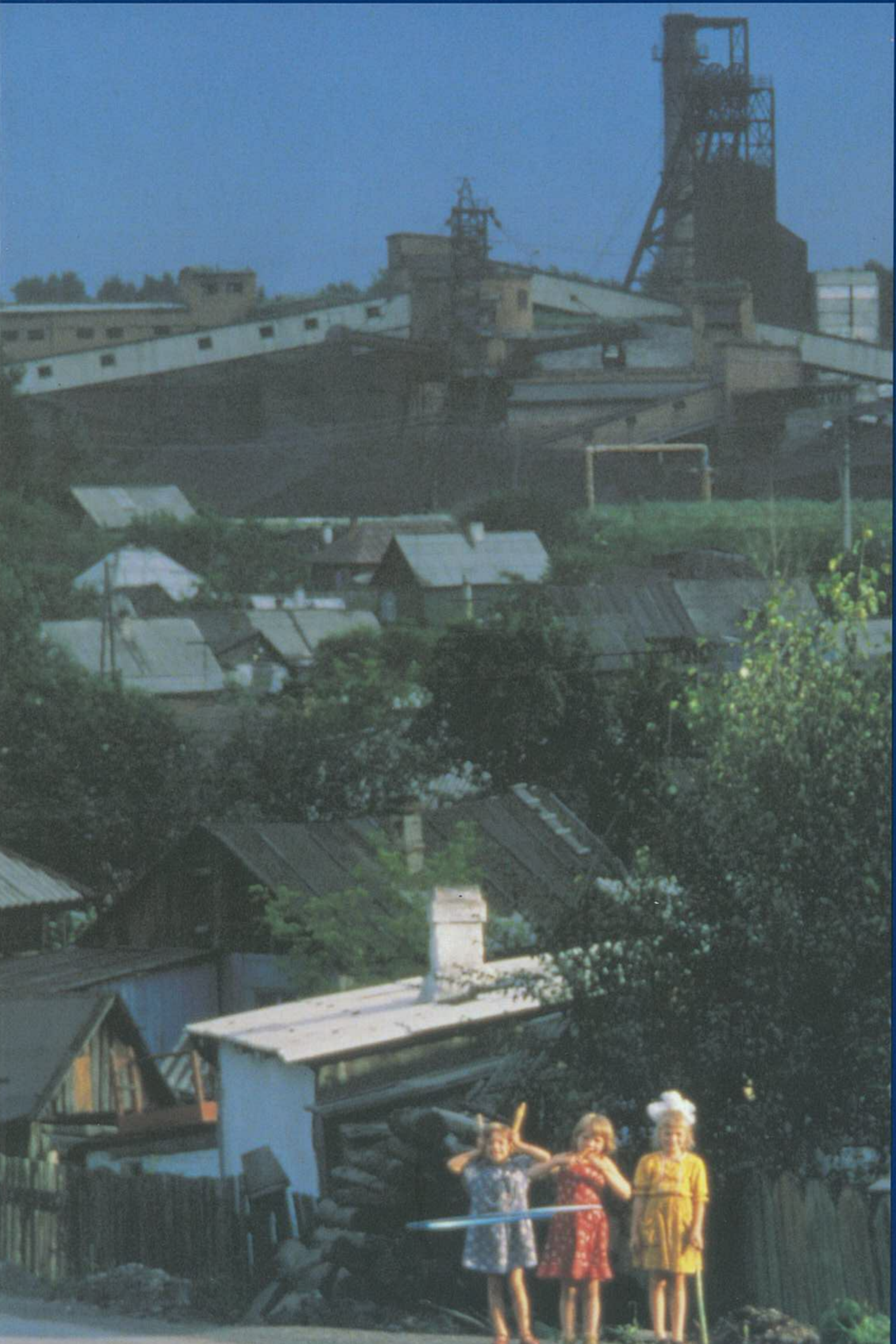
Transition report

October 1994

European Bank
for Reconstruction and Development



Economic transition in eastern Europe and the former Soviet Union

Defining and measuring transition

Institutional reform: privatisation, finance and law

Trade and foreign investment

Macroeconomic developments and prospects

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Guide to readers

Country grouping

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

Eastern Europe	Albania, Bulgaria, Croatia, Czech Republic, FYR Macedonia, Hungary, Poland, Romania, Slovak Republic and Slovenia
Former Soviet Union	Armenia, Azerbaijan, Belarus, Estonia, Georgia, 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
CEFTA	Central European Free Trade Agreement
CEPR	Centre for Economic Policy Research
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)
CSCE	Conference on Security and Cooperation in Europe
CSFR	Czech and Slovak Federal Republic
EA	Europe Agreement
EC	European Community
ECO	Economic Cooperation Organisation
ECU	European Currency Unit
ECSC	European Coal and Steel Community
EFTA	European Free Trade Area
EU	European Union
Euratom	European Atomic Energy Community
FDI	foreign direct investment
G-7	Group of 7 (Canada, France, Germany, Italy, Japan, UK and USA)
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
GSP	Generalised system of preferences: exception to the Gatt's MFN principle; established to accord with lower tariff rates (than MFN) for industrial country imports from developing countries
