Transition report 1997

Enterprise performance and growth

Economic transition in eastern Europe and the former Soviet Union

Progress in transition

Enterprise performance and growth

Macroeconomic performance

European Bank
for Reconstruction and Development

Guide to readers

Country groupings

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

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

Abbreviations

The Bank, EBRD	The European Bank for Reconstruction and Development
BIS	Bank for International Settlements
CEFTA	Central European Free Trade Agreement
CIS	Commonwealth of Independent States (which includes as full or associate members all countries of the former Soviet Union, except the Baltic states)
CMEA	Council for Mutual Economic Assistance (former)
CPI	consumer price index
CSFR	Czech and Slovak Federal Republic
ECE	Economic Commission for Europe
ECU	European Currency Unit
EFTA	European Free Trade Area
EIU	Economist Intelligence Unit
EU	European Union
FDI	foreign direct investment
FYR	Former Yugoslav Republic
G-7	Group of 7 (Canada, France, Germany, Italy, Japan, UK and USA)
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
IFC	International Finance Corporation
IFI	international financial institution
ILO	International Labour Organisation
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
MFN	most-favoured nation: GATT principle that gives a country tariff treatment equal to the lowest rate generally offered to other countries
na	not available
OECD	Organisation for Economic Cooperation and Development
Phare	Poland and Hungary: Aid for Economic Restructuring (EU)
PPP	purchasing power parity
SMEs	small and medium-sized enterprises
UN	United Nations
VAT	value added tax
WTO	World Trade Organisation

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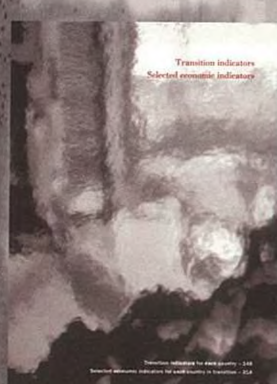
Enterprise performance and growth

Part I.
Assessing progress in transition

Part II.
Enterprise performance and growth

Part III.
Macroeconomic performance



Transition indicators
Selected economic indicators

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Foreword

The purpose of this *Transition Report*, the fourth in an annual series, is to chart the progress of transition from the command to the market economy and to identify and analyse the challenges of the coming years in the countries of central and eastern Europe, the Baltics and the CIS. The two special, and closely related, topics of this year's Report are enterprise performance and growth.

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

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

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

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

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

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

The special topics of this year's Report are enterprise performance and growth. The focus here on sustaining growth reflects the fact that most transition economies have begun to grow, in contrast to the position only a few years ago when many were experiencing severe economic contractions. The question is whether this initial growth will be sustained and what measures are needed to deliver rapid growth over the medium and long term. Sustained growth does require investment in plant and equipment and in new skills, together with innovation in technology and business management, but investment does not, *per se*, automatically generate sustained growth, as the experience of the old regime showed all too clearly. It is important to recognise that sustained growth arises from the initiatives of entrepreneurs, managers and workers. These actions are shaped by many factors in market economies, such as the ability of investors to reap the returns to their investment and the extent of rivalry among producers. This Report examines, therefore, enterprise performance in transition economies, focusing on the factors determining restructuring and the creation of new businesses as well as the policies which encourage this.

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

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

Nicholas Stern
Chief Economist and Special Counsellor to the President

9 October 1997

Executive summary

Chapter 1: Transition: the challenges of the coming years

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

Chapter 2: Progress in market-oriented transition

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

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

Chapter 3: Growth in transition economies: sources and obstacles

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

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

Chapter 4: Structural change, restructuring and enterprise performance

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

Evidence from market economies points to a number of factors that have a significant impact on enterprise performance, particularly product market competition, privatisation, corporate governance, government behaviour and the capabilities of the state. The experiences of transition economies confirm the importance of these factors. The weak capability of the state and arbitrary government behaviour in the transition countries have been significant impediments to new private businesses, particularly in the CIS. In contrast, increased competition resulting from greater levels of imports leads to productivity gains in competing domestic firms while privatisation and concentrated outside ownership of enterprises contribute to strong performance.

Chapter 5: Enhancing enterprise performance

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

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

Chapter 6: Prospects for growth in transition economies

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

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

Chapters 7 and 8: Macroeconomic trends

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

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

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

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The material on legal transition in Chapter 2 (including Box 2.1 and the legal transition indicators on pp. 148-213) was coordinated by Wayne McArdle, with contributions by Takashi Akahane, Carsten Dageförde, Hugh Pigott, Anita Ramasastry, Alessandro Stoppa and Alexei Zverev. Timothy Murphy and Nobuko Ichikawa prepared Box 2.3 on selected indicators in environmental policy reform. Jose Carbajo and Christian Mumssen wrote sections of Chapter 2. Christian Mumssen contributed extensively to Chapter 7 and Martin Raiser to Chapter 8.

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