observation that the "law of one price" does not necessarily hold in the transition economies. That "law" posits that a given tradable good would, in the absence of obstacles to imports and exports, carry the same price in all countries (assuming similar transport and distribution costs). However, severe deficiencies in domestic distribution systems in most transition economies effectively led to a segmentation of markets and, given the initial overcapacity in many industrial sectors, to prices for domestically produced tradable goods that could be far lower than world market levels (even adjusted for quality). In many countries, reducing

transaction costs in trade is still largely an unfinished task. Over time, as more efficient logistics and marketing techniques are developed and wholesale and retail trade mature (and excess capacity in industry is reduced), this price differential for tradables declines, leading to real appreciation.

Real appreciation should in theory also be related to productivity differentials across sectors.³ If productivity rises faster in the tradable sectors (most manufacturing goods) than in the non-tradable sectors (construction and many services), growing demand for limited factors, such as labour and land, will push up costs for both sectors. This in turn would increase prices in the non-tradable sector (which does not face foreign price competition and is therefore able to pass costs through into prices) and thus cause real appreciation.

Comparing manufacturing productivity growth with productivity growth in GDP shows that in the early transition, the decline in productivity was more pronounced in manufacturing than in other sectors (driven by sharply falling output and only slowly falling employment levels). In most countries, the recovery of productivity growth occurred earlier in sectors other than manufacturing. In recent years, however, productivity growth in manufacturing has outpaced productivity growth in GDP as a whole, suggesting a pattern of productivity growth that is more common for industrialised countries. However, real exchange rate appreciation generally started earlier, implying that productivity differentials were not, or at least not the dominant, driving force for real appreciation in the early transition. Also, comparisons of productivity growth across sectors are notoriously difficult since it is hard to adjust for quality changes and since deflators for services are problematic.

However, real appreciation may not have been as large as the data suggest. Measurement errors can exaggerate inflationary measures when quality improvements are not fully taken into account in price statistics. Thus, if the rate of quality improvements is more rapid in eastern European countries than in the Western market economies (as is likely to be the case), the inflation rate differential between these regions and thus real appreciation would tend to be overstated.

¹ There is no unique definition for the real exchange rate. A real exchange rate change generally measures the change of domestic prices converted into international currency relative to the change in foreign prices. These prices can be consumer prices, producers prices, wholesale prices, the GDP deflator, or unit labour costs. Real appreciation was strongest when based on unit labour costs and weaker when based on producer prices. Real exchange rate appreciation based on the CPI was in between the other two measures.

² Non-tradable inputs (e.g. human capital, land) vary across countries, implying productivity differentials. Countries with higher productivity in the tradable sector should usually be the more "expensive" ones in equilibrium. Also, if one government has a more credible policy of maintaining a low variance in inflation, then this currency should be more expensive than in a country with a higher projected inflationary risk.

³ This is commonly referred to as the "Balassa-Samuelson" effect.

7.5 Conclusion

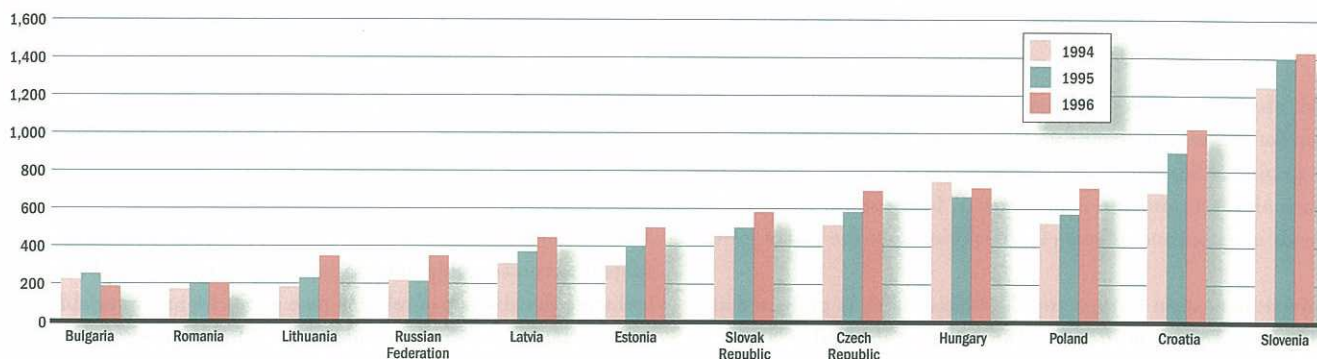
The past year has seen the resumption of growth in the region as a whole, a surge in inflows of private capital and a deterioration of government revenues in the CIS and of external accounts in a wide range of countries. These developments are explained, to some extent, by a revival of domestic demand and, partly related to this, by growing confidence in the region. The combination of growth and current account deficits is not surprising, given the region's significant investment opportunities but relatively low savings rates. Foreign capital can help the transition economies realise

their growth potential. Nevertheless, to ensure a stable recovery, increasing attention will need to be paid to sources of internal and external imbalances, in particular since some of the foreign capital is of a relatively short-term nature and the very large inflows may not be a sustainable phenomenon. Subject to continued advance in the transition, foreign sources of funds will be looking particularly closely at fiscal policies. It is probably fair to say that monetary policies have led the way in restoring macroeconomic stability with, at times, extraordinarily high real rates of interest. To secure the macroeconomic performance, fiscal positions must be put on a

Chart 7.12

Average gross monthly wage costs in manufacturing

In D-Mark



Note:

Data were taken from the sources described in the footnotes on Table 7.7. Average monthly wage costs are average gross monthly wages including pay-roll taxes paid by employees and employers. Employers' pay-roll contributions were estimated from pay-roll tax rates. Wage rates apply to industry in Bulgaria, Croatia, Latvia, Slovak Republic and Slovenia.

sound long-term basis. In many countries there are still difficult adjustments to make on both the revenue and expenditure sides. As a broad generalisation one can say that in the western part of the region the challenges will be particularly severe in controlling expenditure, and to the east in raising revenue. These macroeconomic issues cannot be separated from the general process of reforms. As elsewhere in the transition, improving policy on the fiscal front requires not only careful attention to building institutions, but also promoting and enforcing responsible behaviour both inside and outside government.

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Forecasts and prospects

This chapter presents projections of the growth of output and inflation for the region according to the latest estimates (up to the beginning of September 1997) from a number of institutions. The main aim is to provide a summary of forecasters' views of the trends in output and inflation for the period up to the end of 1998.¹

Growth in eastern Europe and the Baltic states is projected at a little over 3 per cent in 1997. This is below the earlier expectations of many forecasters owing to the sharp contractions in output in both Albania and Bulgaria as well as slower growth in the Czech Republic following the government's deflationary package, intended to narrow the large trade deficit. Growth is expected to strengthen to 4 per cent in 1998. In some countries, however, growth is projected to slow from the high rates achieved in earlier years, partly because forecasters expect that governments will slow the growth of domestic demand as trade and current account deficits have widened. The (unweighted) average inflation rate for the region in 1997 is affected by the high rate for Bulgaria; it is projected to fall from 103 per cent to some 15 per cent in 1998.

In the CIS growth is projected at 0.4 per cent in 1997. However, there is still no consensus among the forecasters as to whether 1997 will represent the first year of recovery for the Russian economy. The forecasters agree that Russia, as well as several other countries in the CIS where output has fallen since the reforms began, will record positive growth in 1998, resulting in growth in the CIS of 2.8 per cent. The success of the stabilisation policies in most countries is reflected in projections of a further decline in the (unweighted) average inflation rate for the CIS from 37 per cent to 34 per cent by the end of 1998.

There is a growing number of institutions making projections of developments in the region, a reflection of the increasing interest in some of these countries as emerging markets for investors as well as the opportunity for greater trade and investment as reform progresses. It has not been possible to include all such institutions. The approach has been to include a number of projections from different types of organisations, including international institutions, consultants, research institutes and banks that are active in the region. The international organisations included are the European Union (EU), the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD), the United Nations Economic Commission for Europe and the EBRD. The two consultants are the Economist Intelligence Unit (EIU) and PlanEcon. The three research institutes are the Institute for Economic Research (IWH), Halle, Germany; Kopint-Datorg in Hungary; and the Vienna Institute for

Comparative Economic Studies. The banks are Credit Suisse First Boston (CSFB), JP Morgan and the Union Bank of Switzerland (UBS).²

As noted in the 1996 *Transition Report*, all these projections are subject to considerable uncertainty. This reflects several factors, including the absence of reliable time series for many variables in some countries so that the estimates tend to be based on informal techniques rather than being derived from econometric models. Differences between some of the projections will also reflect differences in timing. The case of the Czech Republic is an example where most forecasters who completed their projections after the depreciation of the currency in May lowered their estimates of GDP growth for 1997. Those who completed their projections after the end of July will also have had to make a judgement on the effects of the severe floods in both the Czech Republic and Poland.

Almost all of these projections are "baseline" cases and assume the absence of significant shocks. The extent to which such shocks can invalidate short-term projections can be shown by comparing some of the projections for 1997 included in the 1996 *Transition Report* with the latest estimates shown here. For example, both Albania and the Czech Republic were projected to record a further year of strong growth in 1997 (of over 7 per cent and 5 per cent respectively), according to the "average" of growth estimates included in the 1996 *Transition Report*. The latest estimates show that the Albanian economy will contract strongly this year while the Czech economy is likely to grow by just 2 per cent. Several countries in the region have experienced banking crises or sharp falls in the value of their currencies in recent years, all of which have necessitated remedial measures which have had their effect on economic activity. Box 8.1 provides an illustration of how one such shock – a banking crisis – can adversely affect the prospects for growth and price stability.

8.1 Projections of growth and inflation for 1997 and 1998 for eastern Europe and the Baltic states

Economic growth in eastern Europe and the Baltic states is projected to slow to 3.2 per cent in 1997 (weighted average), which is below the 4.4 per cent attained by this group of countries in 1996 and also below the EBRD's projection of 3.9 per cent growth published in the *Transition Report Update* in April 1997 (see Table 8.1). However, much of the deterioration in near-term prospects is due to slower growth in the Czech Republic and the steeper than expected decline in two of the smaller economies, Albania and Bulgaria, as a result of earlier economic crises.

¹ This chapter does not contain a discussion of forecasts for Bosnia and Herzegovina, since there are very few (although EBRD estimates of growth and inflation for this country in 1997 are contained in the Selected Economic Indicators at the end of this Report).

² In the tables estimates from some institutions have been rounded to the nearest whole number or to one decimal place.

Table 8.1

GDP growth forecasts for 1997

(in per cent) ¹

Eastern Europe and the Baltic states	Average ²	Range ³	European		IMF	OECD	United Nations	Economist	PlanEcon	IWH ⁶	Kopint-Datorg ⁷	Vienna Institute	CSFB ⁸	JP Morgan	UBS ⁹
			EBRD (Aug 97)	Union (Mar 97)			ECE ⁵ (May 97)	Unit (July 97)							
Albania	-13.7	19.8	-15.0	-	-10.0	-	-	-5.0	-24.8	-	-	-	-	-	-
Bulgaria	-6.3	7.0	-7.0	-6.7	-7.4	-6.0	-3.0	-5.0	-5.1	-6.0	-10.0	-7.0	-5.0	-6.8	-7.5
Croatia	5.1	2.0	5.0	-	5.5	-	5.5	5.0	4.8	-	4.0	5.0	6.0	-	5.0
Czech Republic	2.0	4.6	1.0	4.6	2.0	2.6	4.5	1.5	2.6	3.0	1.0	1.5	0.0	1.3	1.0
Estonia	5.3	4.0	7.0	3.0	5.0	-	4.5	5.2	6.3	5.0	-	-	-	-	6.0
FYR Macedonia	3.9	3.0	2.0	-	5.0	-	-	4.0	4.6	-	-	-	-	-	-
Hungary	2.8	2.4	3.0	1.5	3.0	2.4	2.0	3.0	3.9	2.5	2.5	3.0	3.0	2.8	3.5
Latvia	3.5	2.0	3.4	2.8	4.0	-	3.5	4.0	3.9	2.0	-	-	-	-	4.0
Lithuania	4.3	2.0	4.5	4.0	4.5	-	5.0	3.8	4.4	3.0	-	-	-	-	5.0
Poland	5.7	2.0	5.5	6.5	5.5	5.0	5.5	6.0	5.8	6.0	5.5	6.0	6.0	5.7	4.5
Romania	-1.9	4.9	-1.5	-3.6	-1.5	-1.0	-2.0	-1.0	1.3	-3.0	-1.0	-3.0	-3.0	-	-3.0
Slovak Republic	4.7	2.6	4.5	5.9	4.5	5.0	6.0	4.0	3.4	4.5	4.0	5.0	4.0	-	5.0
Slovenia	3.6	1.2	4.0	4.2	4.0	3.5	4.0	3.3	3.4	3.5	3.0	3.5	3.0	-	3.5
Average	1.4	2.5	1.3	2.2	1.9	1.6	3.2	2.2	1.1	2.1	1.1	1.8	1.8	0.8	2.5
Weighted average ⁴	3.2	-	3.1	-	3.3	-	-	3.4	-	3.7	-	-	-	-	-
Commonwealth of Independent States															
Armenia	4.4	2.8	5.8	-	5.8	-	-	3.0	3.0	-	-	-	-	-	-
Azerbaijan	5.1	1.1	5.2	-	5.7	-	-	5.0	4.6	-	-	-	-	-	-
Belarus	5.0	3.8	3.0	-	5.0	-	5.0	5.0	6.8	5.0	-	-	-	-	-
Georgia	10.1	0.7	10.5	-	10.0	-	-	10.0	9.8	-	-	-	-	-	-
Kazakhstan	2.2	1.9	2.0	-	1.5	-	2.0	1.5	3.4	-	-	-	-	-	2.5
Kyrgyzstan	5.8	1.9	6.0	-	6.9	-	-	5.0	5.2	-	-	-	-	-	-
Moldova	0.3	8.0	-2.0	-	1.4	-	6.0	-2.0	-1.8	-	-	-	-	-	-
Russia	0.4	4.0	1.0	-	1.5	2.0	1.0	0.0	0.3	-2.0	-1.0	0.0	1.0	-1.0	1.5
Tajikistan	-0.5	10.3	-3.0	-	-5.3	-	-	5.0	1.3	-	-	-	-	-	-
Turkmenistan	-14.5	8.5	-15.0	-	-18.5	-	-	-10.0	-14.5	-	-	-	-	-	-
Ukraine	-4.1	8.0	-3.0	-	-3.0	-	-	-5.0	-2.5	-6.0	-8.0	0.0	-4.0	-	-5.0
Uzbekistan	1.4	4.9	1.0	-	2.2	-	-	-1.5	3.4	-	-	-	-	-	2.0
Average	1.3	8.0	1.0	-	1.1	2.0	3.5	1.3	1.6	-1.0	-4.5	0.0	-1.5	-1.0	0.3
Weighted average ⁴	0.4	-	0.8	-	1.3	-	-	-0.1	0.6	-	-	-	-	-	-

Notes:

¹ All forecasts quoted here were published or reported to the EBRD between March and September 1997. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

² The number at the bottom of this column refers to the mean of all the average forecasts shown in this table.

³ This column shows the difference between the highest and the lowest of the forecasts.

⁴ Weighted average based on EBRD estimates of size of GDP in each country in 1996. Several institutions calculate their own weighted average. For 1997 IWH estimates GDP growth for eastern Europe and the Baltic states at 3.4% and for the CIS at 2.2%. The comparable data for 1998 are 3.6% and 1.6%.

The EU estimates the weighted average growth rate for 10 countries in eastern Europe and the Baltic states (this group excluding Albania, Croatia and FYR Macedonia) at 3.6% in 1997 and 5.2% in 1998. In their *Review and Outlook for Eastern Europe*, PlanEcon gives an aggregate growth rate for this part of the region of 3.6% in 1997 and 4.4% in 1998. However, the country coverage differs from that shown here. PlanEcon excludes the Baltic states and includes Serbia.

⁵ United Nations Economic Commission for Europe.

⁶ Institute for Economic Research, Halle, Federal Republic of Germany.

⁷ Kopint-Datorg is the Institute for Economic and Market Research, Hungary.

⁸ Credit Suisse First Boston.

⁹ Union Bank of Switzerland.

Table 8.2

GDP growth forecasts for 1998

(in per cent) ¹

Eastern Europe and the Baltic states	Average ²	Range ³	EBRD (Aug 97)	European Union (Mar 97)	OECD (June 97)	Economist	PlanEcon (July/ Aug 97)	IWH ⁵ (Aug 97)	Kopint- Datorg ⁶ (July 97)	Vienna Institute (July 97)	CSFB ⁷ (Aug 97)	JP Morgan (July 97)	UBS ⁸ (June 97)
						Intelligence Unit (July 97)							
Albania	8.9	10.7	10.0	-	-	3.0	13.7	-	-	-	-	-	-
Bulgaria	2.2	10.5	2.5	2.9	2.0	5.5	3.6	2.0	-5.0	3.0	-	2.3	3.0
Croatia	5.2	1.5	5.0	-	-	6.0	4.9	-	4.5	5.0	5.6	-	5.5
Czech Republic	2.5	4.0	2.5	5.0	2.0	3.0	3.6	2.5	2.0	2.0	1.0	2.5	1.5
Estonia	4.4	3.0	5.0	3.0	-	4.0	4.6	4.0	-	-	-	-	6.0
FYR Macedonia	5.1	0.4	5.0	-	-	5.0	5.4	-	-	-	-	-	-
Hungary	4.0	2.2	4.0	3.0	3.5	4.4	5.2	3.5	3.5	4.0	4.0	3.5	5.0
Latvia	4.6	2.9	5.0	3.2	-	5.0	5.9	3.0	-	-	-	-	5.5
Lithuania	4.3	2.5	5.5	4.5	-	4.0	3.4	3.0	-	-	-	-	5.5
Poland	5.0	3.0	5.0	7.0	4.9	5.3	4.9	5.0	4.0	6.0	4.0	4.7	4.0
Romania	1.9	4.0	1.5	0.9	3.0	4.0	3.3	0.0	0.0	2.0	-	-	2.3
Slovak Republic	3.7	3.8	3.0	5.4	5.0	3.0	1.6	3.5	2.5	5.0	-	-	4.0
Slovenia	4.3	2.3	4.5	4.8	4.0	3.9	5.3	4.0	3.0	4.0	-	-	5.0
Average	4.3	3.2	4.5	4.0	3.5	4.3	5.0	3.1	1.8	3.9	3.7	3.3	4.3
Weighted average ⁴	4.0	0.5	4.0	-	-	4.5	4.4	-	-	-	-	-	-
Commonwealth of Independent States													
Armenia	5.1	0.2	5.0	-	-	5.0	5.2	-	-	-	-	-	-
Azerbaijan	6.9	2.5	8.5	-	-	6.0	6.3	-	-	-	-	-	-
Belarus	0.6	10.0	2.5	-	-	4.0	-6.0	2.0	-	-	-	-	-
Georgia	9.5	2.4	10.0	-	-	8.0	10.4	-	-	-	-	-	-
Kazakhstan	3.7	1.0	3.5	-	-	4.0	4.2	-	-	-	-	-	3.2
Kyrgyzstan	4.8	0.6	5.0	-	-	5.0	4.4	-	-	-	-	-	-
Moldova	4.0	6.9	3.0	-	-	1.0	7.9	-	-	-	-	-	-
Russia	2.8	4.0	3.0	-	5.0	2.0	3.2	2.0	1.0	2.0	3.0	3.0	4.0
Tajikistan	2.6	5.0	0.0	-	-	5.0	2.9	-	-	-	-	-	-
Turkmenistan	3.7	8.0	8.0	-	-	0.0	3.0	-	-	-	-	-	-
Ukraine	1.1	5.0	2.0	-	-	1.0	1.5	-2.0	0.0	3.0	3.0	-	0.0
Uzbekistan	2.7	4.0	2.5	-	-	1.0	5.0	-	-	-	-	-	2.2
Average	4.0	4.5	4.4	-	5.0	3.5	4.0	0.7	0.5	2.5	3.0	3.0	2.4
Weighted average ⁴	2.8	-	3.1	-	-	2.2	3.2	-	-	-	-	-	-

Notes:

¹ All forecasts quoted here were published or reported to the EBRD between March and September 1997. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

² The number at the bottom of this column refers to the mean of all the average forecasts shown in this table.

³ This column shows the difference between the highest and the lowest of the forecasts.

⁴ Weighted average based on EBRD estimates of size of GDP in each country in 1996. Several institutions calculate their own weighted average. For 1997 IWH estimates GDP growth for eastern Europe and the Baltic states at 3.4% and for the CIS at -2.2%. The comparable data for 1998 are 3.6% and 1.6%.

The EU estimates the weighted average growth rate for 10 countries in eastern Europe and the Baltic states (this group excluding Albania, Croatia and FYR Macedonia) at 3.6% in 1997 and 5.2% in 1998. In their *Review and Outlook for Eastern Europe*, PlanEcon gives an aggregate growth rate for this part of the region as 3.6% in 1997 and 4.4% in 1998. However, the country coverage differs from that shown here. PlanEcon excludes the Baltic states and includes Serbia.

⁵ Institute for Economic Research, Halle, Federal Republic of Germany.

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

⁷ Credit Suisse First Boston.

⁸ Union Bank of Switzerland.

The economic problems in Albania, Bulgaria and Romania have resulted in a substantial increase in the (unweighted) annual average inflation rate for all countries in the group to over 100 per cent in 1997 (see Table 8.3).³ Most of the forecasters expect that the stabilisation programmes currently being implemented by the authorities in both Bulgaria and Romania will be successful, and most also appear to have assumed that Albania's economy will gradually return to normality. Thus in 1998 this group of countries is projected to record growth of 4 per cent combined with a further decline in inflation (an average of some 15 per cent – see Table 8.4).⁴

Growth forecasts for the economies of eastern Europe and the Baltic states compare favourably with growth prospects in western Europe. In their latest *Economic Outlook* (June 1997), the OECD projects GDP growth in the EU at 2.3 per cent in 1997, rising to 2.7 per cent in 1998. However, the success in lowering inflation in most of the industrial countries has resulted in an OECD projection of EU inflation (measured by changes in the GDP deflator) of 1.8 per cent in 1997 and 1.9 per cent in 1998 (and in Germany, the main Western market for a number of countries in this group, inflation is projected at a little over 1 per cent per annum in both years). Thus most of these transition economies are likely to continue to experience some further real appreciation of their exchange rates, especially those that are linked to the Deutschmark.

The impact of shocks to these economies provides one way of distinguishing between them. The Czech Republic, Hungary, Latvia and Lithuania have all experienced economic shocks and have implemented or are implementing measures to ensure a return to steady growth. A second group of countries (Croatia, Estonia, FYR Macedonia, Poland, the Slovak Republic and Slovenia) have to date all achieved steady or, in the cases of Poland and the Slovak Republic, strong rates of economic growth. With the exception of Slovenia, however, they have all experienced large or increasing current account deficits (discussed in more detail in Chapter 7). In 1996 the current account deficits were 10 per cent or more of GDP in Estonia and the Slovak Republic, and 7 per cent of GDP in Croatia and FYR Macedonia. Poland recorded only a small current account deficit in 1996, but it has increased in 1997. Thus one of the main issues facing these countries is their need to be prepared to restrain the growth of domestic demand to lower the trade and current account deficits to more sustainable levels. It is this factor which lies behind some of the projections for 1998 of either slower growth or growth maintained at a similar level to that expected for 1997. The third group of countries, comprising Albania, Bulgaria and Romania, have all been subject to severe struc-

tural problems resulting in negative growth in 1997 and a sharp increase in inflation.

Among the first group of countries, a number of the forecasters, including the EBRD, believe that the stabilisation and reform package introduced by the Hungarian government in 1995 has been successful and will lead to a period of steady growth. After a period of modest GDP growth in both 1995 and 1996 (of 1.5 per cent and 1 per cent respectively), growth is projected to strengthen to 4 per cent in 1998, with both PlanEcon and UBS projecting even stronger growth. Most forecasters project a further gradual decline in inflation to an annual average of 14 per cent in 1998 and to below this level by the end of 1998.

The effects of the 1995 banking crisis and the associated recession in Latvia are now being overcome, and forecasters project a strengthening of GDP growth from an average of 3.5 per cent in 1997 to 4.6 per cent in 1998. The EBRD and several other forecasters expect the economy to grow by 5 per cent or more in 1998. Lithuania, which experienced the largest cumulative decline of GDP among the three Baltic states, is projected to grow by a little over 4 per cent per annum in both years. There is broad agreement among the forecasters that inflation in both countries will fall quite sharply in 1997, and then more gradually to around 8 per cent in 1998. The range surrounding the inflation estimates for 1998 is greater in the case of Lithuania, which may reflect some uncertainty in the forecasters' minds about the future exchange rate regime. The Lithuanian government has recently indicated that it is considering abolishing the currency board (established in 1994), although it has stated that it will retain the exchange rate peg which has been in operation since 1993.

In the Czech Republic the impact of the Government's fiscal measures, as well as higher interest rates – a further legacy of the currency problems in May 1997 – are expected to slow the growth of domestic demand in both 1997 and 1998. This, in turn, should result in an improvement in the trade and current account deficits. Among the projections shown here, there is a marked difference between those prepared before and after the fall of the currency in May: most of the more recent projections anticipate growth of between 1 and 2 per cent in 1997, followed by a gradual recovery in 1998. The impact of the recent floods on economic activity cannot yet be estimated with any precision since some lost output may be restored, while there will also be a boost to construction activity as repairs to the infrastructure are completed. A combination of higher administered prices and the fall in the exchange rate is expected to lead to a small increase in the annual average inflation rate in both years, although inflation is projected to be on a downward trend by the end of 1998. Kopint-Datorg, however, projects a sharp increase in inflation in 1998.

³ If Bulgaria is excluded, the unweighted average falls to 23%.

⁴ The year-end inflation rate of 71% for these countries (see Table 8.5) is an indication that forecasters expect inflation to be steadily reduced during the remainder of the year. However, the fact that the 1998 end-year inflation figure of a little over 12% (see Table 8.6) is not so very different from the annual average rate suggests that some countries may have difficulty in securing further large declines, especially where further increases in administered prices are required.

Table 8.3

Inflation forecasts for 1997

(change in the average consumer price level, in per cent) ¹

Eastern Europe and the Baltic states	Average ²	Range ³	EBRD (Aug 97)	European Union (Mar 97)	IMF (Sept 97)	OECD ⁴ (June 97)	Economist Intelligence Unit (July 97)	PlanEcon (July/ Aug 97)	IWH ⁵ (Aug 97)	Kopint- Datorg ⁶ (July 97)	Vienna Institute (July 97)	CSFB ⁷ (Aug 97)	JP		
													Morgan (July/ Aug 97)	UBS ⁸ (Aug 97)	
Albania	49.1	36.6	33.4	-	52.0	-	70.0	41.1	-	-	-	-	-	-	-
Bulgaria	1,050.6	1,090.0	1,049.0	1,500.0	1,059.2	-	1,030.0	1,068.0	410.0	1,000.0	1,200.0	-	1,100.0	1,090.0	-
Croatia	3.9	1.6	3.7	-	3.6	-	4.2	3.9	-	4.6	4.5	4.0	-	3.0	-
Czech Republic	8.9	5.0	9.5	8.5	9.0	7.8	8.5	9.1	7.0	12.0	9.0	9.0	8.5	8.6	-
Estonia	11.9	4.5	11.0	15.0	11.8	-	12.0	10.5	12.0	-	-	-	-	11.0	-
FYR Macedonia	5.6	5.3	6.0	-	2.0	-	7.0	7.3	-	-	-	-	-	-	-
Hungary	17.8	2.5	18.0	18.0	18.0	17.7	18.5	17.5	16.0	18.5	18.0	17.0	18.2	18.0	-
Latvia	9.2	3.7	8.0	11.7	10.0	-	9.8	8.2	8.0	-	-	-	-	8.5	-
Lithuania	8.9	3.5	9.0	10.5	10.0	-	9.3	8.2	7.0	-	-	-	-	8.5	-
Poland	15.4	2.5	16.0	15.0	15.0	15.3	16.3	14.5	14.0	15.0	16.0	16.5	15.3	16.0	-
Romania	137.5	62.0	145.0	98.0	108.9	-	150.0	153.2	100.0	160.0	160.0	150.0	-	150.0	-
Slovak Republic	6.8	2.0	6.5	6.0	6.5	-	7.2	7.1	8.0	8.0	6.5	6.5	-	6.0	-
Slovenia	8.9	1.1	9.0	8.2	8.6	-	9.3	8.5	9.0	9.0	9.0	9.0	-	8.9	-
Average	102.7	93.9	101.9	169.1	101.1	13.6	104.0	104.4	59.1	153.4	177.9	30.3	285.5	120.8	(32.8) ⁹
Commonwealth of Independent States															
Armenia	12.0	7.1	15.0	-	7.9	-	14.0	11.1	-	-	-	-	-	-	-
Azerbaijan	7.1	2.4	7.0	-	7.0	-	6.0	8.4	-	-	-	-	-	-	-
Belarus	73.6	20.0	78.0	-	76.0	-	80.0	74.1	60.0	-	-	-	-	-	-
Georgia	9.9	4.0	9.0	-	12.0	-	8.0	10.4	-	-	-	-	-	-	-
Kazakhstan	19.0	2.4	18.0	-	20.4	-	19.0	18.5	-	-	-	-	-	19.0	-
Kyrgyzstan	28.3	3.0	27.0	-	27.2	-	30.0	28.9	-	-	-	-	-	-	-
Moldova	13.0	5.6	12.0	-	11.4	-	17.0	11.4	-	-	-	-	-	-	-
Russia	16.1	3.5	17.0	-	15.8	-	16.0	16.1	14.5	18.0	16.0	16.0	16.2	15.5	-
Tajikistan	46.0	28.0	60.0	-	32.0	-	50.0	42.0	-	-	-	-	-	-	-
Turkmenistan	115.3	125.0	90.0	-	96.0	-	200.0	75.0	-	-	-	-	-	-	-
Ukraine	20.5	13.5	20.0	-	17.0	-	18.0	18.4	20.0	20.0	30.0	16.5	-	25.0	-
Uzbekistan	77.0	95.0	65.0	-	70.0	-	140.0	65.2	-	-	-	-	-	45.0	-
Average	36.5	25.8	34.8	-	32.7	-	49.8	31.6	31.5	19.0	23.0	16.3	16.2	26.1	(16.2) ⁹

Notes:

¹ All forecasts quoted here were published or reported to the EBRD between March and September 1997. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

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

³ This column shows the difference between the highest and the lowest of the forecasts.

⁴ Inflation is based on the private consumption deflator.

⁵ Institute for Economic Research, Halle, Federal Republic of Germany.

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

⁷ Credit Suisse First Boston.

⁸ Union Bank of Switzerland.

⁹ The figure in brackets is the Institute's own weighted average of inflation in the region.

With respect to the second group of countries, there is a broad consensus among the forecasters that growth in the Polish economy will slow to 5 per cent by 1998, although this remains well above the regional average. There is also a consensus that inflation will continue to fall, reflected in the narrow range between the forecasts. The main issue raised by several forecasters, for example the Vienna Institute, is the increase in the current account deficit during the first half of 1997. It is acknowledged that there are important differences between Poland and the Czech Republic – for example, the crawling peg exchange rate regime in Poland compared with the Czech Republic's former peg to a currency basket,⁵ which has resulted in a more modest appreciation of the real exchange rate. Nevertheless the forecasters' views suggest that there may be a need for fiscal measures to supplement the monetary tightening that has already occurred.

Most forecasters expect growth to slow in the Slovak Republic from the 6.9 per cent recorded in 1996 to below 4 per cent in 1998, partly because of the weakening of industrial production. PlanEcon projects a sharp deceleration in growth in 1998 as the government is assumed to implement measures to lower the current account deficit. The EU, the OECD and the Vienna Institute, however, project growth at 5 per cent or more in both 1997 and 1998. The average of the inflation projections indicates a small rise in the average annual rate, with both PlanEcon and Kopint-Datorg projecting faster increases.

Growth in Estonia is also projected to slow (to 4.4 per cent on average) in 1998 by virtually all the forecasters shown – the main exception is UBS, which projects growth remaining at 6 per cent. The currency board has contributed to lower inflation, and most forecasters project further declines to an average of 10.8 per cent in 1998. The main exception is IWH, which projects an increase in inflation to 14 per cent.

The near-term prospects for Croatia and FYR Macedonia are seen as favourable by most forecasters, although the sustainability of their current account deficits is one of the main uncertainties behind the projections. There is a broad consensus among the forecasters that the Croatian economy will grow at 5 per cent per annum in both 1997 and 1998 following the modest recovery in output last year, and that growth will strengthen to an average of 5 per cent in 1998 in FYR Macedonia. In 1996 both countries recorded very low rates of inflation. In Croatia much of this is due to the firm monetary policy of the central bank with a stable nominal exchange rate. All the forecasters project a continuation of low inflation, although the annual average rate is projected to increase to 5 per cent in 1998. There is, however, some difference between the more optimistic projections of both the EBRD and UBS and those of PlanEcon. From the few projections available for FYR Macedonia, inflation is expected to increase from 5.6 per cent in 1997 to 8 per cent in 1998 as the recovery strengthens.

As noted above, Slovenia is the main exception in this group of countries since it recorded a small surplus on its current account in 1996. Virtually all the forecasters anticipate some increase in growth combined with a further fall in inflation in 1998. One reason why Slovenia has run a current account surplus in three of the last four years has been the restrictions on capital inflows, which have limited the scope for financing deficits and have also ensured that the real exchange rate has remained broadly constant in recent years. Although both PlanEcon and UBS project stronger than average growth rates in 1998, they also mention the slow pace of industrial restructuring.

Of the countries in the third group, both Bulgaria and Romania are currently implementing tough stabilisation programmes and accelerating structural reforms, supported by Stand-by Arrangements with the IMF. In the case of Bulgaria, the stabilisation programme is centred on the currency board (established on 1 July), with the currency pegged to the Deutschmark. Most of the forecasters expect the stabilisation programmes to contribute to a return to positive growth in both countries in 1998 (only PlanEcon projects positive growth in Romania in 1997), combined with a reduction in inflation. The range surrounding these estimates for 1998 is, however, inevitably quite wide. Thus in the case of Bulgaria, Kopint-Datorg projects a further decline in output in 1998 (of 5 per cent) with low inflation. This may be compared with the more bullish growth projections from the EIU and PlanEcon. In the case of Romania, although most forecasters project modest growth in 1998, IWH and Kopint-Datorg project zero growth; the large range on the inflation projections for 1998 is mainly because of the high estimate from UBS.

The task of making projections for Albania is particularly difficult owing to the shortage of reliable information and data following the collapse in the authority of the central government earlier in 1997 after the failure of several financial pyramid schemes. There is, nevertheless, some similarity between the relatively few projections that are available in so far as all the forecasters expect a rebound in growth in 1998 following the sharp contraction in economic activity in 1997. In addition, there is broad agreement that the annual average rate of inflation will fall in 1998. These estimates should, however, be treated with caution in view of the uncertainty over the extent of the disruption to the economy and over the terms of the programme that the government is negotiating with the IMF.

8.2 Projections of growth and inflation for 1997 and 1998 for the Commonwealth of Independent States

GDP in the CIS is projected to increase from only 0.4 per cent in 1997 to a little under 3 per cent on a weighted average basis in 1998, with the EBRD marginally more optimistic about growth prospects for the CIS in both years. Most forecasters expect that nearly all the countries in the region will record positive growth by 1998 and, if this were attained, it would mark the first year of

⁵ The Czech koruna was pegged to a basket comprising the US dollar and the DM until May 1997. The fluctuation band was very narrow (+/-0.5%) until the end of February 1996 when the band was widened to +/- 7.5%.

Table 8.4

Inflation forecasts for 1998

(change in the average consumer price level, in per cent) ¹

Eastern Europe and the Baltic states	Average ²	Range ³	EBRD (Aug 97)	European Union ⁴ (Mar 97)	OECD ⁴ (June 97)	Economist Intelligence Unit		PlanEcon (July/Aug 97)	IWH ⁵ (Aug 97)	Kopint- Datorg ⁶ (July 97)	Vienna Institute (July 97)	CSFB ⁷ (Aug 97)	JP Morgan (July/Aug 97)	UBS ⁸ (Aug 97)
						(July/Aug 97)	(July/Aug 97)							
Albania	26.6	15.7	17.0	-	-	30.0	32.7	-	-	-	-	-	-	-
Bulgaria	33.4	40.0	37.0	50.0	-	25.0	33.0	38.0	10.0	30.0	-	-	32.4	45.0
Croatia	5.0	3.8	4.0	-	-	4.8	7.3	-	5.0	5.5	5.0	-	-	3.5
Czech Republic	10.0	10.2	8.5	8.4	8.4	8.5	9.3	9.5	18.0	12.0	9.3	10.0	7.8	
Estonia	10.8	4.0	10.0	10.0	-	10.0	10.9	14.0	-	-	-	-	10.0	
FYR Macedonia	7.9	2.8	6.5	-	-	8.0	9.3	-	-	-	-	-	-	
Hungary	14.0	4.0	14.0	13.0	15.5	16.0	13.5	12.0	14.0	13.0	14.8	15.4	13.0	
Latvia	7.7	2.2	7.0	8.4	-	9.2	7.0	7.0	-	-	-	-	7.5	
Lithuania	8.2	4.1	9.0	8.0	-	8.5	10.1	6.0	-	-	-	-	7.5	
Poland	12.9	3.5	14.0	12.0	11.5	12.5	11.8	12.0	15.0	13.0	13.5	12.9	13.5	
Romania	45.2	60.0	40.0	38.0	-	45.0	38.8	25.0	50.0	40.0	-	-	85.0	
Slovak Republic	7.6	7.0	6.5	5.5	-	8.0	11.0	6.0	12.0	7.0	-	-	5.0	
Slovenia	8.2	2.1	8.0	9.2	-	8.5	7.1	8.0	8.0	9.0	-	-	7.5	
Average	15.2	12.3	14.0	16.3	11.8	14.9	15.5	13.8	16.5	16.2	10.7	17.7	18.7	
								(12.9) ⁹						
Commonwealth of Independent States														
Armenia	16.1	6.0	14.0	-	-	20.0	14.3	-	-	-	-	-	-	-
Azerbaijan	8.5	3.6	6.5	-	-	9.0	10.1	-	-	-	-	-	-	-
Belarus	88.7	65.0	105.0	-	-	110.0	94.9	45.0	-	-	-	-	-	-
Georgia	8.9	2.5	7.5	-	-	10.0	9.1	-	-	-	-	-	-	-
Kazakhstan	12.8	7.5	11.0	-	-	17.5	12.7	-	-	-	-	-	10.0	
Kyrgyzstan	24.5	1.4	25.0	-	-	25.0	23.6	-	-	-	-	-	-	
Moldova	11.2	3.5	9.5	-	-	13.0	11.0	-	-	-	-	-	-	
Russia	13.8	9.0	13.0	-	-	14.0	13.1	12.5	20.0	15.0	11.0	13.0	12.5	
Tajikistan	40.6	9.0	36.0	-	-	45.0	40.8	-	-	-	-	-	-	
Turkmenistan	109.0	142.0	58.0	-	-	200.0	69.0	-	-	-	-	-	-	
Ukraine	19.1	10.0	18.0	-	-	16.0	16.5	17.0	25.0	25.0	15.0	-	20.0	
Uzbekistan	52.7	48.0	32.0	-	-	80.0	63.6	-	-	-	-	-	35.0	
Average	33.8	25.6	28.0	-	-	46.6	31.6	24.8	22.5	20.0	13.0	13.0	19.4	
								(13.8) ⁹						

Notes:

- ¹ All forecasts quoted here were published or reported to the EBRD between March and September 1997. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.
- ² The number at the bottom of this column is calculated as the mean of all the average forecasts shown in this column.
- ³ This column shows the difference between the highest and the lowest of the

forecasts.

- ⁴ Inflation is based on the private consumption deflator.
- ⁵ Institute for Economic Research, Halle, Federal Republic of Germany.
- ⁶ Kopint-Datorg is the Institute for Economic and Market Research, Hungary.
- ⁷ Credit Suisse First Boston.
- ⁸ Union Bank of Switzerland.
- ⁹ The figure in brackets is the Institute's own weighted average of inflation in the region.

growth for both Tajikistan and Ukraine since 1989 and for Turkmenistan since 1990.

The growth prospects for the region are still largely dependent on the performance of Russia since it accounts for some 75 per cent of the region's GDP. Although many CIS countries have diversified their exports so that intra-CIS trade now represents a smaller share of total trade than before, there is little doubt that the resumption of growth in Russia would contribute to the recovery in most of the other CIS countries. Thus the timing of the recovery in Russia is important to these economies. However, it is an issue on which the majority of forecasters have proved over-optimistic in the past. The average of those forecasts included in both the 1995 and 1996 *Transition Reports* projected a recovery in Russia in 1996 (of 1.6 per cent) and then in 1997 (of 2 per cent). In practice, recorded output fell by 6 per cent in 1996 and the latest average estimate is for growth of just 0.4 per cent in 1997. Of those projections of GDP growth in 1996 that were included in the 1995 *Transition Report*, for example, only the Vienna Institute projected a decline in output (of 3 per cent). It is difficult to be precise as to why forecasters have proved over-optimistic about the timing of the economic recovery in Russia. However, one important factor has been the tendency to overestimate the pace of enterprise restructuring (perhaps making insufficient allowance for the pattern of ownership and corporate governance, which are not always conducive to rapid restructuring).

It should be noted, however, that there is also greater uncertainty over the levels of output in many of the other CIS countries compared with eastern Europe and the Baltic states. In Russia and Ukraine, for example, it is probable that there is a significant under-recording of output as current reporting systems fail to capture some of the output from the growing private sector, while some enterprises almost certainly under-record their activity to reduce their tax burden. More generally, a combination of high tax rates and excessive regulation means that much activity is carried out in the informal sector which, by definition, is not reflected in the official data. If governments in the region were to implement measures that could quickly improve the business environment, for example removing many of the regulations and bureaucracy that enterprises have to contend with, it is possible that there could be an initial boost to measured growth as the informal sector became absorbed into the official economy.

The (unweighted) annual average rate of inflation is projected to decline from 37 per cent in 1997 to 34 per cent in 1998, although this average is heavily influenced by the high rates projected for Belarus, Turkmenistan and Uzbekistan. Several countries are expected to record inflation rates below 20 per cent by 1998. Whereas forecasters have been too optimistic about the timing of the recovery in Russia, as noted in the 1996 *Transition Report*, there has also been a tendency to underestimate the sharp decline

in inflation in recent years in some countries, especially where inflation was at high levels. Even though inflation is now generally at much lower levels, this tendency has continued. For example, in the 1996 *Transition Report*, the average annual inflation for the CIS in 1997 was projected at 69 per cent. The decline in inflation reflects the success in implementing stabilisation policies in many countries. In both Russia and Ukraine, for example, lower inflation and attractive yields have increased the demand for government securities. With these markets open to foreign purchasers of such paper, the resulting capital inflows have contributed to greater exchange rate stability, thereby also helping to slow inflation. The attainment of lower inflation will, however, depend crucially on maintaining stabilisation policies and dealing with the problem of tax arrears so that the fiscal position is not undermined.

It is possible to identify three main groups of countries across which the path of economic recovery is projected to differ. The first is Russia, where there is still no real consensus among forecasters as to whether 1997 will mark the first year of positive economic growth. The second group comprises Armenia, Azerbaijan, Georgia, Kazakhstan and Kyrgyzstan, where there is a broad consensus among the forecasts shown here that these countries will record positive growth in both 1997 and 1998. The prospects are rather more uncertain for the countries in the third group, generally reflected in the wider ranges surrounding the estimates of growth and inflation. These countries are Belarus, Moldova, Tajikistan, Turkmenistan, Ukraine and Uzbekistan, which tend to be characterised by low or negative growth, reflecting the slow pace of reform, and in certain cases by relatively high rates of inflation.

The range surrounding the growth estimates for Russia is fairly wide, with some forecasters projecting a modest recovery and others zero or negative growth. The uncertainty is primarily over the timing of the recovery. Most forecasters expect growth to strengthen in 1998 (to an average of almost 3 per cent), with the OECD and UBS projecting strong recoveries. They also anticipate further declines in inflation, with average rates declining from 16 per cent in 1997 to below 14 per cent by 1998. The main exception is Kopint-Datorg, which projects higher inflation in 1998. The EBRD expects the Russian economy to grow at 1 per cent in 1997, strengthening to 3 per cent in 1998. This is mainly dependent on the authorities maintaining low inflation, ensuring a stable and predictable exchange rate and some easing of monetary policy, which would result in lower interest rates.

Several of the countries in the second group have recorded substantial current account deficits – in excess of 20 per cent of GDP in 1996 in both Armenia and Kyrgyzstan and 19 per cent in Azerbaijan, which places some uncertainty on projections. Both Armenia and Georgia were among the first countries in the CIS to move out of recession, and the strong growth rates that have been

Table 8.5

Forecasts of year-end inflation for 1997(change in the year-end consumer price level, in per cent) ¹

Eastern Europe and the Baltic states	Average ²	EBRD (Aug 97)	OECD (June 97)	Economist Intelligence Unit (July/Aug 97)	PlanEcon (July/Aug 97)	CSFB ³ (Aug 97)	JP Morgan (July/Aug 97)
Albania	48.2	41.5	-	50.0	53.1	-	-
Bulgaria	653.8	592.0	1,000.0	530.0	561.0	650.0	590.0
Croatia	4.6	4.0	-	5.0	4.9	4.5	-
Czech Republic	9.7	9.0	-	8.4	11.0	10.0	10.2
Estonia	11.4	12.0	-	12.0	10.1	-	-
FYR Macedonia	8.1	8.0	-	8.0	8.4	-	-
Hungary	17.5	17.0	-	18.5	16.6	18.0	17.5
Latvia	8.0	8.0	-	9.4	6.7	-	-
Lithuania	8.7	10.0	-	9.0	7.0	-	-
Poland	14.2	14.5	-	15.0	13.4	14.0	14.3
Romania	129.5	116.0	130.0	130.0	136.7	135.0	-
Slovak Republic	7.7	7.0	6.0	8.8	9.8	7.0	-
Slovenia	8.9	8.8	9.0	9.5	8.2	9.0	-
Average	71.6	65.2	286.3	62.6	65.1	105.9	158.0
Commonwealth of Independent States							
Armenia	18.5	19.0	-	22.0	14.5	-	-
Azerbaijan	7.7	6.5	-	6.0	10.7	-	-
Belarus	98.8	99.0	-	100.0	97.5	-	-
Georgia	8.9	8.5	-	10.0	8.1	-	-
Kazakhstan	15.0	12.0	-	18.0	-	-	-
Kyrgyzstan	24.4	24.0	-	25.0	24.3	-	-
Moldova	12.1	11.0	-	15.0	10.3	-	-
Russia	15.0	14.0	15.0	16.0	15.5	14.0	15.2
Tajikistan	68.2	105.0	-	35.0	64.7	-	-
Turkmenistan	96.3	44.0	-	200.0	45.0	-	-
Ukraine	16.8	15.0	-	18.0	17.5	-	-
Uzbekistan	65.9	40.0	-	140.0	67.1	16.5	-
Average	37.3	33.2	15.0	50.4	34.1	15.3	15.2

Notes:

¹ All forecasts quoted here were published or reported to the EBRD between March and September 1997. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

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

³ Credit Suisse First Boston.

attained reflect partly a rebound from a low base (in 1996, using cumulative reported growth rates, GDP was estimated at 37 per cent and 31 per cent respectively of the level in 1989). The annual average rate of inflation is projected to remain at relatively low levels in Georgia, but to increase in Armenia to 14 per cent according to the EBRD, partly because of an earlier loosening of fiscal and monetary policies. Successful implementation of stabilisation policies has contributed to the steady recovery that Kyrgyzstan has experienced since 1995. There is a broad consensus among the forecasters that growth will be maintained, accompanied by further declines in inflation. Economic prospects will rely heavily on the coming on stream of the Kumtor gold mine, and over the medium term the mine should make a significant contribution to increasing growth and reducing the current account deficit.

The huge energy resource base is the factor that distinguishes both Azerbaijan and Kazakhstan from the other countries in this group.

In the short term, successful stabilisation policies have led most forecasters to project stronger growth in 1998 accompanied by a further fall in inflation in Kazakhstan and the maintenance of low inflation in Azerbaijan. Inflation in Azerbaijan is, however, projected at slightly higher rates than those attained at the end of 1996. The EBRD is relatively optimistic about the prospects for inflation, reflecting the impact of capital inflows on the exchange rate. The longer-term prospects for both of these countries will depend on the successful development of their oil and gas reserves. In recent quarters both countries have recorded increases in flows of foreign direct investment, much of which is related to the oil and gas sector, and these flows should provide an important means of financing the current account deficits.

Among the countries in the third group, both Moldova and Ukraine have had success in lowering inflation and are projected to record positive growth in 1998 (the average estimate of positive growth for Moldova in 1997 is heavily influenced by the optimistic "national

source" in the United Nations ECE projection). In the case of Ukraine several forecasters, including the EBRD, expect the rate of decline in the economy to slow in the second half of 1997, leading to positive growth in 1998. The average growth rate in 1998 is, however, projected at only around 1 per cent, and the range surrounding this estimate remains quite wide. The expectation that the economy is beginning to bottom out, with the prospect of an increase in agricultural output, lie behind the EBRD's projection of a gradual recovery in 1998. A period of sustained growth will depend on government measures to remove some of the constraints to private sector activity and investment. There has been a further sharp fall in inflation in 1997 owing to a tight monetary policy and the stability of the exchange rate. Thus inflation is expected to fall to an annual average rate of 20 per cent in 1997. There are good prospects that inflation will fall further during 1998, although this partly depends on strengthening the fiscal position and in particular resolving the problem of the budgetary wage and pension arrears.

Further declines in output are also expected in both Tajikistan and Turkmenistan in 1997, with the prospect of both recording positive growth in 1998. The EBRD is optimistic about the prospects for Turkmenistan, projecting a strong rebound in growth at 8 per cent in 1998, reflecting higher cotton production after the poor harvests of the two previous years and higher gas exports. Inflation has been lowered in both countries, although in Turkmenistan the rate of inflation is projected to experience a temporary increase towards the end of 1997 before falling to 45 per cent at the end of 1998. Both the EBRD and PlanEcon are considerably more optimistic than the EIU on the prospects for stabilisation in this country.

Both Belarus and Uzbekistan are projected to record positive growth by most of the forecasters (although the range of the growth estimates is large in the case of Belarus), but inflation is projected to be at a higher level at the end of 1997 than it was in 1996. In both cases this reflects slippage in stabilisation policies following the suspension of respective IMF programmes, accentuated by the slow pace of structural reforms in the case of Belarus. In both countries there was a marked deterioration in the trade account in 1996, resulting in current account deficits of between 6 and 8 per cent of GDP. The limited availability of official financing in these circumstances suggests some fiscal adjustment will be required during the course of 1998.

8.3 Conclusion

The forecasts surveyed in this chapter provide a mixed view of the region's prospects. The general trend remains one of robust growth in eastern Europe and the Baltic states and a gradual return to growth in the CIS, most importantly in Russia. Several of the leading countries in transition are projected to experience temporary declines in their growth rates as a result of the implementation of policy changes to slow the growth of domestic demand in view of their growing external imbalances. For another group of countries, macroeconomic shocks have been linked to weaknesses in structural reforms. For these countries, including

Albania, Bulgaria and Romania in eastern Europe and a number of countries in the CIS, the range of forecasts is large, reflecting the uncertainty over their immediate economic prospects.

Considerable progress has been made with stabilisation throughout the region, and most forecasters expect the rate of inflation throughout the region to continue to decline. There are only a few exceptions where earlier achievements in reducing inflation are projected to be reversed in 1997. These are primarily due to a loosening of monetary and fiscal policies, often combined with a slow pace of structural reform.

Lastly, Box 8.1 addresses one cause of systemic risk linked to deficiencies in structural reforms. Banking crises have contributed to unpredicted reversals in recovery and stabilisation in a number of countries. The box explores the inter-relationships between inher-

Table 8.6

Forecasts of year-end inflation for 1998

(change in the year-end consumer price level, in per cent)¹

Eastern Europe and the Baltic states	Average ²	EBRD (Aug 97)	OECD (June 97)	Economist	PlanEcon (July/Aug 97)	JP Morgan (July/Aug 97)
				Intelligence Unit (July/Aug 97)		
Albania	19.3	18.0	-	20.0	19.8	-
Bulgaria	21.2	24.0	30.0	10.0	21.0	21.0
Croatia	5.6	4.0	-	4.0	8.9	-
Czech Republic	7.9	8.0	-	8.5	6.8	8.3
Estonia	10.1	10.0	-	9.5	10.9	-
FYR Macedonia	8.5	6.5	-	10.0	8.9	-
Hungary	13.8	13.0	-	15.0	12.7	14.5
Latvia	7.4	7.0	-	8.5	6.6	-
Lithuania	9.1	9.0	-	8.5	9.8	-
Poland	11.8	13.0	-	12.0	10.2	12.0
Romania	29.2	25.0	30.0	35.0	26.6	-
Slovak Republic	7.9	6.0	6.0	8.0	11.5	-
Slovenia	7.6	8.0	8.0	8.0	6.5	-
Average	12.3	11.7	-	12.1	12.3	14.0
Commonwealth of Independent States						
Armenia	14.2	11.0	-	17.0	14.7	-
Azerbaijan	9.6	6.2	-	13.0	9.6	-
Belarus	104.8	115.0	-	120.0	79.5	-
Georgia	9.1	7.0	-	9.0	11.3	-
Kazakhstan	13.3	10.5	-	16.0	-	-
Kyrgyzstan	21.0	17.0	-	24.0	22.0	-
Moldova	9.8	8.0	-	10.0	11.4	-
Russia	12.2	12.0	12.0	14.0	11.8	11.0
Tajikistan	33.1	27.0	-	40.0	32.4	-
Turkmenistan	98.7	45.0	-	200.0	51.0	-
Ukraine	16.7	20.0	-	14.0	16.0	-
Uzbekistan	47.6	30.0	-	50.0	62.8	-
Average	32.5	25.7	12.0	43.9	29.3	11.0

Notes:

¹ All forecasts quoted here were published or reported to the EBRD between March and September 1997. The dates in brackets indicate the months in which the forecasts were reported or published by each institution. There may in some instances be substantial lags between preparation and publication of forecasts.

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

ited weaknesses and remaining deficiencies in regulatory frameworks and macroeconomic discipline in causing banking crises in transition economies, and the effect of bank failures on macroeconomic

performance. The analysis underlines the main conclusion emanating from a review of forecasts for the region: the transition process remains fraught with uncertainty and systemic risks.

Box 8.1

Banking failures, banking crises and macroeconomic volatility

Most countries in transition have in recent years experienced the failure of banks, often in large numbers and sometimes, as in Bulgaria and the three Baltic states, with massive consequences for the banking sector and the economy as a whole. In several cases where failures developed into broader crises, this has upset earlier forecasts of economic performance. As stressed in various parts of this Report (see in particular Chapters 2 and 5) banking sectors and the regulation of banks continue to be weak in many transition economies. In addition, the growing stability in the macroeconomic environment poses a challenge to banks since it eliminates sources of easy income. At the same time, remonetisation combined with growing capital inflows is providing banks, weak or strong, with the liquidity to expand loan portfolios at very rapid rates. Together, these factors suggest that there will be pressures on banks in the years ahead as well as opportunities to make mistakes. This adds to the uncertainty over economic forecasts in the region.

Widespread losses in banking sectors and even runs on individual banks – common phenomena throughout the region which are to some extent rooted in the transition process itself – should be carefully distinguished from banking crises. The term “crisis” is associated with significant “contagion effects” and with macroeconomic consequences through linkages with the real economy and impacts on public and international confidence. There are various transmission channels through which liquidity or solvency problems in one or several banks may spread to other parts of the economy. Thus, depositor confidence may be shaken overall, leading to a generalised run on deposits which even essentially healthy banks may not be able to satisfy. Further, the liquidity problems of a bank borrowing on the interbank market may be transmitted to its creditor banks. Banking crises may spread to the foreign exchange markets if depositors look for alternatives to local bank deposits for storing their money. A general loss of confidence in the currency, which may be triggered by a banking crisis, would also tend to fuel inflation, both because of falling money demand and because of exchange rate depreciation. Finally, a liquidity squeeze in the banking sector can reduce the ability of enterprises to borrow and refinance existing obligations. Banking crises involve some degree of financial disintermediation which may depress investment.

The way in which banking crises may upset economic forecasts is well documented by the examples presented in the chart. In the three Baltic states and Bulgaria recent banking crises have caused GDP to perform far worse than projected, albeit to different degrees. Interestingly, with the exception of Bulgaria, the banking crises reviewed here have not led to significant deviations in inflation over the projected level.

Banking crises in transition economies have a number of causes. Three major elements will be distinguished here. The first two of these are particular to the transition process. The third reflects experiences from other parts of the world. Banking crises usually have multiple causes. In any individual episode, the three factors discussed here may be present in different combinations and with varying degrees of intensity.

i) Legacies from the past and continuing lack of restructuring

The transition economies inherited a small number of state-owned banks with regionally and sectorally concentrated portfolios of loans to state-owned enterprises. These loans were often extended at subsidised interest rates and reflected government planning priorities rather than assessments of creditworthiness on the part of the lender. Not surprisingly, many of these loans became effectively non-performing as interest rates were liberalised, and state-owned enterprises suffered the shock of the transition-related recession and simultaneously a hardening of their budget constraints. More stringent regulatory requirements led to a change in loan classifications, exposing the weakness of the inherited portfolios. In many countries government intervention into credit decisions and regulators' connivance in the continuation of unsound lending practices between state-owned banks and enterprises has continued well beyond the start of the transition process. In several countries, governments eventually bailed out insolvent banks at considerable cost to budgets, and sometimes without addressing the underlying causes of the problem, namely bad lending decisions.¹

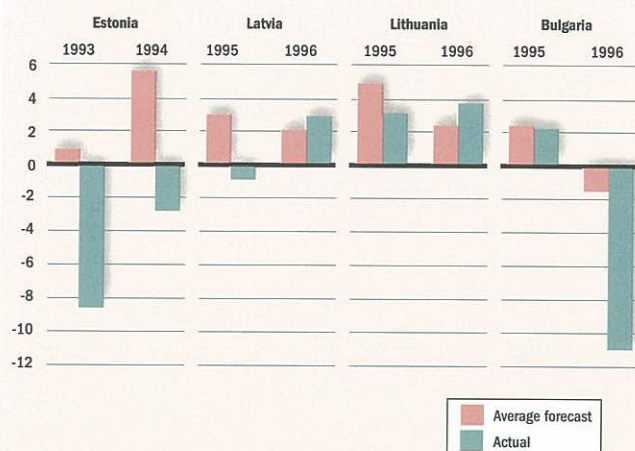
An example of crisis developing from such unsound lending practices is provided by Bulgaria in 1996. Because of continued lending to loss-making state enterprises – with losses amounting to 15 per cent of GDP in 1995 alone – Bulgaria's banking system was essentially insolvent by the end of 1995. The total negative net worth of the sector was estimated at between US\$ 1 billion and US\$ 2 billion. In autumn 1995 various banks developed liquidity problems and were propped up by increasingly massive central bank refinancing. The money creation spilled over into the foreign exchange markets and, from the beginning of 1996, a growing loss of confidence in the currency and successive runs on banks turned into a vicious circle. By March 1997 banks holding 24 per cent of the sector's total assets were subject to bankruptcy procedures. Deposits in the banking sector fell by 75 per cent in real terms over that period. The macroeconomic costs were huge. The exchange rate dropped from 70 BGL/US\$ in December 1995 to 3,200 BGL/US\$ in February 1997, inflation over the 14-month period of January 1996 through February 1997 was 1,878 per cent, GDP contracted by 11 per cent in 1996, and a further 7 per cent decline is projected for 1997.

ii) Undisciplined bank entry

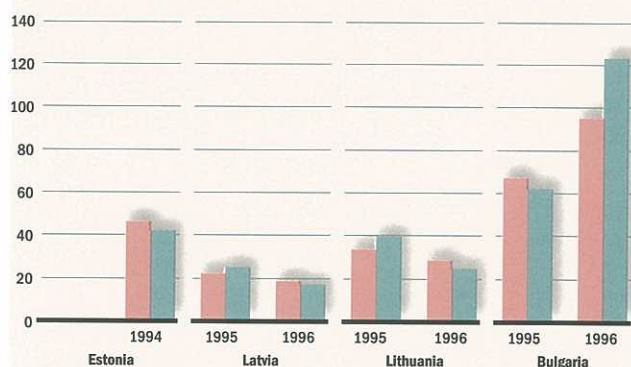
The significance of the inherited bad debt problem was greatly reduced in many transition economies by the very high rates of inflation that characterised the initial transition period. At the same time, lax entry requirements for new banks led to a proliferation of private banks, which were often inadequately capitalised. Some of these had, in fact, been set up by enterprises essentially for their own financial management but were nevertheless permitted to take deposits and participate in the national payments system. With such weak foundations, a process of consolidation has usually followed the period of rapid entry. In many instances, this process has been promoted by the shift to a restrictive monetary policy, such as in the case of Russia, where the tightening of central bank credit precipitated the liquidity crisis of August 1995. As a result, the number of banks declined from a peak of 2,561 in 1995 to 1,887 by June 1997. In the Baltic states the number of banks fell in the aftermath of banking crises from a peak of 43 (1992) to 14 (1996) in Estonia, 61 (1993) to 33 (1996) in Latvia, and 27 (1994) to 12 (1996) in Lithuania. Similar consolidation episodes have occurred throughout the CIS, but generally to a far lesser extent in eastern Europe.

The accuracy of forecasts for GDP growth and average inflation in selected countries affected by banking crises

Growth of GDP, per cent



Consumer price inflation, annual average, per cent



Sources:

EBRD and World Bank.

iii) Rapid remonetisation capital inflows and endemic credit cycles

One potential source of volatility is extremely rapid remonetisation following price stabilisation, a phenomenon that has been observed in several countries of the region. This has led banks to absorb growing liquidity at the very time that previous safe earning opportunities arising from arbitrage on currency markets and high-yielding government securities in the context of price volatility disappeared. In most countries this has so far been achieved successfully. However, it is a lesson of experience, especially from Latin America, that times of rapid liquidity growth are associated with serious information imperfections in the credit market, making client selection (and bank regulation) particularly difficult and increasing the scope for unsound lending.² The growing inflow of foreign capital into an increasingly broad spectrum of countries could, as discussed in Chapter 7, exacerbate the dangers of overheating.

In the transition economies there have been no crises so far that were uniquely or even predominantly associated with the rapid expansion of credit portfolios per se. However, rapid remonetisation certainly magnified the problems of a weak regulatory framework in Latvia and Lithuania.³ In Latvia, the entry of new private banks led to the doubling of the real asset value of the banking sector during 1992-94, and the share of assets in private banks rose from 37 per cent to 85 per cent of total bank assets. This expansion was fuelled by short-term capital inflows for which banks competed fiercely by offering very high interest rates to depositors. A consolidation process set in as profitable opportunities in trade finance gradually receded. When the country's largest private bank, Bank Baltija, failed to provide accounts audited to international accounting standards, this led to doubts over its solvency, deposit withdrawals and the bank's collapse. An investigation revealed flawed lending practices and general management failures, including outright fraud and corruption. In the event, 40 per cent of all bank assets were affected by the crisis, money demand contracted sharply and GDP growth suffered a significant setback compared with earlier expectations.

In Lithuania, as in Latvia, the majority of new private banks entered the market in 1991 and 1992 when licensing requirements were lax and the minimum capital requirement was low. Banks failed to raise their capital in proportionate to the rapid growth of liquidity and loan books during 1993 and 1994. Lack of lending skills and politically motivated and "connected" lending had led to a large number of non-performing loans by 1995. A scandal over the abuse of insider connections eventually led to intervention in the country's second-largest bank, Innovation Bank, with serious repercussions for two further banks. The impact of the crisis is still working its way through the banking sector. Innovation Bank, whose assets in June 1995 had reached US\$ 215 million (around 3 per cent of GDP and 21 per cent of domestic assets), was liquidated earlier in 1997, and more liquidations of private banks may follow. The macroeconomic impact of the crisis has, however, been overshadowed by its political ramifications, leading to the resignation of several government ministers, including the prime minister and the governor of the central bank.

Banking crises can greatly accentuate macroeconomic volatility. The weaknesses in banking systems in transition economies stem from a combination of legacies of bad loans, political interference and lack of skills and capital, with large macroeconomic shocks resulting from rapid disinflation and remonetisation. Most countries of the region have not so far been affected by systemic crises on account of the relatively small role of financial intermediation in their economies, although most have experienced a process of bank consolidation as regulatory frameworks have been tightened. However, the establishment of sound banking principles and appropriate bank supervision has far to go. The financial sector weaknesses in the region hold more potential upsets in store for both forecasters and policy makers.

¹ In Hungary and Bulgaria this led to repeated "rounds" of bailouts.

² IDB (1995). See also Honohan (1997).

³ The following account draws on Fleming et al. (1996).

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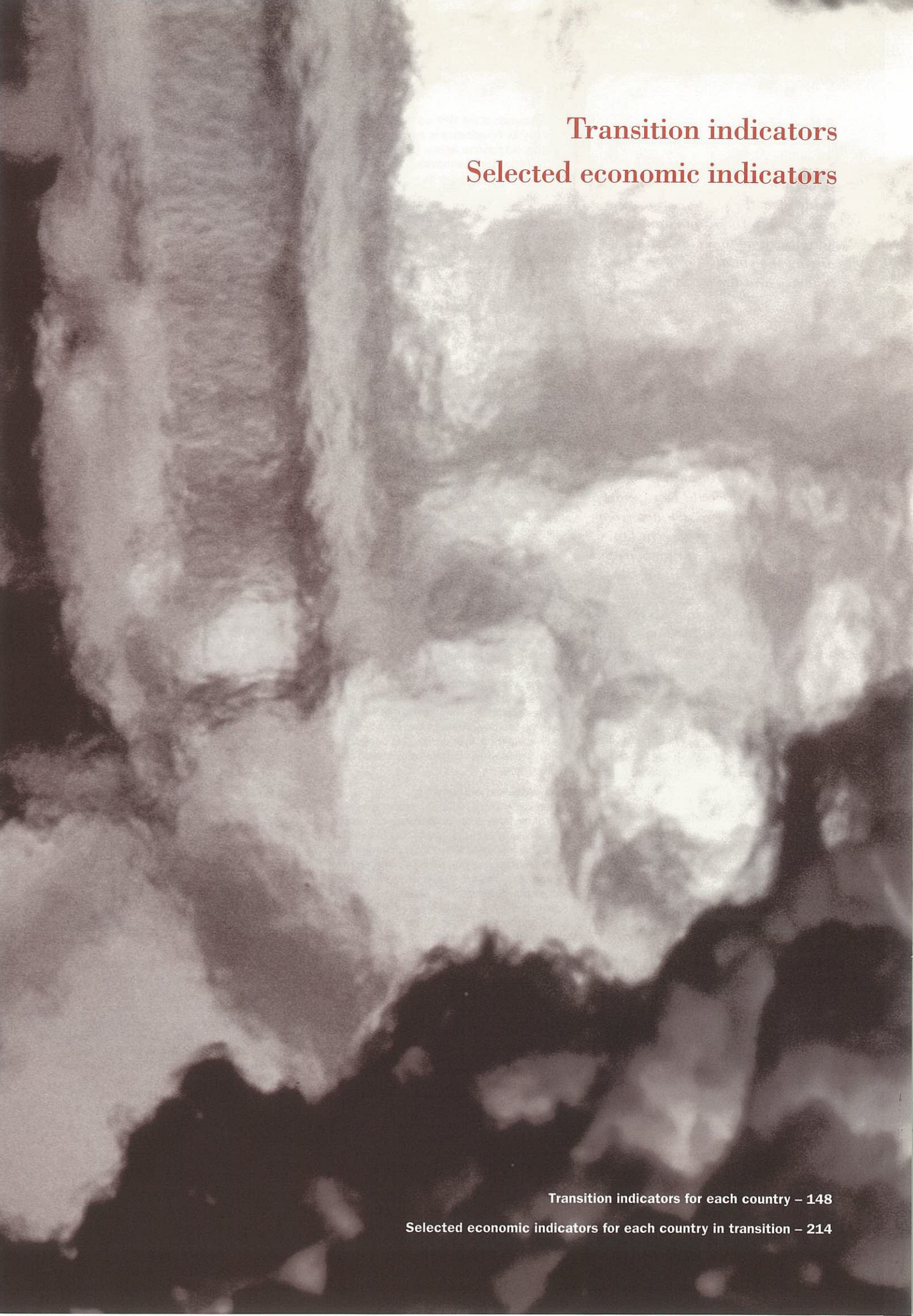
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Note that in addition to the references above, we have communicated extensively with some of the forecasting institutions quoted in this chapter:

EIU, Communication with the Economist Intelligence Unit, London, July 1997.

European Commission, Communication with Directorate General II, Economic and Financial Affairs, August 1997.

IWH, Communication with Institute for Economic Research, Halle, August 1997.



Transition indicators
Selected economic indicators

Transition indicators for each country – 148

Selected economic indicators for each country in transition – 214

Albania

• *Virtually no progress with structural reforms has been made over the past year, as governmental and parliamentary activity came to a standstill during the collapse of pyramid schemes and the ensuing social unrest.*

• *There have been no major setbacks in earlier market-oriented reforms, although this progress remains fragile.*

• *Albania has recently reached an agreement in principle with the IMF on a six-month programme which could be supported by emergency assistance from the Fund. The government has committed itself to a number of important measures under the programme, including raising the VAT rate, winding up the remaining pyramid schemes and undertaking structural reforms in several areas.*

Enterprises

Size of the private sector

In 1996 the private sector accounted for over 85% of GDP and 77% of employment. Agriculture, construction, road transport, retail trade and the food industry are in private hands. While private sector activity spread rapidly in recent years, the almost completely state-owned industrial sector was decimated, accounting for 11.5% of GDP in 1995, down from 40% in 1990. Agricultural production was almost entirely privatised early on in the reform process, which led to expansion of this sector to 56% of GDP in 1995 – up from 37% in 1990. The rapid growth of small enterprises in trade, transport and services was partly financed by a large inflow of remittances from abroad.

Privatisation

A voucher-based Mass Privatisation Programme (MPP) was introduced in May 1995, covering 400 medium-sized or large state-owned enterprises and relying on a system of “unpriced auctions”. Vouchers were tradable and could be exchanged for shares in enterprises in any of the auction centres. The supply of vouchers far exceeded the demand for shares and their market price collapsed to below 4% of face value. As no computerised share register exists a market in these shares is unlikely to emerge in the near future. As of July 1996, 97 enterprises had been sold under the programme. The MPP was expected to be completed by end-1998. However, because auction activity came to a halt during the period of social unrest, it is now likely that completion will be substantially delayed. The problems encountered during

implementation of the MPP led to the creation of a Ministry for Privatisation in July 1996, incorporating the old National Agency for Privatisation and the Enterprise Restructuring Agency. The Ministry put emphasis on finding strategic investors for the remaining large state-owned enterprises. So far, only one large privatisation has been completed. Privatisation is now being handled by the Ministry of the Economy.

Small-scale privatisation progressed rapidly during 1991-92. Privatisation of retail shops is virtually complete.

By the end of 1996, 98% of agricultural land had been privatised. The sale and purchase of land, originally prohibited, were allowed by two laws passed in July 1995. The laws also transformed the titles relating to the usage of the land into property titles, and allowed foreigners to buy land if they combined the purchase with an investment of at least three times the purchase price.

Despite the progress in privatising agricultural land, no land market has developed. The main obstacles have been the requirement that all land holdings in a village be registered before any can be sold (only 3% of privatised land has been registered) and the absence of clear mechanisms for establishing the legality of land transactions. The law states that land must first be offered for sale to relatives of the current owner, owners of neighbouring properties, other villagers, or ex-owners of the land before it can be offered to anyone else. Few informal sales have taken place.

Former owners and their heirs can claim compensation or restitution for government expropriation of non-agricultural land. As restitution of property in Albania was not completed by the time privatisation commenced, a long list of disputes has arisen. For property that was privatised, the law prescribes co-ownership between the new and the former owners, but does not specify precisely how co-ownership should be implemented.

Governance and restructuring

As a result of the privatisation process, ownership of the large enterprises is very dispersed. In the majority of cases control over large enterprises has remained with the old management. Much restructuring took place following a sharp tightening of enterprise access to bank credits and government subsidies. An Enterprise Restructuring Agency (ERA) was established in 1993 to restructure or terminate the operations of 32 large companies. Most of the large enterprises were broken up into parts. Some parts have been closed down, and the viable ones are receiving management support. However, the ERA has only managed to eliminate 10 enterprises from its portfolio through privatisation or liquidation.

Employment in the enterprises in the ERA portfolio fell from 51,000 in 1988 to less than 7,000 in 1995.

Some evidence of restructuring can be seen in the shift of the commodity composition of exports. Food, beverages, tobacco and live animals accounted for almost 50% of total exports in 1990, but dropped to 5.4% in 1996; whereas manufactured goods accounted for only 19.6% of exports in 1990 but rose to 62.4% in 1996. State sector employment dropped from 63% of domestic employment in 1990 to 26% in 1995; private sector employment (excluding agri-

culture) rose from zero in 1990 to 23% in 1996; and agriculture sector employment (all private after 1992) increased from 37% in 1990 to 51% of domestic employment in 1995.

The bankruptcy law adopted by parliament in 1995, defining bankruptcy procedures for all companies (the previous law from 1992 covered only state enterprises), has not yet been implemented.

Markets and trade

Price liberalisation

Price liberalisation has been extensive (and was recently extended to the prices of bread, liquefied gas and kerosene). Price controls and subsidies (less than 1% of GDP) still apply to public transport, rail fares, postal tariffs, electricity and rural water supplies. Prices of public transportation were increased in August 1996. All price controls on food items that were reimposed during the state of emergency have now been removed.

Competition policy

The competition law adopted in December 1995 introduced procedures for mergers and break-ups of dominant companies and established an Economic Competition Department under the Ministry of Trade. Little progress has been made in implementing this law.

Trade liberalisation

Since 1992 there have been virtually no quantitative restrictions on imports and very few on exports. Exports licensing requirements have been eliminated or converted into export bans on a limited number of items.

Since January 1997 the tariff structure has been simplified to five basic rates with a top rate of 30%. Capital goods and goods used in the telecommunications and construction sectors are exempt from import duties (except for office equipment).