IBRD	International Bank for Reconstruction and Development (World Bank)
IFI	international financial institution
IMF	International Monetary Fund
MFN	most-favoured nation: GATT principle; gives the country tariff treatment equal to the lowest rate generally offered to other countries
na	not available
NAFTA	North American Free Trade Agreement
NERA	National Economic Research Associates
NMP	net material product
NTBs	non-tariff barriers
OECD	Organisation for Economic Cooperation and Development
PCA	Partnership and Cooperation Agreement
PPP	purchasing power parity
SMEs	small and medium-sized enterprises
SRP	Special Restructuring Programme (of the EBRD)
STF	Systemic Transformation Facility (of the IMF)
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNECE	United Nations Economic Commission for Europe
UNESCO	United Nations Educational, Scientific and Cultural Organization
VAT	value added tax

ISSN: 1356-3424
ISBN: 1 898802 05 X

One Exchange Square
London EC2A 2EH
United Kingdom
Tel: +44 171 338 6000

Designed and produced by the EBRD - *ref 847 Transition report* - 30/09/94. Reprinted March 1995.
Printed on Classic Art/Matt, paper based on pulp bleached without chlorine compounds, Totally Chlorine Free (TCF), biologically degradable and recyclable to 100%, raw materials from renewable resources. Printed by Libra Group Limited, London.
Cover photograph: "Mines in centre of town", Prokopyevsk, Siberia, Russia, by Alexander Polyakov (Zefa).

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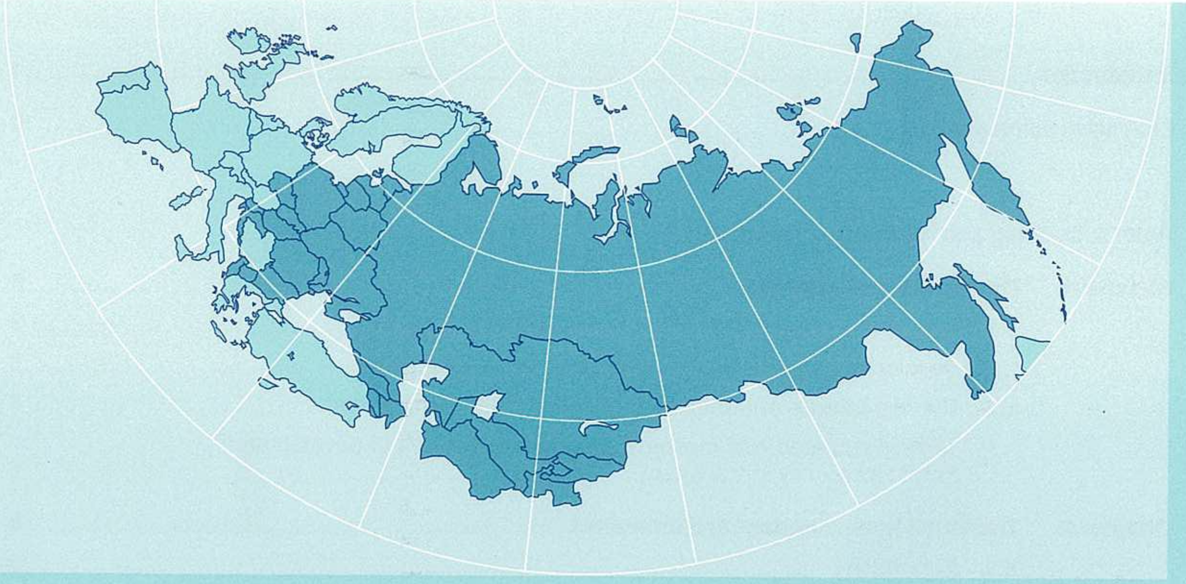

