Part I
Progress in transition

Progress and challenges in transition: key themes of the Report

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1.1 Introduction

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

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

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

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

1.2 Transition: progress, problems and tasks ahead

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

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

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

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

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

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

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

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

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

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

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

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

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

It is encouraging that many countries have reached the intermediate stages of transition or gone beyond this stage. Nevertheless, there is still a group of countries (Azerbaijan, Belarus, Tajikistan and Turkmenistan) for which progress in the transition has been very slow. In these countries, most major economic activity remains under tight central control, and the development of entrepreneurial activity has been hindered. Nevertheless, even in these countries there are some signs of small-scale entrepreneurial activity, indicating a potential for more comprehensive market development if the most important obstacles were to be removed.

1.3 Building a new role for the state

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

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

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

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

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

1.4 Establishing democracy

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

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

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

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

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

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

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

1.5 Overcoming the environmental legacy

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

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

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

1.6 Transforming the infrastructure

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

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

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

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

5 See, for example, Stern (1996).

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

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

8 See, for example, Stern (1996).

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

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

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

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

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

1.7 Savings behaviour and savings institutions in transition

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

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

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

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

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

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

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

1.8 Trends in the macroeconomy

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

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

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

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

1.9 Concluding remarks: main themes of the Report

The Report embodies a number of key themes:

Progress in transition

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

Infrastructure for transition

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

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

Promoting savings

- During the transition, the need for investment, and therefore savings, is vital. Aggregate domestic savings have fallen dramatically from the very high levels achieved (and wastefully used) under central planning. Households have replaced enterprises as the dominant source of domestic savings. The strive for reform of financial institutions and markets must include policies that serve to strengthen the saving opportunities for households and the efficiency with which savings are used. Public savings must also be raised, and enhanced tax administration and compliance will be crucial.
- An important part of the transition is to expand the range of financial instruments and institutions through which households can accumulate savings. Although they are in the early stages of development in the region, contractual savings, such as life insurance and pensions, are beginning to expand the range of choice in financial services. Life insurance and private pensions can also help to reinforce the transition by promoting the development of local capital markets (and therefore corporate governance) and by facilitating the reform of state pension programmes.

Macroeconomic overview

- Growth has been strong during the past three years in eastern Europe and the Baltics, and the rate of output decline has gradually decreased in the CIS. In the first half of 1996, growth remained high in eastern Europe and the Baltics, but slightly lower than the 5 per cent recorded for 1995. Half of the CIS countries recorded positive growth in the first half of 1996, but output continued to decline in the largest CIS countries, Russia and Ukraine.
- The economies of the region have the potential to grow in the medium to long term at "east Asian" rates (see *Transition Report Update* 1996). The realisation of this growth will require sound policies and long-term commitment to the development of essential institutions (including savings and infrastructure institutions). It is encouraging that these policies and commitments are present in many countries of the region.
- Inflation is coming down in most countries but the strains on public expenditure are severe in parts of the region. Some countries are facing a risk of either a relapse or erosion of basic government activities or both.
- The fiscal priorities differ across the region. Broadly speaking the relative priorities are for tighter control of expenditure in more advanced countries and for increasing tax revenue in less advanced countries.

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

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

Progress and challenges in market-oriented transition

2

2.1 Introduction

The broad picture

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

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

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

Outstanding challenges

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

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

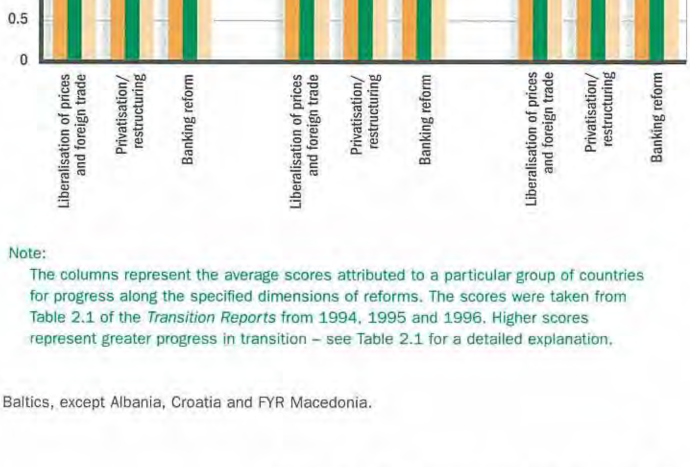
All transition countries also still face other substantial challenges of reform – for example, in the areas of banking supervision, the development of banking skills, capital market development, competition policy, labour market regulation, social security, secured transactions and broad areas of the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