Albania has requested accession to the WTO. A memorandum on the foreign trade regime was submitted in 1995. The working party on Albania's accession is currently scrutinising its consistency with WTO rules.

Currency convertibility and exchange rate regime

The exchange system is largely free of restrictions on current account transactions including 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 informal market – consisting of a number of licensed private dealers, foreign exchange bureaux and unlicensed street vendors. The cash-based market is sophisticated: its daily turnover is over US\$ 2-3 million; the quotes it generates on currencies are consistent with international market quotes in terms of cross currency rates. The central bank is trying to deepen the market by encouraging the passive (a notional interbank market exists and closely follows the informal market quotes) and inexperienced commercial banks to play a more active role.

Albania maintains restrictions on its capital account under Article VIII of the IMF Agreement, due to outstanding balances on inoperative bilateral payments agreements.

Wage liberalisation

The government does not intervene in the setting of private sector wages, except for setting the minimum wage – US\$ 24 per month in mid-1997, compared with an average wage of US\$ 41 per month in budgetary institutions. There are no longer wage ceilings for state-owned or private enterprises.

Since 1994, an agreement between government and the largest trade union has indexed government wages to the prices of 24 basic consumer goods and services.

Interest rate liberalisation

The Bank of Albania sets minimum time-deposit rates. Demand deposit rates were liberalised in January 1996. Lending rates were liberalised in July 1995. Real interest rates on both deposits and lending have been positive since the first quarter of 1993. However, given the imposition of bank-specific credit ceilings and of the inability of local banks to lend commercially, banks' interest rates do not provide a good approximation of the cost of finance. Apart from remittances, the main source of finance for the private sector has been the informal credit sector, initially in the shape of individual money lenders and later in the form of complex pyramid schemes.

Financial institutions

Banking reform

The depth of bank intermediation is low, with broad money equal to 60% of GDP in 1996. Almost all transactions are still in cash, although a "fixed value personal cheque" was introduced in July 1996. Only short-term lending is available from the banking sector, which is actively financing the public deficit. Most lending to the private sector is done by the informal market.

During 1996, three new laws on the structure of the financial sector were approved by parliament. These made the central bank legally independent, assigned it responsibility over the foreign exchange regime and foreign exchange reserves; and provided the legal framework for establishing new banks. The minimum capital requirement for both domestic and joint-venture banks is set at US\$ 2 million. 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 central bank only rarely intervenes in the foreign exchange market. It intervenes indirectly by allowing commercial banks to bypass the informal market and dealing with them at the official rate.

Nine commercial banks operate in Albania: three owned by the state and six private banks with partial foreign ownership. The state-owned Savings Bank (SB) takes the bulk of household deposits. The state-owned National Commercial Bank (NCB) undertakes more than half of all lending to enterprises. The third state-owned bank is the Rural Commercial Bank (RCB). The three state banks fail to meet the provisions of the Banking Law and have no banking licence. As both the RCB and NCB are under-capitalised, they could be legally liquidated by the central bank.

In September 1996, the government approved a "Strategy for bank privatisation", though the strategy did not set out the method of privatisation or establish a time frame. In preparation for privatisation, the NCB has been partially recapitalised

and its capital separated from that of the central bank. In December 1996, the government approved a branch restructuring strategy. Most of the NCB's and RCB's branches were transferred to the SB. The latter can decide whether to incorporate them in its branch network or liquidate them.

During January 1997, the central bank set up a limit of US\$ 300,000 on daily withdrawals from bank deposits, with the intention of minimising the impact of the collapse of the pyramid schemes on the banking system. The return of most of these deposits to pyramid scheme investors seems to have gone quite smoothly.

Non-bank financial institutions

Investment funds have been created to buy vouchers from citizens and use them to build equity portfolios in privatised enterprises. The funds are not allowed to exceed a 10% ownership stake in any one company or own more than 10% of the total amount of distributed vouchers. The first licence was granted in April 1996 to the foreign-managed Anglo-Adriatic Investment Fund.

The law regulating the establishment and operation of insurance companies has not yet been implemented. The state-owned insurance monopoly, INSIG, is regulated by the Privatisation Law for large companies.

Since the transition began, a number of investment funds have operated in Albania *de facto*, taking deposits from households. In the absence of a properly functioning banking system, such funds constituted the only intermediary between recipients of remittances from abroad (estimated at US\$ 300-1,200 million a year) and small Albanian entrepreneurs who had difficulty obtaining credit. Until 1995, the interest rates they offered were higher than those of state banks, but never exceeded about 4-5% per month. In early 1996, more funds entered the market offering higher rates and, very quickly, competition between the funds raised rates to unsustainable levels (up to 40-50% per month). It was obvious these funds behaved as "pyramids", i.e. by using new deposits to finance interest payments on old ones.

From December 1996 to February 1997 most funds collapsed. The funds are estimated to have collected the savings of a large percentage of Albanian households. The Albanian authorities have maintained their position against a bail-out of depositors in schemes that collapsed. As of August 1997, four big funds continue to operate offering lower interest rates than they did during the crisis. None of the pyramid schemes are taking deposits, however.

The liquidation of these remaining funds is a prerequisite for the implementation of an IMF-sponsored recovery strategy. The first legislative action of Mr Nano's Government in August 1997 was the approval of a law that allows for the auditing of all pyramid schemes along the lines agreed with the IMF and World Bank.

Securities markets and instruments

New securities laws regulating the operation of the stock exchange and voucher transactions were adopted in 1996. A stock exchange was established in March 1996, trading in treasury bills and privatisation vouchers. A special Securities Commission was appointed to regulate trading activity. Auctions of treasury bills (3-, 6- and 12-months maturity) have been held twice

a month since July 1994. The market is very thin and highly segmented.

Fiscal and social safety net reform

Taxation

Since 1991 the tax system has included a personal income tax, property tax, customs duties, profit tax and VAT. The profit tax rate is 30% (additional taxes are payable in certain sectors such as tourism, mining and oil). Progressive rates for personal income tax range from 5% to 20%. The basic turnover rate was replaced in July 1996 by a VAT, initially set at 12.5% (and increased to 20% in September 1997). Excise taxes range from 5% to 105% on domestically produced goods and from 20% to 130% to imports. In 1993 a small business tax was introduced ranging from 3% to 10% of turnover, according to the area of activity of the company. Despite the new revenue sources, there has been a steep drop in revenues collected from enterprises (this phenomenon was exacerbated during the pre-electoral period in 1996). A four-year tax holiday for investment in manufacturing and a 60% tax reduction on reinvested profits are in place.

During the first three quarters of 1996, substantial progress in improving the tax administration system was achieved. In particular, a tough set of sanctions against corrupt practices was introduced. Enforcement of tax payment was placed in the hands of the Tax and Customs Department.

However, during the turmoil following the collapse of the pyramid schemes almost all customs offices were destroyed. Two out of 36 tax offices were also destroyed and eight damaged, contributing to the dramatic decline in the collection of tax revenues. Currently customs duties are collected on behalf of the government by customs authorities of Italy and Greece.

Social security

Phased increases in social security tax rates as well as an individual unemployment insurance contribution have been introduced. Earnings-related unemployment benefits have been replaced by flat payments linked to minimum pensions. The government improved the 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% of gross wages from the employer and 10% of gross wages from the employee. Health insurance contributions are 1.7% of gross wages from both employer and employee.

Legal transition

Pledge law

Pledge law is governed by the Albanian Civil Code, which was enacted in 1994. A non-possessory pledge may be created over shares and receivables, but not over other forms of movable property. In order to be enforceable, the pledge agreement must be in writing and notarised. There is no unitary or centralised registry system for non-possessory pledges. Enforcement of a pledge requires court assistance.

Company law

Joint-stock companies are governed by the Companies Act of 1992 and the Companies

Registry Act of 1993. The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is approximately US\$ 500-1,000. The process takes between one and three months. Joint-stock companies are not required to maintain an independent share registry. The law does not afford minority shareholders protection in the event that another company makes a bid for less than all the shares of a widely held target company. Shareholders are given pre-emptive rights in the event of a new share issue. Cumulative voting for directors does not exist. Directors have an obligation to (i) perform their functions in good faith and (ii) to avoid self-dealing. Shareholders may vote by proxy but it is unclear whether companies are required to send shareholders proxy forms in advance of the meeting. Laws exist prohibiting insider dealing in shares of publicly listed companies.

Bankruptcy law

Albania enacted a new Bankruptcy Procedures Law in October 1995. The law defines insolvency as a situation where a debtor is unable to meet liabilities as they fall due. It also provides for a reorganisation system whereby a majority of creditors can reach a binding settlement with the debtor. The settlement must be approved by majorities of at least two classes of creditor and must not adversely affect the other creditors. In bankruptcy proceedings, a liquidator is appointed by the court. The duties of a liquidator include managing the debtor's property, taking inventory, disposing of the debtor's assets and distributing the proceeds. There is no government body that supervises the conduct of the liquidator. The liquidator has the authority to void transactions with third parties that are (i) not at arm's length and concluded in the three years prior to the liquidation or (ii) at below fair value and concluded during the same time period. Secured claims rank below claims for liquidation costs, taxes, pensions, social security and wages. There are specialised courts and judges handling bankruptcy proceedings.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published between one and six months after being passed. Important judgements are not generally published or accessible to practitioners. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait less than six months for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and one year for a final judgement for payment of a sum of money to be executed.

Armenia

• *There has been strong progress in structural reform, though significant risks remain due to political uncertainty (related to the ongoing tension over Nagorno-Karabakh).*

• *Privatisation is targeted to continue at least until mid-1998, when much of the programme is expected to be completed.*

• *Armenia is likely to be among the first countries in the CIS to accede to the WTO.*

Enterprises

Size of the private sector

Some 70% of Armenian enterprises are non-public (64% private and 6% owned by cooperatives). The private sector accounts for over 50% of total employment. By the end of the 1998-99 privatisation programme, the private sector share in GDP is expected to reach 75%.

Privatisation

An estimated 88.4% of medium-sized and large enterprises (1,700 entities) had been privatised by the end of September 1997. The majority of them were offered by public subscription, while others were sold by auction through employee buy-outs. In June 1997, the Armenian government announced its intention to sell 14 enterprises to foreign investors, including the Armenian-US joint-venture telephone company (Armentel), the Yerevan cognac distillery and a number of hotels and mines. The sale of these enterprises is expected to be completed in 1998. The government intends to privatise 650 additional enterprises by the end of 1997, and 120 more during the 1998-99 programme, increasing the number of firms in the private sector to 90% of the total. These initiatives, once carried out, would result in the private sector accounting for some 75% of GDP. In 1997, all energy sector enterprises, except the nuclear power plant, will be corporatised (and subsequently privatised in 1998). Privatisation of all small and most medium-sized and large enterprises should be completed by the end of March 1998.

There are 5,365 small enterprises, almost all of which have been privatised. Privatisation of housing is now virtually complete, with 80% of the housing stock in private hands. In the agricultural sector almost all of the state and collective farms, numbering at least 800, have been broken up, and over 300,000 private farms have been created. At present, private farms provide 95% of agricultural output. Armenia has privatised about 87% of agricultural land and made land titles freely transferable. A total of 147 agricultural enterprises were privatised completely during 1995-96, and an estimated 65-70% of all agricultural enterprises are expected to be privatised by 2000.

New private enterprises have emerged rapidly, although their development has been hampered

by an incomplete legal framework, shortages of energy and other inputs, and the blockade imposed on trade with Armenia.

Governance and restructuring

Pre-privatisation restructuring is monitored by the government and focuses on debt workouts and the reduction of arrears, labour shedding, divestitures and spin-offs, new marketing strategies, and management changes.

Post-privatisation restructuring is impeded by the lack of clarity of the legal environment and the generally underdeveloped state of the institutional infrastructure. This has limited the involvement of foreigners in corporate restructuring to date. Enterprise restructuring is also hindered by a lack of financial discipline, as reflected in increasing inter-enterprise and tax arrears, and increasing inventories. New investment in many of the privatised enterprises is limited.

By the end of 1996, 250 joint ventures and 163 affiliates or subsidiaries of foreign companies were registered in Armenia, but cumulative FDI is only US\$ 35 million.

Macroeconomic data suggest that Armenia has gone through two phases of adjustment. During the initial recession, the share of agriculture in GDP increased from 24% in 1991 to 50% in 1993, while industry's share declined from 47% to 26% over the same period. The recovery has since led to a reversal of this trend and in 1996 agriculture accounted for 38% of GDP and industry 32%.

A new Law on Bankruptcy was enacted in January 1997, which included the initiation of liquidation procedures for enterprises that cannot be successfully privatised. To date, 35 enterprises have been recognised as bankrupt, while others are under bankruptcy procedures. The Ministry of Finance plans to require all enterprises to introduce International Accounting Standards (IAS) during the course of 1997.

Markets and trade

Price liberalisation

Almost all prices have been liberalised, but price controls remain on the following services: urban transport, electricity, hot water, gas, heating, sewerage, rubbish collection, state-owned housing, telephones and irrigation. A centralised wholesale market for fruit and vegetables was opened in mid-1996, and is being further expanded.

Competition policy

The Law on Protection of Economic Competition and the Law on Natural Monopolies were submitted to parliament at (respectively) the end of 1996 and early 1997. Armenia is still in the process of establishing legislation to regulate unfair competition.

Trade liberalisation

Armenia has one of the most liberal foreign trade regimes among the CIS countries. The government is working to eliminate more import tariff exemptions. In December 1995, a five-band import tariff structure was streamlined into a two-band structure, with rates of 0% and 10%. Import, export and domestic production licences are required only for health, security and environmental reasons. There are no limits on hard currency imports. At this time, Armenia does not have an anti-dumping, countervailing or safeguards regime but plans to introduce legislation concerning unfair trading practices in

the near future. All exports from Armenia are duty free and the government uses the Harmonised System of Tariff Classification for customs valuation.

Armenia applied for accession to the WTO in January 1995 and the authorities expect to complete the accession process in early 1998. Armenia has bilateral free trade agreements with 28 countries, including Russia, Ukraine, Moldova, Kyrgyzstan and Tajikistan, but to date only that with Russia has been put into effect.

Currency convertibility and exchange rate regime

The dram is fully convertible for current account transactions. Export surrender requirements were eliminated by mid-1995. Armenia accepted the conditions of Article VIII of the IMF Agreement in 1997. The foreign investment regime is liberal and there are no restrictions on foreigners repatriating profits.

Wage liberalisation

A Wage Indexation Law was adopted in early 1992, giving the government discretion over nominal wage adjustments. A "minimum consumption basket" is used to guide monthly minimum wage adjustments to price increases. In 1996, the minimum monthly wage in Armenia was about 1,000 drams (equivalent to less than US\$ 2.50). The average monthly state sector wage is around US\$ 20, while the average budgetary sector wage is about US\$ 11.

Interest rate liberalisation

Interest rate limits were removed in the last quarter of 1994. The central bank's refinancing rate is determined by the outcome of credit auctions and turned positive in real terms in early 1995. With the abolition of most directed credits at the beginning of 1995, credit auctions became the main means for commercial banks to obtain credit extensions.

Financial institutions

Banking reform

The fragility of the current banking system continues to undermine its role in financial intermediation. The introduction of prudential regulations in 1995 led to a process of bank consolidation and a reduction in the number of domestic and foreign banks.

By spring 1997 there were 32 commercial banks operating in Armenia (most of them joint-stock companies), whose combined capital amounts only to about US\$ 20 million. There are five foreign banks, four non-resident and one resident.

Of the 32 banks in operation, 30 were in compliance with norms set by the central bank and 28 were solvent by international standards. As of early April 1997, 12 banks accounted for over 60% of total capital within the banking sector, over 70% of total assets, and approximately 79% of total outstanding loans.

The Central Bank of Armenia (CBA) is responsible for banking regulation and supervision, and is in charge of issuing bank licences. It began taking decisive moves to strengthen Armenia's banking system and redefine prudential requirements in April 1995. Minimum capital requirements were increased to US\$ 350,000 by the beginning of 1997, and will rise to US\$ 600,000 by 1998 and to US\$ 1 million by the beginning of 2000; banks are required to report daily or weekly to the CBA; and on-site audits and off-site surveillance programmes have been

developed. Banks are to be audited every year by authorised independent auditing companies. International accounting standards (IAS) were introduced in January 1996, but banks have been reluctant to adopt them. The CBA is expected to make the implementation of the IAS mandatory for all banks by January 1998.

The central bank plans additional measures in 1997 to strengthen the banking sector. Dividend payments in three major banks are to be temporarily suspended; restructuring is to be initiated, following the adoption of a law on bank bankruptcy in 1996, the role of government ministers in the management of major banks is to be reviewed, and budget support to the savings bank is to be discontinued.

In June 1995, the 35% limit on foreign shareholdings in the financial sector was abolished. The first foreign-owned bank, Midland-Armenia, was established as a commercial bank in March 1996. No barriers impede the establishment of foreign-owned resident banks as long as the CBA's licensing and prudential requirements are met. Access is far more limited for non-resident banks. Foreign ownership in banks plays an important role in the Armenian economy, accounting for 41% of total bank capital as of March 1997.

Non-bank financial institutions

In late 1994, an Investment Fund Decree was passed that allowed funds to own up to 40% of shares in any given enterprise, but investment funds remain underdeveloped. A state insurance company and several private insurance companies are active in Armenia.

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. The treasury bill market provides the central bank with an alternative method of financing the budget and allows it to conduct open market operations. Foreign interest in the treasury bill market is just beginning. The rates on treasury bills have declined from a peak of 80% in February 1997 to under 50% in late May. This compares with a projected year-end inflation rate of 26%. There is no secondary market for treasury bills. High interest rates on government securities, plus the underdeveloped legal infrastructure for capital markets, have so far limited demand for shares of private sector firms. However, as the legal system is reinforced, the private sector should grow, thereby contributing to the expansion of the capital market.

Fiscal and social safety net reform

Taxation

The Armenian tax regime includes the following components: a VAT of 20%, a social security (payroll) tax of 37%, excise rates (which are ad valorem and quoted on a tax-inclusive basis) of 50-100%, an enterprise profit tax (30% for banks and insurance companies, 70% for casinos and 12-30% for other legal entities), a personal income tax (with rates of 12-30%), a land tax and a property tax. Private farmers are subject to an income tax fixed at 15%.

The income tax is imposed on physical persons with permanent residence in Armenia and those

without permanent residence who earn income in Armenia. Foreign enterprises and joint ventures with a minimum invested capital of at least 30% are exempt from profit taxes for two years and then subject to taxation at only 70% of the full rate. Enterprises with a least 50% foreign ownership receive the same initial grace period, after which profit taxes are charged at only 50% of the full rate.

Armenian enterprises have to pay high effective tax rates, reflecting the number of taxes they are required to pay. For instance, a recent survey estimated that the effective tax rate on official sales was around 70%. As a result, some enterprises present false profits statements, while others continue to operate while being officially closed and hence do not report to the tax authorities.

Nevertheless, tax revenues have increased over the past few years from less than 50% of total government revenue in 1994 to 73% in 1996. VAT accounted for the largest share of tax revenue (25%), followed by personal income tax (10%). Recent figures indicate that central government tax revenue reached 12.3% of GDP in May 1997, up from 5.4% in January. The problems in Armenia's tax system have encouraged the authorities to consider tax reform in an attempt to rationalise and simplify the structure of many major taxes.

Social security

Armenia faces a problem of acute poverty among its population. Inequality remains high and approximately 28% of families are considered poor or very poor. The government has initiated a wide range of reforms in the social sector in response to the widespread poverty and worsening social indicators. As a result, social benefits increased by 60% in real terms in 1996. The government introduced a basic benefits package, effective 1 January 1997, which is fully funded by the budget, with other services available on a fee basis.

Given the budgetary constraints, however, the government has also sought to improve the targeting of the most vulnerable members of the population. In 1996, child allowances were restricted to those aged 6 or under. Pensions accounted for about 65% of total social expenditures in 1995. A new Pension Law was approved at the end of 1995, providing 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 payments to working pensioners. The government intends to reform the public pension system and introduce private pension schemes.

Legal transition

Pledge law

Under the Mortgage Law of 1995, a non-possessory pledge may be created in all types of movable property. The pledge is created by written agreement and must be notarised in order to be enforceable. Registration is required for immovable property and is optional for movable property. There is no uniform or centralised system of registration for pledges over movables. Enforcement must take place with court assistance.

Company law

The cost of formation and registration of a joint-stock company (including legal, notary and court

fees, but not including minimum share capital) is US\$ 100-500. The process takes between one and three months. There is no requirement that joint-stock companies maintain an independent share registry, although the government maintains a share registry. The law does not afford minority shareholders protection in the event that another company makes a bid for less than all the shares of a target company. Shareholders are given pre-emptive rights in the event of a new share issue. Directors have an obligation to (i) perform duties in good faith, (ii) avoid self-dealing and (iii) disclose personal interests in material transactions with the company or its affiliates.

Bankruptcy law

A new law was adopted on 4 December 1996 (effective 1 March 1997). By definition, a debtor is insolvent when it is unable to meet its liabilities for 30 days. A reorganisation proposal may be made by the debtor, the liquidator or certain groups of creditors. For the proposal to be binding on all creditors, it must be approved by simple majorities of at least two of the four classes of creditors provided for in the law. A liquidator must be an auditor, a chief accountant with five years experience, a lawyer or an economist, and is appointed by the court. Liquidators are not regulated by a specific government body. The liquidator has authority to seize the debtor's assets, and to examine and challenge claims. The duties of the liquidator do not include the authority to investigate the debtor's financial affairs. The liquidator may, with the assistance of the court, void transactions that involve the "unfair alienation" of property or the transfer of funds of the debtor. Sale of the debtor's assets must be made with the consent of the court or by public auction. Secured creditors receive first priority in liquidation proceedings.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published within one month of being passed. It is unclear whether important judgements are generally published or accessible to practitioners. There is generally a meaningful right of appeal from first-instance court decisions. There appears to be an independent right of judicial review of administrative action. On average, a party can be expected to wait less than six months for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and one year for a final judgement for payment of a sum of money to be executed.

Azerbaijan

• *The much delayed large-scale privatisation programme got under way in spring 1997.*

• *Serious lags in structural and institutional reforms (including financial and banking sector and legal reform) persist throughout the economy.*

Enterprises

Size of the private sector

The private sector currently accounts for an estimated 30% of GDP and 25% of employment (excluding enterprises with less than 50% private ownership). Conservative estimates of the unofficial economy suggest a level of 40% of GDP figures, making the exact size of the private sector difficult to estimate with precision.

Private sector activity is most concentrated in the new services industries, construction, trade and agriculture. Most of the private economic activities are concentrated in the Baku area.

Privatisation

Laws stipulate the privatisation of about 70% of all enterprises by 1999. Small-scale privatisation (defined as firms under 50 employees) has so far encompassed the sale of 4,000 firms, carried out primarily by cash auctions (the first of which was conducted in March 1996). After the initial leasing of many shops, gas stations, restaurants, small manufacturing companies, and trade and service units, largely to employees, privatisation meant an opportunity to acquire the legal confirmation of *de facto* arrangements. In June 1997 the imminent completion of the small-scale privatisation programme was announced.

Agricultural privatisation was also formalised with the Law on Land Reform adopted in August 1996. Under this law, 90% of the arable land (22% of the total) is to be privately owned, 45% of the total is stipulated for state ownership and 33% for municipal ownership. Approximately 3,200 cooperative or family-owned farms were *de facto* established before the law took effect and livestock had by and large been privatised "spontaneously".

Large-scale privatisation to date has been plagued by extensive delays, limited transparency, and the lack of a successful infrastructure in terms of stock markets and banking regulations needed to ensure its success. The distribution of 32 million privatisation vouchers through a state-owned bank started in spring 1997 and is essentially completed. Although legislation for the privatisation of large enterprises has been prepared over the last year, it is not yet complete.

The first six voucher auctions, offering 10-30% of the shares in 138 enterprises, have been carried out, starting in June 1997 (132 firms were sold). The first cash auctions are in preparation. The programme currently stipulates that at least 50% of the shares will be allocated to the public in voucher auctions, 15% to employees against vouchers, and 25% to be held by the state in closed-end investment

funds. Meanwhile, the country's significant inherited industrial stock – marred by disinvestment, widespread asset stripping and little progress in establishing mechanisms of effective corporate control – has continued its decline.

Foreigners can own property (with the exception of land). Decisions on larger stakes, however, remain at the discretion of the Committee on Property and the relevant ministries.

Governance and restructuring

Enterprise restructuring has remained sluggish. The most obvious problems are faced by that part of the manufacturing sector that has not benefited from early spillovers from the buoyant oil sector.

Productivity is low. As in other transition economies, the cumulative decline of GDP, 62%, reflects to a large extent an accurately measured production decline in Azerbaijan's old manufacturing sector. The pre-independence management structure and relationship between enterprises and ministries remained largely intact, supported until mid-1995 by budgetary subsidies and bank credits to enterprises, and after that by a lack of alternatives. Asset stripping is widespread.

There is no systematic approach to enterprise restructuring and no systematic policy with respect to the management of shares remaining under state control after large-scale privatisation has been implemented.

During the past two years the government has substantially cut back on subsidies and directed credits to enterprises in its efforts to reduce inflationary pressures. Inter-enterprise arrears which initially increased in response to the hardening of budget constraints (to about 100% of GDP in late 1996), started to decline substantially in the wake of successful stabilisation. Budgetary subsidies to enterprises were eliminated as part of the IMF-supported fiscal adjustment programme, and state-owned banks were prevented from lending to enterprises as part of the IMF-supported restructuring programme. With assistance from the EBRD, the government is preparing a Secured Transactions Law, and a new Bankruptcy Law has been enacted this year, supported by a presidential decree on payment discipline. Together with the privatisation of large and medium-sized enterprises and, most important of all, the absorptive capacity of a rapidly developing segment of new private firms, there is the potential for maintaining hard constraints, though this may mean a wave of bankruptcies of old firms in the medium term.

Oil-related capital inflows, together with bilateral and multilateral activities, started to become more pronounced in adjusting the economy's sectoral composition. Next to the upgrading of refineries or industries immediately related to the production of pipeline or drilling equipment, an increasing number of infrastructure investments are under way, concentrated in the transport and power sectors, and also the upgrading of medical facilities.

A disaggregation of output growth by sectors in 1996 indicates that the service sector grew at a rate of 10%. This consists mostly of small, new and private businesses. In contrast, the industrial sector was still in steep decline in 1996, contracting by 10%, though there have been some signs of stabilisation.

Markets and trade

Price liberalisation

In January 1992, 70-80% of producer and consumer prices were liberalised, with further rounds of liberalisation in 1992 and 1993. Bread and energy were the main goods left under price controls.

In January 1995, the old bread-price subsidy was abolished, together with the state order system for agricultural products. Administered prices for oil and oil products were gradually increased toward world market levels during the course of 1995, and again in 1996, in reaction to increasing world market prices. Prices for utilities, housing and transport, however, remain administered and often 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.

Demonopolisation has advanced recently, in preparation for large-scale privatisation. The government has started to break up the large concerns (former ministries) which still control state-owned enterprises. Four concerns in the food and furniture sector have been abolished by decree and their enterprises corporatised and transferred to the State Property Committee for privatisation. Three ministries (Trade, Agriculture and Material Resources) are scheduled to lose their direct control of enterprises and are to be reduced to regulatory functions. Government procurements will be centralised in a new agency.

Trade liberalisation

The dominant role of the central government in foreign trade has been reduced. Quotas and licensing restrictions for imports and exports were removed by spring 1995, with the exception of a selection of "strategic goods", including oil and cotton. All export duties were abolished in 1997. Import tariff bands have been abandoned in 1997, and tariffs substantially diminished.

While the current trade regime is quite liberal, state trading organisations continue to enjoy special privileges in the absence of a well-organised system for government procurement. Since Azerbaijan's exports are highly concentrated in agriculture (mostly cotton) and oil-related products, *de facto* trade monopolies have emerged, with the Ministry of Agriculture controlling cotton exports and the Ministry of Trade controlling food and consumer imports of the government. In addition, a huge amount of unrecorded trading activity takes place.

A reorganised Ministry of Trade and Foreign Relations is in charge of harmonising and enforcing trade policies and rules, and pursuing accession to the WTO.

Currency convertibility and exchange rate regime

Since May 1994, the official manat rate has been 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 allowed the rate applied for surrender requirements to align with the market rate.

The Baku Interbank currency exchange continues to determine the official exchange rate; in practice, it is dominated by the National Bank and the International Bank, a state-owned bank (at which the National Bank has accounts). However, a multitude of exchange offices attract cash exchanges. The use of offshore accounts is widespread. Capital account convertibility remains limited, with full convertibility set for 1999.

Wage liberalisation

Wage setting in the private sector is free and, in the absence of a strong presence of trade unions, remains decentralised. Minimum wages in the state sector are centrally administered.

The real value of the minimum wage, which sets the benchmark for determining social benefit payments and public sector wages, declined significantly until mid-1996. While officially recorded real wage levels have remained stagnant, surveys show an increase in (estimated) household incomes and spending in 1996, reflecting the perception that the level of income (and GDP) is under-reported and that many people hold multiple jobs, in particular in Baku.

More than 60% of the population are estimated to live below the poverty line as defined by the World Bank.

Interest rate liberalisation

Manat lending rates charged by local banks are based on the National Bank refinancing rate, which is currently 12% (down from about 250% in 1995, 45% in 1996 and 15% in July 1997). Local interbank lending rates ranged between 200-300% in 1994, declined to 80-90% in 1995 and 25-45% in 1996, and currently are 16-20%. Local US dollar short-term lending rates range between 15-18%. Deposit rates, on the other hand, vary from one bank to another and range from 2.5% with Sberbank to 15% with local private banks. There is no real interbank deposit market at this stage except on a fully cash-collateralised basis.

Real interest rates have been positive since late 1995 as inflation fell to one of the lowest rates among the former Soviet Union economies. The refinancing rate kept declining in lock-step. Deposit and lending rates of commercial banks followed suit, with a tendency for deposit rates to fall faster than lending rates. Differentials in lending rates for private and state-owned enterprises and non-collateralised lending have diminished significantly.

The National Bank has announced the resumption of open-market operations in treasury bills for 1997, but so far continues to rely on bi-monthly credit auctions to provide liquidity to the commercial banking sector. Secondary markets for treasury bills do not exist, and the instruments of monetary policy are further constrained by the lack of securities markets.

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. Of the 260 very small commercial banks created from 1992 to 1995,

120 are currently listed, accounting for approximately 20% of all bank loans and no more than 20% of bank deposits in the economy. Four state-owned banks account for the remainder. Although legally possible, the presence of foreign banks has remained very limited in practice.

New National Bank and Banking Laws were adopted in June 1996, in an attempt to strengthen the power of the National Bank by establishing it as the sole supervisor of the banking sector. The minimum capital requirement for new banks has been increased to ECU 1.2 million. Prudential regulations were improved in 1995 and 1996, with each bank now required to have a minimum capital adequacy ratio of 8%, a maximum exposure per borrower of 50% of its own capital, and a maximum foreign exchange exposure of 30% of its capital. An increasing number of smaller banks which have failed to comply with these standards are being closed.

However, the state-owned banking system in Azerbaijan remains weak. The National Bank still has technical difficulties in managing its reserves independently, and the four large state-owned banks are hampered by large unrecoverable loans in their portfolios. To avert a systemic failure, these banks were put under a systematic restructuring programme under IMF and World Bank guidance which severely restricts their lending activities and is likely to result in the closure of two of them. From October 1997, the state budget will take over non-performing loans that could not be recovered under the workout programmes presently implemented. Binding privatisation procedures have still to be developed.

Non-bank financial institutions

There are no private pension, investment or mutual funds in Azerbaijan.

Securities markets and instruments

A Law on Securities and Stock Exchange was passed in 1997, but neither stock markets nor security exchanges have been established.

Fiscal and social safety net reform

Taxation

In 1992, turnover and sales taxes were replaced by a value added tax, and a new enterprise profits tax was introduced alongside new excise duties, a car ownership tax, a royalty in petroleum production and a progressive personal income tax. VAT exemptions that used to apply to imports from non-CIS countries have been eliminated. A significant number of exemptions and privileges for special groups have also been eliminated.

Tax collection rates reached a low of about 16% of GDP in 1996. This was partially rooted in structural problems. The marginal rate of the existing wage tax, for example, can exceed 100% and not all wage costs are deductible when enterprises calculate their taxable income. Moreover, the State Tax Inspection collects taxes mostly not at source but at enterprises' settlement accounts held with banks, thus further hampering efficient tax collection. Large parts of the new private sector escape efficient taxation.

Among the most important planned tax reforms are: further shifts of taxation toward consumption; an increased emphasis on expenditure taxation, to counter tax evasion; a reduction of

wage taxes and the enforcement of regular tax withholdings at the enterprise level; the improvement of royalty collection, in particular on part of the State Oil Company (SOCAR); and the establishment of transparent rules, minimising the promotion of particular industries or regions by means of tax incentives.

A working group has been formed, investigating the distribution of tax revenues between local and central branches of the government, and the State Tax Inspection has started to introduce a system of tax identification numbers.

Social security

In 1992 the Social Protection Fund, created from a merger of two existing social security programmes, was established to provide pensions and social allowances, financed by payroll contributions. Almost one-third of government expenditure consists of transfers through the Social Protection Fund, with pension payments constituting the lion's share of its expenditures.

Pension payments, however, have decreased in real terms, from 6.6% of GDP in 1993 to below 2%, with pension arrears re-emerging periodically. Payroll tax compliance plus delays in transferring funds from the budget to the Social Protection Fund have contributed to the decreased availability of funding in the system.

Healthcare has in practice shifted from old-style universal coverage to a system implicitly based on user charges. Reforms of the healthcare system have been announced with the aim of introducing a basic healthcare package with universal access and eliminating informal charges.

The Employment Fund, currently providing unemployment benefits funded largely from employers, is also to be reformed. The current unemployment contributions (below 10% of the average wage in 1995) will be increased and eligibility checks improved. It is further planned to shift the emphasis of the Employment Fund toward the provision of retraining and temporary employment by means of public work programmes.

Legal transition

Pledge law

A pledge may be created by written agreement between the parties or through notarisation. Non-possessory pledges are permitted for any movable property which is capable of being alienated. It is unclear whether non-possessory pledges may be taken with respect to future property. There is no centralised registry for non-possessory pledges, although the law requires registration where a registry exists. A pledgee may enforce a pledge with court assistance.

Company law

The cost of forming a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is US\$ 500-1,000. The formation and registration process takes between one and three months. There is no requirement for joint-stock companies to maintain independent share registries. Company law does not protect shareholders in the event that another company makes a bid for less than all the shares of a target company. The law does not afford shareholders pre-emptive rights in the event of a new share issue. Cumulative voting for directors does not exist. It would appear that directors do not possess legal obligations to (i)

perform duties in good faith, (ii) avoid self-dealing or (iii) disclose personal interests in material transactions with the company or its affiliates. Laws do not exist prohibiting insider dealing of shares in publicly listed companies.

Bankruptcy law

Azerbaijan enacted a new Law on Bankruptcy in 1997. The definition of an insolvent enterprise is that a debtor is unable to meet its liabilities. The law provides for a reorganisation system whereby a majority of creditors can reach a binding settlement with the debtor. During bankruptcy proceedings, a liquidator may be appointed by the court. The liquidator is required to possess professional qualifications. The law provides that certain suspect transactions with third parties may be voided by a liquidator on application to the court. Secured creditors receive the highest priority in liquidation. There are no specialised courts or judges handling bankruptcy proceedings.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published by the private and public sectors between one and six months after being passed. Important judgements are not generally published or accessible to practitioners. There is generally a meaningful right of appeal from first-instance court decisions. There appears to be an independent right of judicial review of administrative action. On average, a party can be expected to wait less than six months for a commercial case to be heard on its merits by a court in the most important commercial centre and between one and two years for a final judgement for payment of a sum of money to be executed.

Belarus

- *The government has maintained price controls on basic food products and instituted ceilings on wholesale and retail margins following the increase in inflation in the first quarter of 1997.*

- *Progress on privatisation has stalled.*

- *The government has increased its intervention in the foreign exchange market, placing new restrictions on currency convertibility.*

- *Directed credits at subsidised rates are still provided to the construction and agricultural sectors.*

Enterprises

Size of the private sector

The private sector share of GDP is estimated to be between 15% and 25%. At the end of 1996, 37% of industrial activity, 12% of agriculture, 18% of construction, 8% of transport and communications and 5% of trade in the central government-owned sector ("republican") were carried out by privatised or corporatised state enterprises. The corresponding figures in the local government-owned sector ("communal"), were 3% of industrial activity, 20% of agriculture, 1% of construction, 0% of transport and communications, and 38% of trade activity.

As of end-May 1997, a little less than 10% of the labour force was employed by privatised enterprises, defined as those with less than 50% state ownership. The share becomes 16% if privatised enterprises with more than 50% state ownership are included.

Privatisation

The privatisation programme dates from 1993. It was intended that of the 8,500 republican and communal enterprises (about 10% of the combined total) selected for privatisation, the privatisation of about two-thirds should be completed by the year 2000. After four years of privatisation, however, as of January 1997, only a total of 2,122 enterprises had been at least partially privatised (564 republican and 1,558 communal), which represents 24% of the original target. The successive annual privatisation programmes approved in the last four years have always fallen short of their targets. Most of the privatisations of large state-owned enterprises have been to management and employees; majority ownership and the transfer of decision-making powers to private investors has not taken place. The privatisation programme for small-scale enterprises has progressed somewhat faster.

Of the republican state-owned enterprises privatised so far, 65% were first converted into

joint-stock companies (33% of which remained majority state-owned in January 1996), while only 1% were sold at auctions. Of the communal state-owned enterprises, the corresponding shares were 26% and 32% respectively.

The privatisation process stalled in 1997; in the first six months of the year, only about 90 joint-stock companies were created but none were privatised. The 1997 privatisation programme, which envisaged the denationalisation of construction, forestry, wood and agricultural processing industries as well as the full privatisation of retail, catering and other consumer services industries, was *de facto* abandoned. Instead, a presidential decree "on carrying out denationalisation and privatisation in Belarus" is being considered by the Council of Ministers. The draft decree restores the privatisation procedures abandoned last July requiring a 50-50 split between vouchers and cash. The consent of the workforce may be made mandatory before a company's privatisation is approved.

Governance and restructuring

There has been no significant effort by the government or the banking system to promote widespread enterprise restructuring. There is still government intervention in capital and investment decisions and in the setting of price and production targets.

Collective farms continue to receive large subsidies, including cheap credits, to purchase machinery and fuel. The proportion of these loans in default increased during 1996. Some progress has been achieved in converting military industries to the production of durable goods and in divesting "social assets", such as housing and district heating, from enterprises to municipalities.

The government appears to be favouring the establishment of joint ventures with foreign investors, some of which, such as the Ford Motor Company, have obtained attractive tax exemptions. Another example is the agreement between MAN, MAZ and Lada to produce truck tractors. As a result of the union treaty with Russia, the two countries have discussed plans to unify their hydrocarbons industries by converting the Belarussian refinery Naftan into a joint-stock company with the participation of the Russian oil companies Lukoil and Yukos.

About one-third of enterprises are loss-making, and overdue payments to the commercial banks grew by 12% in the first quarter of 1997. However, virtually no enterprise has been declared bankrupt and closed. The government continues to provide financial aid to priority enterprises through tax concessions (tax and import duty exemptions, limitations on tax obligations) and directed credits.

All businesses have had to re-register following a May 1996 presidential decree. As a result of the re-registration exercise, about 30,000 companies (about one-third of the total) were liquidated. The State Tax Committee started in April 1997 to stop any business activity and freeze the bank accounts of those businesses that failed to re-register.

Markets and trade

Price liberalisation

The authorities still view the level and structure of prices as instruments of economic policy rather than as outcomes determined by the

market. The government continues to set tariffs for utilities, gas and electricity, to influence the price of basic food products, and to "recommend" profit margins. On the other hand, some price liberalisation did take place in January 1997 and utility prices have been increased to levels closer to cost recovery.

The government implemented a 15% average increase in the price of heating, water and sewerage in January and April 1997. In real terms, however, inflation has already eroded these nominal tariff increases. Price increases averaging 46% in real terms are meant to be gradually phased in during the second half of 1997. The government plans to phase out cross-subsidisation as well as to reduce budget subsidies. In the past, however, similar plans have been delayed.

The prices of basic food products, such as bread, dairy products and meat, were frozen following a presidential decree issued in August 1996. The decree's expiry in January 1997 was followed by a 14% increase in food prices. Although wholesale prices have been freed, food prices remain controlled through "recommended" farm-gate prices. In March 1997 retail outlets were "advised" to reduce their maximum retail margin for basic food products from 30% to 10-20% as monthly inflation rates increased earlier in the year. Although official estimates of prices of "socially important products" and other products from national monopolies indicate that only 10% of value-weighted sales are subject to formal price controls, informal price controls with "advised" margins are extensive.

Competition policy

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. An Anti-Monopoly Ministry regulates and monitors natural monopolies and enterprises where there is little or no domestic competition. The government intends to submit to parliament a law on natural monopolies. Anti-monopoly legislation and regulation need much improvement as does the area of demonopolisation of trade.

Trade liberalisation

Steps towards reducing the dispersion of import tariffs were taken in March 1997, when Belarus unified the import tariffs of about 400 goods with those of its main trading partner, Russia. Nevertheless, there are many export and import restrictions. There are import quotas on alcohol and alcoholic beverages; export quotas on agricultural fertilisers are intended to keep the price of agricultural inputs low. An embargo on imports of butter and margarine and a ban on cattle and beef exports were introduced in October 1997 with the aim of ensuring stable domestic supplies.

In December 1995 the first Belarussian memorandum on trade and economic policies was sent to the WTO. The first meeting of the working party on the accession of Belarus to the WTO took place in June 1997.

On 2 April 1997 Russia and Belarus signed a Union Treaty aimed at closer monetary and economic union with a single currency, current account convertibility, and uniform tax and legal systems as their main goals. Earlier in March the central banks of the two countries indicated that the support of the Central Bank of Russia for Belarus current account convertibility was

conditional on the implementation of further reforms by the Belarussian authorities, including the adjustment of the exchange rate for the Belarussian rouble towards its Moscow market level.

Currency convertibility and exchange rate regime

The government continues to intervene actively in the foreign exchange market. Government policies have limited, directly or indirectly, the access to foreign exchange via legal channels, including temporary bans on foreign cash currency conversion through third countries.

Since April 1996 the nominal exchange rate has been allowed to depreciate within a pre-established dollar band. In early February 1997 the official exchange rates were unified and fixed at a nominally devalued rate of Rb 22,050:US\$ 1, with a plan to complete the transition to a single foreign exchange rate by July 1997 and to reduce the controls over foreign exchange market operations to a minimum. However, the currency continued to depreciate against the dollar during the first quarter of 1997, leading to a 25-30% gap between the average official exchange rate in Minsk and the average market rate in Moscow. Belarus now has an implicit dual exchange rate system. The real depreciation of the currency has slowed down since May 1997 following the slower increase in inflation.

Formal administrative controls have been applied in the foreign exchange market, including the prohibition of interbank trading, restrictions and taxes on the purchase of foreign currency, and compulsory surrender of a percentage of export earnings in hard currency. In April 1996 the Minsk Interbank Currency Exchange (MICE) was nationalised and put under the direct control of the central bank (NBB). A directive issued by the NBB on 20 January 1997 limits purchases of hard currency and Russian roubles at the MICE for the payment of a narrow range of basic imports such as fuel, electricity and medicines. The duration of these restrictions has tended to vary adding to market uncertainty.

Wage liberalisation

The labour market is very rigid and the redundancy costs associated with shedding employees are high, which contributes to over-employment. Although the labour code permits the shedding of employees for due cause, government officials exert informal pressure on public enterprises to retain labour. The number of registered unemployed was estimated at 157,400 in July 1997 or 2.8% of the labour force.

The 1990 Law on Enterprises allowed for the free determination of wages. However, many enterprises follow adjustments in public sector wages. The monthly minimum wage is set by parliament and is periodically adjusted for inflation; as of 1 September 1997, it was Rb 200,000 (US\$ 7.55). Enterprises that receive subsidies must follow the same wage structure as the public sector.

Interest rate liberalisation

Interest rates in commercial banks are controlled by the government through the National Bank of Belarus (NBB). As of 30 May 1997, minimum interest rates on deposits are set at 50% per annum. Government efforts to maintain artificially low nominal interest rates have contributed to a large capital flight to

Russia, where interest rates are higher (and positive, in real terms), and also to the devaluation of the Belarussian rouble due to its relatively wide availability on the Moscow currency exchanges. Real interest rates have recently experienced large fluctuations and remained negative over the period October 1996 to April 1997.

Financial institutions

Banking reform

The banking system in Belarus comprises 38 banks but only 32 are currently operating. The sector is highly concentrated. The assets of the six largest banks account for over 80% of all bank assets; their lending comprises over 75% of the gross credit of the banking sector. The four largest banks are controlled by the state, while the fifth, Priorbank, is privately owned. As of mid-1997, the banking sector had total assets estimated at US\$ 2.2 billion and equity of US\$ 70 million. Although foreign and joint-venture banks are allowed to operate, the regulatory regime is not well-defined and few foreign banks have applied for a licence. Foreign and joint-venture banks account for a very small share of all banking assets. Two small banks, Dukat and Magnat, went bankrupt in 1996 and 1997 respectively, and a number of other small banks are likely to go bankrupt or be merged with larger banks.

In 1996 directed credits provided to agriculture at 50% of the monthly refinancing rate accounted for 77% of total directed credits. A recent draft government resolution intends to strengthen state control over commercial banks through the management of bank shares belonging to state-owned companies.

Several agencies besides the NBB, including the President's administration and the tax authorities, are in prudential bank supervision. Yet bank supervision is weak. Only about one-quarter of all banks currently meet the ECU 2 million minimum share capital requirement, a regulation in place since 1994. About three-quarters of short-term loans and 25% of long-term loans have had late payment or arrears in the first half of 1997. Loan provisioning regulations follow NBB standards but still have major shortcomings because they are based on overdue loans and not on other factors related to the creditworthiness and sectoral conditions of the borrower. International accounting standards are expected to be introduced soon. A law on the bankruptcy of banks is under consideration.

Non-bank financial institutions

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% of collected premiums. There are 34 operating licensed investment funds holding about 8 million vouchers. The assets of non-bank financial institutions represent less than 10% of all assets in the financial sector.

Securities markets and instruments

The Law on Commercial Paper and Stock Exchanges was passed in 1992. Trading volume on the Belarus Stock Exchange is negligible. Trading sessions are held once a week, with active trading in only 10 companies (mostly banks). There are 30 minor stock and commodity exchanges throughout the country.

Given the limited access to foreign financing, the government has increased the issue of domestic debt but has also resorted to the use of the banking system to finance public expenditures. Treasury securities are the most liquid, tax-exempt, financial instrument on the primary and secondary markets. The yield on these securities is pegged to the finance rate, which was raised to 42% in the first quarter of 1997.

Fiscal and social safety net reform

Taxation

In 1996 direct taxes accounted for 25% of total tax revenues, down from 36% in 1993. This fall has been mainly caused by the fall in the profit tax share from 29% to 14% over the same period, while income tax revenue grew from 7% in 1993 to 11% in 1996. Income from VAT has remained stable around 28% over the same period.

In contrast to many other CIS countries, budgetary revenues remain very strong in Belarus. In the first quarter of 1997, general government revenues amounted to 44% of GDP compared with 40% in the same period of 1996. This reflects the elimination of many tax exemptions and improved collection, especially of custom duties.

The current tax system is, however, complex and lacks transparency. A draft Tax Code has been presented by the President to parliament and is expected to be approved by the beginning of 1998. The major challenge lies in reducing the number of taxes and the overall tax compliance burden by simplifying the tax base and improving enforcement mechanisms. Tax authorities operate with considerable discretion, occasionally confiscating financial assets without due process.

A major drawback in the current tax system is the existence of extra-budgetary funds that do not have a social safety net function. Revenues from these funds are not consolidated in the state budget, thereby reducing the efficiency of the tax system. In addition, a presidential extra-budgetary fund exists but there is no available information as to its size or its expenditures.

Social security

The largest extra-budgetary funds are the Social Protection Fund, which provides pensions and other social benefits, and the Employment Fund, which provides unemployment benefits and training and job placement services.

Social security payroll taxes are levied at 35% of the wage bill for private companies and 30% for agricultural producers. In addition, a 12% payroll tax is earmarked for Chernobyl-related expenditures. At the end of 1996 government expenditures on social programmes represented 13% of GDP and 36% of general expenditures. Demographic and system dependency ratios are about 33% and 49% respectively. Male and female retirement ages are set at 60 and 55 years respectively.

Poverty levels have increased from 1% in 1990 to about 22% in 1995 according to a World Bank poverty assessment. This increase indicates that the current system of income transfers is not operating effectively. The social safety net system is based on below-cost prices for basic goods, such as housing, utilities and food, which introduce distortions across the economy. The array of social insurance and assistance

benefits are not well targeted. It is estimated that people not classified as poor receive 1.5 times more benefits than the poor, and that a third of poor families do not receive all their entitled benefits.

Legal transition

Pledge law

Non-possessory pledges may be created by written agreement in a broad range of movable property. Notarisation is required in certain circumstances. There is no uniform or centralised registry for non-possessory pledges over movable property. Enforcement of a pledge involves court assistance.

Company law

The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is US\$ 500-1,000. The process may take up to six months. The law does not provide shareholders with pre-emptive rights in the event of a new share issue. Shareholders may vote by proxy at an annual meeting. Companies are not required to send proxy forms to shareholders in advance of the meeting. It is unclear whether shareholders may solicit proxies to vote on corporate resolutions. There is no cumulative voting for directors. Directors do not have any statutory legal obligations such as that to perform their duties in good faith. Laws do not exist prohibiting insider dealing of shares in publicly listed companies.

Bankruptcy law

A debtor is insolvent when (i) it is unable to meet its liabilities as they fall due or (ii) the liabilities of the debtor exceed its assets. It is unclear whether the law includes reorganisation provisions whereby a majority of creditors can reach a binding settlement with the debtor. In bankruptcy proceedings a liquidator is appointed by the court. It is unclear whether liquidators must possess special qualifications. The liquidator has a broad range of powers. Liquidators are not supervised by a government body. Transactions with third parties that are concluded below fair value and within a fixed time prior to liquidation may be reviewed and declared void. The exact ranking of secured claims is unclear with respect to the costs of liquidation, taxes, social security claims, personal injury claims and wages. There are no specialised courts or judges handling bankruptcy proceedings.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published between one and six months after being passed. Important judgements are not generally published or accessible to practitioners. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait less than six months for a commercial case to be heard on the merits by a court in the most important commercial centre and less than six months for a final judgement for payment of a sum of money to be executed.

Bosnia and Herzegovina

- *A set of laws relating to the establishment of basic state institutions was adopted by the legislature in June.*
- *A common currency was issued in August but its use remains limited to non-cash transactions for the time being.*
- *Progress on structural reform has generally not passed key legislative hurdles despite the existence of a broad array of draft laws and regulations in all areas of market reform.*

Overview

It is too early to present transition indicators for Bosnia and Herzegovina in the format adopted for other countries. Bosnia and Herzegovina does not yet constitute a common economic space, but is divided according to the Dayton Constitution into two separate entities – the Federation of Bosnia and Herzegovina (FBH) and the Republika Srpska (RS). There are severe *de facto* restrictions on the movement of people, goods and capital between different parts of the country and monetary and payments systems remain far from integrated. Where progress has been made towards implementing the economic provisions of the Dayton Constitution, it has generally been as the result of pressure and mediation by the international community. This has borne some fruit. A so-called Quick Start Package of laws governing state institutions, including a budget, a law on the central bank, on customs, and on the responsibility for foreign debt was adopted in June. There are still a variety of outstanding issues, such as the design of the new currency, which may delay implementation. Direct telecommunications links and cooperation in air traffic control between the two entities created by the Dayton Constitution were only re-established in September 1997. The most significant advance so far at the state level has been the opening of a common central bank in August, which has begun to issue a common currency (for monetary transactions only at this stage) and to centralise foreign exchange reserves. There has been little implementation of structural reforms, which are constitutionally the prerogative of the individual entities and cantons (i.e. regional subdivisions within the entities) although a lot of preparatory work has been done. Where reforms have been adopted (such as on privatisation in the RS), they remain piecemeal and are likely to be substantially revised over the coming months. The legal and institutional frameworks for economic activity continue to be essentially those of the former Yugoslavia, with modifications (e.g. greater control of enterprises by government) which resulted from the circumstances of the war. What follows is therefore more a progress report on legislation than on the implementation of reforms.

Reforms at the level of the state

From the perspective of transition to a market-based economy, the key responsibilities of the central government are in the areas of monetary and exchange rate policy and of foreign trade and customs. Although a Central Bank Board of Governors was appointed and has been meeting since November 1996, passage of the Central Bank Law was delayed by political obstacles until June 1997. The law provides for a single Central Bank (CBBH) – though with branches in both entities responsible for much of day-to-day activity – that will operate under strict currency board rules. It has begun to issue an interim currency, the “Convertible Marka” (KM), which is fully convertible and pegged at parity with the Deutschmark. The CBBH opened its doors officially on 11 August. Eligible monetary liabilities have been transferred from the former National Bank of Bosnia and Herzegovina, including the Bosnian dinar circulation (approximately DM 100 million) and the reserves and deposits of commercial banks (DM 30 million). The KM will have different designs, which have yet to be agreed on, but is to be used throughout Bosnia and Herzegovina for all non-cash transactions. In the interim, cash payments would be made in the currencies now in use in the two entities, and the Deutschmark will continue to be used as a medium of exchange. The entities are not legally obligated to take on the KM, but budgetary operations with the state government will have to be conducted in the new currency.

Foreign trade and customs policy is another key state responsibility. The Foreign Trade Law which was passed in June grants special status to trade with Croatia and the Federal Republic of Yugoslavia and eliminates quantitative restrictions such as import quotas and export permits. As with other legislation, however, implementation is still hesitant. Border crossing points along the RS-Croatia border, essential to increase the movement of goods and traffic to and from Bosnia and Herzegovina, have remained closed until recently. While interim state-level customs and tariff laws introduced a unified country-wide tariff with relatively low average rates (which represent a compromise between the generally higher FBH and the lower RS rates), the entities are responsible for customs administration and procedural issues. Each entity is now required to amend its existing customs laws before the end of 1997. Cooperation and communication between the FBH and the RS customs authorities is far from smooth, hampering the movement of goods between the entities. Discussions over the establishment of a shared revenue account have been postponed. The FBH customs administration itself has also not yet been fully integrated between its ethnic Croat and Bosnian components. Permanent State Customs and Tariff Laws are under preparation and are to be presented to the Council of Ministers by the new year.

Reform policies at the entity level

Markets and institutional environment for private sector activity

An onerous and complex tax system distorts trade in both entities. Business is also constrained by a legal and administrative framework that has yet to move much beyond that inherited from the old Yugoslav system. To strengthen the functioning of markets, new legislation is required to simplify taxes and tax

administration, define property rights, contract and enterprise law, provide for secured lending, modern governance, bankruptcy, regulate competition and enable foreign investment. In many of these fields, legislative proposals have been prepared for the Federation area – to a lesser extent for Republika Srpska – but are awaiting debate and passage by parliament.

Enterprise privatisation

Structural reform policies are constitutionally the responsibility of the entities, with much implementing authority in FBH at the level of the cantons. The legislative process, particularly in FBH, has been cumbersome and slow. Laws have to obtain the approval of the Council of Ministers before being sent successively in draft and proposal form to each of the two houses of the Federation parliament (which have to approve them in identical form). While legislation passes the House of Representatives by majority vote, consensus is required in the House of Peoples if any member declares an issue to be of “vital national interest” to an ethnic group, an option that has been repeatedly invoked. This process explains why, in FBH, many key pieces of reform legislation have existed in draft form for a long time, often prepared with international assistance, but are still far from being passed and implemented.

Seven laws relating to privatisation have been moving through the legislative process since the last quarter of 1996. Together, they would give rise to a privatisation process whose primary method is the settlement of outstanding claims against the state at auctions of state property, including apartments. Claimants include former owners, soldiers, and holders of frozen foreign currency accounts. To these would be added universal vouchers which are to be issued to the population at large, for a total face value of privatisation certificates of perhaps DM 18-20 billion. To date only one law, creating the privatisation agency, has been enacted. The agency expects to be fully operational by October. Cantonal agencies, which will be responsible for much of implementation, are at various stages of formation. The law on privatisation of enterprises itself has passed the House of Representatives and appears to be relatively uncontroversial. The same is not true of the laws on restitution, on settlement of citizen (and soldier) claims, and on the sale of apartments with existing tenancy rights, all of which face political difficulties in the House of Peoples as they could give rise to claims on property across ethnic boundaries. A law on the privatisation of banks has moved to the legislative stage. Both the enterprise and bank privatisation laws could face delays in implementation since cabinet discussion of a law on opening balance sheets of enterprises and banks is being delayed pending highly politicised decisions on the allocation of external debt (to final borrowers) between the Entities and within the Federation.

The constitutional framework in RS is simpler and a law on the privatisation of enterprises, which has serious deficiencies, was published in July 1996. It excludes infrastructure and certain “strategic” enterprises. The basic concept, with details yet to be worked out, is that 55% of state ownership would be transferred to socially-oriented funds (e.g. “Education Fund”, “Family Planning Fund”), a further 15% would be reserved for cash sales (to strategic investors) and the remaining 30% would be sold through auctions against vouchers issued to citizens.

State control of enterprises through the funds remains a possibility even though the shares held by funds are to carry no voting rights. Technical assistance is being provided to support a redraft of this law and greater harmonisation with the FBH draft law before it moves into implementation.

Banking sector reform

As of June 1997, there were 27 licensed banks in the Federation and 11 in Republika Srpska. Most of the 17 non-private banks are extremely weak, while the majority of private banks remain small and undercapitalised, incapable of meeting growing deposit and lending needs. Nevertheless, some private banks have shown rapid growth, and private banks now account for the majority of new loans extended. Connected lending based on non-commercial criteria still prevails among state banks, and accounting and regulatory standards do not reflect the needs of market-based banking. Financial sector reform has begun to be tackled in the Federation area, in particular through the formation in October 1996 of a Federation Banking Agency responsible for licensing and supervision. The Agency had, by June, refused the renewal of licenses for 20 banks. A modern Banking Law is on the parliamentary agenda but is unlikely to be finalised and enacted before the end of 1997. The state-owned banks are, without exception, insolvent and a financial restructuring is planned before they are offered for privatisation. Banks are to submit opening balance sheets six months after the law on bank privatisation becomes effective. According to the draft law on opening balance sheets, the external debt on the banks' books is to be extinguished and records moved to an Asset Liquidation Account. Privatisation certificates are to be issued to redeem depositors' claims on US\$ 2 billion of frozen foreign currency accounts that were transferred to the National Bank of Yugoslavia before the war and are unlikely to be recovered in full.

Little progress has been made on banking sector reform in Republika Srpska, though informal statements suggest that the government intends to honour citizens' foreign exchange deposits in cash rather than by issuing privatisation vouchers. Technical assistance from the international community is being targeted to ensure greater harmonisation in approaches between RS and FBH.

Legal transition

Pledge law

A non-possessory pledge may be created by written agreement. The agreement must be notarised in order to be enforceable against third parties. The notary fee is based on a percentage of the underlying loan or collateral, between 0.1 and 1% of this underlying value. Non-possessory pledges are not permitted in changing pools of assets. There is no centralised registry system for non-possessory pledges in movable property. Enforcement of a pledge requires court assistance.

Company law

The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is approximately US\$ 100-500. The process takes between one and three months. All joint-stock companies must maintain a share registry. It is unclear whether the registry must be maintained by an independent party. Shareholders are entitled to vote at meetings by

proxy. It is unclear whether companies must send shareholders proxy forms in advance of meetings. Minority shareholders are not afforded protection in the event that another company makes a bid for less than all of the shares of a target company. Shareholders, however, do possess pre-emptive rights with respect to new share issues. There is no cumulative voting for directors. Directors have an obligation to (i) perform duties in good faith, (ii) avoid self-dealing and (iii) disclose personal interests in material transactions with the company or its affiliates.

Bankruptcy law

The definition of insolvency is when a debtor is unable to meet its liabilities. The law provides for a reorganisation system whereby a group of creditors can reach a binding settlement with the debtor. A majority of the creditors must approve the settlement. In bankruptcy proceedings, the court appoints a liquidator. A liquidator possesses a full range of powers and is required to have special qualifications. A government authority regulates the conduct of the liquidator. Transactions with third parties may be declared void if they are (i) concluded within a fixed time prior to liquidation, (ii) below fair value or (iii) not at arm's length. Liquidation costs, taxes, social security payments and wages rank higher than secured claims. There are no special courts or judges handling bankruptcy proceedings.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published after being passed. Important judgements are not generally published or accessible to practitioners. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait less than six months for a commercial case to be heard on the merits by a court in the most important commercial centre and between two and three years for a final judgement for payment of a sum of money to be executed.

Bulgaria

- *A far-reaching programme of accelerated reform has been under implementation since March 1997.*

- *A currency board system of monetary management was introduced in July.*

- *The privatisation of major enterprises and banks has taken significant forward steps.*

- *Administrative shortcomings continue to affect parts of the privatisation programme.*

- *Institutional capacity remains limited in key areas such as competition policy, utility and banking regulation, as well as the court system.*

Enterprises

Size of the private sector

The private sector share in GDP in 1996 was estimated at 46%, with the share reaching 76% in agriculture (not counting cooperatives), 27% in industry and 50% in services. Over the past year further increases in those shares, to perhaps 50% on average, were largely due to a sharp contraction of the state sector. While gross output fell by 4% in 1996, private sector output declined by only 1%. By March 1997, public sector employment had fallen 13% since end-1995, while private sector employment was relatively stable. A series of major privatisations, which began during the first half of 1997 and is expected to continue until the end of 1998, is likely to boost the private sector share in industry and services (utilities and banking).

Privatisation

Privatisation of large enterprises is speeding up after years of delays. Only about 5% of long-term assets of state-owned enterprises, valued as of December 1995, had been privatised by August 1996, mostly through direct sales. The share exceeded 25% by August 1997 and is now likely to rise to 32-35% by the end of 1997. Recent progress has been largely due to the adoption of an "accelerated privatisation programme" in 1996 and the implementation of the first round of a voucher privatisation scheme.

The "accelerated privatisation programme" involves direct sales targeted at foreign bidders of a limited number of large companies under simplified valuation and administrative procedures. Revenues equivalent to 2.4% of GDP were raised from foreign buyers in the first half of 1997. A new feature of the programme is the tender during August-September 1997 to foreign consulting firms of contracts to privatise 27 large companies (representing 6.2% of state enterprise assets). Altogether, the programme of direct sales for the second half of 1997 targets

(somewhat ambitiously) revenues equivalent to 3.6% of GDP and covers approximately 20% of state assets. An adviser has been selected for the privatisation of a majority stake in the telecommunications monopoly, expected to take place in 1998. Privatisation in the power sector is under consideration.

Outside the "accelerated" programme, however, the institutional set-up for direct sales remains cumbersome, with some potential for conflicts of interest and unclear responsibilities. Sectoral ministries remain responsible for the sale of most assets with a book value of less than US\$ 1 million, but they are actively managing many of those same companies. A draft law to simplify this institutional structure is under discussion. There have been certain preferences for insiders (free and reduced shares), but large privatisations so far have been to outsiders. ZUNK bonds (domestic bank recapitalisation bonds) can be tendered for up to 80% of the value of privatisations, Bulgarian Brady bonds for up to 50%.

Assets in approximately 1,050 companies, representing 20% of long-term assets under state control, were offered for sale in three auctions between October 1996 and June 1997 under a voucher scheme. In 700 companies (9% of assets under state control) the state's share was reduced below a blocking minority. Enterprises representing 3% of state assets found no takers, and the fate of the residual shares in part-privatised firms remains under discussion, but a process of rapid auction appears to be increasingly likely. A second round of voucher privatisations is to be initiated towards the end of 1997. Little development has taken place so far in equity markets and they have not been a vehicle for ownership concentration (see section on securities markets below).

Small-scale privatisation, mainly of property owned by municipalities, is proceeding but has still some way to go (according to estimates, about half of the original list of 4,700 municipal properties remain to be sold). Most small-scale privatisation has taken place through the restitution of housing and land to pre-war owners. The distribution of titles for agricultural land, only 10% completed at the beginning of 1997, is making progress and is expected to be largely finalised by year-end. Regulations on land markets were relaxed by parliament in July, but the constitution continues to bar foreigners from owning land.

Governance and restructuring

Bulgaria's severe economic crisis was fundamentally the result of years of delays in necessary enterprise restructuring, with mounting losses financed by the largely state-owned banking system (amounting to an estimated 15% of GDP in 1995). This gradually eroded bank balance sheets and resulted eventually in a wave of bank failures. Decisions taken in response to the crisis to ensure greater financial discipline have begun to alter the nature of the bank-enterprise relationship and are providing incentives for restructuring. First in importance among these is the accelerated privatisation of both enterprises and banks. Second, programmes of financial "isolation" and liquidation of loss-making enterprises, adopted in mid-1996, are proceeding well. Third, energy price rises have had an important impact on energy-intensive industrial sectors that were kept artificially competitive by the earlier price structure.

The programme of "isolation" from the financial sector of 70 enterprises covering 230,000 employees (10% of employment) and responsible for 50% of state enterprise losses in 1995 has been largely successful in imposing discipline, forcing the downsizing of enterprises and the preparation of restructuring/privatisation plans (yet to be implemented). The "liquidation programme", which covered some 80 enterprises (25,000 employees) responsible for 25% of state enterprise losses, had been largely completed by July 1997 (with one-third of employees left to wind down operations). Together, restructuring and/or privatisation programmes now cover 77% of state-owned enterprises (by asset value as of late 1995); 30% are utilities and 3.9% are other firms placed in financial isolation programmes, 19% are targeted for privatisation through direct sales in 1997, 7% have already been privatised for cash and 13% through a voucher scheme, and 4% are undergoing liquidation.

While financial discipline has increased, tax and other arrears continue to be important, and improved governance is a long-term challenge. The stock of arrears by state-owned enterprises on profit tax and VAT represented 70-80% of taxes due in 1996. The government has announced that it will initiate bankruptcy proceedings for firms accumulating tax arrears and has begun to follow through on this for a number of smaller firms. However, arrears problems in the energy sector are severe, lack transparency (estimates vary widely) and have yet to be seriously tackled. Wage rises in many state enterprises have been out of line with financial results during March-June 1997. Outside shareholdings in enterprises are still a recent phenomenon and shareholder rights remain largely untested. Court cases in the few existing instances have tended to be drawn out and inconclusive, *de facto* supporting management against owners and buyers. The state continues to be heavily involved in the management of remaining state-owned enterprises. The state also retains stakes, including blocking minorities, in many enterprises part-privatised under the voucher scheme. The government has the intention to limit the state's control through the creation, before end-1997, of a residual shareholdings fund. In smaller privatisations to local interests acquisition by insiders has been predominant, but little information is available on the performance of these firms. Bankruptcy legislation, while adequate, has been little used until recently, and courts have shown only a limited understanding of the matter.

Markets and trade

Price liberalisation

Prices at all levels, except those of public utilities, were almost fully liberalised during March-June 1997. This followed an increase in controls for a number of years, affecting more than half of the consumer basket by 1996 as well as key agricultural producer prices. The Price Law passed by the Socialist Government in 1995 allowed broad powers of state intervention. It was effectively neutralised through the implementation of new legislation, but it was not formally repealed. A new law passed in July 1997, however, prescribes that retail prices for key goods are to be agreed contractually between producers and final distributors, thus cutting out wholesalers. The motivation for the law is somewhat confused (the relevant ministry refers to an information objective to pre-empt

shortages) and the law is generally not expected to lead to any practical consequences.

Various utilities tariffs were linked to inflation and devaluation through formulas implemented by the previous government, but during the severe price instability in early 1997 formulas lagged far behind events. Price adjustments were made in spring 1997 to levels recommended by the World Bank, generally covering operating costs plus a margin, and further moves towards fuller economic pricing are envisaged. Minimum farm-gate prices were established by the government for the 1997 wheat crop that lie well above prices in neighbouring countries (US\$ 134/ton as opposed to approximately US\$ 90 in Romania). These minimum prices are backed up by a credit guarantee scheme that is likely to result in substantial budgetary costs.

Competition policy

Bulgaria passed anti-monopoly legislation early in the reform process (Law for the Protection of Competition) and created a Competition Protection Committee, with a membership of 11 appointed by parliament, in 1992. The Committee is, in principle, empowered to force divestment and closure in cases where more than 35% of the market is controlled by one player. A new draft law exists modifying the criteria to "dominant position" instead of a market share threshold. While a long list of cases have been opened, however, there have been no anti-monopoly successes of substance because of the Committee's very limited powers to seek remedy (resulting in lengthy litigation) and its weak endowment in financial and human resources. A new law establishes penalties, but they continue to be extremely low. Given the openness of the Bulgarian economy to imports, monopoly problems are concentrated in trade, services and utilities (as well as state monopolies in oil, fuel and alcohol distribution).

Trade liberalisation

Bulgaria obtained WTO membership in December 1996. Tariffs were bound in a liberal regime, with no quantitative restrictions and at present an average unweighted import tariff of approximately 17%. There are five rates of tariffs, ranging from 5% to 40%, and 55% applied to three agricultural items. A temporary 5% flat import surcharge for balance of payments purposes has been in effect since June 1996, and is being reduced in steps over four years. Bulgaria also agreed to sign WTO subsidiary agreements on services (including telecommunications). Bulgaria is negotiating to join CEFTA, and free trade agreements with the Czech Republic, the Slovak Republic and Slovenia have become effective. Similar agreements are in preparation with Hungary, Poland and Romania. Previously, Bulgaria had signed a Europe Agreement with the EU (effective since January 1995) and free trade agreements with EFTA. Quantitative export restrictions have been abolished and converted into an export tax on 11 groups of products including grain flour, sunflower oil and timber. The government has committed to eliminating these as the domestic supply situation improves.

Currency convertibility and exchange rate regime

The lev is fully convertible on current account at an exchange rate fixed at Lv 1,000/DM under the currency board regime. Rate changes are subject to parliamentary approval. The govern-

ment has agreed to move towards full capital account convertibility. At present, capital outflow restrictions remain for non-banks.

Wage liberalisation

Wages in Bulgaria continue to be set in principle by a trilateral commission, which includes unions, employers and the government. The degree of unionisation in the state sector is high. However, the private sector has remained largely outside this scheme, and the extent of self-employment in Bulgaria is substantial. Wage ceilings have been introduced for the state enterprise sector, linked to the financial performance of the enterprise, after significant wage inflation during the second quarter of 1997. There is a minimum wage, which was increased in May to Lv 41,300 (US\$ 24 at July exchange rates compared with a national average wage of approximately US\$ 65).

Interest rate liberalisation

Interest rates are mostly market-determined. The Central Bank's (reference) "base rate" follows the yield on three-month treasury bills, which is determined in frequent auctions. Under currency board rules, it has no open market policy to actively influence commercial rates. As of mid-1997, base rates had fallen to negative real levels (less than 6% per annum nominally) as a result of a substantial reflow of funds into the financial system. There is no state-directed credit of significance outside the agricultural sector. In the latter, the government has announced an expensive programme of credit guarantees on non-commercial terms for the wheat harvest. The interbank money market, formerly active, disappeared during the recent bout of extreme inflation and is only slowly re-emerging.

Financial institutions

Banking reform

Bulgaria experienced drastic financial disintermediation as a result of extreme inflation and a severe banking crisis, with the value of deposits in the banking system falling from the equivalent of US\$ 7.4 billion at end-1995 to US\$ 1.8 billion in March 1997. There has been a process of partial remonetisation since macroeconomic stabilisation in the second quarter of the year, with real lev money demand up by 60.1% over the March-June period. Inflation has had its benefits for commercial bank balance sheets, at the cost of a huge tax on depositors. Lev-denominated bad assets of what remains of the banking sector, largely insolvent in 1996, have been "inflated away", so that solvency criteria are now much improved. Reinitiation of lending to the enterprise sector is still cautious, but there has been significant expansion in this area by some smaller private banks. The solvency crisis over the past two years has shown up deficiencies in the protection of creditors under Bulgarian law, with banks unduly restricted from collecting on bad loans. A new Banking Law passed by parliament in June 1997 could reduce lending risk and speed up a return of intermediated funds to the enterprise sector.

There has been a programme of banking sector restructuring since June 1996, based on agreed financial targets, organisational changes and ultimately privatisation. However, the banking crisis has imposed a far more rapid process than envisaged. As of late 1996, 67% of banking system assets were held by the seven main state banks, with a further 24% in banks (again mostly state-owned) undergoing bank-

ruptcy proceedings. In fact one-third of banks, four state and 13 private, have been the subject of bankruptcy proceedings in three waves since May 1996, when the Central Bank was legally empowered to intervene in insolvent banks. Courts have substantially delayed the implementation of bankruptcy. A new Banking Law adopted in June 1997 gives wider powers to the Supervisory Authority (a semi-autonomous department of the Central Bank) to close banks whose licences have been withdrawn, and speeds up court procedures. Foreign-owned banks have played only a minor role in terms of assets, although there are few restrictions to foreign entry.

The first privatisation of a major state bank, UBB, took place in July 1997. A majority of UBB shares were purchased by foreign investors (including the EBRD). A management contract and recapitalisation programme for a second bank (Biochim), however, have been delayed. All other state banks are now assumed to be solvent, compared with only two (out of 11) in early 1996. Tenders for three further state banks were announced in September 1997, and the remaining banks are to be privatised by mid-1998 (except for the State Savings Bank).

Central Bank supervision and enforcement capabilities have traditionally been weak and there was little resistance to the erosion of banking sector solvency before mid-1996. Legal changes in May 1996 (Bankruptcy Law) and June 1997 (Banking Law), as well as a degree of autonomy under the new (currency board) structure have strengthened the supervisors' hands. An expansion of staff (by one-half to 90) and the use of technical assistance are beginning to improve their competency. No formal deposit insurance existed before 1996. With the onset of the banking crisis, a law was passed that provided budgetary guarantees for deposits in insolvent banks under a programme of phased withdrawals. However, the real value of the guarantee was eroded by inflation. The government is now preparing a deposit insurance scheme modelled on EU guidelines to go before parliament in October. A share of privatisation income is currently being transferred to a deposit insurance fund.