Economic transition in eastern Europe and the former Soviet Union

Contents

Introduction

The first article of the Agreement Establishing the EBRD defines as its purpose "to foster the transition towards open market oriented economies and to promote private and entrepreneurial initiative". The transition is a complex and varied process which will take different forms in different countries. Effective involvement in that process requires analysis and measurement. One of the EBRD's tasks is to promote and develop that analysis for the benefit of all participants in the process, be they from the private sector, governments or international institutions. This Report is a contribution to that task. It deals with the definition and measurement of transition (Part I), the institutional change which lies at the heart of transition (Part II), trade and foreign direct investment which will be among the key elements in the process (Part III), and macroeconomic developments and trends in the region (Part IV).

When the process of transition began at the end of the 1980s, the experience and theory to guide the course was very limited. Five years on much has been achieved and learned. Some of the early euphoria and simplistic messages have subsided. Most now understand that the process can be neither instantaneous nor painless. Among the 25 countries of operations of the EBRD, the transition is already far advanced in some countries and is under way in all countries. However, the problems and experience vary enormously and the strong differences in experience and performance constitute one of the central messages of this Report.

The design of policies for both public and private participants must be linked to the stage of the transition, whose documentation is therefore crucial to the transition process itself. The report examines some central aspects of the transition, particularly the financial sector, law and taxation. The institutional arrangements for these sectors constitute pillars of the "economic infrastructure" of a market economy and are thus basic to the transition. So too is the creation of the right environment for foreign direct investment. Though domestic investment will provide the main engine for growth in most countries, and is thus a prime concern of the EBRD, foreign direct investment can provide many benefits to the domestic economy in the development of skills, the understanding of the market system and the promotion of further investment opportunities. It is important, therefore, to understand the characteristics and determinants of foreign direct investment and those elements of the environment that will enhance its contribution to the domestic economy.

Both domestic and foreign investment will be greatly influenced by the future prospects for the economy. With statistical systems in an early stage it is not a straightforward matter to understand the recent past and likely future developments. The task of the last part of the Report is to contribute to this understanding.

This is the first *Transition Report* in what will be an annual series. The measurement of transition will remain a central theme, as will the analysis of institutional change and recent and future economic developments. Although many important issues of transition are addressed in this year's Report, others have been left for deeper analysis in the years ahead. This Report is not a totally new departure in that it builds on earlier publications and work of the Bank, particularly the *Quarterly Economic Review* and the natural predecessor of this Report, last year's *Annual Economic Outlook*. Pressure on resources precluded the continuation of the *Quarterly Economic Review* but, in addition to the *Transition Report*, the Bank will continue to report on recent economic developments in a number of forms, including the Statistical Appendix in the economics journal sponsored by the Bank, *The Economics of Transition*, and future statistical updates.