Developments over the past year

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

Chart 2.1

Progress in reform across the region



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

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

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

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

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

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

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

The concept of transition

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

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

Key elements of transition: summary indicators

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

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

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

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

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

Table 2.1

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

(see classification system for transition indicators overleaf)

Countries		Enterprises			Markets and trade			Financial institutions		Legal reform
	Private sector share of GDP in %, mid-96 (rough EBRD estimate)[2]	Large-scale privatisation	Small-scale privatisation	Enterprise restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Extensiveness & effectiveness of legal rules on investment
Albania	75	2	4	2	3	4	2	2	2	3
Armenia	50	3	3	2	3	4	1	2	1	3
Azerbaijan	25	1	2	2	3	2	1	2	1	2
Belarus	15	1	2	2	3	2	2	1	2	1
Bulgaria	45	2	3	2	2	4	2	2	2	4
Croatia	50	3	4*	3	3	4	2	3	2	4
Czech Republic	75	4	4*	3	3	4*	3	3	3	4
Estonia	70	4	4*	3	3	4	3	3	2	4
FYR Macedonia	50	3	4	2	3	4	1	3	1	3
Georgia	50	3	4	2	3	3	2	2	1	2
Hungary	70	4	4*	3	3	4*	3	3	3	4
Kazakstan	40	3	3	2	3	4	2	2	2	2
Kyrgyzstan	50	3	4	2	3	4	2	2	2	2
Latvia	60	3	4	3	3	4	2	3	2	4
Lithuania	65	3	4	3	3	4	2	3	2	2
Moldova	40	3	3	2	3	4	2	2	2	3
Poland	60	3	4*	3	3	4*	3	3	3	4
Romania	60	3	3	2	3	3	1	3	2	3
Russian Federation	60	3	4	2	3	4	2	2	3	3
Slovak Republic	70	3	4*	3	3	4*	3	3	3	3
Slovenia	45	3	4*	3	3	4*	2	3	3	3
Tajikistan	20	2	2	1	3	2	1	1	1	2
Turkmenistan	20	1	1	1	2	1	1	1	1	1
Ukraine	40	2	3	2	3	3	2	2	2	3
Uzbekistan	40	3	3	2	3	2	2	2	2	3

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

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

Classification system for transition indicators[1]

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

Classification system for transition indicators[1]

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

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

Box 2.1

Legal reform – Survey on investment laws

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

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

The Table provides a numerical assessment (as of July 1996) of how conducive the laws of the countries of the region are to fostering investment. The laws of each country have been scored on the basis of two criteria: the extent to which legal rules affecting investment approximate investment rules that are generally accepted internationally; and the effectiveness of legal rules affecting investment, that is, the extent to which such legal rules are clear and accessible and adequately supported administratively and judicially. The classification system is explained in the text below.

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

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

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

Laws fostering investment – 1996

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

Classification system for the legal transition indicators

The extensiveness of legal rules on investment	1	Legal rules are very limited in scope, and impose substantial constraints on creating investment vehicles, security over assets or to the repatriation of profits. Indirect investment is not specifically regulated.
	2	Legal rules are limited in scope and impose significant constraints on creating investment vehicles, adequate security over assets, or the repatriation of profits.
	3	Legal rules do not impose major obstacles to creating investment vehicles and security or to repatriating profits. However, they are in need of considerable improvement.
	4	Legal rules do not discriminate between foreign and domestic investors and impose few constraints on creating a range of investment vehicles and security instruments. Indirect investment is specifically regulated.
	4*	Legal rules closely approximate generally accepted standards internationally and impose few restrictions, including on the creation of sophisticated investment vehicles or security. Indirect investment law is well developed.
The effectiveness of legal rules on investment	1	Legal rules are usually very unclear and often contradictory and the availability of independent legal advice is very limited. The administration of the law is substantially deficient (e.g. little confidence in the abilities and independence of the courts, no or poorly organised security and land registers).
	2	Legal rules are generally unclear and sometimes contradictory. Legal advice is often difficult to obtain. The administration and judicial support of the law is rudimentary.
	3	While legal rules are reasonably clear and ascertainable through legal advice, administration or judicial support of the law is often inadequate (e.g. substantial discretion in the administration of laws, few up-to-date registers).
	4	The law is reasonably clear and legal advice is readily available. Investment laws are reasonably well administered and supported judicially, although that support is sometimes patchy.
	4*	The law is clear and readily ascertainable. Sophisticated legal advice is readily available. Investment law is well supported administratively and judicially, particularly regarding the efficient functioning of courts and the orderly and timely registration of proprietary or security interests.
Overall score		The overall score allocated in the third column of the table is the average (rounded down) of the scores given for the two indicators.