Non-bank financial institutions

The insurance sector continues to be dominated by the previous state monopoly provider. A legislative initiative is under way to improve market access for foreign providers, previously limited to minority stakes. The ratio of insurance premiums to GDP is relatively high for a transition economy, at 2%. There is no law regulating private pension provision. A draft law, prepared by existing providers, has been under discussion for some time and is expected to be presented with modifications for parliamentary approval towards the end of 1997. Despite the regulatory vacuum, private pension funds, often backed by trade unions, have been spreading. While the Privatisation Investment Funds may form the nucleus of an equity fund industry, there are at present no equity investment vehicles for retail investors.

Securities markets and instruments

Bulgaria's incipient stock markets have seriously suffered as a result of macroeconomic instability. After a long period of decline in stock values and turnover, markets virtually stopped trading after mid-1996. A merger of two exchanges in July 1997 which formed the

Bulgarian Stock Exchange, with 49% state participation in the capital, is to prepare the ground for trading in the stock of companies privatised through vouchers in October. Vouchers are not transferable, but "temporary certificates" (private contracts) are being traded in a limited way off-market, helping to increase somewhat the concentration of ownership. There have been no new issues of shares in 1996 and 1997. Privatisation Investment Funds (PIFs) hold 85-90% of vouchers. At present, their shareholdings in individual companies are limited to 34%. Many PIFs are expected to transform themselves into holdings along sectoral lines. The fate of residual state shares in mass-privatised companies has not yet been decided. A custodian fund with a rapid sales mandate is under discussion. There is a central depository for securities.

Though not yet institutionalised, Bulgaria's market in state securities is active by regional standards and covers a broad range of maturities. As of 31 July 1997, securities in circulation totalled Lv 2.8 trillion (US\$ 1.5 billion). US\$ 1.05 billion of these were US dollar denominated, and represented largely bank recapitalisation bonds with 25-year maturities (ZUNKs). Secondary market transactions in July 1997 totalled Lv 77 billion. The maturity structure of new lev-denominated issues shortened significantly during 1996 (when only 7% of issues carried maturities of more than one year) and the first half of 1997, and a programme is under way to reverse this development. While the market has been dominated by local banks, new issues since introduction of the currency board are specifically targeted at retail investors. Foreigners were largely absent from the market until spring 1997; however, the period March-June 1997 saw an estimated US\$ 140 million in foreign portfolio investments in both ZUNKs and lev-denominated securities, with several international investment banks issuing American Depository Receipts (ADRs) backed by ZUNKs.

Securities market regulation is in its infancy. Pre-1996 stock trading was dominated by a small group of insiders. While a Securities and Exchange Commission has been created and is undergoing extensive training, its first real test will come with the opening of trade in the shares of mass-privatised firms late in 1997. The commercial code includes provisions for the protection of minority shareholders, but weaknesses in anti-dilution protection have become apparent in the context of recent capital increases, and the Law on Securities and Stock Exchanges has been criticised for weak disclosure requirements.

Fiscal and social safety net reform

Taxation

There have been no major changes to the rate structure of taxation since publication of the last *Transition Report*. Bulgaria has a high rate of profit taxation in regional comparison, at 40%. However, Bulgaria's tax effort has been in continuous decline since 1994. Tax revenues are projected to yield approximately 23% of GDP in 1997 (32% in 1994), with 10% accounted for by indirect taxes (primarily VAT, assessed at a rate of 20%) and 13% by direct taxes on income and profits (half of which is in social security contributions, with the remainder spread equally between personal and corporate income taxes). The government has initiated a short-term

programme of improvements in tax administration, in particular the establishment of a large taxpayers' unit to closely track some 600 taxpayers who account for 80% of revenues, and the raising of VAT thresholds. A major problem has been the impact of inflation on deductible depreciation charges, which have been unrealistically low because based on historic prices. A key component of the envisaged reforms is the revaluation of assets at the end of 1997.

A new foreign investment law is to be discussed by parliament in October 1997. The provisions of the law remain to be worked out.

Social security

As a result of the widespread use of early retirement options, Bulgaria has 2.5 million pensioners out of a population of 8.3 million. In the public pay-as-you-go pension system, each contributor supports 0.84 pensioners, a situation which results in low wage replacement values, high social security tax rates (35-50% of gross wages) and widespread evasion by the private sector. Pensions in 1996 represented 31% of average salaries and had fallen to 34.7% of the purchasing power of pensions in 1989. In absolute terms, the minimum state pension for the second half of 1997 has been set at Lv 27,000 (US\$ 16) and the maximum pension at Lv 81,000 (US\$ 47). Recent amendments to the Law on Pensions allow pensions to follow the movements of budgetary wages. Reform efforts are under way, aimed initially at raising the very low retirement ages (for some professional groups currently as low as 45 years, in general 55 for women and 60 for men). A law is to go before parliament before end-1997. Steps are being taken to improve the funding of social security through the assignment of privatisation revenues.

Legal transition

Pledge law

Under a new Law on Registered Pledges which came into force on 1 April 1997, a non-possessory pledge may be created over a broad range of movable property, including receivables, shares, future assets, a changing pool of assets and enterprises, by written agreement to be registered with a central registry. Notarisation is not required. The pledge may be enforced without involvement of the court. The new law, however, limits those who may be pledgors to "merchants" and certain other categories. There is no centralised registry system for non-possessory pledges in movable property, although one is contemplated in the new law.

Company law

The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is US\$ 200-1,000. The process takes between one and three months. Shareholders are entitled to vote by proxy at meetings. Companies are not, however, required to send shareholders proxy forms in advance of the meeting. Minority shareholders are not afforded protection if a company makes a bid for less than all of the shares of the target company. Shareholders do, however, possess pre-emptive rights with respect to new share issues. Directors have a duty to perform their obligations in good faith. Directors are not legally bound to avoid self-dealing or to disclose any interests in material transactions with the company or an affiliate, but this may take place in practice. The law does not require companies to maintain share registries.

Bankruptcy law

Bulgaria enacted a new Law on Bankruptcy in 1994, which was incorporated into Part IV of the Civil Code. A debtor is considered insolvent when it is unable to meet its liabilities as they fall due or, if the debtor is a limited liability company, when it is in a state of excessive indebtedness. The new Bankruptcy Law provides for reorganisation proceedings. A settlement between creditors and the debtor may be reached if a simple majority of creditors, in value of claims in each class, approves the settlement. In liquidation proceedings, no claims rank higher than those of a secured creditor. Bulgaria does not have specialised judges or courts handling bankruptcy proceedings. The court appoints a person proposed by the creditors as a liquidator to supervise liquidation proceedings. The liquidator possesses a broad range of powers. Transactions with third parties that are (i) not at arm's length, (ii) below fair value or (iii) concluded within a fixed period prior to liquidation may be reviewed and declared void.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published within one month of being passed. Important judgements are generally published and accessible to practitioners and provide written reasons for courts' decisions. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between seven months and one year for a commercial case to be heard on the merits by a court in the most important commercial centre and between two and three years for a final judgement for payment of a sum of money to be executed.

Croatia

- *A voucher privatisation scheme commenced in mid-1997. Bidding rounds are scheduled for early 1998.*

- *Bank rehabilitation is progressing, but the privatisation of larger banks is not imminent.*

- *The process of restructuring industrial enterprises and utilities remains slow. A new bankruptcy law is in force, while inter-enterprise arrears continue to grow.*

- *The profit tax was raised from 25% to 35% in January 1997. The introduction of VAT, however, was delayed until January 1998.*

- *Croatian sovereign debt received a BBB- risk rating and issued Eurobonds denominated in US dollar and Deutschmark.*

Enterprises

Size of the private sector

The private sector accounted for about 55% of GDP in 1997. It has been expanding steadily due to the ongoing privatisation process as well as higher growth rates in sectors with mostly private ownership (such as trade and transport) relative to sectors with significant state ownership (such as industry). A significant proportion of private sector activity escapes official statistics. The size of the grey economy is estimated to be around 25% of GDP.

The number of active private companies increased by about 5% in 1996, while the number of majority state-owned enterprises fell by about 5%. The private sector share of employment in all registered enterprises rose from 42% to 45%.

Privatisation

The Law on the Transformation of Enterprises (1991), administered by the Croatian Privatisation Fund, required the conversion of almost all socially owned enterprises into joint-stock companies with subsequent privatisation. Excluded were mainly public utilities, which account for a fifth of total enterprise employment. Most privatisations under this law were management and employee buy-outs. Sales through public tenders were introduced in 1993 and insiders' subscription rights were limited to 50% of a company's equity. Furthermore, the Privatisation Fund sold some of its portfolio in public auctions on the Zagreb Stock Exchange. Foreign participation in the process was limited.

By early 1997, over 1,000 from a total 2,550 commercialised companies had been fully priva-

tised and in another 1,350 the state retained only a minority stake. Most of the fully privatised companies are relatively small and the state still accounts for about 40% of the net asset value and of employment in the 2,550 enterprises.

Partly due to the sluggish pace of the privatisation process and the large number of residual shares held by the state, parliament approved a new privatisation law in February 1996, which provides the framework for a voucher privatisation programme. After considerable delay, registration of the 350,000 eligible individuals (mostly refugees, war invalids and other displaced persons) began in June 1997. Each voucher recipient can bid for shares in over 500 companies with a total face value of about US\$ 2.5 billion, either directly or through investment funds (see section on non-bank financial institutions, below). The bidding rounds are planned for early 1998.

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 telecommunications. The details of each privatisation must be individually approved by parliament. It is envisaged that foreign bidding will be permitted for some of these enterprises.

The privatisation of former socially owned housing is almost complete. Out of 330,000 state apartments eligible for privatisation, 86% had been sold by early 1997. The government has raised almost DM 3.6 billion in these sales, which exceeds the proceeds from enterprise privatisation.

In October 1996, parliament passed a law regulating the denationalisation of property confiscated or nationalised since 1945. It gives preference to restitution of property where possible and provides for compensation in other cases. In the corporate sector, the rights of former owners and their heirs have been secured by freezing a percentage of the equity in the Croatian privatisation fund portfolio.

Governance and restructuring

The pace of restructuring remains slow. While sectors such as trade and tourism have emerged from the economic collapse of the early 1990s and are now growing quickly, many industrial enterprises are stagnating. In privatised companies, ownership is very dispersed among employees and managers. The absence of a strong majority owner and the persistence of the old management often inhibit restructuring.

The difficulties of the industrial sector are evident from slow growth in output and stagnating exports to developed countries. On the other hand, many companies have been successful in reducing an excessively large workforce. In early 1997, industrial employment was only 54% of its 1989 level. Productivity growth increased strongly in 1996, but was still largely driven by labour shedding rather than output growth. Industrial productivity has not yet returned to its pre-transition level.

A key challenge for the government is the ongoing rehabilitation of larger loss-making industrial enterprises in shipping, metals, plastics, textiles, wood processing and other sectors. Many of these companies have not yet made much progress in restructuring and face a large debt burden. Difficulties arise from weak

enforcement of creditor rights, related lending and weak corporate governance. Restructuring has also not progressed in the 10 large utilities (accounting for 15% of enterprise employment), including the oil and gas conglomerate INA. However, there are plans to include some subsidiaries of INA in the voucher privatisation programme.

The new Bankruptcy Law came into effect in January 1997. It is aimed at improving payments discipline and reducing the large amount of inter-enterprise arrears, which doubled in a two-year period to about 9% of GDP in mid-1997, excluding interest and tax arrears. There are over 15,000 insolvent firms employing over 150,000 people. For fear of job losses, the government has exempted some 40-50 larger companies from the application of the law.

Apart from rehabilitation programmes, the government continues to provide subsidies for farming (about US\$ 100 million in 1997) and railways (about US\$ 200 million). The government has also introduced subsidies for flights to tourist resorts.

Markets and trade

Price liberalisation

All direct price controls have been removed. Some indirect controls remain, largely through government influence on major enterprises, particularly in the energy sector. Agricultural subsidies take the form of guaranteed prices.

Competition policy

A Law on Competition and Monopoly was passed in the autumn of 1995. The law created a Council for Competition Protection, which is operative and has already delivered some opinions on draft laws to parliament. However, the competition law itself is not yet fully operational and the Competition Protection Agency is yet to become active to implement the policy.

Trade liberalisation

The foreign trade system is liberal. A new customs tariff law came into force in 1996, bringing Croatian tariff codes into line with international practice, and transforming almost all the remaining import restrictions into tariffs. Non-agricultural tariff rates vary between 0% and 25%. The government has recently increased tariffs on agricultural and food products.

Croatia has applied for membership of the WTO and is in the process of negotiating accession. Trade with the EU is still on the basis of the agreement of the EU with former Yugoslavia. Croatia has expressed interest in negotiating a full Association Agreement with the EU. Negotiations with CEFTA countries have made slow progress so far, but are likely to accelerate as Croatia approaches WTO membership.

Currency convertibility and exchange rate regime

The value of the Croatian kuna is determined under a managed float exchange rate regime. The National Bank intervenes to maintain a stable exchange rate against the Deutschemark. Croatia officially notified the IMF 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 capital account transactions, 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 enterprise. There is no formalised national bargaining process for wages and Croatia is one of the few transition economies without minimum wage legislation.

Interest rate liberalisation

Banks are free to set their own credit and deposit rates. The state-financed rehabilitation of two large banks, Rijecka Banka and Splitska Banka, triggered sharp reductions in interest rates. Real interest rates on daily interbank loans were about 7% in mid-1997. Interest rate spreads were 11% on average in May 1997, down from 21% a year earlier, suggesting an increase in competition among banks.

Financial institutions

Banking reform

Over 60 commercial banks are registered, but the two largest, Privredna Banka and Zagrebacka Banka, have a market share of about 50%, and the four largest account for about 65% of all bank assets. While most larger banks suffered from illiquidity and bad loan portfolios and were thus put under rehabilitation, some healthy smaller private banks have emerged and strengthened the financial sector. However, the large number of banks relative to the size of the country suggests that pressures for consolidation in the sector may develop.

Some foreign banks, mainly from Austria, have recently entered the Croatian market. There is hardly any strategic investment in existing Croatian banks. Some banks have increasingly had access to foreign loans.

The rehabilitation of the larger banks remains an important element in Croatia's transition process. In November 1995, Slavenska Banka, the sixth largest, entered rehabilitation, followed in the spring of 1996 by Splitska Banka and Rijecka Banka (the third and fourth largest). After much delay, the government decided in December 1996 to rehabilitate Privredna Banka, the largest bank, and placed it under direct control of the Bank Rehabilitation Agency (BRA).

The Law on Bank Rehabilitation (1994) foresaw a control function for the BRA. Bank rehabilitation involves the separation of bad loans from the balance sheet, an injection of fresh capital in return for equity, reorganisation of management, and privatisation. Earlier attempts to recapitalise the troubled banks were unsuccessful, mainly because of connected lending to loss-making industrial enterprises. Under the new rehabilitation programme, this problem was addressed by writing off their share capital against losses.

So far, Slavenska Banka has completed the process of rehabilitation and is now scheduled for privatisation. The restructuring of the other banks is progressing only slowly and the process can be expected to last several years.

While the emergence of new banks and the restructuring of larger banks have reduced interest rates and increased competition, important constraints remain. Many banks are still poorly managed and have a significant amount of bad loans on their balance sheets. Nevertheless, classified loans fell to 13% of total banking assets by the end of 1996 according to official estimates. Long-term credit remains scarce. Most loans are still indexed to

the Deutschmark exchange rate, effectively transferring foreign exchange risk to enterprises.

A deposit insurance scheme became effective in mid-1997. The scheme fully insures kuna-denominated savings deposits up to 30,000 kuna and offers partial insurance up to 50,000 kuna. A number of prudential regulations are in place and the regulatory framework is close to EU standards. However, rules on lending to related parties appear to be insufficient. Banks submit quarterly reports on capital adequacy as defined by the BIS. Capital adequacy declined in 1996, but is still generally high. However, financial statements continue to lack transparency despite a legal obligation to adopt international accounting standards.

Non-bank financial institutions

A new bill on privatisation and investment funds (PIFs) will be considered by parliament in end-1997 to complement the voucher scheme. It is envisaged that a fund's ownership stake in any one company should not be restricted, which suggests that they could take an important role in enterprise restructuring. There will, however, be exposure limits to ensure portfolio diversification of funds. It is planned that foreigners will be able to register funds and that the number of PIFs will be limited by fees and certain financial thresholds. PIFs will be listed on the Zagreb Stock Exchange.

An Insurance Law was adopted in 1994, envisaging an open market for the insurance industry. There are over 15 insurance companies, but the largest insurer, state-owned Croatia Osiguranje, has about 75% market share.

Securities markets and instruments

In 1996, a law regulating securities and a new law regulating investment funds were both passed by parliament. These laws created 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.

In the second half of 1996, encouraged by the successful flotation – with EBRD assistance – of shares in pharmaceutical manufacturer Pliva and in Zagrebacka Banka, market capitalisation and activity has risen significantly. The OTC market has also become more active. Trading in shares and bonds (excluding auctions by the Privatisation Fund) amounted to DM 4.5 million in 1995, DM 370 million in 1996, and DM 230 million in the first five months of 1997. There were about 550,000 shareholders at the end of 1996.

Interest of foreign investors in Croatia has risen substantially after a BBB- rating by the three main credit rating agencies in early 1997 and two subsequent sovereign Eurobond issues denominated in US dollars (initially priced at 80 basis points above US Treasury Bills) and Deutschmarks (initially priced at 95 basis points above German government bonds) for a total value of almost US\$ 500 million.

However, of about 80 quoted companies, only three are fully listed. Inflow of foreign capital is inhibited by the absence of disclosure rules for quoted companies which are not fully listed. The Securities Commission is drafting a law on take-overs and mergers as well as rules for private share placements. A securities depository was

established in early 1997. Foreigners are free to transfer capital and repatriate profits.

Fiscal and social safety net reform

Taxation

The central government derives about half of its tax revenues from general sales taxes and about 20% from excise taxes on petrol, tobacco, alcohol and coffee. Taxes on foreign trade raise another 15% of total tax revenues, while income taxes account for only 11%. It is estimated that losses to the budget due to tax evasion amount to 25% of actual tax revenues, or 7.5% of GDP.

The abolition of the turnover tax and its replacement with a VAT with a 22% standard rate has been postponed until January 1998. In January 1997, the profit tax was raised from 25% to a flat rate of 35%, which applies equally to domestic and foreign entities. The basic rate of income tax was reduced from 25% to 20%. The standard rate of income tax remains at 35%. There is no capital gains tax.

Social security

One of the most pressing economic needs is a reform of the pension system. Croatia has an increasingly ageing population of 4.8 million, with about 1.5 million employed and 900,000 pensioners. The ratio of the population of retirement age to the working age population is expected to increase from 36% in 1990 to 41% in 2000 and almost 68% in 2035. Expenditures of the pension fund are equivalent to around 13% of GDP in 1997. The need to transfer funds from the central budget to the pension fund is increasing. The share of contributions in total pension fund revenues fell from 93% in 1995 to 83% in 1997.

The government plans to replace the "pay-as-you-go" system, where pensions are funded by payroll contributions by workers and employers of 12.75% each, by a "three pillar" system which is based on a mixture of obligatory and voluntary contributions paid into both a public pension fund and private investment funds. The government estimates that the reform will cost about 3% of GDP for at least 10 years from launch. The healthcare system, which is funded by payroll contributions of 20%, is also in need of further reform.

Legal transition

Pledge law

Pledges are primarily governed by the Ownership and Other Property Rights Law of 1996, and by the Enforcement Procedure Act of 1996. Pledge contracts are governed by the Obligations Law of 1978 of the former Yugoslav Republic, which was amended several times up to 1996. Non-possessory pledges in a broad range of movable property, including tangibles (equipment), intangibles, a changing pool of assets and enterprises, may be created by written agreement, which must be notarised or entered before the competent court in order to be enforceable. The notary fee is 1% of the underlying debt or collateral. There is no uniform or centralised registry for non-possessory pledges in movable property. Enforcement of a pledge normally requires court assistance.

Company law

The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is over US\$ 1,000. The process takes between one and three months. Joint-stock companies

must maintain their own share registries. Some independent parties operate share registries. Shareholders are entitled to vote by proxy at meetings. Companies are not required to send shareholders proxy forms in advance of meetings. There is no cumulative voting for directors. Minority shareholders are not afforded protection if a company makes a bid for less than all the shares of a target company. Shareholders possess pre-emptive rights with respect to new share issues, but such rights may be excluded by a shareholders' resolution passed by a qualified majority of shareholders. Directors have an obligation to (i) perform duties in good faith and (ii) avoid self-dealing. Laws exist prohibiting insider dealing in shares of publicly listed companies.

Bankruptcy law

A new Bankruptcy Law came into effect on 1 January 1997. A debtor is considered insolvent when (i) it is unable to meet its liabilities as they fall due, or (ii) its liabilities exceed its assets. The law provides for reorganisation. A panel of three judges supervises the settlement proceedings between the debtor and its creditors. A settlement may be approved by a simple majority of those creditors who participate in the proceedings. Bankruptcy proceedings are conducted by the Commercial Court within whose jurisdiction the debtor has its registered office. A liquidator must be "qualified", although the law does not list the type of qualifications necessary. The liquidator is required to verify claims, to inquire into a debtor's financial position, to sell assets and to satisfy claims. Transactions with third parties that are (i) not at arm's length, (ii) below fair value or (iii) concluded within a fixed time prior to liquidation may be reviewed and declared void. The claims of secured creditors rank below liquidation costs, but prior to all other claims.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published within one month of being passed. Important judgements are generally published and accessible to practitioners and provide written reasons for courts' decisions. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between one and two years for a commercial case to be heard on the merits by a court in the most important commercial centre and between one and two years for a final judgement for payment of a sum of money to be executed.

Czech Republic

- *Following strong market pressure on the koruna, the Czech National Bank (CNB) allowed it to float with effect from 26 May 1997, abandoning both its fluctuation band and the link with the DM and US\$ basket.*
- *Towards the end of 1996 the government announced it would complete the privatisation of the main banks and improve the regulation, liquidity and transparency of capital markets. The government also indicated its intention to establish an independent Securities Exchange Commission (SEC).*
- *As part of its package of measures to address the problem of the trade deficit, the government announced a range of measures to accelerate structural reform.*

Enterprises

Size of the private sector

According to official estimates, the non-state sector's contribution to GDP increased from 64% in 1995 to almost 75% by the end of 1996. This includes many enterprises in which the state, through the National Property Fund (NPF), continues to hold a minority share. The non-state sector's share was highest in agriculture, construction and trade, followed by industrial production.

By April 1997 the number of companies and partnerships had risen to over 134,000. Among the fastest growing elements has been small enterprises (defined as those with fewer than 99 employees), which are now estimated to account for about 20% of industrial output. Both small and medium-sized enterprises (SMEs) and self-employment have accounted for a growing share of total employment.

Privatisation

Privatisation of small and large enterprises in the Czech Republic was carried out through a variety of methods, including the transfer of state property to municipalities, restitution and the privatisation and transformation of agricultural and other cooperatives. The sale of most large-scale state assets was implemented in two privatisation "waves", although the government retains shares in a number of major commercial and financial enterprises. The Czech mass privatisation was completed on 1 March 1995.

The NPF retains shareholdings either as residual holdings in partly privatised companies or through its holdings in designated "strategic"

enterprises. Among the former group, sales of state-owned companies have continued through direct sales, public auctions and public tenders. The strategic companies included, at mid-1997, 53 enterprises in gas and energy distribution, telecommunications, iron and steel, and coal mining. The value of NPF shareholdings is estimated at 240 billion koruna (US\$ 7.7 billion at the average exchange rate in the second quarter of 1997) of which holdings in strategic enterprises accounted for almost 170 billion koruna (US\$ 5.5 billion). The government's approach to the privatisation of the strategic companies is to promote direct sales, including sales to foreign strategic partners.

In early 1997 the government stated that it would accelerate the completion of the privatisation of the remaining state-owned banks, sell 15% stakes in regional gas and electricity companies, and partially privatise other companies in the construction, telecommunications, pharmaceuticals and metallurgy sectors. In July the government announced that it would sell its 36.3% stake in Investicni a Postovni Banka to Nomura International. In August the government decided to sell a majority of its shares in Komerční Banka, Československa Obchodní Banka (CSOB) and the main savings bank, Česká Spořitelna, with preference to be given to a strategic partner or partners in each case.

A Restitution Law was adopted by the Czech and Slovak Federal Republic in October 1990 designed to return property nationalised since 1948 to its former owners.

Governance and restructuring

A feature of the Czech privatisation was the emergence of Investment and Privatisation Funds (IPFs) and investment companies as dominant shareholders with at least two-thirds of all the voucher points assigned in both waves of privatisation. In 1996 it was estimated that the IPFs (some reorganised as industrial holding companies) controlled approximately 30% of shares and the NPF held a further 40%. Furthermore it is estimated that holdings were very concentrated so that 10 of the largest funds accounted for about 40% of all the voucher points from the first wave. Many of these IPFs are managed by the banks and other financial institutions, leading to patterns of ownership that are not always clear. IPFs are restricted to holding no more than 20% of the shares of any one company, while the holding in any one company cannot represent more than 10% of an IPF's portfolio.

Commencing in 1995, there has been a consolidation of ownership among many enterprises, commonly known as the "third wave" of privatisation, led primarily by the IPFs. Consolidation has accelerated partly because of an amendment to the Commercial Code in 1996 (see Company law section below). In addition, some funds converted into holding companies which did not have to comply with the above-mentioned limits on maximum holdings. A number of large domestic companies and foreign purchasers have also played a major role. Unofficial estimates of trends in ownership suggest that by the end of 1996 a majority of companies included in the mass privatisation programme had either dominant or majority owners.

Despite the consolidation of ownership, there continue to be concerns about the pace and extent of restructuring. These concerns reflect

the decline in profitability. According to the Ministry of Industry, in 1996 pre-tax profits in companies with more than 100 employees fell by 40%, while the average rate of return on equity in non-financial organisations fell to 4.1%. There has also been an increase in inter-enterprise arrears. At the end of June 1997 the government rejected proposals to assist the financial restructuring of two large companies, one private (Tatra) and one where the state-owned Consolidation Bank had a majority share (Zetor).

General concerns have been expressed about potential conflicts of interest between the IPFs, the financial institutions that manage them, and the industrial companies. In its April 1997 package, the government announced that the relationship between the IPFs and the main banks would be reviewed. In mid-1997 the government considered an amendment to the banking law to strengthen the distinctions between the banks' commercial and investment activities. Possible changes include placing limits on the proportion of a bank's share capital that can be invested in non-bank companies and on the right of banks to appoint representatives to sit on company boards.

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 fuels and energy, residential rents, public transport, postal services and telecommunications, health-care, and selected agricultural products. Mark-ups in the energy sector remain closely regulated. From the beginning of July 1997, rents on public housing were raised by between 22 and 100%, gas and electricity prices by 15%, and heating prices by 39%. The government has also decided to increase VAT on gas and electricity from 5% to 22% at the beginning of 1998. These represent further moves towards full price liberalisation, but were also intended to strengthen the fiscal position as the budget moved into deficit in early 1997.

Competition policy

The Competition Law, passed in 1991, is designed to promote competition, prevent abuse of monopoly power, and advise on mergers. Responsibility for implementing competition policy is vested in the Office for the Protection of Economic Competition. Its responsibilities include promoting competition, including in international trade with special reference to trade agreements, and taking action against anti-competitive behaviour. In 1996 the Office considered 128 cases, of which over 70 related to the potential impact on competition of mergers. The remainder were actions likely to affect competition or where enterprises were alleged to have abused their dominant market position. The vast majority of mergers were approved; of the other cases, anti-competitive behaviour was found in 13 out of 24 cases and abuses of dominant market position in 15 out of 25 cases.

Trade liberalisation

Almost complete liberalisation of quantitative controls on imports and exports was undertaken in 1991 with the adoption of the Commercial Code. The Czech Republic became a member of the WTO in January 1995. It maintains a very liberal trade regime and is virtually

free of non-tariff barriers and export restrictions. At present there is no countervailing duty or safeguards legislation, although in May 1997 the parliament passed an anti-dumping law to protect Czech producers from cheap imports. Duties and tariffs set out in the Customs Act are compatible with arrangements for the EU. In 1996 tariffs were applied at low levels – 4% on primary products, 6% on semi-finished goods, and 10% on finished products. The average import tariff is relatively low at 8% on an MFN basis.

In order to deal with the growing trade deficit, the government has proposed a number of measures to promote exports, including additional funds for export credit, accelerated depreciation for relevant machinery and equipment, and tax preferences. The state supports export promotion mainly through export credit guarantees via two state sector institutions – the Czech Export Bank and the Export Guarantee and Insurance Corporation. In April 1997 the government announced an import deposit scheme as part of its package of measures designed to halt the deterioration in the trade deficit, but then abolished it in August.

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. Between early 1991 and May 1997 the exchange rate was pegged to a basket (in recent years comprising just the Deutschmark and the US dollar, with approximate weights of 65% and 35%, respectively). Substantial capital inflows during 1995 under the fixed rate regime made it increasingly difficult for the CNB to meet its inflation target, leading the CNB to widen the fluctuation band around the central parity from +/- 0.5% to +/- 7.5% at the end of February 1996. Despite an increase in the trade deficit during 1996, the exchange rate moved into the upper part of the fluctuation band.

Strong speculative attacks against the koruna in April 1997 caused the currency to fall into the lower part of its band. The CNB provided substantial support in the form of intervention, sharply higher interest rates, and also introduced temporary limits on the access of non-residents to foreign currency (since abolished). On 26 May, however, the CNB was forced to abandon the band and allow the currency to float but only after an effective devaluation of some 14% since the start of the year. Partly in response to the government measures to cut expenditure, the exchange rate subsequently strengthened and by the summer was 10% below its former parity.

Wage liberalisation

The government has pursued a market approach to wage formation, although in the earlier stages of transition it resorted to taxes on "excessive" wage increases and ceilings on real wage growth. In January 1996 the government set the minimum wage at 2,500 koruna (US\$ 81) per month, equivalent to 27% of the average wage in the first quarter of 1997. One of the main features of the Czech economy has been the very low level of unemployment (although it has risen in recent months, to 4.5% in August 1997). As a result, nominal wage growth has been strong at around 18% per year over each

of the last three years, with an annual real wage growth of at least 7% per year. In 1996 wage growth was higher in the public sector than in the private sector. The continued strong growth of nominal wages not only represented a source of inflationary pressure, but also led to a faster increase in unit wage costs. While in April the government announced its intention to curtail wage increases, they may still grow 12.5% in 1997.

Interest rate liberalisation

Interest rates were completely liberalised in April 1992. The Czech National Bank (CNB) implements monetary policy mainly through its repurchase operations, supported by minimum reserve requirements. In May 1997 the CNB was forced to raise sharply its two-week repurchase rate (from 12.5% just before the currency crisis), before lowering it (to 14-15%). The increase was mirrored in higher PRIBOR rates on the money markets, especially at the shorter end of the yield curve.

Financial institutions

Banking reform

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 the first quarter of 1997 the Czech banking sector included 54 licensed commercial banks, of which five were under administration (representing about 4% of the sector's assets). Of the remaining banks, there are 10 wholly Czech-owned banks, nine partly foreign-owned banks, 14 entirely foreign-owned banks, nine branches of foreign banks, six building societies and one state financial institution. The sector is still dominated by five large banks, which account for 49% of the sector's capital and 67% of its assets. Foreign banks and branches of foreign banks account for a further 18% of assets. The main activity of the sector remains credit extension, accounting for about half the total volume of assets. Short-term loans remain the dominant form of credit among newly issued credits. Securities trading accounts for a further 9% of assets, of which bonds account for about three-quarters.

All the banks operating in the Czech Republic are joint-stock companies. The only exception is the state-owned Consolidation Bank. However, the state, through the NPF, retains a substantial minority ownership (Komerční, Ceska Sportelna and CSOB). The state share in the banking sector should decline further with the government's decision to accelerate the completion of the privatisation of the main banks.

Most prudential regulations follow those of the EU, including the need for banks to meet the 8% capital adequacy ratio by the end of 1996. There was a 2.8% increase in the volume of classified credits (excluding those of the Consolidation Bank) so that at the end of 1996 the overall volume of classified credits amounted to 30.8% of total credits, compared with over 33% a year earlier. At the end of 1996 reserves and provisions amounted to 121 billion koruna (US\$ 3.9 billion), an amount that the CNB estimates is roughly equal to potential losses not covered by collateral. According to the CNB, by the end of the first quarter of 1997 the potential losses from the sector's credit portfolios (excluding that of the Consolidation Bank) not covered by provisions or reserves was 0.5% of total credits. Banks are also required to make provisions against potential losses on securities trading

and these provisions will increase further in 1997 as a result of new CNB regulations.

In January 1996 the CNB announced further measures to consolidate the banking sector. The measures were aimed mainly at the smaller banks (which at the end of 1996 accounted for 6% of assets). However, banking problems continued during 1996. These were mainly among small banks and reflected loan losses and an inability to meet capital requirements. As a result the CNB was required to intervene to ensure that portfolios were restructured, mergers were encouraged and in some cases that banks were closed. The problems also extended to certain medium-sized banks. On account of accumulated loan losses and insufficient liquidity, the CNB revoked the banking licence of two banks and conservatorship was gradually imposed on six banks in 1996. In all these cases the interests of depositors have been covered by the Deposit Insurance Fund (DIF) and by additional finance provided by the CNB. During 1996 it is estimated that both the CNB and the DIF spent 37 billion koruna (US\$ 1.2 billion) on bank reconstruction.

In October 1996 the government approved a further CNB bank stabilisation programme to strengthen the small banks. Those banks willing to participate in the scheme would sell their non-performing loans equivalent to the value of the bank's share capital plus 10% to a new company, Ceska Finance, linked to the existing Consolidation Bank. It is estimated that a total of 14 billion koruna of bad loans could be purchased by Ceska Finance from the smaller banks and repurchased by these banks over five to seven years. Money would be made available to assist the banks to strengthen their operations. In return the banks would be required to submit commercial and financial plans to the CNB, while the latter would also have enhanced supervisory powers. In early 1997 six banks had expressed their interest in participating in the scheme.

Non-bank financial institutions

According to the Czech Statistical Office, there were 401 investment funds and companies registered in the final quarter of 1996 (compared with 444 in the first quarter of the year) and 34 insurance companies. Ceska Pojistovna dominates the insurance sector, accounting for 70% of the market in 1995. Towards the end of 1996 the Ministry of Finance (MoF) placed an investment fund under administration following allegations of fraud. In early 1997 the MoF placed four more funds and one investment company under forced administration and withheld licences from several others for failing to meet the deadline to become public listed companies.

Securities markets and instruments

The Law on the Stock Exchange and Securities was adopted in 1992. There are currently three main markets. The Prague Stock Exchange is used mainly by professionals. The RM-system (a joint-stock company) began operating during the first half of 1993 and provides a means whereby voucher holders could receive their shares from the Mass Privatisation Programme in dematerialised form. It is also a computerised off-exchange market for securities, providing an alternative means whereby individuals can trade their shares. There is also the Centre for Securities, established by the Ministry of Finance in 1993 to assist with the issue of

shares of companies privatised under the coupon privatisation scheme. 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 originally comprised both the listed and unlisted equity and bond markets. With effect from 1 September 1995 the market was divided into three (primary, secondary and free markets), with the intention of improving the effectiveness of trading. The market has been affected by a lack of liquidity, by problems of transparency as a high proportion of trades are conducted off market, and by a lack of enforcement of regulation. The problems of liquidity are being addressed by the Stock Exchange by replacing the free market with a new market for small and medium-sized companies. Some 500 blocks of shares in which there had been little trading were removed from the market in March 1997, followed by a further 500 in May. With respect to price transparency, commencing in January 1997, the Securities Centre began to issue daily reports on over-the-counter trades (including prices and volumes). The Stock Exchange has also announced new rules, which took effect at the beginning of August 1997, requiring its members to trade securities via either the Stock Exchange or the RM system and not through the Securities Centre. The intention is to ensure that all trades take place on the official market so that price movements are both representative and transparent.

Overall the capital market has tended to underperform its equivalents in other central European countries. Inflows of foreign portfolio investment have been relatively modest (US\$ 720 million in 1996) and the market is rarely used for primary issues of equity. In order to strengthen regulation of the market, in December 1996 the government announced its intention to establish an independent SEC-type institution with powers to supervise markets, issue regulations and settle disputes. The most recent plans suggest that the SEC might be established early in 1998.

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. Since the beginning of 1995 there has been 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%, although the Ministry of Finance has proposed a reduction to 35% from the beginning of 1998. The marginal rates for income tax range from 15% to 40%.

The severe flooding which affected much of the eastern part of the country in July 1997 will not only affect output but will also have fiscal implications. Tax revenues are likely to be lower from enterprises affected by the floods while the government will have to meet some of the costs of reconstruction. In July and August the government commenced the issue of five-year "flood bonds" for a total value of 5 billion koruna (US\$ 161 million) to help meet the costs. The government is issuing two further tranches amounting to 4 billion koruna. It also intends to use another 5 billion koruna from privatisation receipts.

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% of gross wages for employees and 35% for employers.

The number of health insurance companies declined during 1996 (from 22 at the beginning of 1996 to 16 at the end). Further reforms to healthcare are likely since several health insurance funds have incurred losses while the debate on the future of healthcare funding is continuing.

Legal transition

Pledge law

Pledges are governed by the Civil Code and the Commercial Code. Under Czech law, movable goods that are the subject of a pledge agreement must normally be taken out of the debtor's possession. Alternatively, creditors may transfer title and enter into a written agreement. It is unclear whether pledges may be created in future property. There is no centralised registry system for non-possessory pledges. Enforcement of a pledge normally requires court assistance. Parties may, however, agree to forgo court assistance if they include appropriate language in the pledge agreement.

Company law

In July 1996, the Commercial Code and the Civil Code were amended along with the Securities Act to include greater protection for shareholders. For example, the Czech Civil Code includes a requirement that a shareholder acquiring a holding in publicly tradable shares carrying voting rights that amount to or exceed 50% of the outstanding shares of a target company must offer to purchase the remaining publicly tradable shares for a price not lower than the weighted average trading price over the six months before the acquisition. This provision cannot be waived by the shareholders or directors of the target company. Similarly, a party acquiring more than 10% of the outstanding shares of a joint-stock company must inform the Czech Centre for Securities and publicly register its acquisition. The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is over US\$ 1,000 and takes between one and three months. Joint-stock companies are required to register only book-entry shares. There exists a centralised share registry for book-entry securities. Shareholders may vote by proxy at meetings. Companies are not required to send shareholders proxy forms in advance of meetings but shareholders are entitled to solicit proxy votes on resolutions. There is no cumulative voting for directors. Shareholders also possess pre-emptive rights with respect to new share issues. Directors have an obligation to (i) perform duties in good faith and (ii) avoid self-dealing. Laws exist prohibiting insider dealing in shares of publicly listed companies.

Bankruptcy law

The Czech Bankruptcy and Composition Act was amended in March 1996. Insolvency is defined as a situation where a debtor is either unable to meet its liabilities as they fall due or its liabilities exceed its assets. An insolvent debtor is required to file a bankruptcy petition, failing which, directors and officers may be personally liable for damages caused to creditors. The law provides for a reorganisation system whereby a majority of creditors can reach a binding settlement with the debtor. This is referred to as "forced composition". Transactions occurring less than six months prior to a company's liquidation are presumed void or invalid. A security interest in assets (even if granted for value) comprising part of the bankrupt's estate will be void if obtained less than two months prior to, or after, the filing of the bankruptcy petition. Liquidators are now appointed by the courts from a list of professionals approved by the courts. Secured creditors are entitled to satisfy their claims out of the proceeds of realisation of the secured collateral. However, where the assets of the bankrupt are insufficient to pay the liquidation costs, the secured creditors may be required to contribute up to 30% of the amounts they recover from secured collateral to satisfy the liquidation costs. There are no specialised courts or judges handling bankruptcy proceedings.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published within one month of being passed. Important judgements are generally published and accessible to practitioners and provide written reasons for courts' decisions. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between seven months and two years for a commercial case to be heard on the merits by a court in the most important commercial centre and between one and three years for a final judgement for payment of a sum of money to be executed.

Estonia

• *The large-scale privatisation programme is essentially complete and the privatisation effort is now concentrated on infrastructure and the acceleration of land reform.*

• *Bringing Estonian legislation into line with EU requirements is high on the authorities' agenda in their bid to be among the first wave of new entrants to the EU.*

Enterprises

Size of the private sector

According to Estonian Statistical Office estimates, the private sector share in GDP rose to 67% in 1997, up from 50% in 1993. Data from the latest Estonian Labour Force survey show that the non-state sector ("pure" private sector and cooperatives) accounted for 59% (49% and 10% respectively) of total employment in the first quarter of 1995, up from 24% (3% and 21% respectively) in 1989. As for industrial sector employment the Estonian Ministry of Economy reported a private sector share of 81% in mid-1996.

Privatisation

The Estonian large-scale enterprise privatisation programme (except for utilities) is essentially complete. As of February 1997, assets worth EKr 3.5 billion (approximately US\$ 283 million) had been sold. The investors have assumed the responsibility for enterprise debts of EKr 1.7 billion (approximately US\$ 141 million) and made contractual obligations to the EPA (Estonian Privatisation Agency) regarding their intentions for investment and employment in privatised enterprises. Nearly 90% of the privatised assets were sold through tenders and, according to EPA estimates, some 30-40% of total assets in industry and services are held by non-residents, mostly from Finland, Sweden and Russia.

Future privatisation efforts are to be concentrated in three areas: the privatisation of the remaining 50-60 medium and large state enterprises through tenders and auctions (envisaged to be concluded by the end of 1997); further divestment of the government's minority shareholdings in major companies through public offerings; and the privatisation of utilities and infrastructure enterprises. In November 1996 the national authorities compiled a list of so-called strategic enterprises, the privatisation of which will have to be decided by the parliament rather than the EPA, which had been the sole agency responsible for large-scale privatisation since 1993. However, the EPA can sell minority stakes in these strategic enterprises without parliamentary approval. The largest enterprises included in the list are Tallinn Port, Estonian Telecom, airports, and energy and railways companies.

The preparatory work for the privatisation of the remaining infrastructure and transport enterprises is well-advanced. In June 1997, 70% of the Estonian Shipping Company was sold to a Norwegian-Estonian group. In April 1997 the

government approved a restructuring and privatisation plan for the state railway company.

This envisages its transformation into a holding company and sale of shares in passenger service and cargo subsidiaries during 1998. The state will for the time being retain the ownership of the railway infrastructure, but may offer operating concessions to private operators. The privatisation plan for Eesti Telekom is being discussed by the government, and the corporatisation of the state energy company is currently under way. In addition, the EPA is divesting the majority of the government's 39% stake in Eesti Gaas by offering additional shares to existing shareholders (Russia's Gazprom and Germany's Ruhrgas) and a public offering of a 12% stake.

The Privatisation Act of 1993 allows for the sale of assets against both vouchers (up to 50%) and cash. The right to pay in vouchers was extended to non-residents in 1996. The face value of vouchers is EKr 300 (about US\$ 25) and they are tradable. Currently vouchers are traded at about 40% of face value, up from 20% a year ago. In total, vouchers for a total value of EKr 12 billion (approximately US\$ 980 million) have been issued, of which nearly half have been redeemed. The 1998 redemption deadline for vouchers is likely to be extended if a large share of vouchers is not redeemed on time.

Small-scale enterprise privatisation was completed by the end of 1994. The privatisation of land and residential property, by contrast, has been impeded by continuing uncertainty regarding restitution of land and the slow process of land registration. The authorities have taken measures to accelerate land reform by adopting legal provisions to hasten land sales in 1996. The first auctions of undeveloped land have taken place and the EPA, which is responsible for selling the land under the privatised enterprises, has concluded 169 land purchase agreements for an amount of EKr 179 million (approximately US\$ 15 million).

Governance and restructuring

The thrust of the Estonian privatisation effort has been to find effective owners for enterprises and to promote corporate governance rather than to maximise privatisation revenues. The implementation of the investment and employment guarantees in the privatised enterprises has been successful. During 1995-97 investors have exceeded their contractual obligations, at times by a wide margin. Competition from imports, tight credit policies and privatisation have provided major incentives for enterprise restructuring. The 1992 bankruptcy law, which does not make any formal provisions for restructuring, has also been actively applied.

The share of industry and manufacturing in GDP at constant prices has remained fairly stable from 1993 to 1996, at 21-22% and 16-17% respectively. Labour productivity in manufacturing is growing, driven over the past two years by higher output growth rather than falling employment. Some labour-shedding in the manufacturing sector continues, though at a much slower pace compared with 1993, when employment in manufacturing decreased by nearly 20%. Capacity utilisation in manufacturing is on the increase, rising from 50% in mid-1993 to 60% in mid-1997. Output has been growing most rapidly in the production of wood and wood products and textiles, and also in the production of machinery and equipment, the major export industries. The share of manufacturing produc-

tion for export rose to 49% of total production toward the end of 1996.

Markets and trade

Price liberalisation

Very few formal price controls remain, essentially only for public utilities and oil shale (the main fuel for electricity generation in Estonia). Pricing in the energy sector, while still below full economic cost levels, is being reviewed in the context of the forthcoming privatisation of Eesti Energia, the state-owned energy utility.

Competition policy

The implementation of the 1993 Competition Law is monitored by the Competition Board under the Ministry of Finance. In 1996 the Board undertook 47 investigations into unfair business practices, resulting in the issuance of 10 "orders" and 12 "recommendations", most of which have been implemented. The Board conducts its investigations either on its own initiative or when a complaint has been submitted. A new competition law, modelled on the EU directives, has passed its first reading in parliament. It is scheduled to come into force in January 1998. Given the small size of the country, the main competitive forces have been external trade, liberal rules for the establishment of new companies, comprehensive privatisation, and tight subsidy and credit policies.

Trade liberalisation

The Estonian trade regime is very liberal – all tariff and non-tariff barriers to imports and exports, including those on imported agricultural and food products, were abolished in the early reform years. In April 1997 the government announced the possible introduction of protective agricultural tariffs under new customs regulations. More recently, however, the agricultural lobby indicated that it may drop the demand for the introduction of protective tariffs in exchange for more budgetary support of the agricultural sector.

Estonia has a "Europe Agreement" with the EU, is a member of the Baltic Free Trade Area and has free trade agreements with the EFTA countries and Ukraine. A Most-Favoured-Nation treaty with Russia, Estonia's second-largest trade partner, has remained unratified since 1993.

Currency convertibility and exchange rate regime

A new national currency, the kroon (EKr), was introduced in mid-June 1992 under a currency board arrangement and since then has been pegged to the Deutschmark at EKr 8/DM 1. Estonia has full current and capital account convertibility.

Wage liberalisation

Wage setting in the economy is free and decentralised except for civil servants and top management in state-owned enterprises. The average gross monthly wage amounted to about US\$ 250 in May 1997 and the minimum wage represented less than 30% of the average gross wage.

Interest rate liberalisation

Interest rates are fully liberalised and are fully market determined through the operation of the currency board system. Spreads between average weighted lending and deposit rates in local currency have narrowed to about 6 percentage points, and are lowest for loans and deposits of over one-year maturity, at less than 2 percentage points.

Financial institutions

Banking reform

As of June 1997, 13 commercial banks, two savings and loan cooperatives, and one investment bank were operating in Estonia. The six largest banks together account for over 90% of total assets and 78% of the share capital of domestic banks. Domestic credit amounted to about 22% of GDP in mid-1997, and the share of the private sector in new credit is 85%. The share of term lending is high for a transition economy – loans with a maturity of over one year amounted to 79% of the total loan stock at the end of June 1997.

Foreign ownership of Estonian banks is significant. As of April 1997, the share of equity held by non-residents stood at 40% (of which 53% was owned by foreign banks). The size of the government's stake in the banking sector is small and falling, amounting to 7% of total equity in April 1997. Estonian banks have started to expand their operations to neighbouring Latvia and Lithuania by acquiring stakes in bank and non-bank financed institutions in these countries.

Estonia continues to pursue a regime of tight banking supervision regulated by the 1995 Credit Institutions Act. Recently the Bank of Estonia (central bank) raised the capital adequacy ratio from 8% to 10% (effective from October 1997) and increased the risk rating of certain asset classes in order to curb excessive lending by domestic banks. A deposit insurance law has been drafted which will guarantee 90% of both private and company deposits up to a maximum of Ekr 20,000 (ECU 1,250); the limit will be gradually increased to ECU 20,000 over 15 years.

Non-bank financial institutions

As of May 1997, 19 investment funds were licensed to operate in Estonia, of which 14 were open-ended. Funds are closely grouped around the largest banks. Laws on investment funds and insurance have been drafted which bring Estonian legislation in line with EU directives.

The ratio of total insurance premiums to GDP rose to 1.5% of GDP at the end of 1996, up from less than 1% in 1993.

As of July 1997, there were eight life and 14 non-life insurance companies and eight insurance brokers operating in Estonia. All insurance companies are privately owned (the state-owned insurance company was privatised in 1996) with foreign presence in nearly half of the companies. Competition in the insurance sector is increasing, as reflected in the falling cost of insurance, and some consolidation in the sector is expected. The minimum capital requirement has been raised to Ekr 10 million (about US\$ 800,000) as of January 1997. The new insurance law is scheduled to come into force in January 1998. Leading domestic banks are increasingly active in the non-bank financial sector through their insurance and investment subsidiaries.

Securities markets and instruments

Capital markets in Estonia are dominated by stocks, followed by municipal bonds. There is no treasury bills market. The Tallinn Stock Exchange (TALSE) accounts for most of the market turnover, although an over-the-counter (OTC) market is also active. Stock market capitalisation reached an estimated 26% of GDP as

of mid-1997, having risen from 11% of GDP a year earlier. Stock market liquidity has risen sharply and the annualised market turnover exceeded 60% of stock market capitalisation in the middle of 1997. Share prices have also soared. As of mid-August 1997, the TALSE Index, based on 13 listed shares (dominated by bank stocks), had increased by over 360% in the course of a year, and the index of the Estonian Central Depository (ECD), based on 33 shares registered at the ECD, nearly tripled in the same period. As of mid-1997 non-residents accounted for just under 40% of total investment in the securities traded on the TALSE and price/earnings ratios had risen from 4-5 to over 15. Shares in over 20 local companies, mostly banks, are currently traded on the TALSE, in addition to shares in some 70 companies that are registered at the ECD and traded on the OTC market.

At the end of July 1997, 47 brokerages and 10 asset management firms were licensed to operate in Estonia, with securities and asset management arms of the banks dominating the market. The securities markets are regulated by the 1993 Securities Market Act and various other regulations adopted in 1994. The licences to operate in the securities markets are issued by 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 has remained unchanged since 1994 when a flat rate income tax of 26% was introduced. Over 50% of government revenues are derived from indirect taxes, notably from the VAT (currently set at 18%).

Social security

The social security tax amounts to 33% of payrolls and is fully paid by employers (20% for pensions and 13% for medical insurance). In spring 1997 the Social Security Reform Committee, an inter-departmental task force, proposed a set of principles to reform the existing pension system. These principles were approved by the government in June 1997 and a draft pension reform law is expected to be presented to parliament in the autumn. The current plans foresee the modification of the "pay-as-you-go" (PAYG) system and the establishment of private pension funds for voluntary additional contributions at the beginning of 1998. The biggest change within the PAYG system will be the "personalisation" of individual mandatory contributions, i.e. all contributors will be entered into a special register. The introduction of a "second pillar", i.e. a mandatory funded system of privately managed savings accounts, is envisaged around the year 2001. Changes in the system of medical insurance contributions are also being considered. A proposal has been put forward to reduce the current rate of employers' contribution from 13% to 12%, while employers will be responsible for providing sickness benefits during the first two weeks of illness.

Legal transition

Pledge law

A new Commercial Pledges Act came into effect in 1997. Under this Act, a non-possessory pledge of a company's assets may be taken in most types of movable property except intellectual property, vehicles, cash, stocks and commercial

paper. Most of these types of property may be pledged according to other laws and are subject to separate registration procedures. In order to be enforceable, the pledge must be notarised and registered in a new commercial registry. This system is expected to take effect in September 1997. The notary fee for a commercial pledge is based on a percentage of the amount secured (0.2% up to a maximum of DM 2,500). Enforcement of a pledge may take place without court assistance if the parties have agreed to this in the pledge agreement and the pledgor does not object to the enforcement procedure.

Company law

Estonia enacted a new Commercial Code in September 1995 that regulates the formation of private and public limited companies and other types of enterprises and also creates a centralised commercial registry. The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is US\$ 500-1,000. The process takes between one and three months. Companies must maintain share registries. It is unclear whether registries are maintained by independent parties. Shareholders may vote by proxy at meetings. Companies are not required to send shareholders proxy forms in advance of meetings. Shareholders may solicit proxy votes on resolutions. Estonian company law does not afford minority shareholders protection if another company makes a bid for less than all the shares of the target company. Shareholders do, however, possess pre-emptive rights in the event of a new share issue. There is no cumulative voting for directors. Directors have an obligation to perform their functions in good faith. It is unclear whether they also have a duty to avoid self-dealing. Laws exist prohibiting insider dealing in shares of publicly listed companies.

Bankruptcy law

In Estonia, the definition of insolvency is when a debtor is permanently unable to meet its liabilities as they fall due or a debtor's liabilities exceed its assets. The law provides for reorganisation whereby a majority of creditors can reach a binding settlement with the debtor. In bankruptcy proceedings, the courts appoint a liquidator, who has a broad range of powers. Liquidators must possess special qualifications and are also subject to government supervision. There are no specialised bankruptcy courts or judges. A liquidator may review and apply for a court declaration that transactions that are (i) not concluded at arm's length, (ii) below fair value, or (iii) concluded within a fixed time prior to liquidation are void. Liquidation costs rank higher than secured claims.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and generally published within one month of being passed. Judgements of the National Court are published and accessible to practitioners and provide written reasons for the courts' decisions. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between seven months and one year for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and one year for a final judgement for payment of a sum of money to be executed.

FYR Macedonia

- *During 1996 and 1997 there has been good progress with the privatisation of industrial enterprises; the original programme should be largely completed by the end of 1997.*
- *Privatisation in the agricultural sector started in 1996 and is still being implemented.*
- *Privatisation has not yet led to major changes in corporate governance, however, and the stock market has done little to improve the situation due to restrictions on secondary trading.*

Enterprises

Size of the private sector

Private sector activity, taking into account activity in the informal sector, probably accounts for 60-70% of GDP.

According to the Statistical Bureau, the number of private enterprises had increased from 6,000 in 1992 to almost 130,000 in mid-1997, of which over 50,000 are active, according to data from the Payment Operations Service. Initially these were mostly very small firms, but several hundred medium-sized and larger firms have entered this category as a result of the privatisation of socially owned enterprises.

By mid-1997, about 1,000 of the 1,217 enterprises covered by the Law on Transformation of Social Capital (passed in June 1993) had been privatised. The main method was by management and employee buy-out (MEBO).

Agricultural sector privatisation began in 1996 under the Law for Transformation of Enterprises and Cooperatives with Social Capital. (Agricultural Privatisation Law) and continued in 1997. During 1996, the Privatisation Agency received privatisation plans for 40 of the agro-kombinats. The government plans to privatise 70% of the remaining 200 or so agro-kombinats by the end of 1997, but it is not clear whether this target will be met.

Privatisation

The current legislation on land ownership remains severely restrictive, impeding the creation of a free market in urban land. The new Law on Land Use has been submitted to parliament and is expected to be approved in 1997. This law will also cover the use of agricultural land.

A draft Law on Restitution and Denationalisation of Property was being revised mid-1997, and is expected to be approved by parliament before the year-end.

Governance and restructuring

The style of privatisation by MEBO, not effectively changing ownership, resulted in poor

corporate governance and most companies are not in a position to self-finance investment or attract new capital. Due to restrictions on secondary share transactions the stock market has not improved the situation and no investment funds have developed.

A "Special Restructuring Programme" introduced in 1994 to restructure the 25 largest loss-making enterprises (including two utilities) continued to be implemented in 1996. After some delays in finalising a number of privatisation deals for these enterprises, efforts have recently intensified and the programme now seems to be proceeding smoothly. Under the terms of the programme, firms, denied subsidies and access to bank loans, were required to develop privatisation proposals, set targets for reductions in the labour force, and spin off profitable or potentially profitable sub-units.

The restructuring programme also aimed at liquidating unprofitable enterprises. This group of enterprises includes two utilities, three agro-kombinats, four mines, six textile companies, and six chemical and mechanical/electrical machinery producers: together they account for over half of the total losses in the enterprise sector. Plans to restructure the two utilities (electricity and railways) are intended to reach full cost recovery, achieved by a combination of cost savings through rationalisation and tariff increases.

By mid-1997, from among these 21 large unprofitable firms the government had identified 123 business units and 10 more spin-offs from the electric utility and the railways. For 40 of these units, privatisation contracts had been signed, or operations ceased and liquidation proceedings begun. It is expected that the same will have been accomplished for at least 110 of the 123 business units by early March 1998. Privatisation contracts were also signed for the railways and the electricity companies were downsized, with non-core business units spun off and either privatised or liquidated. Within the 21 original enterprises, over 14,200 employees, or around 25% of the original workforce, has been made redundant.

Markets and trade

Price liberalisation

About 90% of prices in the retail price index are free of controls. However, guaranteed base prices for agricultural products remain for wheat, lamb, beef 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, which foresees institutional strengthening, has been in preparation for some time and is to be presented to parliament before the end of 1997.

Trade liberalisation

All residual quantitative restrictions on exports and imports were abolished in November 1996. A new customs tariff was introduced in July 1996 with rates ranging from zero to 35% for most items. The new customs tariff reduces the average rate to 15% from the previous level of 28%. Customs procedures were simplified on January 1997 with the introduction of a single administrative document, applicable initially to exports, and from September 1997 to imports as well. A programme of further tariff liberalisation,

consistent with negotiations for accession to the WTO, is being prepared. Administrative simplification is to be achieved with the centralisation of all trade policy functions in the Ministry of Finance. A trade cooperation agreement with the EU was concluded in June 1996.

Currency convertibility and exchange rate regime

Officially, the denar has been floating since the beginning of 1994, but it has been fixed *de facto*, being kept closely aligned to the Deutschmark. However, in July 1997, the denar was devalued by 14%. There is almost full current account convertibility, while restrictions remain on capital account transactions.

Wage liberalisation

The Wage Control Law of 1993 restricted wage increases to between 1.5 and 2.5 percentage points below targeted inflation, with a subsequent adjustment to make 50% compensation for inflation in excess of the target. In addition, a six-month wage freeze was imposed which applies to all employees working either in those enterprises that have not been 100% privatised or in the private sector. This translates into a wage freeze for an estimated 80% of all employees in the enterprise and budget sectors combined.

Interest rate liberalisation

Real interest rates are positive and largely market-determined, although a bank-by-bank credit ceiling has remained in place. In January 1997, the central bank advised commercial banks against coordinating deposit and lending rates through "gentlemen's agreements". Compliance with this recommendation is to be monitored and provisions against this practice have been made in the draft Competition Law.

A tight monetary policy has been pursued, including the use of credit ceilings and accumulation of government deposits with the central bank. These instruments, reflecting the lack of sophistication of the financial markets, have in fact impeded development of these markets and have not allowed an efficient allocation of resources. Control over reserve money has been difficult due to the need to provide almost all available credit to Stopanska Banka, the largest state-owned bank.

The interbank market has been inactive since the most liquid banks have perceived this activity as too risky and, in addition, high fees (now abolished) were charged by the Bureau of Payment Operations. Mandatory reserve requirements have been further relaxed, and reserve requirement rates are soon to be equalised.

Financial institutions

Banking reform

While reform of the financial sector has gathered pace in 1997, the effects of delays in reform in earlier years are still affecting the sector. The creation of a Bank Rehabilitation Agency (BRA), which took over the bad loans of 17 of the major socially owned loss-making enterprises, has improved bank balance sheets but, as a result of continued lending to the declining industrial sector in 1996, bank profitability was low. Intermediation costs remain high and there is still excess labour in the banking system.

The non-performing loans of the largest bank (Stopanska Banka, SB), which comprised two-thirds of the credit base, have been transferred to the BRA. However, despite having had its bad

loans replaced by government bonds (worth 4.9 billion denar) in 1995, SB is still financially dependent on the central bank. Five of its largest branches were split off at the beginning of 1995 and are now operating as independent banks. A continuing wage freeze, the lay-off of 360 employees and the interruption of central bank credit are among the measures initiated in 1997 to rehabilitate SB. In mid-1997 the short-term debt of SB to the central bank was exchanged for government bonds held by SB. Following these steps the government is prepared to sell its 23% stake in SB to a strategic investor. Privatisation negotiations have begun but have so far been inconclusive.

The Banking Law of 1996 has improved the regulatory framework. It facilitates the entry of new and well-capitalised banks and allows for orderly exit (already put in practice through banks' liquidations). Prudential regulations for asset classification, provisioning, capital adequacy and exchange rate exposure have been issued. Banking supervision policies and procedures are not yet well developed, although the government is receiving technical assistance from international organisations. The Commercial Bank Law also allows the creation of a deposit insurance scheme. As of mid-1997 the government was poised to introduce such a scheme to improve public confidence in the banking system. Coverage will extend to 75% of denar and foreign currency household deposits.

The National Bank Law was passed in 1992 and amended in spring 1996. The law provides for the independence of the central bank and gives it the power to enforce compliance with its decisions.

Non-bank financial institutions

Non-bank financial intermediaries are at a relatively early stage of development, as is regulation of the sector. There is still no legislation regarding the creation of investment funds. Further impediments to the development of the financial sector stem from the lack of a liquid and competitive banking sector and from tax regulation (which, for example, allows double taxation). There are three insurance companies.

One FYR Macedonian "savings house" ran a pyramid scheme which collapsed in March 1997, with total losses estimated at around US\$ 67 million. Demonstrations by the 25,000-50,000 savers who lost all their deposits were short-lived thanks to the firm stance taken by the government, which initiated a formal investigation into the matter. The National Assembly replaced the governor of the central bank. Confidence in the still weak financial system suffered a temporary set-back as a result of this episode.

Securities markets and instruments

The stock exchange that was created in March 1996 is still small, with a turnover of about US\$ 40 million in 1996. Its original members were 11 banks, three insurance companies and four saving banks: altogether they had founding capital of DM 1 million. So far only three government bonds have been issued, of which only one is traded on the stock exchange. A very small number of shares and other securities are currently traded. Trading on the stock exchange takes place in two official markets and one unofficial market. The primary market was formed as part of the privatisation process, i.e. by the corporatisation of enterprises carried out in the context of privatisation.

Shares in some 250 joint-stock companies, 17 banks and one insurance company have been listed on the "secondary market" after their privatisation. Only a very few new share issues are expected before the privatisation process is completed. The secondary market is currently only trading shares of the Privatisation and Bank Rehabilitation agencies. One reason for the limited number of shares traded is the barriers regarding transferability of shares which were introduced in the statutes of several companies at the time of privatisation. These restrictions on trading are expected to be eliminated by the end of 1997. A third, "unofficial" market exists on the stock exchange; it is unregulated and characterised by low transparency, low protection of shareholders, and non-market price formation. About 50 securities which would not fulfil quotation conditions are offered on the third market.

Fiscal and social safety net reform

Taxation

Fiscal and taxation reforms have seen good progress in 1996 and 1997, although social safety net reforms were slower than expected. In 1996, government revenue and expenditure accounted for 44% of GDP, within a structure characterised by a heavy direct tax burden and a social benefit system comparable to that offered by richer economies.

Parliament adopted a new tax law in late 1996 for implementation in January 1997, with key changes in sales, excise, profit and personal income taxes. A single 13% rate of sales tax was introduced on services, replacing three different rates, and sales taxes on goods were put on an accruals basis. These and other changes are intended to assist the introduction of VAT, planned for 1998. Excise duties on all types of imported cigarettes were standardised at a single rate, those on coffee and beer were also simplified and the overall excise burden was reduced. The profit tax rate was reduced from 30% to 15% and reinvested profits were excluded from taxation. Personal income tax liability on dividends was cut.

The government is considering the elimination of extensive personal income tax exemptions, and the reduction of many of the remaining corporate tax preferences, including those for foreign investors with a single investment expenditure allowance.

Social security

Currently social security contributions and income taxes reduce net labour income to just over half of gross wage costs. Extensive pension reform has been undertaken over the last four 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. Despite this, pension expenditure was 11% of GDP in 1996. The Pension Fund's revenues are decreasing due to both enterprise restructuring and an upward revision in the formula used to calculate benefits for new retirees. In January 1997, the government cut minimum pensions for new retirees by a third. Further measures are under consideration, including a reduction in pension provisions for women (currently more generous than those for men), and revisions of replacement rates and of early retirement provisions.

Legal transition

Pledge law

It is unclear whether a non-possessory pledge may be taken over movable property. A pledge is created by written agreement. It is unclear whether notarisation is required for the pledge to be enforceable. Enforcement of a pledge normally requires court assistance.

Company law

The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is US\$ 500-1,000. The process takes between one and three months. There is no requirement that joint-stock companies maintain independent share registries. Shareholders are entitled to vote by proxy at meetings. It is unclear whether companies are required to send shareholders proxy forms in advance of meetings. Shareholders may solicit proxies to vote on proposed resolutions. Minority shareholders are not afforded protection in the event that another company makes a bid for less than all of the outstanding shares of a target company. Shareholders do, however, possess pre-emptive rights with respect to new share issues. Directors are under obligation to (i) perform duties in good faith and (ii) avoid self-dealing. Laws do not exist prohibiting insider dealing in shares of publicly listed companies.

Bankruptcy law

A debtor is considered insolvent when it is unable to meet its liabilities as they fall due. Reorganisation schemes are permitted, whereby a majority of creditors can reach a binding settlement with the debtor. A liquidator, appointed by the court, possesses a broad range of powers but is not entitled to investigate the debtor's financial affairs. Liquidators need not possess special qualifications and they are not supervised by a specific government body. There are specialised courts or judges handling bankruptcy proceedings. Liquidators may declare void certain transactions concluded within a fixed period of time prior to liquidation. Claims of secured creditors rank below liquidation costs, taxes, social security claims, wages and personal injury claims.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published up to six months after being passed. Important judgements are generally published and accessible to practitioners and provide written reasons for courts' decisions. There generally is a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between seven months and two years for a commercial case to be heard on the merits by a court in the most important commercial centre and between one and two years for a final judgement for payment of a sum of money to be executed.

Georgia

- *250 state enterprises were singled out for privatisation in June 1997 in an effort to speed up the privatisation process.*
- *The government is preparing to issue short-term bonds in a move to encourage the operation of securities markets in the country.*
- *The authorities are in the process of reviewing the tax system. Revenues as a share of GDP in Georgia are the lowest of all the countries of the former Soviet Union.*

Enterprises

Size of the private sector

The private sector accounts for about 55% of GDP and there are currently over 65,000 registered small private businesses. In 1996, private enterprises accounted for 74% of the government's total tax proceeds and 85% of agricultural output. The service sector was one of the driving forces behind Georgia's strong economic recovery in 1996-97.

Privatisation

Georgia started privatisation with a voucher-based programme of mass privatisation, which ended in 1996. The government has since proceeded with the use of cash auctions. A new privatisation law was passed by parliament in May 1997 to speed up the process. This law stipulates that "no minimum price" auctions will be held in order to complete the privatisation of those enterprises unsuccessfully offered in the cash auctions. Shares of state enterprises that remain unsold after the "no minimum price" auctions will be revalued and future auctions will once again take place as cash auctions. In June 1997 the government announced its intention to sell shares in 273 joint-stock companies through the "no minimum price" auction. Furthermore, the new law enables the government to make direct sales to foreign investors. Foreign investors are free to participate in the privatisation process.

Around 1,000 medium and large-scale enterprises, out of 1,189 targeted for privatisation, had been corporatised by December 1996. Of these, some 524 had been privatised by early 1997 (in the sense that more than half of their shares had been sold to private entities or individuals). So-called "strategic" properties, such as hydroelectric, oil, gas and coal production, and metal mining, will not be privatised. According to the Georgian government, over 500,000 citizens have become owners of state property to date. About 20% of shares in medium-sized and large companies were distributed to foreign investors.

Small-scale privatisation of about 10,000 enterprises began in 1993 and has been comprehensive. Privatisation of small-scale

enterprises and housing is now almost complete, with over 90% of all "small" enterprises privatised to date. The bulk of privatisation of small-scale state-owned enterprises took place through cash payments.

In March 1996 the Law on the Ownership of Agricultural Land was passed, starting the slow process of land privatisation. The law enables private entities to buy, sell, lease and inherit land. This type of legislation is particularly important as agriculture remains the largest sector of the economy, accounting for over 30% of GDP.

Governance and restructuring

Enterprises have been faced with relatively hard budget constraints since the autumn of 1994, when subsidies and directed credits were almost completely eliminated. Some degree of "hidden subsidisation", in the form of tolerance of payment arrears on energy bills, remains in place. Nevertheless, with improved energy tariff collection, such "hidden subsidies" are gradually being reduced.

A new bankruptcy law took effect in January 1997. According to this law, creditors are entitled to initiate bankruptcy suits against debtors and receive reimbursement from the bankrupted company.

Georgia embarked on a large restructuring programme of the energy sector during 1996 to improve the efficiency of energy use and ameliorate the existing infrastructure in order to meet increasing energy needs. As a result, collection rates of electricity tariffs have improved.

Markets and trade

Price liberalisation

A price liberalisation programme in 1994 eliminated price controls for over 90% of consumer goods and services. The government continued to reduce the scope of administered prices during 1995 and 1996. As of March 1997, mainly natural gas, electricity, urban transport and municipal services remained under government regulation. In January 1997, the electricity tariff to households was raised by over 30%, and further increases are expected with a view to achieving cost recovery.

Competition policy

The Anti-Monopoly Policy Department was established in 1992 and a new anti-monopoly law (on monopolistic activity and competition) was enacted in 1996. Consumer and anti-trust laws were also passed in 1996. Through the adoption of these laws, the legislative basis for competitive markets was established, thereby also eliminating existing government restrictions on competition in some markets. De facto state monopolies still exist in several sectors: telecommunications, railways, pipeline transport, electricity transmission, and use of air space and ports.

Trade liberalisation

Georgia applied for accession to the WTO in June 1996. Since mid-1995 foreign trade regulations have been substantially liberalised: the export tax has been abolished and a unified import tariff structure has been introduced. The customs tariff rates in Georgia are 0.5% and 12%, depending on the goods in question. Most export restrictions were eliminated by the end of 1996.

There are no export subsidies. Import licensing applies only when public health, the environ-

ment, consumer welfare, or national security are concerned. Georgia intends to adopt legislation dealing with safeguard regimes in accordance with WTO rules and regulations. Although Georgia has anti-dumping regulation, the government has never applied anti-dumping or countervailing duties.

Georgia is participating in the Black Sea Economic Cooperation (BSEC) and is a member of the CIS. Georgia has established free trade agreements with Armenia, Azerbaijan, Russia, Turkmenistan, Ukraine and Uzbekistan. In April 1996 Georgia signed a Partnership and Cooperation Agreement with the EU.

Currency convertibility and exchange rate regime

The Georgian coupon, introduced in 1993, was replaced by a new currency, the lari, in late September 1995. Two foreign exchange markets currently operate in Georgia: the Tbilisi Interbank Currency Exchange (TICEX) and the Foreign Exchange Bureau Market (FXB). The central bank has adopted a "managed floating" exchange rate regime and regularly establishes the lari's official exchange rate in accordance with TICEX. The lari is fully convertible for current account transactions. The currency surrender requirement was eliminated at the end of 1995.

Wage liberalisation

In the first half of 1997 the average monthly salary was 42 laris (US\$ 32), far below what the government calculates is the minimum subsistence level. The average monthly salary of the self-employed was around 160 laris (US\$ 123).

Interest rate liberalisation

Thanks to progress in financial stabilisation and financial sector reforms, real interest rates have become positive. Commercial banks are free to set their own interest rates. Interest rate spreads between loans and deposits are usually very high. At the end of 1996, the average lending rate was about 70%, while the average deposit rate was 20%.

Financial institutions

Banking reform

In May 1997 the banking system comprised 54 commercial banks, of which 47 were certified. The National Bank issues banking licences and defines policies for the banking sector. Seven new banks were licensed in the first half of 1997. Total assets in the banking system now exceed US\$ 195 million, total capital amounts to approximately US\$ 50 million, and total loans represent some US\$ 100 million. The assets of the three largest (formerly state-owned) commercial banks in the country account for 54% of all commercial bank assets (US\$ 133.7 million). The government welcomes the entry of foreign banks in order to foster competition within the banking sector. Commercial banking activity remains limited and largely focused on short-term trade financing.

In the course of 1996 and 1997 the banking sector underwent a process of fundamental reform, which requires banks to meet new regulatory and supervisory guidelines or to close down. A restructuring programme for the three large formerly state-owned banks has commenced. Two of them have written off most of their non-performing loans. 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 by mid-1998. At the end of 1996 more than

three-quarters of the initial 229 operating commercial banks had been merged or closed on the grounds of non-compliance.

A new chart of accounts similar to IAS (International Accounting Standards) has been developed but its implementation is hampered by the absence of the necessary software and hardware in the banks. Hence, for the time being, banks continue to use the old Soviet-style accounting rules.

Non-bank financial institutions

Special investment funds were established in connection with the voucher privatisation programme in the hope of promoting the development of an equities market. However, only 4% of vouchers were invested in the funds. Although 10 new investment funds and a few insurance companies exist, non-bank financial institutions do not play a significant role currently in financial intermediation.

Securities markets and instruments

The Ministry of Finance regulates securities markets in Georgia. Securities markets started functioning in September 1997, when the government issued short-term bonds worth a total of 10 million laris. A stock exchange is expected to open soon.

Privatisation vouchers are traded in an informal, although efficient, market in Tbilisi.

Fiscal and social safety net reform

Taxation

As of January 1997 enterprises were subject to a unified 20% tax and a 1% property tax. A personal income tax was established in January 1994, with marginal rates of up to 20%. There is no capital gains tax. Excise taxes range between 15% and 100%. Bread and flour are taxed at 10%. There are three rates for the payroll tax: 15%, 26% and 29%. The tax reform package approved by parliament in late 1994 increased the standard VAT rate from 14% to 20% and eliminated most VAT exemptions.

In 1996, tax revenues amounted to only 8% of GDP, one of the lowest ratios in the former Soviet Union. The government therefore removed most tax exemptions and abolished incentives for foreign investors at the end of 1996. The government intends to improve tax and customs administration further so as to increase tax revenue to 11.6% of GDP in 1997 and 13% of GDP in 1998.

Social security

Social safety net benefits are provided by the Social Security Fund (SSF), the Employment Fund (EF) and the Health Fund (HF). The SSF provides old-age, invalidity and widows' pensions, while the EF is in charge of unemployment benefits as well as sickness, pregnancy and maternity allowances. Basic healthcare services costs are reimbursed by the HF.