This *Transition Report* is the product of the Chief Economist's Office (CEO) of the EBRD working as a team. The editorial group was led by Kasper Bartholdy and John Flemming. Andrew Tyrie played a substantial editorial role in many chapters. The editorial work drew on extensive comments from Philippe Aghion, Willem Buiter and Ricardo Lago.

The Report is organised as follows: after the executive summary, John Flemming and I set out in Chapters 1 and 2 the definition and measurement of transition. The Appendix to Chapter 2 provides an overview, compiled by economists in the CEO, of each country's progress in transition; this work was organised by Mâcé Mesters. In Chapter 3 John Flemming introduces the detailed treatment of institutional issues with a discussion of strategy. Aspects of institutional change are examined in Chapters 4-6: Steven Fries, assisted by Hubert Vogler, provides an analysis of privatisation, enterprise restructuring and the role played by financial institutions; Sophie Bourguignon discusses the framework of law; and Robin Burgess and Alexander Neuber, assisted by Toni Haniotis and Amrit Singh, consider issues of taxation. In Chapters 7-9, Hans Peter Lankes, drawing on inputs from Brian Hindley, Julie Lissaman, Patrick Messerlin, Alexander Neuber and Hiroko Yamane, presents an overview of policy issues related to trade and foreign direct investment in transition economies. The final two chapters focus on macroeconomic events and prospects. Recent economic developments are reviewed by Kasper Bartholdy and Andrew Tyrie in Chapter 10, which is supported by macroeconomic data series for each of the countries in eastern Europe and the former Soviet Union. The compilation of these tables was the work of all EBRD economists and was organised by Tanya Normak. In Chapter 11, Toni Haniotis analyses available macroeconomic forecasts for the region, emphasising the need to treat projections for transition economies with great caution. The latter analysis is backed by an Appendix, by Kasper Bartholdy, which discusses the large uncertainty that is associated with data on transition economies. While we have attempted to be as up-to-date as possible, the cut-off date for revisions to most of the draft chapters was early August 1994.

The CEO would like to thank EBRD staff from other departments who contributed to the Report: Bart le Blanc, Miklos Nemeth, Philippe Richard and Guy de Selliers for valuable comments, and members of the Office of the General Counsel (OGC) for their guidance on a number of legal issues related to Chapters 5 and 9, although it must be emphasised that the OGC does not necessarily endorse the statements made here. Sandy Donaldson (copy editing), Simon De Nicola (design) and Steven Still (design) have provided invaluable assistance. The support work in the CEO has been organised by Linda Hine. We are very grateful to all those who have contributed in their different ways.

The assessments, statements and views expressed in this *Transition Report* are not necessarily those of the EBRD and responsibility for them, and any errors, is taken by myself on behalf of the Chief Economist's Office.

Nicholas Stern
Chief Economist

26 September 1994

Executive summary

Chapter 1

The meaning of transition

This Report focuses on the progress made by 25 countries in effecting their transition from central planning towards open market-oriented economies. It therefore emphasises the role of private enterprise. This first chapter considers the meaning and essential content of economic transition. The context of different countries' transition programmes varies with their stage of development, and implementation is affected by the degree of macroeconomic stability. The differences between the linked concepts of development, transition and stabilisation are set out; indices of development for the transition economies are presented in a table. The transition economies span the World Bank's "middle-income" category but inherited more equal income distribution and better health and schooling indicators than is typical of that group.

Chapter 2

Transition: measurement and indicators

A summary table presents measures of the stage of transition for each country in the region. The table includes figures on the share of the private sector in GDP, as well as indicators of progress on large-scale privatisation, small-scale privatisation, enterprise restructuring, price liberalisation, the trade system and financial sector reform. An appendix elaborates further on advancement by individual countries in these areas. Most countries have liberalised trade and prices, and privatised most small-scale units. Much less has been achieved in large-scale privatisation, enterprise restructuring and financial sector reform. In these areas of transition the Czech Republic, Estonia, Hungary, Poland and the Slovak Republic are the most advanced. Russia and Kyrgyzstan, of the CIS countries, have gone furthest in institutional reforms. The private sector share of GDP lies in the 40-55 per cent range for most countries in eastern Europe and the Baltic states, as well as for Russia where large-scale privatisation has been rapid; in other parts of the CIS it remains around or below 30 per cent.