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

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

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

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

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

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

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

2.2 Countries at relatively advanced stages of transition

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

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

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

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

Privatisation

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

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

Box 2.2

Progress in transition and the demand for investment finance

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In Slovenia 588 out of 1,549 large socially-owned enterprises have completed their privatisation plans and are awaiting registration in the courts. Privatisation of another more than 500 Slovenian state-owned enterprises is expected before the end of 1996. As in Poland, mass privatisation in Slovenia has been much slower than originally intended. The Privatisation Law was passed in November 1992. Implementation began in the first quarter of the following year. Under the mass privatisation scheme, "ownership certificates" have been issued to all Slovene nationals. The value of each ownership certificate is linked to the age of the citizen. The companies have all been invited to draw up their own privatisation plans, and have been permitted to distribute up to 20 per cent of the ownership to incumbent employees. A further 40 per cent of the shares in privatised companies have been transferred to three funds under state management. By September 1996, three-quarters of the 1,549 participating companies had obtained preliminary approval for their plans from the Privatisation Agency and about 700 had obtained final approval. In practice, implementation has been dominated by employee/management buy-outs. In more than a quarter of the privatised companies, employees have acquired the ownership of more than 60 per cent of the shares, and the average share of employee ownership in participating companies is expected to be close to 50 per cent.

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

Enterprise restructuring

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Market liberalisation

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

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

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

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

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

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

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

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

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

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

Financial sector reform

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

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

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

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

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

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

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

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

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

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

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

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

2.3 Countries at intermediate stages of transition

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

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

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

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

Box 2.3

Bosnia and Herzegovina

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

Policies towards economic transition

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

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

Institutions of government

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

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

Privatisation

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

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

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

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

The pace of privatisation in Russia slowed in the first half of 1996, mainly because of uncertainties associated with the political campaigns in advance of the Presidential elections in June. During this period, the government changed its approach to privatisation, replacing the emphasis of the preceding year on speed and revenue-maximisation by a new focus on transparency and on promotion of enterprise restructuring. In this spirit, the government adopted a new privatisation programme in July 1996. The programme eliminates privileged access to ownership shares previously granted to the workers' collectives. It also expands the rights of the regional authorities in Russia to initiate privatisation, and provides for a more market-based evaluation for enterprises that are candidates for privatisation. The plans of the government foresee the privatisation during the second half of 1996 of several high-profile companies through competitive tendering, including some enterprises in the oil and electricity sectors and the state holding company in the telecommunications sector (Svyainvest). Meanwhile, the government intends to proceed with auction-based sales of state-holding in a number of companies that were only partly privatised in previous privatisation rounds.

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

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

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

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

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

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

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

Enterprise restructuring

The predominant source of enterprise restructuring in countries at intermediate stages of transition, as in the countries at more advanced stages of transition, has been the tightening of access to government subsidies and soft bank credits, increased scope for import competition, and liberalisation of the rules for establishment of new companies, whereas implementation of bankruptcy legislation has played little role, even where such legislation exists.

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

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

Market liberalisation

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

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

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

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

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

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

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

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

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

Financial sector reform

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

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

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

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

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

2.4 Countries at early stages of transition

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

Privatisation

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

Enterprise restructuring

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

Market liberalisation

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

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

Financial sector reform

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

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

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

2.5. Concluding remarks

A general pattern of reform has evolved over the past five years. Most countries in the region have implemented widespread liberalisation of prices, external trade and currency arrangements, and privatisation of small-scale units, all of which constitute necessary conditions for the development of private sector activity and an effective market economy. These measures involved limited or fairly simple institutional development and could thus be adopted rapidly. The early lead of countries in eastern Europe and the Baltics has been narrowed by continued progress in most of the CIS.

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

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

Box 2.4

Issues associated with the measurement of environmental developments

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

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

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

Environmental transition

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

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

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

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

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

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

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

Air pollution concentrations, 1990-92

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

Source
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Introduction

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

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

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

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

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

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

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

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

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

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

Measuring income and its distribution

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

Distribution before transition

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

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

Distribution of income during transition[5]

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

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

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

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

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

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

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

5 See Milanovic (1996, p.57).

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

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

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

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

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

The alleviation of poverty

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

Distribution and economic growth

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

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

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

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

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

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

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

13 See OECD Economic Surveys - Hungary, OECD 1995.

14 See IMF (1994, p.85).

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

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

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

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

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

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