Expenditures on social transfers increased from 2.6% of GDP in 1995 to 3.2% in 1996. As of January 1997, approximately 33% of the population was receiving average monthly allowances of 10 laris (US\$ 7.60). Current legislation requires employers to make social security contributions for employees, but compliance is uneven. Employers are also expected to provide remuneration for the first five days of sick leave, up to a maximum of 30 days per year.

The Georgian government is in the process of establishing an insurance-based system in the

health sector with the help of the World Bank. The Ministry of Health presented a draft law on medical insurance to the parliament in June 1996 and the government created a medical insurance organisation.

Legal transition

Pledge law

Under the Georgian Pledge Law, a security interest may be taken in both tangible and intangible movables. A pledge may also be taken in an enterprise and over a changing pool of assets. A non-possessory pledge may be created by written agreement. Notarisation is not required for most types of non-possessory pledges except ships, aeroplanes, cars and intellectual property. Notary fees are from 0.1 to 1% of the underlying debt or value of the collateral. There is no centralised registration system in place for pledges over other types of movable property. The law permits notice to third parties to be given by means of publication. A secured creditor may take possession of a pledged asset and sell it with court assistance. It is unclear whether the creditor may enforce the pledge without court assistance. A new Civil Code, which contains provisions on pledges, was adopted in 1997, but is not yet in force.

Company law

On 28 October 1994, Georgia enacted a new Law on Entrepreneurs, which governs the formation and governance of joint-stock companies. The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is US\$ 500-1,000. The process takes between one and three months. There is a requirement that companies maintain independent share registries. Shareholders are entitled to vote by proxy at meetings. Companies are not required to send shareholders proxy forms in advance of meetings. It is unclear whether shareholders may solicit proxies to vote on resolutions. There is no cumulative voting for directors. Minority shareholders are not afforded protection in the event that a company makes a bid for less than all the shares of the target company. Company directors and officers have an obligation to (i) perform their functions in good faith, (ii) avoid self-dealing and (iii) disclose financial interests in material transactions with the company or its affiliates.

Bankruptcy law

The definition of insolvency is that a debtor is either (i) unable to meet its liabilities as they fall due during a fixed period of time, (ii) terminates payment of its debts (temporary inability of meeting its obligations cannot be treated as insolvency) or (iii) its liabilities exceed its assets. The law permits a reorganisation system whereby a majority of creditors can reach a binding settlement with the debtor. In bankruptcy proceedings, the court appoints a liquidator, who possesses a broad range of powers. Liquidators are required to possess special qualifications. Liquidators are not supervised by any specific government body, other than the court. The cost of insolvency proceedings, government taxes, social security claims and employee remuneration rank higher than the claims of a secured creditor. Transactions with third parties that are not at arm's length may be reviewed and declared void. There are no specialised courts or judges handling bankruptcy proceedings.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published between one and six months after being passed. Important judgements are generally published and accessible to practitioners and provide written reasons for courts' decisions. There is generally a meaningful right of appeal from first-instance court decisions. There appears to be an independent right of judicial review of administrative action. On average, a party can be expected to wait less than six months for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and one year for a final judgement for payment of a sum of money to be executed.

Hungary

- *Hungary became a member of the OECD in May 1996. This has entailed further capital account liberalisation.*
- *A healthy external balance on the back of gains in competitiveness and substantial debt prepayments allowed the elimination of the import surcharge in July 1997 and the reduction in the rate of devaluation to 1% in August.*
- *Large-scale privatisation through trade sales has continued in 1997 and is expected to be completed by 1998.*
- *The government's role in the economy is to be further reduced under a new pension system. Social security reforms in other areas are proceeding slowly.*

Enterprises

Size of the private sector

The independent Hungarian research company GKI has recently published survey-based estimates, putting the private sector share at 58% for 1993, 65% for 1994, 70% for 1995, 73% for 1996 and 78% in its latest February 1997 survey. These figures are higher than those of the Central Statistical Office (CSO) based on comprehensive reports by all registered enterprises. It has estimated the GDP share of the private sector at 63% in 1995, of which 14.2% was produced by foreign-controlled enterprises and 49.1% by domestic private entities. According to CSO methodology, the private sector share is likely to be around 75% in 1997.

After initial rapid growth, the number of new business registrations remained more or less constant in 1996. By April 1997, there were slightly over 1 million registered businesses, 73% of them active. Of these, 16% were legal entities (joint-stock companies, etc.) – up from 13.5% at the end of 1995.

Privatisation

Hungary's privatisation process has involved trade sales to both domestic and foreign investors, raising a total of Ft 915 billion (US\$ 4.9 billion) in foreign investment in the seven years up to May 1997. Initially strategic investors were sought, but recent major privatisations have included international public offerings. The privatisation process has involved manufacturing enterprises, all major banks, and a significant proportion of public utilities, in the energy sector in particular.

When the State Property Agency (SPA, since 1995 APV Rt. with expanded responsibilities) was created in 1990, it held the ownership rights to 1,857 enterprises from which 1,698

joint-stock companies emerged for privatisation. By the end of May 1997, state ownership had been reduced to less than 50% in 1,489 of these companies. The majority (987) were fully sold, 144 were in liquidation, 63 had been transferred to other institutions (municipalities, ministries etc.) and a few were closed down; leaving 440 joint-stock companies with state ownership, out of which 209 had a state share above 50%.

Privatisation in 1996 and 1997 continued on track. In 1996, trade sales raised US\$ 1 billion. In the first five months of 1997, the APV received Ft 125 billion (US\$ 660 million), including foreign currency revenues of US\$ 450 million from the sale of stakes in the oil company MOL (raising Ft 55 billion), and the large pharmaceutical firm Richter (raising Ft 37 billion). Both firms were offered in global placements as well as to domestic private investors. Kereskedelmi & Hitel Bank, the last of Hungary's five big previously state-owned commercial banks, has been privatised. Contrary to earlier intentions, the privatisation of the electricity company (MVM), which holds the national grid, has been postponed to 1998. Revenues for 1997 are projected at Ft 180-200 billion (US\$ 1 billion).

These transactions have taken place under the 1995 Privatisation Law, which merged the two main privatisation agencies (the State Property Agency and the State Holding Company) into the APV. According to the law (which was amended in June 1997), around 50 companies will remain fully state-owned, including postal services and the railways. The state will maintain a majority stake in MVM. The state will also maintain minority ownership in some of the largest banks (a single golden share in OTP) and golden shares in 20 of the largest companies. As of April 1997, the value of long-term state assets under the management of the APV amounted to Ft 349 billion (US\$ 1.8 billion). The privatisation process is scheduled to end in 1998, with the APV retaining shares in 109 companies overall.

In addition to trade sales of large state-owned enterprises, smaller concerns (up to Ft 800 million in assets and less than 500 employees) have changed ownership under a so-called "simplified privatisation" procedure devised in 1995. 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. During two consecutive rounds so far 121 companies (from an original list of 300 companies held by the APV) with a nominal value of Ft 17.8 billion (US\$ 96 million) have been sold, raising Ft 8.9 billion (US\$ 48 million) in revenues.

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.

About 1.2 million Hungarians have been granted "compensation coupons" as restitution, mainly for nationalisation of property. Coupons have in practice been usable mainly towards the purchase of land, although shares in some industrial companies have also been offered for sale to coupon-holders. By the end of 1996,

75% of all coupons with a total face value of close to Ft 100 billion (US\$ 650 million) had been used.

Governance and restructuring

Restructuring of state enterprises has been achieved mainly through subsidy reduction, tighter access to finance for loss-making enterprises, and greater competition on account of liberal rules for the 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. In privatised enterprises, strategic investors have often pressed for additional adjustments, involving quality upgrading, product and process innovation and marketing.

Foreign-controlled enterprises currently produce around 14% of GDP. In these enterprises, effective corporate governance has arguably been established, mirrored by high profitability and strong growth (in particular export) performance. However, most domestic enterprises are only loosely connected to this dynamic sector and insider influences are considerably stronger as a result of management buy-outs and asset transfers from previous state-owned enterprises. The involvement of banks in enterprise control is relatively less important than in other central European countries. In spite of the rapid privatisation of recent years, significant control rights are still vested with the Hungarian government in a number of important (now private) enterprises, associated with golden share holdings of the APV.

In 1992, the government selected 14 state-owned enterprises of "strategic importance" for special government-supported restructuring. These firms at the time employed 83,000 workers, had US\$ 3 billion in sales and accounted for around a quarter of Hungary's exports. The state injected a total of US\$ 1.7 billion (around 4% of GDP), clearing state debt and tax arrears, swapping bank debt for equity and providing new funds for restructuring. These efforts have met with limited success at best. Only seven of this list are now profitable, two are struggling and the remainder have closed down.

A 1993 revision to the Law on Bankruptcy slowed the rate of filed bankruptcies and liquidations from 14,060 cases in 1992 to 7,477 cases in 1996. At the same time, the ratio of completed to filed cases increased from less than 10% to 40%.

The result of restructuring efforts has been, in the aggregate, a rise in the average productivity of labour in the manufacturing sector to around 140% of its 1989 level. This has been achieved primarily through a substantial shift of employment into services and a rapid rise in unemployment. On the output side, structural change has taken the form of an initial decline but subsequent partial recovery in the share of industry in GDP, while the service sector has greatly expanded from around 50% in 1989 to 60% in 1995.

The framework for state-financed bank recapitalisation has included incentives for banks to help restructure the balance sheets of enterprises. However, government-sponsored conciliation agreements have led to restructuring of only 29% of enterprise bank debt (plus around 60% of enterprise debt to the state) in the 1,950 participating enterprises.

Markets and trade

Price liberalisation

About 84% of consumer prices, weighted by their share in the consumer price index, are free of administrative controls. According to the Laws on Electricity and Gas, prices for these products were to cover costs by 1 January 1997, but price increases planned for 1996 were postponed in October. Price increases in excess of 40% since January 1997 should have gone a long way to meeting the goal of cost recovery. However, the precise cost basis to be included in the pricing formula is still under discussion and foreign investors have complained about insufficient profit margins, which were guaranteed to them in privatisation contracts concluded during 1995.

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. The number of cases decided by the office has risen every year since 1991, reaching 162 in 1996. However, violations were found in less than 30% of all cases. Of the total of Ft 1.8 billion (US\$ 9.7 million) in fines imposed, only Ft 100 million has been collected.

On 1 January 1997 a new competition law became effective, further harmonising Hungary's competition policy with the European Union. Among other provisions, it changed the focus of the law from protection against "unfair" market behaviour to a stronger emphasis on non-competitive ("restrictive") market practices. The new law also outlaws restrictive vertical agreements in addition to horizontal cartels.

Trade liberalisation

While trade liberalisation in the early 1990s was far reaching, some restrictions remain.

Some consumer goods imports are regulated by the so-called "global quota", with individual ceilings set for about 20 product groups. Out of the total value of the quota of US\$ 563 million in 1996, 36% was allocated to clothing, 25% to cars and caravans, and the remainder concerned mainly textiles, footwear and precious metals. Importation of energy products, cars and many agricultural products still requires a licence. This also applies to exportation of energy products, pharmaceuticals and some agricultural goods.

A number of industrial and "sensitive" products (i.e. textiles and agriculture) remain substantially protected by import tariffs. The average import-weighted tariff rate in 1996 was 6.9%, but tariffs on transport equipment stood at 17%. Some tariffs are being phased out for trade with the EU, in accordance with Hungary's Europe Agreement, and for trade with the other members of CEFTA.

An 8% import surcharge introduced in March 1995 has been phased out gradually since mid-1996 and was eliminated in July 1997.

Among the important vehicles for trade liberalisation in recent years has been Hungary's Europe Agreement with the EU (the trade protocol of which entered into force in March 1992). In addition, Hungary participates in CEFTA. Hungary was already a member of GATT in the 1980s and became a member of the WTO in December 1994.

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 VIII 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 in four steps from 1.9% in 1995 to 1% on 15 August 1997. The spot rate may fluctuate within a band of +/-2.25% of the central rate. The basket against which the forint has been pegged since January 1997 consists of 30% of US\$ and 70% of DM.

Hungary became a member of the OECD in May 1996. In connection with the membership, a number of measures were taken in mid-1996 and on 1 January 1997 to liberalise capital transactions. Hungarian investors may purchase government bonds of OECD countries with an original maturity of one year, and shares of OECD-based firms with investment grade credit ratings. The domestic Hungarian market was also opened for trade in such securities. Foreigners may 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. The government attempts to exert a moderating influence on wage increases through tripartite agreements with employers and trade unions. However, wage increases recommended by the Interest Reconciliation Council (IRC) have usually been exceeded. The IRC also decrees a minimum wage, which stood at 31% of the average wage in 1996 and covered around 5% of the labour force.

Interest rate liberalisation

The government removed administrative controls of interest rates on deposits and loans for enterprises in 1987, and for households in 1991-92. Lending rates have recently fallen rapidly and margins have come down to 4-5% from 7-8% during 1994-95 as a result of efficiency improvements and increasing competition.

The central bank has at its disposal the full range of monetary policy instruments. Monetary policy over the past two years has been geared towards sustaining the crawling peg exchange rate through interest rate policy.

There is a well-functioning interbank money market, with interest rates usually following the trend in the central bank's refinancing rate.

Financial institutions

Banking reform

A two-tier banking system was introduced in on 1 January 1987. At the end of 1996, there were 41 banks and 256 savings and loans cooperatives in operation. Their combined stock of domestic credit was Ft 3.5 trillion, or slightly above half of GDP. After significant bank privatisations in 1995 and 1996, the share of assets in foreign-owned banks was estimated at over 50% in early 1997. The seven largest banks have accounted for a falling share of assets, standing at 68.7% in 1996, down from 79% in 1993.

Credits to enterprises represented only a third of the domestic credit stock, following several years of cautious lending policies and substantial crowding out from the budget. Several larger companies have successfully raised funds abroad. However, access to long-term forint loans has remained limited, partly due to very high collateral requirements stemming from an underdeveloped mortgage market and a poorly maintained property register.

The law on commercial banks, effective since January 1992, imposes the "Basle standards" for capital adequacy on Hungarian banks. As a result of several rounds of bank recapitalisation, mainly during 1992-94, the government injected a total of Ft 360 billion into the banking sector, about 8% of 1994 GDP. Following these initiatives, capital adequacy as measured in the official audited balance sheets exceeded 8% in all the large banks by the end of 1994. It reached an average of 19% at the end of 1996.

A major part of banking reforms during 1995-96 has been bank privatisation. The last of the five big previously state-owned commercial banks, K&H, was sold in August 1997 to Kredietbank and Allied Irish Life with EBRD involvement. There is a substantial presence on the Hungarian banking scene of smaller private banks, most of them with foreign participation. The law on commercial banks requires a reduction in state ownership in all banks to less than 15% by the end of 1997, except for special purpose institutions and banks holding more than 25% of the retail banking market as of January 1997.

In March 1997, around Ft 25 billion in deposits were withdrawn in a run on Postabank, the country's second-largest bank. However, no repercussions are expected for the banking sector as a whole from the episode.

Banking supervision is generally good, although events surrounding the Postabank run and lack of full public disclosure of financial information raise some concerns. In January 1997 the State Banking Supervision and the State Securities and Stock Exchange Supervision were merged, as legal barriers against the operation of universal banks were lifted.

Hungary operates a deposit insurance for individual deposits of up to Ft 1 million per registered account. The insurance is financed by levies on retail banks supplemented by budgetary funds if needed and administered by an independent body with representatives from the central bank, the Ministry of Finance and the Bankers' Association.

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. A bill regulating mortgage credit institutions and the issuance of mortgage bonds was passed in April 1997.

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. Their asset value in June

1997 was Ft 35 billion, less than half a per cent of GDP. The Law on Investment Funds was passed in 1991. A large number of investment funds are active in Hungary with a total asset value of Ft 128.2 billion (1.8% of GDP). The planned pension reform (see below) is likely to significantly boost the development of non-bank financial institutions.

Securities markets and instruments

In June 1990 the Budapest Stock Exchange was reopened and a new regulatory framework was introduced (the Act on Economic Associations, the Securities Act and the Act on Mutual Funds). By the end of 1996, 165 securities were listed with a nominal value of Ft 1.8 billion and a capitalisation of Ft 2.4 billion. Turnover rose more than four times in 1996 to Ft 1.14 billion. State bonds and treasury bills accounted for roughly one half of that value. In recent months maturities of new government bond issues have lengthened. A five-year fixed interest bond was successfully placed in early 1997 and a 10-year bond is under consideration. A domestic corporate non-guaranteed bond issue by MOL with a three- to five-year tenor raised only lukewarm investor interest in September 1997.

A number of Hungarian companies are listed on west European and US markets. Hungarian blue-chip companies have also increasingly tapped the international syndicated loan market. The largest single borrower, MOL, raised US\$ 500 million at an average five-year tenor in December 1996. In 1997, margins over Libor have fallen to below 20 basis points in deals involving primarily bank-to-bank lending.

Fiscal and social safety net reform

Taxation

Hungary began fiscal reforms in 1988-89. Reforms in the last few years have focused on removing sector/activity-based tax reliefs. Special tax incentives for new foreign investments were largely phased out by the end of 1993. Personal income is taxed progressively. The top rate (applying to annual incomes above Ft 900,000) was reduced from 48% to 42% as of January 1997. There are two VAT rates of 12% and 25%; their gradual unification is envisaged as part of preparation for EU membership. 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% to 18%, but a tax on dividends was introduced which is currently 20%.

Social security

Hungary inherited a high-cost social welfare system and is currently involved in the process of reducing social benefits. In particular the two independent social security funds, the health and the pension funds, have experienced consistent deficits, and their reform meets with political resistance.

The retirement age is 55 for women and 60 for men. A 1996 amendment provided for a gradual increase in the legal retirement age to 62 for both men and women (to be phased in up to year 2007). Efforts at tightening welfare benefits and broadening the contribution base have been rejected by the Constitutional Court. 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% and 12% respectively of the wage sum in 1993 to 47% and 10% as of 1997. A further reduction in the contribution rate for employers to 40% is envisaged as a result of pension reform.

Under a government proposal, adopted by parliament in April 1997, Hungary's pay-as-you-go (PAYG) pension system is to be replaced by a three-pillar system. The PAYG formula will be retained for the first pillar but eligibility criteria tightened, and the indexation formula will be changed from the current net wage indexation to net wage and inflation (equal weights) indexation. A mandatory second pillar will place a third of all contributions with privately managed pension funds. Top-up contributions are already possible under a third pillar. All new labour force entrants would join the three-pillar system, and current employees could either remain in the PAYG system or switch gradually, depending on their age.

Legal transition

Pledge law

Hungary amended its Civil Code in 1996 to provide for a uniform system for the creation of registered non-possessory pledges over movable property. The 1996 amendments also provide for an enterprise charge. A non-possessory pledge must be notarised and registered in order to be enforceable. Parties must register at any notary's office, where the registration is entered into a computerised and centralised system that was introduced in May 1997. Enforcement of the pledge is normally with court assistance. However, the pledgee needs only to seek an executory warrant from the court rather than undergo extended proceedings.

Alternatively, the parties can agree to sell the pledged property jointly. A third option is for the parties to waive court enforcement, if this is provided for in the pledge agreement. The registration fee is approximately US\$ 500. The same fee is payable for a search of the registry.

Company law

The cost of formation and registration of a joint-stock company (including legal notary and court fees, but not including minimum share capital) is US\$ 500-1,000. The process normally takes between one and three months. There is no requirement that joint-stock companies maintain independent share registries. There are, however, private sector parties who maintain independent registries. Directors possess obligations to (i) perform duties in good faith, (ii) avoid self-dealing and (iii) disclose personal interests in material transactions with the company or its affiliates. Shareholders may vote by proxy at meetings. Companies are not required to send proxy forms to shareholders in advance of meetings. There is no legal provision for cumulative voting for directors, although companies may include this provision as part of their corporate charter. A company that acquires more than 50% of the outstanding shares of a target company may be required to purchase the remaining shares at the same price. Shareholders do not possess pre-emptive rights with respect to new share issues. Laws exist prohibiting insider dealing of shares in publicly listed companies.

Bankruptcy law

A debtor is considered insolvent if it is unable to meet its liabilities as they fall due. The law provides for a reorganisation system whereby a

majority of creditors can reach a binding settlement with the debtor. The settlement must be approved by 50% of the creditors in each class if in the aggregate they represent two-thirds of all claims. In bankruptcy proceedings, the court appoints a liquidator, who possesses a broad range of powers. Liquidators must have special qualifications and are supervised by a government body. Transactions not at arm's length, concluded below fair value or less than one year prior to the liquidation may be declared void. The costs of liquidation, certain taxes and employee wage claims rank higher than secured claims in a liquidation. There are specialised judges to handle bankruptcy cases.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published within one month of being passed. Important judgements are generally published and accessible to practitioners and provide written reasons for courts' decisions. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between seven months and one year for a commercial case to be heard on the merits by a court in the most important commercial centre and between one and two years for a final judgement for payment of a sum of money to be executed.

Kazakhstan

• *The small-scale privatisation programme, involving more than 14,600 enterprises and farms, is drawing to a close. Case-by-case privatisation, targeting firms in the power, energy and telecommunications sectors, has continued to attract foreign participation.*

• *A securities commission has been established, entrusted with developing stock and securities markets by the end of 1997; the sale of remaining government shares in "blue chip" companies is intended to increase the attractiveness of these markets.*

Enterprises

Size of the private sector

According to official estimates, the share of the non-state sector in GDP had grown to more than 55% by 1996 (the non-state sector includes firms with minority private ownership). The private sector (companies with majority private ownership) is likely to account for at least 35% of GDP in 1997. Employment figures are estimated at 60-65% and 35-40%, respectively. The vast majority of private firms are privatised, i.e. the segment of new private enterprises is small.

New firms tend to be concentrated in Almaty and in the energy and mineral sectors. Following the announcement in 1996 of the government's intention to identify and support priority sectors, a law on "State Support of Direct Investment" came into force in February 1997. A state committee is authorised to provide tax holidays for investments in a broad range of activities, including the move of the capital from Almaty to Akmola.

Foreign direct investment increased substantially in 1996 (by about 40% to US\$ 1.22 billion), and this trend is likely to continue. FDI is concentrated mostly in non-renewable resources and is of a long-term nature (80% of total FDI from 1993-96 was for oil, gas, and ferrous and non-ferrous metals). With an accumulated US\$ 200 per capita, Kazakhstan is one of the largest recipients of FDI among the CIS economies. However, a large part of FDI inflows have not yet resulted in the purchase of plant, equipment, etc. but were transfers within the firms involved.

In December 1996 the Caspian Pipeline Consortium contract was signed, opening the way for the construction of an oil pipeline from Kazakhstan's Tengiz field to the Black Sea. Implementation of this project would substantially increase the present capacity to export oil.

Privatisation

Large-scale privatisation has proceeded in three stages. The first programme, launched in 1991, aimed chiefly at the sale of retail trade and service facilities and the legitimisation of *de facto* transfer of state property to insiders

(employees and managers). The second programme, which covered 1993-95, foresaw mass privatisation of medium-sized and large enterprises (i.e. those with over 200 employees) through auction sales of shares, with participation of investment privatisation funds (IPFs). Approximately 170 IPFs were established in 1994. In the second half of that year, vouchers were distributed to the public, who in turn placed them with the IPFs. A total of 1,700 companies were earmarked for privatisation through this programme. Between 51% and 90% of shares in each enterprise was offered for sale (employees received 10% and the state could retain up to 39%). By early 1996, 60% of the total equity of the 1,700 enterprises had been transferred to private hands, with private owners having a majority of voting stock in 43% of the enterprises. Virtually all agro-industrial enterprises had been formally transferred to private hands, albeit often into cooperative ownership. But only five (out of 180) of the "very large" enterprises with more than 5,000 employees had been privatised.

The most important objectives of the third stage of the privatisation programme, covering 1996-98, are: (i) the completion of small scale privatisation, (ii) the cash sale of additional shares in medium-sized and large enterprises, and (iii) the sale of very large enterprises on a case-by-case basis. In February 1996 the government started to divest state-held shares, including the 39% stakes that had been excluded from the auctions. State share packages in two-thirds (823) of the 1,235 joint-stock companies on offer in the cash auction programme were sold by the end of 1996. The coupon-based part of the mass privatisation programme was completed in early 1996. Privatisation through the stock market, however, has remained limited, with 44 state share packets sold this way in 1996.

Meanwhile, the IPFs have been allowed to increase the maximum ownership share that each fund is permitted to hold in a single enterprise to 31%, up from 10%. The privatisation of large enterprises on a case-by-case basis, targeting enterprises especially in the power, energy and communications sectors, continued through 1996 and early 1997, attracting considerable foreign investment. Seventeen joint-stock companies and the property of 11 restructured enterprises were sold under this programme in 1996. The privatisation in the coal sector is close to completion, and considerable progress has been made in the electricity and mining sectors. Case-by-case privatisation accounted for the majority of the privatisation revenues of US\$ 600 million recorded in 1996. Consequently the authorities indicated a preference for replacing management contracts (see below) with direct privatisation. Kazakhstan has announced the imminent prioritised privatisation of oil and gas companies by tender, and also given high priority to foreign investment in mineral and ore extraction.

Under the small-scale privatisation programme (involving companies with fewer than 200 employees), approximately 13,000 entities had been sold by the end of 1996. Although this amounts to 97% of all entities originally targeted, it represents only 88% of firms offered for sale, since the list of entities to be privatised was expanded in April 1996. A number of problems have contributed to a delay in completing small-scale privatisation, among them a lack of

legal clarity. The rate of progress has differed between sectors, with the programme nearly completed in agriculture, retail trade, public catering and service industries; healthcare and some education facilities were added to the programme only in late 1996. In early 1997, a presidential decree established June 1997 as the date for finalising small-scale privatisation, but this target was not completely met.

So far, more than 90% of all farms and more than 80% of farmland has been privatised. Privatisation has typically involved providing farm workers with long-term leases and buy-out options to land and then distributing shares in other farm assets to those with land rights. Farm privatisation has often led to cooperative ownership structures; land reform suffers from a lack of clarity as to the property rights applicable to different types of agricultural land.

There has been no property restitution in Kazakhstan.

Governance and restructuring

Overall, restructuring of large loss-making units has been difficult and slow. Under so-called "management contracts", 47 of the largest enterprises (out of a targeted 60), the majority in the extraction industries, were placed under outside (including foreign) management, in an attempt to foster industrial restructuring. The contracts cover periods between 18 months and 15 years and involve transferring enterprises under the management of an interested outside party, usually a potential investor and usually with an implicit option to buy the enterprise later. However, no formal commitment to privatisation was necessary, so that the strategy essentially amounted to leasing out state-owned enterprises. Twelve of the outside partners were foreign. By early 1997, 12 contracts had led to a formal transfer of equity. Complete buy-outs are rare and corruption, involving large-scale asset stripping, is rumoured to be widespread. Consequently, the Kazakh authorities have increasingly emphasised their desire to replace management contracts with direct privatisation on a case-by-case basis.

Forty-two of the biggest loss-making units have been placed under the control of the Rehabilitation Bank, an agency set up with World Bank funding to restructure or to liquidate financially distressed enterprises. The performance of the Rehabilitation Bank has exceeded expectations; early in 1997 only 17 of the 42 enterprises remained under its control; the rest having been liquidated, merged, or restructured in such a way that they could continue to operate independently.

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.

A code of unified accounting standards in accord with international accounting regulations and a new Law on Bankruptcy were introduced in 1997.

Markets and trade

Price liberalisation

Kazakhstan completed price liberalisation by the end of 1994. 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. Utility

prices (including electricity) have been increased, although not everywhere to cost-recovery levels. Tariff collection is a serious problem with respect to both households and enterprises.

In general, the increased tendency toward privatising public utilities has put severe upward pressure on both utility pricing and collection rates. Price subsidies for basic consumer goods have been removed. Price legislation has been virtually eliminated, except for the regulation of natural monopolies, including private ones.

Competition policy

The existence of monopolies in trade and distribution remains an impediment to competition. The abolition of the State Order System and the removal of internal and external trade restrictions in the early days of reform were the first measures to promote competition. In June 1994 a Anti-Monopoly Law was introduced, giving the anti-monopoly committee the power to regulate the prices of natural monopolies (which effectively is hardly used). In February 1995 the government started the process of dismantling the 80 state holding companies, responsible for about 1,700 enterprises. Sufficient progress has been made for the target of eliminating all state holding companies by the end of 1997 to appear within reach. Additional measures have included the removal of the monopoly rights of 14 state organisations to the external trade of strategic goods.

Trade liberalisation

Kazakhstan has established a very liberal trade system. During the course of 1995, all export quotas and most export and import licensing requirements were abolished, and barter trade was prohibited. While delaying the ratification of the Partnership and Co-operation Agreement (PCA) with the European Union, the European Commission passed the trade provisions of that agreement in 1995, granting MFN status as an interim solution.

Monopoly rights of state trading organisations no longer exist, and export surrender requirements and almost all registration requirements of export contracts have been abolished. Remaining export duties were eliminated with effect from August 1996; tariff rates on imports over 30% have effectively been eliminated and, by January 1997, the weighted average rate on import duties had fallen to about 12%.

Kazakhstan entered a Customs Union with Belarus and Russia in 1995, and also participates in a trilateral agreement on free trade and economic cooperation with Uzbekistan and Kyrgyzstan. Negotiations for membership in the WTO, for which the country applied in June 1996, are advanced and the process may be concluded as early as 1998.

Currency convertibility and exchange rate regime

The tenge is convertible for foreign trade. In July 1996, Kazakhstan accepted all obligations under Article VIII of the IMF Agreement, committing the authorities to refrain from restricting current account transactions or from implementing discriminatory currency arrangements. Official and commercial exchange rates are unified, with rates determined on the Kazakh Interbank Currency Exchange market, 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. The exchange rate regime of the NBK is a managed

float. Interventions have become more frequent recently, in order to allow for a modest and controlled appreciation of the real exchange rate. By and large, the nominal depreciation against major currencies has remained smooth and predictable over the last two years.

In December 1996, Kazakhstan, only the third country of the former Soviet Union (and after Russia only the second CIS country) to obtain an international credit rating (speculative), floated its first Eurobond. The issue was heavily oversubscribed and raised twice the amount initially targeted (US\$ 200 million with a maturity of three years). In September 1997, Kazakhstan established a benchmark for five-year Eurobonds (US\$ 350 million) priced at 245 basic points above comparable US dollar Treasury rates.

Wage liberalisation

The Law on Employment of the Population (1991) gives the government discretion on minimum wage adjustment. Otherwise, workers and enterprises are free to negotiate wages.

Interest rate liberalisation

Interest rates, previously high in real terms, have been gradually reduced since 1995, as inflation continued to decline. Directed credits were abolished in early 1995 and limits placed on the amount of National Bank (NBK) net credits to the government. The extension of credit from the NBK to the government to finance the budget deficit has been drastically reduced, following the development of the treasury bill market, in which foreigners can participate. Repurchase and reverse repurchase facilities were introduced in 1996 to serve the liquidity demands of the banking system but have remained largely inactive. Credit auctions were phased out in 1996, and the NBK currently has no treasury bills on its books. Similarly, the Lombard rate has been largely inactive as credit to commercial banks was apparently decided on a case-by-case basis.

The NBK has actively participated in the interbank credit market (established 1995) to avoid major divergences between the interbank and the refinancing rate. In March 1997 an overnight facility was introduced to provide liquidity to commercial banks and primary dealers; it has recently become more active. Both the overnight and the Lombard rate have been set below the refinancing rate. The refinancing rate itself has continued to decline, reflecting the fall in inflation. This development was particularly pronounced in recent quarters as the refinancing rate was gradually cut from 35% (October 1996) to 21% (July 1997).

Yields on treasury bills have generally tracked the refinancing rate over the past 12 months, and have been supported by the newly gained access to the international capital markets (after Kazakhstan received an international rating) and the alternative source of finance at competitive rates which they provide.

Financial institutions

Banking reform

New banking legislation, adopted in August 1995, separated investment banks from deposit-taking banks on the grounds that the introduction of proper accounting procedures had to precede further liberalisation of banks' activities. Foreign banks are allowed to have only subsidiaries, joint ventures, or representa-

tive offices. Without special permission of the NBK, individual – foreign or domestic – shareholdings in Kazakh banks are not allowed to exceed 25% (excluding portfolio investment); and total ownership in Kazakh banks by foreigners is not allowed to exceed 30% in aggregate. The presence of foreign banks in Kazakhstan is steadily increasing.

The number of banks in Kazakhstan has been subject to large fluctuations. Having risen to 210 by mid-1993, it has fallen back to less than 100 in 1997, largely due to closures imposed by the NBK, with most of the closed banks being small, non-viable entities. Kazakhstan has continued to implement a comprehensive set of reforms designed to strengthen prudential norms for commercial banks and also to establish binding legal and accounting frameworks. While the banking system is still dominated by a few state-owned banks, the number of banks with state shares was reduced to 14 (five of them fully state-owned) and the number of banks with foreign participation had increased to 23 by the end of 1996.

The Programme for the Reform of the Banking Sector of 1995 reconfirmed central bank independence. It required guarantees for all bank payment orders forwarded to the NBK for clearing and settlement, the adoption of BIS guidelines for prudential supervision, compulsory risk classification of assets, provisioning requirements, and a tougher licensing policy. In addition, attempts were made to restructure the sector-specialised banks. This involved the transfer of non-performing loans of Agroprombank to a new agricultural support unit, and the splitting 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, was merged with the Exim Bank.

The trend toward strengthening banking supervision continued through 1996 and 1997.

Two major banks, accounting together for about 20% of the banking sector's outstanding loans, one of them private, were taken over by the government, merged into the TuramAlem Bank and recapitalised by the NBK in 1997. Kramds Bank, the fourth-largest bank in Kazakhstan, was closed in October 1996, after the provision of additional liquidity failed to sustain portfolio improvements. While the true value of bank assets remains low in aggregate, the policy of identifying and eliminating the non-viable banks in the system appears to have reduced the share of non-performing loans and to have led to improved provisioning. According to the NBK, the share of non-performing loans in the banking system's portfolio fell from 55% at end-1994 to 41% at end-1996 and to 22% at the first quarter of 1997. Actual provisioning has reached approximately 42% of the required level.

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 10% to 31%. Private pension funds or insurance companies have yet to develop and insurance companies are not yet players in the security markets.

Attempts to reform the pension system acquired high priority by summer 1997. Discussion has focused on linking the reform of the pension system to privatisation on the one hand and the

establishment of efficient equity and security markets on the other. Efforts are under way to establish a private pension system which would operate in parallel to the old state-owned "pay-as-you-go" system, with mandatory contributions split between private and state-owned pension funds. Both funds would become active participants in the newly established domestic capital market.

Securities markets and instruments

A law on 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 thus far has been conducted outside formal markets, due to taxation of distributed shares, high fees and lack of over-the-counter operations. The market for the trading of tenge-denominated government bonds developed fairly rapidly after 1995.

In 1996, a security commission was set up to prepare the establishment of securities markets. New requirements for the registration of brokers were imposed and negotiations are under way to determine the amount of government-owned shares in "blue chip" companies to be sold at the Almaty stock exchange. In August 1997, 11 large companies were prepared for initial public offerings, with an estimated market capitalisation of US\$ 8 billion. The opening of the Kazakhstan Stock Exchange was announced for September 1997 and trading started in October.

Fiscal and social safety net reform

Taxation

A new Tax Code, effective 1 July 1995, simplified and modernised the tax system. There is a 30% corporate income tax for companies (45% for banks and insurance companies) and the maximum income tax rate is 40%. A uniform VAT was introduced at 20%. To compensate for the expected decline in revenues resulting from these changes, the average import duty was raised from 5% to 15%, excise taxes were imposed on certain goods, and VAT was extended to imports from non-CIS countries as well as to gold purchases.

However, tax revenues have continued to remain extremely low – the share of revenues to GDP has been below 13% in 1997. The ratio of tax revenues in total budget revenues is estimated to be slightly more than 75%. These numbers reflect the difficulty of collecting sufficient taxes to compensate for the payment difficulties of a declining number of state-owned enterprises. Raising the efficiency of tax collection from the emerging private sector therefore remains imperative.

Social security

The social and medical insurance system is currently about to be reformed. Compulsory contributions include 10% of the payroll tax for medical insurance and 5% of the payroll tax for social insurance. In addition, social security payments include an employment fund levy of 1% of wages (which was lowered from 2% at the beginning of 1997) and a pension fund contribution of 30% of wages for most contributors (up from 5% since in 1997 the preferential status of a large contingent of contributors was eliminated). Additional changes, which sparked widespread social disquiet, include increasing the retirement age (from currently 58 years for men and 53 years for women, to 63 and 58

years respectively by 2002) and reducing pension benefits for working pensioners. The payment difficulties in the pension system led to a special presidential decree, ordering the clearance of all pension arrears by January 1998.

Legal transition

Pledge law

Kazakhstan enacted a Law on Pledge in 1991, pursuant to which non-possessory pledges are permitted in certain types of movable property. The pledge is created by written agreement. A pledge of an enterprise is permitted, but registration is required. Pledges of other movables do not require registration. Enforcement of the pledge is generally carried out by court order, although the parties can agree on enforcement without the assistance of the court. The sale must be by public auction.

Company law

The Civil Code (1993) and a presidential decree "On Economic Associations" govern company law. The cost of formation and registration of joint-stock companies (including legal, notary and court fees, but not including minimum share capital) is often over US\$ 1,000. The process takes between one and three months. Joint-stock companies with more than a certain minimum number of shares are required to maintain an independent share registry. Shareholders are entitled to vote by proxy at meetings. Companies are not required to send shareholders proxy forms in advance of meetings. It is unclear whether shareholders may solicit proxy votes on resolutions at meetings of shareholders. There is no legal requirement for cumulative voting for directors. In practice, companies may include this provision in their corporate charter. Minority shareholders are not afforded protection if a company makes a bid for less than all the shares of a target company. Shareholders do possess pre-emptive rights with respect to new share issues. Directors are not subject to any statutory obligations with respect to the performance of their functions or the disclosure of any conflicts of interest with the company.

Bankruptcy law

A new Law on Bankruptcy was adopted in January 1997. The legal definition of insolvency is when either (i) the debtor is unable to meet its liabilities as they fall due or (ii) the debtor's liabilities exceed its assets. The law provides for a reorganisation system whereby a majority of creditors can reach a binding settlement with the debtors. In bankruptcy proceedings, a liquidator is appointed by the court. The liquidator possesses a broad range of powers. Liquidators are not required to have special qualifications. There is no specific government body that regulates liquidators. It is unclear what types of third-party transactions may be reviewed by the liquidator and declared void. The costs of liquidation, personal injury claims and wages of employees rank higher than secured claims. There are no specialised courts handling bankruptcy proceedings.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published within one month of being passed. Important judgements are generally published and accessible to practitioners and provide written reasons for courts' decisions. There generally is a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review

of administrative action. On average, a party can be expected to wait between seven months and one year for a commercial case to be heard on the merits by a court in the most important commercial centre and between one and two years for a final judgement for payment of a sum of money to be executed.

Kyrgyzstan

- *Significant progress has been made in privatisation over the past year. However, in May 1997 the government temporarily suspended the privatisation programme pending an investigation into price rigging.*
- *The government is pressing ahead with legislative initiatives to further agricultural reform, enterprise restructuring and banking sector reform.*
- *Financial sector reform under a World Bank sponsored Financial Sector Adjustment Credit (FINSAC) is progressing. Banking supervision and prudential regulation are gradually being strengthened.*

Enterprises

Size of the private sector

Although about half of medium-sized to large industrial enterprises have been privatised, the state still accounts for a large percentage of industrial assets, employment and output. This is a result of the importance of the remaining 14 natural and "permitted" monopolies (see below). According to official statistics, the share of the state in manufacturing output decreased only from 53% in 1994 to 47% in 1996. The state contributed around 3% of agricultural production in 1996.

Overall, the private sector share in official GDP is around 55%, largely accounted for by agriculture. The share would be higher if the shadow economy (officially estimated as 10-30% of official GDP) were included.

While the formation and growth of new private enterprises is accelerating, particularly in trade and services, the process is impeded by a lack of finance and inadequate infrastructure. In the agricultural sector, problems include bottlenecks in distribution, credit availability, input and raw material supply, and marketing.

Privatisation

Kyrgyzstan has made significant progress with privatisation over the past few years. Between 1991 and 1994 around 4,700 enterprises were privatised through direct sales or lease. Of these, 85% were small trade outlets, retail and service establishments. The remainder were medium-sized and large enterprises which were usually corporatised and shares transferred to workers' collectives.

In November 1994 the government initiated a more transparent mass privatisation programme for 1,300 enterprises to be sold through voucher and cash auctions. The privatisation method involves a combination of free share transfers to employees (5% of total assets), sales through voucher auctions (25% of assets), and cash

auctions or investment tenders (70% of assets). Voucher auctions are to precede cash sales in the process. Only around 20% of vouchers were placed with investment funds, limiting the impact of privatisation on the development of the securities market.

According to the State Property Fund (SPF), approximately 1,000 medium-sized and large enterprises were offered for coupon auction by the end of 1996. In 660 of these, voucher and cash sales have reduced the state's share to zero. Around 200 enterprises were privatised through other methods, liquidated, or restructured. The 1996-97 privatisation programme includes initiating coupon auctions for the remaining 300 enterprises in the mass privatisation programme and completing divestiture of the state shares in the 600 enterprises that still have a state shareholding. In addition, the government has announced its plan to start the privatisation of 11 monopolies and around 76 large industrial companies in which controlling stakes will be offered to foreign investors in 1997. Lastly, the government is considering methods for disposing of the 3,800 state enterprises not yet privatised or covered by the mass privatisation programme. Most of these are communal and social assets, public services and agricultural facilities, some of which are non-viable.

The privatisation process has experienced a number of recent setbacks. The SPF's intention to proceed with privatisation of public utilities faces political opposition, which in 1997 has forced the delay of offering 25% stakes in Kyrgyzalyn and Kyrgyztelekom. A plan to privatise the power industry by 2000 also faces resistance, including from the state energy and fuel company (Kyrgyzenergoholding) itself. In addition, in May 1997 the government suspended the privatisation programme temporarily, pending an investigation into price rigging, and set up a commission to investigate corruption.

In spite of the reduction in state ownership of land, land legislation and administration is still inadequate. A major limiting factor is the constitutional prohibition on full private land ownership, unlikely to be lifted before 1999. Leaseholds were extended to 99 years in 1995 and, following a 1996 decree, 50% of all existing leases will be sold to private investors by March 1998. However, for the remainder, only short-term leases will be extended, greatly limiting farmers' incentives to improve the land. Three important pieces of legislation are currently being considered: (i) the Land Code, which guarantees the right to buy, sell, inherit, mortgage, and transfer land use rights, and prohibits expropriation without compensation; (ii) the Law on Mortgage, which includes procedures for land to be used as collateral, submitted to parliament in May 1996; and (iii) the Land Registration Act, which establishes a unified land registration system.

Governance and 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 28 largest, loss-making, state-owned enterprises. Following the audit of these enterprises, four have been removed from the programme, five were liquidated, and the remainder have undergone downsizing and restructuring. The sale of the 20 restructured

companies (one company was split into two) was completed in June 1997. No additional budgetary allocations for ERRA was made in the 1997 budget and it is expected to cease operations this year.

There is little evidence on the impact of privatisation on corporate governance and enterprise restructuring so far. However, severe impediments to restructuring continue to exist. A general lack of financial discipline contributes to mutual arrears between households, enterprises, agricultural producers, budgetary authorities, utility companies and the banking sector. For instance, outstanding debt for natural gas deliveries amounted to US\$ 26 million (1.5% of GDP) by mid-1997. Insider ownership may have limited managerial turnover and reduced willingness to undertake deep restructuring in many privatised companies. Despite the enactment of an Insolvency Law in 1994 and a series of government decrees aimed at imposing financial discipline, there have been only few cases of bankruptcy.

Efforts are being made to overcome these problems. Out-of-court settlement procedures for creditors of insolvent enterprises have been introduced to side-step the implementation bottlenecks in the legal system. With the assistance of foreign advisers, a new bankruptcy law and a range of insolvency regulations and procedures are currently under preparation. The SPF intends to initiate bankruptcy proceedings against at least half of the approximately 400 non-viable enterprises in its portfolio. It will also launch a programme to provide post-privatisation support during 1997-99 in the areas of corporate governance, restructuring, and marketing, possibly with financial support from foreign donors. The government is initiating a restructuring plan with the help of the Asian Development Bank to make state enterprises in the aviation, mining, gas, telecommunications and oil sectors economically viable and strengthen their financial management.

There has been a significant reallocation of resources since 1992. The share of industry in GDP has steadily declined from 32% in 1992 to 12% in 1996, while the share of agriculture in GDP has increased from 37% in 1992 to 47% in 1996.

Markets and trade

Price liberalisation

Almost all prices for goods and services have been liberalised, but the prices of some utilities are still directly controlled and kept at subsidised levels. Although tariffs for electricity, hot water and heating were increased in 1996, they remain relatively low. The government intends to allow an increase of the overall domestic tariff to cover operational costs and depreciation by the end of 1998. A study of the long-run costs of the energy system was completed and the government will provide financial support to low income groups. Responsibility to establish tariffs and regulatory functions will lie with the State Energy Agency, which was established in accordance with the Energy Law of December 1996 and Electricity Law of March 1997.

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 at least 35%. According to the government, there are currently seven natural monopolies (in the railways, communications, energy, gas, water and sewerage, alcohol and tobacco sectors), seven "permitted" monopolies (in the civil aviation, oil, publishing, coal and gold mining sectors) and 31 "temporary" monopolies (predominately in the machine building, textile and food industries). While all monopolies are being monitored, only the natural monopolies and four of the permitted monopolies, but none of the temporary monopolies, are currently subject to regulation by the Anti-Monopoly Department of the Ministry of Finance.

Trade liberalisation

In early 1994, the trade regime was substantially liberalised. Remaining import and export licensing agreements were lifted, and export taxes reduced. A temporary 30% export duty on grain introduced in August 1996 was abolished a few months later.

Import tariffs are applied on goods from outside the CIS at a uniform 10% rate. However, following the lifting by parliament of the excise tax on petrol, electronic goods, furniture, carpets and crystal, the government replaced these with equivalent customs fees. The customs duties on carpets and crystals were reconverted to excise duties in January 1997. In addition, the customs duty on agricultural products has changed from the flat 10% rate to rates ranging from zero to 25%. The average tariff rate for agricultural products remains at about 10%.

The government estimated the total value of barter trade in 1996 at US\$ 92.9 million (7% of total trade), of which almost 90% was with CIS countries.

The customs union with Kazakhstan and Uzbekistan was established in 1994. In March 1996, Kyrgyzstan, Russia, Kazakhstan and Belarus signed a customs union treaty (envisaging the integration of Kyrgyzstan into the already existing customs union between the other three countries). However, the treaty has not been ratified by Kyrgyzstan and operational aspects of the union are yet to be specified.

The government has applied for WTO membership and was granted WTO observer status in June 1996. WTO accession will also be considered by parliament in 1997. The Partnership and Cooperation Agreement (PCA) with the EU of 1995 provides for further trade liberalisation.

Currency convertibility and exchange rate regime

The national currency, the som, was introduced in May 1993. The exchange rate is determined by a managed float. In 1995 the authorities formally accepted obligations under Article VIII of the IMF's Articles of Agreement regarding full current and capital account convertibility. There are no surrender and repatriation requirements.

In February 1997, the National Bank adopted a new policy on foreign exchange auctions in order to help establish an interbank market for foreign exchange. Prior to this change the official exchange rate was determined as the lowest rate of all valid bids. Now it is determined as an average weighted rate of all valid bids. Thus, the banks and exchange bureaux sell the currency at the offered rate rather than the official rate. The National Bank intends to phase out its foreign currency auctions at the end of 1997.

Wage liberalisation

The minimum wage amounted to 75 soms (US\$ 6) per month in 1996. The government increased the minimum wage by 20% in July 1997 and plans an 11% increase in October 1997. The average wage amounted to 494 soms (US\$ 38) per month in 1996.

Interest rate liberalisation

Following the introduction of the som in 1993, the NBK introduced several indirect monetary instruments, including weekly sales of foreign exchange to the interbank market, as well as auctions for treasury bills and credit. The introduction of the credit auctions as the main determinant of interest rates, and the subsequent adherence to a tight credit policy, has resulted in positive real interest rates since mid-1993. Credit auctions were discontinued at the end of January 1997, and the three-month treasury bill rate has replaced the auction rate as the official reference interest rate. The National Bank also continues to provide a Lombard facility with interest rates exceeding the treasury bill rate to provide temporary liquidity to financially sound banks. Segmentation of the credit market remains high, with significant variation in lending and deposit rates across banks.

Financial institutions

Banking reform

A two-tier banking system was established in 1991 with the National Bank of Kyrgyzstan (NBK) at its core. There were 17 commercial banks and credit institutions with 120 branches at the end of 1996. Aside from two state-owned banks currently undergoing restructuring, all of the other banks are privately owned. Only one bank, Demirbank, is foreign-owned.

In response to severe solvency problems emerging in early 1995, the NBK initiated systemic reform of the banking system. As a result, four banks 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 limited access to refinance auctions. In addition, the NBK initiated the restructuring or liquidation of the four former state banks with the assistance of 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 Agroprombank in May 1996. The two other large banks began the process of downsizing and restructuring.

Restructuring has been successful with the share of doubtful loans decreasing from 72% at the end of 1995 to 18% by the end of 1996. The restructuring of bank portfolios has been assisted by the Debt Resolution Agency (DEBRA) established to help collect or write off non-performing loans. To ensure the continuity of a national payments system, the NBK has also established the Savings Settlement Company.

The Basle standards on capital adequacy were adopted in January 1996. New regulations passed in September 1996 stipulate a stepwise increase in minimum capital requirements from 15 million soms at the end of 1997 to 30 million soms in 2000. Capital requirements for new and foreign banks are to increase to 45 million and 50 million soms respectively by that date. Banks failing to meet capital requirements will be fined up to 1% of paid-in capital and will lose their foreign exchange licences. Additional

important regulatory changes concern improvements in the registration of pledges and the collateralisation of loans, as well as the introduction of international accounting standards.

Non-bank financial institutions

Though capital markets are underdeveloped, there are a number of non-bank financial institutions. These include 17 investment funds, 47 insurance companies, a stock exchange, a coupon privatisation trading centre, a state social fund and two pension funds. There are also around 350 licensed foreign exchange bureaux. The government is in the process of amending prudential regulations governing investment funds and introducing new legislation governing insurance companies and pension funds.

The Kyrgyz State Insurance Inspectorate (KSII) is the regulatory agency in the insurance sector responsible for developing regulations, issuing licences and monitoring the insurance sector. According to KSII legislation enacted in September 1996, minimum charter funds for insurance companies vary from 100,000 soms to 1,000,000 soms depending on the type of insurance provided. There are also limits on investing assets for insurance companies. Furthermore, a Cabinet of Ministers resolution of October 1996 stipulates that insurance companies reinsuring risks abroad must retain no less than 5% of the risk in the domestic insurance market.

Securities markets and instruments

The Law on Securities and Stock Exchanges was passed in 1991. In 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 help ensure transparency and property rights security.

The institutional basis for a secondary market in shares has been established, but trading was still thin at the end of 1996. Some 120,000 physical and legal entities were registered, but only around 200 issued bonds, bills or shares and only 5-10% of these were actively traded.

In September 1996 the government adopted a three-year programme to develop further the domestic securities market. The government plans to attract savings of small private investors by issuing a state investment bond backed by shares of privatised companies, proceeds of which will be used to modernise these companies. The authorities also plan to abolish taxes on the revenues of local investment funds from operations on the securities market. The securities market is currently controlled and regulated by the NBK, the State Property Fund and two ministries, but under the programme the government plans to establish a single national securities commission accountable only to the President.

Fiscal and social safety net reform

Taxation

Profit tax is levied at 30%. Most exemptions and deductions were eliminated in January 1995. Marginal personal income tax rates range from 10% to 40%. On 1 January 1997, the 15% tax on interest and dividend income was abolished.

A revised and simplified tax code was approved in June 1996. Its main provisions concern tax administration and changes to the VAT, while tax rates remain largely unaltered. The new VAT is a

modern, invoice-based tax levied at 20%. As a result of the uncertainties related to the Customs Union with Russia, Kazakhstan and Belarus, it applies the origin principle for imports from CIS countries and the destination principle for imports from other countries. Upon accession to the WTO, Kyrgyzstan plans to harmonise the tax regime for imported and domestically produced goods, by applying VAT to all goods sold or imported regardless of their country of origin and exempting exported goods regardless of their country of destination.

Tax incentives granted to foreign entities include an initial 2-5 year exemption from profit tax and thereafter a reduction in profit tax if profits are reinvested, 50% of the products are exported, 50% of production is derived from imported raw materials or components, or if at least 20% of profits are spent on training.

Social security

The Social Fund includes payments of pensions, health-related benefits, unemployment benefits, general social support programmes (family allowances and disability payments), and a medical insurance programme which was introduced in January 1997. The primary source of revenue is a 39% payroll tax (increased from 37% in January 1997 as the result of a new medical insurance scheme financed by a 2% payroll tax), of which all but 2.5% is paid by employers.

The agricultural sector pays virtually no contributions to the Social Fund 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 of work respectively). The dependency ratio (the number of non-agricultural workers per total pension recipients) is 1.8. The Social Fund has been in deficit since 1994 and pension arrears amounted to 0.3% of GDP at the end of 1996.

Legal transition

Pledge law

The Law on Pledges (adopted in 1997 but not yet in force) provides for a single Pledge Registration Office for the registration of non-possessory pledges, which are permitted for any type of tangible or intangible property, both movable and immovable. It is not clear whether a pledgee has the right to enforce a pledge without seeking court assistance. There is no registry for non-possessory pledges, although one is contemplated in the new law.

Company law

The Kyrgyz Law on Joint-Stock Companies and the Law on Enterprises were both enacted in 1991. The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is US\$ 100-500. The process takes between one and three months. Joint-stock companies with more than a certain minimum number of shares must maintain an independent share registry. There is a government share registry. Shareholders are entitled to vote by proxy at meetings. Companies are required to send shareholders proxy forms in advance of meetings. Shareholders may not solicit proxy votes on resolutions to be considered at the meetings of shareholders. Minority shareholders are not afforded protection in the event of another company making a bid for less than all the shares of a target company. Shareholders of a joint-stock company are granted pre-emptive

rights with respect to new share issues.

Directors have obligations to (i) perform duties in good faith and (ii) disclose personal interests in material transactions with the company or its affiliates.

Bankruptcy law

The Kyrgyz Insolvency Law was enacted in December 1993. The definition of insolvency is that the debtor is unable to meet its liabilities as they fall due. The law provides for a reorganisation system whereby a majority of creditors can reach a binding settlement with the debtor. The liquidator is appointed by the court and is not required to possess specific qualifications, though there is government supervision of liquidators. The liquidator may void transactions that are (i) between related parties (ii) below fair value or (iii) concluded within a fixed period prior to the liquidation. Liquidation costs, social security wages and personal injury claims rank higher than secured claims. There are no specialised courts or judges handling bankruptcy proceedings.

General legal effectiveness

Investment laws appear generally to be drafted by legally trained personnel and published between one and six months after being passed. Important judgements are not generally published and accessible to practitioners. There generally is a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between seven months and one year for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and one year for a final judgement for payment of a sum of money to be executed.

Latvia

• *Privatisation efforts over the past year have focused on energy, gas, telecommunications and transport.*

• *Supervision of the banking sector has been tightened.*

• *Fiscal and social safety net reforms have accelerated, directed at improving tax collection and developing a new pension system combining state and privately managed pension schemes.*

Enterprises

Size of the private sector

According to the estimates of the Central Statistical Bureau of Latvia, the private sector's share in gross value added amounted to 55% in 1996, having risen from 34% in 1994. The share of the private sector in total employment reached 64% in 1996, up from 51% in 1993. The share of the private sector in GDP exceeded 60% by mid-1997. There are no significant administrative obstacles to the entry of new firms, and the number of business licensing requirements has been cut. As in other transition economies, one of the most important obstacles to the establishment of new private enterprises is lack of long-term finance.

Privatisation

The Latvian Privatisation Agency (LPA), established in 1994 to oversee the entire privatisation process, has adopted a case-by-case approach in determining the privatisation method for each entity earmarked for privatisation. The methods include international tenders of stakes in medium and large-scale enterprises (only four were concluded as of August 1996, in which 80 companies out of 153 tendered were sold); restricted tenders and direct sales; domestic auctions or direct sales of smaller enterprises; and public offerings of minority stakes (shares in 56 companies have been offered during 1995-97).

State assets with a book value of 669 million lats (approx. US\$ 1.2 billion) were transferred to the LPA during 1994-97. These state assets comprised: 843 enterprises earmarked for privatisation; 75 enterprises intended for liquidation; state shareholdings in 148 enterprises; 36 property entities; and 321 entities involved in restitution cases. As of September 1997, sales agreements had been concluded for some 700 enterprises or their parts, state shareholdings in 48 enterprises and 18 property entities. A total of 28 enterprises had been liquidated, and the total value of state assets sold by the LPA amounted to over 80 million lats (US\$ 145 million). Some 100 enterprises and organisations are currently excluded from privatisation. These include the Latvian Railways, ports and the postal service.

More than 50% of the total value of state assets sold by the LPA during 1994-96 were paid for in

vouchers (the 1994 regulation stipulates that 50% of any joint-stock company must be privatised for vouchers). Vouchers, issued to the general population in accordance with length of residence and as compensation for nationalised property, 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. As of October 1996, vouchers with an aggregate face value of 3.2 billion lats had been distributed to 2.4 million residents, including compensation vouchers with an aggregate face value of 95.2 million lats. Foreigners can purchase privatisation vouchers to pay for privatised enterprises.

The government has begun the process of privatising utilities and large energy and transport enterprises. The sale of minority stakes in the state-owned gas company Latvijas Gaze to Russian and German strategic investors was concluded in April 1997. A public offering of up to 15% of Latvijas Gaze shares is currently under way. Other major transactions scheduled for 1997-98 include: the combined sale of shares in the Ventspils Nafta oil terminal and the pipeline operator LaSam (20% earmarked for strategic investors, public offering and a 7% stake for a GDR issue); privatisation of the state-owned power monopoly Latveņero (11% stake through public offering in addition to the sale of a 33% stake to strategic investors); divestment of the government's 51% stake in Lattelekom; and a public offering of shares in the Latvian Shipping Company. Further reduction of public stakes in the banking system is also under way (see information on banking reform below).

The privatisation of small enterprises in services and trade, most of which were previously owned by municipalities, is virtually complete. By contrast, the pace of housing privatisation has been slow. As of March 1997, only about 8% of state-owned apartments had been privatised. The authorities are taking measures to accelerate the process. The government has made amendments to the law governing the privatisation of housing: timetables for the privatisation of housing by local governments are being set, rental subsidies are being cut and the requirement to register the land under the buildings prior to privatisation is being eliminated.

Trade in industrial and agricultural land is regulated but unrestricted. However, special regulations apply for nationals from countries with which Latvia does not have a mutual investment treaty. The process of land restitution and registration is being accelerated – the procedures have been streamlined and staffing and funding resources have been increased. As of January 1997, nearly 40% of land restitution claims had been resolved. To mitigate property uncertainty, new owners are issued a governmental guarantee against claims by pre-war owners.

Governance and restructuring

The shareholding structure that emerged in the five public offerings of 36 enterprises by the LPA during 1995-96 was the following: on average, strategic investors acquired 46% of enterprises' shares; 38% were sold via public offerings (mostly to banks and investment funds); current and retired employees received 16% of shares; the management's stake amounted to less than 1%. Nevertheless, the culture of management

accountability to the shareholders, in particular minority shareholders and external investors, has yet to develop.

The process of restructuring in industry and the manufacturing sector is still predominantly at the labour-shedding stage, although industrial and manufacturing production increased modestly for the first time in 1996 – by 1.4% and 0.9% respectively. The rate of capacity utilisation in manufacturing is picking up, rising from 45% in mid-1993 to 56% in mid-1997. Output has recovered most in the major export industries. The share of industry in gross value added at constant prices fell from 31% in 1993 to 24% in 1996, the share of manufacturing from 23% to 19%. Restructuring has largely been left to the new owners of privatised firms. Financial discipline for enterprises has become stricter, particularly related to budget tax arrears. A new, more comprehensive bankruptcy law became effective in November 1996.

Markets and trade

Price liberalisation

Few formal price controls remain. Domestic agricultural prices have been liberalised and rent subsidies are being cut. Electricity tariffs charged by the state-owned power utility are moving towards cost-recovery levels and an increase to full economic cost is envisaged by the authorities by 2005.

Competition policy

With Latvia's liberal trade regime, imports are the main competitive force in the economy. In June 1997 parliament adopted a new Competition Act (effective from October 1997), modelled on the European Union directives. The law defines the concepts of state aid, mergers, unfair competition and the role of the state in promoting and protecting the competitive environment in the economy. An independent agency, the Competition Board, will be created to oversee the implementation of the new Act, which supersedes the 1991 Anti-Monopoly Law.

The implementation of the old competition law was monitored by the Anti-Monopoly Committee of Latvia. The Committee investigates cases of anti-competitive behaviour and has the power to issue orders for the termination of unlawful activity. The recommendations and orders issued by the Committee to the government, municipal authorities and utilities have led to changes in licensing and tendering procedures and price-setting in various market segments during 1995-96.

Trade liberalisation

Latvia's trade regime is liberal for industrial goods. Most-favoured nation import tariffs are generally modest and range from 15% to 20%. The highest rates are applied to agricultural products whereas the tariff structure favours investment goods.

Latvia's accession talks with the World Trade Organisation are in their final stage and the country may be able to join the organisation before end-1997. Latvia concluded a "Europe Agreement" with the EU (1995), bilateral free trade agreements with countries of the European Free Trade Area and several countries of the Central European Free Trade Agreement, and is part of the Baltic Free Trade Agreement (BFTA).

Currency convertibility and exchange rate regime

The national currency, the lats, has effectively been pegged to the SDR basket since February 1994 (although no formal announcement to this effect has been made). Latvia offers complete and effective current and capital account convertibility.

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 about US\$ 191 in the first quarter of 1997 and the minimum wage represented about 35% of the average gross wage.

Interest rate liberalisation

Interest rates are fully liberalised. The Bank of Latvia's refinancing rate stood at 4% p.a. as of May 1997 but, due to the small amounts of refinancing credits, the rate serves as a guide only.

The interbank market operates freely, and most traded maturities vary from overnight to up to one month. Spreads between average lending and deposit rates in local currency have narrowed to less than 10 percentage points.

Financial institutions

Banking reform

More than 30 banks are currently operating in Latvia (compared with some 40 in mid-1995), although only 19 banks are licensed to take household deposits. The six largest banks accounted for 60% of total assets in mid-1997. Domestic credit amounted to 14% of GDP in the first quarter of 1997. Some 60% of domestic credit represented lending to domestic enterprises and private persons, of which about half carried maturities of more than one year. Loan loss provisions amounted to 4.6% of total assets of credit institutions at the end of 1996, down from 6% a year earlier.

Until 1996 four banks, accounting for about 25% of the total assets of the banking system, were either fully or majority state-owned. In 1996 the largest state-owned bank, Unibanka, was privatised through a public offering and the sale of a 38% stake to a number of foreign investors including the EBRD. A further reduction of the government's 33% share is envisaged in 1997 (two-thirds will be placed abroad). The privatisation of the Latvijas Krajbanka (Savings Bank) has started, and a public offering of 25% of the Savings Bank's shares took place in June 1997. Two foreign subsidiaries and one branch are operating in Latvia.

Banking supervision has been tightened considerably following a major banking crisis in 1995. In 1996 the Bank of Latvia performed over 100 on-site inspections and revoked the licences of eight smaller banks. The stipulated risk-weighted capital adequacy ratio is 10%, but amounted to 25% at the end of 1996, partly reflecting the reluctance of commercial banks to extend new credits in the aftermath of the 1995 banking crisis. A draft deposit insurance law is being discussed. The proposed insurance scheme would be limited in size, restricted to banks licensed to take household deposits and funded by participating banks.

Non-bank financial institutions

The development of non-bank financial institutions, in particular insurance companies and local investment funds, in Latvia has received a

boost from the recent adoption of laws on compulsory vehicle insurance (effective September 1997), private pension funds (effective 1998) and an emerging demand for local health insurance associated with ongoing health-care reforms (see section on social security).

The number of insurance companies has fallen to 29 as of March 1997 from 37 a year earlier. In 1996 licences were withdrawn from companies failing to comply with the minimum capital requirements of 1 million lats (US\$ 1.8 million) for life insurers and 0.5 million lats (US\$ 0.9 million) for other types of insurers stipulated by the 1995 Law on Joint-Stock Companies. There are 21 non-life and eight life insurers in the market, of which six are fully and two partly (50%) foreign owned. Foreign-controlled insurers accounted for nearly half of all collected premiums in 1996, although their share dropped closer to 30% in early 1997. Foreign re-insurers dominate the re-insurance business. Local investment funds play a relatively minor role in the non-bank financial sector.

Securities markets and instruments

Securities markets are regulated by a 1995 law and supervised by the Securities Market Committee under the Ministry of Finance. Securities markets are dominated by trade in treasury bills with increasingly lengthening maturities (the longest maturity so far is two years). Foreign banks are allowed to participate in the primary market for treasury bills, and the Bank of Latvia provides repurchase and reverse-repurchase facilities. Capital gains tax amounts to 10%. Treasury bill rates have been falling for two years in a row to less than 5% by mid-1997.

The Riga Stock Exchange (RSE) and the Latvian Central Depository started to operate in 1995 (although the RSE was formally established in 1993). Both treasury bills and stocks (the latter subdivided into the primary, secondary and free lists) are traded. Stock market capitalisation rose to some 7% of GDP in mid-1997 (over 40 companies are listed at the RSE, of which only seven are in the primary list). Average daily turnover at the stock exchange has increased to approximately US\$ 400,000. The Dow Jones RSE Index, based on 10 stocks that represent some 80% of the stock market capitalisation, had more than tripled from its April 1996 value as of August 1997. A further fillip for the RSE is expected with public offerings of major infrastructure and transport enterprises during 1997-98 (see section on privatisation).

Fiscal and social safety net reform

Taxation

A comprehensive programme to improve tax administration is being implemented. The introduction of tax identification numbers for legal and physical persons has been completed and the coverage of the Finance Ministry's large taxpayers unit has been increased to include taxpayers that account for nearly half of all tax revenue. The Arrears Collection Department of the Treasury has tightened its procedures for granting tax deferrals. The standard income tax rate for both private and legal persons is 25%. The VAT rate is 18%.

Social security

The ratio of the population aged 60 and above to the total population was 20% in 1995, and is projected to increase to 24% by 2010. The national authorities have initiated a major overhaul of the social welfare system. Social payroll

taxes are being reduced from 38% in 1996 to 33% by 2001, accompanied by a movement towards a more equitable split of contributions between employers and employees (18% and 15% respectively by 2001).

The Law on Private Pension Funds was adopted in June 1997. The reform of the pension system envisages the introduction of three tiers: first, a modified "pay-as-you-go" (PAYG) system with stronger links between contributions and benefits; second, a mandatory funded system of privately managed savings accounts; and third, voluntary privately managed pensions. The first stage of the reform, the modification of the public PAYG system, took effect in January 1996. Beginning in 1998, the second tier will be introduced, under which contributors will have an option to assign a portion of their contributions to privately managed savings accounts.

According to new healthcare regulations in force since January 1997, a portion of income tax and budgetary funds is transferred to a Central Fund. The Central Fund pays for healthcare services provided under the state healthcare programme and transfers the remaining funds to Regional Sick Funds. These Regional Sick Funds will enter into direct contracts with healthcare providers and are intended to meet at least 80% of the costs of providing minimum service levels to their registered members. The remaining amounts are met by direct contributions by the patients and/or third party funding.

Legal transition

Pledge law

A creditor may take a non-possessory security interest in tangible movables such as equipment and intangible movables such as shares. Security interests may be taken in a changing pool of assets. Latvian law does not require that security interests in all movable property be registered. There are special registries for ships and aeroplanes, but not for other types of movable property. A creditor may take possession and sell a secured asset without court assistance if the creditor and debtor have reached a private agreement to permit this.

Company law

The Law on Joint-Stock Companies was enacted in May 1993. The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is estimated at US\$ 2,500. The process normally takes less than two months. Shareholders are entitled to vote by proxy at meetings. Companies are not required to send shareholders proxy forms in advance of meetings. It is unclear whether shareholders are permitted to solicit proxy votes for resolutions to be considered at the shareholders' meeting. Latvian company law does not afford minority shareholders protection in the event that a third party makes a bid for less than all the shares of a target company. Shareholders of a joint-stock company are given pre-emptive rights with respect to new share issues. There is a centralised registry for dematerialised shares. Directors are under obligations to (i) perform duties in good faith and (ii) disclose personal interests in material transactions with the company or its affiliates.

Bankruptcy law

The Latvian Law on Insolvency of Enterprises and Companies was enacted on 12 September 1996 and became effective in October 1996.

The definition of insolvency is either that (i) the debtor is or will be unable to meet its liabilities as they mature or (ii) the debtor's liabilities exceed its assets. The bankruptcy law provides for reorganisation proceedings whereby a majority of creditors can reach a binding settlement with the debtor. The liquidator or trustee must be a practising lawyer, auditor, audit company or an individual with more than five years' work experience with a company. The liquidator possesses extensive powers provided for in the bankruptcy law. Transactions with third parties may be reviewed and declared void if (i) concluded after the date of insolvency and not at arm's length, or (ii) concluded within five years prior to the liquidation and damaging to the creditors' interests. There are no specialised judges or courts handling bankruptcy proceedings. A pledge agreement may also be invalidated if (i) the pledge was created after the effective date of insolvency or (ii) the pledge was created within six months prior to the date of insolvency and converted an unsecured claim into a secured claim. Secured claims involving interested parties are also invalidated if made within one year prior to the effective date of insolvency. No claims rank higher in liquidation than those of a secured creditor. Secured claims are satisfied separately before the general liquidation of the debtor's assets.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published within one month of being passed. It is unclear whether important judgements are generally published and accessible to practitioners. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between seven months and one year for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and one year for a final judgement for payment of a sum of money to be executed.

Lithuania

- *The privatisation of some large-scale enterprises in infrastructure and energy that were previously exempted from the privatisation programme is under preparation.*
- *A new bankruptcy law streamlining bankruptcy procedures has been passed.*
- *The restructuring of the energy sector is making progress and includes continued increases in energy prices, reduction of consumer indebtedness to the energy sector, the establishment of an Energy Pricing Commission and the decentralisation of district heating.*
- *The market capitalisation of the National Stock Exchange increased sixfold during 1996.*

Enterprises

Size of the private sector

According to government estimates, the private sector accounted for 68% of official GDP in 1996, and employed 67% of the labour force. Survey results suggest that the "hidden economy" represented 20-25% of GDP in early 1997 (compared with an estimate of 6% in the official GDP data).

Privatisation

Privatisation in Lithuania began in 1991. The first phase (from late 1991 until mid-1995) was characterised by voucher-based methods of mass privatisation. The second phase, which began in July 1995, emphasises sales of the remaining state assets for cash, including sales of enterprises in infrastructure to foreign strategic investors.

Based on the Law on Initial Privatisation of State and Municipal Property, 6,644 enterprises from a total of 8,457 were singled out for privatisation in the first phase. These companies represented 73% of all state enterprise assets (by book value). By the end of June 1995, when the first phase ended, about 30% of all state enterprise assets had been sold, mainly via auctions and subscription of shares.

The second phase of privatisation started under the new Law on Privatisation of State and Municipal Property. A State Privatisation Agency and a State Privatisation Commission were established in late 1995 to administer the process. After a disappointing start the size of stakes to be sold was increased and more attractive enterprises were offered, resulting in the successful auctioning of packages of shares towards the end of 1996. Whereas the plan for 1996 involved sales of shares in 400 companies, only 50 companies were eventually sold,

generating 32 million litai in privatisation revenue (US\$ 8 million). The list for 1997 includes more than 800 companies valued at 4.5 billion litai (US\$ 1.1 billion). During the first quarter of 1997, however, only 25 companies worth 1.25 million litai (US\$ 312,500) were privatised.

A law of 28 December 1994 exempted a list of "strategic" enterprises from privatisation until the year 2000 and placed "special purpose" enterprises on a list with a ceiling of 30% private ownership. The lists comprised 234 entities, mainly in infrastructure, worth 6.8 billion litai (US\$ 1.7 billion). This law was partly amended in July 1996 to allow for up to 30% private ownership of "strategic" enterprises before the year 2000. More recently (in April 1997), the number of enterprises exempted from privatisation has been reduced to 110, paving the way for the privatisation of large-scale infrastructure enterprises (see below).

Foreign participation in the privatisation process has so far been minimal. In the first round of international tenders in 1993, only three out of eight open tenders ended successfully. In February 1997, the government approved a list of 14 large-scale enterprises valued at 2.8 billion litai (US\$ 690 million), including those in infrastructure (telecommunications, aviation, shipping, shipbuilding and repair, stevedoring, oil refining and sales, and oil exploration), to be privatised to strategic investors by international tender. These had previously been classified as "strategic" or "special purpose" enterprises. International tenders for privatisation consultants have begun to be issued for some of the enterprises.

Privatisation of small units has been comprehensive, with 2,727 small enterprises privatised. Total sales revenues amounted to 165 million litai (US\$ 41 million). In agriculture, 1,160 collective and cooperative farms were, in 1993, broken into 12,300 units and privatised before the end of that year. Privatisation of the state housing stock proceeded rapidly as vouchers were used and resulted in the sale of 29,323 houses and 503,540 flats. A constitutional ban on foreign land ownership was lifted in June 1996.

In July 1997 the Seimas adopted a new Restitution Law that broadens the application of the previous law to non-resident owners and introduces procedural changes. While restitution had been granted in 86,000 cases, many claims under the old law, whose application deadline was March 1994, have still not been reviewed.

Governance and restructuring

Voucher privatisation has resulted in insider-controlled corporate governance structures, due to preferences given to employees and management (for whom up to 50% of shares were reserved). Moreover, a number of investment stock companies established at the beginning of the process were controlled by managers of investee enterprises. There has been some concentration of ownership stakes through the stock market: 400 investment stock companies are estimated to own around 30% of all privatised assets in 750 enterprises. A few of the large investment stock companies are backed by private commercial banks.

Since remaining state enterprises tend to be larger than privatised ones, the state still controlled around 66% of the share capital of all

enterprises (including agricultural partnerships) operating in Lithuania at the beginning of 1996. In terms of profitability, the aggregate performance of public enterprises was considerably worse than that of private enterprises. In 1995 the ratio of profit over assets in private enterprises was 5.8%, whereas it was 1.8% in state enterprises.