Chapter 3

Transition strategies

This chapter discusses strategies of transition with particular emphasis on the pace and sequence of steps leading to the hardening of budget constraints and to the privatisation of enterprises and banks. Countries undertaking more radical stabilisation and reform strategies have typically been rewarded with better performance. It does not follow, however, that faster would always be better. Measures may be required to mitigate the impact of stabilisation and structural reform on output, employment and social factors. Institutional reform is bound to be lengthy and associated with revisions, which may militate against the general preference of enterprises for regulatory and macroeconomic stability. A coherent reform programme, which includes a clearly defined timetable for institutional change, can, if it is regarded as politically credible, make it easier for enterprises and individuals to form expectations and to adjust their economic decision-making in a rational manner.

Chapter 4

Restructuring, privatisation and financial deepening

Restructuring and privatising former state enterprises is crucial to the transition. Some countries have privatised quickly, typically through mass voucher privatisation, leaving restructuring to the new owners. The adequacy of this approach depends on the corporate governance arrangements implicit in the new ownership structure. Under an alternative approach, a government agency may attempt to ensure the restructuring prior to privatisation. This effort may, however, delay the privatisation process. Both approaches require the problems of inherited bad debts to be tackled. Care has to be taken in devising any form of debt restructuring to ensure that it does not undermine the attempt to establish financial discipline with its ultimate sanction of bankruptcy. Internally generated funds will be an important source of finance for investment, and will demonstrate confidence and commitment by managers. Privatised enterprises will, however, need access to additional investible funds through the development of the domestic financial sector, which itself requires financial restructuring. This process can be assisted by, among others, international financial institutions.

Chapter 5

The framework of law in transition

Certain economic freedoms are required to underpin a market economy. All of the countries in transition have embarked on the reconstruction of, or are constructing from scratch, legal frameworks associated with these freedoms. This chapter, together with an accompanying table, summarises the position in 25 countries. Six major areas for legal reform are briefly examined; property, contract, security, bankruptcy, competition and company legislation. For each area of law a short summary of the purpose of that law in a market economy is provided, followed by an explanation of the legal treatment under socialism. Each section concludes with a description of legal reform to date, drawing on the information in the table. While adding to the statute book may be a step forward, legislation without effective implementation and enforcement may be of limited effect. Progress has, not surprisingly, been slower on implementation and enforcement than on legislation. This reflects, among other things, the need for institutional reform in such areas as the courts and legal education.

Chapter 6

Taxation and transition

Taxation is fundamental to transition. In a market economy the government has to finance the purchase of resources, whereas under the old regime it could command them. This chapter focuses, from a tax perspective, on the radical transformation of the relationship between the government and enterprises, as market reforms lead to an increase in the number of companies and to a weakening of their compliance with tax laws. Meanwhile, because of the changing role of government responsibilities and the economic disruption associated with transition, revenue requirements do not fall greatly despite the phasing-out of subsidies and the shedding of some responsibilities by the state. In response to these pressures, the tax structures of transition economies, which initially shared industrial economies' reliance on direct and domestic indirect taxes, have shifted somewhat, probably temporarily, towards a greater reliance on trade taxes. In the medium term the transition economies will need to reconstruct both a direct and an indirect tax base. Raising adequate revenue is essential if inflation is to be contained in economies whose capital markets do not yet allow adequately for non-monetary financing of government deficits. Some principles for this task are set out, focusing on economic efficiency and administrative effectiveness. In its treatment of direct taxation, the chapter concentrates on the reform of enterprise taxation.

