# Transition report 1995

**Investment and enterprise development**

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

Measuring transition in each country

Investment: conditions, impacts and prospects

Enterprise development

Macroeconomic progress and outlook

European Bank
for Reconstruction and Development

# Guide to readers

**Country grouping**

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

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

**Abbreviations**

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

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# Transition report

# Contents

# Foreword

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

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

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

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

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

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

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

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

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

Nicholas Stern

Nicholas Stern
Chief Economist

*2 October 1995*

# Executive summary

## Chapter 1

### *Introduction: opportunities and challenges in transition*

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

## Chapter 2

### *Transition: measurement and indicators*

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

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

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

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

## Chapter 3

### *Investing for growth*

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

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

## Chapter 4

### *Determinants of investment in the transition*

This chapter argues that the price of existing factors of production – including human capital – has in many cases been driven well below their potential yield and thus, compared with similar projects in more mature market economies, potential returns to investment are high. Returns can differ substantially among sectors, depending on the degree of technological obsolescence of existing assets, the effect of shifts in demand and prices, and the scope for complementarities with assets now in excess supply. Given the inherent complexities and uncertainties, a policy of attempting to target "winners" is unlikely to be successful. Government investment policy should concentrate on facilitating the response to opportunities by helping to reduce or mitigate uncertainty – perhaps the most serious impediment to investment – and administrative constraints, as well as investing in the infrastructure necessary for dynamic private sector development.

## Chapter 5

### *Financing enterprise investment*

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

## Chapter 6

### *The contribution of law to fostering investment*

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

## Chapter 7

### *Transition impact of investment projects*

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

## Chapter 8

### *Ownership, governance and restructuring*

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

## Chapter 9

*Small and medium-sized enterprises*

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

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

## Chapter 10

*Developing financial institutions and markets*

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

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

## Chapter 11

*Recent economic developments*

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

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

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

## Chapter 12

*Forecasts and prospects*

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

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