To date, restructuring in the industrial sector has resulted primarily from trade liberalisation consisting mostly of labour shedding and reductions in capacity utilisation. At constant prices, industry's share in GDP declined from 37% in 1992 to 28% in 1994 and has remained broadly constant since then. Since 1995, labour productivity has increased by around 20% due to continued redundancies, while output has increased slightly. The increase in labour productivity was above average in the chemical, base metals, office machinery and transport equipment sectors. These sectors also increased exports between 1993 and 1995. With respect to capital investment, the share of industry (excluding electricity and water) declined from 27% in 1993 to 18% in 1995. Nearly half of the capital investment in 1995 was in light industries such as food, beverages, tobacco and textiles.

Direct subsidies to enterprises have been largely discontinued. State subsidies for agriculture, energy and housing amounted to 1% of GDP in 1996. Credit policies of banks have been tightened over recent years. After the first phase of privatisation, the remaining stakes in privatised enterprises where the state held less than 20% of shares have been managed by branch ministries, local government or municipalities. State-owned shares exceeding 20% of the capital of a privatised enterprise were transferred to a State Securities Fund (with about 20 employees), which has not been involved in active management. State ownership in "strategic" and "special purpose" enterprises continues to be managed by branch ministries.

A Bankruptcy Law was passed in September 1992, but supporting regulations and institutional arrangements required for enforcement were not finalised until recently. Between 1993 and 1997, a total of 181 cases were initiated, resulting in 16 declared bankruptcies. In order to streamline court procedures and better prioritise creditor claims, a new Bankruptcy Law was approved by parliament in June 1997.

Restructuring in the energy sector is one of the government's priorities. This involves the elimination of state subsidies and the gradual raising of energy tariffs to full cost-recovery levels, as well as the commercialisation and privatisation of state-owned power (including nuclear power), gas and fuel companies.

Markets and trade

Price liberalisation

Administrative controls remain on the prices of around 30 goods and services in energy, transport, housing and other utilities. Some agricultural products are subject to minimum purchase prices. District heating prices have been raised significantly in a number of discrete steps since the winter of 1994 but do not as yet fully cover costs. Nevertheless, with energy conservation investments, the current level of tariffs is estimated to be sufficient to cover operating costs and a margin. As of August 1997, the average electricity tariff was US\$ 4

per kWh (including VAT). While the average electricity tariff for residential users was US\$ 5.5 per kWh (including VAT), tariffs for industrial users ranged between US\$ 2.5 per kWh and US\$ 5 per kWh. These prices cover operating costs but do not cover long-term investment requirements. An Energy Pricing Commission was established in November 1996 to recommend to the government cost-recovery tariffs for electricity, gas and heating. The basic pricing formula under consideration is operating cost plus a profit margin. Decentralisation of district heating has also been decided. The government has launched a campaign to cut energy supplies to non-paying customers with the aim of limiting consumer arrears for electricity, heating and gas.

Competition policy

Lithuania's competition policy has been based on the Law on Competition of September 1992 and has been enforced through the State Competition and Consumer Protection Office. This law applies to all enterprises except state monopolies, which are covered by separate legislation. Between 1993 and 1996, the Office imposed fines totalling 2.8 million litai (US\$ 0.7 million) for violating the competition law. In 1996, 24 enterprises were fined. Early that year, six enterprises were found to have a dominant position (i.e. holding a market share between 60 and 90%) and were required to notify the Office of price changes in advance. However, the list of dominant enterprises has been discontinued and case-by-case investigations will be conducted in future.

A draft of a new competition law compatible with EU competition legislation is under discussion.

Trade liberalisation

Foreign trade has been freed of non-tariff restrictions. Import tariffs are generally moderate. The average MFN import-weighted tariff was 4.5% in 1996. The average tariff on agricultural products fell gradually to 27.5% in October 1995. However, Lithuania failed to comply with an IMF agreement to cut agricultural tariffs further to 20% by March 1997. There are no quantitative restrictions nor tariffs on exports except for four items that are subject to export tariffs of 60% (feathers and down, raw leather, raw timber and medical supplies).

Lithuania applied for membership in the WTO in November 1995 and has submitted its initial offer on import tariffs and services. It has an Association Agreement with the EU and a free trade agreement with EFTA. CEFTA membership is under negotiation. Import tariffs on agricultural products were removed within the Baltic Free Trade Area in 1997.

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 a 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. According to the central bank's medium-term monetary policy programme, it is planned that the anchor currency be changed from the US dollar to a basket of currencies consisting of the US dollar

and the Euro, or to some other basket of EU currencies, by 1999 at the earliest.

Wage liberalisation

Wage-setting was liberalised in mid-1993. The minimum statutory monthly wage was increased from 330 to 400 litai (US\$ 100) in April 1997. This is around 65% of the average net monthly wage in 1996.

Interest rate liberalisation

Banks are free to set interest rates. The central bank's monetary policies have been restricted by the existing currency board arrangement. However, according to the Bank of Lithuania's 1997-99 monetary policy programme, it is proposed that the currency board arrangement be gradually abolished. As a first step, the central bank began conducting repurchase transactions in June 1997 and deposit auctions in September 1997. The spread between the average time deposit rate and the average lending rate declined in 1994-95, but widened in the first half of 1996, following the banking sector crisis at the end of 1995. The spread was around 6% in June 1997.

Financial institutions

Banking reform

Eleven commercial banks were operating in Lithuania at the end of July 1997. Lithuania's three large majority state-owned commercial banks (the State Savings Bank, the State Agricultural Bank and the State Commercial Bank) still hold most of the deposits in the system, although their share has declined slightly from around 53% of deposits at the end of 1995 to 48% at the beginning of 1997. The share of the two largest private commercial banks was 22% at the beginning of 1997.

The ratio of credit to GDP was around 10% in 1996, a decrease from 14% in 1995. Less than half of the total represented credit to the private sector.

The banking sector faced a crisis at the end of 1995 when the central bank halted the planned merger of the country's two largest private banks, having discovered that both banks were insolvent. The problems spread to another, smaller bank. At the time of suspension these banks accounted for about 25% of deposits in the banking system. Innovation Bank, the largest of the suspended banks, was put into liquidation in early 1997, while Litimpeks Bank, the second largest, has resumed operations. In August 1996, parliament authorised the recapitalisation of the state banks as well as the establishment of a "Property Bank", to manage bad loans carved out from the state banks' portfolios. In September 1997, the government issued recapitalisation bonds for the two largest state-owned banks (Savings Bank and State Commercial Bank). Following the establishment of the legal basis for bank privatisation in March 1997, the State Commercial and State Agricultural Bank are to be privatised via international tender.

Following the strengthening of its enforcement powers in 1994 the Bank of Lithuania has applied a stricter prudential regime, which resulted in the reduction of the number of operating banks from 28 in early 1994 to 11 at present. From the financial year 1996, the commercial banks have been required to provide financial statements on the basis of International Accounting Standards. The central bank may suspend the operation of banks that

do not meet a set of standards including a capital adequacy ratio of 10% (BIS definition) and a minimum liquidity ratio of 30%. Parliament has passed amendments to the law on deposit insurance in June 1997. Under the previous law, deposits in private banks were insured only up to 5,000 litai (US\$ 1,250). After the amendment, the maximum amount insured will gradually increase to litai 65,000 (US\$ 16,250) by the year 2000. At the end of 1997, the deposit insurance fund will cover roughly 3% of insured residents' deposits. Parliament has also amended the Civil Code to abolish the full deposit guarantee for accounts held at the state-owned banks. Depositors at the state-owned banks are now under the same partial protection as depositors at private banks.

In June 1996, the Commercial Bank Law was further amended to allow foreign banks to open branches in Lithuania.

Non-bank financial institutions

Investment stock companies held 30% of all privatised assets by the end of 1995. In accordance with the Law on Investment Companies, they had to reregister with the Securities Commission by 1 July 1997 as closed or open investment funds or investment holding companies. Only five companies had been granted an investment holding company licence as of late August. It is expected that many of the former investment stock companies may not obtain new licences, which would trigger a major consolidation in the industry. The law requires that an investment fund must have a minimum capital of 1 million litai (US\$ 250,000) and establish a single exposure limit of 25% of the portfolio. No application has been made to date for an investment fund licence.

One majority state-owned and 35 private insurance companies, including four joint ventures, were operating in Lithuania at the end of 1996, of which 11 were providing life insurance. A new Law on Insurance was passed on 10 July 1996 establishing a State Insurance Supervisory Authority under the Ministry of Finance. The gross premium income of both life and non-life insurance companies increased by 23% from 1995 to 1996, to 186 million litai (US\$ 46 million). The life insurance market is dominated by the state-owned insurance company, which controls 94% of the total life insurance gross premium income. In the non-life market, three companies control 81% of the gross premium income.

Securities markets and instruments

A National Stock Exchange (NSEL) began operations in September 1993. However, the Law on Public Trading of Securities that regulates the Securities Commission and the NSEL was only adopted in January 1996. There is a Guarantee Fund to mitigate settlement risk. Clearing is carried out via accounts with the Bank of Lithuania and the registration of securities is managed by the Central Securities Depository.

The Current Trading List of the NSEL includes 515 issues and is divided into A (safer) and B (riskier) issues. Trading sessions in Group A shares are carried out daily; trading in B shares takes place twice a week. In April 1997, a new Official List of shares, which includes four of the most actively traded shares, was launched, with the aim of increasing transparency. Companies on the Official List must fulfil requirements that include international audits and a capital of not less than 5 million litai (US\$ 1.25 million).

less than 5 million litai (US\$ 1.25 million). Market capitalisation increased from 630 million litai (around 2% of GDP) at the end of 1995 to 3.6 billion litai (around 9% of GDP) by the end of 1996. Total turnover also increased by 27% in 1996 to 189 million litai. It is estimated that listed companies issued new shares worth 118 million litai (US\$ 30 million) during 1996.

The NSEL also lists government treasury bills. There was a total of 1.1 billion litai in treasury bills outstanding at the beginning of 1997. In 1996, total turnover of treasury bills in the secondary market was 321 million litai, a 5% decrease over 1995. Maturities generally do not exceed one year. Non-residents held around 367 million litai in treasury bills at the end of 1996, 33% of the total outstanding stock.

Dividends and interest income are not subject to profit tax and are exempt from withholding taxes.

Foreign portfolio investment into Lithuania (in gross terms) during 1996 was 358 million litai (US\$ 90 million), of which more than 80% was invested in treasury bills.

Few Lithuanian enterprises were successful at raising capital in the international capital markets. Two state-owned enterprises, Lithuanian Energy and Mazeikiiai oil refinery, raised US\$ 75 million and US\$ 40 million respectively, by issuing short- to medium-term Eurobonds in 1997. Two private commercial banks, Vilniaus Bankas and Bank Hermis, raised equity capital (US\$ 13 million and US\$ 2 million respectively) through international issues in the form of Global Depository Receipts, in August 1996 and July 1997 respectively.

Fiscal and social safety net reform

Taxation

Since mid-1990, a series of tax reforms has provided Lithuania with a tax structure broadly similar to those typically seen in Western market economies, with a VAT rate of 18% and a maximum marginal income tax rate of 33%. Recently, tax administration has been improved and a number of exemptions have been abolished and loopholes closed. In April 1997, excise taxes on alcohol, tobacco and petroleum were increased by 36% on average. In 1996, revenues from direct and indirect taxes represented 58% and 42% of total tax revenues respectively. According to recent estimates by the Department of Statistics, under-reporting of economic activities was of the order of 18% of GDP at market prices in 1996. Since 1 April 1997, Lithuania exempts from profit tax all reinvested profits of domestic or foreign enterprises on capital investments.

Social security

Real levels of government transfers to households have fallen sharply in recent years. Nevertheless, pension payments, made on a pay-as-you-go (PAYG) basis, increased from 5% of GDP in 1995 to around 7% in 1996. Contributions to the social insurance payroll tax amount to 30% for employers and 1% for employees. Unless reforms in the social insurance system are implemented, the Social Insurance Fund will begin to have a negative cash flow starting in 1997 and require transfers from the state budget. Proposals were made in 1996 to reform the PAYG scheme, including a tightening of eligibility criteria, changes in the indexation formula and increased retirement ages, but the pension law has not been

amended to accommodate these proposed changes. Similarly, proposals to introduce funded pillars in the pension system have made little progress.

Legal transition

Pledge law

A new Law on the Pledge of Movable Property was adopted on 10 June 1997 and will come into force on 1 January 1998. Under the present law, a creditor may take a non-possessory security interest in both tangible and intangible movables. A creditor cannot, however, take a security interest in a changing pool of assets or over an entire enterprise. The new pledge law will permit pledges over pools of assets but the ability to create a pledge over an enterprise remains unclear. The new law will provide for a registry for all types of movable property except ships and aeroplanes (which currently have their own registries) and both notarisation and registration will be necessary for security interests to be enforceable against third parties. Notary fees are between 0.1 and 1% of the underlying loan or collateral. Under the new law, a sale can be made by the creditor without court assistance.

Company law

The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is US\$ 100-1,000. The process takes between one and three months. Shareholders are entitled to vote by proxy at meetings. Companies are not required to send shareholders proxy forms in advance of meetings. Shareholders may solicit proxy votes on resolutions to be considered at meetings. Lithuanian law permits cumulative voting for the election of a joint-stock company's supervisory board whereby minority shareholders may pool their votes in order to elect at least one board member. A company that acquires more than 50% of the shares of a company must make an offer to acquire the remaining shares of the target company at the same price. Such a requirement cannot be removed or waived. Shareholders also possess pre-emptive rights with respect to new share offerings. Directors are required to keep the company's affairs confidential.

Bankruptcy law

On 10 June 1997, a new Law on Enterprise Bankruptcy was adopted. The bankruptcy law will come into force on 1 October 1997. There is a statutory definition of insolvency, which appears to include cases where the liabilities of a company exceed its assets. The new law permits reorganisation for insolvent companies if approved by a majority of creditors. Liquidators are appointed by the court. In liquidation, social security claims, employee remuneration and personal injury claims by employees rank higher than claims of secured creditors. The new law does not provide for separate or specialised courts or judges to handle bankruptcy proceedings.

General legal effectiveness

It is unclear whether investment laws are generally drafted by legally trained personnel and published within one month of being passed. Important judgements do not appear generally to be published and accessible to practitioners. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of adminis-

trative action. On average, a party can be expected to wait between seven months and two years for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and two years for a final judgement for payment of a sum of money to be executed.

Moldova

• *Progress in the privatisation of large, strategic companies via cash sales has slowed, though there have been improvements in the privatisation of agricultural land and the tradability of land rights.*

• *Moldova gained access to international capital markets through a US\$ 75 million Eurobond issue.*

Enterprises

Size of the private sector

The private sector share of GDP grew from 30% in 1995 to between 40% and 45% in 1996. The private sector then accounted for 70% of total retail trade and services, 60% of industrial output, and 44% of construction and transport activity. The private sector share in employment varied from 50% to 80% across sectors.

After a 30% drop in 1995, new private enterprise registrations grew by 150% in 1996. Of these registrations, 90% were private individual enterprises (of which 80% were farms) and 2% were joint-stock companies. Less than 1% of these new registrations had any foreign capital participation.

Privatisation

Enterprise privatisation in Moldova has taken place through a variety of methods: mass privatisation, small-scale cash sales and cash privatisation, including the sale by tender of large companies. Privatisation in the first two categories has been very rapid and government programmes in these areas are now almost complete. By contrast, privatisation through tenders has been very slow.

Moldova implemented one of the most rapid and comprehensive mass privatisation schemes in the former Soviet Union. In 1994, National Patrimonial Bonds (NPBs) were allocated to 3.5 million citizens in a voucher privatisation scheme, which has been responsible for most of the enterprises privatised to date. At the end of 1996, some 1,400 small-scale firms had been fully privatised and 1,150 medium- and large-scale enterprises partially privatised via NPBs.

Cash privatisation of larger enterprises via tenders has virtually stalled. In the 1995-96 privatisation programme, 41 companies were selected, including 12 that were thought likely to attract foreign investors. By mid-1997, none of these had been privatised. The process suffered a set-back when negotiations for the tender of a tobacco company were cancelled by the government in January 1997.

The 1997-98 privatisation programme envisages three major expansions of the privatisation process: (i) 200 new entities for privatisation by auction; (ii) the sale of state shares in 300 partially privatised enterprises; and (iii) a new list of 30 enterprises to be sold on a case-by-case basis.

By the end of 1996, about 200,000 dwellings had been privatised, corresponding to about 80% of the total to be privatised. Of these, 70% were privatised for free, 28% in exchange for vouchers and 2% for cash. A housing market has started to develop, with prices that reflect differences across cities and villages as well as differences in the availability and quality of infrastructure.

Progress in land privatisation has been slow, despite its important role in an economy highly dependent on its agricultural sector. By the end of 1995, only 10% of the total land in the country had been privatised. The 1991 Land Code was amended in February 1995 to impose additional constraints on the use and ownership of land, including a moratorium on most private sales of land until January 2001. However, the moratorium was declared unconstitutional in October 1996, paving the way for the start-up of a land market. In July 1997, parliament approved a law allowing the sale and purchase of land.

Despite these recent advances, a number of significant constraints remain. Land title and registration continue to be problematic. Also, the high normative price of land (i.e. the price at which land is originally sold to a private party) and the inability to pledge agricultural land as collateral are additional institutional impediments to a well-functioning land market.

Governance and restructuring

In June 1995, the Agency for Enterprise Restructuring and Assistance (ARIA) was created as a non-profit, non-governmental organisation jointly by Moldova, the EU, the World Bank and the German agency GTZ. ARIA introduced a programme of debt restructuring and management advice. Creditors lead an enterprise restructuring plan through an out-of-court adjustment. Once the restructuring plan is confirmed by the Council of State Creditors (CSC), a moratorium of existing debts is agreed for a period of six to nine months, though no debts are written off.

The enterprise restructuring programme has been very successful in improving the performance of participating enterprises. In mid-1996, 60 enterprises were participating in the programme and by April 1997 the CSC had accepted a total of 98 agreements on debt restructuring, totalling close to 500 million lei (US\$ 108 million).

The industrial output mix has experienced significant changes throughout the restructuring process. Measured in constant prices, the energy sector has grown rapidly (from 2.8% of total industrial output in 1991 to 16.6% in 1996), while light industry has shrunk substantially (from 22.2% of total output in 1991 to 6.4% in 1996).

Nevertheless, the energy sector is in need of major restructuring. It has built up internal and external payment arrears that are unsustainable. A debt management plan has been prepared under the auspices of ARIA to restructure the accumulation of arrears by Moldovagas, Moldenergo, Termocom and Termocomenergo. Tariff increases and the reductions in cross-subsidies between industrial and residential consumers are planned. The restructuring programme envisages the demonopolisation and privatisation of the gas and electricity industries.

Privatisation and enterprise restructuring have not yet produced effective corporate governance structures. Dispersed ownership, the absence of a functioning shareholders' registrar, and underdeveloped capital markets have all contributed to preventing the new private owners from exercising effective control over enterprises. A major obstacle has been the inability to organise general meetings of shareholders to transfer the control of the enterprises to elected boards. Investment funds have not yet begun to influence corporate governance.

Markets and trade

Price liberalisation

In 1992, most consumer goods prices were liberalised. 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.

In the first half of 1997, the Government substantially raised tariffs on heating, gas, as well as residential and industrial electricity tariffs. As a result, average gas and electricity tariffs are operating at cost-recovery levels. The government furthermore intends to bring all tariffs to full cost-recovery levels by the end of 1997, and gradually eliminate the current cross-subsidies from industry to households and from gas and electricity to district heating.

In the agricultural sector, prices have been deregulated as part of a wider strategy to liberalise rural and agricultural markets, although there is still the need to reform the current system of direct and indirect taxation and subsidies to agriculture.

Competition policy

Legislation governing anti-monopoly activity was passed in early 1992 but has been relatively ineffective. Most of the state-owned monopolies in the agricultural and infrastructure sectors are scheduled for demonopolisation and privatisation but progress has been very slow. A condition of reform of the energy sector is the demonopolisation of the gas and electricity companies and the establishment of a non-governmental regulatory body. In the district heating sector, it is planned to transfer regulatory responsibility to the municipalities. In the water industry, the process has started in the municipality of Chisinau with the creation of a joint-stock company owned by the government and the municipality. Price regulation remains the government's responsibility.

Trade liberalisation

Moldova is committed to a liberal trade regime. In 1995 a new tariff schedule was introduced which included five tariff bands with a maximum tariff rate of 20%. Export quotas were eliminated and licensing was limited to products subject to security, medical or cultural regulations. Exports of agricultural goods are subject to registration. In 1996, the government increased import tariffs for key intermediate and capital good inputs, but tariffs were reduced again in June 1997 to an average 5%.

A Partnership and Co-operation Agreement with the EU came into force in March 1996, granting Moldova privileges under the EU's Generalised System of Preferences. Wine imports are a notable exception from the concessions. A trade and economic agreement for 1996-97 was signed with Russia.

Active negotiations for Moldova's accession to the WTO were launched in June 1997. Moldova should start WTO bilateral negotiations on market access at the end of 1997. Moldova's trade legislation and trade measures need considerable adaptation to meet WTO requirements, including new custom valuation rules, changes in the basis of customs user fees and licensing fees, introduction of the HS96 custom classification, and application of VAT and excise duties on the same basis to domestic and foreign products.

At the end of 1996, the OECD changed Moldova's country status from "developed" to "developing", a change requested by the Moldovan government which will translate into more generous foreign aid and repayment terms for the country's foreign credits. Moldova has also requested developing country status for its prospective membership in the WTO.

Currency convertibility and exchange rate regime

The exchange rate is determined daily at the Moldovan Foreign Currency Interbank Market. Moldova complies with Article VIII of the IMF Agreement on maintaining an exchange rate regime free of restrictions on payments and transfers for current international transactions. Capital account transactions require licences from the NBM, which are normally granted.

Wage liberalisation

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

Interest rate liberalisation

Commercial banks set their own interest rates, following the refinancing rate quoted by the National Bank of Moldova (NBM) resulting from credit auctions. There is a large spread between the average lending and deposit rates and substantial variance of rates across banks, suggesting a lack of adequate competition. The average interest rate on commercial bank loans is about 36%, while the average interest rate on deposits is about 27%.

Financial institutions

Banking reform

The financial sector consists of four large banks and about 20 other commercial banks. 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.

By the end of 1997, all banks are required to have a minimum capital of 8 million lei (US\$ 1.8 million). Banks are subject to regulations regarding capital adequacy, the ratio of deposits to capital, the maximum exposure to single borrowers and the weighted capital asset ratio. Current prudential standards include a minimum 6% risk-weighted capital adequacy ratio. The NBM requires banks to establish risk capital funds corresponding to 100% of past due credits, which must be fully capitalised by 1 January 1998. Mandatory reserve requirements at the end of 1996 were 8% for deposits in both domestic and foreign currency. International accounting standards and a new chart of accounts are expected to be introduced by all commercial banks in 1997.

While the soundness of the banking system has improved since 1996, serious problems remain:

some banks are severely undercapitalised and actual reserve ratios are well in excess of compulsory ratios; pointing to low levels of financial intermediation.

Non-bank financial institutions

There are 15 investment funds and eight trust companies in Moldova. 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 State Commission on Securities Markets oversees the activity of securities market participants, including security brokers, investment funds, trust companies and independent share registrars.

The central bank has engaged in only limited purchases and sales of treasury securities in open market operations, which are expected to replace credit auctions once liquidity improves. Currently, treasury securities are either short-term treasury bills sold at a discount or treasury bonds with a 365-day maturity sold at a premium or discount.

The Moldovan Stock Exchange has been in operation since June 1995, with 95% of trading constituted by shares of privatised companies. During 1996, a volume of about 3.5 million shares was traded, with a value of 11.5 million lei (US\$ 2.5 million). During the first quarter of 1997 the trading volume increased considerably, reaching about 5 million shares, with a value of 37.7 million lei (US\$ 8.2 million). Total market capitalisation at the end of March 1997 was close to 2.5 billion lei (US\$ 540 million).

Fiscal and social safety net reform

Taxation

Moldova's tax system relies on VAT, company profit tax, personal income tax, a land tax and a system of excise taxes. The VAT rate is uniform at 20% and covers most business activities. The VAT system, however, discriminates in the treatment of export and imports according to country. Company profits are taxed uniformly at a 32% rate but many companies benefit from partial tax relief. Individual income tax rates apply progressively, from 10% for annual incomes up to 4,320 lei (US\$ 940) to 40% for annual incomes above 21,600 lei (US\$ 4,695). The land tax is based on the estimated productive capacity of the land. Excise taxes apply to 14 different goods, including wine and champagne.

By the end of 1996, tax arrears had reached 670 million lei (US\$ 145 million), or 7.5% of GDP, including interest and overdue tax penalties. Tax arrears are concentrated in the agricultural sector and relate to the payment of land taxes and excises.

A new tax code was sent to parliament in 1996 to simplify the tax system, abolish most tax exemptions, improve collection rates and enhance tax administration and compliance. The new code would also reform the VAT system and modernise the real estate and land tax systems. In April 1997, parliament adopted some of the provisions of the new tax code, on company profit and personal income taxes.

Social security

Moldova's Social Fund is composed of a pension fund, an employment fund and a social insurance fund. The Social Fund's main source

of finance is a payroll tax of 35% and a 1% employee contribution.

The social safety net is under considerable financial pressure due to a narrowing tax base, weak tax administration and a build-up of tax arrears. At the end of 1996, pension payment arrears were estimated at about 324 million lei (US\$ 70 million). The government has allowed companies to pay in kind with their unsold stocks, which increases the amount of barter trade in the economy. However, the authorities have agreed to phase out such payments to the Social Fund gradually starting in July 1997.

Planned reform measures in the social welfare and pension system include freezing nominal pensions, reducing payroll taxes and lowering administrative expenditure. The pension age is to be gradually raised over the next 20 years until it reaches 60 for women and 65 for men.

Legal transition

Pledge law

A new pledge law was enacted in 1996. The law is unclear as to whether a pledge may be created in intangible assets such as user rights. The new law provides for a unitary registration system for pledges over certain types of property including land, enterprise and goods in circulation. Registration is completed at a local notary's office (where the debtor is situated) and filed in a single pledge registry. The registration fee is under US\$ 100. Registration can be achieved within 24 hours. Companies are also required to maintain a private pledge book. Notarisation is still required for certain types of movable property. Notary fees vary. For bank loans, the fee is a fixed rate of under US\$ 100. For other pledges, the fee is equal to more than 1% of the value of the underlying loan or collateral. Enforcement of a pledge requires court approval unless the parties have reached a separate agreement. If the court has to enforce the pledge, the sale of the property is by auction at a price determined by the court. The registration process is supposed to take less than 24 hours. The fee is less than US\$ 100.

Company law

The cost for formation of a company (including legal, notary and court fees, but not minimum share capital) ranges between US\$ 100 and over US\$ 1,000. The process takes between one and three months. Joint-stock companies possessing a certain minimum number of shareholders are required to maintain share registries. Share registries are maintained by private sector parties. Shareholders are entitled to vote by proxy at meetings. Companies are not required to send shareholders proxy forms in advance of meetings. It is unclear whether shareholders are permitted to solicit proxies to vote on proposed resolutions. Moldovan company law does not afford minority shareholders protection in the event that another company makes a bid for less than all the shares of the target company. It is also unclear whether shareholders possess pre-emptive rights with respect to new share issues. Directors are under an obligation to (i) perform duties in good faith and (ii) disclose personal interests in material transactions with the company or its affiliates. Laws exist prohibiting insider dealing in shares of publicly listed companies.

Bankruptcy law

Moldova enacted a new Bankruptcy Law in 1996. The definition of an insolvent company is that the debtor is unable to meet its liabilities for three months or has tax arrears of one month. The law provides for a reorganisation whereby a majority of creditors can reach a binding settlement with the debtor. Liquidators possess a broad range of powers, but are not able to dispose of the debtor's assets in liquidation. Liquidators have authority to void transactions that are (i) not at arm's length, (ii) below fair (market) value, and (iii) concluded within one year prior to the liquidation. The ranking of liquidation costs, government taxes, social security claims, wages, personal injury claims and secured claims in a liquidation is unclear. There are no specialised bankruptcy courts or judges. Debtors can be sued if they file for bankruptcy fraudulently.

General legal effectiveness

It is unclear whether investment laws are generally drafted by legally trained personnel. Investment laws are generally published between one and six months after being passed. Important judgements are not generally published and accessible to practitioners. There is generally a meaningful right of appeal from first-instance court decisions. It is unclear whether there is an independent right of judicial review of administrative action. On average, a party can be expected to wait less than six months for a commercial case to be heard on the merits by a court in the most important commercial centre and less than six months for a final judgement for payment of a sum of money to be executed.

Poland

• *The August 1996 Law on Commercialisation and Privatisation of State-owned Enterprises reshaped the framework for medium- and large-scale privatisation beginning in 1997 by eliminating the need for employee consent to privatisation.*

• *Bank privatisation made progress with the June 1997 public offering of Bank Handlowy, but the tender for a strategic stake in Powszechny Bank Kredytowy was cancelled*

• *The June 1997 amendments to the Securities Law provided for the dematerialisation of securities and allowed brokerage houses to develop into investment banks.*

• *Parliament passed pension reform bills in July 1997 which further overhaul the existing pay-as-you-go system, establish mandatory individual retirement accounts managed by private financial institutions and allocate a proportion of privatisation proceeds to fund the reform.*

Enterprises**Size of the private sector**

Since agriculture remained in private hands throughout central planning and small-scale private activity was partially liberalised in the 1980s, the private sector accounted for a significant share of output and employment prior to comprehensive reforms, 29% and 44%, respectively, in 1989. Since then, the size of the private sector has increased steadily, largely on the strength of small-scale privatisation and private business start-ups. In 1996 the private sector share of GDP was 65% and of employment 64%.

Privatisation

Under the 1990 Privatisation Law (as amended), enterprise participation in the national privatisation programme was voluntary, requiring the consent of enterprise managers and employees. The voluntary nature of privatisation reflected in part the devolution of enterprise control rights to managers and employees under partial reforms to central planning. The law also provided for different tracks to private ownership. The privatisation tracks for viable state enterprises included direct privatisation (sale, contribution

or leasing of enterprise assets to a new private company) and commercialisation (conversion into a treasury-owned joint-stock company) followed by privatisation through share sales. The Law on National Investment Funds (NIFs) and the Law on the Financial Restructuring of Enterprises and Banks added additional paths to private ownership.

By the end of 1996, 3,937 of the 8,853 medium- and large-scale enterprises which were state owned in July 1990 had entered into the privatisation process. Direct privatisations totalled 1,712, while commercialised enterprises numbered 1,226, of which 183 were privatised through equity sales. The commercialisation total includes 512 enterprises included in the NIF programme. The NIF programme is a form of mass privatisation involving 15 privately managed investment funds, with a number of the management firms including foreign partners. A lottery served to allocate lead shareholdings in each participating enterprise to one NIF, with the other NIFs receiving small minority stakes. Each citizen was allowed to buy for a nominal fee a certificate which can be exchanged for shares in the NIFs. The exchange of certificates for shares in the NIFs began with the listing of these funds on the Warsaw Stock Exchange in June 1997.

The August 1996 Law on Commercialisation and Privatisation of State-owned Enterprises reshaped the framework for future privatisations with effect from January 1997. Under this law, the State Treasury (which assumed responsibility for privatisation in the government's August 1996 administrative reforms) has the right to commercialise a state-owned enterprise upon written notification to its management and employees. Their consent is no longer necessary. In addition, payment for shares held by the State Treasury can now be made in instalments over five years, provided that at least 30% of the shares are acquired by Polish citizens or a Polish company. Employees of a company also gained the right to acquire 15% of that company's shares held by the State Treasury free of charge.

The 1997 Privatisation Guidelines call for the sale of 120 state-owned enterprises, as well as shares in 50 enterprises of which the state is a partial owner. However, in the first half of 1997, the State Treasury privatised only 15 enterprises through equity sales. A major privatisation planned for the second half of 1997 is KGHM Polska Miedz, a copper producer and one of Poland's largest companies.

At the start of comprehensive reform, there was no formal programme of small-scale privatisation. Rather, the approach of the first reform government focused on the transfer of property from state enterprises and cooperatives in the retail, trade, catering and consumer services sectors to local authorities, which then leased or sold these commercial premises, primarily to the employees in existing establishments. The bulk of these transactions had been completed by 1992.

Governance and restructuring

The multi-track approach to privatisation has led to a variety of post-privatisation ownership structures and forms of corporate governance. So far, direct privatisation has been the primary method of ownership transformation and this approach has resulted primarily in insider ownership by managers and employees. With respect to

commercialisation of enterprises, the August 1996 administrative reforms of government assigned to the newly formed Treasury responsibility for the government's ownership role and for initiating the privatisation of commercialised enterprises (so-called capital privatisation). While the pace of capital privatisation has been slow (in part because of an emphasis on maximising revenue from these equity sales), this privatisation method has led to outside ownership which is often concentrated in the hands of strategic investors (including foreign investors).

The NIF programme was a form of mass privatisation which placed strong emphasis on effective post-privatisation corporate governance. The scheme was designed to ensure that each enterprise privatised through this track had concentrated outside ownership by a lead NIF. However, this attempt to impose outside control in insider-controlled enterprises stirred political resistance and contributed to delays in the programme's implementation.

Government subsidies were substantially reduced early in the comprehensive reform programme, falling from 12.9% of GDP in 1989 to 3.4% in 1992. In 1993-96 there was a gradual, further decline in subsidies, falling to 1.7% of GDP in 1996. Tax arrears are also under firm control. The allocation of credits by commercial banks has become more commercially oriented, following the implementation of the Enterprise and Bank Financial Restructuring programme (see below). Non-performing loans of the bank sector peaked in 1993 at 31% of total loans. Banks' asset quality improved significantly in 1995-96, with non-performing loans declining to 12.5% of total loans at the end of 1996.

The 1934 Bankruptcy Act (as amended) provides for the liquidation of enterprises, but the government and procedural costs rank before creditors in the priority of claimants, contributing to creditor passivity. Also dating from 1934 is a court conciliation procedure that allows ailing enterprises to restructure their debts. However, these workouts exclude secured and government creditors and require a two-thirds majority of creditors for approval. The number of liquidation petitions increased sharply following the comprehensive reforms, peaking at 5,249 filed petitions in 1993 before falling to less than 2,710 in 1996. There have been relatively fewer court conciliation procedures. All bankruptcy proceedings have been hampered by the limited capacity of courts and related professionals.

Two overall indicators of the extent of structural change and restructuring are the share of industrial output in GDP and the trend in productivity. The share of industry in total output has fallen from 44% in 1989 to an estimated 28% in 1996. After falling sharply in 1990-91, labour productivity in manufacturing has increased significantly and by 1996 exceeded its pre-transition level by 38%.

Markets and trade

Price liberalisation

Central to the comprehensive reform package of 1989 was price liberalisation. The share of administered prices in the Consumer Price Index (CPI) basket fell to 11% in 1990 from 19% in 1989. However, prices for district heating, electricity, gas, domestically produced medicines,

rents in local authority housing and spirits remained centrally administered, while price changes for liquid fuels and gasoline required approval of the Ministry of Finance. The share of administered prices in the CPI has remained broadly unchanged since 1990.

In February 1997 the government abolished the requirement that liquid fuel and gasoline price changes receive its approval. Also, the May 1997 Energy Law provides for the establishment of the Energy Regulation Office, which will award licences for private energy producers and regulate electricity prices (the average tariff for electricity was equivalent to USc 6/kWh in 1996, while the estimated long-run marginal cost of electricity is about USc 7.5/kWh).

Competition policy

The 1990 Law on Countering Monopolistic Practices (as amended) prohibits several abuses of a dominant market position, such as imposing onerous contract terms and interfering with the emergence of competition. The Law also prohibits certain agreements among producers that restrict competition, including those that fix prices, limit production or restrict market access. A merger may be prohibited if, as a consequence, the entities gain or consolidate a dominant market position. The Office of Competition and Consumer Protection (OCCP) is responsible for enforcing this law. The most frequently reported monopolistic practices are those imposing unfavourable contract terms and tied selling. From 1993-95 the OCCP decided on approximately 150 cases per year. In 1996 the Office considered 192 cases (including consumer protection). In 80 cases, monopolistic practices were ascertained.

Trade liberalisation

In May 1995 quantitative restrictions on agricultural imports were converted into tariffs in line with GATT (Uruguay Round) and EU commitments. In July 1995 Poland became a member of the WTO and the average tariff rate declined to 9.4%. By the beginning of 1997 the average tariff rate had fallen further to 6.3% (5.1% for industrial products and 17.3% for agricultural goods). The import surcharge, which had been cut to 3% at the beginning of 1996, was eliminated at the beginning of 1997. While import quotas are maintained only on petroleum oils, several imports require licences and there are a number of preferential tariff quotas. Multilateral trade agreements with the EU, EFTA and CEFTA were signed in 1992-93.

Currency convertibility and exchange rate regime

Current account transactions were substantially liberalised in the comprehensive reform plan. In December 1994 a new Foreign Exchange Law provided for the full current account convertibility of the zloty. In June 1995 Poland accepted the obligations of Article VIII of the IMF's Articles of Agreement.

A number of restrictions apply to capital account transactions. Resident entities in Poland are permitted only to make certain investments in OECD countries and other countries which have agreements on investor protection with Poland. Permissible investments include: the establishment of subsidiaries or affiliates, the purchase of property if related to economic activity, the acquisition of stakes in foreign companies of at least 10% and the purchase of securities with a maturity of not less than one year up to the amount of ECU 1 million.

Residents are permitted to issue securities with a maturity of at least one year on foreign markets and to purchase securities with a maturity of at least one year issued in Poland by non-resident entities within an overall limit of ECU 200 million per year.

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% devaluation per month). The central rate of the zloty was revalued by 6% 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 month.

Wage liberalisation

In January 1995 the new law on wage negotiations introduced a consensus approach under which wage settlements are guided by indicative norms for base wages (excluding profit-related bonuses) in enterprises with 50 or more employees. A tripartite commission consisting of government, employer and worker representatives sets the wage norms. Although these norms are not legally binding, the managers of state-owned enterprises are subject to loss of pay or even dismissal if profitability deteriorates as a result. The wage norm for 1996 was set at 21.8%, assuming 19.8% annual average inflation. Wages in the enterprise sector increased by 27% in 1996. This approach replaced an excess wage tax (popiwiek) for state enterprises, which operated between 1990 and 1994.

Interest rate liberalisation

In January 1990 banks were permitted to set deposit and interest rates freely. Since 1992 the National Bank of Poland (NBP) has engaged in open market operations, buying and selling treasury securities to regulate the money supply. Bank deposit and lending rates typically follow closely the interest rate targeted by the NBP in its open market operations (most recently the overnight Warsaw Interbank Offered Rate). At the end of 1996 the average deposit rate at commercial banks was 19.2% and their average lending rate for low-risk loans was 23.3%. The inflation rate in 1996 was 18.5% (end-year).

Financial institutions

Banking reform

Banking supervision is carried out by the NBP, through its General Inspectorate of Banking Supervision. The system of prudential regulation includes a minimum 8% risk weighted capital ratio, classifications for loan quality and other provisions which are generally in line with international standards. While the structure of banking regulation is adequate, its execution requires further strengthening, particularly with respect to training and recruitment of qualified staff and to a more consistent approach to under-capitalised banks.

The 1994 Law on the Banking Deposit Guarantee Fund established a bank-funded scheme for deposit insurance of virtually all banks. It covers deposits up to ECU 1,000 in full and provides 90% coverage for deposits up to ECU 3,000. The state bank for agriculture and the state savings bank for housing finance benefit from full deposit guarantees from the government.

The recapitalisation of the state-owned commercial banks was tied to a special bank conciliation programme for the workout of bad loans, which remained in effect for three years (a March 1996 deadline for reaching agreements) and which shifted the balance of power in a bankruptcy to bank creditors. The programme involved 2,916 bad loans, of which 20% were resolved through conciliation agreements, 28% through other bankruptcy procedures and 18% through loan sales. On 17% of the bad loans, borrowers resumed debt service.

The pace of bank privatisation has been slower than anticipated, with only four of the nine commercial banks spun off from the NBP and one former specialised bank privatised by mid-1997 (Wielkopolski Bank Kredytowy, Bank Slaski, Bank Przemyslowo-Handlowy, Bank Gdanski and Bank Handlowy (June 1997)). Foreign investors (including the EBRD) have taken significant stakes in four of these banks. The original target for completion of commercial bank privatisation was the end of 1996. In an effort to accelerate privatisation, the government consolidated three relatively small state banks (Bank Depozytowo-Kredytowy, Pomorski Bank Kredytowy and Powszechny Bank Gospodarczy) around the state savings bank specialising in foreign exchange (Bank Polska Kasa Opieki) in September 1996. Powszechny Bank Kredytowy was to be privatised in the first half of 1997, but the government rejected the two bids and the tender was cancelled.

In most cases, foreign banks have been required to take over existing troubled Polish banks in order to obtain licences. This practice, although less pervasive than in the past, must be halted by 1999 under the conditions of OECD membership. At the end of 1996 there were 24 banks with foreign majority ownership operating in Poland. Their share of total bank loans was 15.3%. The commercial banks split off from the National Bank of Poland and the former specialised banks dominate the banking industry, accounting for 73% of total bank loans.

Strengthening the banking system's performance is a priority. The ratio of total domestic credit to GDP at the end of 1996 was 38%, up from 37% in 1995. About one-third of domestic credit is allocated to the private sector. Bank earnings improved in 1996, with an average return on assets of 2.2%, up from 1.9% in 1995. However, the ratio of banks' operating costs to assets remains high relative to international comparisons.

Non-bank financial institutions

The 1991 Law on Trust Funds authorised the establishment of a type of trust fund similar to an open-end investment fund. The first such fund was established in 1992, and in 1995-96, four new funds entered the market. At the end of 1996 total assets in open-end investment funds totalled 0.4% of GDP. A new Investment Fund Act in July 1997 authorises the establishment of a wider range of investment funds than permitted under the Law on Trust Funds. These include open-end (similar to those funds operating under the Trust Fund Law), closed-end, hybrid and specialist funds. The existing funds were given three years to adapt their practices to the new legislation.

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, which require substantial restructuring. Another 29 companies operate in the market, of which 17 have at least partial foreign ownership. Gross insurance premiums as a percentage of GDP reached 2.2% in 1996, up from 1.9% in 1994.

Securities markets and instruments

The Warsaw Stock Exchange (WSE) reopened in 1991, with the Law on Public Trading in Securities and the Act Establishing the Warsaw Stock Exchange providing the basic legal framework for securities activities. The securities law regulates the public offerings of securities and the operations of brokers and charges the Securities Commission with supervising the markets. The June 1997 amendments to the Securities Law provide for the dematerialisation of securities, allow brokerage houses to develop into investment banks, liberalise and simplify procedures for introducing securities into public trading and allow for trading in warrants and derivatives.

The WSE has expanded steadily, with 83 listed companies and a total market capitalisation of 6.3% of GDP at the end of 1996. This market is among the most liquid of those in transition economies, with a turnover ratio of 84.8%. While an over-the-counter market opened in December 1996, only a handful of companies have been listed so far on this exchange. The stock exchange received a substantial fillip with the listing of NIFs on the WSE in June 1997. While there have been some private placements of municipal bonds and corporate bonds, these instruments are not yet traded on the WSE.

Fiscal and social safety net reform

Taxation

The government's medium-term economic programme involves gradual cuts in the personal income and corporate profits tax rates. The November 1996 Corporate Income Tax Law reduced the corporate tax rate to 38% in 1997 and provided for further cuts of 2 percentage points in each of the next three years until a 32% rate is reached in the year 2000. The 1997 budget also reduced the three personal income tax rates to 20%, 32% and 40%.

Social security

The Social Insurance Fund and the Labour Fund are the largest extrabudgetary 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 15% of GDP in 1996, up from 8% 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%. The eligibility criteria for disability pensions were tightened in mid-1996 and a new indexation mechanism which subjects pension rises to annual tripartite negotiations was introduced in late 1996. These measures are expected to result in significant savings.

Parliament passed three pension reform bills in July 1997. One bill further overhauls the existing

pay-as-you-go (PAYG) system by raising the retirement age for both men and women and by eliminating sectoral privileges. The second bill introduces a mandatory, fully funded capital system with management of individual pension accounts by private financial institutions. While implementation of this reform will involve a loss of budget revenue of an estimated 1-2% of GDP over the medium term, the third bill provides that these costs will be partially offset by privatisation receipts. The long-term fiscal savings will be substantial.

Legal transition

Pledge law

Poland enacted a new Registered Pledge Law, which will become effective on 1 January 1998. The new law allows non-possessory registered pledges to be created over all kinds of movable property, including a changing pool of assets, future property and a business enterprise. The law provides for a new centralised registry for non-possessory pledges. Enforcement of pledges is possible without court assistance.

Company law

The cost for formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is over US\$ 1,000. The process generally takes one to three months, although some lawyers estimate that the procedure can take four to twelve months. There is a requirement that joint-stock companies maintain an independent share registry. Shareholders are entitled to vote by proxy at meetings. Companies are not required to send shareholders proxies prior to meetings. It is unclear whether shareholders may solicit proxies to vote on proposed resolutions to be considered at the meetings. Polish company law provides for cumulative voting whereby minority shareholders can pool their votes to ensure the election of at least one director who represents minority interests. Companies that acquire more than 33% of the outstanding listed shares of a target company must offer to buy the remaining shares at the same price. This requirement cannot be waived by the shareholders or directors of the target company. Shareholders are also given pre-emptive rights in the event of a new share issue. There is a centralised registry for the registration of dematerialised shares. Directors are under an obligation to (i) avoid engaging in business endeavours competing with the company's business and (ii) disclose personal interests in material transactions with the company. Laws exist prohibiting insider dealing in shares of publicly listed companies.

Bankruptcy law

The Polish Law on Bankruptcy was originally enacted in 1934 and was subsequently amended in 1990. The law defines insolvency as when a debtor's assets exceed its liabilities or the debtor is unable to meet its obligations as they fall due. The law provides for reorganisation proceedings whereby a majority of the creditors may reach a binding settlement with the debtor. The liquidator is appointed by the court but is not required by law to possess specific qualifications. There is no government body that supervises the conduct of liquidators. Courts, rather than the liquidator, verify creditors' claims. The liquidator has the ability to void transactions which are concluded within certain time limits prior to the liquidation and are (i) below fair value or (ii) not at arm's length. A liquidator has the authority to seize the debtor's

assets, to inventory its property and to issue a financial statement. Claims secured by a registered pledge have priority over any other claims in a liquidation except execution costs, employees' claims for three months' wages and for personal injury and registered statutory liens for taxes. Bankruptcy proceedings are closely supervised by the district courts, which have wide powers granted by the Bankruptcy Law.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published up to six months after being passed. Important judgements are generally published and accessible to practitioners and provide written reasons for courts' decisions. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between one and two years for a commercial case to be heard on the merits by a court in the most important commercial centre and between one and two years for a final judgement for payment of a sum of money to be executed.

Romania

• *A comprehensive programme of macroeconomic stabilisation and structural reform was launched in February 1997 after extensive negotiations with multi-lateral financial institutions.*

• *Programmes for restructuring include the liquidation of large commercial enterprises in the energy-intensive industrial sector, agricultural reform, and strengthening of the financial sector.*

• *Attempts are being made to accelerate privatisation, especially through the participation of strategic foreign investors.*

Enterprises

Size of the private sector

According to government estimates, the private sector share of GDP has risen from 35% in 1994, to about 55% in 1997. However, these estimates include firms with a minority stake held by the state. The private sector accounted for about 23% of employment in 1995 and 47% in 1996, according to revised estimates.

The share of private ownership varies considerably across sectors. In 1996, the private sector share in GDP was estimated at 87% in agriculture, 24% in industry, 71% in construction and 75% in trade and services. The private sector accounted for about 52% of foreign trade during the first six months of 1997.

Between 1992 and October 1996, the number of state-owned companies fell slightly, from about 8,000 to 6,000, and the number of private companies rose from 200,000 to 500,000. Self-employment, family businesses and foreign-held companies also increased by about 50%.

Privatisation

By August 1997, approximately 3,800 companies had been privatised. About 80% of privatisations took the form of management and employee buy-outs (MEBOs). The new government has placed priority on the acceleration of the process of large-scale privatisation.

The first Privatisation Law of 1991 established five Private Ownership Funds and one State Ownership Fund (SOF). The SOF was granted 70% of shares in some 6,400 commercialised companies, while the rest of the shares were transferred to five Private Ownership Funds, which were established as state-controlled joint-stock companies. A new voucher mass privatisation framework was put in place in 1995 and the distribution of shares finalised in October 1996. Most vouchers were exchanged against enterprise shares directly; only 14% of the vouchers were exchanged against shares in the Private Ownership Funds, which were

converted into Private Investment Funds – PIFs – in November 1996.

The success of the new programme was mixed. By the end of 1996, only 45% of all enterprises scheduled for privatisation were privatised. About 70% of small enterprises had been sold, but only 24% of medium-sized and 13% of large enterprises.

During the first eight months of 1997, privatisation accelerated. A further 1,100 companies were privatised (140 of these were medium-sized or large), bringing the total proportion of companies privatised to around 60%. The SOF has commenced selling its large minority ownership stakes through the stock exchange. Larger companies, in which the SOF retains a 51% stake, are to be sold progressively through open tenders.

Despite these advances, significant problems remain. The sale of majority state-owned large enterprises is subject to delay, partly because of overly bureaucratic procedures applied by the SOF. The status of the PIFs is not fully resolved, and trading on the over-the-counter (OTC) market and the stock market, although accelerating, has not yet reached a volume sufficient to establish the concentration of ownership necessary to alleviate corporate governance problems.

Interest by strategic investors from abroad in larger companies rose strongly in the first half of 1997. In order to encourage strategic investors, the SOF now provides cash rebates of up to 60% to potential buyers, under the condition that the money is re-invested in the enterprise.

The SOF is legally required to cease operations in 1999, the date when the completion of privatisation was initially envisaged. Formerly independent, it was restructured and put under the direct control of the government in April 1997.

Livestock farming had been largely excluded from privatisation. The state also retained ownership in the large agricultural intermediaries as well as in national distribution and storage companies. Privatisation and restructuring of these entities is a priority of the new reform programme.

Almost all small-scale trade and service activity is in the hands of the private sector. Some 98% of these companies are privately owned, 1.3% with joint state and private capital and only 0.7% with majority state capital. Some 83% of all agricultural land is in private hands, following the break-up of large farms into small units.

Amendments to the law on property restitution, granting more rights to claimants, have been announced for late 1997.

Governance and restructuring

Detailed proposals for the merging, restructuring or liquidation of unprofitable enterprises and Regies Autonomes were launched by the new government in February 1997 after credit policies had begun to loosen considerably in 1996. A bankruptcy law was passed by parliament in March 1995, but arrears continued to be a problem throughout 1996, partly because the law does not apply to the largest state companies, the "Regies Autonomes", for which special bankruptcy legislation applies. Hardly any enterprises were liquidated under the previous reform programmes, which targeted about 150 loss-making enterprises.

A further step towards the necessary industrial restructuring was the dismantling of the National Oil Company, established in August 1996 to unify oil import and export trading and to keep control over the associated foreign currency transactions. A new national operator, Petrom, will be set up to integrate the production and processing of oil in just two refineries and the retail network. The remaining refineries will be put up for privatisation or closed down. The transportation grids will provide services to all operators, dismantling the state monopoly.

In the enterprise sector, emphasis has been placed on the rapid privatisation or liquidation of a group of enterprises that account for about 75% of the total state enterprise losses. They include 42 commercial enterprises and 20 Regies Autonomes. In June 1997, all Regies Autonomes were reorganised as commercial joint-stock companies. New legislation stipulates that these companies be privatised.

In February 1997, the government started the liquidation process with a group of eight companies, covering various sectors from oil processing to state-owned agricultural farms. The second step will be the liquidation of 17 large loss-makers.

Of particular importance in Romania is the energy sector. With energy consumption heavily subsidised for both industry and households, energy intensity in Romania is one of the highest in eastern Europe, about three times the OECD average. Earlier attempts to raise energy prices led to an accumulation of arrears to energy suppliers (from both enterprises and households) and associated shortfalls in the production of electricity and petroleum products, which were bridged by imports. The restructuring or liquidation of the 20 Regies Autonomes, subsequent to tariff adjustments, is a crucial step to address these problems.

Decisive steps to restructure the agricultural sector are also important. Previously this sector was heavily subsidised, benefiting from directed credits through the state-owned banking system. Quasi-fiscal support, refinanced by the National Bank at subsidised interest rates, is estimated to have reached about 2.1% of GDP in 1996. Further distortions arose from administered (wholesale and retail) pricing, monopolistic state-owned intermediaries, storage facilities and distribution networks. While private ownership in agriculture is generally high, there are still large state-owned production units, especially in livestock farming.

The agricultural reform programme focuses on price liberalisation, tariff reduction, and the privatisation and demonopolisation of intermediaries, distributors and large farm units are planned. Most of the loss-making units are to be privatised and split up in the course of 1997 and 1998. By mid-1997, 11 large livestock farms had been liquidated. Prices had been liberalised earlier in the year to initiate the programme

A new Land Law has been announced, establishing improved regulation for the leasing of land. Tariffs on agricultural imports have been reduced from a product-weighted average of 67% to 22% (below the initial target agreed upon with international agencies), and export bans have been abolished. A new subsidy system to allow purchase of inputs by private farmers, will be implemented during the autumn of 1997.

This will end the directed credit system, and replace it with transparent subsidies, included in the state budget.

Markets and trade

Price liberalisation

By mid-1995, the share of administered prices on consumer goods and services had fallen to 3%. However, prices for oil, other energy and some agricultural products remained controlled until early 1997. Foodstuffs subject to (wholesale or retail) price administration accounted for 17% of the average household consumption basket. These price controls have now been lifted. Energy prices were doubled at the beginning of 1997, and are expected to be at world market levels by the end of the year.

Competition policy

A law regulating competition became effective in January 1997. A Council of Competition has been established and become operational to investigate alleged monopoly concentrations.

Trade liberalisation

Quantitative import restrictions apply to only 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. A very liberal tariff reform is currently being implemented for agricultural products.

The full version of Romania's "Europe Agreement" with the EU came into force in February 1995. The most important aspect of the agreement is the gradual introduction of free trade in industrial goods between Romania and the EU by 2003. Romania applied for EU membership in 1995.

Romania has been a member of GATT since the 1970s and became a member of WTO in 1994. New tariff regulations replaced quantitative restrictions with tariffs and allowed exceptionally high tariffs in some cases. However, the authorities have adjusted most of them to internationally accepted levels. Agricultural tariffs, for example, were lowered to a trade-weighted average of about 22%.

In July 1997, Romania joined CEFTA. Although the weight of trade with CEFTA countries does not currently exceed 5%, it signals the commitment to a further relaxation of trade barriers.

Currency convertibility and exchange rate regime

In early 1997, the exchange rate was freed from a previous regime of *de facto* regulation, and convertibility of the Romanian leu was established in July, in preparation for adopting Article VIII of the IMF Agreement. The exchange rate is now unified, after the removal of restrictions on the Interbank foreign exchange market, which had led to overvaluation and dual exchange rates in 1996. In the adjustment process, the leu depreciated some 30% in real terms, but stabilised in the spring of 1997. The exchange rate remains floating for the time being.

Wage liberalisation

Collective bargaining is well established, but the government still pursues an incomes policy through taxation of "excessive" wage increases. The new reform programme includes budgeted social protection of low-income groups. The net average monthly wage stood at approximately US\$ 85 at the end of the first quarter of 1997.

Real wages and productivity grew almost perfectly in step during 1995-96. However, real

wages in the state sector grew much faster than productivity, especially in those sectors that were the most heavily subsidised (food production and energy), while wages in the emerging private sector did not keep pace with productivity gains. In 1997, ceilings were imposed on wage increases in loss-making state enterprises and in the Regies Autonomes.

In July 1995 the government, the employers' association and the trade unions all signed an agreement on the stipulation of a minimum wage, in which the government has promised to revise the gross minimum wage every six months. In mid-1997, the minimum wage was 225,000 lei (US\$ 30).

Interest rate liberalisation

Commercial banks are free to set their interest rates. The Interbank money market was formally established in 1994. Until recently, distortions arose from directed credits, which were channelled through the state-owned banking system, and from the issuance of treasury bills to the state-owned banks that were then refinanced by the National Bank (NBR), in the absence of a functioning secondary market. The second half of 1996 was characterised by artificially low, often negative real interest rates. According to IMF calculations, the quasi-fiscal subsidies provided by the NBR in 1996 amounted to 2.6% of GDP.

These practices were abolished in 1997. The NBK stopped issuing directed credits. Price liberalisation was coupled with a temporary increase in real interest rates, triggered by monetary tightening and the associated adjustments of the NBR refinancing rate. Attempts to introduce a secondary market for treasury bills are under way. While credit auctions remain the main refinancing facility of the NBK, long-term monetary policy appears to target monetary aggregates, implying the need to develop further the instruments for carrying out open market policies, as well as an efficient market for government debt.

Financial institutions

Banking reform

The Romanian banking system is characterised by four large state-owned banks and a larger number of relatively small private banks, which together account for about one quarter of the banking system's total leu deposits (but a much higher share of foreign exchange deposits). Private banks account for an increasing share of capitalisation in the banking sector; the presence of foreign banks is increasing.

In early 1997, the banking system consisted of 39 licensed institutions, seven of which were state owned, 23 have private or mixed (state and private) capital, while nine are branches or subsidiaries of foreign banks. Most institutions provide universal banking services, but the individual product range varies across banks.

The most serious challenge is the task of restructuring the large state-owned banks, which have accumulated large burdens of doubtful loans to state-owned enterprises and agriculture. Most affected by this problem are the former foreign trade bank and Banca Agricola, the agricultural sector bank. Restructuring measures for these banks have been initiated with the support of international financial institutions.

A bank privatisation law was submitted to parliament in April 1997. Shares previously held by the Private Ownership Funds will be transferred

to the SOF, which will be legally responsible for the sale of the banks. Bank privatisation committees are to be established to promote the privatisation of the Romanian Bank for Development, Bank Post and Banca Agricola. There is no limit on the amount of shares that can be acquired by private domestic or foreign investors.

In August 1996, the government approved a deposit insurance scheme, which is designed to cover deposits of up to 10 million lei (US\$ 1,300), with the whole amount being indexed to inflation. The Savings Bank, the only bank with fully guaranteed deposits, was converted into a commercial bank in mid-1996.

Non-bank financial institutions

Private, open-ended mutual investment funds were set up in 1994. The National Securities Commission started enforcing rules on net asset valuation in 1996, which led to sharp reductions in the value of most funds and to the temporary suspensions of some funds. By August 1997, 11 open-ended funds were still operational.

Some 40 companies are active in the insurance market. Most of these are privately owned, but the sector is still dominated by three state-owned firms.

Securities markets and instruments

The National Bank of Romania issued the first treasury bills in 1994. Due largely to the absence of a solid regulatory framework, an active secondary market for government securities has not yet emerged.

A stock exchange and the National Securities Commission became operational in 1995. The stock exchange currently trades stocks of 13 companies on tier one and 47 companies on tier two. Participation in the stock market has increased sharply in 1997. In August total market capitalisation amounted to about US\$ 745 million or 2.5% of GDP.

Listing on the stock market is a difficult process; this may have contributed to the increasing importance of the over-the-counter market (RASDAQ), which was established in October 1996. RASDAQ supports secondary trading of the shares created in the wake of the mass privatisation programme. When it assumed operations, only 12 shares were traded, and six companies listed. By June 1997, the number of listed companies had soared to more than 3,200. Market capitalisation on the RASDAQ in mid-1997 was slightly above US\$ 2 billion, or almost 7% of GDP.

The first Romanian company to launch a private placement (of US\$ 10 million) on international markets was a furniture maker, in April 1996. In February 1997, the Romanian Commercial Bank launched Romania's first corporate bond on the international markets (US\$ 75 million, rated BB- by Standard & Poor's).

Fiscal and social safety net reform

Taxation

Personal income is taxed on a progressive schedule, with a maximum tax rate of 60%. Value-added tax is levied at 18%, with a reduced rate of 9% for a variety of food products and medicines. Excise taxes are levied on alcohol, tobacco and certain luxury items.

A single corporate profit tax rate of 38% applies to all permanently established legal entities.

Branches of foreign companies are subject to an additional 6.2% profit tax. In May 1997, special tax breaks were granted for foreign direct investments larger than US\$ 350,000. Additional incentives apply to foreign direct investments larger than US\$ 5 million.

Further changes in the tax system are expected in 1998. Most pressing is the switch to a transparent and simplified income tax system. Meanwhile, effective tax collection is slightly below 30% of GDP.

Social security

Romania's social security system is financed partly by payroll deductions and partly by the government. Employer contributions to the Social Security Fund are levied at 24% of wages, while employees contribute 3% of their income to the Supplementary Pension Fund. Pensions for certain segments of the population (military and agriculture) are financed by transfers from the budget.

Unemployment contributions are 1% of the gross wage for the employee and 5% for the employer. There are a number of specialised social protection funds (child allowances, minimum income and others), administered partially by local authorities but financed out of the budget.

Major changes are expected towards the end of 1997, when the government intends to set up private pension schemes and a new National Medical Insurance System.

Legal transition

Pledge law

In Romania, pledges are governed by the Civil Code, the Commercial Code and supplementary legislation (Law on the Commercial Registry No. 26 of 7 November 1990; Immovable Property Act of 13 March 1996). Security interests may be taken in a wide range of property, including movables and immovables. Charges over movables are generally possessory. Non-possessory charges may only be created in restricted circumstances. There is a form of enterprise charge, but it does not cover immovable property or accounts receivable. The pledging of future property is generally excluded, but commercial pledges may be created over a changing or floating pool of assets. Pledges of movable property are created by written agreement to be registered in a public registry. However, there are a large number of autonomous registries for different types of pledges. Enforcement of a pledge normally requires court assistance.

Company law

Romania enacted an ordinance for the modification and completion of the Company Law in June 1997 (effective 27 July 1997). The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) can range from US\$ 500 to over \$1,000. The process takes between one and three months. Joint-stock companies are not required to maintain independent share registries. However, the government and private sector parties do maintain registries. Shareholders are entitled to vote by proxy at meetings. It is unclear whether companies must send shareholders proxy forms in advance of meetings. Similarly, it is unclear whether shareholders may solicit proxies for votes on proposed resolutions to be considered at meetings. Minority shareholders are not afforded protection if a company makes a bid for

less than all the shares of the target company. Shareholders possess pre-emptive rights with respect to new share issues. Directors are under an obligation to (i) perform their functions in good faith and (ii) disclose any financial interest they have in material transactions with the company or its affiliates. Laws exist prohibiting insider dealing in shares of publicly listed companies.

Bankruptcy law

Romania enacted a new Bankruptcy Law in June 1995. The definition of insolvency is when a debt remains past due for 30 days. Creditors can petition for the liquidation of the debtor. The law also provides for reorganisation proceedings whereby a majority of creditors can reach a binding settlement with the debtor. The settlement must be approved by creditors who represent two-thirds of all outstanding claims and a majority of each class must also approve the settlement. The powers of the liquidator are not specified in great detail. The liquidator must have demonstrated accountancy, business and legal skills. The liquidator may void fraudulent transactions entered into by the debtor and transfers to related parties within three years prior to the liquidation date, along with pledges and mortgages granted within 120 days of the liquidation date (or, if the pledge or mortgage is in favour of a related party, within one year of the liquidation date). Liquidation and administration costs and six months' unpaid employee wages rank higher than unsecured claims. Claims of secured creditors rank higher than any other claims except for court expenses and expenses for the conservation and disposition of the collateral.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published up to six months after being passed. Important judgements appear generally to be published and accessible to practitioners. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between seven months and two years for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and one year for a final judgement for payment of a sum of money to be executed.

Russian Federation

- *Following slow reforms in 1996 and early 1997, structural reforms have accelerated since the appointment of the new Government and the initiation of a comprehensive reform programme in March 1997.*
- *Privatisation has been reinvigorated since mid-1997 and a new law on privatisation has been adopted.*
- *The new Government has taken substantial initial steps in reforming the natural monopolies, in phasing out subsidisation of utility prices for households and in housing reforms.*
- *Fiscal reforms have been slow but a new Tax Code is planned to be adopted by the end of 1997.*

Enterprises

Size of the private sector

At the beginning of 1997, the private sector accounted for about 70% of GDP, over 60% of employment and 74% of investments. The main source of the expansion of the private sector remains the privatisation process and the contraction of the state sector. The total number of privatised entities amounted to 123,000, while the number of wholly state-owned enterprises was reduced to 88,000 from 205,000 in 1992. The creation of de novo businesses continues to lag far behind the pace typical for the central European countries and many newly established businesses continue to operate in the informal economy. The number of officially registered small businesses remains at only around 1 million. Private sector development is especially hindered in the agricultural sector as the Duma continues to stall legislation enabling the sale of agricultural land.

Privatisation

Under the first voucher privatisation programme, largely completed by mid-1994, more than 15,000 medium-sized and large enterprises, employing over 80% of the industrial workforce, were privatised. The second, cash-based phase of privatisation has proceeded slowly since its inception. This was especially the case during 1996: while about 4,600 mainly small and medium-sized enterprises underwent some form of privatisation in the course of 1996, none of the originally envisaged large-scale privatisation deals under the EFF (Extended Fund Facility) programme were completed. Privatisation revenues to the federal budget came in at less than 10% of the 12.4 trillion rouble target for 1996. However, privatisation revenues increased sharply in the first quarter of 1997, due primarily to the auctioning off of 8.5% of the Unified Energy System (UES), the electricity

holding company. Since September 1996, the beneficiaries of the shares-for-loans scheme of late 1995 have had the right to sell the shares in their possession. By mid-1997, in five of the original 11 shares-for-loans transactions the auctions had taken place and, in each case, were won by the original loan provider.

The government plans to accelerate the privatisation process, primarily through case-by-case deals and has unveiled several lists of large enterprises earmarked for privatisation during the year. The government also increased the privatisation revenue target from 4.2 trillion roubles, as contained in the 1997 budget law, to 10 trillion roubles. The list of enterprises subject to privatisation in 1997 includes Svyazinvest, the telecommunications holding company (a 25% stake was sold in mid-1997); a number of oil and gas companies; Transneft, the oil pipeline operator; Rosgosstrakh, the largest insurance company (privatisation of which was later called off); and a few large enterprises from the machine-building, timber and paper and chemical sectors. An additional sale of 2% of the shares in UES is also planned. However, the privatisation process continues to be burdened with controversies. Most recently the auction of blocks of state shares in Svyazinvest and Norilsk Nickel came under widespread criticism. The government's privatisation programme for 1998 envisages privatisation of 37 fully state-owned enterprises and further sales of blocks of shares in 29 partially privatised firms.

Foreign participation in privatisation and subsequent share transactions continues to be restricted. In the most important strategic enterprises, mostly in the energy sector, foreigners are allowed to have a maximum 15% of the shares. Special restrictions apply to the financial sector and the Duma intends to tighten restrictions on foreign participation in a wide range of sectors through amendments to the Law on Foreign Investment. At the beginning of 1997 foreigners owned less than 2% of Russia's medium-sized and large enterprises. However, in the largest 100 companies, foreign participation amounted to 12%.

In June 1997, the Duma approved the new Privatisation Law, which was subsequently signed by the President. The new law provides a legal basis for privatisation, which since 1992 has proceeded entirely by presidential decrees and government resolutions. According to the law, each year a new privatisation programme has to be passed along with the budget. Major new provisions of the law are related to management of the state shareholding in privatised companies, the rights of workers' collectives in future privatisations and ensuring greater transparency of the privatisation process. The law eliminates most insider privileges during privatisation and sets out procedures for determining more realistic market valuations of assets on sale.

Governance and restructuring

Both corporate governance and enterprise restructuring continue to be handicapped by the dominant role of insiders in the enterprises' ownership structure. In over 65% of Russia's 18,000 privatised medium-sized and large firms management and employees have majority ownership, whereas non-state outsiders control only 20% of these companies. While in the top 100 largest companies outsiders have an ownership stake well above the average, the wide dispersion of these shareholdings often

ensures a controlling position for the management. Insiders typically focus more on maintaining control over their firms than on restructuring. Maintenance of "pocket" share registrars (i.e. registrars controlled by the firm), manipulation of voting procedures and obstacles to board representation of outside shareholders have been widely used as defence mechanisms to preserve insider control. However, recent high-profile cases of enforcing improved corporate governance and respect of shareholder rights (Gazprom, UES, Mosenergo and Novolipetsk) are encouraging signs.

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 shut-downs, changes in management, major reorganisations and modernisation is at a very early stage and is constrained by, among other factors, limited access to investment resources. Recent evidence suggests that roughly 25% of the medium-sized and large companies are engaged in serious restructuring, many of them being members of Financial and Industrial Groups (FIGs). About half of the medium-sized and large companies have not as yet undertaken any meaningful restructuring.

With steady progress in financial stabilisation since early 1995, the budget constraint of the enterprise sector has 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 payment arrears has to a large extent offset such pressures.

The bankruptcy threat for enterprises is not yet credible. Only about 1,000 companies have been declared bankrupt as of mid-1997. The Federal Bankruptcy Service has been unable to implement most of its decisions. Political opposition to bankruptcies, particularly at the regional level, remains strong – but in the current regulatory environment even creditors have limited incentives to initiate bankruptcy proceedings. A new draft bankruptcy law is under consideration by the Duma.

Markets and trade

Price liberalisation

Only basic utilities and a restricted list of producer goods and services remain subject to price controls at the federal level. Prices in sectors or organisations deemed natural monopolies, including gas, electricity, railway transport and telecommunications, are administered, both for households and industrial users. As a rule there is a major element of cross-subsidisation, with household prices and tariffs amounting to a fraction of the level charged to other customers. Housing rents and prices for related communal services remain at an artificially low level, covering only 27% of costs. Subsidies on rents and communal services account for over 40% of the expenditures of the local budgets. A recently launched reform programme envisages a gradual increase in housing rents and prices for communal services to cost-recovery levels by 2003. Since mid-1997, substantial discounts on gas and electricity prices and railway tariffs are offered for industrial users that pay their bills on time and in cash.

In many regions widespread direct and indirect price controls continue to be applied for food and some consumer goods.

Competition policy

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 positions (defined as at least a 35% share of the federal or regional market) is kept by the federal and regional branches of the Committee. At the end of 1996, the federal section of the registry included close to 500 industrial enterprises, accounting for roughly 20% of all industrial output. Dominant market positions, including those created by cartel agreements, are monitored and, in cases of abuse, penalised. In addition, prior approval of the anti-monopoly committee is required for a variety of transactions such as mergers, acquisitions and direct investments in Russian companies above certain limits. For example, acquisitions of more than 20% of the shares of a company, or acquisition of shares in any firms included in the register of dominant firms, requires prior approval. In 1996, the Committee initiated 1,240 proceedings with regard to violations of the anti-monopoly legislation. The most frequent violations were abuse of market dominance, mainly by natural monopolists, and acts and actions of local government bodies aimed at restricting competition. In May 1997, in order to increase the efficiency of anti-monopoly activities a special commission was created, including the State Anti-Monopoly Committee, the federal energy commission and the federal services of transport and communications. A recent presidential decree provides for obligatory and open tendering of all government procurements.

In November 1995 a special Law on Financial and Industrial Groups was adopted, though a full set of implementing legislation has not yet been issued. In early 1997 there were over 60 officially registered FIGs though many more are operating without official registration. The FIGs may be opting to register in the hope of obtaining state support, although so far the establishment of FIGs has remained market driven and no special system of privileges has been created. The practical stance of the Anti-Monopoly Committee in this regard is not yet clear.

Trade liberalisation

The average trade-weighted import tariff during 1996 was around 13-14%. The maximum tariff level (except for alcohol) had been reduced to 30% by the fourth quarter of 1996. As a further measure to contain capital flight, regulation on barter transactions was tightened in late 1996. From early 1997, a new excise law came into effect providing for similar treatment of domestic and imported goods and services. A new law requires all retail goods imports to display a label in Russian.

In response to the sharp real appreciation of the rouble in recent years, protectionist pressures remain strong. Restrictions on alcohol imports have been tightened, including an increase in the minimum price for imported spirits and the introduction of a special licensing system. Driven also by budgetary considerations, new tariff rules have been applied to "shuttle trade", i.e. imports by individuals.

Contrary to the regulations on Russia's trade with Western countries (and international practice), exports to the CIS countries continue to be subject to VAT, while imports from these countries are free from VAT. The draft Tax Code envisages the adoption of international standards in the trade with CIS countries from the beginning of 2000.

Russia made a formal request to join the WTO in 1993 and since July 1995 a number of meetings of the Working Party on Accession have been held. Although the process has recently accelerated, some issues, most importantly regarding trade-related aspects of intellectual property rights, remain to be settled, while others are yet to be discussed. In April 1997, Russia and the EU signed a new steel agreement envisaging a gradual transition to free trade by 2001.

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% surrender requirement continues to be applied for exports. Surrendered currency is sold on the interbank market (i.e. at the prevailing market exchange rate).

The sliding currency corridor exchange rate regime, applied from July 1996, was extended through 1997. The currency band is set to move from its initial level of 5,500-6,100 roubles to 5,750-6,350 roubles to the US dollar by the end of the year. Since 17 May 1996, the CBR has set the official exchange rate daily on the basis of a string of indicators, including inflation, balance of payments and reserves; it is committed to defending this rate. Prior to this change, the official rate was determined on the Moscow International Currency Exchange (MICEX).

Wage liberalisation

Wages are determined without government intervention outside the budgetary sector. The tax-based incomes policy (the so-called excess wage tax), 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 83,490 roubles (US\$ 14.5) in April 1997. At that time, the average monthly wage was about 838,000 roubles (approximately US\$ 146). Wage arrears continue to be widespread and amounted to 54 trillion roubles in June 1997, out of which about 20% was due to arrears on public wages. The government is committed to clear its arrears by the end of 1997. The labour market is formally fully liberalised but the "propiska system" (a system of residence permits) has not yet been phased out completely in practice. Labour mobility is also hindered by the fact that enterprises continue to play a major role in providing social services.