Chapter 7

Openness to trade and foreign investment in transition

World trade has grown faster than output in the post-war period as global economic integration has intensified under more liberal arrangements for international trade and finance. The integration of the reforming economies involves them in substantial adjustments in the direction and composition of trade. Their new openness also allows them to import relative price structures from world markets, and international competition can be brought to bear on monopolistic indigenous industries. Trade can boost both effective aggregate demand and supply with benefits to efficiency and resource utilisation. Openness to foreign investment permits the transfer of technology, design and marketing skills and increases the range of bidders for privatised enterprises. Policies should allow these benefits to be reaped in a non-discriminatory way, without attempts to single out individual sectors or enterprises for privileged treatment. Governments are unlikely to do the job of attracting the "right" kind of trade and investment better than markets.

Chapter 8

Trade policy reform

While CMEA trade collapsed in the early 1990s, the fast-reforming countries of central Europe and the Baltic states achieved a rapid reorientation of trade towards Western markets. This was facilitated by a network of trade agreements. Restrictions on trade were rapidly dismantled. Tariffs were in several cases initially reduced to very low levels; this was subsequently partially reversed in Poland and Russia, for example, while Hungary resorted to non-tariff measures. Real exchange rates have risen since the initial liberalisation, increasing demands from producer groups for protection which is of doubtful general benefit. The chapter includes a table which describes the trading regime in each of 25 countries in eastern Europe and the former Soviet Union. Trade Agreements between east European countries on the one side and EU and EFTA on the other have left Western countries free to invoke contingent protection - which they have done, although the frequency of such restrictive action may be lessening. Trade is also impeded by internal difficulties including inadequate international financial experience and institutional infrastructure.

Chapter 9

Foreign direct investment

Flows of foreign direct investment (FDI) into eastern Europe and the former Soviet Union remain disproportionately concentrated on a few relatively small economies, although most countries in the region have adopted fairly open FDI regimes. The chapter includes a table which describes these regimes country-by-country. Survey evidence suggests that, among the determinants of FDI, gaining access to local product markets is more important than using cheap and skilled local labour to process goods for export. The tax system, particularly its predictability, and capital controls can be important to foreign investors. Countries succeeding in attracting FDI have tended to cut back special privileges previously offered to foreigners and have concentrated more on national treatment for all investors. Governments have been particularly prone to provide the automotive industry with protection, tailor-made to induce particular foreign investments. Industry-specific protection may, however, be difficult to justify from the perspective of the economy as a whole.

Chapter 10

Recent macroeconomic developments

The macroeconomic performance of the countries of eastern Europe and the CIS diverged in 1993, with stabilisation and growth in most of eastern Europe and the Baltic states but high inflation and continuing declines in output in the CIS. Unemployment has stabilised in the mid-teens in eastern Europe, with the exception of the Czech Republic where it is much lower. Recorded unemployment remains very low in the CIS despite falling output; many individuals, who are effectively unemployed, formally retain their jobs in order to qualify for social benefits. An appendix to this chapter presents data on each country's performance.

Chapter 11

Macroeconomic forecasting in transition

The forecasters' predictions for 1993 were typically too pessimistic for the countries of eastern Europe and too optimistic for the CIS countries. The chapter includes the remarkable statistic that growth forecasts for individual countries prepared in 1993 for the same year were on average about four percentage points off target. Judging by the range of forecasts offered for each country, precision is not increasing. The forecasters foresee positive growth for most of eastern Europe in 1994-95 and expect the contraction in the CIS to slow. They also expect an increase in the rate of unemployment and a reduction of inflation in most countries.

An appendix to this chapter discusses the implication of discrepancies between statistics on output and those relating to its uses in consumption, investment and (net) exports. Statistical inconsistencies of this nature are not unique to transition economies but occur there in an acute form. A solution in statistical methodology has been known for 50 years but has rarely been applied. A rough application to Hungary suggests that recorded output figures for this country may not, as many would have expected, understate growth. For the Czech Republic, where statistical matters seem to have received relatively little attention, there are much stronger reasons to believe that growth has been underestimated by a substantial margin.