Interest rate liberalisation

Banks in Russia are free to set deposit and lending rates without government intervention. Government bond yields have generally driven the interest rate structure. Their annualised rate on all maturities has been steadily falling from about 200% in May 1996 to below 20% in June 1997, despite the introduction of a 15% tax on interest on GKOs (treasury bills) in early 1997. The Central Bank of Russia (CBR) can influence the government bond yields by altering the supply and demand conditions on these markets. The CBR refinance rate, another benchmark interest rate, sets the floor on the credit auctions but has not been actively used. The refinance rate has also sharply fallen to 24% (non-compounded) in June 1997 from 120% a year earlier. 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. Other banks can access the interbank market only on a fully collateralised basis.

Financial institutions

Banking reform

On 1 July 1997, there were 1,847 licensed banks in Russia, compared with 2,600 three years ago. The banking system consists predominantly of private banks with only the two largest banks, Sberbank and Vneshtorgbank, remaining in majority state ownership. Sberbank controls 75% of all retail deposits, 30% of all assets and about half of interbank lending. The largest 100 banks accounted for an estimated 75% of total bank assets in early 1997, with the top 30 accounting for around 65%. The banking sector remains small, with total assets below 30% of GDP. Loans account for less than 40% of the banks' total assets. The share of medium- and long-term loans in the banks' portfolios is increasing but it is still below 10%. Only 35% of banks are regarded by the CBR as basically sound; 30% are considered to be in serious difficulties, most of which are likely to be liquidated or merged into stronger institutions. Following the interbank crisis of August 1995 the banking system has undergone a certain degree of consolidation. The CBR has substantially developed its regulatory and supervisory capacities during the last year. To facilitate short-term liquidity management it has introduced deposit auctions, a Lombard facility and repurchase operations. Licensing policies have been tightened and a few large, troubled banks were placed under forced administration. The CBR is conducting monthly assessments of the largest 200 banks. In the autumn of 1996 a separate department was created in the CBR charged with the daily monitoring of Russia's most important 25-30 banks. A special bankruptcy law for banks and a deposit insurance scheme are under discussion in the Duma and are expected to be adopted in the near future. A major accounting reform is scheduled for early 1998, with the aim of imposing international accounting standards. Financial stabilisation, however, poses a general challenge for banks by eroding "easy" sources of profits in hard currency operations and high-yielding transactions in government securities while the majority of banks have yet to develop traditional core banking activities.

Mandatory reserve requirements for rouble deposits were reduced in May 1997 and those for hard currency deposits increased. The minimum capital requirement for banks is to

gradually rise to ECU 5 million by 1999 from ECU 2 million in 1996. The minimum risk-weighted capital adequacy ratio is to rise to 7-11% by 1999 from 6% in early 1997. Liquidity ratios and exposure limits have also been tightened. The Financial Institutions Development Project programme supported by the EBRD and the World Bank, aiming to create a core group of quality banks, has made encouraging progress. By mid-1997 32 banks had been accredited under the programme.

There are 13 wholly foreign-owned banks in Russia and over 150 joint-venture banks. The share of foreign banks in the total capital of the sector continues to be restricted to 12%.

Non-bank financial institutions

A key new development in the area of non-bank financial institutions has been the establishment of a legal and regulatory framework for mutual funds. By mid-1997, nine mutual funds had been given licences to operate, including two foreign funds. Many of the existing voucher investment funds and "investment companies" are also expected to be transformed into mutual funds.

There are around 2,450 insurance companies in Russia at present, the total having decreased by 150 during the first half of 1997. The market is still small, with about US\$ 5 billion in insurance premiums collected annually. Foreign participation is restricted to a maximum 49% of a company's capital. The government's recent decision to allow companies to deduct insurance costs from the taxable base will increase interest in insurance. The number of registered private pension funds amounts to about 1,000, with around US\$ 630 million total assets in early 1997, but only 40% of them are officially licensed. It appears that the existing regulations are frequently violated, especially those on the allocation and protection of the pension funds' assets.

Securities markets and instruments

Within the Russian securities markets, the government bond markets have seen the fastest development with the GKO's (treasury bills), OFZs (federal loan bonds) and MinFins (hard currency denominated bonds) being the key instruments. In May 1997, the nominal value of GKO's/OFZs outstanding amounted to 296.4 trillion roubles (US\$ 51.3 billion) or close to 12% of GDP, sharply up on 7.1% a year ago. The average maturity on all outstanding bonds continued to increase and in mid-1997 stood at above six months. Access for foreigners to the GKO/OFZ market has been permitted since early 1996 and was further eased in July 1996 and early 1997. The government is committed to liberalising the market fully by the end of the year. Currently foreigners account for about 25% of the government bond market. New regulations for the issuance of corporate securities are expected by the end of 1997.

Despite recent positive changes, the stock market remains fragmented, illiquid and non-transparent, with active trading only on the over-the-counter market and mostly in the shares of a few dozen "blue chip" companies. Transactions are typically settled offshore. Companies' lack of transparency remains a key obstacle, but important tasks lie ahead in developing the market infrastructure and also the legal and regulatory framework. Further steps have been made since late 1996 in the protection of shareholders' rights. The Securities

Commission's regulatory and enforcement powers have been enhanced, though in June 1997 the role of licensing the securities activities of commercial banks passed to the CBR. Registration risk has been further reduced and a centralised depository has recently been created. The Russian Trading System now links brokers in Moscow with several other cities. Independent industry and market research and information is increasingly available. The first half of 1997 saw more than a doubling of the share prices in US dollar terms, driving the market capitalisation to over US\$ 80 billion. An increasing number of Russian companies and banks have issued or are in the process of issuing American and Global Depository Receipts, with the aim of gaining access to Western institutional and other investors.

Fiscal and social safety net reform

Taxation

Despite its high priority, progress in tax and fiscal reform has been limited in 1996 and the first half of 1997. The tax system as a whole remains unstable, non-transparent and highly onerous for enterprises. There are major problems with the tax structure, the level of taxation, the application of taxation rules and tax administration. As a result, tax arrears and outright tax evasion are rampant. Tax collection seriously deteriorated during 1996 and the first quarter of 1997. A substantial part of taxes were paid in non-monetary forms (i.e. through commodity credits, tax offsets and promissory notes). In late 1996 an Emergency Tax Commission was established to crack down on the largest tax debtors. Following limited success during the initial months of its operation, the Commission managed to force a number of major enterprises, including the gas monopoly Gazprom, to pay off their tax arrears.

After repeated delays the new Tax Code was approved by the Duma in a first reading in June 1997. If it obtains final approval in late 1997, it may be phased in from early 1998. The draft 1998 budget submitted to the Duma in August is already based on the new tax regime. The new Tax Code provides for a major streamlining of the tax system, elimination of many tax privileges, a substantial reduction of the tax burden on businesses and clear delineation of the rights and responsibilities of tax payers and tax authorities. (On the Russian taxation system see also the box in Chapter 7.)

Social security

The current system of social protection is costly, inefficient and unsustainably extensive in its coverage. Currently over 200 categories of citizens, or more than 70% of the population, are eligible for various benefits (apart from housing subsidies) but, reflecting poor targeting, only an estimated 18% of the allowances reach families in need. The social safety net is financed through a range of extrabudgetary funds (the Pension Fund, the Employment Fund, the Social Insurance Fund and the Medical Insurance Fund), the local budgets and enterprise expenditures on social services. The extrabudgetary funds obtain their revenues from a combination of payroll taxes (adding up to close to 40% of the wage bill) and budgetary transfers. The financial position of all these funds has significantly deteriorated over the last year. The Pension Fund, with expenditures amounting to 4.5% of GDP in 1996, provides income support for 38 million people. The dependency ratio has

increased from 53% in 1994 to 57% in 1996. Pension arrears were paid off by July 1997.

A pension reform programme for 1996-2000 was approved in 1995 but no meaningful progress has been made in its implementation. The government is working on a number of new possible pension reform programmes. A final decision is expected to be reached in early autumn. All versions are envisaging a gradual transition from the current "pay-as-you-go", state-financed system to a multi-tier pension system combining the state-sponsored scheme with privately funded and managed schemes.

Legal transition

Pledge law

Pledges and mortgages are governed by the Pledge Law of 1992 and the provisions of the new Civil Code. Under Russian law, a creditor may obtain a security interest in both tangible and intangible movable property. Additionally, a pledge may be obtained in a changing pool of assets and also over an entire enterprise. Russia does not possess a unified and centralised registry system for non-possessory pledges. Notarisation is generally required for enforcement of non-possessory pledges. Notary fees are 1.5% of the underlying value of the contract. Enforcement of mortgages over movable property normally involves a court decision unless the parties agree otherwise. The sale must normally be conducted through public auction.

Company law

The Russian Law on Joint-Stock Companies came into effect on 1 January 1996. The law, which is comprehensive, includes many provisions for shareholder protection and also includes reasonably comprehensive corporate governance provisions. Shareholders must approve all significant transactions between an interested party and the company. (Interested parties include directors, officers and large shareholders.) Shareholders are entitled to vote by proxy at meetings. Companies with over 1,000 shareholders are required to send shareholders voting "ballot" forms in advance of meetings. If a third party acquires more than 30% of the outstanding shares of a company with more than 1,000 common shareholders, it must offer to purchase all of the remaining shares at a price not less than the weighted average purchase price for such shares in the six months preceding the acquisition of 30% or more of such shares. However, this obligation can be waived at a general shareholders' meeting or by the company's charter. The law also provides for cumulative voting whereby minority shareholders may pool their votes to ensure the election of at least one supervisory board member to represent their interests. Minority shareholders also have appraisal rights in the event of a take-over bid by a majority shareholder. Shareholders may bring derivative lawsuits against corporate management for decisions that injure the company or its shareholders. Directors are under an obligation to (i) avoid self-dealing, (ii) disclose any interests they have in material transactions with the company and its affiliates and (iii) act in the company's interest and exercise their rights and perform their duties with respect to the company in a conscientious and reasonable manner. Joint-stock companies must maintain independent share registries if they have more than 500 shareholders. Specialised licensed

registrars maintain such registries. Laws exist prohibiting insider dealing in shares of publicly listed companies.

Bankruptcy law

Under Russian law, a debtor is considered insolvent if it is unable to meet its liabilities as they fall due. The law provides for reorganisation proceedings whereby a majority of creditors can reach a binding settlement with the debtor. During bankruptcy proceedings, the court appoints a liquidator. The liquidator has relatively limited powers and, for instance, can only challenge transactions of the debtor concluded within a 12-month period prior to the liquidation. Liquidators must seek court approval before selling or disposing of the debtor's assets. Liquidators are appointed and monitored by the courts, and are required to possess special qualifications. There is no government body that supervises liquidators, although there is a functioning Federal Bankruptcy Agency. Transactions concluded within a fixed period of time prior to liquidation may be declared void. Under the new Civil Code, liquidation costs, personal injury claims, royalty claims by authors and employee remuneration rank higher in priority than claims of secured creditors during liquidation proceedings. For credit institutions attracting deposits of individuals, special rules of priority apply. Bankruptcy proceedings are handled by the arbitration courts.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published by the private and public sectors within one month of being passed. Important judgements are generally published and accessible to practitioners and provide written reasons for courts' decisions. There generally is a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait less than six months for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and one year for a final judgement for payment of a sum of money to be executed.

Slovak Republic

• *The privatisation process has proceeded rapidly. The government hopes to complete its programme of direct sales, which have usually taken the form of management buy-outs, during 1997. Privatisation of the main banks also remains to be completed.*

• *New import restrictions have been introduced, partly in response to growing external imbalances.*

• *The government has increased intervention in the enterprise sector through such measures as wage regulation and legislation on "revitalising" loss-making enterprises.*

• *Foreign investment remains very scarce though the government is considering new initiatives, including tax breaks.*

Enterprises

Size of the private sector

According to official statistics, the private sector is estimated to have accounted for 77% of GDP in the first quarter of 1997, up from 71% a year earlier. In the same period, the private sector share of industrial output increased from 66% to 70%, while about 75% of industrial employment is now in private enterprises. State ownership remains significant in capital-intensive sectors.

The private sector continues to expand. The number of private enterprises is growing and private sector companies are growing more rapidly than those in the state sector. The expansion of the private sector raised employment in privately owned industrial enterprises by over 8% in 1996 compared to a year earlier, while industrial employment in state-owned firms fell strongly over the same period. This trend is continuing in 1997.

Of 50,000 commercial organisations, less than 1,600 were majority-owned by the state in early 1997. However, the proportion of state ownership in larger enterprises remains high.

The shadow economy was estimated to have amounted to 12% of GDP in 1996, compared to about 13% in 1993 and 1994.

Privatisation

A comprehensive sell-off of state assets has been pursued through two privatisation "waves". The first of these was launched by the CSFR and had been completed by mid-1993. The majority of shares were distributed through a voucher-based "mass privatisation" scheme. The balance of the assets was sold by standard

methods including direct sales and public tenders. A second wave of privatisation commenced with the distribution of vouchers in 1994, but was cancelled in mid-1995. The 3.5 million voucher holders have, in exchange for their vouchers, received bonds maturing at the end of the year 2000. Before maturity, these bonds can be used to buy company shares in the National Property Fund's (NPF) portfolio, pay for apartments or health insurance. The bonds can also be used by companies to pay off debts to the NPF.

Privatisation has continued via direct sales, in particular through management buy-outs (MBOs). The terms of a sale are typically very favourable for the buyers. The average purchase price of shares was less than 40% of the book value in 1996. Still, only a fraction of the sales price reaches the NPF's account as the investment expenditures specified in the privatisation agreements can be used to offset payments.

The style of privatisation continues to be criticised for a lack of transparency. In June 1997, the National Property Fund sold a 15% stake in the petrochemical company Slovnaft, whose shares are actively traded on the Bratislava Stock Exchange, to the management for 20% of the market price. Transactions of this type appear to have reduced interest by foreign investors.

The pace of privatisation remained high in 1996, when the book value of companies whose majority ownership transferred from state to private was higher in real terms than in any of the previous three years. Of the companies privatised in 1996, 217 were fully state-owned enterprises and 118 were joint-stock companies in which the state had a majority share. In the first half of 1997, the NPF released only 26 privatisation decisions. In mid-1997, assets with a book value of about US\$ 1 billion remained to be privatised.

A law relating to state interests in companies came into force in 1995. It lists 29 companies which will not be privatised, mainly in gas and electricity generation, telecommunications, armaments and agriculture. A subsequent amendment in June 1996 added the names of the three largest banks and the main insurance company to this "negative" list. However, the effect of this amendment expired in March 1997 and it was then decided that two of the banks can be privatised (see below).

The law also lists a further 45 companies, some of which have already been partially privatised, in which the government had intended to retain a "golden share" (mainly in mining, chemicals, construction, engineering and the agricultural sectors). However, the Constitutional Court declared the golden share concept unconstitutional on the grounds that it violated the rights of other shareholders.

In November 1996, the Constitutional Court ruled that the government rather than the NPF is responsible for all direct sales of state property. The ruling does not apply retroactively.

The sale of small state-owned enterprises was largely completed during the first round of privatisation in 1992. A restitution law was adopted by the CSFR in 1990. 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% of shares in privatised companies.

Governance and restructuring

The main restructuring tools have been indirect: privatisation, limited access to credit and subsidies for enterprises, liberal rules of entry, and import competition. Restructuring has essentially been left to the new private owners.

This fairly decentralised restructuring process has produced some positive results. Labour productivity of industrial output has risen continuously since 1992 and now exceeds its pre-transition level. Productivity growth was initially driven by rapid downsizing of the workforce and in recent years by rising production with stable employment levels.

Many companies have been successful in finding new markets. The share of exports to the EU rose from 24% in 1993 to 41% in 1996, while the share of exports to eastern Europe and the former Soviet Union fell from 62% to 52%.

Despite these advances, profitability is low in many enterprises and appears to have worsened in 1996. Profits in non-financial enterprises with more than 25 employees contracted by more than 20% between 1995 and 1996. Only 45% of these firms were posting profits at all. Profits were concentrated among the utilities, retailers and transport companies. The profitability of manufacturing enterprises worsened significantly in 1996, when the sector as a whole recorded a net loss. On the other hand, profits grew strongly in smaller enterprises.

Enterprise restructuring has taken place virtually without foreign involvement. The style of privatisation has not created many opportunities for foreign acquisitions and investors have been hesitant to buy shares in Slovak firms. Total foreign direct investment in 1996 was less than 1% of GDP and portfolio investment remained minimal. The government is considering whether to actively encourage foreign investment, possibly through special tax incentives. It is envisaged that many managers-turned-owners would find it attractive to sell off their shares to foreigners. This "third wave of privatisation" could strengthen corporate governance and strategy. However, foreign interest may remain muted until transparency and fairness in privatisation and capital markets regulation is enhanced.

In a worrying development that could weaken market discipline, a law on the "Revitalisation of Enterprises" came into force in mid-1997.

A committee made up of government officials and bank executives will identify eligible companies which then receive state aid in the form of tax deferrals and debt forgiveness, conditional on criteria related to employment, social and regional development, as well as exports. These companies are also exempt from bankruptcy proceedings.

The Law on Bankruptcy came into effect in 1993, but the number of companies declared bankrupt has been small. Enterprise restructuring and market efficiency have been inhibited by the absence of exit of inefficient companies. A related problem is the large amount of bad company debt. Inter-enterprise arrears amounted to 18% of GDP at the end of 1996, a similar level to that in 1995, but down from 27% in 1993. Classified bank loans accounted for almost 20% of GDP, slightly down from 1995. The government plans to put forward a new draft law on bankruptcy in conjunction with the law on revitalisation.

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%. A general trend, however, has been for the funds to transform into holding companies and restructure their portfolios so that they hold a relatively large proportion of shares in fewer companies, thus accentuating the trends towards a concentration of ownership, which has also occurred as a result of direct sales.

Markets and trade

Price liberalisation

In 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. The current structure of electricity tariffs leads to cross-subsidisation from industry to households. A number of agricultural products fall under a minimum price regulation and surplus production is purchased by the government.

In April 1996, a law took effect allowing the Ministry of Finance to regulate the prices of certain goods and services in the domestic market, including gas and electricity. As part of a general economic package in mid-1997, the government raised taxes on petrol and diesel. Electricity prices for larger companies increased by 10% on average to 1.7 koruna (US\$ 0.05) per kWh, while households continue to pay a two-part tariff with a variable charge of 1.0 koruna (US\$ 0.03) per kWh. Subsidies for heating were cut, raising prices by 10%. Prices in the heavily subsidised railways system were raised in line with inflation.

Competition policy

Some sectors are highly concentrated, in particular banking, steel and petrochemicals. However, the liberal regime towards foreign trade and foreign investment assures some competitive pressure on most domestic companies. The Competition Law, passed in 1991 and amended in 1993, is implemented by the Anti-Monopoly Office which was active in a number of high-profile cases in 1996 and 1997. Current anti-trust legislation is mostly compatible with EU laws. However, special rights for "strategic" and "essential" enterprises are a matter of concern.

Trade liberalisation

The Slovak Republic became a member of the WTO in January 1995, succeeding the CSFR in its GATT membership. The trade provisions of the Slovak Republic's "Europe Agreement" became fully effective in February 1995 and ensure scheduled reductions of tariff barriers for EU industrial goods. The Slovak Republic has free trade agreements with both EFTA and CEFTA. The bilateral Payments Agreement for trade with the Czech Republic ceased to be effective in October 1995, although the customs union was maintained.

The unweighted average import tariff is 6.5% (at the 6-digit level). The average tariff is only 1.7% when weighted by imports from non-preferential trading partners. The simple and weighted average tariffs on EU imports are 3.9% and 3.1% respectively.

Partly as a result of a persistent current account deficit, the government introduced a range of protectionist measures in the spring of 1997.

These included an import deposit scheme which forces importers to deposit 20% of the imported value for 180 days in an interest-free account. However, the measure was replaced by the reintroduction of a 7% import surcharge (which had been reduced to zero in January 1997). It applies to some 80% of all imports. The import surcharge will be gradually reduced until its elimination in January 1999. Other new import barriers include laws against subsidised and "excessive" imports.

More permanent trade measures include an anti-dumping law and the establishment of an Exim bank. The bank opened in July 1997 and will finance and insure exports of public sector projects and those approved by the government. The bank is under the responsibility of the Ministry of Finance.

Currency convertibility and exchange rate regime

Full current account convertibility was established in October 1995. In December 1996, the National Bank of Slovakia announced further liberalisation of capital movements, especially with respect to cross-border loans and real estate transactions. In particular, residents will no longer require NBS approval for foreign loans with maturities in excess of three years. Some restrictions on the capital account remain.

The exchange rate is pegged to a basket in which the Deutschmark has a weight of 60% and the US dollar a weight of 40%. The NBS widened the fluctuation band around the central parity to +/- 7% in 1996. The widening of the band is intended to discourage speculative inflows of foreign capital.

Wage liberalisation

Wage policy is determined via collective bargaining on a tripartite basis between the government, employers and trade unions. Controls on wages were abolished in late 1994, but in mid-1997 – as part of a wider economic package – the government put forward regulation to curtail wage increases that exceed productivity gains. The measure applies in principle to all enterprises but it is expected to be enforced primarily for loss-making firms. In 1996, industrial real wages grew much faster than labour productivity. Real wages grew almost as rapidly in loss-making companies as in profit-making ones.

The minimum wage was set at 2,700 koruna per month (US\$ 80) in April 1996. The governmental Legislation Board has proposed an increase to 3,000 koruna (about one-third of the average wage) from January 1998.

Interest rate liberalisation

Interest rates were completely liberalised in 1992. In the second quarter of 1997, the NBS sharply reduced liquidity in the interbank money market to sustain the exchange rate against a number of speculative attacks. This led to volatile and high interest rates. The Bratislava Interbank Offer Rate (BRIBOR) ceased to be quoted when the NBS temporarily suspended its daily repurchase auctions in May.

Financial institutions

Banking reform

At the beginning of 1997, 29 banks were operating in the Slovak Republic, including nine banks with substantial foreign capital participation, five branches of foreign banks and two state-owned banks. The sector remains domi-

nated by the three main banks, the VUB General Credit Bank (48% state-owned), the IRB Investment and Development Bank (35%) and the Savings Bank (91%). These banks account for over 60% of all outstanding loans and over 70% of all deposits, while the majority of all personal deposits are held with the Savings Bank.

The privatisation of VUB and IRB was permitted by parliament in the spring of 1997, while the Savings Bank and the main insurance company – Slovenska Poistovna – remain excluded from privatisation until 2003.

Total bank loans grew at rates of around 20% during 1996 and early 1997, well above the growth rate of nominal GDP. During 1996, loans to private sector enterprises rose to 60% of all loans, while loans to the public sector fell to 28%. The share of loans to households remained stable at around 5%.

Non-performing loans remain a source of concern. At the end of 1996, classified claims amounted to almost a third of all loans in the banking sector. Most of these bad loans are on the books of the main banks. Uncovered losses decreased in 1996 due to higher provisioning.

The policy of the NBS over the last year has been to strengthen the banking sector by strengthening its own supervisory capability. The regulatory regime sets the required capital adequacy (following the Basle definition) at 8% by the end of 1996. Of 24 commercial banks, four failed to achieve this level. The banking sector as a whole achieved a capital adequacy ratio of 7.7% at the end of 1996, which is worse than in 1995.

The National Bank raised reserve requirements from 3% to 9% in August 1996. It also introduced a requirement for banks to hold a foreign assets/liabilities coverage ratio of at least 65% by the end of 1996. The banking system failed to fulfil reserve requirements in mid-1997 as the NBS sharply reduced liquidity in the money markets to defend the currency against speculative attacks.

The new Deposit Insurance Law, which came into effect in July 1996, provides protection for personal deposits up to a limit of 30 times the average monthly salary in the Slovak Republic. The Deposit Security Fund is financed by regular contributions from the banks.

Non-bank financial institutions

There are some 20 insurance companies, but the sector remains dominated by the state-owned Slovenska Poistovna. In 1996, total insurance premiums were 2.3% of GDP.

Securities markets and instruments

The Bratislava Stock Exchange and the RM-system (an over-the-counter exchange) began operations in 1993. The RM-system has 150 branches and trades in shares distributed under the voucher privatisation scheme. Foreigners are free to participate in the market for shares; profit repatriation is subject to payment of income taxes on capital gains. Foreign participation in the stock and bond markets remains negligible.

Total market capitalisation in mid-1997 was about 28% of GDP. Listed shares accounted for only about 6% of GDP. Turnover on the Bratislava stock exchange was 114 billion koruna (US\$ 3.8 billion) in 1996, 185% more than in 1995. Turnover of listed securities was about 50% of

the total. Anonymous trading accounted for 14% in all transactions. Securities turnover recorded an annual increase of about 50% in the first half of 1997, mostly driven by bond trading.

In December 1996, parliament approved an amendment to the Securities Act after an earlier version, which would have allowed companies to withdraw their shares from public trading, had been returned by the President. The amendment legalises issuance of bearer shares, but prohibits the conversion of registered shares into bearer shares. Further changes to the Securities Act are being developed. A new law allows trading of foreign issues on the Slovak capital market. A planned amendment to the Law on Investment Funds will allow open-ended funds, but will not remove the restrictions on the funds' role in corporate governance.

In 1996, treasury bills worth 120 billion koruna (US\$ 4 billion) were issued with maturities ranging from 3 to 28 days. There were four auctions for government bonds (with maturities of 12 and 18 months), of which three were floated. There were 56 placements of non-government bonds with a value of 22 billion koruna, compared with 11 billion koruna in 1995. In July 1996 bond issues by both the EBRD and the IFC saw the opening of the Euro-Slovakian koruna market.

Fiscal and social safety net reform

Taxation

A comprehensive tax reform was implemented in 1993, introducing a VAT in two tiers, streamlining corporate and individual income taxes, and transferring funding for social security from general taxation to an insurance-based system. Revisions in 1994 reduced the corporate tax rate to 40%, and the maximum personal income tax rate to 42%. The government is considering raising the VAT rate in the lower band to 7% and including more items in the upper band (taxed at 23%) as part of the 1998 budget.

Tax revenues accounted for 26% of GDP, while social insurance payments accounted for 17% of GDP in 1996. This implies a drop in the share of taxes in GDP and a rise in the share of social insurance in GDP relative to 1994 and 1995. Direct taxes accounted for 45% of total tax revenue. The government plans to gradually increase the share of indirect taxes and reduce the share of direct taxes in total revenues.

In 1997, the government began to prepare measures to make financial flows in Slovak companies more transparent in order to reduce tax evasion. In particular, banks are now required to report deposits or withdrawals of cash over 500,000 koruna (US\$ 15,000) to the police. Up to 45 billion koruna (US\$ 1.5 billion) is lost annually through tax evasion, according to official estimates.

Social security

Employers and employees contribute 38% and 12% respectively of the employees' gross income for pension, unemployment and health contributions.

About 15% of the population are over 60 years old. Spending on pensions was below 9% of GDP in 1996. The average pension was 46% of the average gross wage. While the Social Insurance Company, including the pension fund and the sickness fund, has been balanced,

there are plans to reform the public pension system in order to assure funding for the future. An important issue is the low retirement age, currently 60 for men and between 53 and 57 for women.

Legal transition

Pledge law

The creation of pledges is governed by the Civil and Commercial Codes, which were amended in 1991. Movable goods that are the subject of a pledge agreement must normally be taken out of the debtor's possession. Alternatively, creditors may obtain a transfer title (there are no adverse VAT or gift tax implications as in the Czech Republic). It is unclear whether pledges may be created on future property or user rights. There is no unitary or centralised registry for non-possessory pledges. Enforcement of a pledge normally requires court assistance.

Company law

The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not minimum share capital) is often over US\$ 1,000. The process takes between one and three months. Share registries must be maintained for book-entry securities. This service is performed by a quasi-governmental body. Shareholders are entitled to vote by proxy. Companies are not required to send shareholders proxy forms in advance of meetings. Shareholders are permitted to solicit proxies for votes on proposed resolutions to be considered at the meetings. There is no cumulative voting for directors. A shareholder acquiring a holding in publicly tradable shares carrying voting rights which amount to or exceed 50% of the outstanding shares of a target company must offer to purchase the remaining publicly tradable shares for a price not lower than the weighted average trading price during the six months before the acquisition. This requirement cannot be waived by the shareholders or the directors of the target company. Shareholders possess pre-emptive rights with respect to new share issues. Directors are under an obligation to (i) perform their functions in good faith and (ii) avoid self-dealing.

Bankruptcy law

The definition of insolvency is when (i) the debtor is unable to meet its debts as they fall due or (ii) its liabilities exceed its assets. The law provides for a reorganisation system whereby a majority of creditors can reach a binding settlement with the debtor. The law does not, however, provide for an automatic stay of legal proceedings against the debtor during reorganisation. During bankruptcy proceedings, the court appoints a liquidator, who is required to possess specific qualifications. The conduct of liquidators is not regulated by any particular body. Transactions with third parties that are (i) not at arm's length, (ii) below fair value, (iii) entered into within a fixed period of time prior to liquidation or (iv) grossly defraud the creditors may be reviewed and declared void. Liquidation costs, taxes, wages, social security claims and personal injury claims rank higher than secured claims.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published up to six months after being passed. Important judgments are generally published and accessible to

practitioners and provide written reasons for courts' decisions. There is generally a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between seven months and one year for a commercial case to be heard on the merits by a court in the most important commercial centre and between one and two years for a final judgement for payment of a sum of money to be executed.

Slovenia

- *Increased restrictions have been placed on capital inflows, preventing a real exchange rate appreciation.*
- *Banking sector activities have been over-regulated, which has had the effect of further restricting competition and exit in the sector and limiting the access of domestic companies to credit.*

Enterprises

Size of the private sector

According to unofficial estimates, the private sector accounted for about 55% of output and employment in 1996.

Slovenia has a high proportion of small enterprises: 93.4% in 1996. However, the rate of enterprise creation has sharply declined since the beginning of transition, due among other things to high interest rates and tight access to credit.

Privatisation

Privatisation of "socially managed enterprises" through a voucher-based mass privatisation envisaged the distribution of a maximum of 20% of the company shares free of charge to incumbent employees, the transfer of 40% of the shares to three state-run funds (the Development Fund, the Pension Fund and the Restitution Fund), and the sale of the remainder to management/employees or outside investors.

By June 1997, of the initial 1,594 enterprises eligible for privatisation, 1,400 had their privatisation plans approved. Of these, over 1,000 were privatised. Privatisation plans were either completed or are being implemented for over 95% of the equity of companies in trade and industry. Enterprises that did not complete privatisation under the 1992 law by 1 July 1997 have been put under the jurisdiction of the Development Fund.

There is majority insider control in 65% of privatised companies, but these account for only 16% of the total equity of the 1,594 enterprises. Large capital-intensive enterprises have tended to choose other privatisation options, such as public offerings on the stock market.

Large public utilities are still majority or fully state-owned. Almost all small-scale trade and services are in the hands of the private sector.

Given the size of restitution claims, the Restitution Fund appears to be under-capitalised. In July 1997 parliament voted in favour of a constitutional amendment that would allow foreigners to own property.

Governance and restructuring

Privatisation has resulted in a pattern of ownership rights that is very dispersed and fragmented among three groups: (i) institutional investors (the Pension Fund and the Restitution Fund, local voucher and foreign asset management funds and local banks), (ii) insiders and (iii) small investors.

The state-owned Development Fund of Slovenia, SKLAD, set up in 1992 to restructure, privatise and liquidate 98 problem enterprises (only 24 of which remained in its portfolio at the end of 1996) is to be restructured and recapitalised into the "Slovene Development Company". This will assist any Slovene enterprise in its restructuring efforts as well as deal with those socially managed enterprises that were not privatised by July 1997.

Official data on enterprise performance show that losses occurred in 31.6% of the total number of enterprises in 1996. Loss-making enterprises are generally large and concentrated in manufacturing, mining and electricity. Small companies are on average more profitable than large companies.

Enterprise data confirm that restructuring in large and unprofitable enterprises has still a long way to go, though some efforts have been made to break up large enterprises into smaller units. The liquidity problems experienced by a core group of large loss makers affect (through spill-over effects and a build-up of inter-enterprise arrears) the small and profitable enterprises as well.

Markets and trade

Price liberalisation

Most prices were liberalised by mid-1994. Electricity prices are steadily being raised and in June 1996 amounted to just over 70% of EU equivalent levels. In the first half of 1997 the energy price was raised by 15% and telephone charges by 5%. Natural gas prices are close to EU levels. In mid-1997 the government raised the price of postal services, petrol and domestic telephone charges.

Competition policy

Entry barriers have been completely removed in the manufacturing sector, but not in agriculture and services.

The 1993 Law on Protection of Competition introduced two new institutions to implement the law: the Competition Protection Bureau (CPB), which handles restrictions on competition, dumping and subsidised imports, and the Trade Inspectorate, which deals with unfair competition, illicit speculations and restrictions on free market access by state or local authorities. The CPB is an autonomous body under the auspices of the Ministry for Economic Relations and Development. Out of 12 cartel investigations since 1994, the CPB detected and prohibited three. Out of nine investigations of vertical agreements, the CPB detected two and prohibited both. Out of 12 investigations on abuse of a dominant position, three abuses were prohibited. In July 1997 the Constitutional Court found the mobile telephone monopoly of the state-owned company Mobitel to be illegal.

Trade liberalisation

By end-1994, 98% of imports were free from quantitative restrictions. In 1996 customs rates varied from 0% to 27%, and the weighted average MFN tariff rate was about 9%.

The government is committed to further liberalisation and to the elimination of all non-tariff barriers, which are still substantial in sectors such as telecommunications and electrical equipment.

Slovenia became a full member of GATT in 1994 and of the WTO in July 1995, and joined CEFTA in January 1996. In June 1996 it signed an

Association Agreement with the EU and, subsequently, an Interim Agreement, which entered into force in July 1997. Slovenia is among the five east European countries that the European Commission has recommended to be included in negotiations in the next wave of EU enlargement. It has other free trade agreements with the Baltic states, Bulgaria, FYR Macedonia, Israel and Romania.

Currency convertibility and exchange rate regime

The Slovene tolar was introduced in 1991 and is fully convertible for current account transactions. The exchange rate is floating. Foreign investors are permitted to repatriate profits and capital.

During the past year the central bank intensified efforts to restrict capital inflows from abroad. Foreign currency loans to a Slovene beneficiary (including foreign deposits in Slovene banks, but excluding loans contracted for the purpose of importing capital goods) with less than seven years' maturity require a non-interest-bearing deposit with the central bank of 40% of the loan amount. The deposit requirement is 10% for financial loans of more than seven years' duration. Non-residents are obliged to open custody accounts with domestic banks for the purpose of conducting portfolio investments in Slovenia, except when the investor holds on to purchased shares for over seven years, trades them abroad, purchases control packages of shares or purchases newly issued shares.

Wage liberalisation

In 1995 and 1996 a "Social Agreement" between the government and representatives of employers and employees set out guidelines in the labour market, including wage indexation and social security contributions. After the 1996 Social Agreement expired in May 1997 without a new agreement having been reached, parliament adopted a Law on Minimum Wage, which set the minimum wage at 59,150 tolar (US\$ 383) per month (about 40% of average earnings) and confirmed that the base wage is to be indexed to the retail price index.

Collective agreements between the government, employers and trade unions set out minimum pay rates for nine education and skill categories of jobs. Further bargaining can take place at the industry or enterprise level. In September 1996 the employers cancelled the Collective Tripartite Agreement for the Market Sector. The employers proposed a series of reductions in non-wage allowances. This led to strikes in late 1996.

Non-wage allowances and social security contributions are a substantial part of labour costs. Public sector wages are about 27% higher than those in the private sector.

Interest rate liberalisation

Commercial banks are free to set their deposit and lending rates. However, since April 1995, a ceiling on deposit rates has been agreed between banks through "temporary agreements" which are renewed yearly. This collusive behaviour has not been declared a cartel by the Competition Protection Bureau. Interest rates have decreased since 1995 both in real and nominal terms, but real lending rates are still around 10%.

The government is gradually reducing the backward indexation of interest rates to inflation rates.

Financial institutions

Banking reform

There are 29 banks operating in Slovenia, of which 14 have a full licence. Currently, 12 banks have some foreign participation, though only four are majority foreign owned. Two privately owned banks have a nationwide branch network (SKB & A-Banka). About 40% of the assets in the banking sector are held by the state.

Banking supervision is well developed. Since 1994, all banks have satisfied the minimum capital adequacy ratio of 8%. Most banks are highly capitalised. At the end of 1996 all but two banks were profitable. The share of non-performing assets declined from 7.6% in 1993 to 3.9% in 1995. Productivity and efficiency are, however, still low, especially in some smaller banks.

The liquidity of banks oscillated during 1996. Large banks did not suffer, but a smaller bank, KBT, was forced into liquidation during summer 1996 due to insufficient liquidity. The central bank declined to rescue it. This episode prompted the central bank to adopt further precautionary measures in August 1996, such as the alignment of the maturity of new bank deposits and loans. A stand-by mechanism was set up in case of similar events in the future. All banks now voluntarily hold some level of secondary liquidity.

Competition in the sector is artificially restrained by a collusive agreement on setting interest rates (see section above).

A bank rehabilitation programme was started in 1993 with the placement of two of the largest banks in the Bank Rehabilitation Agency (BRA). Of the non-performing loans that ended up in the portfolio of the BRA, 32% were recovered, mostly small company debt. In July 1997 both banks were released from the BRA, and are now ready for privatisation.

Despite the progress achieved so far, the sector is still relatively shallow. Total banking assets are relatively low at 70% of GDP. The ratio of the main money aggregates to GDP is much lower than in the OECD. There is widespread use of foreign currencies for deposits, loans and unit of account. As this element complicates the task of monetary policy, the central bank has increased restrictions on banks' operations in foreign currencies since 1995.

Non-bank financial institutions

About 80 "Authorised Investment Companies" managed by 24 management companies are licensed to collect "ownership certificates" and issue shares. They are closed-ended investment funds which can participate in auctions organised by the development fund, SKLAD, where shares of privatised companies are sold for cash or ownership certificates. Subscription is still under way in 11 investment companies; the remainder have closed.

The insurance sector consists of 15 local insurance companies (of which two are reinsurance companies), which generated a total gross premium income of US\$ 858 million in 1995. Triglav, the state-owned company, has a 45% market share, and the top four companies control in excess of 90% of the market. Foreign operators are allowed to operate in the insurance market. However, foreign interest has been low due to the relatively small size of the local market.

Securities markets and instruments

Slovenia's capital market is still very small. The Ljubljana Stock Exchange (LSE), founded in 1989, had a total market capitalisation of US\$ 1.9 billion, or 10% of GDP, as of 30 April 1997 (75% shares and 25% bonds). About 60 companies are quoted, including almost 40 which are not fully listed, and 40 bonds are traded on the LSE. In April 1997 average daily turnover was US\$ 1.3 million. In January 1995 an over-the-counter market was opened on the LSE with eight companies acting as brokers. Futures trading started in March 1996.

Growth in the equities market has advanced slowly, in line with the progress made with privatisation. With few exceptions, Slovene companies have not yet used the LSE as a means of raising new capital. Constraints such as the recently introduced custody accounts requirements for foreign portfolio investors hinder market development. Banks are not allowed to convert into tolar the foreign currency received for payment of portfolio investments. Fees currently charged by banks for custody accounts reflect the opportunity cost of keeping foreign exchange reserves rather than lending the money domestically. The impact of this measure was a 20% fall in share prices within days of the introduction of the decree, while average daily turnover dropped by 70%.

The bond market is currently dominated by issues of government bonds. A functioning secondary market for short-term government securities and a more long-term corporate bond market are still to be established. The instruments issued at present are more sophisticated than simple bills and notes, which would be more efficient in helping to establish a benchmark and the beginning of a yield curve. By issuing or writing rather sophisticated financial instruments, some of which include warrant clauses options, the central bank effectively sells inflation and exchange rate insurance to the private sector.

Fiscal and social safety net reform

Taxation

Following a comprehensive tax reform during 1990-93, corporate profits are taxed at a flat rate of 25%. One-fifth 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% and a maximum rate of 50%. There is a sales tax of 20% for goods and 5% for services and equipment. Dividends are taxed at a 25% rate for residents and 15% for non-residents. Losses may be carried forward for five years. From January 1997 a 30% capital gains tax on securities held by individuals for less than three years was 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 the tax burden more towards indirect taxes. VAT will be introduced in January 1998.

Social security

The government is pursuing a policy of reducing the social security contribution rate. Social security payments are contributed at a total rate of 38% of the gross wage (22.1% from the employee and 15.9% from employers), down from 42% in July 1996. The pay-roll tax and its 13.6% ratio of pensions to GDP are high by European standards. There has been a sharp

fall in the ratio of contributors to pensioners. The elderly dependency ratio is projected to rise from the current 48% to 90% in 2040. The authorities are evaluating possible models for reform of the pension system.

Legal transition

Pledge law

The creation and enforcement of non-possessory pledges is governed by the 1990 Law on Execution Proceedings. A non-possessory pledge may be created by written agreement. It is unclear whether a non-possessory pledge may be created in future property, a changing pool of assets and user rights. There is no unitary or centralised registry for non-possessory pledges over movable property. A non-possessory pledge becomes enforceable by court approval pursuant to the Law on Execution Proceedings. This process takes less than a week. The court fees for approving the pledge vary but are capped at approximately US\$ 1,500. The court approval has the effect of a final settlement so that a creditor is not required to file a civil suit in order to enforce the pledge. A creditor must seek court assistance to enforce the pledge and to sell the property. Enforcement is much shorter under this procedure (civil suits can take more than two years). These procedures apply predominantly to pledges over equipment. There are separate registration proceedings for several types of movable property including shares (for which there is a separate registry).

Company law

The cost of formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) may exceed US\$ 1,000. The process takes between one and three months. The courts maintain a share registry. Shareholders are entitled to vote by proxy at meetings. Companies are not required to send shareholders proxy forms in advance of meetings. Shareholders may solicit proxies for votes on proposed resolutions. There is no cumulative voting for directors. A company that acquires more than 25% of the shares of a target company must offer to buy the remaining shares at the same price. Shareholders possess pre-emptive rights with respect to new share issues. Directors are under an obligation to (i) perform their functions in good faith and (ii) avoid self-dealing. Laws exist prohibiting insider dealing in shares of publicly listed companies.

Bankruptcy law

Bankruptcy proceedings are governed by the Law on Forced Settlements, Bankruptcy and Liquidation, which was amended in July 1997. Forced settlement is the term used for reorganisation. The definition of insolvency is when a debtor is unable to meet its liabilities as they fall due. The law permits a reorganisation system whereby a majority of creditors may reach a binding settlement with the debtor. The settlement must be approved by creditors representing 60% of the total value of claims. In bankruptcy proceedings, a liquidator is appointed by the court. The liquidators must possess special qualifications and their activities are regulated by a government body. Liquidators possess broad powers. Transactions with third parties entered into within a fixed time prior to liquidation may be reviewed and declared void. Liquidation costs, personal injury

claims and wages (for three months) rank higher than secured claims. There are no specialised courts or judges handling bankruptcy proceedings.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and published within one month of being passed. Important judgements are generally published and accessible to practitioners and provide written reasons for courts' decisions. There is generally a meaningful right of appeal from first-instance court decisions. It appears that there is an independent right of judicial review of administrative action. On average, a party can be expected to wait between seven months and one year for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and two years for a final judgement for payment of a sum of money to be executed.

Tajikistan

• Continued political instability and armed conflict limited the effectiveness of the renewed reform efforts of early 1996 and led to a return to lax financial policies that have threatened macroeconomic stability.

• A number of trade restrictions in the form of increased customs and excise duties were introduced to generate revenues for the budget and to protect local producers.

• The government has steadily increased its intervention in the foreign exchange market in the face of a substantial currency depreciation in recent months.

Enterprises

Size of the private sector

The growth of the private sector has been limited. Apart from the ongoing civil conflict in the country, governmental interference in product markets and the slow pace of privatisation have hindered private sector development. The share of the private sector in GDP is estimated at about 20-30%.

Privatisation

In 1996 a new privatisation programme was launched by the Tajik government, which aimed at privatising about 40% of all small enterprises and around 10% of all medium-sized enterprises by the end of 1997. The programme introduced privatisation vouchers, which were to be distributed to compensate for government arrears on wages and pensions. Vouchers can only be used for purchasing shares of state-owned enterprises to be privatised under the programme. The new programme also called for the transition of medium-sized and large enterprises into joint-stock companies by 1 September 1997. This target is unlikely to have been met: as of mid-1997, only 11% of medium-sized and large enterprises were privatised.

Between 1995 and end-1996, 1,459 small firms (about 20% of all small enterprises), out of the 6,400 enterprises subject to privatisation, were sold to the private sector. Of these, only 160 were state properties, and the rest were communally owned.

Private ownership of agricultural land is not envisaged; land has been assigned to agricultural collectives or joint-stock companies without the right of resale, or leased to farmers on a long-term basis. In December 1996, the government approved the first guidelines on land allocation and the transferability of land access rights. A Land Reform Committee (LRC) was set up, charged with the tasks of designing and implementing the land reform programme, as well as creating local land reform committees at the oblast, rayon and commune levels.

The number of individual leasehold farms created out of agricultural collectives rose from 670 in 1994 to about 5,000 in mid-1997 (covering about 40,000 ha). At the end of 1996, nearly 17% of all arable land was in private hands. Three of the 26 government-owned cotton ginneries have been privatised to date (out of the nine targeted) by sale to employees. The Ministry of Agriculture has set out plans to privatise a further 10 during the course of 1997.

In June 1997 the EU granted ECU 8 million to the Tajik government, to help the Ministry of Agriculture and the State Committee on Land Reform in carrying out the reorganisation of agriculture and the privatisation of facilities in the agro-industrial sector.

Almost all dwellings have been privatised. There has been no property restitution.

Governance and restructuring

As of mid-1997, there have been few serious enterprise restructuring efforts in Tajikistan. While political instability has been a factor, the main reason appears to be the lack of implementation of the bankruptcy and related enterprise adjustment laws. While the government has identified loss-making enterprises under the 1995 Decree on the Identification of Bankrupt Enterprises, only a few of them were forced into bankruptcy and the decree has not been implemented. Obstacles to restructuring include difficult entry and exit rules, lack of finance, limited access to business information, strict labour regulations and an incomplete legal framework.

Markets and trade

Price liberalisation

Prices of electricity, fuel, telecommunications and transportation are controlled. Utility tariffs fall far short of covering costs. Price controls on all agricultural commodities were eliminated between August 1995 and March 1996.

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. The 1996 decree on privatisation contains an anti-monopoly clause, which requires the break-up of large enterprises prior to their privatisation.

Trade liberalisation

Tajikistan's trade regime has been only recently reformed. The first wave of liberalisation occurred in May 1995, when state monopoly export controls on goods were reduced from 54 items (70% of total exports) to only six items, and state export rights were abolished for all commodities. Licensing requirements for agricultural imports and exports were completely eliminated for all products between August 1995 and January 1996. In February 1996, the state order system was effectively abandoned with the abolition of the state monopolies on cotton and aluminium.

The authorities have recently adopted an import tariff structure, with rates ranging from zero to 25%. Import tariffs were imposed on five product categories (alcohol, tobacco, audio equipment, cars and carpets).

Surrender requirements on export receipts were replaced with repatriation requirements on export earnings in February 1996. In early 1997

the government reintroduced export taxes on some selected commodities (primarily grain and scrap metals), ranging between 50% and 100%. Demands by domestic producers for greater trade protection have recently arisen as a consequence of reduced external competitiveness. Recent barter trade arrangements have officially been prohibited, with the exception of contracts involving aluminium. Despite these developments, a large share of external trade is still handled by state organisations. A number of administrative regulations are still in place, particularly in the cotton sector, that discourage direct exports by producers.

Currency convertibility and exchange rate regime

In principle, the Tajik rouble, the country's official currency since May 1995, has a floating exchange rate. The deterioration of the macro-economic situation led to sharp depreciation of the currency. It fell from Rb 328/US\$ in December 1996 to Rb 750/US\$ in September 1997, and the black market premium reached 13% in the same month. Owing to a shortage of foreign exchange rate, the government tightened its controls and only a few auctions took place during the first half of 1997. Weekly auctions have since been resumed in accordance with the IMF programme. However, access is tightly regulated and the administrative setting of the official rate by the National Bank is subject to heavy official intervention.

The government and the central bank still control major foreign exchange transactions, acting through directed credits instead of official auctions, and almost all resources are allocated administratively. As a result, the functioning of the foreign exchange market has been greatly impaired. The central bank still exercises *de facto* control over all hard currency earnings. Capital transactions require licensing by the central bank, but there are no legal restrictions on the repatriation of profit and capital by foreigners.

Wage liberalisation

State sector wages are still tied to the minimum wage through norms set by the government via the Law on Wage Indexation, enacted in December 1993. Outside the budgetary sphere, however, centralised wage setting no longer exists. At the end of 1996, the average monthly wage was about Rb 4,000 (US\$ 13), one of the lowest in the former Soviet Union.

Interest rate liberalisation

The liberalisation of all commercial bank interest rates in December 1995, with the exception of on-lent central bank funds and priority sector loans, led to a rise in deposit rates from an average 25% during the preceding months to an average 120%.

Lending rates were also increased from an average 45% in early 1995 to an average of 160% by the end of 1995. There has been little change in the level of nominal interest rates since then and thus interest rates remain negative in real terms. In addition, the National Bank of Tajikistan (NBT) still imposes maximum lending margins on commercial banks and directs credit resources to priority sectors. Credit allocation has favoured priority sectors such as agriculture and regions affected by natural disasters.

Financial institutions

Banking reform

In February 1991 the Law on Banking Activities and the Law on the National Bank established a two-tier banking system. On 14 December the Law on the National Bank of Tajikistan was adopted.

Apart from the National Bank, to date 26 banks have been officially registered in Tajikistan. Three of these, Agroprombank, Orientbank and Tajikbankbusiness (formerly the state-owned Gosbank), account for more than half of total lending. They hold foreign exchange licences. Sberbank remains the dominant institution in mobilising the savings of the general population.

The NBT still retains a significant role in intermediation and continues to use the old Soviet accounting system. However, a new chart of accounts developed by Arthur Andersen is to be introduced as a pilot project in several banks this autumn, and will be formally introduced across the banking sector in 1998.

Banking regulations were approved by the National Bank board in August 1995, dealing with reserve requirements, asset concentration and the banks' asset-liability structure. In January 1996 the minimum capital requirement for newly created banks was set at US\$ 300,000; there has been no change to that amount. A number of existing banks already comply with this requirement. More than 80% of the total paid-in capital must be in the form of cash (Tajik roubles only). Foreigners are not allowed to own more than 49% of the equity capital of a domestic bank.

Banks are inspected annually by the Supervision Department of the Central Bank, which produces its own annual "audit" of the bank. A law on collateral was introduced in mid-1995. A draft new commercial bank law has been produced. It is being reviewed by World Bank consultants and is planned to be presented to parliament in late 1997 or early 1998.

Non-bank financial institutions

One state and several cooperative insurance companies are operating but reportedly bankrupt.

Securities markets and instruments

A securities market has been established but it is not yet operating.

Fiscal and social safety net reform

Taxation

There has been no significant change in the structure of taxation in 1996 and 1997. VAT remains at 20%. A flat sales tax of 3% introduced in addition to VAT from 1 July 1994 also remains in effect. Excise duties on domestic products, which account for a significant portion of tax revenue, range from 10% (on jewellery) to 90% (on alcohol). The profit tax rates range from 25% (for farmers and small enterprises) to 60%, with the standard rate at 40% (55% for banks). Personal income is taxed at progressive rates, up to 40% for monthly income of more than 43 times the minimum wage.

In 1995, largely due to bread price subsidies, the budget deficit increased dramatically, to 21% of GDP (on an accruals basis). In an effort to combat this, the Tajik government took a series of measures in late 1995 and early 1996 including eliminating the link between bread

subsidies and the minimum wage, as well as restructuring budgetary functions. As a result the government managed to achieve the target budget deficit, of slightly more than 5%, in 1996. The situation significantly worsened in 1997, however, and in the first half of the year the deficit was around 10% of GDP (on a cash basis). While 1997 tax collections have been stronger than in 1996, they have not been able to keep pace with rapidly rising expenditures, largely driven by expenses on military equipment.

The government has recently set out plans to create a State Treasury, with branches to be established in all of the 73 districts of the country by end-1997. The aim is to increase financial control over budget revenue and spending.

Social security

There has been almost no change in social security arrangements in 1996 and 1997. A payroll tax is levied on the monthly wage bill of enterprises at the standard rate of 37%, of which 85% goes to the Pension Fund and 15% to the Social Insurance Fund. Employees pay 1% 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% of wages and the government budget also contributes.

In January 1997 the Ministry of Finance decided to shift the responsibility for social safety net payments to local governments, without, however, a commensurate decentralisation of revenues.

Legal transition

Pledge law

Under the Law on Mortgage (adopted in June 1994), it is possible to take a non-possessory security interest in tangible and intangible movables, future property, a changing pool of assets and an enterprise. Notarisation and registration are required for immovables, goods in circulation and enterprises. There is no centralised registry for pledges over movable property. Enforcement of pledges requires assistance of the court. Sales must be in accordance with the Civil Procedure Code.

Company law

The principal legislative act on joint-stock companies is the Law on Joint-Stock Companies of December 1991. There is also a Law on Enterprises of 1995. The law suggests that it normally takes between one to three months to form and register a joint-stock company. A registration fee of US\$ 200-1,000 applies. It is unclear what additional legal, notary and court fees may be associated with the formation of a company. Companies are required to maintain a share registry and this function may be delegated to an independent licensed registrar. Shareholders are entitled to vote by proxy at meetings. Companies are not required to send shareholders proxy forms in advance of meetings. Minority shareholders are not afforded protection if a company makes a bid for less than all the shares of a target company. The law does not give existing shareholders of a company pre-emptive rights with respect to new share offerings. The law does not provide for cumulative voting by shareholders for the election of supervisory board members. There are no statutory obligations imposed on directors to (i) perform their duties in good faith, (ii) avoid

self-dealing and (iii) disclose personal interests in material transactions with the company and its affiliates.

Bankruptcy law

Tajikistan enacted the Law on Bankruptcy of Enterprises in 1992. The definition of insolvency is when a debtor is unable to satisfy its obligations to creditors and pay taxes on a timely basis. A petition may be filed if a debtor's liabilities are 90 days past due. It would appear that the debtor is responsible for filing an application without delay in circumstances when it is insolvent. Bankruptcy proceedings are handled by the Arbitration Court. The law permits reorganisation schemes whereby the creditors (representing two-thirds of total claims) can reach a settlement with the debtor, which must be approved by the court. A liquidator is chosen by the creditors and approved by the court. The liquidator has the power to take stock of the debtor's assets, manage its property, administer the liquidation plan and sell the debtor's property. The liquidator may investigate and dispute transactions concluded by the debtor during the six-month period prior to the liquidation. In liquidation proceedings, liquidation expenses rank higher in priority than all other claims. It is unclear whether government taxes, social security claims and employee remuneration claims rank higher in priority than claims of secured creditors.

General legal effectiveness

Survey data not available.

Turkmenistan

• Further price adjustments have taken place in the wake of the 1996 liberalisation programme. In agriculture only wheat and cotton prices remain controlled. Land reform has been announced: all cooperative land has been distributed to individual farmers, with the prospect of privatisation in two years.

• Major weaknesses remain in the area of large-scale privatisation (although an acceleration of the process has recently been pledged), corporate governance, trade and exchange rate liberalisation and financial sector development.

Enterprises

Size of the private sector

According to government estimates, officially recognised private production or service units employed about 22% of the labour force and accounted for 10.1% of GDP in 1995 (4.4% excluding private agriculture). Government estimates indicate a total private sector share of GDP of about 18% in 1995, including "home industry" and Sunday market trading. No recent estimates are available but, due to slow progress with privatisation and remaining barriers to entry, the total private sector share is presently unlikely to exceed 25% of GDP. The share of the private sector in GDP and employment would increase to around 35% and 65% respectively if agriculture were fully privatised, as envisaged under the decree on land reform of late 1996.

Privatisation

Privatisation in Turkmenistan has progressed slowly so far, involving primarily small-scale service units. Foreign involvement has been limited to a few joint ventures in oil and gas, textiles and banking. A significant acceleration of the process has been pledged in a series of presidential decrees in April and August 1997. These provide for the privatisation of the majority of medium-sized and large enterprises (up to 330 firms may be concerned) through public tenders over the coming years. Only 45 firms, primarily in public utilities, are exempt from privatisation according to these latest decrees.

At the end of 1996, no large enterprises had been transferred to majority private ownership. However, a total of 10 joint-stock companies had been created from among the large-scale industrial enterprises to be privatised by public tender. In the first half of 1997, a handful of medium-sized factories were privatised by public tender. Most significantly, a 50% stake in the Ashgabat Ice Cream Factory was sold to a Turkish investor for 10 billion manats (US\$ 2

million). Overall during the first seven months of 1997, a total of 108 enterprises (predominantly small) were privatised, raising 63 billion manats (US\$ 16 million). Of these, 93 enterprises were auctioned off, 14 taken over by worker collectives and one enterprise privatised through an investment tender.

In Turkmenistan, large-scale privatisation is usually initiated by line ministries, which formally hold the ownership rights in public enterprises. In 1996, six departments of the Ministry of Agriculture (responsible for the bulk of industrial enterprises outside the energy sector; mainly textiles and food processing) were turned into "associations", which 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. Proposals are submitted to the privatisation agency and decided upon by an intergovernmental committee. Following a new law, private investors (including foreigners) are allowed to bid for a 51% stake. The incentives for the associations to initiate privatisation are contradictory. One the one hand, attracting a foreign investor can significantly ease access to foreign exchange and government concessions. On the other hand, all sales revenues accrue to the Ministry of Finance. Moreover, majority private ownership is subject to approval by the Council of Ministers and contracts can be cancelled within three months of the initial agreement. This, and the poor technological condition of most medium-sized firms, has so far limited foreign interest.

Small-scale privatisation has proceeded more rapidly, as elsewhere in the region. In the first stage of the government's privatisation programme (enacted in 1993), up to the end of 1996, ownership had changed in 1,856 small units (mainly catering shops, tailors, hairdressers, laundries and repair shops). This was largely achieved in 1995, with only 204 enterprises privatised during 1996. Of these small units, 20% were auctioned off to private individuals and the remainder purchased by cooperatives. These 1,856 "privatised" units represent approximately 44% of all the previously state-owned small units (with "small units" defined as those with fewer than 20 employees). Only 10% of all shops, including small outlets for fruit and vegetables, were privately owned by 1996. Partly in response to evidence of the rather disappointing performance of employee-owned enterprises, at the end of 1996 it was announced that the remaining 2,000 or so small units would be privatised exclusively by auction. One of the greatest achievements in the establishment of private ownership rights has been made in agriculture. In December 1996, a land reform initiative was announced, allowing for private ownership in land. During the first half of 1997, almost all land (total arable land is around 1.7 million ha) has been allocated to individual farmers and the transfer of land titles to private ownership is envisaged after a two-year lease. The creation of private ownership titles in land represents a breakthrough by regional standards. However, the land reform will develop its full impact on the productivity of the rural sector only if input and output markets are liberalised further and farmers are guaranteed complete autonomy in their production decisions.

Turkmenistan has no programme of property restitution.

Governance and restructuring

Little effort has been made to initiate orderly restructuring of enterprises. Line ministries still dominate decision making, creating no incentives for efficiency improvements inside state-owned firms. The Law on Bankruptcy was passed in June 1992 but few companies have been forced into bankruptcy to date.

Macroeconomic data provide little evidence of structural change. GDP remains dominated by gas and cotton production, accounting for over half of GDP and three quarters of exports. The shares of agriculture and industry in total employment have remained around 44 and 10% respectively since 1993. Total employment has risen by 7% since 1993, while GDP has declined by 35% since 1992. Employment in state enterprises has, however, declined by 11% since 1994 as a result of privatisation.

Since 1996, the discontinuation of directed credits from the central bank has increased adjustment pressures in state enterprises due to some hardening of budget constraints. In December 1996, a 1.85 billion manats credit injection to pay off wage arrears, mainly in the agricultural sector, temporarily discontinued the tight credit policy to which the central bank has, however, returned since January 1997. Inter-enterprise arrears have been increasing as directed credits were phased out, rising from 8% of GDP in 1995 to 22% in 1996. The central bank has pledged that central bank credit will be unavailable to clear growing arrears.

Markets and trade

Price liberalisation

During the course of 1995 and 1996, Turkmenistan's formerly comprehensive system of price controls has been loosened significantly. Price controls still apply to 26 goods and services (down from 400 at the start of 1995), including basic foodstuffs, energy, public services (rents, heating, water), telecommunication, transport and selected construction materials. In the second half of 1996, the prices for butter, milk, meat and fodder were liberalised and state orders abolished, reducing the number of food items under price controls to six (flour, bread, cotton oil, rice and sugar). Procurement prices of cotton and wheat were adjusted again at the beginning of 1997 but remain considerably below the world market price. Most of the population still has access to free water, gas and electricity.

Price controls have served the purpose of social protection and subsidisation of domestic producers (or, in the case of cotton, of the Ministry of Agriculture). The costs are either borne by the budget directly or by the relevant off-budget ministries. Access to rations of subsidised basic goods is subject to monthly household income limits of 200,000 manats for bread and 80,000 manats for other foodstuffs. As of early 1997 this covered around 70% of the population but the income thresholds are to remain fixed in nominal terms during 1997. Free market trading is tolerated and prices are several times higher than state regulated ones.

Competition

As the economy remains dominantly state-owned, domestic competition is weak. Foreign competition remains very limited due to extensive non-tariff barriers and very high import duties on selected consumer goods (see section on trade liberalisation below).

Turkmenistan does not have an anti-trust law.

Trade liberalisation

There are few formal quota restrictions on imports and exports but most foreign trade is subject to licensing. 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 import duties can be very high (up to 100% in selected categories of consumer goods). Since 1994, all export transactions (domestic or foreign, with the exception of natural gas and reportedly exports of agricultural production by private farmers) and all imports by public enterprises have, by law, to be carried out at (or be registered and endorsed at) the official State Commodity Exchange. All transactions at the Commodity Exchange are valued at the appreciated official exchange rate (see below).

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 exchange.

Although Turkmenistan is a member of the Commonwealth of Independent States, it does not subscribe to the customs union with Russia and has not voiced any intentions to join.

Currency convertibility and exchange rate regime

Turkmenistan introduced its own fully fledged currency, the manat, on 1 November 1993. The Turkmen authorities moved to unify the exchange rate in January 1996 but, in the course of the year, multiple exchange rates re-emerged. The "official" exchange rate is more appreciated and applies to all non-cash purchases of foreign exchange by commercial banks. The commercial rate is that at which commercial banks exchange cash US dollars into manats. Both rates have been more or less stable since the beginning of 1997 and the premium has stood at around 30% during the first half of the year.

The official rate is set at foreign exchange auctions held once a week at the central bank. Enterprises must submit their bids in advance through one of the commercial banks. The official rate is pre-set by the central bank and access to the auctions is screened by a foreign currency committee to avoid "wasteful" imports, particularly by public entities. The commercial rate is set by the commercial banks according to market demand and the supply of foreign exchange by the central bank. Since January 1997, the central bank has aimed at stabilising both the exchange rate and the domestic price level by injecting additional foreign exchange (up to US\$ 15 million per week) into the banking sector.

Since 27 December 1995, currency receipts earned by state entities have, as a general rule, been subject to a 50% surrender requirement, except in the case of oil and gas, to which a 70% surrender requirement applied until April 1997. Surrendered foreign exchange was until recently held in an account at the central bank and credited to the Foreign Exchange Reserve Fund, under direct control of the president. This fund has been a substantial source of off-budget fiscal expenditure, as well as of monetary expansion, as the surrendered foreign exchange was credited in local currency both to the fund and to the exporter. In response to this problem, since

April 1997 all surrendered foreign exchange goes to the central bank at a unified rate of 50%. 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. Average monthly wages in the budgetary sector alone were increased to 120,000 manats on 1 March 1997, to be financed out of foreign exchange revenues from the repayment of arrears on Turkmen gas exports to CIS countries. Over the January-June period of 1997, the average monthly wage has increased from around US\$ 30 to US\$ 48 (valued at the official exchange rate), representing a real increase of 45% in terms of the domestic price level.

Interest rate liberalisation

The flow of directed credits to industry and agriculture dried up in the first half of 1996 and was only briefly resumed in December when emergency credits to agriculture and the state enterprise sector swelled base money by 50%. A further large credit injection (around 130 billion manats) to agriculture, however, reportedly took place in August 1997.

Interest rate ceilings on commercial banks were abolished in December 1995. Real interest rates have occasionally dropped to negative levels during 1996 but, with inflation falling below zero in June and July 1997 the refinancing rate (standing at a yearly rate of 35% in July or 41% on a compounded basis) is now positive in real terms. Interest rates in commercial banks have followed this general trend.

Commercial banks continue to rely heavily on central bank refinancing for their lending operations. The deposit base remains small, at less than a quarter of total liabilities. Commercial banks face reserve requirements of 11%. Additional monetary policy instruments include a small stock of treasury bills and a short-term credit facility available between the weekly credit auctions.

Financial institutions

Banking reform

Turkmenistan's banking sector includes 15 commercial banks. Seven banks are fully or mostly government controlled, the government has minority stakes in two further banks, four banks are private domestic banks and two are branches of foreign banks.

Three of the five major state banks, which were established in the late 1980s to handle commercial lending and deposit taking previously undertaken by the State Bank, still dominate the financial sector, with control over 83% of bank credits. As of December 1996, 90% of bank credit was extended to state enterprises, which also hold most bank deposits.

The financial system in general is underdeveloped. Domestic credit was only 6.7% of GDP in 1996, although it increased more than 2.5 times in real terms in that year. Domestic credit has risen by only 24% since December 1996 on account of restrictive monetary policies.

Bank supervision was strengthened in 1996. The minimum reserve requirements were increased to 500 million manat from 100 million

in July. Regulations regarding loan classification became operational in April, as well as a mandatory risk-weighted capital adequacy ratio of 8% and a required liquidity ratio of 30% of total liabilities. Additionally, the exposure to an individual borrower was limited to 20% of paid-up capital. Average capital adequacy in the banking sector by end-1996 amounted to 30%, but this figure is based on zero provisioning of loans to public enterprises, which are considered implicitly guaranteed by the state. The new loan classification revealed a share of non-performing loans of 14% of manat-denominated credit. There is no depositor insurance in Turkmenistan.

Non-bank financial institutions

An American investment fund (the Central Asian American Investment Fund) has been set up in Turkmenistan, involved mainly in the financing of small and medium-sized enterprises.

Around 20 local insurance companies are operating in Turkmenistan, covering mainly household effects, motor cars, fire and theft. Several companies have minority foreign participation and foreign companies and staff are often the largest group of clients.

Securities markets and instruments

There is no securities market in Turkmenistan.

Fiscal and social safety net reform

Taxation

The standard rate of profit taxation has been 25% since 1993. Certain exemptions apply to foreign investors and some sector-specific rates apply. The personal income tax structure was simplified in July 1995 with a new flat rate of 8% and a tax-free threshold at twice the minimum wage. The VAT rate has stood at 20% since 1993, with a preferential rate of 10% for certain staple goods. Until August 1997 VAT applied to exports following the destination principle prevalent in other CIS countries. From that date, VAT has been levied on domestic sales only.

In 1996, the revenue side of the budget relied mainly on VAT, the profit tax and the natural resource tax, raising 23%, 34% and 12% of total revenues respectively. Pension and social fund contributions added another 13% to revenues. As a result of substantial off-budget, quasi-fiscal activities, the ratio of revenues to GDP was only around 15% in 1996. In 1997, most current extrabudgetary items are to be included in the budget.

Social security

The social security system is partly financed by payroll taxes set at 30% of wages in the enterprise sector and 20% in agricultural associations.

The largest components of the social security system are subsidised basic goods, public pensions (provided to around 425,000 people in 1995), family allowances and an employment guarantee. In 1996 price subsidies amounted to 4.2% of budgetary expenditures and pensions to around 15%. Another 12% of expenditures each was spent on health and education, although, because of generally low revenues, social expenditures as a share of GDP did not exceed 3-4%.

Considerable pressure on the social security system may be anticipated as a result of demographic developments. The employment guarantee is particularly problematic in the face of high population growth (around 2% per annum), and significant excess employment in the state sector.

Legal transition

Pledge law

The Law on Collateral of 1 October 1993 regulates pledges of movable property and rights as well as mortgages of immovable property. Non-possessory pledges are permitted over certain types of movable property. Pledges are created by written agreement. A mortgage of immovable property must be registered. A mortgage of an enterprise is permitted, for which registration is required. Pledges of movables normally do not require registration. Enforcement of collateral is generally exercised by court order, although the parties can agree on enforcement without the assistance of the court. Sales must be conducted by means of an auction.

Company law

Joint-stock companies are governed by the Law on Joint-Stock Companies, as well as the Law on Enterprises and the Law on Entrepreneurial Activity, all of 1991. The cost for formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is US\$ 100-500. The process takes between one and three months. It is unclear whether joint-stock companies must maintain an independent share registry. Non-foreigners may be issued bearer shares. Companies are not required to send shareholders proxy forms in advance of meetings. Shareholders may not solicit proxy votes on resolutions to be considered at meetings. Minority shareholders are not afforded protection in the event of another company making a bid for less than all the shares of a target company. It appears that shareholders of a joint-stock company do not possess pre-emptive rights with respect to new share issues, and that transfers of shares do not require the consent of other shareholders (unless provided for in the charter).

Bankruptcy law

The Bankruptcy Law was adopted in October 1993. The definition of insolvency is that the debtor is unable to meet its liabilities as they fall due. The law provides for a reorganisation whereby at least two-thirds of creditors can reach a binding settlement with the debtor. The liquidator is appointed by the court. Liquidators are not required to have specific qualifications. The liquidator has limited powers and, for instance, can only challenge transactions of the debtor concluded within a 12-month period prior to the liquidation. Secured claims have priority over all other claims and are satisfied outside the debtor's estate. There are no specialised courts or judges handling bankruptcy proceedings.

General legal effectiveness

Survey data not available.

Ukraine

- *A new currency – the hryvnia – was introduced in September 1996.*
- *Further restructuring of the energy sector and the promotion of competition within the power market was initiated in early 1997.*
- *The government submitted wide-ranging proposals for tax reform to parliament at the beginning of the year. By June, parliament had approved only the VAT and corporate tax bills.*
- *In June 1997 the National Bank of Ukraine (NBU) confirmed that it will introduce international accounting standards for itself and commercial banks.*

Enterprises

Size of the private sector

In 1996, according to Ukrainian sources, the non-state sector accounted for almost 58% of industrial output, and the privatised sector accounted for some 40% of industrial and 45% of agricultural production. Yet it remains difficult to estimate the precise size of the private sector, chiefly because much of it is in the informal sector. According to the EBRD's estimate, the private sector accounts for at least 50% of GDP in 1997. At present it is estimated there are some 93,000 small businesses operating in the Ukraine, accounting for over 9% of GDP and 10% of the working population.

Privatisation

Large-scale privatisation began officially in 1992, mainly via non-competitive methods, including management/employee buyouts and leasing to employees, but progress was slow. 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). This was subsequently supplemented by compensation certificates (see below). In 1996 an average of 300 companies a month were auctioned through privatisation and compensation vouchers. Other methods included commercial tenders and cash auctions.

By mid-1997, 86% of Ukraine's citizens had received their vouchers under the MPP and over 45% had invested them in exchange for shares in joint-stock companies which were included in monthly auctions. The vouchers are often exchanged for shares in investment companies and funds, which bid for the vouchers at the auctions. The deadline for investing the vouchers is the end of 1997. The setting of a

minimum price has slowed the pace, as under-subscription has sometimes made multiple auctions necessary.

More recently, compensation vouchers have been introduced to compensate savers for the erosion in the value of their savings. These can be used to buy shares of enterprises offered by the State Property Fund which remain unsold following the main auctions. These vouchers have the advantage that they are tradable, while no minimum price is set during the auctions. At mid-1997, over 17% of citizens had received them.

By April 1997, over 9,600 of the 18,000 existing medium-sized and large enterprises had been privatised, of which it is estimated some 6,300 had been completely privatised (with more than 70% of shares sold to private owners). In addition, 38,600 of 45,000 small enterprises owned by the state had also been privatised. Of the 20,000 enterprises privatised during 1996, it is estimated that 11,500 were sold by competitive methods (auction, tenders and the sale of shares) and the balance by non-competitive methods (buy-outs and leasing). In 1996, over 300 enterprises were sold in cash sales through the stock exchange.

There is, however, still opposition from parliament to a more rapid pace of privatisation. Parliament had earlier voted to exclude over 6,000 companies from the MPP. As a result of government pressure to remove companies from the list, by March 1997 the number of companies excluded from the MPP was reduced to 5,155.

In April 1997 parliament approved the 1997 privatisation programme, which included 1,440 medium-sized enterprises. Another 228 large enterprises are to be sold by tender to foreign companies.

During the first half of 1997, plans for the privatisation of over 150 of these had been approved and the government indicated that the state would retain no more than 26% of the shares in certain enterprises. However, the pace of privatisation among medium-sized and large enterprises slowed during the first half of 1997 – the average number of companies privatised each month fell to 118 in the second quarter. Many of the companies to be privatised are in the agro-industrial sector.

The 1997 small-scale privatisation programme foresees the sale of 3,400 firms, much of which is reported to have been completed during the first half of the year. The majority have been sold to workers and management, and increasing use has been made of auctions. Residential privatisations have also proceeded successfully, with 40% of all formerly state-owned housing privatised by end-1996.

Privatisation in agriculture has had less success, mainly because of opposition from parliament to the sale of agricultural land. A new constitution, adopted in June 1996, guarantees private property rights including land ownership, but there is a six-year moratorium on land sales. In March 1997 the President introduced an amendment to the land code to allow foreigners to own the land on which an enterprise stands and to enable foreigners to participate in the privatisation of agricultural enterprises. Although workers on collective farms have the right to own their own farms, most have opted to retain a share in collective agricultural enterprises.

There has been no restitution to former owners of nationalised property in Ukraine.

The private sector has increased but its growth has been constrained by high effective tax rates and excessive regulation. This has contributed to the growth of a large informal sector, which includes activities of the private and state sector. Various estimates place the informal economy at between one-third and half of the total economy. According to official data, the share of barter trade was 11% of all external transactions and, in the first quarter of 1997, also represented a high proportion of domestic trade. A recent presidential decree seeks to reduce the amount of barter by requiring enterprises to reduce the proportion of such trade each quarter.

Governance and restructuring

Progress with industrial restructuring has been slow, reflecting the slow pace of privatisation up to 1994, the failure to attract much outside capital in the early stages of privatisation, and weak bankruptcy laws.

The Law on Bankruptcy was adopted in May 1992. There has been little enforcement so far, however, chiefly because of the cost and complexity of procedures. A new draft law is under discussion. In an effort to limit the growth of inter-enterprise arrears and increase liquidity in the economy, the NBU approved regulations in the second half of 1996 which give commercial banks the power to seize hard currency assets from debtors if they do not settle their debts (in domestic currency) within a specified time. However, inter-enterprise arrears have continued to grow. The shortage of liquidity in the economy is also reflected in the growth of payment arrears to power utilities (estimated at 3.4 billion hryvnia in July 1997) and in the growth of wage arrears in the economy, estimated at 4.6 billion hryvnia in mid-1997. Of these, arrears on wages and social benefits from the budget were estimated at 3.5 billion hryvnia (US\$ 1.9 billion) in June 1997. The government indicated that it would use some of the proceeds of the US\$ 450 million one-year Euronote issued in July to meet some of the wage arrears.

A presidential decree in April 1997 and a Cabinet decree in May 1997 call for mandatory payments in cash for electricity consumed, a ban on barter for energy supplies, the creation of a special commission to disconnect non-payers, and more targeted assistance in the sector. The government also announced plans to restructure the coal sector, with the intention of closing unprofitable mines.

Markets and trade

Price liberalisation

In October 1994, most direct price controls were eliminated. The only goods and services that remain subject to price controls are bread, utilities, public transport and rents. Since 1993, administered prices have been raised periodically 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 both January and July 1996. These price adjustments increased the proportion of costs paid by consumers (to the extent tariff collection is enforced). The government had proposed a further increase in the charges paid by residential consumers for rents and utility prices from 80% to 100% of costs from mid-1997.

However, parliament placed a moratorium on the proposal and the government subsequently decided that the proposed increase in electricity tariffs should be postponed.

Competition policy

The February 1992 Law on Limitation of Monopolistic Activities provided the basic framework for establishment of a competition policy and created the Anti-Monopoly Committee (AMC), the activities of which are further governed by the November 1993 Law on the Anti-Monopoly Committee.

According to anti-monopoly regulations, the approval of the AMC is required for the creation, merger and acquisition of enterprises where the market share is expected to exceed a specified figure. In 1995, the focus of the AMC gradually shifted from price regulation of monopolies to demonopolisation, although the Committee remains responsible for examining allegations of the abuse of monopoly power. Where possible, however, demonopolisation is undertaken at the time of privatisation, or by breaking up horizontally integrated structures that produce the same commodity.

Under current legislation a monopoly is defined as an entity with a market share in excess of 35%. According to the AMC, at the beginning of 1997 there were 536 enterprises operating in over 750 markets at the national level and 2,180 enterprises operating in more than 1,270 markets at the regional level which could be classified as monopolies. Many of these are regarded as natural monopolies, for example, energy transmission and transport infrastructure.

Trade liberalisation

In 1994 state trading monopoly was abolished, and the process of eliminating export quotas and licences commenced. 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 overall level of nominal tariff protection is estimated at between 5% and 8% on a trade-weighted basis (the modesty of these figures partly reflects the large share of energy imports that are not subject to tariffs). Tariffs on some agricultural products were raised in early 1996 (generally to 30%), 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%, 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 Co-operation 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 WTO.

FDI in 1996 was estimated at US\$ 460 million, taking the stock to US\$ 1.4 billion. FDI flows in the first half of 1997 were reported as US\$ 336 million.

In March, parliament passed a bill that would remove some of the main tax exemptions for joint ventures with foreign partners. Companies

registered before 1995 would lose their five-year tax holiday from paying profit tax, while another proposal would remove the exemption from paying import duties. Although part of the intention of the legislation was to deal with cases of tax abuse, the President vetoed the bill on the grounds that the retrospective nature of the bill could adversely affect investor confidence in Ukraine.

Currency convertibility and exchange rate regime

In October 1994 a unified exchange rate was introduced. In May 1997 the NBU announced that it acceded to full current account convertibility in accordance with Article VIII of the IMF. In June 1997 parliament revoked the requirement that exporters convert 50% of their foreign earnings through the Ukraine Interbank Currency Exchange (UICE), which should increase the hard currency available to exporters.

The government introduced the new currency, the hryvnia, on 2 September 1996. The hryvnia replaced the temporary currency, the karbovanets, at a rate of 1:100,000 and at an exchange rate of 1.76 to the US dollar (at the time of the conversion, the karbovanets was trading at 175,000 to the dollar). The introduction of the hryvnia was accompanied by a one-week price freeze. In April 1997 it was announced that the value of the hryvnia would be maintained within a currency band of hryvnia 1.70-1.90:\$1.

Wage liberalisation

Administrative setting of wages continues. Wage coefficients for workers of different skills are set on the basis of the minimum wage.

Interest rate liberalisation

Since March 1995, real interest rates have generally been positive. During 1996 and 1997, there have been a series of reductions in the NBU's refinancing rate as inflation has slowed. The refinancing rate was lowered to 35% at the beginning of 1997, and has then been lowered in a series of steps to 16% in early August. In April 1997 the central bank, the National Bank of Ukraine (NBU), introduced new reserve requirements requiring all banks to hold reserves in national currency to 11% of their consolidated balance sheets, replacing the earlier differential rates on deposits.

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 early 1997 there were 222 banks registered in Ukraine, of which 187 were operating. During 1996 a number of banks ceased operations, including one of the larger banks – Gradobank – which was placed under administration by the NBU. The banking sector remains dominated by the five former state-owned specialised banks (PromInvest, Ukribank, Ukrotsbank, the Savings Bank and Ukreximbank). The first three banks, with their traditional focus on heavy industry, agriculture, and social and municipal services respectively, were privatised in 1993-94. The last two are still state-owned. 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. In 1996 the volume of commercial bank credits (in domestic currency)

granted to the non-government sector was equivalent to 5% of GDP. Non-performing loans are estimated at 17% of all credits at mid-1997, mainly reflecting debts of state-owned enterprises.

Regulation and bank supervision have been strengthened. Minimum capital requirements were raised at the beginning of 1997. A resolution of the NBU at the beginning of 1996 provided for the establishment of a private deposit insurance fund. A Commission of the NBU was established in 1996 with responsibility for issuing licences for banking operations. The authorities have also introduced prudential ratios for banks, a loan classification scheme, exposure limits and legislation which prohibits insider lending. In June 1997 the NBU confirmed that it would introduce international accounting standards for itself and commercial banks.

Fourteen banks now operating in Ukraine have foreign capital. However, current legislation forbids the establishment of foreign branches, but permits foreign subsidiaries providing foreign capital does not exceed 35% of the bank's capital and the total foreign capital is no more than 15% of the entire capital of the banking sector. There are two wholly owned foreign banks operating in Ukraine, although a number of others have recently received licences.

Non-bank financial institutions

Non-bank financial institutions in Ukraine include trust companies, investment funds, insurance companies, credit unions and pension funds. In April 1997 new legislation came into effect which sets out the regulatory framework under which insurance companies, investment funds and brokers can operate, and establishes minimum capital requirements.

Securities markets and instruments

The Law on Securities and Stock Exchange has been in effect since January 1992 and the Ukraine Stock Exchange (USE) began operations later that year. In July 1996 new securities regulations were adopted by parliament, establishing a new Securities and Exchange Commission. The Commission has administrative and disciplinary powers over brokers and trading activities and, according to a law passed in October 1996, responsibility for supervising the financial markets.

Share trading is conducted on the USE and its 29 affiliates. The USE is divided into three tiers with different size and disclosure requirements. The number of listed companies is small, partly a reflection of the pace of privatisation. Privatisation certificates are not tradable, while investment funds often hold illiquid stock. In addition, the market still lacks central depository, registration, custodial services, clearing and settlements systems.

About 80% of all trading takes place on the over-the-counter market, which lists over 100 companies.

Auctions for treasury bills were first introduced in March 1995 and represent a key instrument in enabling the government to finance part of the budget deficit by non-inflationary means. The auctions are now held on a regular basis, maturities have lengthened and recent issues have been of discount bonds. Sales, which were originally only to institutions, have now been extended to individuals as well as to non-residents providing the transactions are conducted

through authorised commercial banks. There has been a strong demand for the longer dated bills by non-residents in recent quarters, and this has contributed to the stability of the currency since late 1996. A new corporate tax of 30% on all treasury bills issued after 1 July 1997 is now in effect (replacing an earlier 15% withholding tax). Non-residents are exempt if a double taxation treaty is in effect. In June the government announced the issue of inflation-linked bonds (the yield comprises inflation and a real rate of return).

Fiscal and social safety net reform

Taxation

In late 1996 the government announced a major tax reform package as part of its budget for 1997 and presented nine tax bills to parliament. The aim was to broaden the base and lower tax rates. It covered VAT, corporate and personal tax, and included proposals for a property tax, a reduction in the payroll tax from 51% to 34% and the introduction of higher depreciation rates on fixed capital. The package also included proposals for pension reform and for the removal of many of the regulations affecting business.

The number of bills parliament had to consider contributed to the delay in the approval of the budget for 1997, which partly depended on the passage of much of this legislation. Eventually the government proposed that, in order to approve the budget, parliament focus its attention on the main bills. These were reform of the VAT (20% base rate and elimination of all exemptions) and the corporate profit tax (30% base rate, with a switch from revenue to profit taxation); the law on individual income tax (decrease from 40% to 30% in the rate and a reduction in the payroll tax). There was a small reduction in the payroll tax to 49% in the 1997 budget.

By the end of June the parliament had passed only two of these bills – VAT (with implementation delayed until October) and the corporate tax bill, but had not passed the law on personal income tax, even though it had passed its final reading. The corporate tax bill includes changes to accelerated depreciation for certain investments, allows companies reporting losses to carry them forward for five years and increases the scope for the treatment of deductible expenses. Parliament did nevertheless approve the budget for 1997 at the end of June, with a planned deficit of 5.7 billion hryvnia (US\$ 3 billion), an estimated 5.7% of GDP. This was higher than might have been expected following the fall in the deficit in 1996, chiefly because the government was anxious to meet arrears on wages and pensions. The government is, however, continuing with its tax reform proposals.

Social security

The extrabudgetary funds in the social sphere are financed by payroll taxes, with employers paying 37% of the wage bill for the social and pension funds, and 12% for the Chernobyl and employment funds. Employees pay 1% of their wage to the pension fund and 3% to the Chernobyl fund. Contributions to the Chernobyl and pension funds were to be substantially reduced under the proposed tax reform. More than half of the expenditures of the extrabudgetary funds are funded from general taxation.

Until the end of 1994, the social benefit system was one of the most generous in the former

Soviet Union, mainly because it was not targeted, and amounted to over 14% of GDP, most of which was accounted for by pensions and consumer subsidies. The government has already taken some measures to improve the targeting of benefits and reduce the cost. Families are entitled to receive income support if their housing and energy bills exceed 15% of their 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. A combination of relatively low retirement ages, an ageing population and the pay-as-you-go basis has placed the pension system under considerable financial strain. The maximum state pension for the majority of the population is just under 50 hryvnia per month, about one-third of the average industrial wage in 1996.

Legal transition

Pledge law

A non-possessory pledge may be created by written agreement. There appear to be no restrictions on the types of movables which form the basis of a non-possessory pledge. There is no unitary or centralised registry for non-possessory pledges. The pledge only becomes enforceable through notarisation. The fee for notarisation exceeds 1% of the value of the underlying loan or collateral. Enforcement of a pledge normally requires court assistance.

Company law

In 1991 Ukraine enacted the Law on Economic Associations. The cost for formation and registration of a joint-stock company (including legal, notary and court fees, but not including minimum share capital) is US\$ 500-1,000. The process takes between one and three months. Companies with more than a certain minimum number of shareholders must maintain a share registry. Cumulative voting for directors does not exist. Minority shareholders are not afforded protection in the event that a company makes a bid for less than all the shares of a target company. Shareholders do possess preemptive rights with respect to new share issues. There are no specific provisions relative to directors' obligations.

Bankruptcy law

The Law on Bankruptcy came into effect in 1992 and was amended in 1993. The definition of insolvency is when a debtor is unable to meet its liabilities as they fall due. The law provides for a reorganisation system whereby a majority of creditors can reach a binding settlement with the debtor. Stay of all legal proceedings against the debtor is not automatic, but may be granted by the court on the request of one of the parties or at the discretion of the court. During bankruptcy proceedings, the court appoints a liquidator. The liquidator possesses a broad range of powers, although it is unclear whether a liquidator can investigate a debtor's financial affairs. Transactions with third parties that are (i) below fair value, (ii) between related parties, and (iii) entered into within a fixed period of time prior to liquidation may be reviewed and declared void by the court. Liquidation costs rank higher than secured claims. There are no specialised courts or judges handling bankruptcy proceedings.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and are generally published by

the private and public sectors within one month of being passed. Important judgements are generally published and accessible to practitioners and provide written reasons for courts' decisions. There is generally a meaningful right of appeal from first-instance court decisions. There appears to be an independent right of judicial review of administrative action. On average, a party can be expected to wait less than six months for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and one year for a final judgement for payment of a sum of money to be executed.

Uzbekistan

- *Following encouraging progress in the implementation of a comprehensive stabilisation and reform programme initiated in early 1995, the Uzbek transition process has experienced significant setbacks since mid-1996.*
- *In the face of balance of payments difficulties the authorities introduced widespread trade restrictions and a multiple exchange rate regime. These were followed and reinforced by a major loosening of financial policies during the last quarter of 1996.*
- *Although financial policies were tightened in the first half of 1997, the currency and trade restrictions are still in place.*
- *The long-awaited mass privatisation programme got off the ground and is proceeding successfully.*

Enterprises

Size of the private sector

In early 1997, official estimates put the share of the non-state sector in both GDP and employment at above 70%. However, given that in many partially privatised medium-sized and large companies the state remains directly or indirectly in control, and also taking into account the more formal than real reorganisation of the former collective and state farms, the size of the private sector is estimated at around 45% of GDP.

Privatisation

By the end of 1996, small-scale enterprise privatisation and privatisation of housing had been largely completed. About 94% of all previously state-owned small enterprises had been transferred to private hands, typically to employee collectives. Roughly 96% of the housing stock is now private. In addition, about 25% of the agricultural land has been transferred under different kinds of leasehold or use rights arrangements to family-based peasant farms or as household plots to other segments of the population.

However, by end-1996 less than 20% of the 11,800 existing medium-sized and large enterprises had been privatised, in most cases only partially. For 1997, the government announced its plan to incorporate and partially privatise 1,000 additional medium-sized and large companies. The long-delayed mass privatisation programme, based on Privatisation Investment Funds (PIFs), finally began to be implemented in

late 1996. The programme is intended to result in the sale of around 600 companies by mid-1998. The first auction took place in December 1996 and since then auctions have been held monthly. By April 1997, about 50 PIFs and 60 management companies had been established and shares in 55 enterprises had been sold for 240 million som (US\$ 4 million). Under the PIF scheme, individuals can buy shares in the investment companies which, in return, invest this money together with preferential credits from the government (in the amount of five times the value of the cash investment by individuals in the PIFs) in shares of enterprises assigned to this scheme. PIFs are also entitled to increase their shareholdings through the stock exchange.

Governance and restructuring

Both efficient corporate governance and enterprise restructuring have been hindered by the slow pace of privatisation and the modest role of external non-state ownership in privatised companies. The typical ownership structure of privatised firms is: 25% of the shares retained by the State Property Committee (SPC); 26% sold to employee collectives; and 49% available to the general public, including foreign investors. In many cases, however, a large part of this 49% shareholding has been either transferred or sold to other state structures, including sectoral ministries and state-owned banks, or still remains with the SPC. The PIF scheme is expected to increase the role of external non-state ownership, although shareholdings by the individual PIFs in any single enterprise are subject to a limit of 10%.

Although the management of corporatised and privatised companies is de jure independent of the state, the prevailing ownership patterns and the current regulatory regimes leave wide scope for direct administrative interventions by the state. Incentives for restructuring are also weakened by largely soft budget constraints for the enterprise sector, the generally low degree of competition throughout the economy and a major shortage of skilled managers. While industrial enterprises are not receiving explicit subsidies, they continue to benefit from access to commercial credits at relatively low (sometimes negative) real interest rates, the ability to accumulate payment arrears and access to foreign exchange at the official rate.

The bankruptcy law was amended in August 1996 in connection with the preparations for the mass privatisation scheme. A special bankruptcy committee within the SPC and a bankruptcy commission chaired by the prime minister were established to supervise, and in some cases initiate, bankruptcy proceedings. The Economic Courts are responsible for bankruptcy claims. By end-1996, only about 130 enterprises, mostly small businesses, had been declared bankrupt.

Markets and trade

Price liberalisation

Formal price controls had been abolished by 1996 for most foodstuffs, consumer goods and services. Since then, administrative price controls have applied to energy, rents, communal services, public transport and telecommunications. In addition, the government determines prices of a large number of monopoly products and monopoly enterprises. Procurement prices for cotton and wheat, for which the state order system is still in place

(covering 40% of cotton production and 25% of wheat production in 1996), are also administratively set.

In late 1996 and early 1997, as a result of sharp rises in energy prices and communal service charges for households, significant progress was made in reducing the disparity between household and industrial prices and in raising household prices towards cost-recovery levels. However, the process of price reforms remains burdened with (i) widespread use of preferential prices for selected customers, (ii) new price distortions caused by the multiple exchange rate system and (iii) non-transparent regulations for price formation of many monopoly products and enterprises.

Competition policy

Over the last year substantial progress has been made in developing the institutional framework of competition policy. In mid-1996 a separate Anti-Monopoly Committee was established, taking over the relevant functions from the Ministry of Finance. In December 1996, a law on anti-monopoly policies was passed by parliament, followed by a law on natural monopolies. Under the new regulations, an enterprise or product with a share of over 65% of the national or local market is automatically classified as a monopoly. In the case of market shares of 35-65%, the monopoly status depends also on additional criteria. In April 1997, there were 4,520 monopoly products and 774 monopoly enterprises in Uzbekistan at the federal and, primarily, at the local levels.

The new laws identify the following sectors as natural monopolies: oil, gas, gas condensate and coal extraction; pipeline transportation of oil, oil products and gas; production and transportation of electricity and heat energy; railway transportation; services of major transport terminals, ports and airports; telecommunications; and water and sewerage services. The key regulatory instruments for monopolies are price controls.

Trade liberalisation

The steady progress in trade liberalisation of previous years has been reversed through a range of trade restrictions imposed during the second half of 1996. The unweighted average import tariff rose from 12% to 17% (excluding cars) and new excise taxes were introduced on imports of a number of consumer goods and cars. The scope of excise taxes on exports and re-exports also widened. Duty-free imports by individuals were restricted to US\$ 1,000, with a 15% tax on such imports in excess of this limit. Since October 1996, a general requirement for ex-ante registration of import contracts is in place, which is basically functioning as an import-licensing system, reflecting the current priorities of the central authorities. The toughest restrictions apply to the imports of non-essential consumer goods (imports of close to 30 categories of such goods being practically banned) but contracts for other imports are also checked regarding the quality and prices of the imported goods and compliance with exchange regulations. Regulations on barter transactions have also been significantly tightened.

Uzbekistan has applied for membership in the WTO and the memorandum on its trade regime is at an advanced stage of preparation. However, the WTO membership negotiations, as well as negotiations with the EU on the Partnership and Cooperation Agreement, are

likely to be slowed down by the current reversal in the country's trade liberalisation process.

Currency convertibility and exchange rate regime

In late 1995, the Uzbek national currency became *de facto* convertible for current account transactions, with both resident and non-resident companies and private entrepreneurs allowed to buy and sell foreign currency freely at the official auctions through 22 authorised banks. However, since mid-1996, in the wake of intensifying balance of payments pressures, the authorities have increasingly resorted to various restrictions on access to foreign currency, effectively reintroducing a currency rationing and licensing system with little transparency. At the beginning of 1997, an explicit multiple exchange rate regime was institutionalised.

The new regime includes several exchange rates. The official rate is used mainly for accounting and customs purposes and for exchanging export proceeds under the obligatory surrender requirement. The auction rate is applied to importers and transactions enjoying privileged access to foreign exchange, such as debt service payments or imported inputs and investment goods for high priority companies or projects. A special commercial rate is applied to imports of certain consumer goods and services.

A cash market rate is used by the foreign exchange bureaux of the eligible banks (the number of which has been reduced from 14 to two) in their transactions with individuals. Lastly, there is a greatly expanded black market. The difference between the official and the black market rates has widened sharply since late 1996, with the latter oscillating at 40-50% of the official rate. The authorities are committed to phase out the multiple exchange rate regime by the end of 1997.

Wage liberalisation

Wages in budgetary organisations are determined through a wage grid, which currently contains 22 wage categories with a differential of six between the lowest and the highest. The grid is linked to and adjusted in line with the minimum wage. Wage increases in the majority of state-owned enterprises are administratively limited to 70% of the growth in the nominal value of output. In fact, this regulation has a much wider scope of application, also including the bulk of the private sector. Foreign enterprises and majority foreign-owned enterprises have been exempt from wage restrictions since 1996, and joint ventures with less than 50% foreign participation since early 1997. In 1996, valued at the official exchange rate, the monthly minimum wage averaged US\$ 10, while the average wage was equivalent to US\$ 52, up from about US\$ 40 in 1995.

The labour market is distorted by the continued application of the Soviet "propiska" (residence permit) system. Labour mobility is also constrained by the very low level of official unemployment, which, at 0.4% of the active population, is one of the lowest among the transition economies. This is, however, above all an indication of slow enterprise restructuring that affects the reallocation of labour.

Interest rate liberalisation

Given the heavy reliance of commercial banks on central bank refinancing credit, the anchor of the interest rate structure is the refinance rate

of the Central Bank of Uzbekistan (CBU). Since the last quarter of 1996, the refinance rate has become negative in real terms, due to a combination of high inflation and several decreases in the nominal rate, which resulted in some disintermediation. Lending and deposit rates are determined by the commercial banks, and often move in parallel with the CBU refinance rate.

The spread between the lending and deposit rates remains high; this reflects the impact of high reserve requirements, limited competition within the banking sector, generally weak loan portfolios and the high risk premium for lending to enterprises. Preferential credits at below market rates are available under different schemes, including those for small and medium-sized businesses, privatisation investment funds, and selected sectors and projects. From late 1996, the interbank money market has been re-liberalised, with the elimination of a CBU regulation requiring all interbank lending to be channelled through the credit auctions. This measure resulted in greater competition in the sector and there have been significant differences in the interest rates offered by various banks, especially for deposits.

Financial institutions

Banking reform

The banking sector continues to be dominated by the state-owned National Bank of Uzbekistan (NBU), People's Bank, Promstrobank and Pakhta Bank, which control over 85% of the sector's assets. There is a second layer of 14 smaller state-owned banks with strong sectoral orientations. The remaining 30 commercial banks are small private banks, including some joint ventures. Competition within the sector remains weak and most banks are as yet unable to operate according to market principles and impart financial discipline on the enterprise sector.

The continued strong distinction between cash and non-cash money saps confidence in the banking system and incurs major resource misallocation costs. Moreover, commercial banks in many cases act as implementing and controlling agencies of the government, i.e. by playing a major role in enforcing tax, trade and wage regulations. This role stems partly from the requirement that an enterprise has a single bank account with its "house bank". This requirement has recently been lifted for enterprises with foreign participation.

Most state-owned banks are in a very difficult financial situation. In late 1996, the share of overdue principal and interest in the commercial banks' loan portfolio was estimated at 12%, but indirect evidence suggests that the real magnitude of the bad loans problem is greater. From the end of 1996, the CBU – as part of its supervisory activities – restricted the lending operations of 17 banks. In the second quarter of 1997, these restrictions still applied to 11 banks.

Over the last year, particularly as a result of the implementation of the Law on Banks and Banking Activity adopted in April 1996, there have been certain encouraging developments. From late 1996, commercial banks started to set aside reserves against non-performing loans. All banks are now required to have annual audits performed by international accounting firms. The payments system has become fully automated, resulting in a major reduction of

settlement times. A recent presidential decree called for increased private sector participation and reduced administrative interventions in the banking system. A new financial sector reform programme is under preparation, with the assistance of the World Bank, focusing on (i) strengthening competition within the sector, (ii) improving the legal and regulatory framework and (iii) restructuring the sectoral banks.

Non-bank financial institutions

The setting up of the PIFs in 1996 has been the key new development in the non-bank area. By the end of April 1997, 51 PIFs and 60 management companies had been created. Their activities are regulated by a government resolution issued in June 1996. There are a number of newly created insurance companies but the insurance firms with strong state participation, such as Uzbek Invest, continue to dominate the sector.

Securities market and instruments

The setting up of the Commission on Securities and the Stock Exchange (CSSE) in late 1995 led to the issuance of a number of important regulations and has improved conditions in this area of the financial sector. At the end of 1996 the Republican Stock Exchange (RSE) in Tashkent had listed stocks in 400 enterprises. While primary sales of stocks in the RSE increased steadily in 1996 and reached 2.8 billion som, as a ratio to GDP these still remain low at 0.5%. In addition, there have been significant off-market sales of shares worth an estimated 2.3 billion som, which add almost another 0.5% of GDP to the volume of transactions in this market.

A large proportion of the shares on both the stock exchange and the over-the-counter market were bought by state-owned or state-controlled entities, however. Secondary trading has been sluggish up to now as trading in the RSE and off-market is limited to a handful of companies, including a few banks. With the PIFs (explained in the privatisation section above) facilitating large-scale privatisation, it is expected that secondary market trading will expand rapidly.

The number of companies registered with the National Share Depository (NSD), a body related to the RSE, reached about 4,200 at the end of 1996. Due to significant transactions taking place outside the formal market, however, it has been difficult to keep up-to-date records of ownership of enterprises.

Shares can be purchased from one of the 60 "stock shops" operated by the RSE, or from one of the 170 licensed stockbrokers. The RSE has 12 regional offices, linked by a computerised network. Despite the recent efforts of the CSSE, transparency in the stock market is in need of improvement; more specific regulations are required on information disclosure by companies.

In March 1996 the government started to issue three-month bills and at end-1996 sales of these bills amounted to 4.6 billion som. During the first quarter of 1997, the authorities began to issue six-month bills along with the three-month maturity paper. Sales of such securities rapidly expanded and amounted to 3.6 billion som, of which 1.3 billion som was purchased by the non-bank private sector.

Fiscal and social safety net reforms

Taxation

During 1996 there have been various changes in taxation rates and a new tax code, approved by

parliament in April 1997, will be effective in January 1998. In 1996, standard corporate profit tax was 37%, providing about 29% of total budgetary revenues. However, numerous exemptions, differential treatment of sectors and tax holidays affect this tax source. This situation creates distortions and leads to a non-transparent and discriminatory tax regime. Exporting enterprises and start-up firms are eligible for various privileges. Joint ventures in key sectors with more than 30% foreign participation are tax exempt for two years after registration, while joint ventures investing in projects in the Public Investment Programme are given a five-year tax holiday. For firms investing 50% of their profits there is a special tax rate of 28%. Enterprises in the agricultural sector are taxed at a rate of 3% if their profits are below a predetermined level. In both 1995 and 1996, the government granted a special exemption from the profit tax to commercial banks to allow them to improve their information technology and equipment.

Excise taxes, the largest revenue source for the budget, mostly cover oil and gas. The budget for 1997 includes some new taxation measures. These are (i) one percentage point cut in the standard profit tax to 36%, (ii) an increase in the standard VAT rate from 17% to 18% and introduction of a 10% VAT rate for food items, (iii) a 50% rise in the property, land and mining taxes, (iv) introduction of a new ecological tax of 1% on assets of non-agricultural enterprises, and (v) introduction of a 0.5% tax on the gross sales of all enterprises, earmarked for the pension fund. Also, in January 1997, the excise tax on crude oil was raised to 62% and on gas to 53%. The new tax code will introduce a further 1% reduction in the profit tax and an increase in the standard VAT rate to 20%.

Social security

The social security system, mostly financed by extrabudgetary funds, was reorganised in early 1997. The Social Insurance Fund was renamed the Pension Fund and brought under the authority of the Ministry of Social Protection. The Pension Fund's expenditures represented about 7.5% of GDP in 1996. The payroll tax, which is the main source of revenues for this fund (as well as for the Employment Fund and the Trade Union Federation Council Fund), is 41.2% in 1997, with 40% paid by employers and the rest by employees.

The eligibility criteria for the three types of allowance provided under the budget for low-income families and children were changed and made more stringent. Under the new presidential decree that became effective in January 1997, there will be a needs-based assessment for eligibility, with needs determined by local governments.

Legal transition

Pledge law

The Uzbek Law on Pledge was adopted on 9 December 1992. Under Uzbek law, it is possible to take a non-possessory security interest in tangible and intangible movables as well as in a changing pool of assets or an entire enterprise. The system for taking security interests in movable property does not include formal registration for all types of movable property. Normally, movable property must either be transferred to the creditor or pledged property retained by the debtor must be marked to indicate that the property is subject to a pledge. All lien agreements that have foreign participation

must be registered with the Ministry of Justice. Notarisation and registration are required only for land and goods in circulation and enterprises. The major deficiencies in the pledge law regard public access to pledge records and the absence of a centralised registry. The cost of notarisation is between 0.1 and 1% of the underlying debt or of the collateral being secured. A creditor may take possession of a pledgor's asset only through court order. Sale must be by public auction unless the parties have agreed otherwise in a prior written contract.

Company law

The principal legislative acts on joint-stock companies are the Law on Economic Associations and Partnerships of December 1992, and the Law on Joint-Stock Companies and the Protection of Shareholders' Interests of April 1996. The Law on Joint-Stock Companies embodies many of the principles of the Russian Joint-Stock Company Law. It normally takes between one and three months to form and register a joint-stock company and the legal, notary and court fees associated with forming a company can be over US\$ 1,000 (especially for foreign-owned companies as opposed to locally owned enterprises). Companies with more than 500 shareholders are required to maintain share registries with independent licensed parties. Shareholders are entitled to vote by proxy at meetings. It would appear that companies are required to send shareholders proxy forms in advance of meetings. Minority shareholders are not afforded protection if a company makes a bid for less than all the shares of a target company. The law, however, does give existing shareholders of a company pre-emptive rights with respect to new share offerings. The law also provides for cumulative voting by shareholders for the election of supervisory board members, whereby minority shareholders may pool their votes to ensure the election of at least one supervisory board member to represent their interests. Directors are under an obligation to (i) avoid self-dealing, (ii) disclose any interests they have in material transactions with the company and its affiliates, and (iii) act in the company's interest and exercise their rights and perform their duties in the interests of the company.

Bankruptcy law

Uzbekistan enacted a new Bankruptcy Law in 1994. The definition of insolvency is when a debtor is unable to satisfy its liabilities or pay taxes on a timely basis. A petition may be filed if a debtor's liabilities are 90 days past due. Bankruptcy proceedings are handled by the Arbitration Court. The law permits reorganisation proceedings whereby a majority of creditors (representing two-thirds of total claims) can reach a binding settlement with the debtor. A liquidator is appointed by the court in consultation with the creditors. The liquidator must take stock of the debtor's assets, manage its property, administer the liquidation plan and sell the debtor's property. The liquidator may void transactions (i) concluded by the debtor within one year prior to the liquidation, (ii) not at arm's length or (iii) below fair value. Sale of a secured asset may take place without court assistance but must be made by public auction. In liquidation proceedings, government taxes, social security claims, employee remuneration and personal injury claims rank higher in priority than claims of secured creditors. There are no specialised judges or courts to handle bankruptcy proceedings.

General legal effectiveness

Investment laws are generally drafted by legally trained personnel and appear generally to be published within one month of being passed. Important judgements appear not to be generally published and accessible to practitioners. There generally is a meaningful right of appeal from first-instance court decisions. There is an independent right of judicial review of administrative action. On average, a party can be expected to wait between seven months and one year for a commercial case to be heard on the merits by a court in the most important commercial centre and between seven months and two years for a final judgement for payment of a sum of money to be executed.

Albania

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
	<i>(Percentage change)</i>							
GDP at constant prices	-10.0	-27.7	-7.2	9.6	9.4	8.9	8.2	-15
Industrial gross output	-14.2	-42.0	-51.2	-10.0	-2.0	1.0	na	na
Agricultural gross output	-5.4	-17.4	18.5	10.4	10.3	11	na	na
Composition of output								
	<i>(In per cent of GDP)</i>							
Industry (at 1990 constant prices)	39.8	32.1	16.9	13.9	12.4	11.5	na	na
Agriculture (at 1990 constant prices)	37	42.5	54.2	54.6	55.1	56	na	na
Employment								
	<i>(Percentage change)</i>							
Labour force (annual average)	2.1	6.2	-4	0.4	1.3	1.8	na	na
Employment (annual average)	0.0	0.0	-28.9	-3.2	9.7	5.7	na	na
	<i>(In per cent of labour force)</i>							
Unemployment (end-year) ¹	9.5	8.3	24.4	24.8	16.1	13.9	na	na
Prices and wages								
	<i>(Percentage change)</i>							
Consumer prices (annual average) ²	0	36	226	85	23	7.8	12.7	33.4
Consumer prices (end-year) ²	0	104	237	31	16	6.0	17.4	41.5
Civilian state sector wages (annual average)	na	na	94	38	38	28	15	na
Government sector								
	<i>(In per cent of GDP)</i>							
General government balance, commitment basis ³	-15	-31	-22.0	-15	-12.0	-10.0	-12	na
General government expenditure ³	62.1	61.9	43.9	40.2	36.3	34.3	29	na
Monetary sector								
	<i>(Percentage change)</i>							
Broad money (end-year)	23.4	104	153	75	41	52	47	na
Domestic credit (end-year)	na	100	68	153	17.8	-10.0	37.1	na
	<i>(In per cent of GDP)</i>							
Broad money	33	69	54	40	38	48	60	na
Interest and exchange rates								
	<i>(In per cent per annum, end-year)</i>							
Central bank basic refinancing rate	na	na	40	34	25	20.5	24	na
Treasury bill rate (three-month maturity)	na	na	na	na	10	14.7	20.3	na
Deposit rate (one year) ⁴	na	5-8	32	23	16.5	13.7	19	na
Lending rate (one year) ⁵	1-2	8-12	39	30	20	21	26	na
	<i>(Lek per US dollar)</i>							
Exchange rate (end-year)	10	25	97	101	95	94	107	na
Exchange rate (annual average)	8	15	75	102	95	93	105	na
External sector								
	<i>(In millions of US dollars)</i>							
Current account	-122	-249	-434	-365	-283	-181	-122.5	na
Trade balance ⁶	-150	-208	-454	-490	-460	-474	-692	na
Exports ⁶	231	73	70	112	141	205	229	na
Imports ⁶	381	281	524	602	601	679	921	na
Foreign direct investment, net	na	8	32	45	53	70	90	na
Gross reserves ⁷	199	1	72	147	204	240	245	na
External debt stock	377	628	769	877	960	667	753	na
	<i>(In months of current account expenditures, excluding transfers)</i>							
Gross reserves (end-year) ⁷	5.94	0.04	1.4	2.3	3.2	3.5	2.9	na
	<i>(In per cent of current account revenues, excluding transfers)</i>							
Debt service	na	33	56	28	23	6.0	6.4	na
Memorandum items								
	<i>(Denominations as indicated)</i>							
Population (in millions, end-year)	3.3	3.3	3.2	3.2	3.2	3.2	3.2	na
GDP (in billions of lek)	17	16	53	125	188	225	272	na
GDP per capita (in US dollars)	638	346	222	388	620	745	799	na
GDP per capita (in US dollars) at PPP exchange rates ⁸	1,476	1,072	973	1,100	1,169	1,305	1,398	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Armenia

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output								
				<i>(Percentage change)</i>				
GDP at constant prices	-7.4	-17.1	-52.6	-14.8	5.4	6.9	5.8	5.8
Industrial gross output	na	na	na	-28	5.6	1.6	2.2	na
Agricultural gross output	na	na	na	-18.5	3.0	5.0	3.0	na
Composition of output				<i>(In per cent of GDP)</i>				
Industry	na	46.5	36	25.8	35.8	34.0	31.9	na
Agriculture	na	23.6	28.4	49.1	43.5	42.8	38.3	na
Employment				<i>(Percentage change)</i>				
Employment (end-year)	na	2.6	-5.6	-2.2	-3.6	-0.8	-1.8	na
				<i>(In per cent of labour force)</i>				
Unemployment ¹	na	na	na	5.2	6.4	6.6	9.1	na
Prices and wages				<i>(Percentage change)</i>				
Consumer prices (annual average)	10.3	274	1,346	3,732	5,273	177	18.5	15.0
Consumer prices (end-year)	na	25	1,341	10,896	1,885	32	5.6	19.0
Government sector				<i>(In per cent of GDP)</i>				
General government balance ²	na	-1.8	-8.1	-56.1	-16.5	-11.1	-9.3	-6.7
General government expenditure ²	na	7.3	12.3	59.5	34.3	22.5	19.4	18.2
Monetary sector				<i>(Percentage change)</i>				
Broad money (end-year)	na	na	na	na	684	69	35.1	14.8
Domestic credit (end-year)	na	na	195	-97	1,258	26.5	37.9	na
Exchange rates				<i>(Dram per US dollar)</i>				
Exchange rate (end-year)	na	na	na	75	406	403	443	na
Exchange rate (annual average)	na	na	na	8.8	287.3	406.2	414.9	na
External sector				<i>(In millions of US dollars)</i>				
Current account (excl. grants)	na	na	-195	-315	-231	-483	-424	na
Trade balance ³	na	-1,382	-114	-166	-192	-402	-436	na
Exports ³	na	2,904	220	206	209	271	290	na
Imports ³	na	4,286	334	372	401	-673	-727	na
Foreign direct investment, net	na	na	na	na	3	19	22	na
Gross reserves (end-year), excluding gold ⁴	na	0	0	0	32	107	167	na
External debt stock	na	na	na	na	176	371	613	na
				<i>(In months of imports of goods and services)</i>				
Gross reserves (end-year) ⁴	na	na	na	na	1.0	1.6	2.2	na
				<i>(In per cent of exports of goods and services)</i>				
Debt service	na	na	na	na	3.1	20.6	18.7	na
Memorandum items				<i>(Denominations as indicated)</i>				
Population (in millions, end-year)	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
GDP (in millions of dram)	na	80	295	3,898	187,049	522,285	660,311	na
GDP per capita (in US dollars)	na	na	na	120	176	361	447	na
GNP per capita (in US dollars) at PPP exchange rates ⁵	na	na	na	na	na	2,260	na	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Azerbaijan

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output								
<i>(Percentage change)</i>								
GDP at constant prices	-11.7	-0.7	-22.6	-23.1	-18.1	-11.0	1.3	5.2
Industrial gross output	na	-7.5	-23.7	-20	-25	-21	-8	na
Agricultural gross output	na	-2.6	-25.0	-25.0	-12.0	-8.5	2	na
Composition of output								
<i>(In per cent of GDP)</i>								
Industry	22	30	26	25	25	22	23	na
Agriculture	26	39	27	30	30	31	30	na
Employment								
<i>(Percentage change)</i>								
Labour force (end-year)	na	na	na	0.5	-2.1	0.5	0.1	na
Employment (end-year)	-0.3	4.0	-1.7	-0.2	-1.1	-1.7	-3.9	na
<i>(In per cent of labour force)</i>								
Unemployment	na	na	15	16	15	17	20	na
Prices and wages								
<i>(Percentage change)</i>								
Consumer prices (annual average)	7.8	106	616	1,130	1,664	412	19.8	7.0
Consumer prices (end-year)	na	126	1,395	1,294	1,788	85	6.7	6.5
Government sector								
<i>(In per cent of GDP)</i>								
General government balance ¹	na	na	2.8	-12.7	-11.4	-4.2	-2.6	-2
General government expenditure ¹	na	na	46.3	46.1	36.0	19.5	19	na
Monetary sector								
<i>(Percentage change)</i>								
Broad money (end-year)	na	na	na	686	486	122	27	18
Domestic credit (end-year)	na	na	969	422	751	114	40	30
<i>(In per cent of GDP)</i>								
Broad money	na	na	38	45	39	11	9	na
Interest and exchange rates								
<i>(In per cent per annum, end-year)</i>								
Interbank interest rate ²	na	na	13	144	406	144	25	na
Treasury bill rate (three-month maturity)	na	na	na	na	na	na	34	na
Deposit rate (one month)	na	na	22	60	1,355	101	26	na
Lending rate ³	na	na	75	332	502	147	33	na
<i>(Manat per US dollar)</i>								
Exchange rate (end-year)	na	na	45	238	4,318	4,440	4,095	na
Exchange rate (annual average)	na	na	93	1,149	1,457	4,416	4,305	na
External sector								
<i>(In millions of US dollars)</i>								
Current account	na	153	488	2	-121	-318	-811	-725
Trade balance ⁴	na	60	489	-5	-163	-275	-549	na
Exports ⁴	na	295	1,275	716	682	680	789	na
Imports ⁴	na	-336	-786	-721	-845	-955	-1,338	na
Foreign direct investment, net	na	na	na	20	22	284	661	na
Gross reserves (end-year), excluding gold ⁵	na	na	0	0	2	119	214	na
External debt stock	na	na	na	na	89	420	560	na
<i>(In weeks of exports of goods and services)</i>								
Gross reserves (end-year), excluding gold ⁵	na	na	0	0	0	5	7	na
<i>(In per cent of exports of goods and services)</i>								
Debt service	na	na	na	na	na	7.9	9.7	na
Memorandum items								
<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	na	na	7.3	7.4	7.4	7.5	7.6	na
GDP (in billions of manat) ⁶	1.5	2.1	25.1	190	2,685	12,264	14,800	na
GDP per capita (in US dollars)	na	na	364	223	246	368	451	na
GDP per capita (in US dollars) at PPP exchange rates ⁷	na	na	na	na	1,345	1,665	na	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Belarus

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output								
				<i>(Percentage change)</i>				
GDP at constant prices	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.6	3.0
Industrial gross output	na	1.0	-5.2	-10.5	-18.9	-10.2	3.0	na
Agricultural gross output	na	-3.2	-14.4	-10.4	-14.9	-7.6	1.7	na
Composition of output								
				<i>(In per cent of GDP)</i>				
Industry	na	28.6	29.9	30.0	27.8	27.7	27.8	na
Agriculture	na	18.2	17.2	17.3	16.8	17.3	16.7	na
Employment								
				<i>(Percentage change)</i>				
Labour force (end-year)	na	-2.5	-2.6	-1.3	-2.7	-0.7	-2.0	na
Employment (end-year)	na	na	-3.0	-2.1	-3.4	-0.1	-0.2	na
				<i>(In per cent of labour force)</i>				
Unemployment ¹	na	0.0	0.5	1.4	2.1	2.7	3.9	na
Prices and wages								
				<i>(Percentage change)</i>				
Consumer prices (annual average)	na	84	969	1,187	2,221	709	53	78
Consumer prices (end-year)	na	93	1,558	1,994	1,990	243	40	99
Producer prices (annual average)	na	150	2,330	1,495	2,171	499	36	na
Producer prices (end-year)	na	na	4,094	2,281	1,867	141	33	na
Gross average monthly earnings in the economy (annual average)	na	na	838	1,107	1,504	669	na	na
Government sector								
				<i>(In per cent of GDP)</i>				
General government balance ²	na	na	na	-1.9	-2.6	-1.9	-1.6	-2.7
General government expenditure ²	na	na	na	56.6	50.5	45.1	43.5	na
Monetary sector								
				<i>(Percentage change)</i>				
Broad money (end-year)	na	na	na	954	1,878	158	67	na
Domestic credit (end-year)	na	na	na	na	2,031	226	105	na
				<i>(In per cent of GDP)</i>				
Broad money	na	na	na	3.6	38.5	15.1	15.2	na
Interest and exchange rates								
				<i>(In per cent per annum, end-year)</i>				
Refinancing rate	na	na	30	210	480	66	35	na
Treasury bill rate (three-month maturity)	na	na	na	na	320	70	48	na
Deposit rate (one year)	na	na	na	110	98	40	17	na
Lending rate (one year)	na	na	na	136	174	94	40	na
				<i>(Belarussian roubles per US dollar)</i>				
Exchange rate (end-year)	na	na	15	699	10,600	11,500	15,500	na
Exchange rate (annual average)	na	na	17	269	3,651	11,500	13,350	na
External sector								
				<i>(In millions of US dollars)</i>				
Current account	na	na	na	-1,113	-641	-254	-909	-1,150
Trade balance ³	na	na	na	-1,051	-710	-528	-1,335	-1,700
Exports ³	na	na	na	2,812	2,641	4,621	5,404	na
Imports ³	na	na	na	3,863	3,351	5,149	6,739	na
Foreign direct investment, net	na	na	na	18	10	7	75	na
Gross reserves (end-year), excluding gold ⁴	na	na	na	91	101	377	369	na
External debt stock	na	na	na	1,014	1,251	1,513	947	na
				<i>(In months of imports of goods and services)</i>				
Gross reserves (end-year), excluding gold ⁴	na	na	na	0.3	0.3	0.7	0.7	na
				<i>(In per cent of exports of goods and services)</i>				
Debt service	na	na	na	0.5	4.3	3.4	2.5	na
Memorandum items								
				<i>(Denominations as indicated)</i>				
Population (in millions, end-year)	10.3	10.3	10.3	10.4	10.4	10.3	10.3	10.2
GDP (in billions of Belarussian roubles)	na	86	91	978	17,661	118,522	179,820	na
GDP per capita (in US dollars)	na	na	na	350	465	1,001	1,308	na
GNP per capita (in US dollars) at PPP exchange rates ⁵	na	na	na	na	na	4,220	na	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Bosnia and Herzegovina

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output								
				(Percentage change)				
Real GDP	-9	-20	na	na	na	8	50	35
Federation	na	na	na	na	na	28	68	40
Republika Srpska	na	na	na	na	na	-23	19	na
				(1991=100)				
Industrial gross output ¹	112	100	50	4	2	10	19	na
Prices								
				(Percentage change)				
Retail prices (annual average)								
Federation	na	114	73,109	44,069	780	-12	-20	10
Republika Srpska	na	114	7,461	2.2*10 ¹⁵	1,061	133	60	0
Monetary sector								
				(Percentage change)				
M2 (end-year) ²								
Federation	na	na	na	na	na	33	110	na
Republika Srpska	na	na	na	na	na	-57	-5	na
				(Dinar per DM)				
Exchange rate (annual average) ³	na	na	na	na	na	100	100	na
Government sector								
				(In millions of DM)				
Government balance ⁴								
Federation	na	na	na	na	-20	0	26	na
Republika Srpska	na	na	na	na	-37	-9	9	na
Government expenditure ⁴								
Federation	na	na	na	na	421	854	1,752	na
Republika Srpska	na	na	na	na	248	197	167	na
External sector								
				(In millions of US dollars)				
Current account	na	na	na	na	-177	-193	-748	na
excluding official transfers	na	na	na	na	-492	-570	-1,306	na
Exports ⁵	1,990	2,120	495	7	91	152	336	na
Imports ⁵	1,953	1,673	429	60	894	1,082	1,882	na
of which humanitarian aid in-kind	na	na	na	na	561	459	260	na
Gross official reserves ⁶	na	na	na	na	17	138	384	na
				(In months of merchandise imports)				
Gross official reserves ⁶	na	na	na	na	0.2	0.8	2.4	na
Memorandum items								
GDP (in millions of US dollars)	10,471	8,670	na	na	na	2,100	3,260	na
Population (in millions) ⁷	4	4	4	4	4	4	4	na
GDP per capita (in US dollars)	2,396	1,979	na	na	547	607	815	na

Notes: Data for 1990-96 represent official estimates of outturns as reflected in publications from the national authorities and the International Monetary Fund. Data for 1997 reflect EBRD evaluations, partly based on information from these sources. Data refer to the entire territory of Bosnia and Herzegovina, unless otherwise indicated.

Methodological notes can be found on pp. 240 to 243.

Bulgaria

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
	(Percentage change)							
GDP at constant prices	-9.1	-11.7	-7.3	-2.4	1.8	2.1	-10.9	-7
Industrial gross output	-16.0	-27.8	-15.0	-11.8	7.8	-6.3	-7.9	na
Agricultural gross output	-3.7	7.7	-13.8	-18	10.0	14	-18	na
Composition of output								
	(In per cent of GDP)							
Industry	na	37	35	29	27	29	32	na
Agriculture	na	14	12	11	12	13	11	na
Employment								
	(Percentage change)							
Labour force (end-year)	na	na	-3.3	-0.1	-5.2	na	na	na
Employment (end-year)	-6.2	-13.0	-8.1	-1.6	0.6	2.1	0	na
	(In per cent of labour force)							
Unemployment	1.5	11.5	15.6	16.4	12.8	10.5	12.5	na
Prices and wages								
	(Percentage change)							
Consumer prices (annual average)	26.3	333.5	82.0	73.0	96.3	62.0	123.0	1,049.0
Consumer prices (end-year)	72.5	338.9	79.4	63.9	121.9	32.9	311.0	591.5
Gross average monthly earnings in industry, public sector (annual average)	na	na	na	na	53	60	95	na
Government sector								
	(In per cent of GDP)							
General government balance ¹	na	na	-5.2	-10.9	-5.8	-6.4	-13.4	-6.3
General government primary balance ¹	na	3.2	-0.4	-4.7	3.9	6.6	6.7	4.1
General government expenditure ¹	65.9	45.6	45.4	48.1	45.7	43	47.6	na
Monetary sector								
	(Percentage change)							
Broad money (end-year)	17	125	42	48	79	40	111	na
Domestic credit (end-year)	26	148	52	56	37	16	216	na
	(In per cent of GDP)							
Broad money	na	na	na	65	63	57	46	na
Interest and exchange rates								
	(In per cent per annum, end-year)							
Interbank interest rate (up to 30-day maturity)	na	na	na	68	108	44	449	na
Treasury bill rate (less than one-year maturity)	na	na	na	59	92	43	477	na
Deposit rate (one month)	na	na	na	54	72	25	212	na
Lending rate (less than one year)	na	na	na	84	118	51	481	na
	(Leva per US dollar)							
Exchange rate (end-year)	7.0	21.8	24.5	32.7	66	71	496	1,720
Exchange rate (annual average)	3.9	18.1	23.4	27.7	54	67	190	1,657
External sector								
	(In millions of US dollars)							
Current account	-1,180	-406	-801	-1,386	-203	-59	117	65
Trade balance ²	na	404	-212	-885	-17	120	209	180
Exports ²	2,534	2,734	3,956	3,727	3,935	5,344	4,881	na
Imports ²	3,086	2,330	4,169	4,612	3,952	5,224	4,673	na
Foreign direct investment, net	na	56	42	40	105	82	100	na
Gross reserves (end-year), excluding gold ³	na	331	935	655	1,002	1,236	518	na
Gross external debt	10,000	11,802	12,548	13,890	11,411	10,229	9,660	na
	(In months of current account expenditures, excluding transfers)							
Gross reserves (end-year), excluding gold ³	na	0.8	1.7	1.2	2.1	2.3	1.1	na
	(In per cent of current account revenues, excluding transfers)							
Debt service	64.8	24.1	22.8	16.6	12.9	14.8	19.5	na
Memorandum items								
	(Denominations as indicated)							
Population (in millions, end-year)	8.7	8.6	8.5	8.5	8.4	8.4	8.4	na
GDP at market prices (in billions of leva)	45	136	201	299	526	868	1,660	na
GDP per capita (in US dollars)	1,343	872	1,012	1,276	1,157	1,538	1,038	na
GDP per capita (in US dollars) at PPP exchange rates ⁴	na	na	4,112	4,193	4,377	4,588	4,190	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Croatia

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output								
				<i>(Percentage change)</i>				
GDP at constant prices	-6.9	-19.8	-11.1	-0.9	0.6	1.7	4.2	5.0
Industrial gross output	-11.3	-28.7	-14.6	-6.0	-2.6	0.3	3.1	na
Agricultural gross output	-2.9	-7.2	-13.5	4.5	-2.9	0.7	1.5	na
Tourism ¹	-16.0	-85.2	11.7	29.2	59.4	-45.3	94.3	na
Composition of output				<i>(In per cent of GDP)</i>				
Industry (at 1990 constant prices)	26.0	23.4	22.6	21.5	20.8	20.5	20.3	na
Agriculture and fishing (at 1990 constant prices)	8.3	9.6	9.5	10.0	9.6	9.5	9.2	na
Employment				<i>(Percentage change)</i>				
Labour force (annual average)	na	na	na	na	-1.0	-1.3	-4.1	na
Employment (annual average) ²	-3.6	-13.7	-12.7	-2.6	-4.2	-3.3	-1.4	na
				<i>(In per cent of labour force)</i>				
Unemployment	9.3	13.2	13.2	14.8	14.5	14.5	16.4	na
Prices and wages				<i>(Percentage change)</i>				
Retail prices (annual average)	610	123	666	1,518	97.6	2.0	3.5	3.7
Retail prices (end-year)	136	250	938	1,149	-3.0	3.8	3.4	4.0
Producer prices (annual average)	455	146	825	1,512	77.6	0.7	1.4	2.0
Producer prices (end-year)	na	412	1,079	1,076	-5.5	1.6	1.5	2.0
Monthly earnings per employee (annual average) ³	480	69	309	1,477	137	34	12	na
Government sector				<i>(In per cent of GDP)</i>				
Government balance ⁴	na	na	-4.0	-0.8	1.7	-0.9	-0.5	-2.7
Government expenditure ⁴	na	na	37	33	42	47	47	na
Monetary sector				<i>(Percentage change)</i>				
M1 (end-year)	na	na	na	na	112	25	38	na
Domestic credit (end-year)	na	na	na	na	35	19	3	na
				<i>(In per cent of GDP)</i>				
M4 (end-year)	na	na	na	24	21	26	35	na
Interest and exchange rates				<i>(In per cent per annum, end-year)</i>				
Overnight money market rate	na	na	2,182	34.5	8.5	27.3	9.7	na
Treasury bill rate (three-month maturity)	na	na	na	97.4	14.0	27.0	9.5	na
Average deposit rate	na	na	435	27.4	5.0	6.1	4.2	na
Average lending rate	na	na	2,333	59.0	15.4	22.3	18.5	na
				<i>(Kuna per US dollar)</i>				
Exchange rate (end-year)	na	na	0.80	6.56	5.63	5.32	5.54	na
Exchange rate (annual average)	0.01	0.02	0.26	3.59	5.99	5.23	5.43	na
External sector ⁵				<i>(In billions of US dollars)</i>				
Current account	1.05	-0.59	0.82	0.10	0.10	-1.71	-1.45	-1.90
Trade balance	-1.17	-0.54	-0.30	-0.76	-0.97	-2.88	-3.28	-4.31
Merchandise exports	4.02	3.29	3.13	3.90	4.26	4.63	4.51	na
Merchandise imports	5.19	3.83	3.43	4.67	5.23	7.51	7.79	na
Foreign direct investment, inflow	na	na	0.01	0.07	0.10	0.08	0.35	na
Gross reserves (end-year), excluding gold ⁶	na	0.0	0.17	0.62	1.41	1.90	2.31	na
External debt stock (end-year)	na	2.98	2.74	2.64	3.07	3.66	4.85	na
				<i>(In months of imports of goods and services)</i>				
Gross international reserves (end-year), excluding gold ⁶	na	0.0	0.4	0.6	2.5	2.4	2.7	na
				<i>(In per cent of exports of goods and services)</i>				
Debt service	na	12.3	8.9	7.2	4.6	6.3	8.4	na
Memorandum items				<i>(Denominations as indicated)</i>				
Population (in millions, end-year)	4.8	4.8	4.8	4.8	4.8	4.8	4.8	na
GDP (in billions of kuna)	0.3	0.4	2.6	41.8	85.3	94.6	103.6	na
GDP per capita (in US dollars)	5,106	3,510	2,079	2,440	2,980	3,786	3,992	na
GDP per capita (in US dollars) at PPP exchange rates ⁷	na	na	na	3,828	na	na	na	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Czech Republic

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
	<i>(Percentage change)</i>							
GDP at constant prices ¹	-1.2	-11.5	-3.3	0.6	2.7	5.9	4.1	1.0
Private consumption	6.7	-28.5	15.1	2.9	5.3	6.2	6.3	na
Public consumption	0.9	-9.0	-3.1	-0.1	-2.3	0.4	2.8	na
Gross fixed investment	-2.1	-17.7	8.9	-7.7	17.3	22.3	8.7	na
Exports of goods and services	na	na	6.7	7.5	0.4	15.8	3.2	na
Imports of goods and services	na	na	22.0	10.2	7.8	21.7	11.7	na
Industrial gross output	-3.5	-22.3	-7.9	-5.3	2.1	8.7	6.4	na
Agricultural gross output	na	-8.9	-12.1	-2.3	-6.0	5.0	-1.4	na
Composition of output								
	<i>(In per cent of GDP)</i>							
Industry	na	na	40.2	34.9	33.6	34.1	33.8	na
Agriculture	8.4	6.0	6.1	6.5	3.8	5.3	5.1	na
Employment								
	<i>(Percentage change)</i>							
Labour force (end-year)	na	na	na	na	-0.2	0.0	-0.5	na
Employment (end-year)	na	na	-2.6	-1.6	0.8	2.6	1.2	na
	<i>(In per cent of labour force)</i>							
Unemployment	0.8	4.1	2.6	3.5	3.2	2.9	3.5	na
Prices and wages								
	<i>(Percentage change)</i>							
Consumer prices (annual average)	10.8	56.6	11.1	20.8	10.0	9.1	8.8	9.5
Consumer prices (end-year)	18.4	52.0	12.7	18.2	9.7	7.9	8.6	9.0
Producer prices (annual average)	4.4	70.3	9.9	13.1	5.3	7.6	4.8	na
Producer prices (end-year)	na	na	9.4	7.5	5.6	7.2	4.4	na
Gross average monthly wages in manufacturing (annual average)	4.5	16.7	19.6	23.8	15.7	17.0	17.4	na
Government sector								
	<i>(In per cent of GDP)</i>							
General government balance ²	na	na	na	2.7	0.8	0.4	-0.2	-1
General government expenditure ²	na	na	na	41.9	43.3	43.4	42.8	na
Monetary sector								
	<i>(Percentage change)</i>							
Broad money (end-year)	0.5	26.8	22.8	19.8	19.9	19.8	9.2	na
Domestic credit (end-year)	na	na	na	18.5	15.5	6.3	8.5	na
	<i>(In per cent of GDP)</i>							
Broad money	na	na	na	71.0	74.0	76.7	74.3	na
Interest and exchange rates								
	<i>(In per cent per annum, end-year)</i>							
Interbank interest rate (up to 30-day maturity)	na	na	12.7	6.7	12.6	11.1	12.6	na
Discount rate	na	na	9.5	8.0	8.5	9.5	10.5	na
Deposit rate	na	na	6.3	7.0	6.9	6.9	6.7	na
Lending rate	na	na	13.3	14.1	12.8	12.7	12.5	na
	<i>(Koruna per US dollar)</i>							
Exchange rate (end-year)	28.0	27.8	28.9	30.0	28.0	26.6	27.3	na
Exchange rate (annual average)	18.0	29.5	28.3	29.2	28.8	26.6	27.1	na
External sector								
	<i>(In billions of US dollars)</i>							
Current account	-1.1	0.4	-0.3	0.1	-0.1	-1.4	-4.5	na
Trade balance ³	-0.8	-0.4	-1.9	-0.3	-0.9	-3.7	-6.0	na
Exports ³	5.9	8.3	8.4	13.0	14.0	21.5	21.7	na
Imports ³	6.5	8.8	10.4	13.3	14.9	21.4	27.7	na
Foreign direct investment, net	na	na	1.0	0.5	1.0	2.7	1.3	na
Gross reserves (end-year), excluding gold ⁴	0.2	0.7	0.9	3.9	6.2	14.0	12.4	na
External debt stock (convertible currency)	6.0	6.7	7.1	8.5	10.7	17.2	20.7	na
	<i>(In months of imports of goods and services)</i>							
Gross reserves (end-year), excluding gold ⁴	0.3	0.8	1.1	2.7	3.9	5.6	4.4	na
	<i>(In per cent of exports of goods and services)</i>							
Debt service	na	na	11.4	8.4	13.1	10.3	12.8	na
Memorandum items								
	<i>(Denominations as indicated)</i>							
Population (in millions, end-year)	10.3	10.3	10.3	10.3	10.3	10.3	10.3	10.3
GDP (in billions of koruna)	579	750	847	1,002	1,143	1,319	1,490	na
GDP per capita (in US dollars)	3,126	2,466	2,903	3,332	3,853	4,814	5,340	na
GNP per capita (in US dollars) at PPP exchange rates ⁵	na	na	na	na	na	9,770	na	na

Notes: Data in bold type refer to former Czechoslovakia. Data for 1990-96 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the OECD, PlanEcon and the Institute of International Finance. Data for 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Estonia

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
	(Percentage change)							
GDP at constant prices	-8.1	-7.9	-14.2	-8.5	-1.8	4.3	4.0	7
Private consumption	na	na	na	na	7.1	5.1	9.1	na
Public consumption	na	na	na	na	2.2	13.0	5.8	na
Gross fixed investment	na	na	na	na	2	2	4	na
Industrial gross output	na	na	na	na	-2.2	4.7	6.3	na
Agricultural gross output	na	na	na	na	-14.2	-1.2	na	na
Composition of output								
	(In per cent of GDP)							
Industry	na	na	27.5	22.0	21.1	20.2	18.9	na
Agriculture	na	na	12.6	9.8	9.0	7.1	6.4	na
Employment								
	(Percentage change)							
Employment (annual average)	-2	2	-6	-12	-1	-1	na	na
	(In per cent of labour force)							
Unemployment ¹	na	na	na	5.0	5.1	5.1	5.6	na
Prices and wages								
	(Percentage change)							
Consumer prices (annual average)	23	211	1,076	90	48	29	23	11
Consumer prices (end-year)	na	304	954	36	42	29	15	12
Producer prices (annual average)	na	na	na	na	36	26	15	na
Producer prices (end-year)	na	na	na	na	33	22	10	na
Gross monthly earnings per employee in manufacturing (annual average)	na	na	na	93	72	36	24	na
Government sector								
	(In per cent of GDP)							
General government balance ²	na	5.2	-0.3	-0.7	1.3	-1.2	-1.5	na
General government expenditure	na	na	34.9	40.3	38.3	40.8	40.4	na
Monetary sector								
	(Percentage change)							
Broad money (end-year)	na	na	71	87	31	30	37	na
Domestic credit (end-year)	na	na	30	61	40	63	98	na
	(In per cent of GDP)							
Broad money	na	na	na	na	26	25	27	na
Interest and exchange rates								
	(In per cent per annum, end-year)							
Interbank interest rate (up to 30-day maturity)	na	na	na	na	na	na	5.82	na
Treasury bill rate (three-month maturity)	na	na	na	na	na	na	na	na
Deposit rate (over 12 months) ³	na	na	na	na	10.13	7.21	7.48	na
Lending rate (1-3 years)	na	na	na	21.90	19.08	16.82	17.23	na
	(Kroon per US dollar)							
Exchange rate (end-year)	na	na	12.9	13.9	12.4	11.5	12.4	na
Exchange rate (annual average)	na	na	na	13.2	13.0	11.5	12.0	na
External sector								
	(In millions of US dollars)							
Current account	na	na	36	23	-165	-166	-448	-470
Trade balance ⁴	na	na	-90	-145	-335	-674	-1,058	na
Exports ⁴	na	na	461	812	1,329	1,857	2,064	na
Imports ⁴	na	na	551	957	1,664	2,531	3,122	na
Foreign direct investment, net	na	na	na	156	212	199	110	na
Gross reserves (end-year), excluding gold ⁵	na	na	170	386	443	580	637	na
External debt stock (end-year)	na	na	na	161	194	273	344	na
	(In months of current account expenditures, excluding transfers)							
Gross reserves (end-year), excluding gold ⁵	na	na	2.8	3.7	2.5	2.3	2.0	na
	(In per cent of exports of goods and non-factor services)							
Debt service	na	na	na	1.4	0.4	0.5	0.8	na
Memorandum items								
	(Denominations as indicated)							
Population (in millions, end-year)	1.6	1.6	1.6	1.5	1.5	1.5	1.5	na
GDP (in millions of kroon)	na	na	13,054	21,918	30,268	41,279	52,379	na
GDP per capita (in US dollars)	na	na	632	1,105	1,553	2,400	3,000	na
GDP per capita (in US dollars) at PPP exchange rates ⁶	na	na	3,957	3,785	3,842	4,138	4,431	na

Notes: Data for 1990-96 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD, PlanEcon, Stockholm Institute of East European Economics and the Institute of International Finance. Data for 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

FYR Macedonia

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection	
Output									
				<i>(Percentage change)</i>					
GDP at constant prices	-9.9	-12.1	-21.1	-8.4	-4.0	-1.4	1.1	2	
Industrial gross output	na	-17.2	-13	-9	-7	-6	2	na	
Agricultural gross output	na	17.1	0.5	-23.5	7.1	4	na	na	
Composition of output ¹				<i>(In per cent of GSP)</i>					
Industry (including mining)	48.0	45.6	44.7	44.4	42.8	39.3	na	na	
Agriculture	10.3	13.8	16.8	15.8	16.5	17.8	na	na	
Employment				<i>(Percentage change)</i>					
Labour force (end-year)	na	1.3	1.3	0.6	na	na	na	na	
Employment (end-year)	na	-6.5	-5.2	-6.2	-5.9	-13.4	-5.7	na	
				<i>(In per cent of labour force)</i>					
Unemployment ²	na	19.2	19.8	20.0	23.7	24.9	na	na	
Prices and wages				<i>(Percentage change)</i>					
Retail prices (annual average)	608	115	1,691	350	122	16.4	3.1	6	
Retail prices (end-year)	121	230	1,925	230	55	9.3	0.2	8	
Producer prices in industry (annual average)	394	112	2,198	258	89	4.9	-0.1	na	
Producer prices in industry (end-year)	42	282	2,149	176	28.6	2.2	-0.6	na	
Average take-home pay in industry	na	79	1,084	454	106	11.1	na	na	
Government sector				<i>(In per cent of GDP)</i>					
General government balance ³	na	na	-9.6	-13.6	-3.2	-1.3	-0.4	-1	
General government expenditure	na	na	48.2	54.5	54.2	46.5	44.3	40	
Monetary sector				<i>(Percentage change)</i>					
Broad money (end-year)	na	na	na	na	na	0.3	0.5	na	
Domestic credit (end-year)	na	na	na	na	na	-22.3	-12.3	na	
				<i>(In per cent of GDP)</i>					
Broad money	na	na	na	25.6	17.1	16.2	16	na	
Interest and exchange rates				<i>(In per cent per annum, end-year)</i>					
Interest rate on regular liquidity credit	na	na	719	848	66	30	18.4	na	
Discount rate (end-year)	na	na	250	295	33	15	9.2	na	
Deposit rate (3-6 months)	na	na	435-885	322-418	32-49	9-21	9-21	na	
Lending rate (one year)	na	na	na	275-368	77-81	25-30	19-30	na	
				<i>(Denar per US dollar)</i>					
Exchange rate (end-year)	na	na	na	44.5	40.6	38.0	41.4	na	
Exchange rate (annual average)	na	na	na	23.6	43.2	38.0	40.0	na	
External sector				<i>(In millions of US dollars)</i>					
Current account	-400	-262	-19	-87	-181	-232	-288	na	
Trade balance ⁴	-418	-225	-7	-171	-186	-235	-317	na	
Exports ⁴	1,113	1,150	1,199	1,056	1,086	1,204	912	1	
Imports ⁴	1,531	1,375	1,206	1,227	1,272	1,439	1,435	2	
Foreign direct investment, net	na	na	0	0	24	13	39	na	
Gross reserves (end-year), excluding gold ⁵	na	na	na	105	149	257	249	na	
External debt stock	na	744	812	873	898	1,115	1,176	na	
				<i>(In months of current account expenditures, excluding transfers)</i>					
Gross reserves (end-year), excluding gold ⁵	na	na	na	1.03	1.41	2.14	2.08	na	
				<i>(In per cent of current account revenues, excluding transfers)</i>					
Debt service	na	na	na	13.0	15.7	10.3	11.1	na	
Memorandum items				<i>(Denominations as indicated)</i>					
Population (in millions, end-year)	2.1	2.2	2.2	2.2	2.1	2.0	2.0	na	
GDP (in millions of denar)	507	920	11,791	59,161	136,033	143,597	147,554	na	
GDP per capita (in US dollars)	na	na	na	1,141	1,500	1,887	1,845	na	
GDP per capita (in US dollars) at PPP exchange rates ⁶	na	na	na	2,289	2,189	2,131	2,147	na	

Notes: Data for 1990-96 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 1997 reflects EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Georgia

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output								
				<i>(Percentage change)</i>				
GDP at constant prices	-12.4	-13.8	-44.8	-25.4	-11.4	2.4	10.5	10.5
Industrial gross output	-30	-24	-43	-21	-40	-10	4.5	na
Agricultural gross output	62	-11	-34	-42	-15	18	11.0	na
Composition of output				<i>(In per cent of GDP)</i>				
Industry	na	na	13	6	21	15	14	na
Agriculture	na	na	55	68	29	38	33	na
Prices and wages				<i>(Percentage change)</i>				
Consumer prices (annual average)	3	79	887	3,125	15,606	163	39	9
Consumer prices (end-year)	5	131	1,177	7,488	6,473	57	14	8.5
Gross average monthly wages in industry (annual average)	na	na	na	1,950	23,314	122	na	na
Government sector				<i>(In per cent of GDP)</i>				
General government balance ¹	na	-3.0	-25.4	-26.2	-7.4	-4.5	-4.4	-3.5
General government expenditure and net lending	na	33.0	39.0	36.0	24.0	12.3	13.9	na
Monetary sector				<i>(Percentage change)</i>				
Broad money (end-year)	na	na	464	4,319	2,229	146	42	na
Domestic credit (end-year)	na	na	794	2,048	3,255	86	60	na
				<i>(In per cent of GDP)</i>				
Broad money	na	na	31.3	19.3	5.3	4.9	4.5	na
Exchange rates				<i>(Lari per US dollar)</i>				
Exchange rate (end-year)	na	na	na	0.1	1.28	1.23	1.28	na
Exchange rate (annual average)	na	na	na	na	1.10	1.29	1.26	na
External sector				<i>(In millions of US dollars)</i>				
Current account, including official transfers	na	na	-248	-354	-278	-236	-222	-273
excluding official transfers	na	na	-319	-485	-448	-405	-362	-333
Trade balance ²	na	na	-378	-448	-365	-335	-295	na
Exports ²	na	na	267	457	381	358	415	na
Imports ²	na	na	645	905	746	693	710	na
Foreign direct investment, net	na	na	na	na	8	6	25	na
Gross reserves (end-year) ³	na	na	0.7	1	41	157	158	na
External debt stock	na	na	na	na	987	1,223	1,373	na
				<i>(In months of merchandise imports)</i>				
Gross reserves (end-year) ³	na	na	na	na	0.7	2.7	2.7	na
				<i>(In per cent of exports of goods and services)</i>				
Debt service ⁴	na	na	na	na	na	7.3	9.8	na
Memorandum items				<i>(Denominations as indicated)</i>				
Population (in millions, end-year)	5.4	5.4	5.4	5.4	5.4	5.4	5.4	na
GDP (in millions of lari)	na	na	0.2	16	1,373	3,694	5,724	na
GDP per capita (in US dollars)	na	na	na	na	231	530	841	na
GNP per capita (in US dollars) at PPP exchange rates ⁵	na	na	na	na	1,320	1,813	na	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Hungary

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
				<i>(Percentage change)</i>				
GDP at constant prices	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.0	3.0
Private consumption	-3.6	-5.6	0.0	1.9	-0.2	-7.1	-4	na
Public consumption ¹	2.6	-2.7	4.9	27.5	-12.7	-4	-3	na
Gross fixed investment	-7.1	-10.4	-2.6	2.0	12.5	-4	-3	na
Exports of goods and services	-5.3	-13.9	2.1	-9.1	13.7	13.4	11	na
Imports of goods and services	-4.3	-6.1	0.2	20.2	8.8	-0.7	7	na
Industrial gross output	-9.3	-18.4	-9.7	4.0	9.6	4.6	3	na
Agricultural gross output	-4.7	-6.2	-20.0	-9.7	3.2	0	5	na
Composition of output				<i>(In per cent of GDP)</i>				
Industry	28.8	26.7	24.4	23.2	22.8	23.9	na	na
Agriculture	9.6	7.8	6.5	5.8	6.0	6.4	na	na
Employment				<i>(Percentage change)</i>				
Labour force (end-year)	-2	-4	-4	-4	-3	-2	-0.7	na
Employment (end-year)	-3.1	-9.6	-9.3	-5.0	-2.2	-1.4	-5.6	na
				<i>(In per cent of labour force)</i>				
Unemployment ²	1.9	7.5	12.3	12.1	10.4	10.4	10.5	10
Prices and wages				<i>(Percentage change)</i>				
Consumer prices (annual average)	28.9	35.0	23.0	22.5	18.8	28.2	23.6	18
Consumer prices (end-year)	33.4	32.2	21.6	21.1	21.2	28.3	19.8	17
Producer prices (annual average)	22.0	32.6	12.3	10.8	11.3	28.9	21.8	20
Producer prices (end-year)	39.3	23.5	18.8	10.3	19.9	30.2	20.1	17
Gross average monthly earnings in manufacturing (annual average)	22.9	25.6	25.9	24.7	21.5	21.3	21.6	na
Government sector				<i>(In per cent of GDP)</i>				
General government balance ³	0.4	-2.2	-5.5	-6.8	-8.2	-6.5	-3.5	-5
General government expenditure	53.5	54.3	61.6	62.2	62.1	56.1	50.0	na
Monetary sector				<i>(Percentage change)</i>				
Broad money (end-year)	29.2	29.4	27.3	17.2	13.0	18.5	20.9	na
Domestic credit (end-year) ⁴	na	8.0	7.8	3.7	17.3	-0.9	29.0	na
				<i>(In per cent of GDP)</i>				
Broad money	na	47.4	51.2	49.6	45.5	42.8	42.1	na
Interest and exchange rates				<i>(In per cent per annum, end-year)</i>				
Interbank interest rate (up to 30-day maturity)	na	na	na	21.8	31.3	27.8	23.2	na
Treasury bill rate (three-month maturity)	na	na	na	24.3	31.6	30.1	22.1	na
Deposit rate (one year)	28.5	29.4	16.1	16.6	22.9	24.4	18.6	na
Lending rate (one year)	32.1	35.5	28.8	25.6	29.7	32.2	24.0	na
				<i>(Forints per US dollar)</i>				
Exchange rate (end-year)	61.5	75.6	84.0	100.7	110.7	139.5	164.9	na
Exchange rate (annual average)	63.2	74.8	79.0	91.9	105.2	125.7	152.6	na
External sector				<i>(In billions of US dollars)</i>				
Current account	0.1	0.3	0.3	-3.5	-3.9	-2.5	-1.7	-1.9
Trade balance ⁵	0.3	0.2	-0.1	-3.2	-3.6	-2.4	-2.6	-3.0
Exports ⁵	na	9.3	10.0	8.1	7.6	12.8	14.2	na
Imports ⁵	na	9.1	10.1	11.3	11.2	15.3	16.8	na
Foreign direct investment, net	0.3	1.5	1.5	2.3	1.1	4.5	2.0	na
Gross reserves (end-year), excluding gold ⁶	na	3.9	4.3	6.7	6.8	12.0	9.8	na
External debt stock	na	22.6	21.4	24.6	28.5	31.7	27.6	na
				<i>(In months of current account expenditures, excluding transfers)</i>				
Gross reserves (end-year), excluding gold ⁶	1.3	3.8	3.6	5.2	5.1	7.0	5.3	na
				<i>(In per cent of current account revenues, excluding transfers)</i>				
Debt service ⁷	48.2	33.9	34.4	43.2	54.8	47.3	50.4	na
Memorandum items				<i>(Denominations as indicated)</i>				
Population (in millions, end-year)	10.4	10.3	10.3	10.3	10.2	10.2	10.2	na
GDP (in billions of forints)	2,089	2,498	2,943	3,548	4,365	5,494	6,750	na
GDP per capita (in US dollars)	3,179	3,242	3,617	3,748	4,069	4,286	4,357	na
GNP per capita (in US dollars) at PPP exchange rates ⁸	na	na	na	na	na	6,410	na	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Kazakhstan

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output								
				<i>(Percentage change)</i>				
GDP at constant prices	-0.4	-13.0	-2.9	-10.4	-17.8	-8.9	1.1	2.0
Industrial gross output	-1.0	-1.0	-14.0	-14.0	-27.5	-8.2	0.3	na
Agricultural gross output	16.0	-9.0	1.0	-6.9	-21.0	-24.4	3.9	na
Composition of output				<i>(In per cent of GDP)</i>				
Industry	41.5	38.0	34.7	28.7	29.1	23.4	21.3	na
Agriculture	28.1	29.0	30.4	16.4	14.9	12.1	11.9	na
Employment				<i>(Percentage change)</i>				
Labour force (end-year)	na	na	na	na	-2.5	-3.0	-1.5	na
Employment (end-year)	1.2	-1.0	-1.9	-5.8	-3.8	-7.8	-11.3	na
				<i>(In per cent of labour force)</i>				
Unemployment ¹	0.0	0.0	0.5	0.6	0.8	1.7	3.6	na
Prices and wages				<i>(Percentage change)</i>				
Consumer prices (annual average)	na	79	1,381	1,662	1,892	176	39.1	18.0
Consumer prices (end-year)	105	137	2,984	2,169	1,160	60	28.6	12.0
Government sector				<i>(In per cent of GDP)</i>				
General government balance ²	1.4	-7.9	-7.3	-1.3	-7.2	-2.0	-2.5	-4.2
General government expenditure	31.4	32.9	31.8	25.2	25.9	20.7	18.5	na
Monetary sector				<i>(Percentage change)</i>				
Broad money (end-year)	na	211	391	692	576	103.8	14.7	na
Domestic credit (end-year)	na	289	1,343	653	710	-22.5	-12.0	na
				<i>(In per cent of GDP)</i>				
Broad money	na	na	45	21	26	11.5	4.4	na
Interest and exchange rates				<i>(In per cent per annum, end-year)</i>				
Interbank interest rate (up to 30-day maturity)	na	na	na	240	230	52.5	31.7	na
Treasury bill rate (three-month maturity)	na	na	na	na	354	58.8	28.9	na
Deposit rate (one year) ³	na	na	na	na	na	53.3	30.0	na
Lending rate (one year)	na	na	na	na	na	58.3	39.4	na
				<i>(Tenge per US dollar)</i>				
Exchange rate (end-year)	na	na	0.8	6.1	54.3	64.0	73.3	na
Exchange rate (annual average)	na	na	0.4	1.9	36.0	61.0	68.0	na
External sector				<i>(In billions of US dollars)</i>				
Current account	na	-1.3	-1.9	-0.4	-0.9	-0.7	-0.7	-1.4
Trade balance ⁴	na	-3.2	-1.1	-0.4	-0.9	-0.2	-0.3	-0.8
Exports ⁴	na	10.2	3.6	4.8	3.3	5.2	6.3	na
Imports ⁴	na	-13.4	-4.7	-5.2	-4.2	-5.4	-6.6	na
Foreign direct investment, net	na	na	na	0.47	0.64	0.86	1.10	na
Gross reserves (end-year), excluding gold ⁵	na	na	na	0.64	1.22	1.66	2.01	na
External debt stock	na	na	1.48	1.85	2.72	3.43	3.89	na
				<i>(In months of imports of goods and services)</i>				
Gross reserves (end-year), excluding gold ⁶	na	na	na	1.48	3.5	3.2	3.5	na
				<i>(In per cent of exports of goods and services)</i>				
Total debt service	na	na	4.3	1.4	3.3	8.0	5.5	na
Memorandum items				<i>(Denominations as indicated)</i>				
Population (in millions, end-year)	16.6	16.7	16.9	16.9	16.7	16.5	16.4	na
GDP (in billions of tenge)	na	na	2	32	450	1,086	1,416	na
GDP per capita (in US dollars)	na	na	322	981	785	1,079	1,278	na
GNP per capita (in US dollars) at PPP exchange rates ⁷	na	na	na	na	3,518	3,664	na	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Kyrgyzstan

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output								
<i>(Percentage change)</i>								
GDP at constant prices	3	-5	-19	-16	-20	1.3	5.6	6
Industrial gross output	-0.6	-0.3	-26	-25	-28	-12.5	10.8	na
Agricultural gross output	1.3	-10	-5	-10	-15	4	13	na
Composition of output								
<i>(In per cent of GDP)</i>								
Industry	26	27	32	25	20	16	12	na
Agriculture	32	35	37	39	38	40	47	na
Employment								
<i>(Percentage change)</i>								
Labour force	na	na	0.4	-3.1	-1.5	2.0	0.6	na
Employment ¹	na	0.4	4.7	-8.5	-2.1	-0.3	0.0	na
<i>(In per cent of labour force)</i>								
Unemployment rate ²	na	0.0	0.1	0.2	0.7	3.0	4.5	na
Prices and wages								
<i>(Percentage change)</i>								
Consumer prices (annual average)	na	85	855	772	229	53	30	27
Consumer prices (end-year)	na	170	1,259	1,363	96	32	35	24
Government sector								
<i>(In per cent of GDP)</i>								
General government balance ³	0.3	4.6	-17.4	-14.2	-7.7	-13.5	-6.4	-5.3
General government expenditure and net lending	38.3	30.3	33.9	39.1	28.6	30.2	23.4	22.3
Monetary sector								
<i>(Percentage change)</i>								
Broad money (end-year)	na	84	428	180	125	78	22	na
Net domestic assets	na	na	761	307	84	91	25	na
Interest and exchange rates								
<i>(In per cent per annum, end-year)</i>								
Refinancing rate ⁴	na	na	na	277	89.5	45.8	45.9	na
Treasury bill rate (three-month maturity)	na	na	na	na	73	44	64.4	na
Deposit rate (three-month, min/max rates)	na	na	na	na	na	20/50	15/40	na
Lending rate (min/max rates)	na	na	na	na	na	35/140	45/120	na
<i>(Denominations as indicated)</i>								
Exchange rate (end-year) ⁵	1.7	1.7	415	8	10.7	11.0	16.7	na
Exchange rate (annual average) ⁵	1.8	1.8	222	6.1	10.9	10.8	12.9	na
External sector								
<i>(In millions of US dollars)</i>								
Current account balance	na	na	-61	-162	-124	-288	-414	na
Trade balance ⁶	na	-41	-74	-166	-119	-263	-373	na
Exports ⁶	na	3,845	258	335	340	409	529	na
Imports ⁶	na	3,886	332	501	459	672	902	na
Foreign direct investment, net	na	na	na	10	45	61	31	na
Gross reserves (end-year), including gold ⁷	na	na	na	46	97	115	129	na
External debt stock	na	na	na	290	414	543	746	na
<i>(In months of imports of goods and services)</i>								
Gross reserves (end-year), including gold ⁸	na	na	na	1.1	2.5	2.5	2.0	na
<i>(In per cent of merchandise exports)</i>								
Debt service	na	na	na	0.6	5	22	18	na
Memorandum items								
<i>(Denominations as indicated)</i>								
Population (in millions, beginning of year)	4.4	4.4	4.5	4.5	4.5	4.5	4.6	na
GDP (in millions of som)	43	93	741	5,355	12,019	16,100	22,500	na
GDP per capita (in US dollars)	na	na	na	195	245	331	379	na
GNP per capita (in US dollars) at PPP exchange rates ⁹	na	na	na	na	1,559	1,621	na	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Latvia

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
<i>(Percentage change)</i>								
GDP at constant prices	2.9	-10.4	-34.9	-14.9	0.6	-0.8	2.8	3.4
Private consumption	na	-26.0	-43.3	-7.4	3.2	na	na	na
Public consumption	na	-4.9	5.6	1.6	-0.9	na	na	na
Gross fixed investment	na	-63.9	-28.7	-15.8	0.8	na	na	na
Exports of goods and services	na	-32.2	14.9	-22.4	-8.4	na	na	na
Imports of goods and services	na	-43.9	8.0	-39.8	-0.7	na	na	na
Industrial gross output	na	-0.3	-46.2	-29.8	-7.7	0.9	3.1	na
Agricultural gross output	na	-1.1	-28.6	-18.2	-15.0	3.1	-10.1	na
Composition of output ¹								
<i>(In per cent of GDP)</i>								
Industry	38.3	39.9	29.8	30.8	25.4	25.3	27.8	na
Agriculture	21.9	23.1	17.6	11.8	9.5	9.8	9.1	na
Employment								
<i>(Percentage change)</i>								
Labour force (annual average)	na	-0.8	-2.7	-3.4	-1.5	-1.8	-1.0	na
Employment (annual average)	na	-0.9	-3.7	-7.4	-3.2	-1.3	-1.8	na
<i>(In per cent of labour force)</i>								
Unemployment	na	na	2.3	5.8	6.5	6.6	7.2	na
Prices and wages								
<i>(Percentage change)</i>								
Consumer prices (annual average)	10.5	172	951	108	36	25	18	8
Consumer prices (end-year)	na	262	959	35	26	23	13	8
Producer prices (annual average)	na	na	2,554	117	17	12	14	na
Producer prices (end-year)	na	638	1,920	36	11	16	8	na
Gross monthly earnings per employee in industry (annual average)	na	na	na	na	60.0	24.1	14.9	na
Government sector								
<i>(In per cent of GDP)</i>								
General government balance ²	na	na	-0.8	0.6	-4.1	-3.5	-1.4	-0.9
General government expenditure	na	na	28.2	35.2	38.2	40.5	40.2	na
Monetary sector								
<i>(Percentage change)</i>								
Broad money (end-year)	na	153	170	84	48	-23	20	na
Domestic credit (end-year)	na	91	304	146	66	-25	6	na
<i>(In per cent of GDP)</i>								
Broad money	na	na	na	32	34	22	23	na
Interest and exchange rates								
<i>(In per cent per annum, end-year)</i>								
Interbank interest rate	na	na	na	na	37.8	21.1	9.7	na
Treasury bill rate (three-month maturity)	na	na	na	na	21.5	33.4	10.1	na
Deposit rate (less than one year)	na	na	na	28.39	18.8	15.0	10.0	na
Lending rate (less than one year)	na	na	na	70.78	36.7	31.1	20.3	na
<i>(Lats per US dollar)</i>								
Exchange rate (end-year)	na	na	0.835	0.595	0.548	0.537	0.556	na
Exchange rate (annual average)	na	na	0.669	0.674	0.560	0.528	0.551	na
External sector								
<i>(In millions of US dollars)</i>								
Current account	na	na	25	151	-86	-166	-361	-390
Trade balance ³	na	na	-215	-160	-378	-513	-929	na
Exports ³	na	na	831	998	997	1,304	1,511	na
Imports ³	na	na	1,046	1,158	1,357	1,817	2,440	na
Foreign direct investment, net	na	na	43	51	155	165	230	na
Gross reserves (end-year), excluding gold ⁴	na	na	na	432	545	506	654	na
External debt stock (end-year)	na	na	43	225	359	423	444	na
<i>(In months of imports of goods and services)</i>								
Gross reserves (end-year), excluding gold	na	na	1.5	4.4	4.5	2.9	2.9	na
<i>(In per cent of exports of goods and services)</i>								
Debt service	na	na	0	2	5	3	5	na
Memorandum items								
<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	2.7	2.7	2.6	2.6	2.5	2.5	2.5	na
GDP (in millions of lats)	62	143	1,005	1,467	2,043	2,349	2,768	na
GDP per capita (in US dollars)	na	na	525	836	1,459	1,780	2,010	na
GDP per capita (in US dollars) at PPP exchange rates ⁵	na	na	3,451	3,070	3,204	3,291	3,484	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Lithuania

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection	
Output									
				<i>(Percentage change)</i>					
GDP at constant prices	-5.0	-13.4	-37.7	-24.2	1.0	3.0	3.6	4.5	
Industrial gross output	na	na	na	-34.4	-26.5	5.2	1.3	na	
Agricultural gross output ¹	-9	-5	-24	-8	-18	10	10	na	
Composition of output									
				<i>(In per cent of GDP)</i>					
Industry	32.8	55.7	39.4	30.4	25.8	29	28.3	na	
Agriculture and forestry	27.6	19.2	11.60	11	7.3	9.3	11.4	na	
Employment									
				<i>(Percentage change)</i>					
Labour force (annual average)	na	2.7	-1.2	-1.1	-6.4	0.7	1.8	na	
Employment (annual average)	na	2.4	-2.2	-4.2	-5.8	-1.9	0.9	na	
				<i>(In per cent of labour force)</i>					
Unemployment	na	0.3	1.3	4.4	3.8	6.2	7.0	na	
Prices and wages									
				<i>(Percentage change)</i>					
Consumer prices (annual average)	8.4	224.7	1,020.5	410.4	72.1	39.5	24.7	9	
Consumer prices (end-year)	na	345.0	1,161.1	188.8	45.0	35.5	13.1	10	
Producer prices (annual average)	na	148.2	1,517.4	397.7	44.7	28.3	17.2	na	
Producer prices (end-year)	na	na	2,407.1	131.6	33.8	20.6	12.8	na	
Average monthly wages (whole economy)	21.1	129.2	797.7	171.0	95.9	47.2	29.5	na	
Gross average monthly earnings in industry (annual average)	na	na	na	233	82	43	27	na	
Government sector									
				<i>(In per cent of GDP)</i>					
General government balance ²	-5.4	2.7	0.8	-3.1	-4.2	-3.3	-3.6	-2.8	
General government expenditure and net lending	49.1	38.7	31.3	33.3	29.3	27.9	26.9	29.3	
Monetary sector									
				<i>(Percentage change)</i>					
Broad money (M2, end-year)	55	143	245	100	64	30.8	-2.0	na	
Domestic credit (end-year)	na	na	na	na	na	16.6	1.2	na	
				<i>(In per cent of GDP)</i>					
Broad money	na	na	na	21.9	19.7	18.4	14.0	na	
Interest and exchange rates									
				<i>(In per cent per annum, end-year)</i>					
Interbank interest rate	na	na	na	98.3	24.9	22.4	10.7	na	
Treasury bill rate (three-month maturity)	na	na	na	na	na	22.4	10.8	na	
Deposit rate ³	na	na	na	39.3	8.9	8.0	na	na	
Lending rate ³	na	na	na	88.3	29.8	23.9	16.0	na	
				<i>(Litai per US dollar)</i>					
Exchange rate (end-year) ⁴	17	110	379	3.9	4.0	4.0	4.0	na	
Exchange rate (annual average) ⁴	na	38	177	4.3	4.0	4.0	4.0	na	
External sector ⁵									
				<i>(In millions of US dollars)</i>					
Current account	na	na	203	-132	-175	-343	-440	na	
Trade balance	na	na	101	-283	-308	-487	-631	na	
Exports (merchandise)	na	na	1,142	1,709	1,930	2,814	3,413	na	
Imports (merchandise)	na	na	1,041	1,992	2,238	3,301	4,044	na	
Foreign direct investment (net) ⁶	na	na	na	30	31	72	152	na	
Gross reserves (end-year), excluding gold ⁷	na	na	45	350	525	757	772	na	
External debt stock (end-year)	na	na	59	325	529	845	1,189	1,545	
				<i>(In months of merchandise imports)</i>					
Gross reserves (end-year), excluding gold ⁷	na	na	0.5	2.1	2.8	2.8	2.3	na	
				<i>(In per cent of merchandise exports)</i>					
Debt service	na	na	na	1.6	2.2	2.9	6.7	na	
Memorandum items									
				<i>(Denominations as indicated)</i>					
Population (in millions, mid-year)	3.72	3.74	3.74	3.73	3.72	3.71	3.71	na	
GDP (in millions of litai/litai equivalent)	129	382	3,387	12,217	22,208	31,143	40,070	na	
GDP per capita (in US dollars) ⁸	na	265	511	754	1,501	2,099	2,700	na	
GDP per capita (in US dollars) at PPP exchange rates ⁹	na	na	5,174	4,049	4,203	4,471	4,766	na	

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on preliminary estimates for 1996 from these sources.

Methodological notes can be found on pp. 240 to 243.

Moldova

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output								
				<i>(Percentage change)</i>				
GDP at constant prices	-2.4	-17.5	-29.0	-1.0	-31.2	-3.0	-8.0	-2
Industrial gross output	na	-21.0	-29.5	3.9	-30.2	-2.4	-8.0	na
Agricultural gross output	na	-28.0	-56.9	5.8	-27.2	3.6	-13.0	na
Composition of output								
				<i>(In per cent of GDP)</i>				
Industry	na	na	na	39	31	24	25	na
Agriculture	na	na	na	31	27	30	30	na
Employment								
				<i>(Percentage change)</i>				
Labour force (end-year)	na	na	na	na	-0.4	-1.5	-5.1	na
Employment (end-year)	na	na	na	na	-0.4	-0.5	na	na
				<i>(In per cent of labour force)</i>				
Unemployment ¹	na	na	0.1	0.7	1.1	1.4	1.6	na
Prices and wages								
				<i>(Percentage change)</i>				
Consumer prices (annual average)	4	98	1,208	1,283	330	30	23.5	12
Consumer prices (end-year)	na	151	2,198	837	116	24	15	11
Producer prices (annual average)	na	na	na	na	712	50	na	na
Producer prices (end-year)	na	na	na	6,947	207	47	na	na
Gross average monthly earnings in manufacturing (annual average)	na	na	na	na	325.0	36.6	44.0	na
Government sector								
				<i>(In per cent of GDP)</i>				
General government balance ²	na	0.0	-26.2	-7.4	-8.7	-5.7	-6.7	-4.5
General government expenditure	na	24.7	28.5	23.4	30.5	29.9	31.9	na
Monetary sector								
				<i>(Percentage change)</i>				
Broad money (end-year)	na	na	358	317	94	64	17	na
Domestic credit (end-year)	na	na	3,450	345	127	48	5	na
				<i>(In per cent of GDP)</i>				
Broad money	na	69	43	16	13	16	16	na
Interest and exchange rates								
				<i>(In per cent per annum, end-year)</i>				
Interbank interest rate (up to 30-day maturity)	na	na	na	na	42	21	20	na
Treasury bill rate (three-month maturity)	na	na	na	na	na	43	37	na
Deposit rate (one year)	na	na	na	na	na	21	23	na
Lending rate (one year)	na	na	na	na	na	42	34	na
				<i>(Lei per US dollar)</i>				
Exchange rate (end-year) ³	na	0.0	0.4	3.64	4.3	4.50	4.65	na
Exchange rate (annual average) ³	na	na	0.2	1.5	4.1	4.49	4.60	na
External sector								
				<i>(In millions of US dollars)</i>				
Current account	na	na	-39	-182	-98	-146	-250	-216
Trade balance ⁴	na	na	-37	-180	-54	-55	-234	-202
Exports ⁴	na	na	868	451	618	739	822	na
Imports ⁴	na	na	905	631	672	794	1,056	na
Foreign direct investment, net	na	na	17	14.0	18	73	56	na
Gross reserves (end-year), excluding gold ⁵	na	na	na	89	179	257	315	na
External debt stock	na	na	16	254	506	671	824	na
				<i>(In months of imports of goods and services)</i>				
Gross reserves (end-year), excluding gold ⁵	na	na	na	1.7	2.9	3.0	3.0	na
				<i>(In per cent of exports of goods and services)</i>				
Debt service	na	na	na	na	na	10	6	na
Memorandum items								
				<i>(Denominations as indicated)</i>				
Population (in millions, end-year)	na	na	4.3	4.3	4.3	4.3	4.3	na
GDP (in millions of lei)	na	na	192	2,210	5,780	7,636	8,798	na
GDP per capita (in US dollars)	na	na	290	350	327	392	443	na
GNP per capita (in US dollars) at PPP exchange rates ⁶	na	4412	3,130	3,100	2,130	2,069	1,900	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Poland

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
<i>(Percentage change)</i>								
GDP at constant prices	-11.6	-7.0	2.6	3.8	5.2	7.0	6.0	5.5
Private consumption	-15.3	6.3	2.3	5.5	4.3	4.5	8.2	na
Public consumption	0.5	10.2	6.4	4.0	2.8	2.9	na	na
Gross fixed investment	-10.6	-4.4	2.3	2.9	9.2	18.5	21.6	na
Exports of goods and services	15.1	-1.7	10.8	3.2	13.1	18.4	na	na
Imports of goods and services	-10.2	29.6	1.7	13.2	11.3	22.7	na	na
Industrial gross output	-24.2	-8.0	2.8	6.3	12.1	9.7	8.5	na
Agricultural gross output	-2.2	-1.6	-12.7	6.8	-9.3	10.7	0.3	na
Composition of output								
<i>(In per cent of GDP)</i>								
Industry ¹	44.9	40.2	34.0	32.9	32.2	28.9	na	na
Agriculture	7.4	6.8	6.7	6.6	6.2	6.6	na	na
Employment								
<i>(Percentage change)</i>								
Labour force (end-year)	-0.7	1.9	-0.4	0.7	0.6	-1.0	0.4	na
Employment (end-year)	-7.2	-4.3	-2.8	-1.7	1.1	2.9	2.2	na
<i>(In per cent of labour force)</i>								
Unemployment (end-year)	6.3	11.8	13.6	16.4	16.0	14.9	13.6	na
Prices and wages								
<i>(Percentage change)</i>								
Consumer prices (annual average)	585.8	70.3	43.0	35.3	32.2	27.8	19.9	16.0
Consumer prices (end-year)	249.0	60.4	44.3	37.6	29.4	21.6	18.5	14.5
Producer prices (annual average)	622.4	40.9	34.5	31.9	25.3	25.4	12.1	11.5
Producer prices (end-year)	192.8	35.7	31.5	37.0	27.9	18.9	10.5	10.0
Gross average monthly earnings in manufacturing (annual average) ²	371.1	63.1	38.7	35.4	36.7	32.7	27.7	n.a.
Government sector								
<i>(In per cent of GDP)</i>								
General government balance ³	3.1	-6.7	-6.6	-3.4	-2.8	-3.6	-3.1	-4.0
General government expenditure ³	39.8	48.9	50.4	50.5	49.2	49.9	na	na
Public debt	na	na	147.3	108.6	69.0	59.0	53.6	na
Monetary sector								
<i>(Percentage change)</i>								
Broad money (end-year) ⁴	160.1	37.0	57.5	36.0	38.2	35.0	29.3	na
Domestic credit (end-year) ⁴	183.5	158.7	55.6	44.2	30.1	20.1	29.7	na
<i>(In per cent of GDP)</i>								
Broad money ⁴	32.2	31.6	35.8	35.9	36.7	36.5	37.5	na
Interest and exchange rates								
<i>(In per cent per annum, end-year)</i>								
Interbank interest rate (up to 30-day maturity)	na	36.7	30.8	25.2	21.1	24.7	21.2	na
Treasury bill rate (three-month maturity)	na	na	41.4	33.7	27.0	24.2	18.8	na
Deposit rate ⁵	53.0	36.0	32.0	25.0	26.0	22.0	18.3	na
Lending rate ⁶	61.0	40.0	39.0	35.0	31.0	24.0	23.3	na
<i>(Zloty per US dollar)</i>								
Exchange rate (end-year)	0.950	1.096	1.577	2.134	2.437	2.468	2.876	na
Exchange rate (annual average)	0.950	1.058	1.363	1.812	2.272	2.425	2.696	na
External sector								
<i>(In billions of US dollars)</i>								
Current account	0.6	-2.0	0.9	-0.6	2.3	5.5	-1.3	-5.5
Trade balance ⁷	2.2	0.1	0.5	-2.3	-0.8	-1.8	-8.2	-12.0
Exports ⁷	10.9	12.8	14.0	13.6	17.0	22.9	24.4	na
Imports ⁷	8.6	12.7	13.5	15.9	17.8	24.7	32.6	na
Net unclassified transactions ⁸	0.0	1.3	1.8	2.2	3.2	7.8	7.2	na
Foreign direct investment, net ⁹	0.0	0.1	0.3	0.6	0.5	1.1	2.7	na
Gross reserves (end-year), excluding gold ¹⁰	4.5	3.6	4.1	4.1	5.8	14.8	18.0	na
External debt stock	49.0	48.0	47.6	47.2	42.2	43.9	40.4	na
<i>(In months of current account expenditures, excluding transfers)</i>								
Gross reserves (end-year), excluding gold ¹⁰	3.8	2.5	2.9	2.6	3.2	6.1	5.8	na
<i>(In per cent of current account revenues, excluding transfers)</i>								
Debt service	53.7	68.9	19.3	20.1	14.3	6.7	7.6	na
Memorandum items								
<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	38.2	38.3	38.4	38.5	38.6	38.6	38.6	na
GDP (in billions of zloty)	59	83	115	156	210	286	360	na
GDP per capita (in US dollars)	1,630	2,037	2,197	2,234	2,399	3,055	3,459	na
GNP per capita (in US dollars) at PPP exchange rates ¹¹	na	na	na	na	na	5,400	na	na

Notes: Data for 1990-96 represent official estimates of outcomes 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Romania

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
<i>(Percentage change)</i>								
GDP at constant prices	-5.6	-12.9	-8.7	1.5	3.9	7.1	4.1	-1.5
Private consumption	na	na	-7.5	0.9	2.1	19.1	6.8	na
Public consumption	na	na	2.2	2.7	11.7	0.7	7.0	na
Gross fixed investment	na	na	11.0	8.3	19.6	11.2	4.0	na
Exports of goods and services	na	na	2.9	11.1	19.0	32.7	2.8	na
Imports of goods and services	na	na	7.5	4.4	2.8	44.9	9.0	na
Industrial gross output	-23.7	-22.8	-21.9	1.2	3.1	10.0	8.2	na
Agricultural gross output	na	-8.6	-12.2	13.4	3.2	4.5	1.8	na
Composition of output								
<i>(In per cent of GDP)</i>								
Industry	40.6	37.9	38.3	33.8	35.6	34.6	36.0	na
Agriculture	21.8	18.9	19.0	21	19.8	19.9	19.1	na
Employment								
<i>(Percentage change)</i>								
Labour force (end-year)	-1.0	1.8	-1.8	-3.0	0.0	-7.1	na	na
Employment (end-year)	-1.0	-0.5	-3.0	-3.8	-0.5	-5.2	-0.1	na
<i>(In per cent of labour force)</i>								
Unemployment ¹	na	na	6.2	9.2	11.0	9.9	7.8	na
Prices and wages								
<i>(Percentage change)</i>								
Consumer prices (annual average)	5.1	161	210	256	137	32	39	145
Consumer prices (end-year)	37.7	223	199	296	62	28	57	116
Government sector								
<i>(In per cent of GDP)</i>								
General government balance ²	1.0	3.3	-4.6	-0.4	-1.9	-2.6	-3.9	-4.5
General government expenditure	38.7	38.7	42.0	34.2	33.9	34.5	33.7	na
Monetary sector								
<i>(Percentage change)</i>								
Broad money (end-year)	22.0	101	80	141	138	72	66	na
Domestic credit (end-year)	7.5	122	35	131	114	92	88	na
<i>(In per cent of GDP)</i>								
Broad money	59.6	46.7	28.9	9.1	21.5	25.4	28.9	na
Interest and exchange rates								
<i>(In per cent per annum, annual average)</i>								
Interbank interest rate (up to 30-day maturity)	3.8	19.5	43.6	86.4	62.4	41.5	46.9	na
Treasury bill rate (three-month maturity)	na	na	na	na	na	45.0	55.0	na
Deposit rate (one year)	na	na	38	52	62	38	47	na
Lending rate (one year)	na	na	53	129	83	59	71	na
<i>(Lei per US dollar)</i>								
Exchange rate (end-year)	34.7	189	460	1,276	1,767	2,578	4,035	na
Exchange rate (annual average)	22.4	76	308	760	1,580	2,037	2,752	na
External sector								
<i>(In millions of US dollars)</i>								
Current account	-1,656	-1,181	-1,518	-1,239	-516	-1,732	-2,336	-1,400
Trade balance ³	-1,743	-1,254	-1,373	-1,130	-483	-1,605	-2,130	na
Exports ³	3,364	3,241	4,286	4,882	6,067	7,882	8,238	na
Imports ³	-5,107	-4,495	-5,659	-6,012	-6,550	-9,487	-10,368	na
Foreign direct investment, net	18	37	73	97	347	404	210	na
Gross reserves (end-year), excluding gold ⁴	524	695	826	995	2,086	1,579	2,103	na
Total external debt stock	1,140	2,131	3,240	4,249	5,509	6,710	8,480	na
<i>(In months of current account expenditures, excluding transfers)</i>								
Gross reserves (end-year), excluding gold ⁴	1.0	1.5	1.5	1.7	3.1	1.6	2.0	na
<i>(In per cent of current account revenues, excluding transfers)</i>								
Debt service	0.2	2.3	8.9	6.2	8.7	11.5	14.8	na
Memorandum items								
<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	23.2	23.2	22.8	22.7	22.6	22.6	22.6	na
GDP (in billions of lei)	858	2,204	6,029	20,036	49,768	72,560	109,515	na
GDP per capita (in US dollars)	1,257	1,187	859	1,159	1,324	1,573	1,437	na
GNP per capita (in US dollars) at PPP exchange rates ⁵	na	na	3,542	3,698	3,931	4,312	4,591	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Russian Federation

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
<i>(Percentage change)</i>								
GDP at constant prices	na	-5.0	-14.5	-8.7	-12.6	-4.0	-5.0	1.0
Private consumption	na	na	na	-13.4	-7.8	7.7	-1.8	na
Public consumption	na	na	na	32.1	-5.8	-23.6	-4.4	na
Gross fixed investment	na	10.1	-37.1	-21.1	-29.3	-6	-15	na
Exports of goods and services	na	na	na	-7.7	11.8	8.0	-0.4	na
Imports of goods and services	na	na	na	-14.7	3.5	17.1	1.0	na
Industrial gross output	-0.1	-8.0	-18.8	-16.2	-22.8	4.7	-5.0	na
Agricultural gross output	-4.0	-3.7	-9.0	-4.0	-12.0	-8.0	-7.1	na
Composition of output								
<i>(In per cent of GDP)</i>								
Industry	na	45.9	42.2	40.6	37.6	39.0	39.3	na
Agriculture	na	13.8	7.3	7.5	8.7	8.6	8.6	na
Employment								
<i>(Percentage change)</i>								
Labour force (annual average)	na	na	na	0.0	-0.7	-0.8	-0.3	na
Employment (annual average)	na	-2.0	-2.3	-1.7	-3.4	-3.1	-0.6	na
<i>(In per cent of labour force)</i>								
Unemployment ¹	0.0	0.0	4.8	5.6	7.4	8.2	9.3	na
Prices and wages								
<i>(Percentage change)</i>								
Consumer prices (annual average)	5.6	93	1,526	875	307.4	197.7	47.7	17
Consumer prices (end-year)	na	144	2,501	837	217	132	21.8	14
Producer prices (annual average)	3.9	193	3,916	1,149	347	243	52	na
Producer prices (end-year)	na	345	6,115	1,007	235	182	26	na
Gross monthly earnings per employee in manufacturing (annual average)	13	95	1,066	798	261	144	55	na
Government sector								
<i>(In per cent of GDP)</i>								
General government balance ²	na	na	-21.6	-7.2	-10.4	-5.5	-8.3	-8
General government expenditure	na	na	65.8	43.3	45.0	37.7	38.7	na
Monetary sector								
<i>(Percentage change)</i>								
Broad money (end-year)	17.6	126	568	409	200	126	33.7	na
Net domestic assets (end-year)	na	na	na	770	360	70.3	80.9	na
<i>(In per cent of GDP)</i>								
Broad money	70.1	68.4	34.7	19.0	16.0	13.3	13.1	na
Interest and exchange rates								
<i>(In per cent per annum, end-year)</i>								
Interbank interest rate (up to 30-day maturity)	-	na	na	352	261	94	44	na
Treasury bill rate (all maturity)	-	na	na	217	265	163	36	na
Central bank refinance rate	na	6 to 9	117	593	435	347	60	na
<i>(Roubles per US dollar)</i>								
Exchange rate (end-year)	1.7	169.0	415	1,247	3,550	4,640	5,560	na
Exchange rate (annual average)	1.7	67.1	222	933.2	2,205	4,565	5,124	na
External sector								
<i>(In billions of US dollars)</i>								
Current account ³	na	na	na	2.1	10.4	4.5	9.6	na
Trade balance ³	na	na	na	9.5	21.1	17.5	23.1	na
Exports ³	na	na	na	44.4	69.6	81.5	88.2	na
Imports ³	na	na	na	34.9	48.5	64.0	65.1	na
Foreign direct investment, net	na	na	0.7	0.4	0.6	2.0	2.0	na
Gross reserves (end-year), excluding gold ⁴	na	na	1.9	5.8	4.0	14.4	11.3	na
External debt stock ⁵	61.1	67.0	107.7	112.7	119.9	120.4	125.0	na
<i>(In months of import of current account expenditures, excluding transfers)</i>								
Gross reserves (end-year), excluding gold ⁴	na	na	na	1.2	0.7	2.1	1.5	na
<i>(In per cent of current account revenues, excluding transfers)</i>								
Debt service due	na	na	na	35.7	24.2	19.1	15.6	na
Debt service paid	na	na	na	5.2	4.7	6.7	7.3	na
Memorandum items								
<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	148.3	148.9	148.6	148.3	148.2	148.0	147.5	na
GDP (in trillions of roubles)	0.6	1.4	19.0	172	611	1,631	2,256	na
GDP per capita (in US dollars)	2,554	140	575	1,239	1,870	2,455	2,985	na
GNP per capita (in US dollars) at PPP exchange rates ⁶	na	na	na	na	na	4,480	na	na

Notes: Data for 1990-96 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the Economist Intelligence Unit and Russian Economic Trends. Data for 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Slovak Republic

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
<i>(Percentage change)</i>								
GDP at constant prices ¹	-2.5	-14.6	-6.5	-3.7	4.9	6.8	6.9	4.5
Private consumption	na	na	-6.4	-1.6	0.0	3.4	7.2	na
Public consumption	na	na	9.9	-2.2	-10.5	1.6	24.2	na
Gross fixed investment	na	na	-4.5	-4.2	-5.1	5.8	33.3	na
Exports of goods and services	na	na	na	-0.2	14.1	3.5	-1.6	na
Imports of goods and services	na	na	na	-0.8	-3.5	9.6	18.5	na
Industrial gross output	-3.6	-17.6	-14.4	-10.2	6.4	8.3	2.5	na
Agricultural gross output	-7.2	-7.4	-13.9	-8.0	0.4	0.4	na	na
Composition of output								
<i>(In per cent of GDP)</i>								
Industry	na	na	32.0	29.2	28.7	28.6	26.3	na
Agriculture	na	na	6.2	6.6	6.6	5.6	5.2	na
Employment								
<i>(Percentage change)</i>								
Labour force (end-year)	na	-1.8	-0.8	2.1	-0.7	0.5	1.8	na
Employment (end-year)	-1.8	-12.5	1.1	-2.6	-1.0	2.4	2.3	na
<i>(In per cent of labour force)</i>								
Unemployment	na	na	na	12.2	13.7	13.1	11.1	na
Prices and wages								
<i>(Percentage change)</i>								
Consumer prices (annual average)	10.8	61.2	10.1	23.2	13.4	9.9	5.8	6.5
Consumer prices (end-year)	18.4	58.3	9.1	25.1	11.7	7.2	5.4	7.0
Producer prices (annual average)	4.4	68.8	5.3	17.2	10.0	9.0	4.1	5.0
Producer prices (end-year)	na	na	na	18.8	9.4	7.1	4.7	na
Average monthly wages in industry ²	3.1	16.3	16.4	22.9	17.7	15.2	14.6	na
Government sector								
<i>(In per cent of GDP)</i>								
General government balance ³	na	na	na	-7.0	-1.3	0.1	-1.2	-3.5
General government expenditure ³	na	na	na	51	48	47	46	na
Monetary sector								
<i>(Percentage change)</i>								
M2 (end-year)	na	na	na	16.8	20.1	19.1	16.6	na
Domestic credit (end-year)	na	na	na	na	9.2	7.8	14.4	na
<i>(In per cent of GDP)</i>								
Broad money	68	73	73	68	68	69	71	70
Interest and exchange rates								
<i>(In per cent per annum, end-year)</i>								
Money market rate (one month)	na	na	na	16.2	5.9	9.5	14.9	na
Average lending rate ⁴	na	na	na	14.1	14.4	14.9	13.2	na
Average deposit rate	na	na	na	8.7	9.2	8.2	6.2	na
Discount rate	8.5	9.5	9.5	12.0	12	9.8	8.8	na
<i>(Koruna per US dollar)</i>								
Exchange rate (end-year)	28.00	27.84	28.90	33.20	31.28	29.57	31.90	na
Exchange rate (annual average)	17.95	29.57	28.26	30.77	32.05	29.71	30.65	na
External sector								
<i>(In billions of US dollars)</i>								
Current account	na	na	na	-0.6	0.7	0.39	-1.94	-2.02
Trade balance ⁵	na	na	na	-0.91	0.11	-0.23	-2.11	-2.19
Exports ⁵	na	na	na	5.54	6.74	8.59	8.83	na
Imports ⁵	na	na	na	6.37	6.63	8.82	10.94	na
Foreign direct investment, inflow	na	na	na	0.13	0.18	0.13	0.18	na
Gross reserves (end-year), excluding gold ⁶	na	na	na	0.45	1.75	3.42	3.47	na
External debt stock	na	na	na	3.34	4.66	5.68	7.81	na
<i>(In months of imports of goods and services)</i>								
Gross international reserves (end-year), excluding gold ⁶	na	na	na	0.7	2.5	3.8	3.2	na
<i>(In per cent of exports of goods and services)</i>								
Debt service	na	na	na	8.6	8.7	9.3	10.8	na
Memorandum items								
<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	5.3	5.3	5.3	5.3	5.3	5.3	5.3	na
GDP (in billions of koruna)	258	320	332	370	441	515	581	647
GDP per capita (in US dollars)	2,710	2,046	2,216	2,258	2,576	3,230	3,525	3,596
GDP per capita (in US dollars) at PPP exchange rates ⁷	na	na	6,393	6,285	6,712	7,320	7,970	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Slovenia

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
<i>(Percentage change)</i>								
GDP at constant prices	-4.7	-8.9	-5.5	2.8	5.3	4.1	3.1	4
Private consumption	na	-11.0	-3.6	13.9	3.8	9.2	1.7	na
Public consumption	na	-0.3	-1.7	5.3	2.1	2.5	4.7	na
Gross fixed investment	na	-11.3	-12.9	10.7	12.5	17	8.9	na
Exports of goods and services	na	-20.1	-23.5	0.6	10.5	1.0	2.5	na
Imports of goods and services	na	-22.4	-22.9	17.6	10.7	11.6	2.7	na
Industrial gross output	-10.5	-11.6	-12.6	-2.5	6.6	2.3	1.2	2.5
Agricultural gross output	1.6	-2.5	-6.7	-4.2	4.2	1.6	1.7	1.5
Composition of output								
<i>(In per cent of GDP)</i>								
Industry	38	40.8	32.1	29.3	29.6	27.9	27.2	26.9
Agriculture	4.7	4.9	5.2	4.5	4.7	4.4	4.3	4.2
Employment								
<i>(Percentage change)</i>								
Labour force (end-year)	na	na	na	0.3	-1.7	-0.9	-0.8	na
Employment (annual average)	-3.9	-5.1	-4.1	-1.8	-0.4	0.5	-0.5	na
<i>(In per cent of labour force)</i>								
Unemployment ¹	4.7	8.2	11.5	14.4	14.4	13.9	13.9	13.8
Prices and wages								
<i>(Percentage change)</i>								
Retail prices (annual average)	550	118	201	32.3	19.8	12.6	9.7	9.0
Retail prices (end-year)	105	247	93	22.9	18.3	8.6	8.8	8.8
Producer prices (annual average)	390	124	216	21.6	17.7	12.8	6.8	na
Producer prices (end-year)	44	312	76	18.6	18.2	7.9	5.8	na
Net wages (annual average) ²	379	83	199	52.0	28.3	18.6	14.8	na
Government sector								
<i>(In per cent of GDP)</i>								
General government balance ³	-0.3	2.6	0.2	0.3	-0.2	0.0	0.3	-1
General government expenditure	49.6	41.1	45.8	46.7	46.1	45.7	45.7	46
Monetary sector								
<i>(Percentage change)</i>								
Broad money (end-year)	na	na	131.6	64.2	50.7	30.2	19.4	na
Domestic credit (end-year)	na	na	90.1	101.4	27.1	35.1	12.5	na
<i>(In per cent of GDP)</i>								
Broad money	na	na	28.1	32.8	38.3	42.2	44.6	na
Interest and exchange rates								
<i>(In per cent per annum, end-year)</i>								
Interbank interest rate (average)	na	na	60.5	34.7	24.7	15.9	10	na
Treasury bill rate (on tolar part of twin bills)	na	na	50.9	30.2	26.3	19.4	10	na
Deposit rate (one year and over)	na	na	53.8	33.9	32.2	24.4	14	na
Lending rate (short-term working capital)	na	na	72.2	42.6	38.5	28.0	18.3	na
<i>(Tolar per US dollar)</i>								
Exchange rate (end-year) ⁴	10.70	56.69	98.70	131.84	126.46	125.99	141.48	na
Exchange rate (annual average) ⁴	11.30	27.60	81.29	113.24	128.81	118.52	135.37	na
External sector ⁵								
<i>(In billions of US dollars)</i>								
Current account	0.53	0.13	0.93	0.19	0.54	-0.04	0.05	-0.04
Trade balance ⁶	-0.61	-0.26	0.79	-0.15	-0.34	-0.95	-0.85	na
Exports ⁶	4.12	3.87	6.7	6.08	6.83	8.34	8.37	na
Imports ⁶	4.73	4.13	5.9	6.24	7.17	9.30	9.22	na
Foreign direct investment, net ⁶	0.00	0.04	0.11	0.11	0.13	0.17	0.18	na
Gross reserves (end-year), excluding gold ⁷	na	0.1	0.7	0.8	1.5	1.8	2.3	na
External debt stock	na	1.9	1.7	1.9	2.3	3.0	4.0	na
<i>(In months of current account expenditures, excluding transfers)</i>								
Gross reserves (end-year), excluding gold ⁷	0.6	0.4	1.2	1.2	2.1	2.0	2.5	na
<i>(In per cent of current account revenues, excluding transfers)</i>								
Debt service	na	7.0	5.2	5.5	5.4	6.9	9	na
Memorandum items								
<i>(Denominations as indicated)</i>								
Population (in millions, annual average)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
GDP (in 10 trillions of dinars up to 1990, in billions of tolar thereafter)	197	349	1,018	1,435	1,853	2,221	2,512	2,848
GDP per capita (in US dollars)	8,706	6,330	6,261	6,336	7,193	9,372	9,279	9,058
GDP per capita (in US dollars) at PPP exchange rates ⁸	na	na	8,722	9,234	9,946	10,594	na	na

Notes: Data for 1990-96 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 1997 reflects EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Tajikistan

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output								
<i>(Percentage change)</i>								
GDP at constant prices	-1.6	-7.1	-29.0	-11.0	-21.5	-12.5	-7.0	-3
Industrial gross output	na	-2.0	-23.3	-17.8	-31.4	-5.1	na	na
Agricultural gross output	na	-4.4	-26.7	-4.4	-23.1	-20.9	na	na
Composition of output								
<i>(In per cent of GDP)</i>								
Industry	na	31.6	36.4	33.5	34.6	37.5	37.3	na
Agriculture	na	26.1	27.1	21.7	19.0	17.2	17.1	na
Employment								
<i>(Percentage change)</i>								
Employment (end-year)	3.3	1.7	-3.0	0.1	0.5	0.0	-2.5	na
<i>(In per cent of labour force)</i>								
Unemployment ¹	na	na	0.3	1.1	1.7	1.8	2.8	na
Prices and wages								
<i>(Percentage change)</i>								
Consumer prices (annual average)	4.0	112	1,157	2,195	350	609	418	60
Consumer prices (end-year)	na	204	1,364	7,344	1	2,132	40.6	105
Producer prices (annual average)	na	163	1,320	1,080	328	1,080	449	na
Producer prices (end-year)	na	184	5,926	5,996	295	628	21	na
Average monthly wages (annual average)	9.9	64	464	746	115	70	275	na
Government sector								
<i>(In per cent of GDP)</i>								
State budget balance ²	na	-16.4	-31.2	-25.0	-10.5	-11.2	-5.3	na
State budget expenditure	na	49.6	57.8	52.1	55.0	30.5	17.6	na
Monetary sector								
<i>(Percentage change)</i>								
Broad money (end-year)	na	68	579	1,429	159	413	144	na
Domestic credit (end-year)	na	na	na	na	125	393	124	na
<i>(In per cent of GDP)</i>								
Broad money	na	na	na	9.1	8.6	24.5	10.7	na
Interest and exchange rates								
<i>(In per cent per annum, end-year)</i>								
Interbank interest rate (up to 30-day maturity)	na	na	na	na	na	152.5	na	na
Deposit rate (one year) ³	na	30	30	30	30	100	60	na
Lending rate (one year) ³	na	30	30	30	30	500	175	na
<i>(Tajik roubles per US dollar)</i>								
Exchange rate (end-year) ⁴	na	1.8	415	1,247	3,550	285	320	400
Exchange rate (annual average) ⁴	na	1.7	222	930	2,204	86	302	350
External sector								
<i>(In millions of US dollars)</i>								
Current account	na	na	52.8	-208	-169	1	-110	na
Trade balance ⁵	na	na	-54.8	-204	-147	29	-50	na
Exports ⁵	na	na	na	456	559	657	503	na
Imports ⁵	na	na	na	660	707	628	553	na
Foreign direct investment, net	na	na	na	9	12	13	13	na
Gross reserves (end-year), excluding gold ⁶	na	na	na	0	0	7	28	na
External debt stock	na	na	0	509	760	817	na	na
<i>(In months of merchandise imports)</i>								
Gross international reserves (end-year), excluding gold ⁶	na	na	na	0.0	0.0	0.2	0.6	na
<i>(In per cent of merchandise exports)</i>								
Debt service	na	na	na	4	6	20	53	na
Memorandum Items								
<i>(Denominations as indicated)</i>								
Population (in millions, end-year)	5.2	5.3	5.6	5.7	5.7	5.8	6	na
GDP (in millions of roubles until 1994, in millions of Tajik roubles thereafter) ^{5,490}	10,540	64,760	631,162	1,717,974	54,606	304,000	na	na
GDP per capita (in US dollars)	na	1503	52	131	137	131	177	na
GNP per capita (in US dollars) at PPP exchange rates ⁷	na	na	na	na	na	920	na	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Turkmenistan

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output				<i>(Percentage change)</i>				
GDP at constant prices	2	-4.7	-5.3	-10	-19	-8	-3	-15
Industrial gross output	na	4.8	-14.9	5.4	-25	-7	18	na
Agricultural gross output	na	na	-9	8	-11	-7	-49	na
Composition of output				<i>(In per cent of GDP)</i>				
Industry	na	20	59	55.1	73.2	52.2	50	na
Agriculture	na	46	19	11.5	9	30.3	17.5	na
Employment				<i>(Percentage change)</i>				
Labour force (end-year)	na	2.6	2.7	2.9	2.5	10.9	4.0	na
Employment (end-year)	na	1.9	0.1	4.4	1.4	0.5	0.4	na
				<i>(In per cent of labour force)</i>				
Unemployment ¹	2.0	2.0	na	na	na	3.0	na	na
Prices and wages				<i>(Percentage change)</i>				
Consumer prices (annual average)	4.6	103	493	3,102	1,748	1,005	992	90
Consumer prices (end-year)	na	155	644	9,750	1,328	1,262	446	44
Gross average monthly earnings in industry (annual average)	na	na	na	na	na	686	969	na
Government sector				<i>(In per cent of GDP)</i>				
General government balance ²	1.2	2.5	13.2	-0.5	-1.4	-1.6	-0.2	na
General government expenditure	43.6	38.2	42.2	19.2	11.9	14.0	15.7	na
Monetary sector				<i>(Percentage change)</i>				
Broad money (end-year)	na	na	na	na	1,084	548	529	na
Domestic credit (end-year)	na	na	na	na	1,015	503	1,488	na
				<i>(In per cent of GDP)</i>				
Broad money	na	na	na	22.0	15.8	11.4	7.7	na
Interest and exchange rates				<i>(In per cent per annum, end-year)</i>				
Interbank interest rate (up to 30-day maturity)	na	na	na	na	na	55	121	na
Treasury bill rate (three-month maturity)	na	na	na	na	150	60	120	na
Deposit rate (one year)	na	na	na	50	206	80	130	na
Lending rate (one year)	na	na	na	108	300	70	200	na
				<i>(Manat per US dollar)</i>				
Exchange rate (end-year)	na	na	na	2	75	200	4,070	na
Exchange rate (annual average)	na	na	na	2	19	111	3,232	na
External sector				<i>(In millions of US dollars)</i>				
Current account	na	na	na	776	84	23	43	na
Trade balance ³	-249	590	1,140	1,100	485	441	159	na
Exports ³	151	1,238	2,149	2,693	2,176	2,084	1,691	na
Imports ³	400	648	1,009	1,593	1,691	1,644	1,532	na
Foreign direct investment, net	na	na	na	79	103	233	129	na
Gross reserves (end-year), excluding gold ⁴	na	na	na	818	927	1,170	1,172	na
External debt stock	na	na	na	168	418	550	668	na
				<i>(In months of current account expenditures, excluding transfers)</i>				
Gross reserves (end-year), excluding gold ⁵	na	na	na	6.2	6.6	8.5	9.2	na
				<i>(In per cent of current account revenues, excluding transfers)</i>				
Debt service	na	na	na	0.02	1.8	12.6	16.3	na
Memorandum items				<i>(Denominations as indicated)</i>				
Population (in millions, end-year)	3.66	3.8	4.0	4.11	4.27	4.44	4.57	na
GDP (in billions of manat)	na	na	na	9	141	1,072	8,384	na
GDP per capita (in US dollars)	na	na	na	929	354	491	461	na
GDP per capita (in US dollars) at PPP exchange rates ⁵	na	na	na	na	2,210	2,345	na	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Ukraine

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection	
Output									
				<i>(Percentage change)</i>					
GDP at constant prices	-3.4	-11.6	-13.7	-14.2	-23.0	-11.8	-10.1	-3.0	
Industrial gross output	-0.1	-4.8	-6.4	-8.0	-27.3	-12.0	-5.1	na	
Agricultural gross output	-4.0	-13.0	-8.3	1.5	-16.5	-4.0	-9.0	na	
Composition of output				<i>(In per cent of GDP)</i>					
Industry	34.7	45.8	44.6	29.7	35.0	34.4	na	na	
Agriculture	24.4	24.4	20.8	21.5	14.6	13.6	na	na	
Employment				<i>(Percentage change)</i>					
Labour force (end-year)	na	na	na	-1.7	-0.3	1.0	-5.0	na	
Employment in industry (end-year)	na	na	na	-8.3	-7.5	-9.4	-3.4	na	
				<i>(In per cent of labour force)</i>					
Unemployment	0.0	0.0	0.3	0.4	0.4	0.5	1.3	na	
Prices and wages				<i>(Percentage change)</i>					
Consumer prices (annual average)	4.2	91	1,210	4,700	891	376	80	20	
Consumer prices (end-year)	na	161	2,730	10,155	401	182	40	15	
Producer prices (annual average)	4.5	125	2,384	2,453	1,134	490	52	na	
Producer prices (end-year)	4.5	163	3,828	9,668	774	172	17	na	
Gross average monthly wage in industry	na	na	na	2,475	727	421	71	na	
Government sector				<i>(In per cent of GDP)</i>					
General government balance ¹	na	na	-25.4	-16.2	-7.8	-4.9	-3.2	na	
General government expenditure ¹	na	na	58.4	54.5	48.1	42.7	40.4	na	
Monetary sector				<i>(Percentage change)</i>					
Broad money (end-year)	na	na	na	758	568	173	32	na	
Domestic credit (end-year)	na	na	2,400	1,529	207	152	35	na	
				<i>(In per cent of GDP)</i>					
Broad money	na	na	na	31.8	26.2	12.7	11.6	na	
Interest and exchange rates				<i>(In per cent per annum, end-year)</i>					
Refinancing rate	na	na	71	132	135	104	40	na	
Treasury bill rate (three-month maturity) ²	na	na	na	na	na	155	49	na	
Average deposit rate	na	na	82	216	140	51	24	na	
Average lending rate	na	na	77	295	205	106	61	na	
				<i>(Hryvnia per US dollar)</i>					
Exchange rate (annual average, auction rate) ³	0.59	1.74	242	10,668	49,861	158,302	1.82	na	
Exchange rate (annual average, auction rate)	na	na	na	0.1	0.5	1.50	1.84	na	
Exchange rate (end year, auction rate)	na	na	0.01	0.25	1.04	1.79	1.88	na	
External sector				<i>(In billions of US dollars)</i>					
Current account	-	-2.9	-0.6	-0.8	-1.4	-1.5	-1.2	na	
Trade balance ⁴	-12.7	-3.4	-0.6	-2.5	-2.5	-2.3	-4.3	na	
of which with non-FSU countries	-2.6	-2.7	0.5	0.5	1	0.5	-0.2	na	
Exports ⁴	74.6	50	11.3	12.8	13.9	13.6	15.5	na	
of which to non-FSU countries	13.2	7.3	6	5.2	6.1	5.7	6.7	na	
Imports ⁴	87.3	53.4	11.9	15.3	16.5	15.9	19.8	na	
of which from non-FSU countries	15.8	10	5.5	4.7	5	5.2	6.9	na	
Foreign direct investment, net	na	na	0.2	0.2	0.1	0.3	0.5	na	
Gross reserves (end-year), excluding gold ⁵	na	na	0.5	0.2	0.6	1.1	1.9	na	
External debt stock	na	na	0.5	3.7	7.2	8.1	9.2	na	
				<i>(In weeks of imports of goods and services)</i>					
Gross reserves (end-year), excluding gold ⁵	na	na	0.5	0.1	1.8	3.2	4.6	na	
				<i>(In per cent of exports of goods and services)</i>					
Debt service	na	na	na	1.3	11.0	8.8	6.4	na	
Memorandum Items				<i>(Denominations as indicated)</i>					
Population (in millions, end-year)	51.8	51.9	52.0	52.1	51.7	51.3	50.9	na	
GDP (in millions of hryvnia)	2	3	51	1,483	12,038	54,516	80,510	na	
GDP per capita (in US dollars)	na	na	404	269	445	723	864	na	
GNP per capita (in US dollars) at PPP exchange rates ⁶	na	na	na	na	na	2,400	na	na	

Notes: Data for 1990-96 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank and PlanEcon. Data for 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Uzbekistan

	1990	1991	1992	1993	1994	1995	1996 Estimate	1997 Projection
Output and expenditure								
GDP at constant prices	1.6	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	1.0
Industrial gross output	na	-3.8	-23.9	1.5	-3.4	2.0	-7.0	na
Agricultural gross output	na	-0.4	-9.7	-4.2	-6.6	-5.6	1.7	na
Composition of output								
Industry	22.7	26.3	26.6	22.4	17.0	17.1	17.4	na
Agriculture	33.4	37.3	35.4	27.9	34.5	28.1	22.5	na
Employment								
Labour force (end-year)	2.0	2.1	1.9	3.3	-4.1	0.6	2.3	na
Employment (end-year)	4.1	4.0	0.2	-0.1	-1.3	3.7	1.3	na
Unemployment ¹	0.0	0.0	0.1	0.3	0.4	0.3	0.6	na
Prices and wages								
Consumer prices (annual average)	3.1	82.2	645	534	1,568	305	54	65
Consumer prices (end-year)	na	169.0	910	885	1,281	117	64	40
Producer prices (annual average)	7.2	147.3	3,275	2,545	1,428	499	64	na
Producer prices (end-year)	na	311	1,300	1,919	1,422	215	57.8	na
Monthly average wages (annual average in local currency)	11.2	51.1	612.0	11.5	9.6	2.5	1.0	na
Government sector								
Consolidated state balance ²	-1.1	-3.6	-18.4	-10.4	-6.1	-4.1	-7.3	-3.0
Consolidated state expenditure	46.1	52.7	43.4	38.8	33.3	37.6	36.2	30.0
Monetary sector								
Broad money (end-year)	na	na	468	784	680	158	100	na
Domestic credit (end-year)	na	na	na	854	239	58	253	na
Broad money	na	na	69.4	53.5	32.8	18.1	19.6	na
Interest and exchange rates								
Treasury bill rate (three-month maturity)	na	na	na	na	na	na	30.8	na
Deposit rate (one year)	na	7	10	30	60	90	40	na
Lending rate (one year)	na	na	na	na	100	105	60	na
Exchange rate (end-year) ³	na	2.0	415.0	1,247.0	25.0	36.0	55.0	na
Exchange rate (annual average) ³	0.6	0.6	222.0	1.0	11.4	30.2	41.1	na
External sector								
Current account	na	7,225	-238	-429	118	-49	-1,075	-500
Trade balance ⁴	na	688	-236	-378	213	208	-931	na
Exports ⁴	na	11,829	1,424	2,877	2,940	3,806	3,781	na
Imports ⁴	na	11,141	1,659	3,255	2,727	3,597	4,712	na
Foreign direct investment, net	na	na	9	48	73	-24	50	na
Gross reserves (end-year) ⁵	na	na	1	1,273	2,917	2,013	2,221	na
External debt stock	na	0	65	948	1,101	1,782	2,331	na
Gross reserves (end-year) ⁶	na	na	0.6	3.8	5.9	6.2	4.8	na
Debt service	na	na	0.4	0.7	10.5	15.8	8.2	na
Memorandum items								
Population (in millions, end-year)	20.5	20.9	21.3	22.0	22.7	22.7	23.1	na
GDP (in millions of som)	32.4	61.5	447	5,095	64,878	302,787	560,147	na
GDP per capita (in US dollars)	na	1,706	95	254	117	369	391	na
GNP per capita (in US dollars) at PPP exchange rates ⁷	na	na	na	na	na	2370	na	na

Notes: Data for 1990-96 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 1997 reflect EBRD evaluations, partly based on information from these sources.

Methodological notes can be found on pp. 240 to 243.

Methodological notes

Albania

- 1 Unemployment as a percentage of domestic labour force is much higher (17% in 1995). Emigrant workers abroad accounted for 18% of the total labour force in 1995.
- 2 Data for 1997 are based on information from those parts of Albania where data collection was possible.
- 3 General government includes the state, municipalities and extrabudgetary funds. 1996 figure refers to the first half of 1996.
- 4 Until 1995 the figures show the floor of the band set by the Bank of Albania (central bank). Thereafter data refer to weighted average interest rates on new 12-month deposits in commercial banks.
- 5 Until 1995 data refer to the guideline rate announced by the Bank of Albania (central bank). Thereafter data refer to weighted average interest rates for 12-month loans by commercial banks.
- 6 Data from the balance of payments.
- 7 Foreign exchange reserves of monetary authorities, excluding gold, portfolio and SDR holdings and US treasury bill collateral issued under the Brady deal on commercial debt restructuring.
- 8 PPP stands for purchasing power parity. The estimate quoted here is measured in 1993 dollars and stems from the *PlanEcon Review and Outlook for Eastern Europe*, December 1996. In the computation of this estimate the country's nominal GDP 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.

Armenia

- 1 Registered unemployed.
- 2 Consolidated state government.
- 3 Data from the balance of payments.
- 4 International reserves of monetary authorities.
- 5 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1997*. 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.

Azerbaijan

- 1 General government includes the state, municipalities and extrabudgetary funds.
- 2 Central bank's compounded refinancing rate 1992-95.
- 3 Average lending rate for private enterprises.
- 4 Data from the balance of payments.
- 5 International reserves of monetary authorities.
- 6 GDP figures in roubles for 1990-91 were converted at the rate of 10 roubles per manat.
- 7 PPP stands for purchasing power parity. The estimate quoted here stems from the *OECD Short-Term Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP per capita in local currency was divided by 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

- 1 Officially registered unemployment.
- 2 General government includes the state, municipalities and extrabudgetary funds.
- 3 Data from the balance of payments.
- 4 International reserves of monetary authorities.
- 5 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1997*. 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.

Bosnia and Herzegovina

- 1 Until 1995 data for only the Bosniak-majority area, Federation area thereafter.
- 2 Figures for 1996 refer to the first nine months.
- 3 Bosnia and Herzegovina has a currency board. The currency is pegged to the DM.
- 4 Cash basis, including grants. Data for 1996 are estimates for the first nine months from different sources and are not consistent.
- 5 Data for 1992-93 are based on limited customs data for the Bosniak-majority area. 1994-96 data are rough estimates for the whole territory of Bosnia and Herzegovina.
- 6 Until 1995 data for the Bosniak-majority area only, Federation area thereafter.
- 7 Data include refugees abroad.

Bulgaria

- 1 General government includes the state, municipalities and extrabudgetary funds. 1997 data are from the budget law (passed 28 June 1997).
- 2 Data from the balance of payments.
- 3 International reserves of the monetary authority.
- 4 PPP stands for purchasing power parity. The estimate quoted here stems from the *OECD Short-Term Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP 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.

Croatia

- 1 Nights spent by foreign tourists.
- 2 Excluding small enterprises, self-employed people, farmers, employees of the Ministry of Defence.
- 3 Until 1994 net wages, gross wages thereafter.
- 4 Consolidated central government.
- 5 Data for 1990-92 exclude trade with the republics of former Yugoslavia.
- 6 International reserves of monetary authorities.
- 7 PPP stands for purchasing power parity. The estimate quoted here stems from the *European Comparison Programme (ECP)*, 1995. In the computation of this estimate the country's nominal GDP 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.

Czech Republic

- 1 All GDP and GDP component data in 1984 constant prices with the exception of all data for 1996 and GDP growth for 1991-97 inclusive. These are in 1994 constant prices.
- 2 General government includes the state, municipalities and extrabudgetary funds.
- 3 Data from the balance of payments. Data for 1990-92 represent the Czech Republic's share of the total for Czechoslovakia. Break in series in 1995 due to a change in the reporting system.
- 4 International reserves of monetary authorities.
- 5 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1997*. 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

- 1 Unemployed job seekers as a percentage of the labour force, which is substantially higher than the rate based on the number of people receiving unemployment benefits.
- 2 General government includes the state, municipalities and extrabudgetary funds.
- 3 Time deposit rate for 1994 and 1995, which also includes deposits with up to three and 3-12 month maturities.
- 4 Data from the balance of payments.
- 5 International reserves of monetary authorities.
- 6 PPP stands for purchasing power parity. The estimate quoted here stems from the *OECD Short-Term Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP 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.

FYR Macedonia

- 1 GSP is the value added concept of former Yugoslavia, which excludes the value added by the government, financial and some personal services.
- 2 The figure provided in this table refers to officially registered unemployment. No survey-based measure is yet available.
- 3 General government includes the state, municipalities and extrabudgetary funds.
- 4 Data from the balance of payments.
- 5 International reserves of monetary authorities.
- 6 PPP stands for purchasing power parity. The estimate quoted here is measured in 1993 dollars and stems from the *PlanEcon Review and Outlook for Eastern Europe*, December 1996. In the computation of this estimate the country's nominal GDP per capita in local currency was divided by 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.

Georgia

- 1 General government includes the state, municipalities and extrabudgetary funds.
- 2 Data from the balance of payments.
- 3 International reserves of monetary authorities.
- 4 Following debt restructuring.
- 5 PPP stands for purchasing power parity. The estimate quoted here stems from the *OECD Short-Term Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP per capita in local currency was divided by 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

- 1 Data for public expenditure and imports in 1993/94 include payments for Russian military equipment. Government consumption excludes social transfers, which are included in household final consumption.
- 2 Registered unemployed. Data from the labour force survey indicate a slightly lower rate of 8.6 per cent at year-end 1996.
- 3 General government includes the state, municipalities and extrabudgetary funds.
- 4 Change in credit has been computed from an adjusted series, taking into account the recapitalisation of banks with government bonds, totalling Ft 560 billion over 1993-96.
- 5 Data from balance of payments. Balance of payments data include trade from and to free export zones. These data have in the past deviated from mirror data of trade partners. Customs-based trade data, excluding trade from free export zones, show considerably higher trade growth in 1994 but lower growth in 1995-96.
- 6 International reserves of monetary authorities.
- 7 Debt service in 1996 includes substantial prepayments (US\$ 1.687 billion) to international financial institutions and commercial creditors.
- 8 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1997*. 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.

Kazakhstan

- 1 Unemployed registered with the Public Employment Service.
- 2 General government includes the state, municipalities and extrabudgetary funds. Even before the reform programme started, unemployment according to ILO estimates may have been about 1 per cent of the labour force.
- 3 Time deposits for individuals.
- 4 Data from the balance of payments.
- 5 International reserves of monetary authorities.
- 6 Foreign exchange reserves of monetary authorities in months of merchandise imports until 1995.
- 7 PPP stands for purchasing power parity. The estimate quoted here stems from the *OECD Short-Term Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP per capita in local currency was divided by 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

- 1 An industrial sector enterprise survey conducted by the ILO in 1995 found that employment fell by about one-third between 1991 and 1994.
- 2 Registered unemployed.
- 3 General government includes the state, municipalities and extrabudgetary funds.
- 4 Simple average of National Bank's credit auction rates. Credit auctions were discontinued at the end of January 1997 and the three-month treasury bill rate has become the official reference rate.
- 5 Rouble per dollar until 1992, som per dollar thereafter.
- 6 Data from the balance of payments.
- 7 International reserves of monetary authorities.
- 8 Excluding Kumptor gold imports.
- 9 PPP stands for purchasing power parity. The estimate quoted here stems from the *OECD Short-Term Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP per capita in local currency was divided by 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

- 1 In per cent of gross value added at current prices.
- 2 General government includes the state, municipalities and extrabudgetary funds.
- 3 Data from the balance of payments.
- 4 International reserves of monetary authorities.
- 5 PPP stands for purchasing power parity. The estimate quoted here stems from the *OECD Short-Term Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP 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

- 1 Including forestry.
- 2 The general government sector includes the state, municipalities and extrabudgetary funds.
- 3 Weighted average rate of commercial banks.
- 4 Roubles per US dollar for 1990 and 1991; taloni per US dollar for 1992; and litai per US dollar for 1993-95.
- 5 Data here are based on balance of payments estimates by IMF staff.
- 6 Covers only investment in equity capital for 1993 and 1994; equity capital and reinvested earnings for 1995 and 1996.
- 7 International reserves of monetary authorities.
- 8 Nominal GDP data are based on IMF staff estimates.
- 9 PPP stands for purchasing power parity. The estimate quoted here is based on *OECD Short-Term Economic Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP 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.

Moldova

- 1 Registered unemployment.
- 2 General government includes the state, municipalities and extrabudgetary funds.
- 3 Russian roubles per US dollar until August 1993; Moldovan roubles per US dollar until November 1993; and Moldovan lei per US dollar thereafter.
- 4 Data from the balance of payments.
- 5 International reserves of monetary authorities.
- 6 PPP stands for purchasing power parity. The estimate quoted here, presented in 1993 dollars, stems from the *PlanEcon Review and Outlook for Eastern Europe*, December 1996. In the computation of this estimate the country's nominal GDP per capita in local currency was divided by 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.

Poland

- 1 Beginning in 1993, industry is classified according to the Polish version of the NACE-EKD classification system. The 1993 index includes VAT and excise taxes; from 1994 onwards it excludes VAT; and from 1996 it excludes excise taxes.
- 2 Gross wages are those before deducting income taxes. Prior to 1993, the change in wages is net of income taxes.
- 3 General government includes the state, municipalities and extrabudgetary funds. General government balance excludes privatisation receipts.
- 4 Beginning in 1992, data are based on a new system of accounts and an improved reporting system.
- 5 Beginning in 1995, weighted average of rate offered by commercial banks on household deposits. Prior to 1995, lowest rate offered on six-month time deposits.
- 6 Beginning in 1995, weighted average rate charged by commercial banks on lowest risk loans. Prior to 1995, lowest rate charged by commercial banks to prime borrowers.
- 7 Balance of payments data based on banking statistics and presented on a settlements basis. On the basis of customs questionnaires, exports are virtually the same as on a settlements basis, while imports are higher (about 20% in 1994-96).
- 8 Sales of foreign exchange from kantors (small foreign-exchange bureaux) to commercial banks. A survey by the National Bank of Poland in 1995 indicated that about 85-90% of such transactions were associated with border trade (including services).
- 9 Balance of payments data based on banking statistics and presented on a settlement basis. Estimates of foreign direct investment on the basis of voluntary reports to the State Foreign Investment Agency (PIAZ) show much larger inflows, with the cumulative stock of FDI from 1989 reaching US\$ 12.0 billion at end-1996. The difference between the two series arises in part from investments-in-kind and reinvested earnings.
- 10 International reserves of the monetary authority.
- 11 PPP stands for purchasing power parity. The estimate reported here is from the *World Bank Atlas 1997*. 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

- 1 Registered unemployment.
- 2 General government includes the state, municipalities and extrabudgetary funds.
- 3 Data from the balance of payments.
- 4 International reserves of monetary authorities.
- 5 PPP stands for purchasing power parity. The estimate quoted here stems from the OECD *Short-Term Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP 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.

Russian Federation

- 1 Estimates provided are based on the International Labour Organisation definition and are considerably higher than estimates calculated from officially registered unemployment.
- 2 General government includes the state and local budgets, extrabudgetary funds and unbudgeted import subsidies for the period 1990-94.
- 3 Data from the consolidated balance of payments, which covers transactions with both CIS and non-CIS countries.
- 4 International reserves of monetary authorities.
- 5 From 1992 including debt to former COMECON countries.
- 6 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1997*. 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.

Slovak Republic

- 1 Figure for 1990 refers to former Czechoslovakia.
- 2 In enterprises with more than 25 employees.
- 3 General government includes the state, municipalities and extrabudgetary funds.
- 4 Excluding loans at zero interest rate since 1995.
- 5 Data from the balance of payments.
- 6 International reserves of monetary authorities.
- 7 PPP stands for purchasing power parity. The estimate quoted here stems from the OECD *Short-Term Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP 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

- 1 The percentage share of unemployed in total active population, based on labour force surveys consistent with International Labour Organisation definitions has been consistently lower than that calculated as officially registered unemployment. For the period 1991-96 the surveys provided the following estimates of annual unemployment (in per cent): 7.3 in 1991, 8.3 in 1992, 9.1 in 1993, 9.0 in 1994, 7.4 in 1995 and 7.3 in 1996.
- 2 Data for 1990-91 covers only the social (public) sector. Data for subsequent years take into account private enterprises employing three or more persons.
- 3 General government includes the state, municipalities and extrabudgetary funds.
- 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 an exchange rate of 10,000 dinar per tolar.
- 5 Data for 1990-91 exclude transactions with former Yugoslav republics.
- 6 Data from the balance of payments.
- 7 Foreign exchange reserves of the Bank of Slovenia (central bank).
- 8 PPP stands for purchasing power parity. The estimate quoted here stems from the OECD *Short-Term Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP 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.

Tajikistan

- 1 Officially registered unemployed. No labour force survey estimates available.
- 2 General government includes the state, municipalities and extrabudgetary funds.
- 3 Interest rates were set by the parliament until June 1995.
- 4 Roubles per US dollar until 1994; Tajik roubles per US dollar thereafter.
- 5 Data from the balance of payments.
- 6 International reserves of monetary authorities.
- 7 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1997*. 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

- 1 Every Turkmen citizen is guaranteed employment, thus official unemployment does not exist. These figures are household survey estimates, but do not include substantial public sector overemployment.
- 2 General government includes the state, municipalities and some extrabudgetary funds. However, until 1997, most quasi-budgetary expenditures of sectoral ministries fell outside the budget and several off-budget funds were in operation.
- 3 Data from balance of payments. From 1996 exports of gas are recorded fob and transit costs are added to imports. The current account on a cash basis (excluding the flow accumulation of gas payment arrears) was in deficit over 1993-96.
- 4 Foreign exchange reserves of the central bank plus the foreign exchange reserve fund. The ratio is to imports only. Current account expenditures up to 1996 included gas transit fees, making the later figures uncomparable. Including transit fees, the ratio of reserves is around 6.6 %.
- 5 PPP stands for purchasing power parity. The estimate quoted here stems from the OECD *Short-Term Indicators Transition Economies*, 3, 1997. In the computation of this estimate the country's nominal GDP 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

- 1 General government includes the state, municipalities and extrabudgetary funds.
- 2 Treasury bills were introduced in March 1995.
- 3 Roubles per US dollar until 1991; karbovanets per US dollar until 1995; and hryvnia per US dollar from 1996.
- 4 Data from the balance of payments.
- 5 International reserves of monetary authorities.
- 6 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1997*. 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.

Uzbekistan

- 1 Officially registered unemployment. No labour force survey based estimates available.
- 2 Includes extrabudgetary funds.
- 3 Roubles per US dollar until 1993; som per US dollar thereafter.
- 4 Data from the balance of payments.
- 5 Reserves in millions of som were converted to millions of US dollars using the average exchange rate reported above.
- 6 International reserves of monetary authorities, including gold.
- 7 PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1997*. 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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